

## Mind Over M&A Matter

### Delaware Decisions Resist Blanket Rules, Scrutinize Motives of Dealmakers in Private Equity Takeover Transactions

By Nancy T. Avedissian and Adam R. Moses

#### From the Field

In a recent string of notable decisions, the Delaware Court of Chancery has closely examined and found suspect the underlying motives of directors and management in several takeover transactions. These opinions emphasize that the context of a transaction is essential to an understanding of whether directors have satisfied their fiduciary duties. Underscoring the prevalence in the market of private equity transactions – at least until the recent pullback in credit conditions – the three recent cases involve the behavior of directors in deals with buyout shops. The target companies in these cases were **Netsmart Technologies**, **The Topps Company** and **Lear Corp.**



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The decisions, each penned by Vice Chancellor Leo E. Strine Jr., offer narrow, fact-specific holdings and therefore do not significantly alter the core principles underlying the fiduciary duties of directors under Delaware law. However, they do serve as instructive cautionary tales set against fact patterns that have become common in the merger market today. Of particular interest is the heightened focus on transactions involving financial buyers since such deals can present markedly different incentives for deal participants than takeovers executed by strategic purchasers.

Directors' fiduciary duties are prescribed by state law and therefore differ somewhat across jurisdictional lines. However, Delaware figures prominently in the national conversation since many corporations are chartered in that state and its bench has produced a robust, thoughtful body of case law on the subject. Generally, directors owe the duties of care, candor and loyalty. Once a determination is made to sell a corporation or start down the road to a change in control transaction, under Delaware law, directors also owe a heightened so-called *Revlon* duty, which is essentially the obligation to maximize shareholder value.

Factors a board should consider in evaluating a prospective sale include purchase price, the form and expected future value of any securities to be received, and the likelihood of closing the transaction. Although a formal auction is not required, the board must act reasonably in soliciting and negotiating with bidders and must generally “level the playing field” for all buyers.

Over time, and because there are no blanket rules for directors seeking to fulfill their fiduciary duties in buyout situations, certain conventional practices have emerged. The use of auctions, special committees, pre-signing market checks, “fiduciary out” provisions, “go-shop” and “window-shop” provisions, and two-tier termination fees are all meant to give dealmakers the sense that their transactions should withstand judicial scrutiny.

However, a common thread woven through the recent Delaware decisions is that the context of a transaction and the incentives of deal participants matter -- often more than formulaic “market” conventions that do not take account of a particular situation.

#### Context Matters

The first lesson yielded by these cases is that context is king. Netsmart, a supplier of software to the health care industry with a market capitalization of less than \$100 million, received advances from private equity buyers. Its board determined to pursue a sale of the company and focused its auction exclusively on financial suitors since the board predicted that strategic buyers would not be interested. The auction produced a merger agreement with two partnering private equity firms.

Erasing the appealing simplicity of bright-line tests, the *Netsmart* court rejected the Netsmart board's “rote assumption...that an implicit, post-signing market check” in the form of a fiduciary out coupled with a window-

shop provision “would stimulate a hostile bid by a strategic buyer for Netsmart – a micro-cap company – in the same manner it has worked to attract topping bids in large-cap strategic deals.” Although pundits have since debated how trenchant Strine’s micro-cap vs. large-cap distinction really is, the basic lesson is clear: One size does not fit all. Directors should always pay attention to a company’s size, market capitalization and other relevant “market dynamics” rather than relying on a standard checklist of contractual devices that, depending on the situation, may not provide a meaningful market check.

Stressing the importance of taking strategic buyers seriously, the *Netsmart* court insisted that market context – not the board – should dictate the universe of prospective buyers. The *Netsmart* decision sharply criticized the Netsmart board for failing to contact strategic buyers.

### Motives Matter

In the flurry of M&A activity in recent years, many companies have welcomed private equity buyers while rebuffing strategic buyers due in part, some commentators have suggested, to the belief that financial buyers are more likely to retain management. This theory continues that senior managers often serve on boards and can be well situated to influence – often indirectly or unintentionally – the views of independent directors. Because of this, the motives of a target’s management team are very important to understand. Management-led buyouts executed with the support of private equity co-investors can raise even thornier questions about incentives. When considering the incentives of managers, the Delaware courts have registered their skepticism and have sought to root out indications that management or boards have unfairly favored financial buyers.

If a board takes action to support a transaction based on factors other than obtaining the best terms for shareholders, it should expect legal challenges. In *Topps*, the court enjoined the use by the baseball card company’s board of a standstill agreement to block a strategic buyer and clear the path to the altar for buyout firms led by Michael Eisner. The court explained that “[w]hen directors have made the decision to sell a corporation, any favoritism they display toward particular bidders must be justified solely by reference to the objective of maximizing the price” paid.

In *Lear*, Strine thundered that it would be “silly” to think that compensation arrangements intended to incentivize managers are wholly benign. Lear’s CEO approached its compensation committee in November 2006 to explore accelerating his retirement payments, although they were not accelerated at that time. Only a few months later, Carl Icahn, a 24% shareholder in the auto parts company, initiated discussions with the CEO regarding a going-private transaction. The board formed a special committee, which then authorized the CEO to lead negotiations with Icahn. The negotiations resulted in a takeover deal which would trigger a payout of the CEO’s retirement benefits while enabling him to keep his job. To shine a spotlight on the CEO’s possible motives, the *Lear* court delayed the shareholder vote and required additional disclosure about the CEO’s original

request to accelerate his retirement payments.

### It’s a Matter of Fact

The recent Delaware cases highlight the importance of protecting shareholders by requiring meticulous and balanced disclosure of a transaction’s material facts in proxy statements, especially facts that bear upon the motives of management or the board. In addition to the *Lear* example, the court in *Netsmart* criticized the failure of that company to include in its proxy statement projections of its future results. The *Netsmart* court concluded that such projections are “probably among the most highly-prized disclosures by investors” and emphasized that this “is especially the case when most of the key managers seek to remain as executives.”

Meanwhile, the *Topps* court took issue with: the failure of the Topps board to disclose Eisner’s assurances to senior management that they would be retained; a presentation to the board that “cast doubt on the fairness of the merger”; and the seriousness of the interest of Upper Deck, a prospective strategic buyer, in acquiring Topps and its willingness to pay a higher purchase price. Accordingly, the *Topps* court ordered that Topps include corrective disclosure in its proxy statement and delayed the shareholder meeting to permit the market to absorb the new information.

### No Laughing Matter

None of the recent Delaware decisions enjoined an acquisition outright, but the Delaware Court of Chancery has evidenced a willingness to flex its muscles by requiring corrective disclosure, delaying shareholder meetings, and tossing out impediments to competitive bidding conditions. Although these forms of relief are not as draconian as an outright block, they can still draw out or even derail a transaction by inflaming target shareholders and introducing an element of uncertainty. For instance, shareholders ultimately rejected Icahn’s bid for Lear. In addition, Topps was forced to postpone the shareholder vote on its deal with the Eisner-led group amid wavering investor support once details of Upper Deck’s higher offer surfaced.

Thus, dealmakers should be wary of the recent inclination of the Delaware courts to closely scrutinize the context of transactions and the motives of directors and management, keeping in mind as well that deal techniques appropriate in one transaction may be found wanting in another. When choreographing transactions involving Delaware chartered targets, dealmakers would do well to view each move through the prism of the recent Delaware cases and focus intently on how the incentives of deal participants, when exposed to the light of day, will appear in the eyes of shareholders and the courts. Heeding the lessons offered by these cases may just save a deal.

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