

Delaware Chancery Court Gives Close Scrutiny to Private Equity Transactions

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In three opinions issued this year arising out of the recent wave of private equity transactions, Vice Chancellor Leo E. Strine, Jr., of the influential Delaware Court of Chancery, has granted limited injunctive relief to stockholder plaintiffs, delaying the consummation of mergers between Delaware corporations and private equity firms pending additional disclosures regarding the sale process, valuations, and management incentives to agree to private equity transactions.

In the first case, which the court described as “a microcosm of a current dynamic in the mergers and acquisitions market,” NetSmart Technologies, Inc. had entered into a merger agreement with two private equity firms following a sale process in which NetSmart’s financial advisors sought bids from seven private equity buyers, but made no active search for a strategic buyer. *In re NetSmart Technologies, Inc. Shareholders’ Litigation*, C.A. No. 2563-VCS, 2007 Del. Ch. LEXIS 35 (Del. Ch. Mar. 14, 2007). As is common in private equity transactions, NetSmart’s management at the time was expected to continue to manage the company and to share in an option pool “designed to encourage them to increase the value placed on the company in the Merger.” The merger agreement prohibited NetSmart’s board of directors from shopping the company but did permit consideration of a superior proposal (none were made). The court concluded that the plaintiff stockholders established at the preliminary injunction stage a reasonable probability of success on the merits of two issues: (1) that the NetSmart board likely did not have a reasonable basis for failing to undertake any exploration of interest by strategic buyers and (2) that the proxy statement was materially incomplete because it did not disclose the projections used by NetSmart’s financial advisors to perform the discounted cash flow valuation supporting the fairness opinion, information a reasonable stockholder would find material in deciding whether to accept the one-time payment of cash in the merger and, if the merger were approved, whether to seek an appraisal.

The opinion discusses at some length the *Revlon* duties assumed by the NetSmart board when it decided to sell the company for cash. Emphasizing that *Revlon* does not require a board to follow a judicially prescribed sale process, the court went on to note that having a sales process approved by the court in the context of another transaction does not mean that that same sales process is reasonable in all situations: “The mere fact that a technique was used in different market circumstances by another board and approved by the Court does not mean that it is reasonable in other circumstances that involve very different market dynamics.” In this case, the court concluded that “an inert, implicit post-signing market check” commonly used in large-cap transactions did not, in NetSmart’s microcap environment, “suffice as a reliable way to survey interest by strategic

players.” As a result, the court concluded that the plaintiffs demonstrated a reasonable probability that they could prove at trial that “the Board’s failure to engage in any logical efforts to examine the universe of possible strategic buyers and to identify a select group for targeted sales overtures was unreasonable and a breach of their *Revlon* duties.”

On the question of remedy, the court concluded that the stockholder plaintiffs were not entitled to broad injunctive relief and that, in fact, an injunction against the merger when there was no other higher bid pending could jeopardize the possibility of a transaction altogether, to the detriment of the stockholders. The court concluded that the NetSmart stockholders could decide for themselves whether to accept or reject the proposed merger, and the dissenters could decide for themselves whether or not to seek an appraisal once they had more complete and accurate information about the board’s decision not to explore the market for strategic buyers and about the projected future cash flows used in the fairness analysis. The merger vote was enjoined until those disclosures were made.

Three months later, in *The Topps Company* shareholders’ litigation, Vice Chancellor Strine addressed challenges to a merger proposed by the Topps board with Michael Eisner and two private equity companies. *In re The Topps Company Shareholders Litigation*, C.A. Nos. 2786-VCS, 2998-VCS, 2007 Del. Ch. LEXIS 82 (Del. Ch. June 14, 2007). During the Go Shop process, the company’s investment bankers contacted more than 100 potential strategic and financial bidders. One serious bidder emerged, Upper Deck, Topps’s principal competitor in the American baseball card industry. Upper Deck signed a confidentiality agreement containing a standstill provision, required by Topps of all potential bidders seeking access to confidential information regarding Topps’s operations. The standstill agreement included a provision prohibiting Upper Deck, for a period of two years, from acquiring or offering to acquire Topps’s common stock by way of open-market purchases, tender offer, or otherwise without Topps’s consent, or from soliciting proxies or seeking to control Topps in any manner.

The court concluded that the plaintiffs (stockholders and Upper Deck) established a reasonable probability of success on the merits on their claim that the Topps board breached its fiduciary duties by refusing to release Upper Deck from the standstill agreement so that it could communicate with Topps’s stockholders and present a bid that those stockholders could find to be materially more favorable than the proposed merger with the Eisner parties: “When directors bias the process against one bidder and toward another not in a reasoned effort to maximize advantage for the stockholders, but to tilt the process toward the bidder more likely to continue current management, they commit a breach of fiduciary duty.” The court likewise found that the plaintiffs had shown a reasonable probability of success on their disclosure claim that the proxy statement was materially misleading in several respects, including in its failure to disclose Eisner’s assurances that he would retain existing Topps management after the merger. The court enjoined the merger vote until after Topps made additional disclosures and waived the standstill agreement to permit Upper Deck to make a tender offer and to communicate with Topps’s stockholders.

Finally, in the *Lear Corporation* shareholders’ litigation, Vice Chancellor Strine again entered a limited injunction delaying a merger vote on a going private transaction, spearheaded by Carl Icahn, until Lear Corporation made supplemental disclosures regarding the financial incentives (related to personal retirement benefits) of the company’s CEO who had negotiated the merger terms with Icahn. *In re Lear Corporation Shareholders Litigation*, C.A. No. 2728-VCS, 2007 Del. Ch. LEXIS 88 (Del. Ch. June 15, 2007). Although granting the limited injunction as to one of the plaintiff stockholders’ disclosure claims, the court concluded that the stockholders had not shown a reasonable likelihood of

success at trial on their *Revlon*-based breach of fiduciary duty claims. The court was critical of the decision to permit the CEO to negotiate the merger terms with Icahn without supervision by the special committee of the board, but found there was no evidence that that decision adversely affected the overall reasonableness of the board's strategy to obtain the highest possible value for the stockholders. The court noted that under the terms of the merger agreement, the board was allowed to freely shop the company after execution of the merger agreement, that the company's financial advisors did aggressively shop the company to both financial and strategic buyers without generating a superior bid, and that the other deal protection measures in place (such as a 3% termination fee) did not present an unreasonable barrier to other bidders.

These opinions convey a message to public companies and their counsel that the courts will closely scrutinize private equity transactions given the perceived conflict of interest in situations in which public shareholders' shares are being purchased for cash while officers and directors maintain their management positions and have an equity stake in the company going forward. The courts may delay merger votes, pending supplemental disclosures or other corrective action, should the sale process appear to be biased in favor of the private equity buyer or where the disclosures are inadequate in any material respect.

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