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Delaware Court of Chancery Reviews
Directors' Duties in Private Equity Deals

In two decisions last week, the Delaware Court of Chancery carefully scrutinized the conduct of two private equity sales. The two opinions — both on motions for preliminary injunctive relief, and both by Vice Chancellor Strine — reflect both the skepticism and the real world knowledge that the Delaware courts bring to bear on fiduciary duty challenges to private equity deals. In the first decision, the Court forcefully reiterated the principle that, in reacting to post-signing expressions of interest by bona fide and financially-capable third parties, directors cannot employ pretextual reasons to avoid dealing with the new bidder. In the second, the Vice Chancellor criticized a process in which the CEO was the front-line negotiator, but stopped short of issuing an injunction against the transaction. Although both decisions found much that was less than perfect, they nonetheless recognize that Delaware law authorizes directors to employ their business judgment in designing and conducting sales processes and post-signing dealings with overbidders, and that such judgments will only be set aside in truly egregious cases. The Upper Deck Co. v. The Topps Co., C.A. No. 2998-VCS (Del. Ch. June 14, 2007); In re: Lear Corp. Shareholders Litigation, C.A. No. 2728-VCS (Del. Ch. June 15, 2007).

Topps. The opinion in Topps endorses the board's decision not to conduct a public auction but instead to negotiate, essentially on an exclusive basis, with a buying group led by Michael Eisner. The Court also approved the array of deal protection terms in the Eisner agreement (match rights, 4.3% break-up fee and others). The Court further found that the Topps board was justified in signing the Eisner deal at a time when Topps' chief competitor, Upper Deck, had already communicated its interest in a transaction — recognizing the board's legitimate interest in having "the proverbial bird in hand."

The Topps merger agreement contained a typical "go shop" provision, and during the "go shop" period, Topps received an indication of interest from Upper Deck at a price above Eisner's. Where the Topps board erred, the Vice Chancellor found, was in its failure to conduct serious negotiations with Upper Deck:

> [T]hey did not pursue the potential for higher value with the diligence and genuineness expected of directors seeking to get the best value for stockholders. Topps made no reasonable counter-offer [on various non-contract issues such as regulatory risk]. . . . [Topps] never made reasonable suggestions to Upper Deck about a higher reverse break-up fee, antitrust issues, or price.

The Court's negative view of the board's negotiation posture likely was the result of the perceived preference certain founding-family board members had for the Eisner transaction, a view that was reinforced by its finding that the Topps proxy statement presented a misleading and one-sided version of the background facts. As a result, the Court entered an injunction requiring corrective proxy disclosure and an unusual order that requires the Topps board to waive the standstill entered into with Upper Deck during the "go shop" period to the extent

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Upper Deck makes "an all shares, non-coercive tender offer" at a price no less than its most recent proposal.

Significantly, the Topps opinion recognizes that non-price deal terms — such as the apportionment of regulatory and financing risk — are highly relevant in merger negotiations. Price is not everything. Once a premium price is put on the table by an overbidder, however, the lesson of Topps is that the board must fully engage on both price and non-price terms to determine if a truly "superior" transaction is available. The courts will intensely search the factual record for evidence of half-hearted negotiations and pretextual obstacles. In addition, the Topps opinion endorses the appropriateness of a board's decision to require bidders to sign standstills before confidential information is provided to them, and suggests that — at least in some cases, such as where a robust auction process has occurred — a winning bidder may obtain the contractual right to have the corporation enforce those rights against subsequent overbidders who participated in the process.

Lear. Vice Chancellor Strine's opinion in Lear is critical of the fact that the special committee allowed the CEO to handle the negotiations with the buyer (Icahn) without direct supervision by the committee or its bankers. The Court termed this "far from ideal" — and assumed that the CEO was conflicted by virtue of his nondiversified equity holding in the company, interest in remaining with the company post-buyout, and expectation of post-buyout options at a price dependent on the deal price. The Court emphasized that in a sale of the company, unlike normal corporate business, directors should not "allow the actual work to be done by management and sign off on it after the fact." The Court required supplemental disclosures of the CEO's economic motivations, which the Court considered "could have influenced his negotiating posture," given that the CEO had been delegated authority to conduct the negotiations. Nonetheless, the Court concluded that there was no evidence that the error adversely affected the overall effort to secure the highest possible value, and hence no basis for an injunction blocking the transaction. Relatedly, the Vice Chancellor excused the failure to conduct a formal pre-signing auction ("the clearest way to signal a desire for bids") — there was only a three-day limited canvass of possible financial buyers — because it avoided the risk of losing Icahn's $36 bid, either by Icahn's following through on his threat to withdraw altogether or by his returning at a lower price if an auction generated underwhelming response. Importantly, the Court agreed that the Lear board was justified in taking at face value Icahn's indication that he "was not willing to be an amateur stalking horse — i.e., one without a definitive acquisition agreement containing a termination fee."

In denying relief notwithstanding the criticism of the CEO-out-front process, the Vice Chancellor relied on three points. First, the Court noted that Lear's elimination of its poison pill in 2004, and Icahn's appearance on the scene in 2006, had already served to draw attention to Lear's openness to a sale. Second, the Court considered that the board had retained the right to shop the company post-signing, and that the deal protections in the merger agreement did not preclude a subsequent higher bid. The Court termed the go-shop period "truncated" (because it, unusually, obliged the new bidder to go all the way to a signed agreement in the 45-day period in order to qualify for the lower termination fee; as the Court put it, "get the whole shebang done," as opposed to the typical go-shop which requires only that an overbidder get started during the period). But the Court considered the overall terms acceptable because the contract allowed for a post-go shop termination fee of 3.5% of equity value (2.4% of enterprise

value), coupled with the buyer's match right limited to one round for a bid that exceeded the merger price by over $1/share. Third, the Court rejected the contention that other bidders would not cross Icahn, finding unpersuasive the notion that private equity players do not compete with each other, especially given that the management team had indicated a willingness to deal with other credible buyers. And the Court considered that the door was even more open to a strategic buyer able to top the Icahn offer.

Neither Topps nor Lear changes the substance of Delaware law in any respect, but the opinions are important in demonstrating the intense scrutiny that the courts will apply to directorial decision-making in both pre- and post-signing sale periods. While both decisions criticized the process employed by the directors, the deeper lesson of the two cases is the Court's recognition of the variety of legal, business and tactical rationales that are permissible in shaping a sale process.

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