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Delaware Court of Chancery Addresses Defects in Board Process  
Approving Sale to Private Equity Buyer

In a major opinion deciding a shareholder challenge to a going-private transaction, the Delaware Court of Chancery has found that independent directors breached their duties by limiting the group of potential buyers contacted to private equity firms and excluding strategic buyers. In re Netsmart Technologies, Inc. Shareholders Lit., (March 14, 2007) (Strine, V.C.). Although the Netsmart transaction was small by current standards (\$115 million), it included many features common to larger deals — a private auction among several financial buyers; approval by a special committee of independent directors; a 3% break-up fee and post-signing “window shop” period; and a free shareholder vote. Moreover, the Court found that the committee “proceeded in an appropriately price-driven manner,” and rejected the argument that management had favored one bidder over another.

Despite these findings and despite the typicality of the process, the Court ruled that the Netsmart board erred by contacting only private-equity buyers (who all offered management an equity stake, as strategic buyers would presumably not have). The Court found that the board had no informational basis to conclude that strategic buyers would have had no interest in buying the company, and thus had failed in its duty to run a process reasonably designed to achieve the highest price. The opinion rejects the argument that a “window shop” provision was sufficient to elicit post-signing bids from strategic buyers, given that Netsmart was a “micro-cap” company. Accordingly, “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.”

Netsmart is a rare case in finding that independent directors acted without a reasonable basis in structuring a sale process. Ever since the Delaware Supreme Court ruled in 1989 that “there is no single blueprint” for conducting a sale process, and ever since the effectiveness of post-signing market checks were recognized in the late 1980’s, the Delaware courts have been reluctant to substitute their judgment for those of independent directors when it comes to such matters as how many potential buyers to approach, how long a process should last and other structuring issues.

Netsmart does not signal an end to the broad latitude Delaware boards have in fashioning the direction and structure of a sale process, especially given that much in the reasoning of the opinion rests on Netsmart’s small size. The case, is, however, a reminder that Delaware courts will forcefully scrutinize the record advanced to support the directors’ decisions, and will be skeptical of arguments that deal-structuring and deal-protection decisions are proper because they are common or have been approved in other contexts. As the recent Caremark ruling also cautioned, directors and their advisors should take care that board decisions are custom-tailored to the factual circumstances of any given situation.

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