
MEMORANDUM

TO: JEFF HOOKE
FROM: DANIEL J. HURSON, THE HURSON LAW FIRM
SUBJECT: LEGALITY OF TERMINATION FEES AND DEAL PROTECTION MEASURES IN THE FAILED TAKEOVER BID FOR CONSTELLATION ENERGY (CEG) BY MIDAMERICAN ENERGY (MAE)
DATE: 12/22/2008

On behalf of the Maryland Tax Education Foundation (the "Foundation"), you have asked me informally to review the legal issues (under Maryland and Delaware law) surrounding the termination fees and deal protection devices imposed by MAE in the takeover proposal originally accepted by the CEG Board, and more recently modified in light of CEG's ultimate rejection of the MAE deal. At your request, I have done only a limited amount of research on the issues. This review does not constitute a legal opinion. Moreover, this research and my observations are for the Foundation's use only, and should not be relied upon by others.

My observations, in summary form, are: (1) the original termination fee itself as set forth in the deal is on the upper range of accepted fees, given the size of the deal, but would likely be considered acceptable standing alone; (2) when other aspects of the termination provisions are included (so-called "deal protection" provisions), and the new termination provisions added after CEG's recent rejection of the MAE offer, the total termination costs and restrictions are onerous and excessive, and could well be subject to challenge. However, Maryland law appears to more restrictive than Delaware's in terms of overcoming the business judgment rule; (3) the recent successful competing offer by Electricite de France (EDF) will trigger the termination provisions and create a windfall

for MAE, the costs of which will be borne by CEG and to some extent Maryland ratepayers.

a) The Termination Fee

CEG and MAE originally negotiated a \$175 million termination fee in connection with its \$4.7 billion, \$26.50 per share offer. This represents about a 3.7% termination fee, based on the value of the deal. A commentator had noted:

As a general rule, Delaware courts have upheld termination fees that do not exceed 2-3 ½% of the value of the transaction. Where a termination fee begins to exceed 3-4% of the transaction value and/or if the termination fee is significantly larger than the actual costs incurred, the possibility is raised that the termination fee will be viewed as a device motivated to *preclude* bona fide third parties from coming forward. Varallo and Raju, *A Process Based Model for Analyzing Deal Protection*, 55 *Bus. Law.* 1609, August 2000. (italics in original).

However, one Delaware case, *McMillian v. Intercargo Corp.* (Del. Chancery Apr. 20, 2000), noted that, in determining validity, the structure of the fee was as important as the amount of the fee. The Court noted that the fee was to be paid only if the stockholders rejected the merger and the stockholders were benefited by a more beneficial proposal within a specified period of time. Thus, a “no” vote alone would not trigger the payment of the fee. Here, the fee is payable “if the merger agreement is terminated for any reason” (other than a breach by MEA). In fact, this is what has now happened. Moreover, CEG has now modified the deal in a new termination agreement with MAE in the wake of its agreement to go with the EDF offer. The actual amount of the fee associated with the termination is now around \$593 million (not counting the value of the 20 million shares of Constellation common stock MAE gets—9.9% of outstanding shares), or close to 13% of the original deal value. Thus, the final amount payable by CEG under the deal termination provisions as modified is well in excess of

traditional termination fees and should engender greater judicial scrutiny of both the fee itself, and the other termination provisions built into the original and termination agreements.

The same commentators cited above also suggest that the courts will examine:

“...primarily the economic effect of the fee itself on the stockholders and other bidders. For example, a court probably will assess whether the structure and size of the termination fee is likely to preclude the emergence of other bidders or to impose a penalty on shareholders for deciding to vote against a particular deal. If either of these factors appears, the fee is likely to receive very close judicial scrutiny. Alternatively...a properly structured fee which is within the 2-3 ½% range appears to receive less searching review when challenged.”

A Maryland Circuit court, in deciding against a shareholder’s request for a preliminary injunction to stop the upcoming proxy vote on the takeover of the Rouse Company, appeared to accept Rouse’s argument that the termination fee (there 2.5%) “is squarely with the range [2% to 4%] that has been approved by the courts...” *Jasinover v. The Rouse Company*, 2004 MDBT 12; 2004 Md. Cir. LEXIS 18 (2004).

Thus, it would appear that the original \$175 million termination fee, if considered in isolation, would probably be acceptable to a Delaware or Maryland court, however, the final total cost to CEG of disengaging from the MAE deal will be well outside the normal range of termination costs and should draw “heightened” judicial scrutiny. While the original fee provisions did not deter the reemergence of the better bid from EDF, the final termination costs arguably “impose a penalty” on CEG (and thus its shareholders and ratepayers) for deciding to accept the EDF offer.

b) The Additional “Deal Protection” Measures

In this case, the termination fees themselves are only one of the consequences of the failure by CEG to complete the merger. As set forth in detail in the Proxy Statement’s

extensive disclosures regarding the negative impacts on CEG of a failure to complete the merger (relevant portion attached hereto), and in recent filings by CEG describing the termination agreements with MAE post-EDF offer, there are other provisions that could prove quite onerous as a result of MAE's offer being terminated. MAE advised of these consequences in the Proxy: "...in addition to the \$175 million termination fee", termination of the merger agreement will cause "significant" dilution of the stock and that shareholders "will incur substantial additional indebtedness."

These terms, as well as the new terms agreed to by CEG and MAE in new termination agreement in the wake of the successful EDF bid, effectively increase the actual termination costs to around \$1.1 billion. As noted above, if these costs and deal protection measures are reviewed as part of an overall judicial review of the merger, they would push this deal well beyond the traditional acceptable range in terms of termination and other deal protection costs as a percentage of deal value. As described in the Proxy and termination agreement, these provisions in total are expensive, onerous and even give MAE continuing influence over the business of CEG. Thus, taken in tandem, the fee and the other provisions impose significant financial burdens on CEG in the short run, affect its business operations going forward, and have resulted in a windfall for MAE.

As noted in a very recent Delaware Chancery opinion:

Delaware law does not bestow upon a board of directors "unbridled discretion" to consent to deal protection measures in derogation of their unyielding fiduciary duties toward the shareholders. Thus the Board's decision to accede to [the bidders'] demands for deal protection measures must withstand enhanced judicial scrutiny.

Ryan v. Lyondell Chemical Co., 2008 Del. Ch. LEXIS 105 (July 28, 2008).

Thus, at least under Delaware law, all these deal provisions, over and above just the fee itself, should be subject to judicial scrutiny and should be considered in a reasonableness analysis of the board's decision to enter into the merger, then reject it in favor of the EDF bid, with the attendant termination costs. As noted in a leading Delaware case:

Defensive devices, as that term is used in this opinion, is a synonym for what are frequently referred to as "deal protection devices." Both terms are used interchangeably to describe any measure or combination of measures that are intended to protect the consummation of a merger transaction. Defensive devices can be economic, structural, or both.

Omnicare Inc. v. NCS Healthcare Inc., 818 A2d 914, 934 (Del. 2003). These devices should be subject to "enhanced judicial scrutiny" under Delaware law when a change of control is involved (as it originally was in the MAE bid) in which case the court must look beyond the normal protections and presumptions of the business judgment rule and review the merger under so-called Revlon standards (set forth in the case of *Revlon v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173 (Del. 1985). The *Revlon* standards require directors in change-of-control transactions to try to secure the "best" merger terms available for stockholders.

Maryland law, however, may be less favorable to those seeking to challenge merger terms approved by a board of directors. A recent Maryland Circuit court case evaluating a merger cites *Revlon*, and indicates "Maryland law appears to impose the same duty, *Whitman v. Crooke*, 120 Md. App. 369, 376-77 (1998), but the business judgment rule presumes that directors satisfied this duty." (citing to the rule as set forth in Maryland at Md. Code *Corps. & Ass'ns* Sec. 2-405.1(e), which indicates that "an act of a director of a corporation is presumed to satisfy the standards" imposed by the rule itself

(which is codified at Md. Code Ann. *Sec. 2-405.1(a)* (1999)).¹ *Hudson v. Prime Retail*, 2004 MDBT 2, 2004 Md. Cir. LEXIS 26, *29 (Md. Cir. Ct. Baltimore City, 2004)). That court noted that “unlike Delaware law, in Maryland the business judgment rule applies even to directors’ change-in-control decisions”, citing the leading Maryland treatise on corporate law. Nevertheless, the Court added “...the business judgment rule merely places upon plaintiffs the burden of rebutting the presumption.” The plaintiff can still attempt to overcome the presumption, but must provide a strong case of impropriety.

The *Rouse* court, cited above, reached the same conclusion that Maryland law may be more lenient on directors than Delaware in challenges to corporate decisions: “Regardless of whether Plaintiff’s rendition of Delaware law is accurate, the fact remains that it is Maryland law that governs a Maryland corporation like Rouse and its Board.” *Janisover, supra*, at *22. These limited references indicate that if termination fees and deal protection devices are challenged in Maryland, directors will have the presumption of the business judgment rule running in their favor, and a Maryland Court might not subject such provisions to as much “enhanced scrutiny” as would a Delaware court.

However, in *Rouse*, the company did “market-check” the deal, by negotiating with several other bidders to get “a realistic sense of where the market was.” *Id.* The leading Maryland Treatise notes that: “...[I]n a change of control, any process that does not involve some demonstrable market check, even post agreement, may be difficult to uphold.” Hanks, *Maryland Corporation Law*, Sec. 6.6(b). Here, there is no indication the

¹ The “business judgment rule” establishes a standard of care for directors. Codified as part of Maryland corporate law, directors must perform their duties in good faith, in a manner reasonably believed to be in the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would use under the circumstances. As noted, Maryland law presumes that the acts of a director satisfy

CEG board did attempt to gauge the market for higher bids before it made the original deal with MAE, given that it rushed to MAE over fears of impending bankruptcy. In fact, it apparently ignored an earlier EDF offer to pay \$6.2 billion, 32% above the CEG price. Now, as it turned out, EDF successfully upped its offer to \$52 per share for half of CEG's nuclear power unit. This factor, as well as the onerous nature of the deal protection devices, might help to overcome the business judgment rule presumption in a Maryland court and allow a more critical review of the overall terms involving the termination of the MAE deal, even though in the end there will be no change in control.

c) Repercussions of the EDF deal

CEG now accepted EDF's new offer to pay \$4.5 billion for half of CEG's nuclear power unit. Apparently this deal was structured in an attempt to avoid the need for both shareholder approval and PSC regulatory approval. The State of Maryland has just advised the PSC should it should take jurisdiction to review the CEG-EDF deal. The rejection by CEG of the MAE merger, and the subsequent termination agreement between CEG and MAE, clearly results in substantial costs to CEG and ultimately to ratepayers. Regardless of whether the EDF deal is considered to be better for CEG and its shareholders than the MAE deal would have been, a case can be made that CEG should never have entered into such onerous and costly termination fees and deal protection provisions with MAE in the first place. EDF is evidently anxious to get a foothold in the US to develop nuclear plants, and views the additional restrictions and payments that CEG will have to make to be worth the cost. Nevertheless, there should be

these standards. Directors can also rely on lawyers, accountants, or other experts as to matters which directors reasonably believe to be within the person's professional or expert competence.

a thorough review of these transactions by the PSC and if necessary by a court to determine if costs imposed on CEG's Maryland ratepayers as a result of these transactions are appropriate as a matter of law, and if some form of re-regulation should be considered for the benefit of Maryland ratepayers.

SELECTED PORTIONS OF FINAL PROXY STATEMENT

If the merger agreement is terminated other than due to a breach by MidAmerican, holders of Constellation Energy common stock will be diluted significantly and Constellation Energy will incur substantial additional indebtedness.

If the merger agreement is terminated other than due to a breach by MidAmerican, in addition to the \$175 million termination fee that Constellation Energy will be required to pay to MidAmerican, the Series A Preferred Stock acquired by MEHC Investment Inc., a wholly-owned subsidiary of MidAmerican, pursuant to a purchase agreement executed contemporaneously with the merger agreement will automatically convert into \$1.0 billion in aggregate principal amount of 14% Senior Notes and, subject to the receipt of all required regulatory approvals, 35,679,215 shares of Constellation Energy common stock. In addition, the Series A Preferred Stock will, subject to the receipt of all required regulatory approvals, automatically convert into shares of Constellation Energy common stock and 14% Senior Notes on [June 19, 2009](#) (or [September 19, 2009](#) if all conditions other than those relating to regulatory approvals, debt ratings and/or required consents have been fulfilled as of [June 19, 2009](#)), whether or not the merger agreement is terminated on such applicable date. At the time of conversion of the Series A Preferred Stock, to the extent Constellation Energy has not received all regulatory approvals required for the issuance of all of the 35,679,215 shares of Constellation Energy common stock, Constellation Energy would be required to pay MidAmerican \$26.50 for each share that could not be issued to MidAmerican because such regulatory approvals had not been received. The issuance of shares of Constellation Energy common stock upon conversion of the Series A Preferred Stock will cause a significant reduction in the relative percentage ownership of Constellation Energy common stock of current Constellation Energy shareholders.

Further, the 14% Senior Notes to be issued upon conversion of the Series A Preferred Stock will mature on [December 31, 2009](#). This obligation will reduce the cash available to finance our operations and other business activities and could limit our flexibility in planning for or reacting to changes in our business. The conversion of the Series A Preferred Stock into additional indebtedness could also have a negative impact on Constellation Energy's credit ratings.

13

The merger agreement contains provisions that could affect the decisions of a third party considering making an alternative acquisition proposal to the merger.

Under the terms of the merger agreement, except where Constellation Energy terminates the merger agreement due to a breach of the merger agreement by MidAmerican, Constellation Energy will be required to pay to MidAmerican a termination fee of \$175 million in connection with termination of the merger agreement. In addition, upon such termination of the merger agreement, the Series A Preferred Stock will, subject to receipt of all required regulatory approvals, automatically convert into 35,679,215 shares of Constellation Energy common stock, subject to certain adjustments, and \$1.0 billion aggregate principal amount of 14% Senior Notes. At the time of conversion of the Series A Preferred Stock, to the extent Constellation Energy has not received all regulatory approvals required for the issuance of all of the 35,679,215 shares of Constellation Energy common stock, Constellation Energy would be required to pay MidAmerican \$26.50 for each share that could not be issued to MidAmerican because such regulatory approvals had not been received. The merger agreement also limits the ability of Constellation Energy to initiate, solicit, encourage or facilitate acquisition or merger proposals from a third party. In addition, even

if Constellation Energy receives an acquisition or merger proposal from a third party that Constellation Energy's board of directors concludes is superior to the merger with MidAmerican, Constellation Energy is not permitted to terminate the merger agreement for that reason unless and until Constellation Energy shareholders have voted on the merger and failed to approve it. The merger agreement also does not permit Constellation Energy to enter into an agreement to complete a transaction that it concludes is superior to the merger prior to termination of the merger agreement. These provisions could affect the decision by a third party to make a competing acquisition proposal, or the structure, pricing and terms proposed by a third party seeking to acquire or merge with Constellation Energy. See "*The Merger Agreement—Termination Fee*" beginning on page 85, "*The Merger—Background of the Merger*" beginning on page 27 and "*The Merger Agreement—Restrictions on Solicitation of Alternative Transactions*" beginning on page 80.

The voting rights and conversion features of MidAmerican's \$1.0 billion Series A Preferred Stock investment in Constellation Energy, along with MidAmerican's right to designate one nominee to serve as a member of Constellation Energy's board of directors, may provide MidAmerican with influence over certain corporate matters and may impact the likelihood that a third party would seek to acquire, or succeed in acquiring, Constellation Energy (or its stock or assets).

Under the articles supplementary that designated certain preferences, conversion and other rights, and the terms and conditions of redemption of the Series A Preferred Stock (which we refer to as the articles supplementary) and the Investor [Rights Agreement](#), dated as of [September 19, 2008](#), by and between Constellation Energy and MidAmerican (which we refer to as the investor [rights agreement](#)), the number of members of Constellation Energy's board of directors was initially increased by one, and MidAmerican has the right to nominate one individual to the new directorship so long as MidAmerican and its affiliates beneficially own at least 33.3% of the shares of Series A Preferred Stock that were originally issued to MEHC Investment Inc. If MidAmerican does not exercise its right to nominate one individual to the new directorship, it may appoint a board observer who has the right to attend and participate in all meetings of, and receive all material distributed to, Constellation Energy's board of directors (subject to customary exceptions), but will not be entitled to vote at meetings of the board of directors or any committees thereof. As of the date of this proxy statement, MidAmerican has not exercised its right to nominate a director or appoint a board observer.

The Series A Preferred Stock generally does not have voting rights, but the consent of holders of such stock is required for specified matters in accordance with the terms of the articles supplementary. However, the holders of Series A Preferred Stock do not have the right to vote with respect to the merger. In addition, upon the occurrence of a conversion event of the Series A Preferred Stock, the Series A Preferred Stock subject to the receipt of all required regulatory approvals, will convert into 35,679,215 shares of Constellation Energy common stock (representing approximately 19.9% of the outstanding shares of Constellation Energy common stock on [September 22, 2008](#), or approximately 16.6% on an as-converted basis), subject to certain adjustments, and \$1.0 billion in aggregate principal amount of 14% Senior Notes.

[Table of Contents](#)

Moreover, following such a conversion, MidAmerican would continue to have the director nomination and related rights described above so long as MidAmerican and its affiliates beneficially own at least 50% of the shares of Constellation Energy common stock received by MidAmerican and its affiliates upon conversion of the Series A Preferred Stock. Accordingly, if the merger agreement is terminated other than due to a breach by MidAmerican or Merger Sub, MidAmerican's common stock ownership and director

nomination rights will enable it to exert significant influence over the outcome of a range of corporate matters, including significant corporate transactions requiring a shareholder vote, such as a merger or a sale of Constellation Energy or its assets. In that circumstance, this combination of significant common stock ownership and influence in board decision-making also could negatively affect the price of Constellation Energy common stock by, among other things, discouraging a potential acquirer from seeking to acquire shares of Constellation Energy common stock (whether by making a tender offer or otherwise) or otherwise attempting to obtain control of Constellation Energy. In addition, Constellation Energy and its [subsidiaries](#) will be subject to certain negative covenants relating to limitations on: amending or revising the organizational documents of Constellation Energy and its [subsidiaries](#); liquidation; incurring indebtedness of Constellation Energy and its [subsidiaries](#); and entering into affiliate transactions. See “*The Merger—Background of the Merger*” beginning on page 27, “*The Merger—Restrictions on Solicitation of Alternative Transactions*” beginning on page 80 and “*The Merger—Summary of Series A Preferred Stock and 14% Senior Notes*” beginning on page 68.

If the merger agreement is terminated and the 14% Senior Notes are issued by Constellation Energy upon conversion of the Series A Preferred Stock, the 14% Senior Notes will contain restrictions on Constellation Energy’s operation of its business.

The terms of the 14% Senior Notes to be issued upon conversion of the Series A Preferred Stock contain various covenants that will limit Constellation Energy’s ability to engage in specific types of transactions and in operating its business. Constellation Energy will be subject to certain affirmative covenants relating to the payment of its obligations; the conduct of its business and corporate existence; maintenance of its property and insurance; and the inspection of its books and records. In addition, Constellation Energy and its [subsidiaries](#) will be subject to certain negative covenants relating to limitations on: indebtedness of Constellation Energy and its [subsidiaries](#); incurring certain liens; engaging in certain fundamental changes (including, among other things, entering into a merger other than with a subsidiary of Constellation Energy; the sale of its assets; certain types of restricted payments; investments, loans and advances; acquisitions; optional payments and modifications to debt instruments; transactions with affiliates; changes to Constellation Energy’s fiscal year end; conduct of business; and the issuance of capital stock of any subsidiary). Accordingly, if the Series A Preferred Stock is converted, Constellation Energy will be subject to certain additional restrictions on the operation of its business, including the types of transactions in which it may engage. See “*The Merger—Background of the Merger*” beginning on page 27, “*The Merger—Restrictions on Solicitation of Alternative Transactions*” beginning on page 80 and “*The Merger—Summary of Series A Preferred Stock and 14% Senior Notes*” beginning on page 68.