January 9, 2013

# *In re Ancestry.com Inc. Shareholder Litigation*

## Delaware Court of Chancery Rules That "Don't Ask, Don't Waive" Standstills Are Not Per Se Unenforceable, but Their Use and Effect Should Be Disclosed to Shareholders

### SUMMARY

Two weeks after Vice Chancellor Laster's bench ruling in *In re Complete Genomics*[1] enjoining the enforcement of a so-called "Don't Ask, Don't Waive" provision in a confidentiality agreement, Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery made clear in a transcript bench ruling in *In re Ancestry.com*[2] that there is no per se rule in Delaware against the use of "Don't Ask, Don't Waive" provisions. In its bench ruling, which the Court stressed "are limited rulings," necessarily "time-pressured," and therefore "shouldn't make broad law,"[3] the Court:

- Emphasized that because of the potency of "Don't Ask, Don't Waive" provisions, a target board would need to establish a clear record that it consciously and carefully employed the provision to maximize the target's sale price; and
- Ruled that the use and effect of "Don't Ask, Don't Waive" provisions are material to shareholders in determining how to vote on a proposed merger and thus should be publicly disclosed, especially where the restrictions potentially account for why no superior offers have been made.

In its bench ruling, the Court also held that the financial advisor's expression of doubt in its ability to provide a fairness opinion based on management's projections prepared in anticipation of a sale process, which arguably precipitated revisions to those projections, was a material fact that should be disclosed to shareholders.

## BACKGROUND

In May 2012, the board of directors (the "Board") of Ancestry.com Inc. ("Ancestry")—a NASDAQ traded company—initiated a sale process/auction, after having received a number of private unsolicited expressions of interest earlier in the year.

By June, at least 12 parties, comprising a mix of strategic and financial suitors, had entered into confidentiality agreements with Ancestry as a condition to receiving due diligence. All of those agreements contained so-called "Don't Ask, Don't Waive" provisions, which prohibited the prospective buyers for a period of 12 months from, directly or indirectly, requesting the Board to waive the agreed standstill restrictions without an express invitation from the Board.

Only the three highest bidders, which included Permira Advisers, LLC ("Permira"), the winning bidder, advanced to a second round of bidding. Citing problems uncovered during diligence, each finalist either lowered its initial bid or withdrew from the auction. Permira, however, indicated that it remained interested in a deal at $32 to $33 per share in cash, but only with participation from other equity sources of at least $150 million.

In October, Ancestry's largest shareholder—Spectrum Equity Investors ("Spectrum"), which held approximately 30% of Ancestry's shares and a right to designate two directors to the nine-member Board—offered to roll $100 million worth of its existing equity into the surviving company to facilitate Permira's offer for the remaining, outstanding shares. Senior management made a similar offer of approximately $80 million. Relieved of the need to acquire 100% of Ancestry, Permira made a firm offer of $32 per share in cash.

On October 3, Qatalyst Partners LLP ("Qatalyst"), Ancestry's financial advisor, informed the Board that it likely could not provide a fairness opinion at $32 per share based on the financial projections management had prepared in May in anticipation of the sales process. Management promptly revised its long-term projections to reflect, in defendants' account, more current information and adjustments for the issues bidders had expressed concern over during the diligence process. Based on those revisions, Qatalyst provided a fairness opinion on October 18. That same day, the Board approved a definitive merger agreement with Permira at $32 per share, with the two Spectrum-designated directors and one inside director abstaining. The final merger agreement and all ancillary documents were executed on October 21.

Following the public announcement of the Permira merger, several Ancestry public shareholders filed suit in the Delaware Court of Chancery alleging breach of the Ancestry directors' *Revlon* duties and seeking to enjoin the shareholder vote on the Permira merger scheduled for December 27. More specifically, the plaintiffs argued that (1) the "Don't Ask, Don't Waive" provisions impermissibly precluded the Board from being fully informed of possible superior offers and (2) Spectrum and management disloyally gave

preferential treatment to Permira, including by revising the May projections to justify the "tainted" deal already reached, to ensure their ability to participate in the buyout at an unfair price and at the expense of the unaffiliated shareholders.

On December 11, apparently in response to the litigation, Ancestry informed the non-winning bidders it was waiving the "Don't Ask, Don't Waive" provisions of their confidentiality agreements. The plaintiffs argued that the proximity to the shareholder vote made the December 11 waiver ineffective and that therefore their argument that the "Don't Ask, Don't Waive" provisions were preclusive continued to have force. The plaintiffs also argued that the Ancestry proxy statement to shareholders was materially incomplete for not disclosing the existence and import of the "Don't Ask, Don't Waive" provisions or Qatalyst having informed the Board of its inability to provide a fairness opinion based on the May management projections.

## THE COURT OF CHANCERY'S RULING

### A. "DON'T ASK, DON'T WAIVE" STANDSTILLS ARE NOT IMPERMISSIBLE PER SE, BUT THEIR USE IS A MATERIAL FACT THAT MUST BE DISCLOSED TO SHAREHOLDERS

In arguing that "Don't Ask, Don't Waive" provisions necessarily are impermissible under Delaware law, the plaintiffs relied primarily on Vice Chancellor Laster's recent bench ruling in *Complete Genomics*. In that case, the Vice Chancellor found that "Don't Ask, Don't Waive" standstill provisions preclude the "flow of incoming information" to a target's board and, analogizing to Delaware's wariness about "no-talk" provisions, concluded that the Genomics board "impermissibly limited its ongoing statutory and fiduciary obligations to properly evaluate a competing offer, disclose material information, and make a meaningful merger recommendation to its stockholders" by agreeing to cut off a bidder's ability to communicate a potentially higher offer to the board.[4]

Without reaching any conclusions with respect to the effect of "Don't Ask, Don't Waive" provisions in all cases, Chancellor Strine expressed disagreement with the seemingly categorical conclusion of the *Complete Genomics* ruling, noting:

> Per se rulings where judges invalidate contractual provisions across the bar are exceedingly rare in Delaware, and they should be. . . . I know of no statute, I know of nothing, that says that ["Don't Ask, Don't Waive"] provisions are per se invalid. And I don't think there has been a prior ruling of the Court to that effect. I know people have read [the *Complete Genomics* transcript ruling] that way. I think there was a lot going on in that case. Again, there is a role that bench opinions play, and I don't think it's to make per se rules.[5]

Chancellor Strine acknowledged that he could see how a "Don't Ask, Don't Waive" provision could serve a value-maximizing purpose by forcing potential bidders to put their highest bid forward or risk being shut out of the opportunity to top the winning bidder after a definitive agreement is reached.[6] The Chancellor emphasized, however, that if targets "are going to do something that's this potent, there is some

responsibility to actually attend to it."[7] The Chancellor noted, some bidders are more likely to take the prohibition against indirect approaches to a target board more seriously than others and, if a target chooses not to enforce the prohibition, "the arguments about how it creates value are silly."[8] Recognizing that "there are a lot of dangers with this kind of tool, and it can't be just embedded in everything in the marketplace,"[9] the Chancellor raised the question of whether winning bidders should, for example, be asking for—and targets should be prepared to give them—assignments of the right to enforce the restrictions against all of the non-winning bidders, if they are trying to establish that the provisions actually enhance value. Given the factual and procedural setting of this ruling (*i.e.*, a preliminary injunction motion challenging a merger agreement that did not contain such an assignment), the Court did not take under consideration whether, in a different setting, plaintiffs could argue, among other things, that such an assignment (taking the decision out of the hands of the target board) would be viewed as an unreasonable deal protection in violation of *Unocal*. In the circumstances of this case, however, where Permira did not request such an assignment and the Board did not immediately waive the restriction for all other bidders of its own accord, the Court found that "this [B]oard was not informed about the potency of this clause" and thereby probably violated its duty of care.[10] Because Ancestry eventually and voluntarily waived the restrictions, however, the mooted issue did not require additional injunctive relief and the finding effectively was dicta.

During oral argument, the Court also gave short shrift to the notion that there is any difference between a prohibition on a private request versus a public request for a an opportunity to approach a target board, saying "[t]here is no such thing as [a] public/private" distinction[11] for a company that is subject to the federal securities laws. Such a view undercuts the argument advanced by some that the consequences of privately asking for a waiver on the standstill prohibition are less onerous to a target and, therefore, should be distinguished in the drafting of the provision.

Finally, the Court ruled that the proxy statement sent to shareholders impermissibly failed to disclose the import of the "Don't Ask, Don't Waive" provisions. Chancellor Strine found that these omissions "created the false impression that any of the [other bidders] who signed the standstill could have made a superior proposal."[12] Reasoning that shareholders are entitled to know what "comfort they should take" from the absence of better offers based on bidders' "ability to make a superior proposal,"[13] the Court enjoined the shareholder vote until Ancestry disclosed the effect of the "Don't Ask, Don't Waive" provisions and when those provisions were waived.

### B. FACT THAT TARGET REVISED FINANCIAL PROJECTIONS FOR FAIRNESS OPINION DID NOT SHOW PROBABILITY OF SUCCESS ON *REVLON* CLAIM, BUT IS A MATERIAL FACT THAT MUST BE DISCLOSED TO SHAREHOLDERS

As to the allegations that Spectrum and management favored Permira, Chancellor Strine was "not convinced" by the plaintiffs' "basic story of motivations."[14] The Court noted that all of the preliminary bids in June expressed an interest in retaining management, Spectrum had no economic motive to forego a

higher price in selling its stake, and the Board's active engagement with all interested bidders undercut a claim that any was discriminated against.

The Court stated that the "subsidiary issue" of the last-minute revisions to the projections, however, was more problematic.[15] Various defendants testified at their depositions that the original May projections were deliberately bullish and prepared only to facilitate a sale, whereas the revised projections reflected a more honest picture of Ancestry's prospects. The Court admitted that that story "makes a lot of sense," but the Chancellor also found it "vexing to deal with" because the Board minutes and materials were silent on this characterization and there was a "cognitive dissonance" in the fact that Qatalyst apparently believed it was supposed to base its fairness opinion on the original projections (*i.e.*, if Ancestry always thought of the original projections as "just sell-side puffery," Qatalyst would not have thought it needed to base its opinion on those projections and, in turn, would not have felt compelled to express concern with them in the first place).[16] As an aside, Chancellor Strine added, "I think there are lessons in this . . . for everybody writing these hygienic depictions of the process," in that omitting details "actually told to the directors that might be valuable" can undermine the record on which "the directors are actually supposed to be entitled to rely."[17]

Despite finding these circumstances "troubling,"[18] the Court stated that on the existing record the overall auction process "had a lot of vibrancy and integrity to it,"[19] which weighed against enjoining the transaction itself as entirely tainted. Nevertheless, it did find that the objective fact that the revised projections were prepared in response to Qatalyst's affirmative statement to the Board that it was unable to give a fairness opinion was material information improperly omitted from the proxy statement. Furthermore, the Court reasoned that its refusal to enjoin the deal itself "only works if the electorate in fact has that full information."[20] Accordingly, the Court also enjoined the shareholder vote pending corrective disclosure of Qatalyst's communicated potential inability to issue a fairness opinion based on the original projections.

### C. TAKE-AWAYS

Because the *Ancestry* decision, like the *Complete Genomics* ruling, is a bench ruling that, as Chancellor Strine stated, is "limited," "time-pressured," and "shouldn't make broad law,"[21] it is difficult to say that there are any take-aways other than that "Don't Ask, Don't Waive" provisions are not per se invalid and may be enforceable in the *Revlon* context if there is a record that the target board uses them in a reasonable and good faith attempt to maximize the sale price of the company. The *Ancestry* ruling, however, does provide some additional insights into the Delaware courts' approach:

- In light of *Genomics* and *Ancestry*, "Don't Ask, Don't Waive" provisions are likely to engender greater scrutiny by the Court of Chancery of the facts and circumstances surrounding their use in any particular case. Because in practice the provisions usually are negotiated well in advance of any transaction without the oversight of the target board and before any decision necessarily has been made as to the type of auction, if any, the target is likely to engage in, sell-side practitioners will need to counsel boards during the auction process as to the import of "Don't Ask, Don't Waive" provisions.

- Because the Court of Chancery views "Don't Ask, Don't Waive" provisions as particularly "potent," parties to M&A transactions and their counsel should take care to ensure that the effect of "Don't Ask, Don't Waive" provisions are disclosed in proxy statements distributed to shareholders.
- Although the Court of Chancery appreciates that projections prepared outside of the normal course of business and only in connection with a potential sale may not always reflect an objective account of a target's future prospects, practitioners should expect courts to examine whether there is any disclosure in the proxy of any deal-specific reason for material revisions to the ultimate projections upon which a financial advisor bases a fairness opinion.
- Delaware courts remain hesitant to enjoin M&A transactions altogether, even where they find "troubling" process concerns, where there is no challenging bidder and shareholders are not precluded from voting down the only transaction at hand.

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## ENDNOTES

1 *In re Complete Genomics, Inc. S'holder Litig.*, C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012) [hereinafter *Complete Genomics*].

2 *In re Ancestry.com Inc. S'holder Litig.*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012) [hereinafter *Ancestry*].

3 *Id.* at 222.

4 *Complete Genomics*, tr. at 14-15, 18. For a full discussion of the *Complete Genomics* decision, see our publication, dated November 30, 2012, entitled "In re Complete Genomics, Inc. Shareholder Litigation."

5 *Ancestry*, tr. at 223-24. The plaintiffs also relied on dicta in *In re Celera Corp.*, in which Vice Chancellor Parsons concluded in approving a class action settlement that the plaintiffs had "at least a colorable argument that ['Don't Ask, Don't Waive' standstills coupled with a no solicitation provision] collectively operate to ensure an informational vacuum." 2012 WL 1020471, at *21 (Del. Ch. Mar. 23, 2012), *aff'd in part and rev'd in part*, No. 212, 2012 (Del. Dec. 27, 2012). The *Celera* Court, however, also stated, "I do not find, either in the circumstances of this case or generally, that provisions expressly barring a restricted party from seeking a waiver of a standstill necessarily are unenforceable," *id.* at *22, a caveat that Chancellor Strine reiterated, *Ancestry*, tr. at 224 ("the Celera case expressly went out of its way to say it's not making a per se rule").

6 Vice Chancellor Parsons made a similar observation in *Celera*: "Viewed in isolation, these Don't-Ask-Don't-Waive Standstills arguably foster legitimate objectives" by giving "'the corporation leverage to extract concessions.'" *Celera*, 2012 WL 1020471, at *21 (quoting *In re Topps Co. S'holders Litig.*, 926 A.2d 58, 91 (Del. Ch. 2007)).

7 *Ancestry*, tr. at 171.

8 *Id.* at 173.

9 *Id.* at 171.

10 *Id.* at 227.

11 *Id.* at 69.

12 *Id.* at 228.

13 *Id.* at 230.

14 *Id.* at 217.

15 *Id.*

16 *Id.* at 217-18.

17 *Id.* at 217.

18 *Id.* at 221.

19 *Id.* at 232.

20 *Id.* at 233.

21 *Id.* at 222.

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