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Delaware Court Gives Guidance on Top-Up Option Process and Structure

In a series of recent opinions and bench rulings, the *Olson v. ev3* decision being the latest, the Delaware Court of Chancery has approved the use of the top-up option and discussed a number of necessary process points and features for these devices.

The top-up option has become an increasingly common feature of most so called "two-step" acquisitions (involving a tender offer followed by a back-end merger) because it enhances the speed and reduces the costs of closing transactions. The top-up option provides this benefit by allowing the acquiror to purchase from the target an amount of shares that when added to the shares already tendered into the tender offer or owned by the acquiror equals at least 90% of target's outstanding stock, thereby permitting the acquiror to consummate a short-form merger without the expense or delay associated with a long-form merger.

The recent *Olson v. ev3* decision (and an earlier decision on this topic, *In re Cogent*) advises the following features for top-up options:

- Because a top-up option is an option to acquire stock, the Delaware General Corporation Law (the "DGCL") requires specific authorization by the target board of directors. In particular, the DGCL requires that the board approve the option's terms by resolution, including the consideration to be paid upon exercise. Thus, a board should consider specifically referring to the top-up option in the resolutions approving the merger transaction, or should have a separate top-up option resolution.

- The DGCL also requires that the option terms be set forth (or incorporated by reference) in the instrument evidencing the top-up option. Thus, if consideration to be paid upon the exercise of the option is to be in the form of a promissory note, as is customary for top-up options, then the material terms of such note (*e.g.,* payment schedule, interest due) should be specified in the top-up option and also approved by the board in order to fulfill this statutory requirement.

- The *Olson v. ev3* court also recommends that cash be paid upon the exercise of the top-up in an amount equal to the aggregate par value of the stock to be issued. While the DGCL contemplates that consideration for stock may consist of cash, any tangible or intangible property or other benefit to the corporation, *Olson* states that payment, in cash, of the aggregate par value of the stock to be issued in the top-up option should remove any doubt that sufficient consideration is being paid for the stock issuable upon exercise of the top-up option.

- The top-up option also should be capped at the number of authorized but unissued shares of the target. A purported issuance above the authorized level would be invalid.

- The merger documents should exclude the shares issued pursuant to the top-up option (and the consideration to be received upon exercise) from being considered in the appraisal process. Plaintiffs have challenged top-up options on the basis of "appraisal dilution", the theory being that the shares issued pursuant to the top-up option dilute the value of the existing stock for appraisal purposes either because the per-share consideration for the top-up shares (principally an arguably discounted promissory note) is less than the per-share merger price, or because the issuance of a large number of new shares at the deal price dilutes the arguably higher intrinsic value of the shares subject to appraisal. Under either theory, the appraised value of the shares is reduced. Even though the Court of Chancery has described this claim as "barely" colorable, merger agreements should expressly exclude the top-up option shares and consideration from appraisal calculations to avoid the issue.

In addition to the foregoing features, Vice Chancellor Laster has in other public forums recommended that top-up options include the following provisions:

- Setting a limited time for the exercise of the option and having the option terminate with the termination of the related transaction;

- Limiting the option to a one-time exercise; and

- Conditioning the use of the option upon the receipt of at least a majority of the outstanding shares of the target.

As Vice Chancellor Laster stated in *Olson*, the law relating to top-up options "has become rapidly settled," with the result that there will likely continue to be an increase in the use of top-up options and the related tender offers.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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