Institutional Investor

Delaware Chancery Court Chides Pension Fund for Boosting Returns

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Pension funds may have to think twice about selling shares while seeking to block what they consider unfairly priced acquisitions, if judicial admonishment that dimmed a recent victory for the New Orleans Employee Retirement System (Noers) in Delaware Chancery Court sets a precedent.

The little-noticed opinion in late March by vice chancellor Donald Parsons, Jr. affirmed a class action settlement arising from the sale of Celera Corporation to Quest Diagnostics in 2011. The original lawsuit charged that Celera breached fiduciary duty by conducting a defective two-tier sales process. The first tier set a tender offer price of $8 for Celera shares, far below $10.25 that Quest offered in June 2010, as Celera's business was losing traction. The second tier allowed Quest to squeeze out remaining shares for the same price without a vote by shareholders.

Between tiers one and two, Noers lodged a complaint, signed a memorandum of understanding that allowed the merger to proceed subject to further due diligence, then sold its shares on the open market for more than Quest was going to pay. As the representative shareholder in a class action that eased restrictions on the sales process, Noers acted hastily, in Parsons' view, by selling shares at a premium just days before the deal closed. Never mind duty to plan participants. The sale looked "careless and cavalier" and "substandard," sufficient cause for Parsons — had he been inclined — to dismiss Noers as the class representative.

The admonishment left some observers scratching their head.

“I was puzzled by the breast-beating about the sale of stock in the secondary market,” says Lawrence Hamermesh, the Ruby R. Vale professor of corporate and business law at Widener’s Institute of Delaware Corporate Law. Once the pension fund found itself unable to prevent the merger, fiduciary duty compelled it to seek the highest price for its stake — in the open market if necessary. “I don’t see the point of requiring a class representative to forego an opportunity that is available to all class members, as long as taking advantage of that opportunity doesn’t advance the challenged transaction.”

In addition, the March decision questioned but did not dismantle a standstill provision. Five companies in addition to Quest had signaled at least preliminary interest in buying Celera. In order to undertake due diligence, all five signed confidentiality agreements that barred them from bidding for Celera shares without an invitation from the board. The confidentiality agreements prevented potential bidders from asking the board to waive the restriction.

The vice chancellor reckoned that provisions expressly barring restricted parties from seeking to end a standstill might be enforceable even though the 2011 Celera settlement relaxed them. Hamermesh views the provision more critically. “I don’t see how it does anything to improve protection of confidential information,” he says. “All it seems to do is impose a no-solicitation obligation on third parties that, as the vice chancellor suggested, makes a mockery of the typical fiduciary out.”

Making matters worse for Celera, a botched fairness opinion added evidence that Quest paid too little. By misreading a benchmark study, Credit Suisse underestimated the probability of success for drugs in Celera’s development pipeline. Where the fairness opinion should have recognized a 20 percent probability of success for a drug in phase I reaching the market, according to the court’s opinion, Credit Suisse assigned only a 3 percent probability of reaching consumers. That’s a whopping margin in high-stakes drug development.

Until altered by the settlement, a standstill froze out likely bidders whose due diligence might have exposed the flawed fairness opinion, perhaps inviting a higher price. But even after standstill restrictions were relaxed, no bidders stepped up.

Finally, the court left the plaintiffs with more of the legal bill. Their attorneys sought $3.5 million in fees while $1 million looked adequate to the defendant, though its had a fiduciary obligation to defray plaintiff's expenses. Judge Parsons nonetheless clamped down hard. He lowered the ceiling for fees to $1.35 million.