Milbank

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CONTACT

Alan Stone
Partner
+1-212-530-5285
astone@milbank.com

David Schwartz
Of Counsel
+1-212-530-5260
dschwartz@milbank.com

Corporate Governance Group Client Alert: NetSpend Board in Breach of *Revlon* Duties as Sale Process is Determined not to be Designed to Produce Best Price

However, Court of Chancery refuses to grant injunctive relief, fearing loss of substantial premium given lack of competing bids

In a highly contextual decision on a motion for a preliminary injunction, Vice Chancellor Glasscock recently held in *Brenda Koehler v. NetSpend Holdings Inc. et al*[1] that the Board of Directors of NetSpend Holdings, Inc. failed to satisfy its *Revlon*[2] duties when agreeing to be acquired by Total System Services, Inc. (TSYS) because the NetSpend sale process, which involved a single-bidder strategy, was "not designed to produce the best price for the stockholders" and "reviewed as a whole, was unreasonable".

BACKGROUND

NetSpend is a publicly traded company that "provides reloadable prepaid debit cards and financial services to consumers who do not have traditional bank accounts or who rely on alternative financial services". Meanwhile, TSYS is a strategic provider "of global payment services to financial and nonfinancial institutions, generally under long-term processing contracts."

NetSpend was incorporated in 2004 and went public in October 2010. During its history as both a privately-held or publicly-traded company, NetSpend was party to various acquisition negotiations, some of which the Court characterized as "very advanced". Prior to conducting its IPO, in the period between 2007 and 2009, NetSpend engaged in three separate negotiations, but in each instance, no deal to acquire NetSpend ever materialized. Following its IPO, after NetSpend's stock price plummeted to $3.90 per share in the third quarter of 2011 (a price that the Board

[1] C.A. No. 8373-VCG (May 21, 2013).

[2] *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.*, 506 A.2d 173 (Del. 1986).

believed greatly undervalued the Company's long-term potential), NetSpend "conducted two rounds of $25-million stock repurchases" and then explored other "possibilities for enhancing stockholder value, including additional stock repurchases, a self-tender offer, or a possible sale of the Company." However, despite being contacted by multiple entities (four potential suitors in 2012 alone, with one such suitor in May 2012 expressing an interest to merge with NetSpend for shares priced at little to no premium), no acceptable acquisition bids ever materialized, so the Board "determined that it was in the stockholders' best interest to maintain NetSpend as an independent, publicly owned entity".

Roughly at the same time that the Board was exploring strategic alternatives to enhance stockholder value, NetSpend's two largest stockholders (a 31% holder and a 16% holder, each with affiliate-designees on the Board) separately approached the Company about disposing of all or substantially all of their equity interests. In order to alleviate any downward pricing pressure on NetSpend's stock that could result from such amounts of stock being sold in the open market, the Board accommodated its 31% stockholder by providing material, non-public information to two potential buyers of such equity position. The information provided by NetSpend was subject to a confidentiality agreement that contained "a clause colloquially known as a 'don't-ask, don't-waive' clause which prevents the contracting party from 'directly or indirectly request[ing] that Netspend [sic] or any of its Representatives . . . amend or waive any provision of this agreement (including this sentence) or otherwise consent to any action inconsistent with [the standstill agreement]."

While the 31% stockholder engaged in discussions to sell its equity position (including agreeing to a $12.00 per share price with one bidder), TSYS's COO initiated contact with NetSpend's CEO in June 2012, at which time NetSpend's CEO responded that NetSpend "was not for sale". In the fall of 2012, TSYS reinitiated contact with NetSpend and in early December 2012, TSYS delivered a written indication of interest to NetSpend summarizing TSYS's desire to acquire NetSpend for $14.50 per share. The Board convened a meeting to discuss this indication of interest with its advisors, with its financial advisor presenting a "list of nine potential purchasers for the Company." Several of these potential bidders were "discounted as unlikely to bid on NetSpend", especially seeing how some of the companies were recently informed that "NetSpend was not for sale". Even with TSYS, the strategy adopted by the Board to maximize value was to consistently deliver a message that the Company was "not for sale" and that "'convincing the Board to depart from the Company's existing business strategy would require a substantial improvement in TSYS' proposed price'".

As for contacting potential suitors other than TSYS, the Board declined to pursue such a course of action for various reasons, including: "(1) the possible adverse effect of a leak of information regarding the sale on customers and employee morale; (2)" the lack of any response whatsoever from a strategic party that was notified pursuant to a pre-existing contractual obligation of TSYS's indication of interest and on-going discussions, which "lack of response" was "taken as a proxy for general market indifference; (3) the possible loss of negotiating leverage if no other bidders emerged to compete with TSYS;" and "(4) a recommendation from [its financial advisor] that a financial bidder was unlikely to match TSYS's offer".

Over the course of the next several months, the parties engaged in discussions about a potential acquisition by TSYS, focusing namely on price and the inclusion of a "go shop" provision to permit the Board to actively solicit other bidders following the execution of a TSYS merger agreement, which the Board argued was necessary given its lack of a pre-signing market check.

Eventually on February 19, 2013, the merger agreement and related voting agreements were executed. The final key terms of the merger agreement included a $16.00 per share purchase price (representing "a 45% premium over NetSpend's stock price one week before the deal"), a no-shop provision with a "fiduciary out" (rather than a "go-shop" provision that the Board desired) and matching rights, and a 3.9% termination fee. Additionally, the merger agreement prevented NetSpend from waiving any existing standstill agreements, which meant that the two bidders for the 31% stockholder's equity position were contractually restricted from approaching NetSpend and making an unsolicited bid that could be deemed to be a superior proposal relative to TSYS's deal. Finally, the related voting agreements were with the two largest stockholders of NetSpend and locked up approximately 40% of NetSpend's stock. The voting agreements terminated only if and when the merger agreement terminated (as opposed to terminating upon an adverse change in recommendation by the Board as relates to the TSYS transaction).

The plaintiff, who is a public stockholder of NetSpend, moved to enjoin the merger and postpone the "closing for a sufficient period during which the deal-protection devices would be inoperative, presumably allowing topping bids to emerge." Plaintiff asserted that "NetSpend's Board breached its fiduciary duties of loyalty and care under *Revlon* by"..."(1) allowing [its CEO] to negotiate with TSYS on behalf of NetSpend, (2) deciding not to seek alternative bidders, (3) relying on a weak fairness opinion from [its financial advisor], (4) agreeing to unreasonable deal-protections, and (5) retaining the don't-ask, don't waive clauses in the standstill agreements with [the two bidders for the 31% stockholder's position]."

THE COURT'S ANALYSIS

The Court held that the plaintiff had "shown a likelihood of success on the merits of her *Revlon* claim" because the Board was "unlikely to meet their burden at trial of proving that they acted reasonably throughout the sale process to TSYS". However, because the plaintiff could not show that the magnitude of the harm absent an injunction exceeded the potential harm of an injunction (*i.e.*, removing the only deal on the table, which deal also happens to afford NetSpend stockholders a premium), the Court denied plaintiff's motion for enjoin the proposed TSYS merger transaction.

Overview of Revlon standard: Vice Chancellor Glasscock began his analysis by reviewing the *Revlon* standard in general, noting that when "a board decides to enter into a transaction that involves the sale of the company in a change of control transaction, the directors of the company have a duty to secure the best value reasonably attainable for the stockholders...Directors need not follow a particular path to maximize stockholder value, but the directors' path must be a reasonable exercise toward accomplishing that end...Reasonableness requires that the board be informed and that it construct a sale process to maximize value in light of that information...Still, *Revlon* requires only a reasonable decision, not a perfect decision..."

Adequacy of the Board Process: Against this backdrop, the Court analyzed in chronological order the adequacy of the Board's sale process.

CEO-Led Negotiations Determined to be Reasonable

The Court quickly concluded that the Board's decision to permit its CEO to spearhead the deal negotiations was reasonable seeing how his "interests appear to have been aligned with the interests of the stockholders at all times."

Single-Bidder Strategy Determined to be not Unreasonable Per Se

Next, the Court determined that the Board's initial decision to forego a pre-signing market check and to adopt a single-bidder strategy was "within the range of actions a reasonable board could take to maximize stockholder value."

In this regard, Vice Chancellor Glasscock noted that "if a board is considering selling the company and there is only one offer on the table, the general rule is that the board must canvass the market to determine if higher bids may be elicited, since the board 'has no reliable grounds upon which to judge [the offer's] adequacy...' However, a board may [sic] dispense with a market check where 'the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction...'"

Against this backdrop, Vice Chancellor Glasscock pieced together the following factors to conclude that the Board was reasonable in initially adopting a single-bidder strategy:

- that the NetSpend directors were "sophisticated professionals with extensive business and financial expertise";
- that "the Board had several indicia as to how the market valued NetSpend" (*e.g.*, (i) NetSpend's stock price remained at $8 per share despite various

repurchases by the Board, (ii) the $12.00 per share price agreed to by the 31% stockholder in 2012 to sell its entire equity position, (iii) a proposal by a suitor in May 2012 to merge with NetSpend for little to no premium, (iv) the fact that no offers were ever made from four other suitors in 2012 despite initial overtures, and (v) the fact that the entity that was provided notice pursuant to a pre-existing contractual obligation that NetSpend was in play as a result of TSYS's indication of interest also did not opt to make an offer to acquire NetSpend);

- "that the Board was well-informed about the process of selling the Company" given the recent failed acquisition negotiations as well as its IPO process;
- "Based on the negative consequences that accompanied these failed deals,...the Board consciously adopted the strategy of telling would-be acquirers that it was 'not for sale,' while intimating that it could be for sale for a high enough offer...", which "deliberate strategy...allowed NetSpend to focus on maintaining the business in the ordinary course while forcing TSYS to bid against itself".

Remainder of Sale Process, in light of Single-Bidder Strategy, Determined to be Unreasonable

Transitioning to the next steps in the sale process, the Court noted that when "a board decides to forgo a market check and focus on a single bidder, that decision must inform its actions regarding the sale *going forward*, which *in toto* must produce a process reasonably designed to maximize price." [*emphasis added*] Accordingly, the Court analyzed "the remainder of the sale process, including the reliance on [the] Fairness Opinion, and the deal-protection devices, including the don't-ask, don't-waive clauses" to determine whether "the Board's actions were reasonable in light of the Board's awareness that it had no external market check."

- *Fairness Opinion*: The fairness opinion delivered to the Board by its financial advisor contained several valuations of NetSpend, including valuations based on NetSpend's stock price, a comparable companies analysis and a discounted cash flow (DCF) analysis. The Court, however, characterized the fairness opinion as "weak" and not a "strong indication of NetSpend's value" because (i) the "comparable companies used...were dissimilar to NetSpend, which greatly reduces their utility" and (ii) the DCF analysis "indicates that the TSYS offer was grossly inadequate"[3] because the "$16.00-per-share merger price is 20% below the bottom range of values implied by the DCF" and "was based on financial projections that were outside the range of management's customary projections." The Court noted

[3] While not addressed by the Court, the lack of a "downside case" DCF analysis in this situation (*e.g.*, a DCF analysis that stress-tests various underlying management assumptions, and as a result, projects a less favorable outlook) is noteworthy because it may have been possible that such a "downside case" DCF analysis could have projected that the $16.00 merger consideration was in fact adequate relative to such "downside case".

that the "relative weakness of the Fairness Opinion does not demonstrate that the price is unfair; instead, it indicates that the Fairness Opinion is a poor substitute for a market check." In summation, Vice Chancellor Glasscock stated that while "I do not find that the directors' reliance on the Fairness Opinion was itself a breach of fiduciary duty", "...I do find that the Directors' reliance on a weak fairness opinion is context for the Board's other decisions, and pushes those decisions farther towards the limits of the range of reasonableness."

- *Deal Protection Devices*: In the merger agreement, the deal-protection devices used were "a no-shop clause, a 3.9% termination fee (valued at $53 million), and matching rights" as well as voting agreements that locked up approximately 40% of the NetSpend stock in favor of the TSYS merger.

  - *Voting agreements*: The Court noted that any concerns that these agreements "impermissibly lock up the deal are alleviated by the fiduciary-out clause of the Merger Agreement" and the fact that the voting agreements are co-terminus with the merger agreement itself. Accordingly, the voting agreements were determined to "pose no credible barrier to the emergence of a superior offer".

  - *No-shop clause*: The Court noted that the "Board only agreed to the no-shop once it had extracted further consideration from TSYS, in the form of a raised price and a lower termination fee", and further noted that it "is not per se unreasonable for a board to forgo a go-shop where it makes an informed decision that such forbearance is part of a process designed to maximize price." However, the Court nevertheless stated that the Board "discarded" an important utility of the no-shop clause – which according to Vice Chancellor Glasscock is to "determine whether...maximum price...has been achieved" - because "the Board anticipated a short period before the deal's consummation...in April. Thus, the Board cannot have intended that a leisurely post-agreement, pre-closing period would provide an adequate alternative to a market check."[4]

  - *The Don't-Ask, Don't-Waive Clauses*: Vice Chancellor Glasscock expressed various concerns with these clauses in the standstill agreements (especially as reinforced by the terms of the merger agreement prohibiting NetSpend from waiving such provisions). To begin, "the Board blinded itself to any potential interest [the two entities]", which were "the only two entities which had

[4] It is unclear what the Court is intimating in this regard (*i.e.*, whether a board that engages in a single-bidder strategy without a go-shop provision in its merger agreement should delay a merger's closing for a sufficient amount of time (even if all closing conditions are satisfied) so that an "adequate", post-signing, de facto market check can be achieved), especially given the fact that one rationale cited by the Court for denying plaintiff's injunctive relief was the potential harm that could be caused by delaying the TSYS closing, which was the only deal on the table.

> recently expressed an interest in acquiring at least a large minority position in NetSpend...Most problematically, it does not appear that the Board even considered whether the standstill agreements should remain in place once the Board began negotiating with TSYS, which would have been the ideal time to waive the [don't ask, don't waive] clauses..." And contrary to NetSpend's belief that neither of these entities would have bid for the Company[5], the Court simply noted that "NetSpend's sanguine confidence is misplaced" in this regard and that "NetSpend cannot have known with certainty that those entities are uninterested in NetSpend."

Vice Chancellor Glasscock concluded his *Revlon* analysis, stating that:

> "Faced with the particular facts...above—the lack of a market check at any stage in this process; the Board's reliance on a weak fairness opinion; the deal protections, including the [don't-ask, don't waive] clauses...; and the lack of an anticipated leisurely post-agreement process which would give other suitors the opportunity to appear—I believe that the Defendants will fail to meet their burden at trial of proving that they acted reasonably to maximize share price. Though several of these facts, alone, are not outside the range of reasonable actions the Board could take, in their aggregate, these facts indicate a process that is unreasonable. In particular, in failing to waive the [don't ask, don't waive] provisions prior to entering the Merger Agreement, and in agreeing to forgo the right to waive them in the Merger Agreement, without considering or understanding the effect this would have on its duty to act in an informed manner, the Board acted unreasonably. The sale process, reviewed as a whole, was unreasonable."

CONCLUSION

The *NetSpend* decision once again illustrates the highly fact-intensive nature of the *Revlon* analysis, especially in a sale process initiated by a single-bidder strategy with no pre-signing market check. As demonstrated by the *NetSpend* decision, the recent *Plains Exploration* decision and various other *Revlon* cases before them, an equilibrium between a target's pre-signing strategy and post-signing deal protections must be met to survive a Court's enhanced scrutiny under a *Revlon* analysis. In other words, the more limited a target surveys the "market" prior to entering into a change-

[5] NetSpend proffered evidence that (i) the entity that previously bid $12.00 for the 31% equity position had contacted NetSpend management shortly after signing to congratulate the Board on its $16.00 per share price and to express that it would have never agreed to pay such a high value per share and (ii) its financial advisor recommended that a financial buyer – such as each of the entities subject to the standstill agreements – was unlikely to match TSYS's $16.00 per share price.

of-control Revlon transaction, the less lenient a Court will likely be when analyzing the deal protection devices employed and the sale process as a whole.

The *NetSpend* decision also reiterates the disdain Delaware courts have had for "don't ask, don't waive" clauses in standstill agreements[6], especially when such clauses are combined with restrictive provisions in an acquisition agreement that reinforce their application. While the *NetSpend* decision should not be read as a per se prohibition against the use of "don't ask, don't waive" clauses, practitioners should be very wary of utilizing these provisions in the context of a sale process in which a board could be viewed as willfully blinding itself to information.

Finally, the *NetSpend* decision continues another recent trend in Delaware case law, this time with respect to the increasing scrutiny being placed on fairness opinions and the role of financial advisors in general in a sale process. Accordingly, practitioners should continue placing greater emphasis on the assumptions underlying fairness opinions, including whether financial advisors should include a "downside case" DCF analysis even when projections provided by management are considered conservative in nature.

[6] Please see our prior Client Alert, dated December 11, 2012, entitled "*Delaware Chancery Court Enjoins Standstill Agreement – 'Don't Ask, Don't Waive' Provision Deemed To Impermissibly Limit The Board's On-Going Statutory And Fiduciary Obligations*."

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NEW YORK
One Chase Manhattan Plaza, New York, NY 10005

Scott Edelman	sedelman@milbank.com	+1-212-530-5149
Roland Hlawaty	rhlawaty@milbank.com	+1-212-530-5735
Thomas Janson	tjanson@milbank.com	+1-212-530-5921
Joel Krasnow	jkrasnow@milbank.com	+1-212-530-5681
Alan Stone	astone@milbank.com	+1-212-530-5285

LOS ANGELES
601 South Figueroa Street, 30th Floor Los Angeles, CA 90017

Ken Baronsky	kbaronsky@milbank.com	+1-213-892-4333
Neil Wertlieb	nwertlieb@milbank.com	+1-213-892-4410

SÃO PAULO
Rua Colombia, 325 Jardim América, São Paulo, SP 01438-000

Andrew Janszky	ajanszky@milbank.com	+55-11-3927 77013

SINGAPORE
12 Marina Bay Financial Centre, #36-03 Tower 3, Singapore 018982

David Zemans	dzemans@milbank.com	+65-6428-2555
Naomi Ishikawa	nishikawa@milbank.com	+65-6428-2525

TOKYO
21F Midtown Tower, 9-7-1 Akasaka, Minato-ku Tokyo 107-6221 Japan

Gary Wigmore	gwigmore@milbank.com	+813-5410-2840