Corporate and Securities Update:

M&A Development—Deal Process and Protections *(Netsmart, Lear and Topps)*: Lessons On What Not To Do When Selling Your Company

BY DAVID W. HEALY

Several recent Delaware Chancery Court cases, *In re Netsmart Technologies, Inc. Shareholders Litigation*, *In re Lear Corporation Shareholders Litigation* and *In re Topps Company Shareholders Litigation,* provide useful guidance on how Boards should conduct a market check, comply with their *Revlon* duties and negotiate deal protections.

KEY POINTS

DO A PRE-SIGNING MARKET CHECK

Micro-cap public targets with limited analyst coverage and trading volume should conduct a **pre-signing market check** rather than relying on a post-signing market check, at least where a private equity buyer is involved. (*Netsmart*)

RARELY JUST RELY ON A POST-SIGNING MARKET CHECK

In contrast, larger public targets with more substantial analyst coverage may be able to satisfy *Revlon* duties through use of a vigorous **post-signing market check**, especially if using a "go shop" arrangement that contemplates a modest termination fee. (*Lear*)

ALWAYS SOLICIT STRATEGIC BUYERS

Engaging with only private equity buyers, and **failing to undertake any exploration of interest by potential strategic buyers**, at least absent a reasonable, factual basis for doing so based on current information, may be a breach of a board's *Revlon* duties. (*Netsmart*)

FAIRLY TREAT BIDDERS

In dealing with competing bids, **a Board should be evenhanded** except as necessary to maximize price. The Board should make a good faith attempt to resolve the certainty issues that prevent a higher bid from being viewed as a superior offer. The Board should avoid actions that appear to unreasonably favor a lower but more certain bid desired by management, such as failing to exercise a right to exempt the potentially higher bidder from a binding no shop provision and using a standstill agreement to prohibit the potential bidder from making a higher bid. (*Topps*)

DON'T JUST RELY ON A MODEST BREAK UP FEE

A modest termination fee of 3% of equity value is **not sufficient to cure defects in the pre-signing market check**. In determining whether a termination fee is preclusive, it is arguably more important to **look at the fee as a percentage of enterprise value**, rather than of equity value, for example because enterprise value bears on the ability of a financial buyer to refinance post-acquisition. (*Netsmart*; *Lear*)

DISCUSSION

1. *Netsmart*: Inadequate Pre-Signing Market Check

As noted, *Netsmart* holds that micro-cap public targets with limited analyst coverage and trading volume, in the absence of any reasonable current basis for evaluating the company's value and the level of interest from potential buyers, should conduct a **pre-signing market check** rather than relying on a post-signing market check, at least in the context of a private equity buyout for cash that triggers an enhanced scrutiny review under *Revlon*. This holding contrasts with other cases holding that a post-signing market check may be an acceptable method for maximizing stockholder value (*In Re Pennaco Energy, Inc. S'holders Litig.*; *In re Fort Howard Corp. S'Holders Litig.*; *In re MONY Group Inc. S'holders Litig.*; *Lear*).

Netsmart's analysis is instructive in guiding directors as to how to conduct a market check that complies with their enhanced *Revlon* duties, which apply in any cash merger. Directors, when evaluating a change in control transaction, must ensure that management's process of finding the highest price for investors is reasonable in light of the company's position in the market and other circumstances (in this case, a micro-cap company of limited value to a strategic bidder). There is no single blue-print or checklist that a board must follow to fulfill its *Revlon* duties, but the board must act reasonably by undertaking a logically sound process to get the best deal that is realistically attainable, keeping in mind that no particular market check (or deal protection) approach will be reasonable in all situations. A court applying enhanced scrutiny under *Revlon* must determine if the directors made a reasonable decision, not a perfect decision.

Compliance with *Revlon* may require a board to examine the universe of potential strategic buyers and select for sales overtures a targeted group for whom an acquisition might make sense. *Netsmart* holds that at least for a micro-cap (here $81.8M) public company with limited trading volume, a single analyst and non-current information as to the level of potential strategic acquiror interest, it was unreasonable and a breach of *Revlon* duties to forego a pre-signing market check involving such an examination and rely instead on an inert, implicit post-signing "market check" consisting of an announcement of the merger, a fiduciary out, and a modest break-up fee in the merger agreement. The court

reasoned that it was less likely, in the case of a small public company, that an outside bidder would make an unsolicited superior offer. "Moreover, all of the strategic acquirors who might have had an interest in Netsmart were much, much larger and likely to see Netsmart as the sort of nice bolt-on one would add through a friendly process, not the type of key strategic move that would likely justify making a hurried unsolicited overture without prior discussions or information." (Vice Chancellor Strine in *Lear*, distinguishing his decision in *Netsmart*.) The court characterized as "less than exciting" the deal valuation at the bottom end of the Netsmart banker's own valuation range, implying it demonstrated that the strategy of excluding strategic buyers was not reasonable under *Revlon* in Netsmart's particular circumstances.

Netsmart makes clear that a pre-signing market check must consist of a vigorous, active canvassing of potential bidders, or at least a discreet, targeted and controlled marketing effort towards select strategic buyers. The market check must be reasonably designed to maximize value for the specific company involved, given an actual consideration of the M&A market dynamics relevant to that company's situation. A material effort at salesmanship is expected; optimally, top bidder executives would be contacted, appropriate pitch materials would be utilized, and any banker making contact with a potential bidder would be authorized to solicit bids for a particular target rather than, as in *Netsmart*, merely making generic cold calls, apparently made without authority, to solicit interest in multiple targets.

In any event, to justify not conducting a pre-signing market check or contacting a reasonable group of potential bidders (including potential strategic buyers), the target's board must have a reasonable, factual basis, based on current information, for that course of action. The board must have established a record that demonstrates a genuine and reasonably informed evaluation of whether a targeted search might make sense. *Netsmart* concludes that sporadic, isolated contacts with strategic buyers stretched out over several years (during which period Netsmart's banker had made only a handful of generic cold calls, Netsmart was smaller and less attractive, strategic buyers were materially different and market and competitive conditions had markedly changed), is not such a reasonable basis and did not constitute the required close examination of the market. Further, a board cannot simply conclude that private equity buyers can outbid strategic acquirors, and use that as a basis for only contacting the former. In sum, when, as in *Netsmart*, directors do not possess reliable evidence of the market value of their company as a whole and evidence that deal announcement would generate a reliable post-signing market check as would be the case for a large-cap company, the lack of an active sales effort pre-signing is strongly suggestive of a *Revlon* breach.

2. *Lear*: Adequate Post-Signing Market Check

In contrast to *Netsmart*, *Lear* holds that a widely traded public company may rely primarily on a post-signing market check to comply with *Revlon* duties. Lear was a widely traded Fortune 200 company with an extensive analyst following. Lear was considered to be "in play" because it had rescinded its poison pill and the noted financier Carl Icahn had taken a substantial equity stake, which caused the trading price to rise substantially (from $17 to about $30). Icahn offered to buy the company at $36 per share, provided that the company did not conduct an auction. Nevertheless, the Lear board quickly contacted eight potential investors over a few days, in a process that the court did not regard as a genuine pre-signing market check, but no alternative bidder emerged. Accordingly, the Lear board relied on a post-signing market check consisting of a 45 day go shop provision, with a reduced termination fee for any deal signed in that period and a higher fee for any deal signed thereafter. Lear conducted an extensive, active canvassing of 41 potential buyers in the go shop period. The court held that because Lear was so visible and well known, this post-signing market check did comply with *Revlon* in that it was reasonable and provided adequate assurance that no bidder willing to materially top Icahn existed. The Lear board viewed this approach as locking in Icahn's bid, while securing a chance to prospect for more. In that context, Icahn's agreement to vote his shares in favor of a topping bid was strong evidence that the post-signing market check was designed to result in the best value.

3. *Topps*: Baseball Card Company Uses A Non-Level Playing Field!

In *Topps*, the family-controlled public company had a management friendly bid from a buyer group consisting of former Walt Disney Company CEO Michael Eisner and a private equity firm, Madison Dearborn Partners, and the prospect of a competing higher bid from its primary competitor in the baseball card business, Upper Deck. In essence, the Topps board acted as if it was doing management's bidding by favoring the lower Eisner group bid over Upper Deck's higher bid, particularly after a merger agreement with the Eisner group had been signed. Questionable actions by the Topps board included not exempting the Upper Deck offer from the no shop provision in the signed Eisner group merger agreement (which the Topps board had the right to do), not seeking to negotiate a resolution of the aspects of the Upper Deck bid that troubled the Topps board relating to deal certainty associated with antitrust and financing issues, not allowing Upper Deck relief from a standstill agreement to enable it to bring its higher bid directly to the Topps stockholders, and including misleading statements in the proxy that

cast doubt on Upper Deck's intentions. The court indicated that accepting the lower Eisner group bid alone was not a *Revlon* breach given the noted concerns about the certainty of the Upper Deck deal and the risk that Upper Deck was just seeking competitive information or to kill the Eisner group bid, which are legitimate non-price considerations under *Revlon*. However, the court held that the Topps board was required to negotiate in good faith to seek to resolve its concerns about Upper Deck's bid, rather than simply refusing to engage with Upper Deck, and that its failure to do so (along with the misleading statements in the proxy statement) could be attributed to the board seeking to help management remain in control, rather than a good faith desire to maximize price. The court found that these motivations combined to cause the directors to favor the Eisner group over Upper Deck without regard for the price ultimately received by Topps' stockholders, thus breaching their fiduciary duties. As *Topps* demonstrates, when directors have made the decision to sell the company, any favoritism they display towards a particular bidder must be justified solely by reference to permissible objectives such as maximizing deal value and improving deal certainty.

As a post-script, after *Topps* was decided, influential proxy advisory firm ISS recommended that Topps' stockholders reject the Eisner group offer because of flaws in the sales process and questions about whether that offer was the best available. In addition, hedge fund Crescendo Advisors opposed the Eisner group offer. As a result, Topps deferred its stockholders' meeting, noting that the deal wouldn't go through if its stockholders voted on the date originally scheduled. Nevertheless, Upper Deck withdrew its competing offer, citing Topps' lack of cooperation. These developments demonstrate that both practical, as well as legal, factors should be taken into account in determining how to deal with competing bidders.

4. *Netsmart*, *Lear* and *Topps*: Process and Deal Term Tips

Several process tips can be gleaned from *Netsmart*, *Lear* and *Topps*:

Board Control: Especially in a private equity buyout where the courts perceive a greater potential for management conflict of interest, the board or special committee should shape and carefully supervise the market check, deal term negotiations and due diligence processes to be sure that *Revlon* duties are satisfied and that no bidder is given preferential treatment or given signals, without authorization, as to an acceptable price level. *Lear* was critical of the Lear CEO being given authorization to negotiate directly with Icahn, particularly since the CEO had a large financial incentive to consummate the merger, and of the CEO's one week delay in advising the board of Icahn's interest in making a going private proposal (which delay resulted in the board losing valuable time to inform itself, shop the company and plan negotiations). *Netsmart* was critical of management's role in shaping the board's and special committee's determination to solely pursue private equity buyers. *Topps* criticized the board's apparent tendency to do management's bidding in failing to properly consider a possibly superior offer from a competitor. The perception of board control can be enhanced where the board meets frequently in executive session without management and the board plays a role in selecting a financial advisor and the timing of hiring that advisor.

Preparation of Minutes: Minutes of board and special committee deliberations should be approved currently, not months after the fact, to avoid the perception that the minutes are merely an after-the-fact rationalization for the Board's actions. Further, any meeting at which important decisions regarding the shopping process are to be made must be held and documented as a formal board or committee meeting. Any rationale for the Company's actions taken to comply with *Revlon* that is described in the proxy statement should be supported by board or committee decisions that are properly documented in the minutes. For example, *Netsmart* concluded that the board's decision to not solicit strategic buyers, based on an ostensible lack of acquiror interest and competitive concerns, lacked factual support and was not "confidence-inspiring", where it was considered only at an "informal" meeting at which no minutes were taken and all the minutes from the numerous special committee meetings were formally approved at once, several months after the fact.

Disclosure: In general, at least in all cash deals with private equity buyers where management is being retained, the proxy statement should include the projections upon which the bankers relied, particularly those used to prepare the discounted cash flow analysis. Any topic addressed in the disclosure materials should be described in an accurate, fair, balanced and materially complete fashion. In general, Delaware courts are far more likely to enjoin the vote on the acquisition until any material disclosure problems are corrected, so stockholders can make an informed decision, than to enjoin the deal itself. For example, in *Topps* the proxy was found misleading and thus the basis for an injunction because it gave a biased and misleading account of negotiations that favored the Eisner group bid and it failed to mention that the Topps board was using the standstill agreement to prevent Upper Deck from making a higher bid.

Termination Fee: *Netsmart*, *Lear* and *Topps*, coupled with the *In re Toys "R" Us S'holders Litig.* case and the recent *Express Scripts, Inc. v. Caremark RX, Inc./CVS Corporation*

case, provide a good summary of the relevant analytical framework for analyzing the appropriateness of termination fees. In evaluating the maximum termination fee to which a target board can agree, the board should consider factors such as the absolute amount of the termination fee; the size of the transaction; the percentage of equity value and enterprise value that the fee represents; the benefit to shareholders, including a premium, that directors seek to protect; the per share dollar amount that the fee represents and thus that a competing bidder must top (it being the intention of *Revlon* to encourage bidders who wish to bid materially more, not incrementally more); the relative size of the parties to the merger; the degree to which the buyer found the protections to be crucial given relative bargaining power; and the preclusive or coercive power of all deal protections taken as a whole. There is no presumptively reasonable level of termination fee or naturally occurring rate or combination of deal protection measures--the fee and measures adopted must be reasonable and non-preclusive as a whole given the particular circumstances. A modest termination fee does not, per *Netsmart*, cure defects in the pre-signing market check. Applying these principles, *Netsmart* found that a break up fee (including expenses) of 3% of the deal's implied equity value was modest and not unreasonable given the small size of that deal, particularly given that over one third of the fee would go to reimburse expenses. *Lear* found a break up fee/ reimbursement arrangement amounting to up to 2.8% of the equity value and 1.9% of the enterprise value during the go shop period and 3.5% of equity value and 2.4% of enterprise value (about $1.25 on a $36 bid) after the go shop period to be not unreasonable (even though a cited JP Morgan survey had found that median termination fees were about 1.8% of equity value during the go shop period and 2.9% thereafter). *Topps* found a termination fee (including expense reimbursements) of up to 3% of equity value in the go shop period and 4.6% of equity value after the go shop period to be not unreasonable (but a bit high in percentage terms), given it only represented $.42 per share, which was not enough to deter a serious rival. *Lear* noted that in determining if the fee is preclusive, it is arguably more important to look at the enterprise value metric because that bears on the ability of the buyer to refinance after the acquisition. *Caremark* cites Delaware cases approving fees ranging from 2.8% up to 3.5% of equity value. *Toys"R" Us* requires that real world risks and prospects must be considered in evaluating deal protections and upheld a termination fee of 3.75% of equity value and 3.25% of total transaction value, given that the board had negotiated a .25% reduction in the fee and that the highest bidder, KKR, had bid so much more than the next competing bid and the board understandably wanted to lock in KKR's bid. A review by our firm of 14 recent enterprise software deals over $1B indicated that termination fees in those transactions represented 3.44% (mean) and 3.55% (median) of equity value and 3.21% (mean) and 3.17% (median) of enterprise value, arguably the more important measure. Even if a termination fee were unreasonably high, however, the plaintiffs must still prove that a given set of deal protections operate in an unreasonable preclusive or coercive manner, under the *Unocal* standards, to inequitably harm stockholders.

Right to Match: This right must be considered along with the termination fee and other deal protections to determine whether the deal protections taken as a whole are preclusive or coercive, but in general, the combination of a termination fee and a right to match has been found to be not unreasonable. *Lear* includes a reference to 15 transactions with a 3% or higher termination fee and match rights that had overbids. The right to match periods are normally three to five business days; in *Lear*, there was a ten day right to match, but if the new bidder overbid by approximately 2.8% then the original bidder only had one right, not multiple rights, to match. Such provisions are consistent with encouraging only meaningful overbids.

If you have any questions about this memorandum, please contact David W. Healy (dhealy@fenwick.com) or Douglas Cogen (dcogen@fenwick.com) of Fenwick & West LLP.

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