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Client Alert

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Delaware Court Provides New Guidance on Go-Shops, Standstills and Management Conflicts

In two recent Court of Chancery decisions, key deal processes and mechanisms received careful scrutiny due to the presence of conflicting interests, providing the court the opportunity to address issues particularly relevant to going–private transactions, and of broader import to any auction process.

Background

Topps

Topps manufactures and sells some of America's best-known products including Bazooka Joe bubble gum, Ring Pops, baseball cards, and other entertainment cards such as Garbage Pail Kids. In 2005, Topps management was threatened by a proxy contest, which it defused by agreeing to explore strategic alternatives. Another proxy contest loomed in 2006, which Topps settled by increasing the size of its board of directors and appointing three members of the insurgent slate to the board. Shortly before Topps settled its latest proxy contest, Michael Eisner, acting as a private equity investor, contacted Topps's CEO, Arthur Shorin, and offered to be "helpful," which Shorin understood to mean that Eisner was proposing a going-private transaction.

Other potential financial buyers had expressed interest in Topps at low valuations, but were rebuffed by public statements by Shorin that Topps was not for sale. Eisner, however, received a much warmer response from Shorin and proceeded to make a bid at $9.24 per share that also included the retention of current management, including Shorin's son-in-law. An ad-hoc committee consisting of two incumbent directors and two recently appointed "dissident" directors deadlocked on whether to negotiate with Eisner, with the dissident directors favoring a public auction. Eisner threatened to withdraw his bid if Topps initiated a public auction, and the Topps board determined to proceed with Eisner on an exclusive basis.

Following a negotiating process with Eisner as the lone bidder, Topps agreed to be taken private for $9.75 per share in cash. The process was contentious, and the merger agreement was approved over the objection of the three dissident directors. Topps obtained a 40-day "go-shop" period during which Topps was free to solicit other offers, subject to a tiered termination fee that would increase at the close of the go-shop period, and Eisner obtained the right to match competing offers made for Topps.

Topps' chief competitor in the sports card industry, Upper Deck, independently expressed a willingness to acquire Topps shortly before the Topps board accepted Eisner's proposal. Upper Deck had expressed a desire to acquire Topps on multiple

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>
> –*Topps*

occasions since 1999. Topps signed the merger agreement with Eisner without responding to Upper Deck. During the go-shop period, Upper Deck emerged as the only serious bidder and entered into a standstill agreement that prohibited Upper Deck from making an unsolicited tender offer to Topps shareholders or commenting publicly about its discussions with Topps. Upper Deck ultimately communicated a non-binding indication of interest at $10.75 per share two days before the expiration of the go-shop period, but this offer was subject to receipt of additional due diligence and certain other conditions. Despite the financial superiority of Upper Deck's offer, the Topps board rejected it, citing antitrust risks and the uncertainty created by the other conditions.

Topps shareholders and Upper Deck both sought injunctive relief in the form of additional disclosures and a release from the standstill agreement. The Court of Chancery granted an injunction requiring Topps to make additional disclosures regarding management's potential for future employment at Topps under Eisner's ownership. In addition, the court forced Topps to waive the standstill agreement with Upper Deck such that: (1) Upper Deck can communicate its own version of events and why it believes its proposal is superior to Topps shareholders; and (2) Upper Deck can make a tender offer for Topps' shares, provided that the offer was on terms no less favorable than those contained in its previous $10.75 per share offer.

Lear

Lear is a leading supplier of components to the automotive industry. Together with the US automobile industry generally, Lear has recently fallen on hard times. Faced with mounting debt and the prospect of bankruptcy, Lear began evaluating its strategic alternatives in 2005. During this process, Carl Icahn purchased $100 million of Lear's stock (about 4.9 percent) at $16 to $17 per share. Icahn subsequently made further open market purchases of Lear's stock, bringing his interest in the company to nearly 10 percent. In October 2006, Icahn acquired an additional $200 million of Lear stock at $23 per share in a secondary offering. As part of the secondary offering, Icahn obtained approximately 24 percent of Lear's stock, together with a limited waiver of the protections of the Delaware business combinations statute (§ 203 of the DGCL), and in turn agreed to limit his holdings to 24 percent.

In November 2006, Lear's long-time CEO, Robert Rossiter, had approximately $14.6 million vested in Lear's Supplemental Executive Retirement Plan (SERP). Concerned with his financial future should Lear end up in bankruptcy, Rossiter approached the compensation committee and expressed a desire to accelerate his SERP payments to provide his family with enhanced financial security. The compensation committee retained Towers Perrin, which presented several alternatives for achieving Rossiter's purposes, but also noted that any of the proposals would likely receive strongly adverse reactions from shareholders and shareholder advisory firms. No further action was taken on the matter.

Beginning on January 16, 2007, Icahn initiated a series of discussions with Rossiter related to the possibility of Icahn taking Lear private. Rossiter first informed certain board members about these discussions a week later, then notified the full board shortly thereafter, which formed a special committee to evaluate Icahn's proposal. Rather than lead the negotiations, however, the special committee allowed Rossiter to take that role, believing him to be the most capable and knowledgeable negotiating agent, even though he would be retained by Icahn and have a continuing interest in Lear after the completion of the merger

After an initial offer of $35 per share, Rossiter persuaded Icahn to raise his offer to $36 per share, which Icahn declared to be his highest and final offer. Icahn also indicated that if his proposal were rejected or an auction occurred, he would withdraw his offer. Without conducting an auction, Lear subsequently entered into a merger agreement with Icahn providing for a go-shop period of 45 days, a matching right and a tiered termination fee. Interestingly, Icahn also signed a voting agreement that he would vote his shares in support of any superior proposal, if Icahn was not willing to match that proposal. No higher offer for Lear emerged during the go-shop period.

Lear shareholders brought suit and sought an injunction against the transaction, complaining of the process by which the transaction came about (and, in particular, that Rossiter personally negotiated the transaction) and certain disclosure violations. The Court of Chancery rejected plaintiffs' claims regarding the process surrounding the transaction, and most of plaintiffs' disclosure claims, but nonetheless enjoined a shareholder vote on Icahn's proposal until such time as additional disclosures were made concerning Rossiter's request in late 2006 that the compensation committee provide him greater security in his SERP.

Key Guidance

Both Decisions Validate the Use of Go-Shops

The use of go-shop provisions as a substitute for a pre-signing auction has become increasingly prevalent over the past two years. In contrast to the standard "no-shop" and "fiduciary-out" provisions that allow a board of directors to respond to unsolicited proposals received after the merger agreement is executed, go-shop provisions allow the target company to actively solicit competing proposals for a defined period of time after the merger agreement is executed (generally between 20 and 50 days).

In both *Topps* and *Lear*, the target company entered into a merger agreement with go-shop provisions in lieu of engaging in an auction or other broad-based pre-signing market check. Both companies had reasons to be wary of a full-blown auction. Topps had recently struck out in its attempt to auction off its confectionary business. Further, although Upper Deck made an acquisition proposal days before Topps entered into the merger agreement with Eisner, Vice Chancellor Strine noted that "Topps appears to have had rational reasons to be suspicious of Upper Deck's sincerity. Upper Deck had made proposals before … [and] was only expressing an interest in the Entertainment Business, not the whole company." Under such circumstances, Vice Chancellor Strine therefore concluded that "[s]igning up a sure thing with Eisner forced Upper Deck to get serious about the whole company, and set a price floor that Upper Deck knew it had to beat by a material amount."

Lear similarly had reasons to forego a pre-signing auction. Icahn had made it clear to Lear that he was not going to play ball if the company decided to run an auction, but instead would pull his bid. In addition, Vice Chancellor Strine noted that "[n]o one had asked Lear to the dance other than Icahn as of that point, even though it was perfectly obvious that Lear was open to invitations." Finally, both Lear and Icahn publicly disclosed Icahn's $36 per share offer several days prior to the execution of the merger agreement, and in that period prior to execution, Lear's financial advisors "tested the waters" by reaching out to eight financial buyers to solicit their interest in acquiring Lear. None of the parties contacted during that short period "expressed even a concrete desire to pursue due diligence and none made even a preliminary proposal."

As a result, both Topps and Lear entered into merger agreements with go-shop provisions, tiered break-up fees and matching rights for Eisner and Icahn, respectively. The Topps merger agreement contained a 40-day go-shop period, provided that if Topps accepted another deal during the go-shop period, it would have to pay a break-up fee

In both cases, Vice Chancellor Strine determined that the use of the go-shop period in lieu of a full-blown pre-signing auction was a reasonable approach to value maximization.

and maximum expense reimbursement of approximately 3.0 percent of the transaction value (as opposed to 4.6 percent if Topps accepted a deal after the expiration of the go-shop period). The agreement also granted Eisner a four business-day matching period to beat any competing proposal.

The Lear merger agreement contained a 45-day go-shop period, provided that if Lear accepted another deal during the go-shop period, it would have to pay a break-up fee and maximum expense reimbursement of approximately 2.79 percent of Lear's equity value or 1.9 percent of Lear's enterprise value (as opposed to 3.52 percent and 2.4 percent, respectively, if Lear accepted a deal after the expiration of the go-shop period). The agreement also granted Icahn a 10-day matching period to beat any competing proposal (although if the competing proposal was more than $37 per share, then Icahn would only have one 10-day period to match, but if it was below $37 per share, Icahn would be entitled to additional three-day matching periods for each subsequent increase to the competing proposal).

In *Lear*, no competing proposals emerged during the go-shop period. In *Topps*, however, Upper Deck made a competing proposal at $10.75 per share during the go-shop period. Despite the fact that this was $1 per share higher than Eisner's bid, the Topps board concluded that the Upper Deck proposal was not credible, and therefore refused to declare Upper Deck an "Excluded Party" under the merger agreement, a finding that would have otherwise allowed Topps to continue negotiating with Upper Deck despite the expiration of the go-shop period.

In both cases, Vice Chancellor Strine determined that the use of the go-shop period in lieu of a full-blown pre-signing auction was a reasonable approach to value maximization, and thus consistent with the board of directors' *Revlon* duties to obtain the best price reasonably available for shareholders in a change of control transaction. In particular, Vice Chancellor Strine acknowledged in *Topps* the permissibility of the Board making such a business judgment: "[a]lthough a target might desire a longer Go Shop period or a lower break fee, the deal protections the Topps board agreed to in the Merger Agreement seem to have left reasonable room for an effective post-signing market check." However, as discussed below in more detail, Vice Chancellor Strine was not so forgiving regarding the actions of the Topps board vis-à-vis Upper Deck's standstill during the go-shop period.

In addition to confirming the validity of go-shop provisions if there is "reasonable room for an effective post-signing market check," both decisions have important specific guidance in structuring deal protections embedded in them:

- Vice Chancellor Strine gave little weight to the lower break-up fee during the go-shop period – noting in *Lear* that "[t]he go-shop period was truncated and left a bidder hard-pressed" to round the bases from completing due diligence to getting a deal signed during such period, making it unlikely that a potential buyer would be able to make a bid during the go-shop period and obtain the advantage of the lower break-up fee as opposed to the higher, post-go-shop fee
- A post-go-shop break-up fee of 4.6 percent of total deal value, although "a bit high in percentage terms" was acceptable in light of the relatively small size of the deal, as it included reimbursement of Eisner's fees
- Enterprise value as the metric to use for analyzing a break-up fee is arguably more important for highly levered companies than equity value, since most acquisitions require the buyer not just to acquire equity but also to refinance the target's debt
- Courts will scrutinize how the target company responds to proposals during the go-shop period, insisting on a "level playing field", unless differential treatment is needed to maximize shareholder value and
- Matching rights are an acceptable deal protection measure despite the

friction they may create for an auction process.

Standstills can Serve Legitimate Purposes, but must not be Abused

Target companies generally insist upon "standstill" agreements before providing non-public information to, or entering into discussions with, potential buyers. Standstill agreements prohibit potential buyers from, among other things, acquiring shares in the target company, making a public offer to acquire the target company, commencing a tender offer for the target company or commencing a proxy solicitation without the approval of the target company's board of directors.

Successful buyers in an auction process frequently prohibit the target company from waiving standstill provisions and affirmatively require that the target company enforce such provisions, which could prohibit bidders who lost in the auction from getting another at bat. In the case of *Topps*, the merger agreement provided that the Topps' board of directors could waive the restrictions of a standstill agreement if it determined that failure to do so would be inconsistent with its fiduciary duties. Vice Chancellor Strine praised Topps for reserving such a right, particularly since there had been no meaningful pre-signing market check.

Vice Chancellor Strine found, however, that the Topps board of directors used the standstill to prevent Upper Deck from making a higher offer directly to Topps' shareholders, in circumstances suggesting that Topps was seeking to favor the Eisner bid improperly. Topps also made public statements about the Upper Deck bid that the Court labeled "disparaging," and then used the standstill to prohibit Upper Deck from responding. As a result, Vice Chancellor Strine issued somewhat extraordinary relief: an injunction prohibiting a vote on the Eisner merger until after Topps released Upper Deck from the standstill in order to permit Upper Deck to make a tender offer directly to Topps' shareholders (on terms at least as favorable as Upper Deck's previous $10.75 per share offer) and to inform those shareholders of its version of the facts. Interestingly, the terms of the injunction do not prevent Topps from keeping the standstill in place if it decides not to proceed with the vote on the Eisner merger.

We do not believe that *Topps* will impact the prevalence of or ability to use standstills. This is because the outcome in *Topps* rests on the court's determination that the Topps board inappropriately favored Eisner's bid over the Upper Deck bid for reasons other than maximizing shareholder value – and in the process used the standstill agreement to do so. In fact, *Topps* provides a current judicial validation of the use of standstills in many circumstances. Specifically, the *Topps* decision confirms that standstills "serve legitimate purposes" and are "responsible, if not mandated" in the context of an auction process. More broadly, we believe the reasoning of *Topps* supports the use of standstills:

- If the board of directors desires to engage in discussions with potential strategic or other buyers and is concerned about the potential misuse of its confidential information or being put "in play" prematurely
- As a condition to participation in an auction process, if the board of directors desires to establish a "level playing field" and protect the integrity of the auction to maximize shareholder value
- After an auction process is completed to prevent new offers by bidders who participated in the auction and lost, if the board of directors believes that auction participants had a full and fair opportunity to participate

The extraordinary remedy granted by the court in *Topps* arising out of the misuse of the standstill – allowing Upper Deck to make a tender offer directly to Topps stockholders – reminds boards of directors that their duties under *Revlon* to maximize shareholder value apply not only to the ultimate decision as to which bid offers superior value, but also to the process the bidders are required to

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follow in developing their bids and how they are treated in that process.

Management and Director Motives and Conduct Continue to Undergo Detailed Judicial Scrutiny

In *Topps* and *Lear*, the court delved deeply into the economic and other motives of key managers and ostensibly independent directors, both to (1) assess the quality and independence of the sale process and (2) assure that stockholders are afforded the information required to evaluate the transaction not only from a financial perspective, but also as to other "soft" considerations which may have influenced the board's decision to sell and the process through which it arrived at the recommended transaction.

The court in *Topps* laid out the following as the foundation of its analyses:

> "When directors have made the decision to sell the company, any favoritism they display towards particular bidders must be justified solely by reference to the objective of maximizing the price the stockholders receive for their shares."

This is not, of course, "inside baseball." The *Revlon/QVC* standard has long guided the conduct of directors and the standard of judicial review in change-of-control transactions. The important lesson to be learned from these two decisions is that the presence of non-economic conflicts of interest will result in detailed scrutiny of the sale process and its participants.

As to potential conflicts, the court in *Lear* noted not only the more obvious conflicts presented by management's "rollover" of equity, but also the more subtle interest of the CEO in monetizing his shareholdings in Lear without losing his position at the company. *Topps* also suggested a possible bias of management towards a bidder who was best able to address particular interests of management that are not shared by all stockholders. Again, this was not a traditional economic conflict, but rather a commitment to maintain the legacy, culture and leadership of a business, together with apparent enmity for the interloper, Upper Deck. These "softer" conflicts have gained much attention, particularly in the private equity context, where plaintiffs have alleged that these biases may lead to premature and/or undervalued sales of public companies.

From a process perspective, in both *Topps* and *Lear,* the court expressed significant concern regarding the discussions between management and the successful bidder in advance of the board becoming aware of the bidder's interest. The consequences of leaving the bag early can be twofold:

- The court is likely to order additional disclosure if contacts between management and the private equity sponsor are not fully articulated, with attendant delay in the proxy solicitation process
- Such activities can play a significant role in changing the court's perception of the process from one properly led by independent directors to one dominated by management and/or the interested directors, such that the entire process loses credibility

Further, actions of management and directors in the sale process that reflect either a disregard for the apparent conflicts or that, in and of themselves, could be interpreted as being motivated by interests other than value maximization may result in:

- If particularly egregious, the ordering of equitable relief to address the consequences of such acts, as with the court-ordered entertainment of an Upper Deck proposal in *Topps*
- The court perceiving conflict and ill intent by the directors who undertook such actions, even if they are otherwise apparently independent and disinterested

For example, Vice Chancellor Strine in *Topps* declined to find affirmatively that the directors were conflicted in a traditional sense, but appeared to infer from their actions, both as to the tenor of the proxy disclosure and their decisions on the Upper Deck standstill, that the Board's motivation may not have been value maximization. In seeking to address these issues, it is important for counsel to the directors to document the decision process thoroughly, particularly the determinations that led to critical actions in the sale process. This is especially the case as to any action as to which the motivation, in hindsight, might be misinterpreted. High-profile decisions such as *Disney* and *Netsmart* make clear that the courts are generally unwilling to accept *post hoc* justifications for board action absent a contemporaneous record of such motives and advice in the minutes of meetings.

In addition to an independent and effective board process, in the context of transactions in which material conflicts are present, the Delaware courts are insistent upon complete disclosure, not only as to the specific facts, but as to *overall tenor*. As noted in *Topps*,

"The directors must also avoid making material and misleading disclosures, which tell a distorted rendition of events or obscure material facts."

In the context of *Topps*, the court focused on the alleged longstanding disdain of Topps' management for a combination with Upper Deck and on the editorial tone and characterization of the discussions between Topps and Upper Deck, particularly as to the enthusiasm with which Upper Deck approached the process and the willingness of Topps to engage fully in negotiations that might achieve a superior transaction.

In the *Lear* decision, the court focused on the absence of full disclosure to stockholders on the CEO's interest in diversifying his holdings "…when that motivation could rationally lead that negotiator to favor a deal at a less than optimal price." It is important to note that the court mandated disclosure not because it found that the CEO "acted in any way inappropriately," but rather because the court believed stockholders would find it material to know that "the motivations he harbored substantially differed from someone who only owned equity in Lear." This echoes concerns articulated by the court in *SS&C* regarding non-share economic interests of senior management and highlights the importance of counsel drafting not only "boilerplate" disclosure regarding potentially conflicting economic interests of "rollover" management, but also identifying other interests which might, in hindsight, be perceived to create ulterior motives.

Additional Observations

Like all opinions from Vice Chancellor Strine, *Topps* and *Lear* reflect on important issues not directly addressed in the relief:

- Boards faced with recalcitrant and disruptive directors, which can lead to near-dysfunction of the board (as is the case with some frequency following insurgent campaigns), should note the Vice Chancellor's implicit acceptance in *Topps* of the exclusion of the insurgent directors from the "go-shop" process to facilitate an effective marketing effort for the company, as well as his observation that the proxy solicitation activities by the hedge fund that appointed the dissident directors compensated for any limitations in the company's proxy statement on the role the dissident directors played in the process
- The Vice Chancellor's articulation of the *QVC* standard in evaluating the "softer" motivations of the transaction participants might portend difficulties for a sale process in which a CEO declines to work for a particular bidder which has offered, or has a realistic prospect of providing, greater value to stockholders
- The absence of written documentation defining arrangements between a private equity buyer and management may not alone obviate the need for disclosure regarding informal assurances provided by the buyer. Not only might such undisclosed discussions result, as it did in *Topps*, in injunctive relief requiring detailed disclosure of such matters, but these conversations might also color a court's perspective on the motivations of managers playing a significant role in the transaction process.

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Full text of the decisions can be obtained at the Court of Chancery's website: http://courts.delaware.gov/Courts/Court%20of%20Chancery/ or via Westlaw at 2007 WL 1732586 and 2007 WL 1732588.

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