DELAWARE CHANCERY COURT ORDERS SPECIFIC PERFORMANCE OF MERGER AGREEMENT: AN ANALYSIS OF THE IBP-TYSON LITIGATION

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INTRODUCTION

In IBP, Inc. v. Tyson Foods, Inc. et al., C.A. No. 18373 (Del. Ch. June 18, 2001), Vice Chancellor Leo Strine of the Delaware Chancery Court compelled Tyson to consummate its Merger Agreement with IBP and, in reaching his decision, held that IBP had not suffered a Material Adverse Change ("MAC") that would have excused Tyson's obligation to close the merger. The Court also concluded that IBP had neither fraudulently induced the merger nor breached its representations and warranties by virtue of having had to restate financial statements. 2001 WL 675330 (Del. Ch. June 18, 2001).

While a number of courts have considered whether specific changes to a target company satisfied the MAC clause of a merger agreement,[1] courts have rarely ordered an unwilling acquiror to perform the agreement and complete a merger.[2] The unusual decision to order specific performance resulted, in part, from a stipulation by the parties to expedite the trial on the merits and the question of whether specific performance was appropriate (and defer any issues of damages).[3] Accordingly, the decision's precedential value may be limited to the extent

1 See Katz. v. NVF Co., 473 N.Y.S.2d 786 (1st Dep't 1984); Bear Stearns Cos. v. Jardine Strategic Holdings, No. 31731/87, slip op. (N.Y. Sup. June 17, 1988), aff'd mem., 533 N.Y.S.2d 167 (App. Div. 1988), slip op. (N.Y. Sup. June 5, 1990); Carlisle Ventures, Inc. v. Banco Español de Crédito, S.A., No. 94 Civ. 5835 (SS), 1996 WL 680265 (S.D.N.Y. Nov. 25, 1996), rev'd on other grounds, 176 F.3d 601 (2d Cir. 1999); Raskin v. Birmingham Steel Corp., Civ. A. No. 11365, 1990 WL 193326 (Del. Ch. Dec. 4, 1990); KLRA, Inc. v. Long, 639 S.W.2d 60 (Ark. Ct. App. 1982); Pine State Creamery v. Land-O-Sun Dairies, Inc., 201 F.3d 437 (4th Cir. 1999).

2 See Leasco Corp. v. Taussig, 473 F.2d 777 (2d Cir. 1972) (upholding court ordered sanctions for violations of order granting specific performance to complete merger).

3 The purpose of this unusual arrangement was twofold – first, it allowed the Court to expedite its ruling on the merits without precluding IBP's chance for specific performance due to delay, and second, it permitted an expedited appeal by the losing party. See IBP, 2001 WL 675330, at *2, n.l.

that the Court's order of specific performance was a product of this unusual agreement of the parties.

While the remedy ordered by Vice Chancellor Strine has limited precedent, the IBP-Tyson decision confirms the view of most practitioners that a buyer has a high burden in persuading a court that a MAC has occurred. Specifically, the Court was not persuaded that IBP had suffered a MAC despite a 64% decline in earnings from operations in the most recent quarter when compared with the same quarter a year earlier. The Court did not hold that a MAC occurred because, among other reasons, Tyson understood the cyclical nature of IBP's business and knew that IBP was falling short of projections that had been provided to Tyson. Tyson did not appeal the decision and agreed to complete the transaction on the same economic terms as provided in the original agreement.

FACTUAL BACKGROUND

THE BIDDING FOR IBP

The proposed IBP-Tyson merger arose out of a competitive bidding process for the purchase of IBP, the country's leading beef producer and second biggest pork processor. Ultimately, the auction process pitted Smithfield Foods, the leading pork producer, against Tyson, the leading chicken producer. Following Smithfield's unsolicited bid for IBP, Tyson's senior management entered into discussions with IBP and arranged a meeting of senior management of the two companies on November 24, 2000. By virtue of preliminary meetings and a formal diligence process that began in November 2000, Tyson became aware of accounting fraud at an IBP subsidiary, DFG, including a charge to earnings of at least $30 million. Tyson was also informed that IBP was projected to fall seriously short of the fiscal year 2000 earnings projections prepared by IBP.

After a series of interim bids, Smithfield made a final bid of $32 in stock and Tyson submitted the winning bid of $30 per IBP share, consisting of half stock and half cash. The IBP Special Committee considered Tyson's bid to represent a better alternative than Smithfield's bid because it provided greater certainty of value due to the cash portion as well as presenting less antitrust risk.

THE MERGER AGREEMENT

On January 1, 2001, following the end of the auction process, IBP and Tyson signed the Merger Agreement. The Merger Agreement had customary representations about the accuracy of IBP financial statements, lack of material undisclosed liabilities, and absence of "any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] subsidiaries taken as a whole. . . ." A section of the disclosure schedule relating to the "undisclosed liabilities" representation did refer to, and exclude, any representation about any liabilities relating to improper accounting practices at IBP's troubled subsidiary, DFG. This section of the Disclosure Schedule did not, however, expressly extend to the representation concerning the financial statements or the MAC condition.

ADVERSE DEVELOPMENTS AT IBP

Following announcement of the transaction, both Tyson's and IBP's results began to suffer due to a severe winter, which adversely affected livestock supplies. Tyson's first quarter 2001 earnings per share were down 50% from the same quarter in the previous year and the second quarter was shaping up even worse. Meanwhile, IBP was suffering similar problems making it virtually impossible for it to meet the projections it had previously provided to Tyson. When the quarter ended on March 31, 2001, IBP's earnings from operations were off 64% when compared with the same quarter in the prior year.

As these struggles deepened, Tyson's anxiety concerning the problems at DFG and anticipated restatements were heightened and its desire to buy IBP weakened. Accordingly, Tyson slowed down the process of consummating the transaction, which it attributed to IBP's ongoing effort to resolve issues that had been raised about IBP's financial statements by the SEC. The most important of these issues was how to report the problems at DFG. The SEC first raised certain of these issues in a faxed letter to IBP's outside counsel on December 29, 2000, although neither Tyson nor IBP management learned of the letter until the second week of January 2001 (following the execution of the Merger Agreement). The letter called for an SEC investigation into DFG's (and IBP's) financials and the need for a possible fuller restatement. After learning of the letter, however, Tyson management had still put the Merger Agreement to a successful board and stockholder vote on January 12, 2001.

On February 22, 2001, IBP announced that it would have to restate its financial statements to take an additional DFG charge of $32.9 million, or a total of $41.3 million on an after-tax basis. On March 13, 2001, IBP formally filed its restatement of its financials, which included a $60.4 million DFG impairment charge to its 2000 10-K (roughly $.50 to $.60 per IBP share).

In light of the revised IBP financials, Tyson attempted to renegotiate the deal and on March 26, 2001 sought to lower the price to between $27 to $28 per share. IBP advised Tyson of its view that the DFG restatement did not warrant a reduction of more than $.50 per share off of the $30 agreed price.

By late March, Don Tyson, Tyson's founder and controlling stockholder, had decided that he no longer wanted to go through with the IBP transaction. Mr. Tyson was concerned about Tyson's and IBP's performance. The Court found that neither the problems at DFG nor the related SEC issues apparently played any part in Mr. Tyson's decision. Nevertheless, on March 29, 2001, Tyson advised IBP in writing that it was terminating the deal citing the financial restatements and the failure to disclose the SEC letter that raised important financial issues. Interestingly, Tyson did not indicate in its termination letter that IBP had suffered a MAC as result of its first quarter performance.

THE LITIGATION

The fundamental question for the Court was whether Tyson properly terminated the Merger Agreement.

Tyson argued that:

(i) IBP breached its contractual representations as evidenced by its financial restatements;

(ii) IBP suffered a MAC as a result of the DFG impairment charge and its poor earnings in the first quarter of 2001; and

(iii) IBP fraudulently induced Tyson to enter into the Merger Agreement by, among other actions, failing to disclose the SEC comment letter.

IBP argued that Tyson was suffering from "buyer's regret" and did not have any valid basis for terminating the Merger Agreement.

THE DECISION

NEW YORK CHOICE OF LAW FAVORED IBP'S POSITION

A critical preliminary question for the Court was whether to apply New York or Delaware law. The Merger Agreement contained a standard New York choice of law provision and the parties agreed that New York law governed the substantive aspects of the Merger Agreement. The parties disagreed as to whether New York law would govern the precise burden of proof to justify specific performance because the applicable conflict of law principles did not clearly provide that the choice of New York law in the Merger Agreement would govern this burden of proof. 2001 WL 675330, at *31. Under New York law, which the Vice Chancellor recognized was a minority approach, the party seeking specific performance bears the burden of proof to justify its entitlement to that remedy by a preponderance of the evidence. By contrast, under Delaware law, the party seeking such relief would be required to show its entitlement to specific performance by the higher standard of clear and convincing evidence. Id. Vice Chancellor Strine applied New York law based on New York public policy and, most importantly, the parties' own choice to have New York law govern as reflected in the Merger Agreement. Id. Vice Chancellor Strine conceded that the choice of law in this particular case could be outcome determinative on the availability of the remedy of specific performance. Id. at *46, n.172; but see id. at *55.[4]

IBP DID NOT BREACH ITS REPRESENTATIONS AND WARRANTIES

The Court agreed with IBP's contention that the disclosure schedule exception for DFG-related problems to a representation regarding undisclosed liabilities should be read to also modify a representation with respect to financial statements. The Court reached this conclusion even though the financial statements representation was not explicitly modified by the schedule setting forth the DFG–related problems.

The Court noted that the schedule in question was specifically drafted with the DFG-related problems in mind. Id. at *36. The Court reasoned that Tyson understood that there was additional risk for increased charges growing out of the DFG-related problems and that Tyson's conduct indicated they were prepared to accept that risk. While the disclosure schedule states that items disclosed for one section are deemed to be disclosed for other sections if reasonably apparent that such disclosure is applicable, the Vice Chancellor did not rely on this provision for his decision.

NO MATERIAL ADVERSE CHANGE

Although the Vice Chancellor acknowledged that whether IBP had suffered a MAC was a close call, he ultimately concluded that no MAC had occurred. The Court framed the inquiry as whether a MAC occurred to the December 25, 2000 condition of IBP, after adjustment for the specific disclosures contained in the Merger Agreement and the disclosed financial statements.[5] Id. at *41. The key elements of the Court's holding regarding the absence of material adverse change, included the following:

- New York courts would incline toward the view that a buyer should make a strong showing to invoke a MAC exception to its obligation to close;
- MACs are best read by courts as a backstop protecting the acquiror from the occurrence of "unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner";

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[4] Although the Court recognized that a party seeking specific performance in Delaware must demonstrate its entitlement by clear and convincing evidence, it did not decide whether that burden would also apply to the Court's determination that the party resisting specific performance is in breach of contract. The decision to apply New York law, however, mooted this issue.

[5] The Court noted that such an inquiry made commercial sense because it created a baseline roughly reflecting IBP as Tyson knew it upon entering into the Merger Agreement. Id. at *41.

- A short term hiccup in earnings should not suffice; rather the MAC should be material when viewed from the longer term perspective of a reasonable acquiror;

- IBP's poor results were substantially related to cyclical changes that Tyson knew were an inherent part of the livestock business;

- Although IBP's first quarter 2001 earnings from operations ran 64% behind the comparable period in 2000, IBP had two weeks of strong earnings prior to the drop dead date that signaled a strong period ahead;

- Not all analyst reporting services were as pessimistic as Tyson portrayed; according to Morningstar, the analyst community (which Tyson had embraced) was predicting that IBP would return to historically healthy earnings in the following year; and

- Immediately prior to Tyson's termination of the Merger Agreement, Tyson's financial advisor concluded that, even taking into account all facts known to Tyson in late March, the original $30 purchase price for IBP was within the range of fairness and a great long term value (this factor was clearly critical in coloring the Court's view of Tyson's underlying claim).

NO EVIDENCE OF FRAUD

The Court rejected Tyson's claims based on fraud, as well as misrepresentations and omissions, pointing to the nature of the negotiations between two equally sophisticated parties acting with the aid of highly skilled advisors. The Court found no evidence of intent by IBP to mislead Tyson and noted the wealth of data and information communicated at each stage by IBP. The Court stated that caveat emptor is still the basic law of New York, and it applies with full force in these circumstances. The Court concluded that despite the "grandstand full of waving red flags," Tyson voluntarily proceeded with all deliberate speed into the negotiations, the auction process and the Merger Agreement. Id. at *50.

THE REMEDY

The most novel aspect of the Court's decision was the award of specific performance. While the Court recognized the weighty nature of an order compelling two public companies to merge, the Court nonetheless found this remedy practicable. Id. at *53. The Court noted that if the tables were turned and Tyson was seeking to force an unwilling target to complete the deal, specific performance could be readily achieved, as no viable alternative remedy would make Tyson whole. The Court, applying this analysis in reverse, found it equally applicable to Tyson despite it being an unwilling acquiror. Id. at *54. The Court did not note, however, the absence of a specific performance clause in the Merger Agreement.

While awarding IBP specific performance, the Court rested much of its conclusion on the inherent difficulty of calculating monetary damages in this case, and stated that "the amount of any award could be staggeringly large." Id. In a passing reference to potential monetary damages, Vice Chancellor Strine also noted the "very difficult" determination of monetary damages in the IBP-Tyson case as another basis for the award of specific performance. Id. The decision does not, however, engage in any specific assessment of what those monetary damages would include nor was that the mandate of the Court given the parties' agreement to limit the damage consideration to specific performance. Id. at *2, n.l. While the Court's discussion presumes that a claim against Tyson for monetary damages could be stated for the diminution in the market value of IBP as a result of Tyson's breach, a number of courts in the context of proposed mergers of public companies have excluded from consideration monetary damages in the form of diminution in value of the publicly traded shares of the target company.[6]

LESSONS FROM IBP-TYSON

The IBP decision is such a comprehensive decision concerning the implications of a possible material adverse change that it offers a number of lessons to practitioners:

- Choice of law counts - - the Vice Chancellor was quite explicit that New York law made it easier for IBP to obtain specific performance while Delaware law may not have provided for such relief.

- Schedules to merger agreements are ignored at one's peril - - Tyson's lead lawyer, general counsel and chief financial officer claimed to be unaware of schedules that excluded DFG issues from certain representations. Moreover, the schedules were literally sent over the day before the Merger Agreement was signed. Buyers should insist that the complete schedules be delivered sufficiently in

[6] See In re Gulf Oil/Cities Serv. Tender Offer Litig., 725 F. Supp. 712 (S.D.N.Y. 1989); Cities Serv. Co. v. Gulf Oil Corp., 797 P.2d 1009 (Okla. Ct. App. 1980); Bush v. Brunswick Corp., 829 S.W.2d 352 (Tex. App. 1992); Matheny v. Ohio Bancorp., 1994 Ohio App. Lexis 6007 (Dec. 30, 1994). Complete analysis of this issue requires a more extensive treatment than is possible in this context.

advance of the signing of the merger agreement in order to allow a proper analysis of the schedules as well as a briefing of senior management.

- MACs are difficult to demonstrate - - the IBP decision is consistent with most precedent by reading MAC clauses in a seller friendly manner to address only fundamental events that would materially affect the value of a target to a reasonable acquiror with a long term perspective. Of course, an event that occurs within a short period of time between the signing and closing of a transaction could be durationally significant in its impact on value.

- Industry conditions should qualify a MAC clause - - although the Court believed that cyclical industry conditions affecting IBP should not have been viewed as a MAC, IBP could have avoided much heartache if it had qualified its representation as to the absence of a MAC with standard qualifiers such as general changes in industry conditions (and the economy generally).

- The opinion does not encourage a seller to negotiate extremely detailed MAC clauses - - by embracing a MAC standard that encompasses unknown events substantially threatening the overall earnings potential of the target in a durationally significant manner, the decision seeks to obviate the need for extensive qualifiers that go beyond the standard litany. On the other hand, the decision may encourage a buyer to graft upon a MAC clause a variety of circumstances that shall be deemed to constitute a MAC (i.e., specific targets not being achieved). To the extent that a party seeks to negotiate an extremely detailed MAC clause, the result may be prolonged, or even a breakdown of, negotiations.

- Specific performance clauses benefit the party seeking to enforce an agreement - - while IBP was entitled to specific performance even though the Merger Agreement did not contain a specific performance clause, the inclusion of such a clause should generally facilitate the award of that remedy.

- Senior management considering the termination of a merger agreement should be coordinated with its entire

> management team and advisors - - Tyson terminated the agreement on March 29, 2001 based on the restatements and the DFG issues, but its investor relations person sent an internal e-mail on March 13, 2001 outlining Tyson's strategy with analysts to the effect that "[w]e know these accounting issues aren't the biggest reason to renegotiate." Moreover, only two days before the deal was terminated, Tyson arranged to have its financial advisor deliver an analysis that the original price was in the fairness range and that even at the original deal price the "transaction still makes tremendous strategic sense."

While the IBP decision is the most significant decision in recent years concerning a MAC, the precedential impact should not be overstated given that a Delaware Vice Chancellor conceded that the question was a close call under his interpretation of New York law (and may have reached a different result if he were applying Delaware law). Moreover, the parties' willingness to agree to an expedited schedule to consider the award of specific performance made the legal relief easier to obtain. The absence of such expedited relief could make a party, particularly a seller, unwilling to put its business at risk while it pursues a lengthy legal process.

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If you have any questions concerning the IBP-Tyson decision or its effect on potential mergers and acquisitions, please do not hesitate to contact Michael Chepiga (at 212-455-2598; mchepiga@stblaw.com), John Finley (at 212-455-2583; jfinley@stblaw.com); Robert Spatt (at 212-455-2685; rspatt@stblaw.com), or Jacob Pultman (at 212-455-7133; jpultman@stblaw.com).

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