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IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

FRONTIER OIL CORPORATION, a Wyoming corporation, Plaintiff, v. HOLLY CORPORATION, a Delaware corporation, Defendant.	:	C.A. No. 20502
HOLLY CORPORATION, a Delaware corporation, Counterclaim Plaintiff, v. FRONTIER OIL CORPORATION, a Wyoming corporation, Counterclaim Defendant.	:	

MEMORANDUM OPINION

Date Submitted: May 4, 2004
Date Decided: April 29, 2005

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NOBLE, Vice Chancellor

Plaintiff and Counterclaim Defendant Frontier Oil Corporation ("Frontier") and Defendant and Counterclaim Plaintiff Holly Corporation ("Holly") on March 30, 2003, agreed to merge.[1] On August 19, 2003, Frontier concluded that Holly had repudiated the Merger Agreement and brought this action the next day. In this post-trial memorandum opinion, the Court explores how and why the transaction fell apart and determines the consequences of the parties' conduct.

I. FINDINGS OF FACT[2]

A. *The Parties*

Frontier, a Wyoming corporation, and Holly, a Delaware corporation, are both mid-sized petroleum refiners. Frontier, headquartered in Houston, Texas, operates in a market that lies primarily on the eastern slope of the Rocky Mountains; Holly, with its headquarters in Dallas, Texas, focuses on the western slope of the Rockies. In addition, Holly owned and operated approximately 1,600 miles of pipeline with support facilities to transport crude oil and refined products.

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[1] Agreement and Plan of Merger Among Frontier Oil Corporation, Front Range Himalaya Corporation, Front Range Merger Corporation, Himalaya Merger Corporation and Holly Corporation and Related Documents (the "Merger Agreement") H 727.

[2] Not all of the Court's factual findings are presented under this heading. For convenience, some findings of fact are set forth during the analysis of the various issues.

B. *Merger Negotiations Begin*

For several years, Frontier had recognized the benefits of a combination with Holly. James R. Gibbs, Frontier's chief executive officer, predicted that Frontier and Holly together would be "one incredible company" which would be "either the largest or second largest refiner" in the Rocky Mountain region. C. Lamar Norsworthy, IIII, Holly's chief executive officer, also saw the advantages that could result from joining with Frontier.

Serious efforts to bring Frontier and Holly together were frustrated for several years because of Holly's role as a defendant in a lawsuit brought in a Texas court by an entity controlled by major national petroleum companies.[3] Holly was accused of having engaged in anticompetitive conduct by opposing (and surreptitiously supporting the opposition to) the Longhorn pipeline, proposed by the plaintiff in that action. The Longhorn pipeline would have been competitive with Holly's pipeline facilities. Although Holly considered the Longhorn Litigation to be without merit, the plaintiff claimed damages in excess of $1 billion. W. John Glancy, Holly's general counsel, said that the litigation made him feel as if "he was in jail." More specifically, Glancy understood that the Longhorn Litigation severely

[3] *Longhorn Partners Pipeline, L.P. v. Holly Corp.*, No. 98-2991 (Dist. Ct. El Paso County, Texas) (the "*Longhorn Litigation*"); *see* PX 21.

impaired Holly's ability to borrow, tied up management time and energy, and "walled off [Holly] from the whole M&A field."[4] For Gibbs, the "uncertainty" and "risk" associated with the litigation deterred him from pursuing Holly. Eventually, Holly was able to negotiate a settlement under which it agreed to provide approximately $25 million worth of refined petroleum product transportation services.

The settlement was announced on November 15, 2002. A few days later, Gibbs called Norsworthy to propose negotiations that would lead to a merger between Holly and Frontier. Merger negotiations commenced in late November, but, by the end of January 2003, the parties had reached an impasse. Holly then turned its attention to enhancing shareholder value through creating (and sale to the public of a portion of) a master limited partnership ("MLP") into which it would contribute its pipeline assets.[5] Holly retained Lehman Brothers to assist in the MLP effort.

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[4] Tr. at 1496-97.

[5] Placing its pipeline and terminal assets in a tax-advantaged master limited partnership would permit Holly to access greater value, both from the proceeds of the public offering and through the increase attributable to its retained interest. First, the operating income would not be taxed at the corporate level. This would support a higher EBITDA multiple on the pipeline assets than on Holly's refinery assets. Second, the projected income of the MLP would not be as susceptible to cycles in the petroleum refining market. With more reliable projections of operating income and cash distributions, the lower interest rates that Holly's advisers foresaw made the opportunity even more favorable.

C. *The Merger Agreement is Negotiated*

In February 2003, merger negotiations resumed. By March 3, 2003, the parties had agreed upon the basic terms of a merger. For each share of Holly common stock, its shareholders would receive one share of Frontier and $11.11 in cash.[6] No protection, such as ceilings, floors, or collars, was afforded the shareholders to guard against fluctuation in market price.

The merger terms were finalized on March 24, 2003. As to corporate governance, Norsworthy would become chairman of the board of the "new" Frontier; Gibbs would be its chief executive officer; and all directors of both constituent corporations would become directors of the "new" board. One adjustment to merger consideration was through a "contingent value right" ("CVR") that Holly shareholders would receive.[7] The contingent value right represented the potential value of a litigation claim asserted by Holly against the United States with respect to the sale of jet aviation fuel. The value of the claim was uncertain.

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[6] The cash portion would total $172.5 million. The shareholders of Frontier would own approximately 63% of the combined company. As of March 28, 2003, the last full day of trading before announcement of the merger, the last reported sale price for Frontier was $17.85 per share, and for Holly it was $22.10 per share.

[7] Thus, on combination of Frontier and Holly (the "Merger"), for each share of Holly, the Holly stockholders would receive one share of Frontier, $11.11 in cash, and a CVR.

D. *Enter Erin Brockovich*

During March 2003, in advance of a definitive merger agreement, the parties proceeded with their due diligence efforts. On March 15, Frontier delivered due diligence materials to Vinson & Elkins ("V&E"), the law firm representing Holly in the transaction. One of the items provided was an article from the February 22, 2003, edition of the *Los Angeles Times*, entitled "Cancer Cluster Alleged."[8] The article described plans by activist Erin Brockovich and the Masry & Vititoe law firm to bring a mass toxic tort suit against Beverly Hills (California) High School, the Beverly Hills municipality, and three oil companies. An oilrig had been in operation for decades on the campus of Beverly Hills High School, next to the athletic field. Brockovich claimed that the students attending the high school suffered from a disproportionately high incidence of various cancers, which she attributed to exposure to air contaminants released during the drilling and on-site processing activities. The crude oil production activities were carried out, at that time, by Venoco, Inc. ("Venoco"), which had acquired its interest in the Beverly Hills site from Wainoco Oil & Gas Company ("Wainoco") in 1995. Wainoco had obtained its interest in 1985 from Waverly Oil Company, an assignee of Chevron USA, Inc. The article,

[8] PX 37.

however, failed to set forth one fact that would become critical to the Merger: Wainoco is a wholly-owned subsidiary of Frontier.

E. *Due Dilligence I: Holly Becomes Concerned About Beverly Hills*

V&E, following receipt of Frontier's due diligence materials, ascertained that Frontier had made no public disclosure regarding the threatened Beverly Hills litigation and realized that only limited information regarding the potential litigation was readily available. On March 27, 2003, as the final details of the Merger documents were being worked out, V&E informed Glancy about the possibility of a toxic tort suit involving prior operations of a Frontier subsidiary. Glancy promptly informed other senior Holly executives. With their sensitivity to complex litigation having been heightened by their unhappy experience in the Longhorn Litigation, Holly management decided to seek additional information from Frontier regarding Beverly Hills. In addition, Holly retained Gibson, Dunn & Crutcher ("Gibson Dunn"), a national law firm headquartered in Los Angeles, to provide advice and guidance with respect to toxic tort litigation in California. As Glancy phrased it in an e-mail to Currie Bechtol, Frontier's general counsel, Holly's management needed to know whether the Beverly Hills problem was "a gnat or an elephant."[9]

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[9] F 805.

F. *Frontier Describes the Potential Litigation as a "Bunch of Hooey"*

Frontier attempted to assuage Holly's concerns in several ways. Gibbs told Norsworthy that the Beverly Hills problem "was likely to be a nuisance claim."[10] Similarly, Julie H. Edwards, Frontier's chief financial officer, in talking to Matthew Clifton, Holly's president, characterized the claim as a "bunch of hooey" and a "Hollywood stunt."[11]

Frontier was most persuasive, not in attacking Brockovich's motivations or her science, but with its argument that Frontier was protected from liability because of the separate and distinct corporate structure of Wainoco. In short, Frontier assured Holly that any liability could be confined to the subsidiary Wainoco and would not reach the parent Frontier. Frontier bolstered this argument by producing a Canadian tax ruling which, it claimed, demonstrated that the manner in which Frontier operated its subsidiaries would minimize the risk of any successful veil-piercing effort by toxic tort plaintiffs.

G. *The Boards' Reactions*

On March 28, at a special meeting, Frontier's Board unanimously approved the Merger Agreement, authorized Frontier's management to execute the Merger Agreement and related documents, and established a

[10] Tr. at 35.
[11] Tr. at 430-31; 433.

special committee to which it delegated the power to approve changes to the Merger Agreement.

Holly's Board also met on March 28. That meeting did not go as well as Frontier's. Holly's Board was informed of the potential for litigation arising out of the Beverly Hills problem. Alan Bogdanow, who led V&E's merger efforts for Holly, told the Board what was known about Beverly Hills and reviewed its potential consequences. Holly's Board minutes reflect Bogdanow's concerns:

> In respect of the potential California litigation, Mr. Bogdanow informed the Board that a recent article stated that Erin Brockovich and Ed Masry were preparing a lawsuit against the city of Beverly Hills, Beverly Hills Unified School District and three oil companies, alleging that there was an abnormally high rate of cancer, or a "cancer cluster," among former Beverly Hills High School students due to polluted air caused by oil wells operating in the area. Mr. Bogdanow noted that this raised the issue of a potential toxic tort claim against the Frontier subsidiary which once owned oil and gas wells in the Beverly Hills area that were sold in 1995 to Venoco, Inc. . . . Mr. Bogdanow, among other things, noted that (i) Frontier had not publicly disclosed the potential claim in its Securities and Exchange Commission filings, (ii) Frontier had a strong indemnity right against Venoco, but Venoco may not have the financial ability to satisfy all of its indemnification obligations, (iii) Frontier probably did not have insurance coverage that would cover such potential claim, (iv) potential legal defenses that might be available to Frontier, including expiration of the applicable statute of limitations period, whether any potential liability could be limited to Frontier's subsidiary, whether California has damage caps, and burden of proof issues were being looked at, (v) the Company was assessing whether the potential claim was a substantial practical risk, but there was no

> assurance as to whether a more meaningful assessment could be made in any particular time frame, (vi) Mr. Gibbs, the Chief Executive Office of Frontier, had stated that Frontier was not concerned about this matter becoming significant and that the previous Longhorn litigation against the Company had been much worse than this potential claim, which was considered by Frontier to be only a nuisance claim, . . . and (vii) he did not know if the potential claim might raise a financing issue for Frontier.[12]

Thus, the Board concluded that it would need additional information before deciding to proceed with the Merger. Holly's desire to take the time necessary to acquire the additional information was tempered by Frontier's concern that the plans for the Merger might be leaked to the public or that stock might be traded based on nonpublic information regarding the transaction.[13] Nonetheless, Holly's Board directed its management to pursue various options regarding the threatened litigation, including:

> (i) strengthening Frontier's representations and warranties, (ii) strengthening the definition of material adverse effect, (iii) determining whether Frontier had any obvious legal defenses if a claim were made against it, (iv) clarifying the Board's rights under the merger agreement to terminate the merger in exercise of the Board's fiduciary duties, and (v) performing additional analysis of the potential claim over the weekend so that the Board could better evaluate the issue.[14]

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[12] PX 98 at 5-6. Holly's banker, Credit Suisse First Boston, expressed the view that Frontier would be able to meet its borrowing needs.
[13] Frontier's sense of urgency is evidenced by a voicemail left by Gibbs for Norsworthy shortly before Holly's board meeting: "There is a locomotive running down the road—too many people know about this and we need to get it closed and out. There is not much exposure on the Brockovich lawsuit. . . ." H 881.
[14] PX 98 at 13.

The Board then decided to reconvene on Sunday, March 30, to evaluate any new information and to decide on a course of action.

H. *The Merger Agreement is Renegotiated*

The confluence of Holly's concerns about the risks associated with the potential Beverly Hills litigation and Frontier's desire to reach an agreement as quickly as possible resulted in several modifications to the Merger Agreement. These modifications were negotiated over a very short period of time. First, Section 4.8 of the Merger Agreement was changed to read as follows:[15]

> *Except as set forth on Schedule 4.8 of the Frontier Disclosure Letter*, there are no actions, suits or proceedings pending against Frontier or any of its Subsidiaries or, to Frontier's knowledge, threatened against Frontier or any of its Subsidiaries, at law or in equity, or before or by any federal, state or foreign commission, court, board, bureau, agency or instrumentality, other than those that would not *have or reasonably be expected to* have, individually or in the aggregate, a Frontier Material Adverse Effect.[16]

Second, the Definition of "Material Adverse Effect" was modified to read as follows:

> "Material Adverse Effect" with respect to Holly or Frontier shall mean a material adverse effect with respect to (A) the business, assets and liabilities (taken together), *results of operations*, ~~material~~ condition *(financial or otherwise) or*

[15] Additions are noted in italics; deletions are struck through.
[16] PX 98 at 32.

> *prospects* of a party and its Subsidiaries on a consolidated basis . . ."[17]

Third, Schedule 4.8, referenced in Section 4.8, was added to the Frontier Disclosure Letter:

> Wainoco Oil & Gas Company ("Wainoco") owned an interest in an oil field from 1985 until early 1995 in the area where the Beverly Hills High School is located. News articles in February 2003 indicated that the Brockovich and Masry law firm were preparing a lawsuit involving that site. Wainoco sold its interest to Venoco, Inc. by a Purchase and Sale Agreement dated February 9, 1995. Frontier has not been contacted by anyone concerning a possible lawsuit, and does not have any knowledge of any litigation being filed.
>
> For avoidance of doubt and only for the limited purpose of the Agreement, Frontier agrees with, and for the sole benefit of, Holly that this potential litigation will be considered as "threatened" (as such term is used in Section 4.8 of the Agreement) and that the disclosure of the existence of this "threatened" litigation herein is not an exception to Section 4.8, 4.9 or 4.13 of the Agreement and despite being known by Holly, will have no effect with respect to, or have any limitation on, any rights of Holly pursuant to the Agreement.

When the Holly Board reconvened on March 30, Glancy presented (indeed, he read aloud) to the Board a six-page memorandum prepared by Jeffrey D. Dintzer of Gibson Dunn. In his memorandum, Dintzer summarized what was known about the anticipated Beverly Hills claim and he attempted to gauge its likely effects.[18]

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[17] PX 106 at 71.
[18] PX 112.

I. *Gibson Dunn Explains the Risks*

Dintzer's memorandum informed the Board that the potential for litigation was first reported by a local Los Angeles television station on February 10, 2003. The report indicated that Brockovich and the law firm of Masry & Vititoe were preparing a lawsuit on behalf of at least twenty Beverly Hills High School students who had been diagnosed with one of three types of cancer: Hodgkin's disease, non-Hodgkins lymphoma, and thyroid cancer. Brockovich had identified the oil wells at the High School as the potential cause. According to an "environmental specialist" from Masry & Vititoe, tests of the area conducted seven times over five months revealed "abnormally high levels of benzene, methane and n-hexane—all by-products of the oil industry."[19] This report also noted that while benzene is a known carcinogen, a recent test conducted by the South Coast Air Quality Management District ("SCAQMD") had found nothing abnormal, except for elevated levels of toluene.

Dintzer also discussed subsequent reports. For instance, one report noted that the current owner of the oil wells, Venoco, had acquired its ownership interest from Wainoco in 1995 and that "Wainoco has since

[19] *Id.*

changed its name to Frontier Oil Corporation."[20] This report also quoted a Frontier representative as having said, "Anything to do with those sites and royalties would have been transferred to Venoco when they bought our assets."[21] From this report, Holly's Board also learned that Brockovich had hosted a dinner for 600 alumni of, and parents of students attending, Beverly Hills High School and that 170 graduates and staff had developed one of the three cancer types over the last decade. Masry was quoted as having stated that the ratio of these cancers was eighteen times the national average.

Dintzer's memorandum, however, was not devoid of good news. For example, it described a March 25, 2003, release by the Superintendent of the Beverly Hills Unified School District which noted that tests conducted by SCAQMD on three separate occasions in February 2003 did not show "readings of benzene, hexane and other air toxic levels that are considered abnormal."[22] In fact, the Superintendent was quoted as having said that the levels were "well below" what the California Environmental Protection Agency deemed to be the minimum exposure risk for public health. Moreover, the release observed that there was no "consistent evidence" that benzene exposure caused any cancer other than acute myelogenous leukemia

[20] *Id.*
[21] *Id.*
[22] *Id.*

and that "there is a threshold below which the risk of cancer from benzene exposure is negligible."[23]

Holly's Board was warned that the lawsuit would be prosecuted by a "highly-organized, well-funded group of law firms."[24] In addition to Masry and Brockovich, the memo noted that the "lawsuit will likely be funded in part by the well-known and highly successful plaintiffs' law firm Girardi & Keese, who prosecuted the famous Anderson chrome case against PG&E which is the subject of the Brockovich film."[25] It noted that "Girardi and its partner law firms have the resources to vigorously and aggressively prosecute any lawsuits filed and have the wherewithal to go to great lengths to bring these lawsuits to a successful conclusion."[26]

Dintzer's memorandum also advised Holly's Board that since "[t]he science of connecting human exposures to chemicals, such as those released from oil and gas production, to serious disease outcomes is complicated and often difficult to explain . . . , the plaintiffs' story—very sick plaintiffs exposed to chemicals, fighting large corporations—[would be] attractive to a lay jury."[27] It noted that there were at least five different causes of action

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[23] *Id.* at 3.
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*

that could be brought and more than seven types of damages that could be sought—including punitive damages and emotional distress damages. Furthermore, the Holly Board learned that "[i]n California, there is no limit to the amount the plaintiffs can collect on personal injury claims. . . . [and p]unitive damages are only limited by the general factors that apply to such damages and any Constitutional limits."[28] While there was no estimate of potential liability, as a point of reference, Dintzer's memorandum did note that the Anderson case against PG&E, which was the subject of the *Erin Brockovich* movie, resulted in a $400 million award, which was later reduced to $333 million by settlement.

Dintzer also anticipated the "shark effect" leading to an increase in the costs of defending any potential litigation. The shark effect was defined as the risk, after the settlement of a toxic tort case, that additional lawsuits would be filed against the same defendants, at times by the same law firms who filed the original suit, on behalf of different plaintiffs. Several examples were supplied, including the Anderson litigation, as a way of demonstrating that "[s]ettling cases with certain plaintiffs is no guarantee that the controversy will go away."[29]

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[28] *Id*. at 5.
[29] *Id*.

Lastly, the memorandum predicted that the duration of any lawsuit might be prolonged, thus leading to an increase in costs. Furthermore, the Board was advised that "recent changes in California law to the procedures for summary judgment which strongly favor plaintiffs . . . make it very difficult to achieve summary judgment."[30] The memorandum forecast that, even though it might be possible to achieve summary judgment, "extensive and expensive discovery would have to occur before" it would be ripe.[31] The memorandum finally cautioned that it might be easier for plaintiffs in California to present questionable science to the jury as a way of proving liability "because California has not adopted the *Daubert* standard, which applied to the Federal Rules of Evidence."[32]

J. *Holly's Board Approves the Merger Agreement*

After receiving Dintzer's memorandum, Holly's Board "continued to consider and discuss the benefits of the proposed transaction for the Company's stockholders versus the potential risks associated with the transaction in light of the potential California Claim."[33] "[A]lthough the Board noted that its legal counsel probably would not be able to advise the Board with absolute certainty that Frontier was clearly insulated from any

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[30] *Id*. at 6.
[31] *Id*.
[32] *Id*.
[33] PX 125 at 5.

potential liability,"[34] the Board decided "that it was in the best interest of the Company's stockholders to proceed with the proposed transaction now and for the Company to continue to investigate and evaluate the potential California claim."[35] Thus, the Board ended the meeting by approving the Merger Agreement.

K. *The Merger Agreement*

Before turning to the events following execution of the Merger Agreement, it may be helpful to review the various exit strategies afforded by that agreement. For purposes of this action, there were, in general, three avenues: (1) if a party's representations and warranties in the Merger Agreement were or, in some instances, became inaccurate, including, if threatened litigation would have or would reasonably be expected to have a Material Adverse Effect; (2) if a party exercised its "fiduciary out"; and (3) if the parties mutually agreed to termination.[36] Recitation of pertinent provisions of the Merger Agreement is unavoidable.

Section 7.1 allows "Termination by Mutual Consent":

> This Agreement may be terminated at any time prior to the Effective Time by the mutual written agreement of Holly and

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[34] *Id*. at 7.

[35] *Id*. at 8.

[36] A fourth strategy, one not expressly sanctioned by the Merger Agreement, might be to delay, but without being charged with causing the delay, until the "drop deal date" passed.

> Frontier approved by action of their respective Board of Directors in their respective discretion for any reason, including due to the number of Holly Dissenting Shares exceeding 5% of the Total Holly Common Stock Number or the number of Frontier Dissenting Shares exceeding 5% of the total number of shares of Frontier Common Stock outstanding immediately prior to the Effective Time.[37]

Section 7.2 establishes other ways the Merger Agreement could be terminated by either party, including a failure to close by the "drop dead date" of October 31, 2003, or a failure of one of the parties to obtain the requisite stockholder vote to send the transaction to closing. This provision provides in pertinent part:

> **Section 7.2 TERMINATION BY FRONTIER OR HOLLY.** At any time prior to the Effective Time, this Agreement may be terminated by Holly or Frontier, in either case by action of its Board of Directors, if:
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> (a) the Mergers shall not have been consummated by October 31, 2003; provided, however, that the right to terminate this Agreement pursuant to this clause (a) shall not be available to any party whose failure or whose affiliates' failure to perform or observe in any material respect any of its obligations under this Agreement in any manner shall have been the principal cause or, or resulted in, the failure of the Mergers to occur on or before such date; or
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> (b) the Holly Requisite Vote shall not have been obtained at a meeting (including adjournments and postponements) of Holly's stockholders that shall have been duly convened for the purpose of obtaining the Holly Requisite Vote; or
>
> (c) the Frontier Requisite Vote shall not have been obtained at a meeting (including adjournments and

[37] "Effective Time" means the "date and time when the Mergers become effective." Merger Agreement, Section 1.3(b).

> postponements) of Frontier's stockholders that shall have been duly convened for the purpose of obtaining the Frontier Requisite Vote. . . .

Sections 7.3 and 7.4 contained comparable provisions authorizing Frontier and Holly to terminate the Merger Agreement, for reasons, such as breach of representations,[38] without cure within thirty days, and the transaction's "fiduciary out" for those instances when the directors' fiduciary duties would no longer allow them to support the Merger. The similar provisions stated in full:

> **Section 7.3 TERMINATION BY HOLLY.** At any time prior to the Effective Time, this Agreement may be terminated by Holly, by action of its Board of Directors, if:

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[38] The obligation of Holly to complete the Merger was conditioned by Section 6.2(a) which provides in part:

> Frontier shall have performed in all material respects its covenants and agreements contained in this Agreement required to be performed on or prior to the Closing Date and the representations and warranties of Frontier contained in this Agreement and in any document delivered in connection herewith (i) to the extent qualified by Frontier Material Adverse Effect or any other materiality qualification shall be true and correct and (ii) to the extent not qualified by Frontier Material Adverse Effect or any other materiality qualification shall be true and correct in all material respects, in each case as of the date of this Agreement and as of the Closing Date (except for representations and warranties made as of a specified date, which need be true and correct only as of the specified date), and Holly shall have received a certificate of Frontier, executed on its behalf by its Chairman of the Board, President and Chief Executive Officer, dated the Closing Date, certifying to such effect.

Frontier's obligation to proceed with the Merger was similarly conditioned by Section 6.3.

(a) (i) there has been a breach by Frontier of any representation, warranty, covenant or agreement set forth in this Agreement or if any representation or warranty of Frontier shall have become untrue, in either case such that the conditions set forth in Section 6.2(a) would not be satisfied and (ii) such breach is not curable, or, if curable, is not cured within 30 days after written notice of such breach is given to Frontier by Holly; provided, however, that the right to terminate this Agreement pursuant to this Section 7.3(a) shall not be available to Holly if it, at such time, is in material breach of any representation, warranty, covenant or agreement set forth in the Agreement such that the conditions set forth in Section 6.3(a) shall not be satisfied;

(b) prior to obtaining the Frontier Requisite Vote, the Board of Directors of Frontier shall have withdrawn, modified, withheld or changed, in a manner adverse to Holly, such Board's approval or recommendation of the Agreement or the transactions contemplated hereby, or recommended a Frontier Superior Proposal, or resolved to do any of the foregoing; or

(c) prior to obtaining the Holly Requisite Vote, Holly is the Withdrawing Party pursuant Section 5.4(b) (it being understood that Holly shall not have the right to terminate this Agreement pursuant to this Section 7.3(c) unless and until Holly shall have paid Frontier all amounts due under Section 7.5(a)).

Section 7.4 TERMINATION BY FRONTIER. At any time prior to the Effective Time, this Agreement may be terminated by Frontier, by action of its Board of Directors, if:

(a) (i) there has been a breach by Holly of any representation, warranty[,] covenant or agreement set forth in this Agreement or if any representation or warranty of Holly shall have become untrue, in either case such that the conditions set forth in Section 6.3(a) would not be satisfied and (ii) such breach is not curable, or, if curable, is not cured within 30 days after written notice of such breach is given by Frontier to Holly; provided, however, that the right to terminate this Agreement pursuant to Section 7.4(a) shall not be available to Frontier if it, at such time, is in material breach of any representation, warranty, covenant or agreement set forth in this Agreement

> such that the conditions set forth in Section 6.2(a) shall not be satisfied;
>
> (b) prior to obtaining the Holly Requisite Vote, the Board of Directors of Holly shall have withdrawn, modified, withheld or changed, in a manner adverse to Frontier, such Board's approval or recommendation of this Agreement or the transactions contemplated hereby, or recommend a Holly Superior Proposal, or resolved to do any of the foregoing; or
>
> (c) prior to obtaining the Frontier Requisite Vote, Frontier is the Withdrawing Party pursuant to Section 5.4(b) (it being understood that Frontier shall not have the right to terminate this Agreement pursuant to this Section 7.4(c) unless and until Frontier shall have paid Holly all amounts due under Section 7.5(b)).

The term "Withdrawing Party," employed in both Section 7.3 and Section 7.4, is defined in Section 5.4(b) which provides in part:

> The Board of Directors of Holly or Frontier, as applicable (the "Withdrawing Party," the other party being the "Non-Withdrawing Party"), may at any time prior to obtaining the Holly Requisite Vote or Frontier Requisite Vote, as applicable, (A) withdraw, withhold, modify, or change, in a manner adverse to the Non-Withdrawing Party, any approval or recommendation regarding this Agreement or the transactions contemplated hereby or (B) approve and be prepared to enter into or recommend and declare advisable any Holly Superior Proposal or Frontier Superior Proposal, as the case may be, if its Board of Directors determines in good faith after consultation with its outside legal counsel that the failure to take the action in question would be inconsistent with the fiduciary obligations of such Board of Directors under applicable law.[39]

[39] Section 5.4(b) obligated Holly (and Frontier), through its Board of Directors, to recommend the Merger Agreement to the shareholders. The language quoted in the text allowed it to back out of the transaction if certain circumstances, including payment of the break-up fee, were first satisfied. Also, the directors had signed Support Agreements committing to support the Merger.

If either party used the fiduciary duty termination provisions to avoid the Merger, Section 7.5 provides that the terminating party would pay the other party $15 million as a break-up fee in addition to reimbursing the other party up to $1 million in expenses incurred in connection with the Merger Agreement. Section 7.5 provides in part:

> **Section 7.5 EFFECT OF TERMINATION**
>
> (a) If this Agreement is terminated
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> (i) by Holly or Frontier, after the public announcement (made prior to the closing of the polls for the vote of Holly stockholders for the purpose of obtaining the Holly Requisite Vote) of a Holly Acquisition Proposal, pursuant to Section 7.2(b);
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> (ii) by Frontier pursuant to Section 7.4(b);
>
> (iii) by Holly pursuant Section 7.3(c);
>
> then Holly shall pay Frontier the Holly Termination Amount (as defined below) and, in addition, reimburse Frontier for all expenses incurred by Frontier in connection with this Agreement up to the Reimbursement Maximum Amount (as defined below) prior to or upon termination of this Agreement. All payments under this Section 7.5(a) shall be made in cash by wire transfer to an account designated by Frontier at the time of such termination or, in the case of a termination pursuant to Section 7.3(c), prior to such termination). The term "Holly Termination Amount" shall mean $15,000,000. The term "Reimbursement Maximum Amount" shall mean $1,000,000. In addition, Holly shall reimburse Frontier for all expenses incurred by Frontier in connection with this Agreement up to the Reimbursement Maximum Amount if this Agreement has been terminated pursuant to Section 7.2(b) even if Frontier is

> not entitled to any Holly Termination Amount under this Section 7.5(a). Holly acknowledges that the agreements contained in this Section 7.5(a) are an integral part of the transactions contemplated by this Agreement, and that, without these agreements, Frontier would not enter into this Agreement; accordingly, if Holly fails promptly to pay any amount due pursuant to this Section 7.5(a), and, in order to obtain such payment, Frontier commences a suit which results in a judgment against Holly for the payment set forth in this Section 7.5(a), Holly shall pay Frontier its costs and expenses (including attorneys' fees) in connection with such suit, together with interest on the Holly Termination Amount and other amounts to be reimbursed to Frontier under this Section 7.5(a) from the date payment was required to be made until the date of such payment at the prime rate of Union Bank of California, N.A. in effect on the date such payment was required to made plus one percent (1%). If this Agreement is terminated pursuant to a provision that calls for a payment to be made under this Section 7.5(a), it shall not be a defense to Holly's obligation to pay hereunder that this Agreement could have been terminated at an earlier or later time.

Section 7.5(b) is the mirror image of Section 7.5(a), with Holly and Frontier substituted for each other.

Frontier's representations and warranties are set forth in Article IV of the Merger Agreement which provides in part:

> Except as set forth in the disclosure letter delivered to Holly concurrently with the execution hereof (the "Frontier Disclosure Letter"), . . . Frontier represents and warrants to Holly that:
>
> * * *
>
> **Section 4.8 LITIGATION AND LIABILITIES**. Except as set forth on Schedule 4.8 of the Frontier Disclosure Letter, there are no actions, suits or proceedings pending against Frontier or any of its Subsidiaries or, to Frontier's knowledge, threatened against Frontier or any of its

Subsidiaries, at law or in equity, or before or by any federal, state or foreign commission, court, board, bureau, agency or instrumentality, other than those that would not have or reasonably be expected to have, individually or in the aggregate, a Frontier Material Adverse Effect. There are no outstanding judgments, decrees, injunctions, awards or orders against Frontier or any of its Subsidiaries, other than those that would not have, individually or in the aggregate, a Frontier Material Adverse Effect. There are no obligations or liabilities of any nature, whether accrued, absolute, contingent or otherwise, of Frontier or any of its Subsidiaries, other than those liabilities and obligations (a) that are disclosed in the Frontier Reports, (b) that have been incurred in the ordinary course of business since December 31, 2002, (c) related to expenses associated with the transactions contemplated by this Agreement or (d) that would not have or reasonably be expected to have, individually or in the aggregate, a Frontier Material Adverse Effect.

Section 4.9 ABSENCE OF CERTAIN CHANGES. Since December 31, 2002, Frontier has conducted its business only in the ordinary and usual course of business and during such period there has not been any (i) event, condition, action or occurrence that has had or would reasonably be expected to have, individually or in the aggregate, a Frontier Material Adverse Effect; . . .

Holly, by Article III, made similar representations, except that Section 3.8 did not carry the same modifications as did Section 4.8, to accommodate the Beverly Hills concerns.

Finally, Section 8.9(d) provides in its entirety:

(d) "Material Adverse Effect" with respect to Holly or Frontier shall mean a material adverse effect with respect to (A) the business, assets and liabilities (taken together), results of operations, condition (financial or otherwise) or prospects of a party and its Subsidiaries on a consolidated basis or (B) the

ability of the party to consummate the transactions contemplated by this Agreement or fulfill the conditions to closing set forth in Article 6, except to the extent (in the case of either clause (A) or clause (B) above) that such adverse effect results from (i) general economic, regulatory or political conditions or changes therein in the United States or the other countries in which such party operates; (ii) financial or securities market fluctuations or conditions; (iii) changes in, or events or conditions affecting, the petroleum refining industry generally; (iv) the announcement or pendency of the Mergers or compliance with the terms and conditions of Section 5.1 hereof; or (v) stockholder class action or other litigation arising from allegations of a breach of fiduciary duty relating to this Agreement. "Holly Material Adverse Effect" and "Frontier Material Adverse Effect" mean a Material Adverse Effect with respect to Holly and Frontier, respectively.

L. *Holly Passes on Acquiring the Denver Refinery*

During the negotiations with Frontier, Holly was also pursuing the acquisition of a refinery in Denver, Colorado (the "Denver Refinery") which ConocoPhillips had been required by the FTC to divest. Because of Frontier's substantial presence in the Denver area, Holly's acquisition of the Denver Refinery would have posed significant antitrust concerns if it combined with Frontier. Thus, in anticipation of entering into the Merger Agreement, Holly abandoned its efforts to purchase the Denver Refinery.

M. *Frontier Completes Financing for the Merger*

Frontier needed to finance the cash portion of the merger consideration to be paid to Holly shareholders.[40] With Holly's concurrence,[41] Frontier proceeded in April to borrow $220 million. The funds were borrowed well before the anticipated closing because of favorable interest rates. When it became apparent that the Merger would not close, Frontier would repay the debt. Its unreimbursed costs associated with the borrowing were approximately in excess of $20 million, including interest.

N. *Two Important Developments*

During the fourteen weeks following execution of the Merger Agreement, two matters, both previously mentioned, would evolve. The Merger, because of one, both, or some combination of the factors, would not happen. The parties are deeply divided as to their relative significance. The first involves Beverly Hills. Not only was litigation commenced, but also, and more importantly, it was learned that Frontier would not be able to rely upon its "corporate separateness" defense because it had guaranteed Wainoco's obligations under the lease for the oil production site at Beverly Hills High School. The second was a new MLP presentation by Lehman

[40] The Merger Agreement was not contingent upon financing.
[41] PX 150.

Brothers for a public offering of Holly's pipeline assets. Lehman Brothers' analysis suggested that Holly had significantly undervalued those assets and, thus, that Frontier had struck a good, perhaps too good of a, deal.

1. (a) The Beverly Hills Litigation

In early April, Norsworthy and Glancy flew to California to meet with Holly's attorneys at Gibson Dunn and to visit the site of oil wells on the campus of Beverly Hills High School.

On April 28, 2003, the Masry law firm filed twenty-three initial notices of claims with the City of Beverly Hills and the Beverly Hills Unified School District on behalf of former students of Beverly Hills High School, employees of the school, and residents living near the school. Those notices contained allegations that emissions from the oil field or production facilities had caused cancers and related health problems. In light of these notices, Gibson Dunn informed Holly of its view that a lawsuit would be filed within the next two months.

On June 9, the Beverly Hills Litigation became a reality with the commencement of an action entitled *Moss et al. v. Venoco, Inc., et al.* (the "*Moss* Complaint") in the Superior Court of the State of California for the County of Los Angeles, Central District.[42] The seventy-page complaint was

[42] N 50. There are five lawsuits (the "Beverly Hills Litigation").

brought on behalf of twenty-one plaintiffs, two of whom were deceased. It alleged that toxic emissions from the oil production facilities had caused an unusually high rate of cancer and Hodgkin's disease among former students of Beverly Hills High School.[43] Significantly, and perhaps most importantly from the point of view of Holly, the action was directed not only against Wainoco, but Frontier as well; it alleged that Frontier had contractually guaranteed Wainoco's obligations under the lease of the Beverly Hills oil wells.

At this point, Holly decided that it needed a second opinion as to the risks associated with the Beverly Hills Litigation. Thus, on June 11, 2003, Holly retained the firm of Carrington, Coleman, Sloman & Blumenthal, LLP ("Carrington Coleman") to evaluate the Beverly Hills claims and to determine if Frontier, in contrast to a mere subsidiary of Frontier, faced potential liability.

On June 12, the Holly Board met and received a presentation from Gibson Dunn about the Beverly Hills Litigation.[44] Gibson Dunn reported that it expected as many as 200 additional plaintiffs to file claims; that it could take two to three years, or more, to prepare the initial case for trial;

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[43] Gibson Dunn advised Holly that the venue could be transferred to Central Civil West, which is known to plaintiffs' law firms in Southern California as "the Bank" because of its tendency to provide favorable verdicts.

[44] H 381.

that it would be hard to exclude adverse expert witnesses; that there would be no cap on punitive damages; and that legal fees could be $200,000 per month or more. Gibson Dunn also advised that while it could not predict the ultimate outcome of the litigation, Frontier's exposure could run into the hundreds of millions of dollars.[45] Gibson Dunn nevertheless remained optimistic about Frontier's ability to extricate itself at an early stage from the litigation by use of the corporate separateness defense.

(b) Frontier as Guarantor and Indemnitor

Both Frontier and Holly were shocked by the allegation in the *Moss* Complaint—which was factually correct—that Frontier had guaranteed Wainoco's performance and indemnified various Beverly Hills entities. To fully understand their impact, a short history of the Beverly Hills oil wells is necessary. In 1959, the Beverly Hills Unified School District leased the portion of its lands which now contain the oil wells to one Allen Guiberson. This lease contained a provision which called for the lessee to indemnify Beverly Hills Unified School District for any costs it might incur as a result

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[45] There is substantial debate as to what figure was actually given. Frontier, looking at drafts of the meeting minutes, claims it is tens of millions of dollars; Holly, using the signed minutes, claims it is in the hundreds of millions. Although not critical to the ultimate decision, the number of potential plaintiffs, the seriousness of the diseases, and the projected monthly fees, tend to support the range sponsored by Holly as the one presented to the Board.

of the lessee's use.[46] In 1985, this lease was assumed by Wainoco Oil & Gas Company, and guaranteed by its parent Wainoco Oil Corporation,[47] which is now Frontier. Thus, Frontier has guaranteed Wainoco's performance through the indemnification provision in the 1959 lease.[48] Waverly Oil Company, Inc. assigned the lease to Wainoco. Chevron USA, Inc. (or its predecessor, Standard Oil Company of California) at one time had held the lease rights. As part of the lease assumption, Wainoco (including the corporate entity now known as Frontier) executed a Consent Agreement which, in substance, made Frontier directly liable to Chevron for

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[46] PX 1 at 17.

[47] PX 9.

[48] The Court does not, even if words which may suggest otherwise are used from time to time, determine Frontier's obligations under the various indemnity or guarantee provisions. That question, involving California law, documents evidencing an interest in California real property, and a dispute in California, is better resolved in California. It is sufficient for purposes of this Memorandum Opinion that it is likely, or that it is reasonable to expect, that Frontier will be deemed directly obligated with respect to the claims, whatever their merit, asserted in the Beverly Hills Litigation. That exposure may be mitigated by, for example, cross-indemnities from one or more of the other defendants in those proceedings.

Frontier correctly points out that its indemnification obligations do not affect the "corporate separateness" argument which Gibbs relied upon at the end of March 2003 to persuade Holly to proceed with the Merger Agreement. That "corporate separateness" or "corporate veil-piercing" argument depends upon the status of Frontier and Wainoco as distinct corporate entities. The existence of the indemnification agreements does not affect their relative independence as corporate entities. Gibbs, however, used his corporate separateness argument to demonstrate that Frontier was not liable for the obligations of Wainoco. Because of the indemnification obligation, whether Frontier and Wainoco are separate and distinct corporate entities loses much significance in this context. What mattered for purposes of the Merger Agreement was whether Frontier could keep itself out of the Beverly Hills litigation by virtue of an arms-length relationship with Wainoco; with the indemnities, that goal was frustrated.

performance of the lessee's obligations.[49] Thus, Frontier may have a direct obligation to indemnify Chevron.

Before the Merger Agreement was signed, Holly had engaged in the typical due diligence effort of a company considering a merger. As part of this inquiry, Holly specifically requested from Frontier any materials relating to indemnities or guarantees, and, in fact, made the following request in its initial due diligence request list:

> Indemnities, Guarantees and Other Obligations. Copies of all documents and agreements pursuant to which the Company or any other [Frontier] Entity has any continuing indemnification, guarantee or other obligations to any third party with respect to the disposition of assets.[50]

Frontier has suggested that the Wainoco indemnification documents were available to Holly, in the sense that Holly's V&E lawyers were in the same room where they were stored and had access to the board minutes reflecting their approval. Nevertheless, these documents were neither discovered during due diligence nor directly provided by Frontier.[51]

On the other hand, it is also clear that Frontier's management did not know about the indemnities—or had forgotten about them—when the

[49] PX 10.
[50] PX 54A.
[51] Board minutes, reflecting that the parent (now Frontier) had accepted guaranty and indemnification obligations at Beverly Hills (PX 12) were also among the records available during Holly's due diligence effort.

Merger Agreement was signed. For instance, during the due diligence period, Bechtol had represented that there were "none other than ordinary course."[52] Gibbs admitted that he "had personally forgotten about [the] very existence" of the indemnities and was "shocked" by their discovery.[53] However, these indemnities were included in an appendix to a memorandum to Frontier from Andrews Kurth on April 23, 2003, but they seemed to have escaped the notice of Frontier's management until approximately two months later.[54]

(c) Due Diligence II: The Indemnities are Discovered

The fact that Frontier had indemnity obligations to the Beverly Hills Unified School District and Chevron, both named defendants in the Beverly Hills Litigation, came to the attention of Gibbs, Bechtol, and Robert V. Jewell, one of the Andrews Kurth lawyers representing Frontier, by at least June 30, 2003.[55] Interestingly, when three of Holly's lawyers from Carrington Coleman, including Ken Carroll, came to Frontier's offices the next day, July 1, 2003, Frontier was not immediately forthcoming with this information. Instead, Holly's lawyers were taken to a meeting room where Gibbs surprised them with an hour-long presentation regarding the corporate

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[52] Tr. at 736.
[53] Tr. at 95.
[54] F 174; Tr. at 551-52.
[55] Tr. at 91, 527, 841.

separateness defense.[56] This prepared presentation was also attended by Edwards, Bechtol, and Jewell, who chimed in with other information at various points, including the Canadian tax ruling which, Frontier claimed, showed the viability of the corporate veil between it and Wainoco.

While Carroll's chances to ask questions during the conversation were limited during the presentation, Carroll did ask several questions about various indemnities after Gibbs had finished. For instance, Bechtol confirmed that Wainoco had executed guarantees of the Beverly Hills High School leases when the leasehold interest had been acquired, something which Bechtol had originally indicated in an e-mail to Carroll on June 26.[57] After being informed of this, Carroll asked the following question, "Well, in light of that guarantee, does the parent, Wainoco Oil Corporation [Frontier], have a direct obligation to indemnify the school district or the city?"[58] The question was answered by a simultaneous "no" from Gibbs, Bechtol, and either Jewell or Edwards.[59] After the meeting, Frontier did not immediately produce the indemnity and guaranty documents, but instead Holly's lawyers

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[56] Tr. at 2239-40.
[57] Tr. at 2242-43.
[58] Tr. at 2243.
[59] *Id.* Carroll was uncertain if it was Edwards, Jewell, or both, because they were further down the table from him. Tr. at 2243-44.

were told that the ten to twelve boxes in the room contained all of the documents relating to Beverly Hills.[60]

In these boxes, the Carrington Coleman lawyers would find the following indemnities: the 1978 amendment to the 1959 lease of the oil wells which contained "kind of an oddball indemnification provision which required that the lessee indemnify both the city and the school district with respect to certain . . . challenges,"[61] an obligation subsequently undertaken by Wainoco and guaranteed by Frontier; the Wainoco's sale agreement with Venoco in 1995 which contained "cross indemnities or reciprocal indemnities between the buyer and the seller;"[62] and a consent agreement, signed with Chevron, whereby "Wainoco Oil & Gas had assumed the obligation to the lessee and Frontier . . . had guaranteed those obligation to the school district."[63]

One thing absent from the boxes was the 1959 lease of the property, although a number of the documents made reference to it. Carroll asked Bechtol for a copy, but he could not immediately produce it. It was sent to Carroll at his office the following day. The contents of the lease contained the very indemnity Gibbs and Bechtol had disclaimed the previous day with

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[60] Tr. at 771-72.
[61] Tr. at 2247.
[62] Tr. at 2247-48.
[63] Tr. at 2248.

their unison "no." As Carroll wrote in an e-mail to two other Carrington Coleman lawyers:

> And finally, I now have the '59 lease. Remember yesterday when I asked if WOC had a direct obligation to indemnify the City or School district and 3 of them answered "NO" in unison? Well, look at paragraph 24 of the '59 lease: "Lessee shall and hereby agrees to indemnify, defend, and hold Lessor harmless from all damages, costs, . . . arising out of or in any way connected with . . . the conduct of any operations hereunder. . . ."[64]

Discovery of the indemnities was critical for Holly. Dintzer advised the Board that the existence of the indemnities "[c]hanged the whole picture in terms of what Frontier could be facing as this litigation unfolded."[65] Existence of the indemnities essentially meant that the corporate shield defense was meaningless as Frontier now likely had a direct obligation to pay at least some of the damages and costs that might be incurred.

2. <u>The Lehman Brothers MLP Presentation</u>

Before entering into the Merger Agreement, Frontier had performed its own analysis of Holly's proposed MLP and had projected a value in the range of $140 million to $150 million.[66] On April 3, 2003, Gibbs and Edwards attended a meeting with Norsworthy and Clifton at Holly's offices in Dallas during which a presentation was given on the potential benefits of

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[64] H 386.
[65] Tr. at 1981.
[66] Tr. at 47.

the proposed MLP[67] by Holly's adviser, Townes Pressler. This slide-show predicted a current value of the MLP assets as $248.3 million. After this presentation, Gibbs told Edwards, "We got a good deal."[68]

Norsworthy was aware, around the time of the Merger Agreement and in the weeks following, that the market was "hot" for MLP assets such as those Holly could offer.[69] He also recognized that, as interest rates decrease, as they did during the period from March to summer 2003, the MLP would become more valuable.[70]

On June 23, 2003, Clifton received by e-mail a report, entitled "MLP Presentation" (the "Lehman Brothers MLP Presentation"), from Lehman Brothers.[71] This report contained both the Frontier and Holly logos in the margins; it does not appear that Lehman Brothers ever sent the report directly to Frontier. The Lehman Brothers MLP Presentation included the following chart, which showed a substantial increase in value from the $248.3 million set forth by Townes Pressler at the beginning of April:

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[67] Tr. at 48, 208, 452.
[68] Tr. at 52.
[69] Tr. at 1296-97.
[70] *Id*. at 1298.
[71] PX 220; Tr. at 2513.

Sources and Uses of Funds[72]

(*$ in millions*)

	Base Case	Case A
Sources		
IPO Proceeds	$114.60	$160.30
Debt Issuance	100.0	150.0
Total Sources	$214.60	$310.30
Uses		
Cash Distribution to Frontier	$203.70	$295.70
Estimated Transaction Fee	10.9	14.6
Total Uses	$214.6	$310.3
Pre-tax Value to Frontier		
Cash at IPO	$203.7	$295.7
Value of Retained Interest (at 7.19% yield)	142.8	199.9
	$346.5	$495.6
Pre-tax Value:		
Multiple of 2004E EBITDA	11.9x	12.0x
% of Holly Enterprise Value	75.8%	108.5%

In sum, this report predicted a value for the MLP assets of between $346 million and $495 million—more than double what Frontier had thought the value of the MLP effort was when the Merger was negotiated and, under Case A, double what Holly had thought the value was only two months earlier. Furthermore, under Case A, the value of the MLP exceeded the implicit valuation of the Merger by 8.5%. In other words, were this

[72] PX 220 at 00373 (footnotes omitted).

report believed, by completing the Merger and then proceeding with the MLP, Frontier would essentially be acquiring Holly's refineries for free.

The implications of the Lehman Brother's MLP Presentation were not lost on Clifton, who forwarded it to Jim Townsend, Holly's Vice President of Pipelines and Terminals, the following day, noting: "Although, [Lehman Brothers'] #'s maybe somewhat higher than they should be, look how high a value [they have for] the MLP worth post expansion/SLC related terminals/& exp. Rio Grande & interest."[73]

However, Clifton would also note that the Lehman Brothers MLP Presentation contained several errors and assumptions that resulted in overstating the value of the pipeline assets. For instance, he observed that the differences in value between the Base Case and Case A were the result of including in the MLP assets that Holly had acquired in 2003, the projected effects of expanding Holly's New Mexico refinery to increase flow through the pipeline, and an increase in debt.[74] Lehman Brothers had assumed that the interest expense, or cost of debt, was 7% and the yield to the unit holders, when the units were sold, was 9%; therefore, an increase in debt had the corollary effect of increasing value.[75] Even the Base Case

[73] PX 223.
[74] Tr. at 2514-15.
[75] *Id.*

assumed $100 million in debt which was $50 million more than assumed in the presentation from Townes Pressler.[76] Furthermore, Lehman Brothers had forgotten to include more than $4.5 million in expenses, related to such matters as corporate overhead, insurance and property tax, all of which would drive the value down by approximately $50 million.[77]

Clifton would eventually make handwritten notations on the Lehman Brothers MLP Presentation to correct for the errors he perceived, as well as to note where Lehman Brother's assumptions differed from those of Townes Pressler or included projected expansions.[78] Thus, simply taking into account the expenses Lehman Brother forgot to include, while leaving all other assumptions the same, Clifton would recalculate the projections from the Lehman Brothers MLP Presentation as follows:[79]

[76] PX 461 at 18; Tr. at 2517.
[77] Tr. at 2519.
[78] H 874.
[79] *Id*. at HC000883 (footnotes omitted).

Sources and Uses of Funds

(*$ in millions*)

	Base Case	**Case A**
Sources		
IPO Proceeds	$90.0	$136.0
Debt Issuance	100.0	150.0
Total Sources	$190.0	$286.0
Uses		
Cash Distribution to Frontier	$181.0	$274.0
Estimated Transaction Fee	9.0	12.0
Total Uses	$190.0	$286.0
Pre-tax Value to Frontier		
Cash at IPO	$181.0	$286.0
Value of Retained Interest (at 7.19% yield)	115.0	169.0
	$296.0	$455.0
Pre-tax Value:		
Multiple of 2004E EBITDA	11.9x	12.3x
% of Holly Enterprise Value	65.8%	101.4%

On July 3, 2003, Clifton e-mailed the original version of the Lehman Brothers MLP Presentation to Edwards along with the following message:

> Julie [Edwards]: I don't know whether you & Jim [Gibbs] got a copy of this latest analysis from Lehman. For some reason, they have EBITDA in both cases overstated by $4.4MM (didn't include some o/h & insur, etc.) which would lower enterprise values by roughly $40MM + more or less. Dollars are bigger than Townes presentation due to higher debt @ 7% and IPO

> assumed yield of 9%. Also case A includes the additional Rio Grande %, SLC terminals & expansion volume effects.[80]

While the Lehman Brothers MLP Presentation is a critical part of Frontier's repudiation case, I find as a matter of fact that no one on behalf of either Holly or Frontier accepted the projections at face value. For instance, Edwards, even after receipt of the Lehman Brothers MLP Presentation, believed the enterprise value for the MLP to be less than $280 million, and probably in the "mid 200s."[81] This is not inconsistent with the testimony of Clifton who put the value in the range of $275 million to $300 million[82] and Norsworthy who noted the increase in value from "the mid twos to the upper twos."[83]

O. *The Holly Board Meets on July 9*

The Holly Board met again on July 9 and received a status report on the Beverly Hills Litigation. Gibson Dunn informed the Board that defense costs alone would be substantial: early drafts of the Board's minutes indicate

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[80] H 534. Clifton was uncertain if he ever actually sent Edwards his handwritten changes to the calculations or if his e-mail was the only way he ever showed her what adjustments needed to be made to the analysis. Tr. at 2518-19.
[81] Tr. at 455-57.
[82] Tr. at 2522.
[83] Tr. at 1299.

they could be between $25 million and $40 million[84] and the final version indicates that a range of $40-$50 million was discussed.[85]

The Board also received a presentation from Fletcher Yarbrough of Carrington Coleman. He was introduced as having been hired to "undertake an independent review of the Beverly Hills situations. . . . in addition to the analysis being done by Gibson Dunn."[86] Yarbrough informed the Board that, based on what he had learned, Frontier was likely to be involved in the Beverly Hills Litigation through trial, and that it had direct contractual obligations to guaranty and indemnify other parties named as defendants in the Beverly Hills Litigation.[87] As Yarbrough put it, the existence of the indemnities and guarantees meant that there was no "silver bullet" to protect Frontier from substantial litigation costs and liability.[88]

The Board, as might be expected, did not relish this news. For instance, Norsworthy expressed concern about Frontier stock "with this big, black cloud hanging over it."[89] Similarly, Clifton "felt pretty uncomfortable personally about [the March 30] deal" and was unwilling to move forward

[84] PX 271 at 4.
[85] PX 264 at 4. Frontier argues that these changes show that the "Board Minutes" are a record created for this litigation. I need not resolve the issue, although the practice of delaying the final form of board minutes, unfortunately and perhaps unnecessarily, raises some doubt about their reliability.
[86] PX 271 at 6, 8.
[87] H 387.
[88] PX 265 at 7, 8.
[89] Tr. at 1259.

"without something that Frontier could bring to the table to mitigate the concern over Beverly Hills."[90] Board member Jack P. Reid ("Reid") recalled that he had "greatly increased" concern over the indemnities, but believed that Holly would "probably be able to reach some type of agreement with Frontier" to address these concerns.[91]

During the course of the meeting, the Board considered issuing a Material Adverse Effect ("MAE") notice, but it ultimately rejected that course of action in favor of instructing Holly management to report its concerns to Frontier and to engage in a dialogue about those concerns.[92] While the record is clear that the Holly Board did not change its recommendation or determine that an MAE notice should be sent on July 9,[93] the record is also clear that, after the July 9 Board Meeting, Holly likely would not proceed to closing on the Merger Agreement in accordance with its express terms. This is not to suggest that Holly had repudiated the Merger Agreement; instead, it still had multiple options available to it, if Frontier did not adequately address its concerns, including declaring an MAE, exercising its fiduciary out, or seeking a mutual termination.

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[90] Tr. at 2631.
[91] Tr. at 2114-15.
[92] PX 262 at 15.
[93] Tr. at 1400-01; 1528–30; 2071-72; 2117-18.

P. *Holly and Frontier Meet on July 9*

Immediately following the July 9 Board meeting, Norsworthy, Glancy, and Clifton flew (in a thunderstorm) from Dallas to Houston to convey the Board's concerns to Frontier. There, they met with Gibbs, Edwards, Bechtol, and Jewell. What happened at this meeting is the subject of some debate. Holly asserts that Frontier management was informed of the Holly Board's concerns and was presented with three options (1) restructuring the deal; (2) declaration of an MAE regarding the Beverly Hills Litigation; or (3) mutual termination. Frontier claims that, while Holly indicated its concerns, it was less than clear as to what options were available to accomplish the closing. The record is clear that at one point either Norsworthy or Glancy mentioned the possibility that the Beverly Hills Litigation could be an MAE to which Jewell responded that he "respectfully disagreed."[94] Thus, while that exchange was short, lasting less than thirty seconds, the possibility of Holly's declaring an MAE and ending the transaction was expressed to Frontier at the meeting.[95]

Q. *Frontier Decides to Renegotiate the Merger Terms*

Regardless of precisely what was said and what options were presented to Frontier at the July 9 meeting, the effect of it is clear—Frontier

[94] Tr. at 1708-09, 533-34, 1411.

[95] Neither side sought to discuss the MAE question in greater detail.

was placed on notice that, unless Holly's concerns were in some way assuaged, Holly would not proceed to closing under the Merger Agreement. For instance, Gibbs testified that "Mr. Norsworthy told [Frontier management] that his board would not—was very concerned about Frontier's stock and taking—taking the Frontier stock that we had in the original deal."[96] In his deposition, he more clearly stated his understanding following the July 9 meeting that "Holly was not going to go forward with the merger based upon the March 30th agreement."[97] Similarly, Edwards testified that she "understood on July 9 that it was very unlikely, if [Frontier] didn't do something, that Holly was going to proceed to a closing."[98] Likewise, Bechtol recalled that he left the July 9 meeting thinking "that the business folks were going to need to get together and start trying to work towards some sort of renegotiation."[99] Jewell perhaps put it most clearly of all by testifying that following the July 9 meeting "the ball was in our court to come up with some ideas . . . . [and] if we wanted to keep the deal together, we thought we would have to restructure."[100]

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[96] Tr. at 348-49.
[97] Tr. at 347-49; Gibbs Dep. at 168–69.
[98] Tr. at 470.
[99] Tr. at 853.
[100] Tr. at 537. Gibbs testified that, at the conclusion of the meeting, Norsworthy said, "We still have a deal." Tr. at 64. Edwards testified that both parties said this, Tr. at 387, and Jewell testified that someone from Holly, probably Norsworthy,

The reasons for Frontier's willingness to renegotiate, instead of holding Holly to its deal, were best expressed by Gibbs:

> Q. Why didn't you just say to Mr. Norsworthy on July 9, "Hold on, Lamar. You signed a deal, and a deal is a deal and you're going to live by that or else?"
> A. You know, *we had transactions put together here that we—you only live once or twice for*. You only get to these where it makes so much sense for your shareholders, their—Holly shareholders, for Wall Street, for the bondholders, for employees. When you put the two companies together, creative form or fashion, helps the balance sheet, creates a real competitive power in the Rocky Mountains in an industry that's dominated by majors.
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> We wanted to do this transaction—this transaction badly. We knew we had a good deal. We knew we had significant value for our shareholders going forward if this thing got closed. And we knew that we had quite a bit of leeway as far as being able to accommodate and sweeten and still maintain a good trade for our shareholders. And if [the Lehman Brothers MLP Presentation] was correct, had to assume it was, then the difference between the valuation that we had and this number, $250 million.
>
> So yes, we didn't want to lose the deal. We thought it was good for everybody going forward. Wall Street loved it. We had quite a bit of leeway in order to move up both the cash portion and the stock portion that we had. *In the back of my mind was if—if the new valuation, even on an apple-to-apple*

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said, "We do still have an agreement." Tr. at 534-35. Holly's witnesses have neither agreed with nor refuted this. Frontier has asked for a specific factual finding that this was in fact said. Whether or not this was said, it was the clear understanding of Frontier's management after the meeting—that the terms of the deal needed to be altered in order for the Merger to occur. Thus, this "we still have a deal" statement, if uttered, would only indicate Holly's desire to find terms for a merger that were satisfactory to both parties. More likely, it reflected Holly's expectation that a solution could be found. This statement, of course, would not have prevented Holly from using any of the exit provisions in the Merger Agreement if its concerns were not met.

> *basis of between $114 to $140 million of additional volume has been discovered here, Holly could at that point in time simply slip us $16 million and walk out into the sunset.* Rather than have that happen, we were willing to go forward with a restructured deal.[101]

Thus, Frontier's decision to renegotiate was based on both its perception of an increase in MLP value in which it wanted to share and its knowledge that if Holly was not satisfied with the deal, it had an available exit strategy (and a relatively cheap one if the Lehman Brothers MLP Presentation were believed) under the Merger Agreement. This is the back-drop against which the subsequent negotiations took place.

From July 9 to August 5, the parties engaged in protracted negotiations regarding how to restructure the transaction. These negotiations would eventually yield at least four models for a restructuring, all of which would be rejected, by one party or the other, for various reasons.

R. *The Put Proposal*

On July 17, the parties met in Dallas and held a lengthy "brainstorming session" during which several proposals were discussed, including an all-cash deal with upside participation for Holly shareholders,[102] a "synthetic" put with a financial institution, and a

[101] Tr. at 66-67 (emphasis added).
[102] Tr. at 72.

combination of cash, notes, and warrants.[103] They agreed on a restructuring under which, for a period after closing, Holly shareholders would be able to "put" their shares back to Frontier at a fixed price (the "Put Proposal"). The Put Proposal would have given Holly shareholders protection against Beverly Hills Litigation in that, should the litigation drive the price of Frontier stock down, they could "put" the shares received in the Merger back to the surviving company at a guaranteed minimum price for a limited time following the Merger.[104] If the Beverly Hills Litigation resolved itself or Frontier stock rose above that price, Holly shareholders could also participate in the appreciation in value.[105] At the conclusion of the meeting, Frontier directed Andrews Kurth to work out the mechanics of the Put Proposal and to draw up a term sheet.

Frontier, however, backed away from the Put Proposal several days later after Gibbs and Edwards discovered that the puts would have to be recorded as Frontier debt. Gibbs did not want to "leverage [Frontier's] balance sheet."[106] He explained his concerns:

> This is a very capital-intensive business that also has a very large amount of working capital. A lot of that working capital is financed through trade terms. And even though it's very

[103] Tr. at 1264-65.
[104] Tr. at 1266.
[105] *Id*.
[106] Tr. at 73.

> large, it's very small as far as participants. Once you become overleveraged and illiquid, all that trade credit dries up; and many companies have found themselves in pretty sad situations by overleveraging, getting illiquid and have a commercial trade credit dry up.[107]

S. *The Canoe Proposal*

Frontier's rejection of the Put Proposal was communicated to Holly, along with another restructuring proposal under which Holly would implement the MLP before the Merger and the proceeds from the MLP placement would be used to finance an all-cash transaction for the Frontier-Holly Merger (the "Canoe Proposal").[108] In effect, under the Canoe Proposal, Holly was expected to pay the purchase price for the benefit of Frontier with its own money. This proposal infuriated Norsworthy, who had been expecting a final term sheet on the Put Proposal. In a phone call to Edwards on July 21, Norsworthy rejected the Canoe Proposal, saying, "[W]hy would I need Frontier if I can do that? I can sell my own pipes. I can paddle my own canoe."[109]

The following day, after Norsworthy had calmed down, he called Edwards again and proposed a transaction which Glancy and he had formulated. This transaction would involve "moving the boxes" or finding a

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[107] *Id.*
[108] Tr. at 395; 1267-68.
[109] Tr. at 395.

way to organize the various entities in such a way that Frontier's potential liability would stay with Frontier stockholders and Holly's shareholders would be insulated from any potential exposure.[110] While Edwards initially thought this was "a good idea" with "some feasibility," it was ultimately not pursued, most likely because of difficulties encountered in assuring the desired result.[111]

T. *The July 29 Proposal*

Another concept was a cash/stock election option—a merger structure under which the stockholders of Holly would have a choice between the original deal and one with more cash and less stock. Clifton faxed this proposal to Edwards on July 29 (the "July 29 Proposal")[112] after he had reviewed it first with Norsworthy, Paul Stoffel, a Holly director, and Robert Wheeler) of Credit Suisse First Boston.[113] This approach essentially converted the transaction from a merger to an acquisition. It eliminated the concept of a shared board and management structure and increased the cash consideration. The pertinent terms were as follows:

> 2. Holly Corporation shareholders can pick one of the two following options subject to a maximum cash outlay from [Frontier ("FTO")] of $275MM (Over-subscription of

[110] Tr. at 397-98; 1268-69.
[111] Tr. at 397-98.
[112] PX 294.
[113] Tr. at 2643.

"Option 2" will be prorated back to "Option 1" on equal basis to keep below maximum cash outlay of $275MM).

Option 1

Cash	$11.11
FTO Stock	1 Share
CVR	1 CVR

Option 2

Cash	$18.11
FTO Stock	½ Share
CVR	1 CVR

Note: As long as FTO stock value is above $14 per share when election is made, there would be an economical incentive to pick "Option 1."

3. CVR – Original CVR is modified by adding the following right to the jet fuel claim right:

   CVR holders will receive a payment equal to 50% of the "value" receive by FTO from the sale of "Holly Corporation's Pipeline and Terminal" assets to a third party or to a new MLP formed by FTO in excess of $250 MM, but less than $350 MM, plus 40% of the "value" receive by FTO in excess of $350 MM.

   In the event that FTO does not sell "Holly Corporation's Pipeline and Terminal" assets to a third party or a newly formed MLP within 18 months from the date of the merger, the CVR holder will receive a payment equal to $4 per share.[114]

Edwards liked this plan.[115] From July 29 through August 5, the parties worked hard to adapt the July 29 Proposal into a form that would be

[114] PX 294.
[115] Tr. at 398.

acceptable to all involved. Indeed, Edwards recalls "the last half of July as a blur of conversations and different things [they] were trying . . . to . . . solve the problem."[116] Similarly, Clifton's desperation to close the deal is reflected in an e-mail sent to Edwards on August 1:

> I can't stress how important it is to get a proposal ASAP. If we blow another week I don't know if it will stay together. *Again, I'll go anywhere, any time to try to resolve outstanding issues.* . . . Let's keep it going to see if we can get there. Even I am losing patience.[117]

U. *The Denver Agreement*

The parties came to an agreement on August 5, 2003 in Denver (the "Denver Agreement"). The meeting was among Holly and Frontier's senior management and financial advisors, but without lawyers. The Denver Agreement differed from the July 29 Proposal: Holly stockholders could elect to receive all stock or all cash; the cash portion of the deal was raised from $172.5 million to $210 million;[118] Holly shareholders would receive a contingent value right equal, in the aggregate, to 35% of the consideration which Frontier would receive from the MLP to the extent that it exceeded $280 million. Under this deal Holly stockholders could elect to receive $28.25 in Frontier stock, or $27 in cash, subject to a $210 million cash

[116] Tr. at 394.
[117] F 549 (emphasis added).
[118] Tr. at 1451.

limit.[119] Assuming full proration, this was an increase of approximately $2 per share for the Holly stockholders over the March 30 deal.[120]

At the conclusion of the meeting, both sides agreed to take the Denver Agreement back to their respective boards. Norsworthy committed to support the transaction before the Holly Board.[121] According to George C. Morris, III, Frontier's financial advisor from Petrie Parkman, "[Gibbs] looked across the table to [Norsworthy] and said 'Lamar, do we have a deal? Is this a deal that you'll do?' And [Norsworthy] said 'Yes, that's a deal I'll do.'"[122] The parties then called their lawyers to discuss the terms of the deal and to begin the document preparation process.[123] According to Morris, at the end of the meeting "[e]verybody was feeling very good, because it was a very stressful situation going into this thing, but now everybody felt relieved that we had solved the problem."[124] That feeling would not last long.

V. *On the Road to Banff*

The night of August 5, Norsworthy would fly from Denver to Calgary. Upon his arrival, he was driven to Banff—a ride of about two

[119] Tr. at 81; PX 319.
[120] Tr. 84-85; 1451; PX 319.
[121] Tr. at 1443.
[122] Tr. at 651.
[123] Tr. at 86-87.
[124] Tr. at 651.

hours. During this ride, Norsworthy began to have second thoughts about the Denver Agreement:

> I was sitting in the back thinking about it. And I don't know why I was so dumb that it didn't occur to me earlier; but the more I though about it, I felt, you know, this thing feels kind of funny, that you've got a deal here where you're inducing stockholders to take Frontier stock and all of the liability of Beverly Hills, if there is any, and you're structuring such a way that the insiders maybe can get all cash and outsiders, who don't know anything about it, are going to end up with Frontier stock, and is this the right kind of thing to do . . . .[125]

Norsworthy's concerns were further compounded by the limited disclosure Frontier had given its stockholders concerning the Beverly Hills Litigation:

> Frontier disclosed very little about what we thought we knew about this thing, the indemnities and everything was closed; and that if we were to proceed with this deal we were talking about, that clearly all this—all this we would have to try to make an effort to disclose all this stuff—as to the stockholders. And by people being focused on this stuff, nobody in their right mind would want to take [Frontier's] stock. They would want to take the cash, and there wouldn't be enough cash to satisfy anybody. If they didn't disclose—well, it was just something we couldn't do.[126]

Norsworthy had come to realize that by making the Denver Agreement he had shirked his fiduciary responsibilities to his shareholders; he was concerned about his personal liability if the transaction were to close on these terms. He and his associates had intended to take the cash option,

[125] Tr. at 1275.
[126] Tr. at 1276-77.

in essence, hoping that enough of the other (*i.e.*, less-informed) Holly shareholders would take Frontier stock. If not enough of Holly shares were tendered for stock, then the cash Frontier would make available would not be adequate to assure Norsworthy and the others that they would not be "stuck" with Frontier stock.[127] The topic of personal liability was again stressed the following day, August 6, in conversations Norsworthy had with Glancy and Robert G. McKenzie, another Holly director. As Norsworthy stated in his deposition, by this point, the Denver Agreement was effectively "DOA."[128]

W. *Holly and Its Lawyers Gather*

On August 11, Glancy convened a meeting involving nine different outside lawyers to evaluate Holly's rights under the Merger Agreement. The lawyers discussed declaring an MAE and the effect of issuing a press release

[127] Holly's public shareholders would have been able to trade freely their new Frontier stock upon the Merger. The risk that Norsworthy faced (in addition to potential liquidity problems resulting from his status as an insider if he received a substantial portion of the Merger consideration in new Frontier stock) was that the public shareholders who held onto their new Frontier stock would subsequently pursue him and the other Holly insiders who took the all-cash option, in the event that the new Frontier stock fared badly. They, it was feared, would argue that Holly's insiders, buoyed by misleading public disclosures and aided by their own insights, had duped the public shareholders into taking new Frontier stock, thereby allowing Norsworthy and the other Holly insiders to escape with nothing but cash.

[128] Norsworthy Dep. at 298.

relating to an MAE.[129] A draft MAE notice letter and a draft press release were prepared shortly thereafter.[130]

X. *The All-Cash Proposal*

On August 12, the Holly Board gathered to consider the Denver Agreement. It also received an update on the Beverly Hills Litigation, which by this time had expanded to three separate lawsuits on behalf of over 400 plaintiffs. Gibson Dunn reiterated that the litigation was serious and predicted defense costs in the range of $40 million to $50 million simply to prepare the first case for trial with ultimate exposure potentially in the range of $500 million to $1 billion.[131]

Norsworthy, after his drive from Calgary to Banff, did not endorse the Denver Agreement, and the Holly Board, not surprisingly, rejected it. The Board continued to have concerns about a transaction involving Frontier stock and instead determined to ask Frontier to accept an all-cash proposal. Holly's Board was advised that Frontier could finance an all-cash transaction, but the Board also authorized Holly management to help finance such a transaction.

[129] Tr. at 1724.
[130] Tr. at 1724-25.
[131] H 55 at 381.

Immediately following the August 12 board meeting, Norsworthy, Clifton, Holly director Stoffel, and advisor Vestor Hughes called Gibbs and informed him of the Holly Board's rejection of the Denver Agreement and proposed an all-cash transaction of $28 per share. Holly also advised Gibbs that Holly would provide bridge financing for the transaction and no longer expected to participate in the upside of the MLP. Gibbs testified that:

> I told them that we had a discussion in the past about taking all cash. We had pretty much eliminated that as an option. I had told Paul Stoffel that on a telephone conversation with him a week before. And *I didn't think that this was something we could do*. We had already considered it and determined that, *but we would look at it and get back in touch with them*.[132]

Gibbs would then consult with Edwards and Frontier's bankers about the all-cash proposal. Edwards testified that hearing that the Denver Agreement had been rejected "was like being kicked in the stomach."[133] Between August 12 and 19, Edwards and Clifton would have numerous discussions about the latest proposal; Edwards would run multiple models on it, but her response to Clifton would be that "it would be really risky and imprudent to overleverage Frontier" to close the transaction.[134]

[132] Tr. at 101-02 (emphasis added).
[133] Tr. at 411.
[134] Tr. at 411-12.

Gibbs testified that the proposal would make Frontier "75 percent debt" which was "awfully dangerous."[135] At some point he called Stoffel and communicated his concern about taking the debt required for the transaction because "of the impact on [Frontier's] balance sheet and liquidity and the perception it would create in the debt markets, equity markets, and the oil markets."[136]

Y. *Frontier and Its Lawyers Develop a Strategy*

Other than his conversation with Stoffel, Gibbs would have no communication with Holly. He would instead be taking the first steps which would lead to this litigation. On August 18, Gibbs met with Richard Caldwell of Andrews Kurth to begin planning to sue Holly. At this meeting Gibbs heard the word "repudiation" applied to this matter for the first time.[137] Caldwell provided Gibbs with a script of questions to ask Norsworthy when they next talked. This script would be used the following day.

Z. *The August 19 Phone Call*

Holly had heard nothing from Gibbs regarding the all-cash proposal since making it on August 12. Thus, on August 18 Holly contacted Frontier

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[135] Tr. at 104.
[136] *Id.*
[137] Tr. at 163.

and arranged a telephone call with Gibbs for the following day. On August 19, the phone call between Gibbs and Norsworthy took place (the "August 19 Phone Call"). Edwards was with Gibbs in his office in Houston and Norsworthy was with Clifton in Dallas. This phone call is the crux of Frontier's claim that Holly repudiated the Merger Agreement. Gibbs took notes of this conversation as it transpired, then recopied these notes into a final form (the "Transcript"),[138] and discarded the original. The full text of his recopied version of the Transcript is as follows:

HOLLY PHONE CALL – 8/19/02
2:00 p.m. CDT

1. Attendees (assumed)
   Holly – Lamar Norsworthy
   Matt Clifton
   Frontier – JRG [Jim Gibbs]
   JHE [Julie Edwards]

1. After a few cordial addresses got right to business
2. JRG – "what's up"
3. Lamar – reiterated that Holly wanted an all cash deal and not agreed to deal.
4. JRG – explained that this was discussed with Paul (Stoffel) last week and that it was impossible for us to do an all cash deal. I explained again why we could not do it and drew the analogy to Tesoro's experience during the last 2 years.
5. I asked then what he proposed – nothing substantive came out.
6. I then explained that [Frontier's] position was that "we liked the signed and agreed to deal, thought that we still had an agreement and it and its terms were still effective, [Frontier] would abide by its terms and expected Holly to do likewise, expected final comments

[138] PX 355.

from the SEC on Thursday, Friday or Monday—would be preparing to go effective and mailing proxy shortly.

7. Lamar then stated that "his Board was not prepared to recommend the transaction to their shareholders."
8. I then asked Lamar and asked him to listen carefully "Is your Board no longer willing to do or support our signed deal on its existing terms?"

   He clearly, unambiguously, distinctly and unequivocally responded "No [they are not][139]
9. I repeated this for the second time."
10. I asked Lamar then what amended terms would they support? Lamar responded "all cash"
11. I told him that was not possible.
12. I asked Lamar if we could provide insurance for the suit would this board support the existing deal. He responded that if the insurance was provided by a big well funded insurance company like AIG and the terms it contained were acceptable they might consider it.

    When asked what terms and conditions were acceptable, he responded whatever claims and forever terms.

    This is clearly impossible to provide. There was no reason to continue.
13. The meeting then concluded.

As Gibbs testified, this is not a complete or accurate transcription of what was said; statements that he considered "unimportant" were not recorded.[140] The Transcript clearly shows the influence of a meeting with a lawyer.

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[139] The last part of this, "[they are not]," was not said by Norsworthy but was added by Gibbs to the "Transcript" for "clarification."
[140] Tr. at 170-171.

While much of the conversation between Gibbs and Caldwell was cloaked in privilege,[141] Gibbs did testify that he received the questions on line 8 and 10 of the "Transcript" from Caldwell.[142] Furthermore, Gibbs also received the words characterizing Norsworthy's answer, "clearly, unambiguously, and unequivocally" from Caldwell, before the statement was given.[143] In fact, Gibbs had this characterization already written down on a separate sheet of paper.[144] Gibbs explained his "choice" of words:

> Q. As a straight-talking, boot-wearing Texan who does not speak legalese, is this how you talk? Clearly, unambiguously, distinctly, and unequivocally, is that an example of the manner in which you speak?
> A. No.
> Q. Well, pray tell, why is it written in that fashion?
> A. That was information that I got from my attorneys.[145]

Norsworthy's recollection of the phone call, while essentially similar, does contain some differences. For instance, Norsworthy testified that Gibbs asked him, '"Are you prepared to proceed with the transaction we executed on . . .'—whatever it was—'. . . March the 30th.'"[146] Norsworthy agreed

[141] The Court draws no inference from the exercise of the attorney-client privilege. Both Frontier and Holly asserted their privilege from time-to-time during this proceeding.
[142] Tr. at 166.
[143] Tr. at 167-68.
[144] Tr. at 168.
[145] Gibbs Dep. at 202-03.
[146] Tr. at 1288.

with Gibbs that he answered "no."[147] Norsworthy testified that he discussed the Board's continued reluctance to take Frontier stock with "the Brockovich problem hanging over them."[148] Norsworthy also recalled that Gibbs asked if he would be willing to talk to Frontier's outside counsel about the Beverly Hills Litigation.[149]

His version of the insurance discussion was also quite different:

> A. At some point in time [Gibbs] asked me would insurance solve the problem. And I said, "well if there is a triple A rated company, and it would take care of the Beverly Hills situation, I'm sure that would solve it."
> Q. How did he react to that?
> . . . .
> A. His question was: "What if it was something less than that?"
> Q. How did you react?
> A. My answer was, like it usually is, "we just have to look at it, Jim."[150]

Importantly, Norsworthy also stated that he would have Holly's lawyers at V&E contact Frontier's Andrews Kurth lawyers "to figure out what [to] do next."[151] That Norsworthy indicated the lawyers should talk to each other, which is not in the Gibbs' Transcript, was confirmed by Edwards.[152]

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[147] *Id.*
[148] Tr. at 1288.
[149] Tr. at 1289. Edwards also recalled this portion of the conversation. Tr. at 487.
[150] Tr. at 1288-89
[151] Tr. at 1290.
[152] Tr. at 489. Interestingly, Edwards, who testified that she was sitting within five or six feet of Gibbs during the August 19 Phone Call, did "not recall" seeing him take notes during it. Tr. at 487.

AA. *Frontier Claims Repudiation and Files Suit*

On August 20, 2003, the day after the phone call, Frontier filed this action. Shortly after the complaint was filed, but before Holly had learned of it, Clifton sent Edwards the following e-mail:

> Julie: Wheeler called me this morning and said that you had told him [Frontier] got insurance re: the Ca case. If this is so we should have a discussion on the coverage etc to see if this mitigates the Board's concerns. Stoffel's has called numerous times this morning and would be quite anxious to review any coverage you could obtain.[153]

Edwards responded by calling Clifton and letting him know that "it [was] too late" because a lawsuit had been filed.[154] She also forwarded him a copy of the Complaint within nine minutes of his e-mail.[155]

Around the same time Edwards was informing Clifton about the suit, Gibbs was leaving the following voicemail for Norsworthy:

> Lamar this is Jim, Jim Gibbs. I'm sorry I didn't get a chance to talk to you but I tried. At any rate what I was trying to do was give you a heads up and tell you what was happening. As you know we've been[,] really been[,] working diligently to try to come up with some type of alternative or amendment to our existing agreement that would satisfy you and certain of your directors so that we could get this transaction going. But yesterday in our conversation you clearly and unequivocally stated that the Holly Board of Directors were not willing to proceed with or support the merger under its existing terms. So that essentially represented a repudiation of our agreement.

[153] PX 359.
[154] Tr. at 2553, 492.
[155] H 872A.

> That leaves us no alternative and we have already filed in the last 10 minutes a lawsuit in Delaware court to protect our shareholders' interest. That's about the only thing we could do. I tell you that this is the first time in 22 years that we've ever filed a lawsuit and I hate that it's going to be between Frontier and Holly. I really have grown to appreciate the staff at Holly and you and Lamar . . . you and Matt particularly. Really enjoyed you two guys. I'm certainly sorry that we couldn't get together to come up something that would work. I'm still a big proponent for this merger. I think it would represent a hell of a company. That I'm sorry that we just can't get your directors comfortable with the transaction. So . . . . Give me a buzz if you have any questions. Again I wanted to give you a heads up, heads up. This will hit the wire in about probably 10 or 15 minutes. I suspect the New York Stock Exchange will stop trading on our stock. You all might act accordingly. Talk to you later. Thank you.[156]

BB. *Holly Gives Its MAE Notice*

On August 21, 2003, Holly sent Frontier a letter[157] in which it asserted that Hilly had breached its representations in Section 4.8 and Section 4.9[158] of the Merger Agreement. In essence, Holly claimed that the Beverly Hills Litigation would have a Frontier MAE.

CC. *Frontier Abandons the Merger Effort*

After filing suit, Frontier stopped taking the actions necessary to implement the Merger Agreement. For instance, it refused to proceed with

[156] PX 361A.
[157] PX 365.
[158] Section 4.9 of the Merger Agreement is set forth *infra* note 220.

the preparation of the financial information required by securities laws[159] and declined to respond to an SEC comment letter.[160]

DD. *Frontier Procures Insurance for Beverly Hills*

On September 30, 2003, Frontier was able to obtain insurance for the Beverly Hills Litigation from an AIG affiliate. Under the terms of the insurance agreement, Frontier would be covered for five years from any bodily injury, property damage, or potential contractual indemnity claims for all amounts up to $120 million in defense costs and liability payments.[161] For this coverage, Frontier had to pay a risk transfer premium of $5.75 million and place $19.5 million in a commutation account, in addition to various fees and costs.[162] The insurance coverage was layered. For the first $40 million of covered claims Frontier did not have any co-insurance requirement, although the first $19.5 million in costs would be taken out of the commutation account. Between $40 million and $41.5 million Frontier would be responsible for all payments, and from $41.5 million to $120 million Frontier would incur the first 3% of the claims. After $120 million, of course, Frontier would be uninsured. On each anniversary of the policy, Frontier could commute the account, or cancel the insurance, and be

[159] F 789.
[160] F 958.
[161] PX 406.
[162] Tr. at 1087.

refunded the unused portion of the commutation account, as well as a portion of the risk transfer premium.[163]

EE. *Holly Offers Its Pipeline Assets*

On March 15, 2004, Holly issued the S-1 for its MLP transaction. It projected a unit price of $22.25, for, according to Frontier, approximately $335 million in value.[164] When the offering closed in July 2004, the unit price was $23.50.[165] Holly notes that the market value of such MLP transactions generally increased between March 2003, when the Merger Agreement was executed, and Holly's closing on its MLP transaction.[166]

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[163] Tr. at 1088-89.

[164] Frontier's Mot. to Reopen Ev., at Ex. B, 2.

[165] Frontier's Mot. to Take Judicial Notice, at ¶ 3.

[166] The parties have debated how to compare the value of the MLP transaction closed in July 2004 to the various values ascribed by the participants after the Merger Agreement. The assets to be included and the debt to be assumed, which would vary from projection to projection, would have had a significant impact. One can debate minority discounts and control premiums. Developments in the financial markets, such as lower interest rates, also would come into play. Fortunately it is not necessary to resolve this fascinating debate with any precision. The increase in value that could be achieved through an MLP offering of Holly's pipeline and terminal assets exceeded significantly the $16 million payment to Frontier that would accompany Holly's exercise of its fiduciary out. Frontier assumed, before the Merger, that an MLP would generate perhaps $150 million, but it realized, in early April 2003, that $250 million might be the more accurate number. By July 2003, Holly (depending upon which Holly representative) viewed the value as somewhat less than $300 million. During the ensuing six months or so, it would grow to more than, on a roughly equivalent basis, $330 million.

II. CONTENTIONS

A. *Frontier's Perspective*

Frontier first asserts that Norsworthy's statements during the August 19 Phone Call demonstrated that Holly repudiated the Merger Agreement. That allowed Frontier to declare a breach of the Merger Agreement and to sue for contract damages. Because of the favorable deal that it had negotiated, the increase in value associated with Holly's pipeline assets, and the more than $20 million spent by Frontier in support of the Merger, Frontier claims a right to recover in excess of $160 million.

In addition to its repudiation claim, Frontier contends that Holly breached the covenant of good faith and fair dealing implicit in every contract governed by Delaware law. According to Frontier, the Lehman Brothers MLP Presentation in June persuaded Norsworthy, who may already otherwise have reached the same conclusion, that he had made a very bad bargain. Holly used the Beverly Hills Litigation as a pretext for renegotiating the Merger Agreement and to drag out the process; the objective was to delay until the "drop dead" date at the end of October and, thus, to avoid all potential exposure.

Finally, Frontier asserts that the Holly Board's decision, as early as July 9, not to proceed to closing entitles it in accordance with the Merger

Agreement, and especially in a court of equity, to an award of the break-up fee.

B. *Holly's Perspective*

Holly takes the position that the August 19 Phone Call cannot form the basis for a repudiation claim because there was no clear and unequivocal expression of intent not to comply with the Merger Agreement. Norsworthy told Gibbs that there would be no deal, but the "deal" was the exchange of one Holly share for one Frontier share, $11.11, and a CVR. Frontier, however, is not suing for breach of that "deal." Instead, Frontier is suing for breach of the Merger Agreement and the Merger Agreement, even as of the August 19 Phone Call, entitled Holly to exit either by declaring an MAE or other breach of warranty or by exercising its right to a fiduciary out. Norsworthy, Holly claims, informed Gibbs that it was "up to the lawyers," thus conveying the notion that it was time to evaluate the various exit strategies. In short, Holly did not refuse to perform its duties under the Merger Agreement.

Holly also argues that Frontier breached its representations and warranties in the Merger Agreement with respect to the then-threatened Beverly Hills Litigation and the existence of a Frontier guarantee of its subsidiary's obligations. Specifically, it asserts that the threatened litigation

would have or would reasonably be expected to have (or that Frontier must and cannot prove otherwise) an MAE.

Holly points out that a wrongful repudiation is also a breach of contract. That, in addition to Frontier's misrepresentations, authorizes Holly to recover damages that it has incurred. Holly's damage claims focus on the lost opportunity to acquire to Conoco/Phillip's refinery in Denver, its loss of favorable small refiner status with respect to its sale of aviation fuel, and the substantial costs that it incurred as it pursued closing under the Merger Agreement.

Holly, furthermore, has a different view of the efforts to renegotiate. It concedes that, as of the July 9 meeting in Houston, it was not likely to close under the express terms of the Merger Agreement. This reluctance resulted from growing concerns over Frontier's potential exposure in the Beverly Hills Litigation and the accompanying risks involved in acceptance of Frontier stock. Far from breaching the covenant of good faith and fair dealing, Holly made reasonable and well-intentioned attempts to salvage the transaction.[167]

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[167] Both parties have applied for an award of attorneys' fees. Because those applications have not been fully developed, the Court defers decision of that aspect of this proceeding.

III. ANALYSIS

A. *Principles of Contract*

This case is about a contract.[168] "[T]he Court first looks to the express terms of the contract to see 'whether the parties' intent can be discerned' from those terms. If the terms of the contract are clear on their face, the Court will give those terms the meaning that 'would be ascribed to [them] by a reasonable third party.'"[169] If, however, the contract is "reasonably or fairly susceptible of different interpretations or may have two or more different meanings,"[170] it is ambiguous, and the Court will resort to extrinsic evidence to ascertain the "reasonable shared expectations of the parties at the time of contracting."[171] The extrinsic evidence may include "the overt statements and acts of the parties, the business context, prior dealings between the parties, and other business customs and usage in the

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[168] The Merger Agreement is to "be governed by and construed in accordance with the laws of the State of Delaware." Merger Agreement, Section 8.6 (original in capitals).

[169] *BAE Sys. N. Am., Inc. v. Lockheed Martin Corp.*, 2004 WL 1739522, at *4 (Del. Ch. Aug. 3, 2004) (quoting *Comrie v. Enterasys Networks, Inc.*, 837 A.2d 1, 13 (Del. Ch. 2003) & *True N. Communications, Inc. v. Publicis, S.A.*, 711 A.2d 34, 38 (Del. Ch. 1997), *aff'd*, 705 A.2d 244 (Del. 1997)) (footnotes omitted).

[170] *Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1196 (Del. 1992).

[171] *Comrie*, 837 A.2d at 13.

industry."[172] In addition, the Court must strive to "interpret contractual provisions in a way that gives effect to every term of the instrument, and that, if possible, reconciles all of the provisions of the instrument when read as a whole."[173]

B. *Did Holly Repudiate the Merger Agreement?*

An "unequivocal statement by a promisor that he will not perform his promise" is the essential underpinning for a repudiation claim.[174] Repudiation occurs upon "an outright refusal by a party to perform a contract or its conditions."[175] A party may be treated as having repudiated his contract if he announces his refusal to perform under the contract "unless terms different from the contract are met."[176]

The Merger Agreement, of course, was not an ordinary contract. Before the Merger could occur, the shareholders of Holly had to approve it. The directors of Holly were under continuing fiduciary duties to the

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[172] *In re Explorer Pipeline Co*., 781 A.2d 705, 714 (Del. Ch. 2001) (quoting *Bell Atl. Meridian Sys. v. Octel Communications Corp*., 1995 WL 707916, at *6 (Del. Ch. Nov. 28, 1995)); *see also Cincinnati SMSA, L.P. v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 993 (Del. 1998).

[173] *Council of Dorset Condominium Apartments v. Gordon*, 801 A.2d 1, 7 (Del. 2002).

[174] *Carteret Bancorp, Inc. v. The Home Group, Inc.*, 1988 WL 3010, at *5 (Del Ch. June 13, 1988) (citing FARNSWORTH ON CONTRACTS § 8.20, at 630 (1982)). The unequivocal statement must be "positive and unconditional." *Id*. at *6 (citing WILLISTON ON CONTRACTS § 1322 (3d ed. 1968)).

[175] *CitiSteel USA, Inc. v. Connell Ltd. P'ship*, 758 A.2d 928, 931 (Del. 2000); *see PAMI-LEMB I, Inc. v. EMB-NHC, L.L.C.*, 857 A.2d 998, 1014 (Del. Ch. 2004).

[176] *CitiSteel*, 758 A.2d at 931.

shareholders to evaluate the proposed transaction.[177] The Merger Agreement accommodated those duties by allowing, under certain circumstances, the board of directors to withdraw or change its recommendation to the shareholders that they vote for the Merger.[178] The presence of a "fiduciary out" does not preclude a finding of repudiation.[179] It does, however, establish a specific context in which the conduct of the players must be assessed.[180]

Holly's repudiation of the Merger Agreement, if it occurred, occurred during the August 19 Phone Call. Holly arranged for the call because it was seeking Frontier's response to the all-cash offer of August 12. Given Frontier's previous concerns about more debt, Holly had more than an inkling of the answer it would receive. Gibbs, in contrast, arrived at the call with an entirely different agenda. His purpose was to induce Norsworthy to

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[177] *See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 932-35 (Del. 2003).

[178] Merger Agreement, Section 5.4. The recommendation to approve the Merger could be withdrawn, withheld, modified, or changed if the board of directors determined in "good faith after consultation with its outside legal counsel that the failure to the take the action in question would be inconsistent with the fiduciary obligations of such Board of Directors under applicable law."

[179] *See, e.g.*, *Consolidated Edison, Inc. v. Northeast Utils.*, 249 F. Supp. 2d 387 (S.D.N.Y. 2003).

[180] For example, a statement by a promisor who has a contractual out that he will not perform under the contract because of the contractual out will not automatically be "repudiation." Otherwise, any affirmative reference to the contractual out would be a repudiation, and such an approach would defeat the purposes behind such protective provisions.

repudiate the Merger Agreement.[181] With the prior guidance of counsel, he sought to induce Norsworthy to tell him "unambiguous, distinctly and unequivocally" that Holly would not go forward. Gibbs knew that he had out-negotiated Norsworthy. He also knew that changes in market conditions, including the significant appreciation in the value of an MLP offering, had made his good deal even better. He believed that Holly was worth 100 million more than the Merger price reflected. What he could not abide was the thought that Holly would simply walk away (through exercise of the fiduciary out) for $16 million, an amount less than Frontier's costs already occurred in borrowing the cash necessary for the Merger.[182]

Norsworthy did tell Gibbs that the Holly Board was no longer willing to support the deal on its existing terms. The answer could not have been a surprise to Gibbs. After all, as of the July 9 meeting, everyone understood

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[181] Early in the conversation, Gibbs informed Norsworthy that Frontier would not pursue an all-cash acquisition. His position was consistent with the concerns that he had previously expressed about burdening Frontier with additional debt of the magnitude necessary for an all-cash acquisition.

[182] As Gibbs, in describing the reasons for pursuing a negotiated resolution after the July 9 meeting, put it, "Holly could . . . simply slip us $16 million and walk out into the sunset." What Gibbs failed to appreciate was that if the transaction was too good (from Frontier's perspective), especially because of the uncertainty arising from the Beverly Hills Litigation, Holly's Board, properly acting with the best interests of the shareholders in mind would likely—and perhaps necessarily—invoke the fiduciary out provision (assuming that it did not pursue a more aggressive strategy involving declaration of an MAE or asserting that it had been misled to enter into the Merger Agreement because of the failure to disclose the Beverly Hills guarantees).

that the “deal” of one Frontier share, $11.11 and a CVR was not going to happen.

Ultimately, Frontier has failed to prove that Holly, through Norsworthy or its other representatives, made “an unequivocal statement” that would “it would not perform [its] promise.” The “deal” to which Norsworthy referred was not the Merger Agreement; instead, it was, in accordance with the way the parties had discussed this matter for the preceding six weeks or so, the deal of one Frontier share, $11.11, and a CVR.

The lack of clarity and precision here is the result, in large part, of actions taken by Frontier. Gibbs, or Frontier’s counsel, “wrote the script.” Norsworthy did not say that Holly was going to ignore the terms of the Merger Agreement.[183] Moreover, the questions, as written in the Transcript, are directed to whether the Holly Board would recommend the Merger to the shareholders. Revisiting the commitment to recommend the Merger was not merely something that the Merger Agreement allowed the Holly Board to do; it was the duty of the Holly Board to review the transaction to confirm that a favorable recommendation would continue to be consistent with its fiduciary duties. In that light, merely stating that the Board was no longer

[183] Tr. at 489 (Edwards).

recommending a transaction (particularly in the same conversation in which a pending offer from Holly was rejected) cannot, in this context, be considered a repudiation of the Merger Agreement, entitling Frontier to damages.[184]

[184] A phone call is a somewhat strange (perhaps calculated) way to close off a contract involving several hundreds of millions of dollars and which had been negotiated and monitored by a number of talented and informed lawyers. The Restatement provides the following guidance as to the nature of a demand for adequate assurances: "A party who demands assurances must do so in accordance with his duty of good faith and fair dealing in the enforcement of the contract. . . . Whether a particular demand for assurance conforms to that duty will depend on the circumstances. The demand need not be in writing. Although a written demand is usually preferable to an oral one, if time is of particular importance the additional time required for a written demand might necessitate an oral one. RESTATEMENT (SECOND) OF CONTRACTS, § 251, cmt. d. Thus, as Frontier points out, written notice is not absolutely required. However, a written demand is "preferable," especially for a transaction of the complexity and sophistication of the one anticipated by the Merger Agreement. Frontier seeks to excuse its decision not to make a written demand for assurances by arguing that time was of "particular importance" because of the impending release of the S-4 as part of the process of securing shareholder approval of the Merger. Frontier, understandably, did not want to see the proxy statement released to the public, only to learn after-the-fact that Holly was going to abandon the Merger. Frontier's argument fails to acknowledge three significant considerations. First, although the imminence of the proxy process was mentioned by Gibbs during the August 19 Phone Call, that call had been arranged by Holly, not by Frontier. Second, and more importantly, Frontier had known for several weeks that Holly was not likely to go forward on the original terms (and Frontier had not responded to the all-cash offer made by Holly a week earlier) and, thus, to the extent that the proxy statement issuance date created a temporal exigency, it was largely of Frontier's own making. Third, Frontier still had a few days before it reached what it considered to be the crucial point. Thus, there was sufficient time to make the demand in writing. Holly certainly could not have professed surprise at such an inquiry, and Frontier would have been entitled to expect a prompt response.

This conclusion is bolstered by Edwards' testimony, which also confirms Norsworthy's view that there was more to do under the Merger Agreement:

> Q: And so Mr. Norsworthy [after the August 19 Phone Call] was going to have the lawyers talk to each other to figure out what to do next. Right?
>
> A: Yes.
>
> Q: Because you guys were parties to a merger agreement. Right?
>
> A: Yes. We had a contract.
>
> Q: Right. You had a contract. That contract had rights and it had obligations. Correct?
>
> A: Yes.
>
> Q: The lawyers were going to figure out what to do next in view of those rights and obligations. Weren't they?
>
> A: I don't know what they were going to do next. They were going to do something next.[185]

By declaring a repudiation the following day, Frontier deprived Holly of the opportunity that it had under the Merger Agreement to exercise its

[185] Tr. at 491. Norsworthy, according to Gibbs' testimony (Tr. at 108-09, 115-117) and the Transcript, referred to the "signed deal." The only "signed deal" was the Merger Agreement. The deal of one Frontier share, $11.11 and a CVR was not a separately signed agreement: it was simply the merger consideration that would flow to Holly shareholders upon consummation of the Merger Agreement. In light of the lengthy, personal contacts among the principals, a technical reading of a necessarily imprecise recollection cannot support the conclusion that Norsworthy was expressing the intention that Holly would refuse to act in compliance with the Merger Agreement.

right to a fiduciary out, or, possibly, to declare an MAE based on the Beverly Hills circumstances.[186]

C. *Did Holly Breach Its Covenant of Good Faith and Fair Dealing?*

The covenant of good faith and fair dealing, implied in every Delaware contract, arises from "fundamental notions of fairness."[187] It "is a judicial convention designed to protect the spirit of an agreement when, without violating an express term of the agreement, one side uses oppressive or underhanded tactics to deny the other side the fruits of the parties' bargain."[188] The Court, of course, may not substitute its notions of fairness for the terms of the agreement reached by the parties. Indeed, the implied covenant may only be invoked where it is "*clear* from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of [their agreement] had they thought to negotiate with respect to that

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[186] At about the time that Frontier was filing this action, Clifton sent Edwards an e-mail (PX 359) that addressed insurance coverage for the potential Beverly Hills liability. This reflects either Clifton's understanding that Holly had not repudiated, and was still a participating party to, the Merger Agreement, or extreme disingenuousness on the part of Clifton. As a factual matter, the latter explanation is rejected.

[187] *Williams Natural Gas Co. v. Amoco Prod. Co.*, 1991 WL 5838 (Del. Ch. Apr. 16, 1991).

[188] *Chamison v. HealthTrust, Inc.—The Hosp. Co.*, 735 A.2d 912, 920 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Del. 2000) (TABLE); *see also PAMI-LEMB I, Inc.*, 857 A.2d at 1016; RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

matter."[189] "[W]here the subject at issue is expressly covered by the contract, . . . the implied duty to perform in good faith does not come into play."[190] Finally, imposing an obligation on a contracting party through the covenant of good faith and fair dealing "is a cautious enterprise"[191] and instances "should be rare."[192]

The covenant of good faith and fair dealing is, by its very nature, context-specific. The directors of publicly traded companies pursuing a merger are frequently buffeted by conflicting forces. The Holly-Frontier Merger presented unusually difficult problems, especially for the Holly directors. They, of course, were required, as a matter of fiduciary duty, to continue their assessment of whether to recommend the Merger to Holly's shareholders. The directors had learned of Frontier's potential liability in the Beverly Hills Litigation and had seen the scope of that litigation increase significantly. Also, they had come to realize that they had approved a transaction which had not maximized value for the shareholders.

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[189] *Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992 (Del. 1998) (emphasis in original).
[190] *Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc.*, 622 A.2d 14, 23 (Del. Ch. 1992), *aff'd*, 609 A.2d 668 (Del. 1992) (TABLE).
[191] *Aspen Advisors LLC v. United Artists Theatre Co.*, 861 A.2d 1251, 1259 (Del. 2004).
[192] *Cincinnati SMSA*, 708 A.2d at 992.

Frontier's assertion that Holly engaged in underhanded tactics can best be understood as based on two overlapping theories. One is that, in general, Holly was not candid. The other is that all the activity and hand-wringing over the Beverly Hills Litigation was nothing more than a pretext to escape from the Merger Agreement and to avoid the break-up fee that would be incurred through exercise of the fiduciary out.

Frontier starts with the Lehman Brothers MLP Presentation which was submitted to Holly on or about June 23, 2003.[193] The presentation informed Holly that an MLP transaction could generate between $346.5 million and $495.6 million. Contrasting that with the $248 million estimate discussed immediately after the Merger, Frontier argues that this provided

[193] Lehman Brothers had worked with Holly on a possible MLP transaction during the January-February 2003 lull in the negotiations with Frontier. Following execution of the Merger Agreement, Holly and Lehman Brothers continued discussions about a public offering of the pipeline assets. Such an offering after the Merger seemed likely. During these discussions and presentations (*see, e.g.*, a June 5, 2003 memorandum, PX 396A), Holly was shown that the pipeline assets were increasing in value. It does appear, however, that the scope of the increase had not earlier been portrayed as dramatically as in the June 23, 2003, document. Lehman Brothers did not forward the Lehman Brothers MLP Presentation to Frontier, but, shortly after receiving it, Clifton forwarded it to Edwards and explained to her why he believed that Lehman Brothers had been overly optimistic. Thus, Holly did not hide the news from Frontier. Moreover, Edwards, both savvy and knowledgeable in these matters, did not fully believe the numbers either. It should also be noted that Lehman Brothers' projections were higher than the prior valuations of the pipeline assets in part because additional assets were included and additional debt was to be assumed by the new entity. Nevertheless, all involved took the following from the Lehman Brothers MLP Presentation: Holly, in entering into the Merger Agreement, had understated significantly the value of its pipeline assets.

the impetus for Holly's subsequent conduct. Or, as Norsworthy later put it, "I got skinned."[194]

Frontier would have the Court find that the July 9 meeting in Houston, where Holly advised Frontier that renegotiation was in order, was prompted by concerns about the value of the pipeline assets and other factors indicating that Holly had been far too generous in its negotiations leading to the Merger Agreement. Isolating Holly's actions from the developments in Beverly Hills is not so easy.

Norsworthy and Glancy had visited the Beverly Hills site and conferred with Gibson Dunn in early April. In late April, the Masry firm had given notice of claim to the governmental defendants of impending litigation. Holly did little more, as it was in a holding pattern, until the first of the suits was filed on June 9. The complaint alleged, contrary to the representations of Frontier and to the genuine surprise of both Holly and Frontier, that Frontier, by virtue of its guarantee of Wainoco's obligations, was directly liable to the plaintiffs; indeed, Frontier was named as a defendant. Two days later, on June 11, Holly hired Carrington Coleman.[195]

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[194] Tr. at 77 (Gibbs).

[195] Two Carrington Coleman lawyers, Yarbrough who led the effort and Carroll who did the work, testified at trial. Both were highly credible. Neither understood nor perceived the firm's assignment to be anything other than what it purported to

It would be almost two weeks later, June 23, when Clifton would receive Lehman Brother's MLP presentation.

When Carrington Coleman was retained, Holly had not received the documents establishing Frontier's liability for the conduct of its subsidiary at the Beverly Hills site.[196] A few days before, the first Beverly Hills complaint had alleged Frontier's involvement, but there was uncertainty, if not skepticism, in the response of both Frontier and Holly to the allegation.

As Carrington Coleman pursued its efforts to ascertain Frontier's exposure in the Beverly Hills Litigation, it met with Frontier on July 1. For a party that now complains about Holly's lack of candor, that was not a good meeting for Frontier. Gibbs spent the first hour defending the "corporate separateness" defense even though the documents refuting the value of that defense—by now known to Frontier's representatives—were in boxes no more than several feet away. Carroll, and his colleagues, eventually worked through the boxes and found the pertinent documents. As Dintzer of Gibson

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be: an assessment of Frontier's liability in the Beverly Hills Litigation, with emphasis on the "corporate separateness" defense.

[196] Of course, Holly had asked for the documents as part of its due diligence and, at least arguably, Frontier was required by the Merger Agreement to supply them. The critical documents may have been available for a V&E associate during the course of the due diligence preceding the Merger Agreement. The associate either did not review the documents or did not appreciate the significance of the documents; for current purposes, it is sufficient, and undisputed, that V&E did not inform Holly about Frontier's obligations at the Beverly Hills site (and that the senior V&E lawyers supporting Holly on the Merger Agreement had no knowledge either).

Dunn explained it, finding the indemnities "changed the whole picture in terms of what Frontier could be facing as the litigation unfolded."[197] At the July 9 meeting of Holly's Board, following Carrington Coleman's explanation of the troubling new developments increasing the potential exposure of Frontier in the Beverly Hills Litigation, the directors instructed Norsworthy, as he had expected, to meet with Frontier and to share their concerns about Beverly Hills. At that point it was clear that the directors would not continue to support the transaction on the basis of one Frontier share, $11.11, and a CVR, unless some arrangement were made to protect against the potential exposure from the Beverly Hills Litigation. Yet, Holly's Board never formally determined to change its recommendation.

Frontier complains that Holly failed to convey its concerns candidly. During the July 9 meeting with Frontier after the Holly Board meeting, Norsworthy may have reassured Gibbs with a comment along the lines of, "we still have a deal," but no one at the meeting, including Gibbs, could have had any reason to believe that the Merger would proceed in accordance with the specific terms negotiated in March.[198] In short, Holly did not mislead Frontier at the July 9 meeting about the need to adjust the terms under which the Merger would close.

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[197] Tr. at 1981.
[198] *See supra* Part I.P (quoting testimony of Frontier representatives).

Of course, that Frontier had been informed that a change of terms would be required does not necessarily lead to the conclusion that it been fairly informed of what changes would be needed or the real reasons behind the request. In the ensuing weeks, several approaches to address Holly's concerns would be considered in some detail. Significantly, these efforts all focused on protecting Holly's shareholders from exposure to Frontier's Beverly Hills liability. No substantial increase in share price was sought. Holly agreed to the Put Proposal, but Frontier withdrew its support when it realized the adverse impact it would have had on its balance sheet. Frontier suggested that a cash transaction could be achieved if Holly undertook the MLP—the Canoe Proposal. Holly rejected that concept because it saw no reason why it should assume the burdens and risks associated with the MLP solely for the benefit of Frontier. Norsworthy and Edwards considered "moving the boxes," again a solution that would enhance the position of the Holly shareholders, but only in the larger sense of protecting them from the downside that might result from the Beverly Hills Litigation. The Denver Agreement, a cash/stock proposal, added a little value to the transaction, but its primary consequence would have been to afford Norsworthy and his associates the opportunity to cash out their Holly interests with the expectation that other Holly shareholders would take away the Frontier

stock. This solution collapsed, not because of value, but because Norsworthy came to realize that he could not pawn off the Frontier stock on Holly shareholders without either disclosing his true aspiration (cash, not Frontier stock) or violating his fiduciary duties. Finally, Holly proposed an all-cash transaction of $28 for each Holly share, only a slight increase in the effective merger consideration and without any upside for Holly shareholders under either an MLP or the aviation fuel claim that was the basis for the CVR. Again, there is no suggestion that Holly was seeking to increase consideration materially; Holly even offered to help finance the additional cash requirements for an all-cash transaction.[199]

The Court, thus, concludes that Holly pursued the post-July 9 negotiations in a good faith effort to find a way to meet the concerns that it

[199] Frontier accurately points out that all-cash consideration had been discussed and that Gibbs had expressed great reluctance to agree to such a transaction because of the negative impact on Frontier's balance sheet. Thus, it is likely that Holly expected Frontier to reject the all-cash offer even though Gibbs did agree to consider it. That much is true. If, however, the value of Holly—because of favorable economic conditions, the escalation in consideration to be obtained through an MLP, the "good deal" that Frontier had negotiated, or some other factor—had increased as substantially as Frontier now advocates (after all it is the enhancement in value that leads, in its view, to Holly's "ultimate" motivation), then one cannot help wondering why Frontier did not rethink its aversion to an all-cash transaction and, what it now suggests, the minimal risk associated with turning the MLP assets into a sizeable pile of cash, in addition to the interest to be retained. It should be noted, on the other hand, that the retained interest, representing approximately half of the value ascribed to MLP offering would be illiquid. Also, Frontier would have likely needed the consent of the lender of the cash portion of the merger consideration to pursue such an effort and that consent might have come at a cost.

had identified.[200] Holly had shared the Lehman Brothers MLP Presentation with Frontier. As soon as the Holly Board met after having been informed of Frontier's indemnities at Beverly Hills, it advised Frontier of its concerns. All subsequent negotiations focused on finding a way around Beverly Hills issues.

Frontier, nevertheless, complains that Holly's Board never disclosed that it was, in effect, withdrawing its recommendation of the Merger and that it continued to hold out the possibility of closing the Merger. Yet, Frontier wanted the opportunity to save the transaction. Frontier's position would suggest that once a board with responsibility for determining whether to exercise a fiduciary out decides that the transaction cannot go forward under the precise contract terms, it must act forthwith to terminate the agreement. No good reason has been offered for why parties should not try to resolve the differences and, more importantly, why a party must exercise its exit rights without offering the other party at least the opportunity to salvage the transaction. If the concept of Holly's seeking to renegotiate the Merger Agreement is so offensive, Frontier must confront the question which it

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[200] Norsworthy reached the Denver Agreement in good faith with respect to Frontier. When he recognized its implications, he abandoned it, in a way reminiscent of Gibbs' abandonment of the Put Proposal. Whether Norsworthy's initial support for the Denver Agreement was in good faith with respect to other stakeholders, such as Holly's public shareholders, is a question not germane to this proceeding.

cannot answer: why then did Frontier engage in the negotiations?[201] Again, Frontier's angst stems from the nature of an agreement that allowed multiple exit strategies. As conditions change, frequently without the responsibility of either party to the transaction, the need to reevaluate the Board's recommendation to complete the Merger proceeds apace. When the Holly Board learned of Frontier's potential direct exposure in the Beverly Hills Litigation, it had to evaluate whether it should declare an MAE or whether it should use its fiduciary out to protect the interests of the shareholders who would be receiving Frontier's stock if the Merger closed. Perhaps, Holly would have declared an MAE (as it did after this litigation was filed). Perhaps Holly's Board would have concluded that the facts would not support declaring an MAE (or that it did not want the litigation that such a declaration might bring forth). Perhaps Holly's Board would have concluded that the risks of the Beverly Hills Litigation were large enough to withdraw, in accordance with its fiduciary duties, its recommendation to merge. Frontier, by peremptorily declaring a repudiation, denied the Holly Board that opportunity (and the Holly shareholders the benefit of that

[201] All of this is not to suggest that the Holly directors were oblivious to the run-up in value of the Holly enterprise. Multiple motivations are not uncommon in the human experience. Frontier has failed to persuade the Court that all of this was nothing more than a charade to avoid the fiduciary out payment (or the public embarrassment of admitting that an improvident merger had been recommended).

opportunity). Indeed, the Holly Board was confronted with a difficult question. It had begun discussions with counsel over what course to follow if Frontier did not take the August 12 all-cash offer. Frontier relieved Holly's directors of that burden.[202]

In sum, Holly was reasonably candid with Frontier; it did not deny Frontier "by arbitrary and unreasonable conduct . . . the fruits of the [Merger Agreement]." Holly still had the opportunity to invoke one or more of its various exit strategies, exit strategies to which Frontier had agreed and accepted through the Merger Agreement. On the facts before the Court, Frontier has not proven that Holly breached its implied covenant of good faith and fair dealing.[203]

* * *

[202] Of course, if Frontier had accepted the all-cash proposal at $28 per share and then Holly's Board had reneged, this might have been a very different case.

[203] Frontier, by the middle of August was faced with a quandary. The October "drop dead date" was approaching. It may have been that Holly was trying to delay away payment of the break-up fee. Perhaps, Holly was planning to deliver a an MAE or other default notice that would not have afforded Frontier the thirty-day cure period. On the other hand, the drop dead date provision required that the party invoking it not have caused the delay. Frontier could have selected a more formal and more precise method for ascertaining Holly's intent than that provided by the August 19 Phone Call. It did not, and the decision on how to go about making the demand for assurances was not inadvertent. Frontier decided to go after broad contract damages as if Holly had breached the Merger Agreement. Structuring it as a repudiation must have been the most appealing strategy. Thus, this action resulted.

Holly, by its counterclaim, seeks damages from Frontier because of (1) wrongful repudiation[204] and (2) Frontier's breach of its representations and warranties in the Merger Agreement.

D. *Did Frontier Breach the Merger Agreement By Declaring that Holly Had Repudiated and By Filing this Action?*

As Holly argues, a wrongful repudiation is a breach of contract and entitles the injured party to damages as if (or because) a total breach occurred. Holly's damage claims fall into three categories: (1) loss of the opportunity to acquire the Denver Refinery; (2) loss of the small refiner exemption for the sale of jet aviation fuel; and (3) its costs incurred in supporting the Merger after entry into the Merger Agreement.

A party who is the victim of a wrongful repudiation is ordinarily entitled to damages for breach of contract because, in the absence of repudiation, the party would have performed under the contract and would have received the benefits of its bargain. This case, again, is not ordinary. As set forth above, after Frontier concluded, wrongly it turns out, that Holly had repudiated the Merger Agreement, and then Frontier proceeded with this action, Frontier ceased its efforts to complete the transaction. Under the circumstances, that constitutes a repudiation, or breach, of the Merger

[204] To the extent that Frontier meets this contention by asserting its conduct was justified by the change in attitude of Holly's Directors to the Merger, that argument is addressed at Part III.H, *infra*.

Agreement by Frontier. Thus, Frontier is liable to Holly for the damages caused by its wrongful repudiation. However, before August 20, 2003, Holly had already decided that the Merger would not happen on the terms negotiated in March. Either the terms would be renegotiated or Holly would be forced to choose an exit strategy. Under no foreseeable circumstances would Holly get the benefit of its bargain. Thus, the harms about which Holly complains were not caused by Frontier's breach. If, for example, Holly had exercised its fiduciary out, all of the damages which it has identified would still have been incurred and there would have been no basis for obtaining relief from Frontier.[205]

* * *

Exercise of its fiduciary out, however, was not Holly's only potential course of action. Even before Frontier's intervening acts, Holly was evaluating whether it could avail itself of an exit strategy based on misrepresentations which it believed Frontier made in the Merger Agreement.[206] Holly relies upon two provisions of the Merger Agreement. The first, Section 4.8, is Frontier's representation that there existed no

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[205] Thus, Holly is only entitled to an award of nominal damages of $1.00.

[206] By declaring without a sufficient basis that Holly had repudiated the Merger Agreement, Frontier could not cut off Holly's claim that Frontier had breached its warranties in the Merger Agreement. Thus, Holly's misrepresentation claims survived Frontier's failed attempt to hold Holly in breach.

"Material Adverse Effect." This turns on whether the Beverly Hills Litigation does or would reasonably expect to have an MAE. The second, Section 4.19, is Frontier's representation that there were no material and undisclosed contractual obligations. This implicates Frontier's indemnifications and guarantees regarding the Beverly Hills site. I turn first to the question of whether the Beverly Hills Litigation would have (or reasonably be expected to have) an MAE.

E. *Did Frontier Breach Its Representation that the Beverly Hills Litigation Would Not Have and Would Not Reasonably Be Expected to Have a Material Adverse Effect?*

Frontier warranted in Section 4.8 of the Merger Agreement:

> Except as set forth on Schedule 4.8 of the Frontier Disclosure Letter, there are no actions, suits or proceedings . . . , to Frontier's knowledge, threatened against Frontier or any of its Subsidiaries, . . . , other than those that would not have or reasonably be expected to have, individually or in the aggregate, a Frontier Material Adverse Effect.[207]

Learning of the threatened litigation involving Frontier's subsidiary at the Beverly Hills site in March 2003 had been a major impediment to Holly's execution of the Merger Agreement. Gibbs and Edwards both downplayed

[207] Under Section 6.2 of the Merger Agreement ("Conditions to Obligation of Holly to Effect the Mergers"), Frontier's representations and warranties had to be "true and correct . . . as of the date of [the Merger] Agreement and as of the Closing Date (except for representations and warranties made as of a specified date, which need be true and correct only as of the specified date)." Thus, it was a condition to Holly's closing obligation that Frontier's representation that no MAE existed remain accurate, even as intervening events occurred.

the risks, but, within a short time span, the parties had agreed on how to handle the Beverly Hills matter. As set forth in Schedule 4.8 to the Merger Agreement:

> For avoidance of doubt and only for the limited purpose of this Agreement, Frontier agrees with, and for the sole benefit of, Holly that this potential litigation will be considered as "threatened" (as such term is used in Section 4.8 of the Agreement) and that the disclosure of the existence of this "threatened" litigation herein is not an exception to Section 4.8, 4.9 or 4.13 of the Agreement and despite being known by Holly, will have no effect with respect to, or have any limitation on, any rights of Holly pursuant to the Agreement.

From the parties' handling of the disclosure of the potential for litigation involving Beverly Hills, two guiding principles emerge: (1) the Beverly Hills Litigation is "threatened litigation" and, thus, within the scope of the representation of Section 4.8; and (2) Frontier's disclosure (or listing on Schedule 4.8) of this threatened litigation did not create an exception to Frontier's responsibility for its warranties under Section 4.8 or otherwise limit Holly's rights under the Merger Agreement.[208] Although acknowledging the threatened litigation at Beverly Hills, Frontier, nonetheless, assured Holly that there were no threatened legal proceedings "other than those that would not have or reasonably be expected to have . . . a Frontier Material Adverse Effect." Thus, in substance, Frontier

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[208] Accordingly, even though the threatened Beverly Hills Litigation is "disclosed" on Schedule 4.8, it is not "disclosed" for purposes of Section 4.8.

represented to Holly that the Beverly Hills Litigation *would not have* an MAE and *would not reasonably be expected to have* an MAE.[209] The test—"would have" or "would reasonably be expected to have"—is an objective one.[210]

For purposes of ascertaining whether the parties intended for a problem such as the Beverly Hills Litigation to be treated as an MAE, the words chosen by the parties provide a starting point:

> "Material Adverse Effect" with respect to Holly or Frontier shall mean a material adverse effect with respect to (A) the business, assets and liabilities (taken together), results of operations, conditions (financial or otherwise) or prospects of a party and its Subsidiaries on a consolidated basis. . . .[211]

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[209] The parties used "would," not "could" or "might." "Would" connotes a greater degree (although quantification is difficult) of likelihood than "could" or "might," which would have suggested a stronger element of speculation (or a lesser probability of adverse consequences).

[210] I do not doubt that Gibbs and Edwards both sincerely believed, when the Merger Agreement was executed, that the threatened Beverly Hills Litigation was of little moment to Frontier. Similarly, I do not doubt that Norsworthy, in light of his unhappy and then recent experience with the Longhorn Litigation, would have considered the threatened Beverly Hills Litigation material if he had been aware of Frontier's indemnification obligation running to the benefit of Wainoco. Of course, the good faith views of Gibbs and Edwards, if wrong, would not preclude a finding that Frontier breached the warranty of Section 4.8. The point is the obvious: the honestly held subjective beliefs of even the most knowledgeable and experienced individuals are, to an unavoidable extent, the product of individual experience and perceived self-interest. This is but one of the many reasons counseling in favor of an objective standard.

[211] Merger Agreement, Section 8.9(d). The parties excluded from the scope of the MAE provision those adverse effects that may result from general economic, regulatory, or political conditions or changes, financial market fluctuations, and changes in the petroleum refining industry generally.

It would be neither original nor perceptive to observe that defining a "Material Adverse Effect" as a "material adverse effect" is not especially helpful. Moreover, the definition chosen by the parties emphasizes the need for forward-looking analysis; that is especially true because the parties, through the drafting changes designed to assuage Holly's concerns about the threatened Beverly Hills Litigation added the "would not reasonably be expected to have" an MAE standard to the scope of inquiry regarding threatened litigation and the term "prospects" to the list of "the business, assets and liabilities . . . results of operations [and] condition" in the definition of an MAE.

The parties chose to use the term "Material Adverse Effect" and it is the Court's function to discern what they intended. They could have simply agreed that there was no threatened litigation which was or would be material. Because they did not choose that concept, it is reasonable to infer that something more is involved. The notion of an MAE is imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties. The drafters of the Merger Agreement had the benefit of the analysis in *In re IBP, Inc. Shareholders Litigation* ("*IBP*")[212] which considered whether the acquiring party in a merger transaction could

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[212] 789 A.2d 14 (Del. Ch. 2001).

successfully invoke an MAE provision to escape the agreed-upon combination:

> Practical reasons lead me to conclude that a New York court would incline toward the view that a buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close. Merger contracts are heavily negotiated and cover a large number of specific risks explicitly. As a result, even where a Material Adverse Effect condition is a broadly written as the one in the Merger Agreement, that provision is best read 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. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror.[213]

Although *IBP* involved application of New York law, I see no reason why the law of Delaware should prescribe a different perspective. Because Section 4.8, and not Section 4.9 which addresses changed circumstances, is involved, it may be more useful to consider the standard drawn from *IBP* as one designed to protect a merger partner from the existence of unknown (or undisclosed) factors that would justify an exit from the transaction.

Before attempting to ascertain whether the Beverly Hills Litigation should be treated as an MAE, the threshold question of who bears the

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[213] *Id*. at 68 (applying New York law) (footnote omitted).

burdens of proof and persuasion must be first addressed.[214] Holly argues that Frontier agreed to bear the burdens because of structural aspects of the warranty. Frontier generally warranted that there was no threatened litigation. That precise warranty (as both parties knew) was not accurate. That warranty, however, was subject to an exception: an exception for threatened litigation that would not (or would not reasonably be expected to) have an MAE. Holly contends that it only must show that there is, in fact, threatened litigation known to Frontier; then it becomes Frontier's burden to demonstrate that it is entitled to the exception, that is, the threatened litigation would not be an MAE.

Frontier relies primarily upon *IBP* for the premise that "a defendant seeking to avoid performance of a contract because of the plaintiff's breach of warranty must assert that breach as an affirmative defense."[215] If a defendant seeking to avoid a contract bears the burden, it follows that the same defendant pursuing an affirmative claim, based on the breach of

[214] This issue arises in the context of Holly's counterclaim: Holly seeks an affirmative award because of an alleged misrepresentation. It would also have arisen if the Court had concluded that Holly had repudiated or otherwise breached the Merger Agreement, in the context of Holly's affirmative defense that Frontier's misrepresentation excused any subsequent breach by Holly.

[215] 789 A.2d at 53; *see also Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1090 (Del. Ch. 2004) (applying New York law).

warranty, would also be charged with the burden as well.[216] The opinion in *IBP*, of course, was issued well-before the Merger Agreement was negotiated. The parties could have expressly allocated the burdens as a matter of contract, but they did not do so.

The Court's function is to ascertain the intent of the parties. To obtain relief for a breach of warranty, one would expect to be required to demonstrate an entitlement to that relief. That Frontier may have breached a warranty—no threatened litigation—accomplishes nothing by itself. Unless the threatened litigation has (or could reasonably be expected to have) an MAE, Holly has no claim. That is because breach of the warranty, if it is with respect to incidental litigation, is of no moment.[217] In sum, the Court

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[216] At issue in *IBP* was a warranty which recited in pertinent part: "Except as set forth in Schedule 5.11 . . . , there are no liabilities of the Company . . . and there is no existing condition, situation or set of circumstances which could reasonably be expected to result in such a liability, other than: . . . (d) other liabilities which individually or in the aggregate do not and could not reasonably be expected to have a Material Adverse Effect." 789 A.2d at 39-40 (emphasis in original removed). Thus, the warranty in *IBP* used the same "other than" transition from the promise that there was no liability to the qualifying standard of whether any liability (existing in contradiction of the representation) could have a Material Adverse Effect.

[217] Holly looks to cases involving insurance coverage for support. *See, e.g., Judge v. State Farm Ins. Cos.*, 1993 WL 1611307, at *4 (Del. Super. May 3, 1993). Insurance cases reflect important public policy considerations not present here. Moreover, the insurance cases generally deal with exclusions. The insured has the coverage unless there is reason, as set forth in the policy or arising as a matter of law, for the insurer to avoid its obligation. The insured, thus, has a right that may be taken away; if all that happened under the Merger Agreement was the failure of

concludes that the expectation of the parties, as reflected in the Merger Agreement and as informed by the case law, was that the burden of demonstrating that the Beverly Hills Litigation would have (or would not reasonably be expected to have) an MAE falls on Holly.[218]

Frontier argues that threatened litigation can never constitute an MAE because litigation results are inherently speculative.[219] This argument ignores that threatened litigation can be so certain, the outcome so predictable, and the likely consequences (*i.e.*, "prospects") so negative, that an observer could readily conclude that the impact that one would reasonably expect to result from the litigation would be material and adverse. Predicting the outcome of unfiled (or even filed) litigation may be difficult and conclusions must be drawn with care; those considerations, however, neither require nor prudently allow for the absolute rule espoused by Frontier, particularly in light of the parties' drafting efforts to accommodate the then-threatened Beverly Hills Litigation.

Frontier to disclose threatened litigation, Holly, without more (*i.e.*, its showing of an MAE) has nothing.

[218] Sometimes a court is able to deflect the import of allocating burdens by opining that, regardless of who has the burden, the outcome would be the same. This case is not so convenient.

[219] Post Trial Br. of Frontier, at 39 ("[C]ourts do not find lawsuits to constitute MAEs because of the speculative nature of the litigation."). If that is the case, one wonders why Frontier entered into an agreement which required disclosure of threatened litigation unless it would not have an MAE. *But cf. S.C. Johnson & Son, Inc. v. Dowbrands, Inc*., 167 F. Supp. 2d 657, 670 (D. Del. 2001).

The Beverly Hills Litigation poses serious risks for Frontier. Defense costs will be substantial; the risk of adverse results exists; and it is likely that, given the nature of the alleged health effects, if plaintiffs prevail on the merits of their claims, damage awards will be large. Whether this all reaches "Material Adverse Effect" under the terms of the Merger Agreement, however, mandates a more thorough review of the details.[220]

Holly focuses on the nature of the Beverly Hills forum and not on the merits of the actions there. Much of its argument is premised on its impressions of California law and procedure as plaintiff-friendly for mass toxic tort claims. This ranges from reporting that plaintiffs' lawyers affectionately refer to the venue as "the Bank" to noting that California has not adopted the *Daubert* standard which authorizes an expanded role for the trial judge as a gatekeeper with respect to so-called "junk science" expert testimony. Holly also foresees an antibusiness jury pool that would be sympathetic to the plaintiffs. The choice of a forum, of course, may be a factor in assessing the probable outcome of any litigation. Yet, Holly has

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[220] Holly at one time asserted that Frontier had beached its representations in Section 4.9 of the Merger Agreement which provides in part:

> **ABSENCE OF CERTAIN CHANGES**. Since December 31, 2002, Frontier has conducted its business only in the ordinary and usual course of business and during such period there has not been any (i) event, condition, action or occurrence that has had or would reasonably be expected to have, individually or in the aggregate, a Frontier Material Adverse Effect.

Holly has since abandoned any claim under Section 4.9.

not demonstrated, and I would suspect that is because it cannot, that Frontier would not receive a fair trial in California.

Significantly, Holly devotes little effort to developing the merits of the plaintiffs' case against Frontier.[221] It produced no data or studies suggesting that individuals with long-term exposure to petroleum suffer a higher incidence of the cancers suffered by the plaintiffs in the Beverly Hills Litigation. It offered no expert testimony as to how current scientific and medical knowledge supports its position.[222] It did perform a "back of the

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[221] Perhaps Holly was reluctant to advance a scientific, including epidemiological, basis (assuming that one exists) to support, on the substantive merits of the dispute, its view that the litigation poses great risk to Frontier. It might not be in Holly's self-interest, as a participant in the petroleum industry, to champion the cause of linking exposure to petroleum (or petroleum products) to cancer.

[222] Holly sought to bolster its claims regarding Frontier's exposure, both in terms of adverse outcome and in terms of defense costs, in the Beverly Hills Litigation through the testimony of Steven L. Hoch, an experienced environmental and toxic tort practitioner in California. Indeed, Hoch represented the defendant in the lawsuit upon which *Erin Brockovich* was based.

Hoch initially expressed the opinion that it would be reasonable to expect that Frontier's ultimate liability in the Beverly Hills Litigation could exceed $100 million. Tr. at 2361. At its core, his opinion relied upon an "ingrained fear of people" about chemicals. Tr. at 2363. Hoch may be right in his assessment that the initial reaction of jurors will be to identify with the plaintiffs because of this "ingrained fear." Nonetheless, Holly, in this proceeding, still must demonstrate a basis in fact (*i.e.*, in science) for a causal connection between Wainoco's activities at the Beverly Hills site and the cancers suffered by the plaintiffs who are asserting their claims in the Beverly Hills Litigation. More importantly, Hoch later significantly qualified his testimony:

> Q: It's correct that you would not tell a client [*i.e.*, Frontier] at this point that it would be reasonable to expect $100 million in liability, given what you know about this case right now? That's right, isn't it?

envelope" calculation to the effect that the cancer rate among the Beverly Hills High School community was higher than that of the general populace, but the process had no validation and no rigorous review.[223]

Holly is correct that the Beverly Hills litigation could be catastrophic for Frontier. It is not possible to rule out judgments running into the hundreds of millions of dollars. Holly has not, however, demonstrated (or even seriously tried to demonstrate) the likelihood of the event. It suggests that any jury trial carries a ten percent chance of losing. That contention is little more than an acknowledgement that the system is not perfect. More importantly, it is more in the nature of random speculation. It is possible, in the right case, for a party in a position comparable to Holly's, to come forward with factual and opinion testimony that would provide a court with the basis to make a reasonable and an informed judgment of the probability

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A: That's right.

Tr. at 2374. Moreover, he had also testified in his deposition that he was unable even to say that it is "likely that [Frontier] will be held liable." Tr. at 2375.

[223] Dintzer, as responsible as anyone for persuading Holly's Board that the Beverly Hills Litigation could be a serious problem for Frontier, had come around by August 2003 to the point where he could tell Glancy that he was optimistic that Frontier could ultimately extricate itself from the litigation. Tr. at 1652.

of an outcome on the merits. Holly simply has not provided that foundation.[224]

Alternatively, Holly projects the costs of defense against the claims in the Beverly Hills Litigation and argues that the burdens of litigation would have an MAE. Estimating the cost of litigation, as a general matter, is difficult; it is even more difficult for mass toxic tort litigation. Many plaintiffs, numerous experts, and uncertain science may all add to the complexity of anticipating the staffing needs for a responsible defense. Of course, various case management techniques may work to contain costs.

At the July 9 meeting of the Holly Board, Dintzer of Gibson Dunn estimated defense costs, depending upon which version of the board minutes one accepts, ranging from $25 million to $40 million, or from $40 million to $50 million. This contrasts with an earlier estimate (but one based on

[224] In assessing whether the risk of litigation (as contrasted with the cost of litigation) may have a Material Adverse Effect, the mere existence of a lawsuit cannot be determinative. There must be some showing that there is a basis in law and in fact for the serious adverse consequences prophesied by the party claiming the MAE. It could turn out that the plaintiffs in the Beverly Hills Litigation have a sound case, both as a matter of fact and as a matter of law. After all, the first claims regarding tobacco use or asbestos exposure may have been met with skepticism. It is not, however, for the Court to speculate. It is for the Court, instead, to evaluate the evidence presented to it. Holly, other than proclaiming that bad things can happen in mass toxic tort litigation in California, has not come forth with substantive arguments (as opposed to procedural concerns which may impact the cost of litigation) supporting its claim that Frontier was subject to a cognizable risk on the merits. Indeed, Holly has not presented sufficient evidence to require the Court to seek to describe that level of such proof necessary to sustain an MAE claim in this context.

essentially the same factors and anticipated developments) of perhaps $200,000 per month. If one assumes four years of litigation, that approaches is $10 million. As Frontier put it, Dintzer never tried a toxic tort case to completion; he was both soliciting business and providing estimates that, if low, might have made him look bad; and his firm's rates, as a national firm, are substantially above those of local, but experienced and talented, insurance defense firms.[225]

Frontier, through its expert, Stephen Jones, a California practitioner with extensive experience in trying toxic tort cases in California, provided an estimate of defense costs in the range of $11 million to $13 million.

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[225] Hoch, Holly's toxic tort practice expert, estimated that total defense costs would be in a range between $40 million and $50 million. This was based on his assumption that the proceedings would take five years (Tr. at 2403) and his views as to the staffing that would be required. He distinguished his estimate of $40 million to $50 million for the full effort from Dintzer's estimate of $40 million to $50 million, by indicating that he understood Dintzer's estimate to be simply through the first of a series of trials (and thus leaving open the resolution of the claims of other plaintiffs). He anticipated that a fairly small number of individual claims would be litigated; those results would form a template for resolving other claims. Again, while Hoch's projections are entitled to some weight, the assumptions that drive his costs above the range of $20 million to $25 million are questionable, both in terms of rates and staffing. *See* Tr. at 2406-08 (addressing cost savings that can be achieved through prudent use of bellwethers). Also, certain defense costs (especially expert witness costs) may be divided among the defendants because, for example, as to the causal connection between the drilling and processing activities at the Beverly Hills site and the cancers suffered by the plaintiffs, the defendants share a common defense. Hoch implicitly acknowledges that potential (Tr. at 2397), but does not adequately incorporate the benefits. (Interestingly, Hoch represented the only defendant in the litigation recounted in *Erin Brockovich*, a case with 648 plaintiffs and ultimate liability of $333 million, but his firm's fees were less than $10 million. Tr. at 2418-22).

Jones assumed an hourly rate roughly half of that charged by Gibson Dunn. Moreover, he differed substantially on staffing requirements—both with respect to lawyers and consulting experts.[226]

The purpose here is to reach a reasonable estimate; it is inherently inexact. Frontier's Jones underestimates somewhat the staffing requirements. Holly's projections turn to speculation as they rise above $25 million. Holly's estimate of $25 million would fall below $20 million if the defense is not handled by a national firm. In sum, the evidence leads to a conclusion that a reasonable estimate for Frontier's defense costs is in the range of $15 million to $20 million.

With that range as a reference, the question becomes one of whether meeting it would have (or reasonably be expected to have) an MAE. Holly relies on testimony from Frontier's comptroller to the effect that $10 million would have been material to Frontier in 2002[227] and testimony from a Frontier director that tens of millions of dollars in defense costs would have

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[226] In the early stages of assessing the risks of the Beverly Hills Litigation (and through August 20, 2003), Holly was represented by Gibson Dunn and Frontier was represented by Irell & Manella, another national firm with comparable billing rates. In fact, neither of these firms ended up with the job of defending Frontier. Instead, an insurance defense firm, with a lower hourly rate, was selected. As Holly observes, the difference between the billing rates of a national firm and the billing rates of a local insurance defense firm could account for a difference of more than $5 million in the cost estimates.

[227] Zupan Dep. at 86.

made the litigation material.[228] It also points out that Edwards was unable to characterize projected defense costs of that magnitude as not material.[229] Of course, whether those witnesses were considering materiality in an accounting sense or an MAE sense (or if they considered them the same) is not clear.

The question of whether a particular "problem" would have an MAE has both quantitative and qualitative aspects. In any given year, particularly in light of the cyclical nature of Frontier's business, the burden of paying defense costs, such as those projected here, could be difficult. Holly, however, has not shown that Frontier could not pay them or that their payment would have had a significant effect if viewed over a longer term. The forward-looking basis for evaluating an MAE as chosen by Holly and Frontier does not allow the Court to look at just one year (assuming, as one may here, that the short-term consequences would not significantly interfere with the carrying on of the business). Instead, given Frontier's enterprise value,[230] it is reasonable to conclude that Frontier could absorb the projected defense costs without experiencing an MAE. More importantly, Holly has

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[228] Schafer Dep. at 73.
[229] Tr. at 439.
[230] By the discounted cash flow analysis of Frontier's valuation expert, the net present value of Frontier on a going-forward, stand-alone basis (*i.e.*, without Holly) was approximately $338 million. PX 419 ¶ 45.

not proved that the defense costs would have, or would reasonably be expected to have, a Frontier MAE.

Thus, Holly has not met its burden of proving by a preponderance of the evidence that the Beverly Hills Litigation, because of the risk of adverse results, because of the costs of defense, or because of both considerations taken together, does have, would have, or would reasonably be expected to have a Frontier MAE.[231]

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[231] Other factors, upon which the Court does not rely, may tend to support this conclusion. Some are set forth for a better understanding of the circumstances surrounding the failed transaction:

1. Venoco indemnified the Frontier interests at Beverly Hills. The scope of the indemnification (as with Wainoco's cross-indemnification) and Venoco's ability to pay are open to debate.

2. Frontier (and Wainoco) had historical insurance coverage from the mid-1980s that may have contained more insured-friendly pollution exclusion clauses. Any expectation of substantial assistance from the historical policies may be optimistic.

3. Frontier's actual defense costs through the end of 2003 were slightly over $1 million.

4. Frontier was able to borrow the funds needed to close the Merger. Presumably, a lender of $220 million would have contemplated whether the Beverly Hills Litigation would impair Frontier's ability to repay the loan (at least on a post-merger basis).

5. Holly, on August 21, 2003, delivered a notice to Frontier (PX 365) declaring that the Beverly Hills Litigation constituted an MAE. More precisely, it asserted that Frontier had breached its warranties in Section 4.8 and Section 4.9 (but with no reference to Section 4.19) of the Merger Agreement. If this had been done in the absence of Frontier's filing of this lawsuit, Frontier, under the Merger Agreement, would have had thirty days in which to cure the default. Presumably, one cure opportunity would have been through insurance. Frontier was able to obtain coverage from an AIG affiliate at the end of September 2003. It did not obtain the coverage before the expiration of thirty days following delivery of Holly's MAE notice, but, had it chosen to do so, it could have. The policy, with a five-year term, provides limits of $120 million covering all claims asserted in the

F. *Did Frontier Breach Its Warranty as to the Absence of Material Contracts?*

Holly also asserts that Frontier breached its contractual warranties when, in the Merger Agreement executed on March 30, 2003, it failed to disclose those documents evidencing Frontier's indemnification obligations involving Wainoco's activities at the Beverly Hills site. By Section 4.19 of the Merger Agreement, Frontier warranted, in relevant part:

> [A]s of the date hereof, there are no contracts or leases that are material to the business, properties, assets, financial condition or results of operations of Frontier and its Subsidiaries taken as a whole.

Unlike Frontier's forward-looking warranty regarding MAEs, this warranty is to be measured "as of the date [of the Merger Agreement]."[232] Significantly, although the parties expressly used the term "prospects" to

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various cases filed in the Beverly Hills Litigation. In addition to claims for personal injury and property damage, it also covers the contractual indemnity claims. Frontier incurred a premium of $5.75 million that is earned over the life of the policy and paid $19.5 million into a commutation account that will fund certain costs. One could view the acquisition of this insurance as evidence that the payment of $25 million was within Frontier's ability to pay; that the defense cost issue was under control; and that a sophisticated party took on the risks associated with the Beverly Hills Litigation after due inquiry. (The insurer's risk assessor stated, "We had determined that a likely exposure, including defense costs, was somewhere south of $20 million." (Winick Dep. at 118; PX 392)). Of course, if the worse case scenario evolves, the difference between Frontier's exposure and its insurance coverage will be devastating.

[232] Frontier's representations and warranties had to be "true and correct" as of both the date of the Merger Agreement and the Closing Date, "(except for representations and warranties made as of a specified date [such as those in Section 4.19], which need to be true and correct only as of the specified date)." Merger Agreement, Section 6.2(a).

emphasize the forward-looking nature of the MAE warranty, no such term was employed with respect to Frontier's warranty with respect to outstanding contractual obligations.

The documents evidencing potential Frontier liability for Wainoco's operations at Beverly Hills would be material to Frontier's financial conditions at the time of the Merger Agreement if the litigation risks associated with that threatened litigation were sufficiently foreseeable and sufficiently large. In other words, the failure to disclose the Wainoco indemnification obligations would have constituted a breach of Section 4.19 if (1) they demonstrated that Frontier would be directly liable in the threatened Beverly Hills Litigation, and (2) the potential adverse consequences of the threatened Beverly Hills Litigation, as measured as of the date of the Merger Agreement either by the risk of an adverse outcome and its potential magnitude or the cost of defense, would have been material to Frontier.

Accordingly, the Court again confronts a question of whether the threatened Beverly Hills Litigation could fairly be considered material to Frontier (assuming its liability at the site) as of the date of the Merger

Agreement.[233] The materiality of an indemnification or a guarantee can only be measured objectively with reference to the underlying obligation. In the context of the Merger Agreement, the concept of "Material Adverse Effect" and "material" are analytically distinct, even though their application may be influenced by the same factors. For example, the Merger Agreement requires an assessment of whether threatened litigation would be an MAE, thereby suggesting the parties' common understanding that threatened litigation at least could be an MAE. Holly and Frontier did not modify the terms of Section 4.19 (unlike Section 4.8, with Schedule 4.8) to address specifically the potential impact of the then-threatened Beverly Hills Litigation. A fact is generally thought to be "material" if it is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[234]

As a general matter, the consequences of threatened litigation are speculative and hard to quantify and, thus, courts are hesitant to find

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[233] Holly is charged with the burdens of proof and persuasion under Section 4.19. The language of Section 4.19 is even clearer than that of Section 4.8 (as discussed above). The warranty of Section 4.19 is syntactically straightforward: "There are no contracts . . . that are material . . ." Thus, the burden is on Holly to demonstrate the materiality and the inaccuracy of the representation.

[234] *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

threatened litigation material.[235] Because of the concentrated efforts of the parties in the days leading up to execution of the Merger Agreement to grasp the potential consequences of the Beverly Hills Litigation, it is difficult to dismiss Holly's claim under Section 4.19 out-of-hand simply because all that is at issue was then-threatened litigation. However, even in this somewhat unusual context, the Court cannot conclude that Frontier's failure to disclose those contractual obligations linking it directly to the Beverly Hills site can fairly be classified as "material" within the meaning of Section 4.19. As discussed above, the cost of the litigation itself cannot fairly be labeled material and there is a lack of a scientifically-recognized causal connection between site operations and the various cancers suffered by the plaintiffs (at least on this record). Also, while not preclusive, the litigation had not been filed, and, thus, any view of its likely consequences necessarily was somewhat speculative. In short, the risk that Frontier would be found liable at Beverly Hills, and to what extent based on what was otherwise known as of March 30, 2003, was too uncertain to be material within the meaning of Section 4.19.[236]

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[235] *See, e.g.*, *Gen. Elec. Co. v. Cathcart*, 980 F.2d 927, 935 (3d Cir. 1992).

[236] This is a claim for breach of an express contractual warranty, not for inducement to enter into the Merger Agreement through misrepresentation. Holly framed this aspect of this proceeding to be one of "declaring that Frontier breached Section 4.19 of the Merger Agreement." Joint Pretrial Order,

G. *Some Thoughts on Holly's Efforts to Prove Damages*

A few words about Holly's damages claim may, nonetheless, be appropriate. The proper measure of damages for breach of contract is an amount sufficient to restore the injured party "to the position [it] would have been in had the breach not occurred."[237] A prevailing party must prove its damages by preponderance of the evidence; absolute precision is not required but the proof may not be speculative either.

Holly failed to prove that it suffered any damages because of its failure to acquire the Denver Refinery. First, although it perhaps could have later rekindled its efforts, Holly's directors voted not to pursue that acquisition on March 7, 2003, some three weeks before execution of the

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Section IV(B)(5). Thus, it is viewed from the perspective of the objective third-party observer considering whether the contracts at issue were material to Frontier.
It might be different if the question, instead, were: was the representation that there were no contracts linking Frontier directly to Beverly Hills (and, thus, impairing Frontier's corporate separateness argument) material to Holly? If Frontier had not persuaded Holly that Frontier's potential liability in Beverly Hills was precluded (or substantially minimized) by the corporate separateness argument, Holly would not have entered into the Merger Agreement. Bechtol, on behalf of Frontier, conceded as much: "If Holly had thought that Frontier could avoid exposure in the Beverly Hills litigation by asserting corporate separateness . . . the guarantees [would] be pretty important to it." Tr. at 816. Thus, the absence of such a contractual obligation may have been material to Holly in reaching its decision to enter into the Merger Agreement. The warranty of Section 4.19, however, is not measured against Holly's subjective expectations; the parties did not draft it that way and the Court may not rewrite it.

[237] *Del. Limousine Serv., Inc. v Royal Limousine Serv., Inc.*, 1991 WL 53449, at *3 (Del. Super. Apr. 5, 1991).

Merger Agreement.[238] Thus, there could not have been any reliance on the warranties of the Merger Agreement because those warranties had not yet been made by Frontier. Second, the evidence of agreement with ConocoPhillips is unpersuasive.[239] It is clear that Holly and ConocoPhillips were close to an agreement, but that is all. Finally, Holly's proof of loss—presumably the difference between the purchase price (never established) of the Denver Refinery and the value to Holly with its synergistic benefits—was also insufficient. Even though damages need not be proven with absolute precision, Holly failed to provide the Court with a reasonable basis for any such calculation.

As to its loss of small refiner status and the impact on revenues from the sale of aviation fuel, Holly concedes that its expert used the wrong basis for calculating damages. The expert used contracted volumes, but, historically and for the period in question, Holly never reached those volumes.[240] Recognizing its problems, Holly asked the Court to assign a

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[238] PX 44. That decision was motivated by the anticipated agreement with Frontier. Holly's ownership of the Denver Refinery would have spawned antitrust concerns upon a merger with Frontier which already operated in the Denver market.
[239] No testimony (or other evidence) from Conoco/Phillips was offered.
[240] Actual volumes are not in the record.

conservative, but nonetheless speculative, number. The Court declines Holly's invitation to guess.[241]

Finally, Holly seeks reimbursement of $2,063,504.43 for out-of-pocket expenses incurred in pursuing the Merger, after execution of the Merger Agreement, but excluding litigation costs.[242] Frontier does not challenge the amount and those costs all appear to have been reasonably foreseeable under the circumstances; if Holly had prevailed on one or both of its misrepresentation claims, it would have been entitled to an award of these damages accordingly.

H. *Frontier's Claim for an Award of the Break-up Fee*[243]

Frontier separately argues that, if it is not entitled to the benefit of its bargain, then it should at least be awarded the break-up fee of $15 million, in addition to $1 million in expenses.[244] Under Section 7.4(b) of the Merger Agreement, Frontier could terminate the Merger Agreement if, before the Holly stockholders' vote on the Merger, "the Board of Directors of Holly

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[241] It is not that proof was not available (or even not readily available). It is that Holly did not present it.

[242] N 55; *see also* Tr. at 1602-03.

[243] This may seem a strange place (*i.e.*, at the end of a memorandum opinion) to consider a plaintiff's claim. Frontier's first two claims—repudiation and breach of the covenant of good faith and fair dealing—could be addressed without reaching Holly's arguments under Sections 4.8 and 4.19. Frontier's third argument—a blend of contract and equity—could not fully be explored without first resolving Holly's allegations of misrepresentation.

[244] It is undisputed that both Frontier and Holly incurred well over $1 million in qualifying expenses.

shall have withdrawn, modified, withheld or changed, in a manner adverse to Frontier, such Board's approval or recommendation of [the Merger] Agreement or the transactions contemplated thereby."[245] If Frontier terminated the Merger Agreement "pursuant to Section 7.4(b)," then, by Section 7.5(a)(ii), Holly would be obligated to pay Frontier the break-up fee. Accordingly, if Holly's Board withdrew (or modified) its support for the Merger Agreement, Frontier could have terminated the Merger Agreement and collected $16 million. By the time of the July meeting, a majority of the members of the Holly Board (indeed, all but possibly one) had concluded not to continue supporting the deal with the terms negotiated at the end of March 2003. Thus, Frontier contends, it follows, under Section 7.5(a)(ii), that it is entitled to the break-up fee. This argument fails.

First, the Holly Board never took formal action with respect to withdrawing or otherwise modifying its recommendation to the shareholders. No determination was made, as anticipated by Section 5.4(b), as to whether the directors' fiduciary duties required the Board to act. From Glancy's notes, it appears that the Holly Board may have come close; his notes reflect that the Board instructed Norsworthy to seek different terms.

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[245] By Section 5.4(b), Holly, through its Board of Directors, agreed to "recommend approval" of the Merger to the stockholders. By authorizing the Merger Agreement, the Board had "approved" it. The directors were also subject to their Support Agreements.

However, that direction, while it may foreshadow a change in recommendation, does not amount to a change in recommendation or a formal board decision to that effect.[246]

Second, Frontier fails to acknowledge that the members of the Holly Board could have decided not to go forward with the Merger and never reached the fiduciary out issues. Perhaps, although unlikely, a voluntary termination could have been negotiated. Perhaps a breach of warranty claim could have been asserted. Because the Merger Agreement afforded a number of exit strategies, the conclusion by the members of the Board, especially without collective action, not to proceed with the transaction on the then-existing terms does not automatically force the process into the one channel that leads to payment of the break-up fee.[247]

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[246] This is but one factor in the analysis. A formal resolution by the Board is not necessarily required. Indeed, with a recalcitrant merger partner, it may be unreasonable to expect or require formal action. On the other hand, the parties chose the term "Board of Directors" but, instead, could have used the term "Directors," thereby suggesting a more individualized consideration.

[247] There is admittedly a timing problem here because, otherwise, an unfair opportunity for delay may occur. The answer for a party in Frontier's position may be a more focused demand for assurances. Also, the issue here is complicated by the presence of significant questions regarding the accuracy of Frontier's representations and warranties.

There is also a question of whether Holly would have had the opportunity to cure if the withdrawal of support had not been in compliance with the Merger Agreement (*e.g.*, exercise of a fiduciary out without the guidance of outside counsel).

Finally, Frontier's right to seek the break-up fee is conditioned upon termination of the Merger Agreement "by Frontier pursuant to Section 7.4(b)." Frontier has not proven that it terminated the Merger Agreement under the auspices of Section 7.4(b). Indeed, no such allegation appears in its complaint filed on August 20, 2003, a complaint which does not purport to seek recovery of the break-up fee.[248]

Frontier's efforts to obtain payment of the break-up fee are, at least up to a point, not without equitable appeal. Holly, although it is concededly a close question, could not (or, at least, it did not here) prove that Frontier breached its warranties under Section 4.8 or 4.19 of the Merger Agreement. Holly, however, at least from early July 2003, was not going forward with the Merger under the express terms of the Merger Agreement. Because of the escalation in (or recognition of) the value of its pipeline assets, a difference far in excess of $16 million, Holly would have, and, at least arguably, should have, escaped from the Merger Agreement and paid the break-up fee. (That is, Holly recognized that if it guessed incorrectly as to whether the Beverly Hills Litigation would be perceived by a judicial officer as having an MAE, it could be found liable for perhaps $150 million; that

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[248] Instead, the complaint sought an award of "substantial damages" for repudiation and for breach of the covenant of good faith and fair dealing. It is clear that Frontier did not consider the break-up fee as the equivalent of "substantial damages."

would have provided Holly with an incentive to pay the break-up fee.) All of that may be accurate, but Frontier, in August 2003, was not content to accept or to seek the break-up fee. It wanted the benefit of its bargain. By its very conduct, it terminated the Merger Agreement under which it might otherwise have obtained the break-up fee. The fiduciary out is designed to allow for an orderly disentanglement of merger partners when the directors' fiduciary duties require it. Frontier, by orchestrating the August 19 Phone Call and by launching this litigation, disrupted that process. Frontier made its choices; one consequence of those choices is that it now has no claim to the break-up fee.

IV. CONCLUSION

For the foregoing reasons, the Court concludes as follows:

1. Holly did not repudiate the Merger Agreement;

2. Holly did not breach its implied covenant of good faith and fair dealing under the Merger Agreement;

3. Frontier breached the Merger Agreement by declaring a repudiation by Holly;

4. Holly suffered no damages as a result of Frontier's breach of the Merger Agreement and, thus, is entitled only to an award of nominal damages;

5. Frontier did not breach Section 4.8 of the Merger Agreement;

6. Frontier did not breach Section 4.19 of the Merger Agreement; and

7. Holly is not obligated to pay Frontier the break-up fee.

Counsel are requested to confer and to submit an appropriate order to implement this memorandum opinion.[249]

[249] As noted above, the Court has deferred resolution of any application for an award of attorneys' fees or, for that matter, costs.