New York Law Journal
SECURITIES LITIGATION & REGULATION
Monday, July 9, 2007
ALM

New Wave of M&A Litigation Attacks Private Equity Deals

The players have changed but legal principles remain the same.

BY JOSEPH S. ALLERHAND AND BRADLEY R. ARONSTAM

THE GROWING footprint of private equity firms on the merger and acquisition landscape cannot be overstated. Private equity firms played a role in over 25 percent of domestic deals last year and raised more than $200 billion in 2006 alone.[1] This trend has shown no signs of letting up as private equity "deals have accounted for more than a third of all merger activity this year."[2]

The Delaware Court of Chancery has taken note of the rising tide of private equity transactions as well as seemingly new fiduciary duty issues raised by the participation of senior management in these buyouts. While merger and acquisition activity in the 1980s was epitomized by hostile takeovers and the "omnipresent specter" of entrenched management implementing defensive measures to thwart hostile bids, the new fear is that senior management may be incentivized to pave the way for a sale to a private equity firm without due regard for the interests of stockholders. Management participation in these transactions has drawn sharp criticism from a number of commentators and even a call by one for outlawing such transactions altogether.[3]

Fortunately, as in the past, Delaware courts have married concepts of fiduciary duty to marketplace realities. Although the players in the merger and acquisition market may have changed, the rules of the game have not when directors determine that it is time to sell: (i) interested party transactions, even buyouts led by senior management, are not prohibited as such, and often provide stockholders with the opportunity to cash out at premium prices; (ii) disinterested directors must run a reasonable—not "perfect"—process designed to achieve the highest price for stockholders; and (iii) the stockholder vote to approve a transaction must be based on full and fair disclosure.

Plaintiffs Attack

Plaintiff law firms have unleashed a torrent of litigation challenging private equity deals involving senior management. Typically, plaintiffs seek to preliminarily enjoin a proposed deal in combination with a prayer for unspecified damages resulting from the allegedly "too low" bid price caused by "breaches of fiduciary duties." In the rush to the courthouse after the announcement of a proposed buyout, plaintiffs assert that a flawed and tainted process controlled by insiders has led to an inadequate price.

These cases ramp up, and expedited discovery begins, following approval of a transaction by a target's board—often after extensive negotiations by, and upon the recommendation of, an independent committee of directors. In seeking to enjoin a stockholder vote on the proposed transaction, plaintiffs argue that the disclosures are inadequate and/or materially misleading, and that the entire transaction is infused by breaches of fiduciary duty by the insiders participating in the proposed buyout.

Recent Cases

Four recent Delaware Court of Chancery decisions have grappled with the rise of private equity buyouts and the issues faced by directors of target companies presented with these deals.

In re Lear Corporation Shareholder Litigation. *Lear*[4] involved a motion to preliminarily enjoin a stockholder vote of a proposed acquisition of the Lear Corporation, a troubled automotive supplier, by a fund controlled by Carl Icahn. Mr. Icahn first discussed a going private transaction with Lear's longtime CEO. After being informed of the proposal, Lear's board formed a special committee to consider a possible deal. That committee authorized Lear's CEO to negotiate terms with Mr. Icahn notwithstanding that a going private transaction would enable him immediately to cash in on his multimillion dollar retirement benefits (which were tied up in the company's stock) and share in future equity growth experienced by the company as a participant in the buyout.

Negotiations resulted in a $36 per share price (a modest increase over Mr. Icahn's initial $35 per share offer), a "go-shop"

Joseph S. Allerhand *is a partner at Weil, Gotshal & Manges and co-head of the firm's securities/corporate governance litigation group.* **Bradley R. Aronstam** *is an associate at the firm and a member of that group.*

clause which allowed Lear to pursue other bidders for 45 days after the transaction was signed, and a "fiduciary out" enabling Lear to accept a superior third-party bid after the go-shop period ended. Mr. Icahn contractually committed to vote his Lear stock in favor of any superior deal accepted by Lear's board as well, and received an approximately 3 percent termination fee and limited matching rights as to any competing bid.

Notwithstanding its pointed observation that the "Lear Special Committee made an infelicitous decision to permit the CEO to negotiate the merger terms outside the presence of Special Committee supervision," the court found "there [wa]s no evidence that that decision adversely affected the overall reasonableness of the board's efforts to secure the highest possible value."[5] Even though "the directors allowed the actual work to be done by management and signed off on it after the fact…in circumstances in which [the CEO] (and his top subordinates) had economic interests that were not shared by Lear's public stockholders," the court was "not persuaded that the Special Committee's less-than-ideal approach to the price negotiations with Icahn ma[de] it likely that the plaintiffs, after a trial, [would] be able to demonstrate a *Revlon* breach."[6]

In rejecting the argument that Lear's directors had acted unreasonably in accepting Mr. Icahn's bid without demanding a full pre-signing auction, the court observed that "[n]o one had asked Lear to the dance other than Icahn…even though it was perfectly obvious that Lear was open to invitations"[7] as a result of Lear's elimination of its poison pill years earlier and Mr. Icahn's public stake in the company. The go-shop provision also enabled Lear's board to seek higher bids after the signing, and the deal protections were not unreasonably preclusive and did not foreclose a topping bid.[8] In short, the court was satisfied that "[t]he Lear board had sufficient evidence to conclude that it was better to accept $36 if a topping bid did not emerge than to risk having Lear's stock price return to the level that existed before the market drew the conclusion that Lear would be sold because Icahn had bought such a substantial stake."[9]

The court also rejected the lion's share of plaintiffs' disclosure attacks, holding that "the proxy statement fairly disclose[d] that Lear did not do any meaningful pre-signing market check, that it merely made a few hasty phone calls to see whether it was missing any imminently available opportunity, and that Lear was depending on the post-signing go-shop process to be its real market check."[10] It did, however, fashion "a very limited injunction" ordering additional disclosures describing "the CEO's overtures to the board concerning his retirement benefits" and regarding the fact that "the CEO harbored material economic motivations that differed from [the stockholders'] that could have influenced his negotiating posture with Icahn."[11]

In re Topps Company Shareholders Litigation. In *Topps*,[12] management and directors of The Topps Company, Inc. allegedly favored a bid by private equity buyers led by former Disney CEO Michael Eisner that would retain incumbent management over a bid from an industry competitor (The Upper Deck Company) that would not.[13] Significantly, the court found "no unreasonable flaw in the approach that the Topps board took in negotiating the Merger Agreement with Eisner,"[14] including its decision to negotiate almost exclusively with Mr. Eisner even though Upper Deck had communicated an interest in a transaction. "Critical" to this determination was the recognition by Topps' board "that they had not done a pre-signing market check" and their corresponding actions in "secur[ing] a 40-day Go Shop Period and the right to continue discussions with any bidder arising during that time who was deemed by the board likely to make a Superior Proposal."[15] The court "also [took] into account the potential utility of [Topps] having the proverbial bird in hand."[16]

Following the end of the go-shop period (during which Topps could actively solicit topping bids), Upper Deck made another offer to buy Topps for $10.75 per share—$1 per share higher than Mr. Eisner's $9.75 price per share bid—with no financing risk and a "strong come hell or high water promise" to address antitrust issues previously raised by Topps.[17] But Topps' directors "refused to treat Upper Deck as having presented a Superior Proposal, a prerequisite to putting the onus on Eisner to match that price or step aside," and went public with a "one-sided" disclosure concerning Upper Deck's bid "in a form that did not accurately represent [Upper Deck's] expression of interest and disparaged Upper Deck's seriousness."[18] Notably, a previously executed "standstill" agreement with Topps prohibited Upper Deck from publicly responding about its higher-priced bid or making that bid directly to Topps' stockholders by way of a tender offer.

In response to a motion to preliminarily enjoin the meeting of Topps stockholders to approve the Eisner deal, the court found that Topps' proxy statement had omitted material facts concerning, among other things, Upper Deck's competing bid and Mr. Eisner's intentions to retain Topps' existing management. It also found that Upper Deck was likely to succeed on its claims that Topps' board had breached its fiduciary duties in terminating its negotiations with Upper Deck after the go-shop had expired and failing to release Upper Deck from the prohibitions of the standstill agreement. Given the marketplace reality of a bidder willing to pay more than Mr. Eisner, the court enjoined the merger vote until after Topps made corrective disclosures and waived the standstill agreement to allow Upper Deck to comment on its negotiations with Topps and make a non-coercive tender offer to Topps' stockholders at a price of at least $1 per share higher than Mr. Eisner's bid.

In re Netsmart Technologies, Inc. Shareholders Litigation. *Netsmart*[19] involved a challenge to a proposed merger between two private equity firms and Netsmart Technologies, Inc. "As in most private equity deals," the court noted that "Netsmart's current executive team [would] continue… manag[ing] the company and…share in an option pool designed to encourage them to increase the value placed on the company in the Merger."[20]

Recognizing that "it was incumbent upon the board to make a reasonable effort to maximize the return to Netsmart's investors" once it "embarked on the pursuit of a cash sale," the court was critical of the board's having limited its search for potential buyers to private equity firms (and its failure to contact prospective strategic buyers).[21] Specifically, the court held that plaintiffs had "established that the Netsmart board likely did not have a reasonable basis for failing to undertake any exploration of interest by strategic buyers."[22]

The court additionally rejected the notion that a post-signing market check for other buyers, coupled with a traditional 3 percent break-up fee if the board found an alternative buyer, automatically passed muster as a reasonable method for maximizing value for a micro-cap

company like Netsmart without any significant following on Wall Street by analysts. The court held that "[t]he 'no single blueprint' mantra is not a one way principle" and "[t]he 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."[23] It also took issue with, among other things, the special committee's having allowed management to "drive" the due diligence process with respect to other potential bidders given management's participation in the proposed transaction.[24]

Notwithstanding its concerns as to whether Netsmart's directors had run a reasonable process, the court did not issue an injunction on that basis. Instead, it required corrective disclosures concerning its opinion and the final projections relied upon by Netsmart's financial advisor in providing its fairness opinion of the deal, albeit with the not insignificant threat of money damages and appraisal awards looming in post-transaction proceedings. The court reasoned that "[b]y issuing an injunction requiring additional disclosure, the court gives stockholders the choice to think for themselves on full information, thereby vindicating their rights as stockholders to make important voting and remedial decisions based on their own economic self-interest."[25] "The granting of a broader injunction," however, would "pose a risk that [the acquiror] might walk or materially lower its bid."[26]

In re SS&C Technologies, Inc., Shareholders Litigation. At issue in *SS&C*[27] was a management-led buyout of SS&C Technologies Inc. sponsored by private equity firm Carlyle Investment Management L.L.C. Carlyle's proposal was solicited by SS&C's CEO, William C. Stone, "as part of an informal process to 'test the waters' regarding a sale of the company during which Stone and an investment banking group retained by him in his official capacity met with six private equity firms."[28] Mr. Stone disclosed his solicitation of financial buyers to the full SS&C board only after Carlyle submitted its initial proposal to acquire SS&C. In response, SS&C's board appointed a special committee, which ultimately negotiated a merger agreement with Carlyle.

Plaintiffs in *SS&C* settled the action in exchange for SS&C's agreement to make unspecified additional disclosures in supplemental proxy materials seeking approval of the transaction with Carlyle. The court disapproved the settlement, however, because, among other things, it was unable to conclude that plaintiffs' counsel had adequately represented the interests of the class or that the settlement terms were fair and reasonable.

The court chastised plaintiffs' attorneys for "fail[ing] to come to grips with the fact that Stone had an array of conflicting interests that made him an unreliable negotiator or that the special committee was placed in a difficult position by [his] pre-emptive activities."[29] Specifically, it noted that "a manager who has the opportunity to both take $72.6 million in cash from the transaction and roll a portion of his equity into a large equity position in the surviving entity has a different set of motivations than one who does not."[30] It also took issue with plaintiffs' attorneys' failure to address adequately "whether, given Stone's precommitment to a deal with Carlyle, the board of directors was ever in a position to objectively consider whether a sale of the enterprise should take place" and whether "Stone's general agreement to do a deal with Carlyle made it more difficult for the special committee to attract competing bids, especially from buyers not interested in having Stone own a significant equity interest in the surviving enterprise."[31]

Lessons Going Forward

Despite the intense criticism of private equity deals in some quarters, the focus in the Delaware courts continues to be on process: Did disinterested directors act reasonably in trying to obtain the highest price for stockholders and have they made full disclosure to stockholders? If the answers to these questions are "yes," then the ultimate decision whether to accept a premium buyout will be left to stockholders and, if the transaction is approved, the board's prior conduct should be protected from "second guessing" by courts under the venerable business judgment rule. But as *Lear* makes clear, Delaware courts will not hesitate to remove roadblocks constructed by management that prevent third parties from coming into an auction process or making bids directly to stockholders which would top a previously approved private equity buyout proposal supported by management.

1. See Dennis K. Berman, "Year-End Review of Markets & Finance 2006—Can M&A's 'Best of Times' Get Better? Private Equity Fuels a Frenzy of Deals; Cash on Sidelines," WALL ST. J., Jan. 2, 2007, at R5; see also Gregory Zuckerman et al., "Hedge-Fund Crowd Sees More Green as Fortress Hits Jackpot With IPO," WALL ST. J., Feb. 10, 2007, at A1.
2. See Henry Sender & Monica Langley, "How Blackstone's Chief Became $7 Billion Man," WALL ST. J., June 13, 2007, at A1.
3. See, e.g., Gretchen Morgenson, "Just Saying No to Lowball Buyout Offers," N.Y. TIMES, May 20, 2007, at C1; Andrew Ross Sorkin, "Rewriting the Rules for Buyouts," N.Y. TIMES, Nov. 19, 2006, at C4; Ben Stein, "On Buyouts, There Ought to Be a Law," N.Y. TIMES, Sept. 3, 2006, at C3.
4. *In re Lear Corp. S'holder Litig.*, 2007 WL 1732588, at *23 (Del. Ch. June 15, 2007).
5. Id. at *2.
6. Id. at *22-23.
7. Id. at *23.
8. Indeed, the court found that plaintiffs had failed to establish a reasonable likelihood of success "on their argument that the Lear board acted unreasonably in agreeing to the deal protections in the Merger Agreement rather than holding out for even greater flexibility to look for a higher bid after signing with Icahn." Id. at *24.
9. Id. at *27.
10. Id. at *17.
11. Id. at *2.
12. *In re Topps Company Shareholders Litigation*, 2007 WL 1732586 (Del. Ch. June 14, 2007).
13. *Topps* thus resembles a classic 1980s scenario: competing bids with interested directors allegedly favoring a chosen bidder.
14. *Topps*, 2007 WL 1732586, at *25.
15. Id.
16. Id. at *26.
17. Id. at *2.
18. Id. at *2-3.
19. *In re Netsmart Technologies, Inc. Shareholders Litigation*, 2007 WL 1576151 (Del. Ch. March 14, 2007).
20. Id. at *1.
21. Id. at *18.
22. Id. at *3.
23. Id. at *19.
24. Id. at *16. *Lear's* distinction of the facts before it from those in *Netsmart* bears emphasis. Whereas "Netsmart was a microcap company with limited trading in its shares" and "[o]nly one analyst cover[ing] it," Lear was "one of the largest corporations in the United States with deep analyst coverage" and "[e]ven after Icahn singed up his bid, over 40 strategic and financial buyers were invited to obtain due diligence in a non-public way in order to formulate topping bids." *Lear*, 2007 WL 1732588, at *27 n. 22. Thus, "unlike in *Netsmart*, no one had to discover Lear; they were invited by Lear to obtain access to key information and decide whether to make a bid." Id.
25. *Netsmart*, 2007 WL 1576151 at *28.
26. Id. at *29.
27. *In re SS&C Technologies, Inc., Shareholders Litigation*, 911 A2d 816 (2006).
28. Id. at 818.
29. Id. at 820.
30. Id.
31. Id.

Reprinted with permission from the July 9, 2007 edition of the NEW YORK LAW JOURNAL. © 2007 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact 212-545-6111 or visit **almreprints.com**. #070-07-07-0007