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Shareholder Rights Plans: After 25 Years the Controversy Continues

BY FRANK AQUILA

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The early 1980s saw the rise of the corporate raider and a plethora of hostile takeover bids. Vulnerable companies often found themselves at their mercy until a broad range of appropriate and effective defenses were crafted.[1] Born out of necessity, the first shareholder rights plan, the so called "poison pill," was developed in 1982. Truly effective, no U.S. company has been acquired where the board of directors has opposed the transaction and kept a rights plan in place.

Challenges to rights plans were quick in coming from potential acquirors. The validity of shareholder rights plans was resolved by the late 1980s with the Delaware Supreme Court holding that the adoption of a shareholder rights plan is consistent with a board's exercise of its fiduciary duties[2] and New York adopting a statutory provision permitting shareholder rights plans.[3] Nevertheless, almost 25 years later the opposition to rights plans is just as fierce. However, the opposition is not just coming from potential acquirors, it's being driven by large institutional shareholders and activist shareholders.

A common misconception is that shareholder rights plans abruptly halt unsolicited bidders; however, a shareholder rights plan is not designed to, nor does it, prevent hostile takeovers. Rather, it gives directors the necessary time to evaluate all alternatives in order to maximize value for all shareholders. This extra time also provides the board with leverage in negotiating with the hostile bidder. When a company with a rights plan is presented with an unsolicited acquisition proposal the primary practical benefit of the rights plan is that the company's board is able to take time to respond and the ability to control the process. In contrast, when the target is a company without a rights plan, subject to applicable regulatory requirements, a potential acquiror could potentially take down shares 20 business days after

CONTINUED ON PAGE 4

Content HIGHLIGHTS

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Table of CONTENTS

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From the Editor

Despite Market Blips and Taxation Fears, Private Equity Still Raking in the Cash

It's a sticky time in the nation's Private Equity arena—and not just because of the summer humidity. Private equity firms, the prime movers of the past several years of booming M&A activity, are noticing that over the past few weeks some needed investors and members of Congress have slowly started turning against them.

First, some recent buyout deals have faced some balky investors. And nervous debt investors couldn't come at a worst time because several major takeover deals—including First Data Corp. and Chrysler—are slated to seek financing from the debt markets very soon. Indeed, for its need financing First Data is looking to raise $8 billion in high yield bonds—the largest junk bond sale ever.

Second, and just as worrisome, is the growing likelihood that Congress will take some action to change the taxation policy given private equity partnerships and may even further seek to regulate publicly traded partnerships. The industry has taken notice, and several major players—including Stephen Schwartzman, head of Blackstone Group, and Henry Kravis of Kohlberg Kravis Roberts—reportedly made the trip to Washington, D.C. to try to change the minds of members of Congress.

Now, you'd think this environment would make it harder for private equity funds to secure willing investors—but you'd be wrong. Caryle Group recently increased its newest planned fund to $17 billion. And several big PE titans recently have raised even larger funds than that.

More importantly, the amount of private equity capital floating around out there looking for deals to do is still at mind-boggling levels, making it quite likely that even if the market goes sour private equity firms will have the dollars to do the deals for some time to come.

In this issue… Author Frank Aquila, a partner in the Mergers & Acquisitions Group of Sullivan & Cromwell LLP, takes *The M&A Lawyer* on a details tour of the history and current value of shareholder rights plans.

From the dawn of the "poison pill" in the early 1980s until now, Aquila explains that rights plans were so effective that "no U.S. company has been acquired where the board of directors has opposed the transaction and kept a rights plan in place." Of course, that didn't keep the plans from being challenged by potential acquirors and some shareholder groups who felt poison pills discouraged companies from being sold and entrenched current management. However, once the Delaware Supreme Court decided in the late-1980s that the plans passed legal muster, poison pills were here to stay and became a fixture in the booming deal-times of then and now. Still, as the author notes, opposition to such plans are just as fierce, and studies are beginning to show a reluctance on the part of companies to adopt them.

Also, *The M&A Lawyer* follows-up on what is still one of the hottest phenoms in deal contracts—the Go Shop provision. Authors Stephen I. Glover and Jonathan P. Goodman in the Washington, D.C. office of Gibson, Dunn & Crutcher LLP, who penned our June analysis of these provisions, now look at two recent decisions which allowed the Delaware courts to further refine how they look at Go Shop provisions.

GREGG WIRTH, MANAGING EDITOR

Publisher's Note:

We are pleased to present you with a newly redesigned newsletter starting with this issue. Our goal, when we set out to redesign the newsletter, was to provide our readers with a fresh and modern look and an easy to read layout. Our new design continues to bring you informative content written by experts and now includes information about events, publications and services relevant to your business.

CONTINUED FROM PAGE 1

commencement of a tender offer, leaving the target's board of directors a very short period of time to consider alternatives and adopt and implement a course of action. With a rights plan in place, the pressure is on the acquiror, not the board. So long as it acts diligently, the board—and not the bidder—can dictate the time schedule. Within reason, a rights plan enables the company's board to take sufficient time to consider the situation, provide the company's shareholders with full information concerning the alternatives and attempt to arrange a potentially more desirable alternative.

After the early judicial rulings on their validity, shareholder rights plans were quickly recognized as a legitimate and effective anti-takeover device. Companies rushed to adopt shareholder rights plans in the mid to late 1980s. The number of initial shareholder rights plan adoptions jumped from less than 15 in 1984, to nearly 340 in 1986, and that trend continued for many years thereafter.[4] By 2003, approximately 58% of the companies in the S&P 500 and 54% of Fortune 500 companies had adopted a shareholder rights plan.[5] Nevertheless, criticism of shareholder rights plans has never lessened and has in fact intensified over the last several years as the focus has turned to corporate governance practices.

Some of the criticism of shareholder rights plans has come from the academic community. A paper published in the February 2003 edition of the *Quarterly Journal of Economics* took the position that companies with strong shareholder rights (i.e., no shareholder rights plan) outperformed those with weaker shareholder rights by a "statistically significant" 8.5% per year.[6] Companies with weak shareholder rights were defined as companies that have adopted anti-takeover mechanisms, such as shareholder rights plans. The authors asserted, "[i]f an 11.4% point difference in firm value were even partially 'caused' by each additional governance provision, then the long-run benefits of eliminating multiple provisions would be enormous."[7]

However, the preponderance of scholarly studies have actually reached the opposite conclusion. In a study published in September 2000, Indiana University professor Randall Heron and Erik Lie, of the University of Iowa, found that shareholder rights plans enhance the bargaining power of boards and managements, and as a result, lead to increased bid premiums that benefit all shareholders.[8] A study published in 2003 found that although anti-takeover provisions have a significant effect if adopted by all targets in a particular industry or by none, anti-takeover provisions have the potential to "guarantee higher [takeover] premiums to shareholders in the event of a takeover".[9]

Perhaps the most interesting findings came from scholars at Georgia State University in their report on a study funded by Institutional Shareholder Services ("ISS"), the leading provider of vote recommendations to institutional shareholders and a strong opponent of shareholder rights plans. The Georgia State study found that there is actually a positive correlation between the strength of a company's anti-takeover arsenal and its financial performance.[10] Much to the surprise of ISS, the study found that the more packed a company's takeover defense arsenal, the better its long-term performance and profitability and the higher its dividend payout ratio and dividend yield.[11]

It is ironic that institutional shareholders are increasingly supporting these proposals at the urging of ISS, even though ISS's own study appears to show that "companies with poison pills and other takeover defenses performed better than companies without such defenses for most of the metrics analyzed."[12]

While corporate raiders and many institutional shareholders have opposed shareholder rights plans from the earliest days, the rise of shareholder activism in the post-Enron/Worldcam era has renewed the battle over the rights plan and its place in corporate governance. Since rights plans are adopted by the company's board of directors without shareholder approval, there is little that shareholders can do to eliminate the rights plan once adopted. Supported by ISS and other shareholder watchdog groups, activists have used two primary tools to attack rights plans. First is the shareholder proposal asking the board to simply eliminate the shareholder rights plan. The proposal is merely a precatory resolution placed on the agenda of the company's annual meeting by one or more shareholders. While the resolution is not binding on the company nor the board, essen-

tially it is simply a request that the rights plan be terminated, and adoption by holders of a majority of the shares can send the company's board a clear signal. Second is the withhold vote. Except in the rare case of a proxy contest, corporate directors run unopposed. Since the bylaws of most U.S. companies provide that directors are elected by a plurality of the shares voting, the only way to register opposition to directors is by withholding votes for their election.

ISS and the institutions they represent will withhold votes for directors for a variety of reasons. Two of those reasons relate directly to their opposition to shareholder rights plan. To the extent that the board has failed to act on a shareholderapproved resolution to remove the shareholder rights plan then ISS will recommend withholding votes for the directors' reelection.[13] ISS will also recommend withholding votes from directors if the company has a rights plan with a deadhand or similar provision (a "dead-hand" provides that only the directors that adopted the right plan, or their designated replacements, can redeem the rights) or if the board adopts or renews a rights plan without shareholder approval or without committing to putting it to a shareholder vote within 12 months of adoption. The Council of Institutional Investors[14] has outlined a number of shareholder rights plan provisions that it considers to be problematic:

> **"A dead hand poison pill is a shareholder rights plan that can be redeemed only by the directors who were on the board when it was adopted, or by their designated replacements. So even if the shareholders voted to replace the board and redeem the pill, the new board would be prevented from doing so. The provision is also known as a continuing director or deferred redemption provision; another variation is called a slow hand pill. A slow hand poison pill is a shareholder rights plan that restricts the ability of directors to redeem a pill for a specified amount of time after director elections. A no hand poison pill is a shareholder rights plan that is not redeemable. . . the Delaware courts have ruled [no hand provisions] illegal. A people pill is an agreement under which the entire management team of the target company threatens to resign in the event of a successful takeover, thereby leaving the company without experienced leadership. A suicide pill is an extreme version of a poison pill in which the target company engages in an activity that might destroy the company in order to avoid a hostile takeover. This is also called a scorched-earth policy, and it can involve assuming cumbersome liabilities and liquidating valuable assets to deter the takeover attempt. A poison put is a right distributed to common stockholders which gives them the option to sell some or all of their stock to the acquiring company at an extremely high price in the event a takeover is completed."[15]**

To the extent that a company actually submits its rights plan to shareholders, ISS will recommend that shareholders vote against the rights plan if it contains certain features, such as the plan's trigger is less than 20%, the plan has a term of more than three years, it contains a deadhand (or similar feature), or it does not contain a qualifying offer clause (often referred to as a "chewable pill").

ISS and other shareholder watchdog groups will generally support shareholder approval of rights plans that contain a "qualifying offer" provision. A qualifying offer provision provides that the rights plan will be terminated in the face of an offer that meets certain criteria:

- Fully financed all cash tender offer or stock exchange offer or combination thereof;
- The offeror (including its affiliates or associates) beneficially owns less than 5% of the outstanding common shares;
- Is conditioned on a minimum of twothirds of the outstanding shares of common shares being tendered;
- Upon completion of the offer a secondstep transaction will be effected whereby all shares of common stock not tendered into the offer will be acquired at the same consideration paid pursuant to the offer;

- The offer will remain open for at least 90 business days (and if a special meeting demand is delivered, for at least 10 business days after the special meeting);
- No amendments will be made to the offer to reduce the offer price, or make any other adverse changes; and
- It contains written representations and certification of the offeror's CEO and CFO that all material facts about the offeror have been, and will be, fully and accurately disclosed.

The inherent weakness in a chewable pill is that it provides the hostile bidder with a roadmap, limits the board's options and may not provide the board with the necessary time to achieve the best result for shareholders. Rather than adopting a chewable pill, many companies are simply permitting their rights plans to expire (most rights plans have a ten year term) or some companies are even terminating their rights plans. As a consequence, today less than a majority of the S&P 500 companies have a shareholder rights plan. Surely the number will continue to drop further in the coming years.

All seem to agree that the opposition to the shareholder rights plan is likely to remain intense and, over time, fewer U.S. companies will have them. Still, it is clear that in the face of an unsolicited acquisition proposal one of the best and most effective anti-takeover protections remains the shareholder rights plan. Ultimately that is why takeover targets like rights plans and why potential acquirors and shareholders oppose them.

NOTES

1. Takeover defenses that were adopted by many U.S. corporations included shareholder rights plans, staggered board provisions, anti-greenmail provisions, supermajority voting provisions, fair price provisions, provisions requiring advance notice of director nominations, caps on the number of directors, provisions requiring the vote of a majority of directors to fill newly created directorships or vacancies, provisions allowing removal of directors only with cause, provisions disallowing shareholders ability to call special meetings, provisions requiring that shareholder action by written consent would only be effective when signed by holders of *all* outstanding shares and provisions allowing the repurchase of its own shares. Many companies also eliminated preemptive rights and cumulative voting.
2. *Moran v. Household Int'l Inc.*, 500 A.2d 1346 (Del. 1988).
3. N.Y. Bus. Corp. Law §505(a).
4. Robert Comment & G. William Schwert, *Poison or Placebo: Evidence on the Deterrence and Wealth Effects of Modern Anti-takeover Measures*, 39 J. FIN. ECON. 3-43, (Sept. 1995).
5. Tom Quinn, *Companies Dismantle Takeover Defense Arsenals in 2003, at* http://www.SharkRepellent.net.
6. Paul A. Gompers, Andrew Metrick, & Joy L. Ishii, *Corporate Governance and Equity Prices,* Q.J. ECON., Feb. 2003, at 112.
7. *Id.* at 155.
8. Randall A. Heron & Erik Lie, *On the Use of Poison Pills and Defensive Payouts by Targets of Hostile Takeovers, at* http://www.bus.indiana.edu/Finance/workingpapers/PillDefPay.pdf.
9. Sharon Hannes, *The Hidden Virtue of Anti-takeover Defenses*, 24 CAR. L. REV. 1903 (2003).
10. Lawrence D. Brown, Ph.D. & Marcus L. Caylor, *The Correlation between Corporate Governance and Company Performance, available at* http://www.issproxy.com/corpgovstudy.
11. *Id.* at 6.
12. Mark D. Brockway, *New Study Links Corporate Governance and Firm Performance,* THE FRIDAY REPORT, February 20, 2004, *at* http://www.issueatlas.com/content/menutop/content/subscription/usvmfiles/content/menutop/content/menutop/content/subscription/usvmfiles/content/menutop/content/free/content/menutop/content/subscription/content/menutop/content/menutop/content/subscription/content/menutop/content/subscription/fridayreportfiles/fridayreport02202004.html#1.
13. According to the ISS 2007 Proxy Voting Guidelines, they withhold votes from all directors seeking reelection if the resolution was approved by a majority of the shares outstanding the previous year or by a majority of the shares voting the previous two consecutive years.
14. The Council of Institutional Investors' website is www.cii.org.
15. *Ibid.*, found at http://www.cii.org/library/learning/poison_pills.htm.

Go-Shops Follow-Up: Lear & Topps Decisions Hone Delaware Courts' View

BY STEPHEN I. GLOVER AND JONATHAN P. GOODMAN

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Over the last two years, go-shop provisions have appeared with increasing frequency in definitive acquisition agreements. A go-shop provision enables a target board to lock up a deal on price and contract terms and then shop the deal for a finite period of time in an effort to secure either a superior deal or confirm that the board has obtained the best price possible for the shareholders. Target boards are relying on these provisions, in part to satisfy their duty under *Revlon v. MacAndrews & Forbes Holdings, Inc.* to conduct a sale process that is reasonably designed to maximize price.[1]

In an article that appeared in last month's edition of *The M&A Lawyer*,[2] we analyzed the use of go-shops and observed that the Delaware courts had not yet examined any of the recent transactions in which target boards had used go-shop provisions to satisfy their *Revlon* duty. That has now changed. In June, Vice Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery issued opinions in two cases where go-shops featured prominently: *In re: Lear Corporation Shareholder Litigation*[3] and *In re: Topps Company Shareholder Litigation*.[4] These decisions indicate that a target board may rely in part on the post-signing market check contemplated by a go-shop provision to satisfy its *Revlon* duty. The decisions also suggest, however, that the courts will carefully scrutinize the decision to use a go-shop in light of all of the facts and circumstances. They will

insist that the target board have a reasonable basis for its decision to rely on this approach, and that the target board deal appropriately with any bidders who emerge in the post-signing process.

Moreover, in each of *Lear* and *Topps* the Chancery Court examined the target's proxy statement disclosures regarding the target board's sales process, its interaction with bidders, management's potential conflicts and issues of valuation. In finding that deficient disclosure of these issues warranted the granting of preliminary injunctions, the Court sends a strong signal to targets of its willingness to examine thoroughly the details of the transaction process and to delay transactions when disclosure comes up short.

The Story of Lear and its Sales Process

Over the course of 2005 and 2006, investor Carl Icahn acquired a significant equity stake in automotive systems supplier Lear. In January 2007, Icahn met with several members of Lear's senior management, including the CEO, and broached the idea of a going-private transaction. Over the following week, the parties discussed this possibility and Icahn expressed his interest in retaining management and his disinclination to proceeding with a hostile bid. After a week of discussions, the CEO informed the board of Icahn's interest and the existence of discussions.

The board formed a Special Committee to expedite responses to deal-related issues and tasked the CEO with leading the negotiations with Icahn. The Special Committee did not perceive the CEO to be conflicted in this role and as a result did not participate directly in the discussions. As Vice Chancellor Strine emphasized, however, shortly before Icahn broached the idea of a going-private transaction, the CEO had expressed to the board his desire to alter his employment arrangements to allow him to cash in his retirement benefits while continuing to manage Lear. The CEO had been with Lear for 35 years and a significant amount of his assets were locked-up in retirement accounts that could not be accessed until retirement and in Lear stock that could not easily be liquidated because of trading blackouts and the negative market response likely to result from the CEO of a troubled business liquidating his equity position. Given Lear's recent history, the CEO was particularly concerned with the possibility that if Lear were to enter bankruptcy he would be treated as an unsecured creditor with respect to his retirement accounts. The CEO and the board decided not to adjust the arrangements because of their fear of a negative investor response. Thus, when discussions with Icahn began, the CEO's problem had not been resolved.

Icahn made an opening bid of $35 per share. The CEO persuaded him to increase his bid from $35 per share to $36 per share, after which he refused to go any higher. During the negotiations, Icahn vowed to withdraw his offer if Lear decided to conduct a pre-signing auction, and that if the auction failed he would return to make a new offer at a much lower level. In lieu of a pre-signing auction, though, Icahn indicated that he would accept a go-shop arrangement under which the board could actively attempt to sell the company after signing a definitive agreement. Lear's financial adviser conducted a limited pre-signing market canvass which did not result in any indications of interest. The contacts included private equity group Cerberus, which had expressed an interest in acquiring the company in 2006, when the stock was trading at much lower levels.

The target board feared that if it did not acquiesce, it would lose Icahn's $36 per share bid. It also believed that a pre-signing auction would be very disruptive, and might not produce an alternative bid. It therefore decided to accept Icahn's offer and enter into a definitive agreement that contained a go-shop provision. The go-shop was fairly typical, providing for a 45-day shopping period, and a fiduciary out that gave the board the right to consider unsolicited proposals after the 45-day period expired. It established a two-tiered termination fee structure, under which a lower fee would be payable if Lear entered into an alternative transaction during the shopping period. The provision gave Icahn the right to match alternative proposals. During the go-shop period, Lear contacted 24 financial buyers and 17 strategic buyers, but did not receive any preliminary indications of interest.

Plaintiffs' *Revlon* Claim

The plaintiffs sought to preliminarily enjoin the consummation of the acquisition by Icahn, alleging, in part, that the Special Committee failed to satisfy its *Revlon* duty because it (1) improperly delegated

to the CEO the task of negotiating the acquisition and (2) failed to conduct a sales process reasonably designed to obtain the highest price. Vice Chancellor Strine rejected both of these claims and refused to grant a preliminary injunction on these grounds.

With respect to the first claim, the plaintiffs argued that the CEO was incapable of taking the actions necessary to reasonably obtain the best price for the Lear shareholders because he had conflicts of interest that might cause him to favor a deal with Icahn over potentially higher priced deals. They argued that under the agreement with Icahn, the CEO would achieve his own financial goals – he could accelerate payment of his retirement benefits, liquidate his Lear equity position without causing negative market reaction, and maintain his management position with Lear with the opportunity to acquire a significant equity stake.

In considering whether the Special Committee improperly delegated to the CEO the task of negotiating the acquisition, the Court recognized, in plaintiffs' favor, that the actions of the Special Committee were less than perfect. Specifically, the Court faulted the Special Committee for failing to recognize that in negotiating the merger, the CEO had powerful interests to agree to a price and terms suboptimal for public shareholders and for failing to properly control and oversee the negotiation process by not involving members of the Special Committee or its advisors. However, the Court noted that conflicts in and of themselves are not sufficient to support a *Revlon* claim. Rather, to support a Revlon claim, the conflicts must inhibit the sales process from being able to reasonably obtain the highest possible price for shareholders.

In its examination of the sales process, the Court faulted the CEO for discussing with Icahn a possible deal for a week prior to informing the board. The Court noted that this "deprived the board of important deliberative and tactical time, and, as a result, caused it to quickly decide on an approach to the process" similar to the approach used in situations where there are no conflicts."[5] However, given the relatively limited scope of the discussions (for instance there was no discussion of price or any agreement on key terms of a deal), the Court determined that the delayed disclosure to the board, while less than ideal, did not render the overall sales process ineffectual in obtaining the highest possible price.

The plaintiffs also argued that the Special Committee's sales process was deficient because to the Committee did not conduct a full auction, the go-shop provision was too restrictive to facilitate an effective post-signing market check and the deal protections were preclusive of alternative bids. On these issues, the Court said that it would review the sales process in its entirety to determine whether the board's actions were reasonable. "Reasonableness, not perfection, measured in business terms relevant to value creation, rather than by what creates the most sterile smell, is the metric."[6]

In addressing the plaintiffs' assertion that the Special Committee was required to conduct a full auction, the Court recognized a number of countervailing factors that made it reasonable for the board to favor a post-signing market check. First, the market widely perceived Lear as being open to a sale because in 2004 it had allowed its poison pill to lapse and because Icahn is well-known to the market to be both a buyer and a seller of his investments. Second, there were significant risks associated with conducting a full auction. Icahn had vowed to Lear to withdraw his offer, let the stock price fall to lower levels and then return to do a deal at a price much lower than $36 per share. This was a real possibility because the success of any auction was in doubt. Lear had been known to be open to a sale for years but had only received an overture from Cerberus at a price around $16 to $17 per share, the pre-signing market canvass conducted by Lear's financial advisor did not produce any serious indications of interest, and other large shareholders had recently expressed no interest in expanding their equity position. And third, the existence of the go-shop provision enabled the board to comfortably address these risks by securing a deal with Icahn at a floor price of $36 per share and using the deal to actively prospect for more.

In addressing the plaintiffs' assertion that the go-shop provision itself was preclusive because of its structure, the Court recognized that indeed "[t]he go-shop period was truncated and left a bidder hard-pressed to do adequate due diligence, present a topping bid with a full-blown draft merger agreement, have the board make the required decision to declare the new bid a superior offer, wait Icahn's 10-

day period to match, and then have the board accept that bid, terminate its agreement with Icahn, and 'substantially concurrently' enter into a merger agreement with it."[7] The Court did not find plaintiffs' argument persuasive, however, because the no-shop period following the expiration of the go-shop allowed the board to consider unsolicited proposals and because the deal protections in the no-shop period were not preclusive. The Court noted that the deal protections were "hardly of the magnitude that should deter a serious rival bid"[8] and that the existence of a termination fee and matching rights has previously been found by the Court not to act as a serious barrier to any bidder willing to pay materially more for the target.[9] Vice Chancellor Strine was not impressed with the argument that the termination fee served to chill potential bidders and he noted that the matching rights were crafted to be value enhancing by providing incentives to potential bidders to bid materially higher than Icahn.[10] In the event of a bid over $37 per share, Icahn could only match one time.

In addition, plaintiffs also argued that the very fact that the initial acquiror was Icahn was also bid-chilling because potential bidders would be afraid of crossing an investor with the power and acumen of Icahn. Vice Chancellor Strine dryly noted that this argument was closer to "mirth-producing" than "injunction-generating." Contrary to plaintiffs' arguments, Vice Chancellor Strine found little reason to believe that professionals would be scared off by the presence of Icahn and noted that topping bids were made in five of the 10 acquisition attempts made by Icahn since 2000. He also noted Icahn's history of "happily stepping aside and cashing in his equity stake at a substantial profit when other bidders submit more attractive offers."

The Disclosure Claims

Plaintiffs had more success with their claim that Lear's proxy statement failed to disclose material facts related, in part, to the potential conflicts of interest of the CEO. Vice Chancellor Strine was persuaded by these arguments and ordered Lear to amend its proxy statement to expand the disclosure. He reasoned that "a reasonable stockholder would want to know an important economic motivation of the negotiator singularly employed by a board to obtain the best price for the stockholders, when that motivation could rationally lead that negotiator to favor a deal at a less than optimal price, because the procession of a deal was more important to him, given his overall economic interest, than only doing a deal at the right price."[11]

Based on the facts and circumstances of the Lear case, the Court determined that the following facts were material and required to be disclosed in the proxy statement:

- the CEO discussed a going private transaction with Icahn for more than a week before he disclosed Icahn's expression of interest to the board;
- the board thereafter permitted the CEO to negotiate the key terms of the merger with Icahn outside the presence of any independent director or the Special Committee's investment banker without any specific pricing guidance from the Special Committee;
- the merger allows the CEO to cash out all of his equity stake in Lear in one lump sum; and
- Icahn agreed to employment terms with the CEO that allowed the CEO to secure a short-term schedule for the payout of his retirement benefits, obtain an improved salary and bonus package, and secure a large grant of options giving him a lucrative upside if Lear performed well after the merger.

The Court's decision on the disclosure arguments reflects a very high level of sensitivity to the impact of potential management conflicts, and serves as an important reminder to targets that are structuring a sales process and making disclosure decisions.

The Topps Saga

The Topps Company, Inc. has two lines of business, baseball and other cards and old-style confections such as Bazooka bubble gum. In 2004, dissatisfied with its lackluster financial performance, the Topps board undertook a strategic review of the business and determined that the principal problem was the confectionary business. In April of 2005, in order to settle a proxy contest for the election of directors by a hedge fund, the board agreed to intensify its review of strategic alternatives and agreed not to adopt a poison pill without shareholder approval. The board determined to conduct a sale of the con-

fectionary business because it believed, although it is not clear from the record why, there would be no buyer for the entire company. The auction was an unmitigated disaster: only two non-binding preliminary indications of interest were proffered, each at low valuations, and both parties exited the process following initial due diligence.

On several occasions, including the time of the auction for the confectionary business, Upper Deck Co., Topps' principal competitor in the sports card business, made overtures to the company about a possible acquisition. Discussions with Upper Deck never progressed past the preliminary stage, however.[12] In May 2006, two private equity firms, one led by Michael Eisner, expressed an interest to the Topps CEO in a potential going-private transaction. The CEO directed Eisner to a long-time independent director for further discussion. By March of the next year, over the objection of dissident directors, the board approved a merger agreement with the Eisner group. The deal price was $9.75 per share and included provisions for a 40-day go-shop period and a subsequent no-shop period.

Pursuant to the agreement, Topps was permitted at the end of the go-shop period to continue talks with a potential bidder only if such bidder had already submitted a "Superior Proposal," or the Topps board determined that the bidder was an "Excluded Party," which was defined as a potential bidder that the board considered reasonably likely to make a Superior Proposal. A Superior Proposal was defined as a proposal to acquire at least 60% of Topps that would provide more value to Topps stockholders than the Eisner Merger. Topps was also permitted to consider an unsolicited bid after the expiration of the go-shop period if the unsolicited bid constituted a Superior Proposal or was reasonably likely to lead to one. Topps could terminate the Merger Agreement in order to accept a Superior Proposal, subject only to Eisner's right to match any other offer to acquire Topps. The agreement also contained a two-tier termination fee.

In the go-shop period, the board's financial advisor contacted over 100 strategic and financial bidders, out of which only one, Upper Deck, made a serious offer. To gain access to confidential information during the go-shop period, Upper Deck entered into a non-disclosure agreement, which included a standstill provision that prohibited Upper Deck from making a tender offer for Topps shares without the company's consent and from making public statements about its bid. Despite Upper Deck's higher bid of $10.75 per share, the board determined not to declare Upper Deck an "Excluded Party," which would have enabled the board to continue negotiating with Upper Deck, or a "Superior Proposal." The board based its decision on Upper Deck's failure to show it could finance the deal, antitrust concerns and the small size of the reverse termination fee. Following the board's decision, Upper Deck made an unsolicited bid for $10.75 per share, supplied a letter from its banker to the effect that it was highly confident in Upper Deck's ability to finance the deal, and also offered to be flexible on antitrust issues, including divesting key assets if necessary. In connection with its bid, Upper Deck requested a waiver of the standstill provision. The board determined the unsolicited bid was not a "Superior Proposal" for similar reasons and rejected Upper Decks' request for a waiver of the standstill.

Plaintiffs' *Revlon* Claim

Similar to the Lear case, plaintiffs (which included Upper Deck and Topps shareholders) sought to preliminarily enjoin the consummation of the acquisition and the standstill provision on the basis, in part, of an alleged breach by the board of its *Revlon* duty. Plaintiffs based their claim on (1) the board's failure to conduct a full auction; (2) the allegedly preclusive terms of the definitive agreement, including the go-shop provision, the termination fee and the matching rights; and (3) the board's actions with respect to its decision not to deem Upper Deck an "Excluded Party" and its unsolicited proposal a "Superior Proposal." Vice Chancellor Strine rejected the first two arguments but accepted the third and granted injunctive relief.

In assessing whether the board was obligated to conduct a full auction to satisfy its *Revlon* duty, the Court, as in *Lear*, found a number of countervailing factors that made the decision to forego an auction reasonable. It noted that the market was well aware that Topps was open to a sale because of its public dispute with the hedge fund investor, its failed auction for the confectionary business and its agreement not to adopt a poison pill without shareholder

consent.[13] It also noted that under the circumstances it was reasonable for the board to consider the risks associated with another failed auction and Eisner's vow to withdraw his bid when deciding whether to conduct another auction.

In assessing whether the definitive agreement was preclusive and favored the deal with Eisner over other bidders the Court found the existence of the go-shop and its interplay with the no-shop provision to be critical to its determination. It noted that:

> **"[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 agreement seem to have left reasonable room for an effective post-signing market check. For 40 days, the Topps board could shop like Paris Hilton. Even after the go-shop period expired, the Topps board could entertain an unsolicited bid, and, subject to Eisner's match right, accept a Superior Proposal. The 40-day go-shop period and this later right work together, as they allowed interested bidders to talk to Topps and obtain information during the go-shop period with the knowledge that if they needed more time to decide whether to make a bid, they could lob in an unsolicited Superior Proposal after the period expired and resume the process."[14]**

Lastly on this point, the court recognized as part of its analysis the role the go-shop plays in allowing the board to set a floor price and the favorable psychological impact that has on future bidders. "Human beings, for better or worse, like cover. We tend to feel better about being wrong, if we can say others made the same mistake. Stated more positively, recognizing our own limitations, we often, quite rationally, take comfort when someone whose acumen and judgment we respect validates our inclinations. A credible, committed first buyer serves that role."[15]

In reviewing the board's actions with respect to its decision not to deem Upper Deck an "Excluded Party" and its unsolicited proposal a "Superior Proposal," the Court found sufficient support to buttress the granting of a preliminary injunction. According to Vice Chancellor Strine, the board's actions suggest that it simply preferred to do a deal with Eisner as opposed to with Upper Deck. Specifically, the Court noted the difficult position the board put itself in by not declaring Upper Deck an "Excluded Party." While it may have had legitimate concerns about the risks associated with Upper Deck's bid, the Court noted that it could have done more to address those risks by continuing to negotiate with Upper Deck. By not declaring Upper Deck an "Excluded Party," the board unnecessarily relinquished its ability to negotiate with Upper Deck. Also important to the Court's decision was the board's refusal to grant a waiver to Upper Deck of the strictures of the standstill provision. According to Vince Chancellor Strine, the record suggests that Topps was not using the standstill to extract more value from Upper Deck. Rather, Topps seemed to be using the standstill to fend off a higher bidder in order to entrench management. Under the Eisner merger, the senior management (one of the founder's sons and his son-in-law) would be able to retain key positions at the company, attractive compensation packages and freedom from the dissident hedge fund shareholder.

Plaintiffs' Disclosure Claims

As in *Lear*, plaintiffs also asserted a bevy of disclosure claims. In reviewing the record, the Court determined that several material facts were omitted from or misstated in the proxy statement, including:

- that (1) "Eisner specifically stated that his proposal was 'designed to' retain 'substantially all of [Topps'] existing senior management and key employees,"[16] and (2) Eisner repeatedly made assurances about management's likely future.
- that the board's financial adviser had provided an earlier set of valuations than those disclosed in the proxy, and that the earlier valuations suggested that Topps should be valued at higher levels;
- that the CEO had made statements that were potentially bid-chilling; and
- various facts that bear on Upper Deck's credibility as a bidder, including that Upper Deck had submitted an indication of interest before the go-shop period had begun, that Upper Deck's proposal was not contingent on financing, that the letter from Upper Deck's lender was conditional in part because of Topps' refusal to share certain information with it, that Upper Deck

had proposed a strong "hell or high water" antitrust provision in its unsolicited bid, that Topps' had prevailed in antitrust proceedings in the past, and that the terms of the standstill prevented Upper Deck from making a tender offer or publicly discussing its bid.

Conclusion

Lear and *Topps* provide the first direct guidance on state-of-the-art go-shop provisions. The decisions suggest several factors that should be taken into account in deciding whether to rely on a go-shop, and also provide some guidance on how to use the go-shop during the post-signing period.

- Do prospective buyers already know that the company might be for sale, or that the board might consider unsolicited offers in the past? Has it recently eliminated its poison pill – a fact that Vice Chancellor Strine believes sends a message to the marketplace? Has it publicly announced that it is conducting a strategic review? Are potential buyers already making overtures? Has the company recently attempted to sell some or all of its businesses? If the answer to any of these questions is yes, the case for a go-shop becomes stronger.
- Was the target board able to conduct at least a limited pre-signing market check? A pre-signing check may not be mandatory, but it will certainly strengthen the case for reliance on a post-signing go-shop.
- Is the target board concerned that a pre-signing auction will disrupt the business or damage customer and employee relations? This concern helps lay the foundation for a post-signing market check.
- Has the bidder threatened to withdraw its offer if the target conducts a pre-signing auction? Is this threat credible? Both *Lear* and *Topps* emphasize this fact.
- Does the go-shop give the target an adequate opportunity to shop the company after signing? The *Lear* and *Topps* decisions suggest that a shopping period of 40 or 45 days is short but acceptable – particularly if there is an opportunity to continue to negotiate with alternative bidders who make attractive offers during the shopping period. They also suggest that a structure under which the initial bidder has the right to match an offer made by a new bidder is not unnecessarily preclusive. And they indicate that the go-shop may be coupled with reasonable termination fees.
- Has the target board played fair in using the go-shop and related provisions? In *Topps*, even though Vice Chancellor Strine approved the decision to rely on a post-signing market check, he concluded that the target board had violated its *Revlon* duty because it did not give Upper Deck, the alternative bidder, an adequate opportunity to negotiate. Stated another way, it did not take advantage of the flexibility that the go-shop provided.

The *Topps* and *Lear* decisions also provide a reminder that the Delaware courts will pay very close attention to target management's role in the negotiations, and whether conflicts of interest or entrenchment motives may have tainted the process, regardless of whether the target chooses to rely on a pre-signing auction or a post-signing market check.[17] The decisions highlight the need to ensure that the board is directly involved in the acquisition negotiations and in decisions about how to design and manage the sales process. And they provide a reminder that even if potential flaws in the process are not sufficiently serious to lead to the conclusion that the target board violated its fiduciary duties, the target should think carefully about whether the flaws should be disclosed in the proxy statement so that target shareholders have a thorough understanding of how the negotiations unfolded.

NOTES

1. Once a target board has decided to sell control of the target, Delaware law imposes upon the board a fiduciary duty to conduct a sales process reasonably designed to achieve the highest possible price for the target's shareholders. This duty is referred to as the board's *Revlon* duty in reference to the landmark case of *Revlon v. Mac Andrews & Forbes Holdings, Inc.*, where the Delaware Supreme Court held that once directors have determined to sell control of a company, "[t]he directors' role changes from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders." 506 A.2d 173, 183 (Del. 1986).

2. Glover, Stephen I. & Goodman, Jonathan P., "Go-Shops: Are They Here to Stay?" *The M&A Lawyer* (vol. 11, no. 6); June 2007, page 1; © Thomson West LegalWorks.
3. C.A. No. 2728-VCS (Del. Ch. June 15, 2007).
4. C.A. No. 2786-VCS (Del. Ch. June 14, 2007). *See also Berg v. Ellison*; C.A. No. 2949-VCS (Del. Ch. June 12, 2007) (Transcript).
5. *Id.* at 44.
6. *Id.* at 45.
7. *Lear* at 47.
8. *Id.* at 48.
9. *In re: Toys "R" Us Shareholder Litigation*, 877 A.2d 975 (Del. Ch. 2005). *See also Berg v. Ellison,* C.A. No. 2949-VCS (Del. Ch. June 12, 2007) (Transcript) (noting that the combination of a match right, a termination fee of approximately $5 of equity value and a restrictive 25-day go shop is a "potent combination of deal protection" and something the Court "should at least look at the reasonableness of … on an expedited basis.").
10. Vice Chancellor Strine was also not impressed with Lear's argument that the two tier termination structure would encourage bids during the go-shop period. He pointed out that a bidder would get the benefit of the lower fee only if it were to finalize a deal with the company during the short shopping period, which he believed would be extremely difficult. Vice Chancellor Strine in *Berg* also gave little attention to arguments based on the two-tier termination fee structure in that deal.
11. *Lear* at 37.
12. Around the time of the auction, the company also received unsolicited non-binding bids from two private equity firms for the entire company (the bids ranged from $9 to $9.75 and $9.50 to $10). After initial due diligence, these bidders also moved on.
13. *Compare In re: Netsmart Technologies, Inc. Shareholder Litigation*, C.A. No. 2563-CVS (Del. Ch. 2006) (finding that in the context of a micro-cap company with limited analyst coverage, the market would be unlikely to be aware that the company was open to a sale and therefore a robust canvass of potential financial and strategic buyers would be necessary to satisfy the board's *Revlon* duty).
14. *Topps* at 53.
15. *Id.* at 54.
16. *Id.* (quoting the record).
17. *See e.g., In re: SS&C Technologies, Inc. Shareholder Litigation* (Del. Ch. Nov. 29, 2006) and *The Need for Careful Choreography in LBOs,* by Ethan Klingsberg, *The M&A Lawyer*, April 2007.

Third Circuit Court of Appeals Endorses Use of Market Evidence in Business Valuation

BY DAVID C. BRYAN

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A recent decision by the federal Court of Appeals for the Third Circuit has strongly endorsed the use of contemporaneous market evidence, rather than after-the-fact litigation experts, to value a spun-off business in a fraudulent transfer and breach of fiduciary case. The Third Circuit rejected the claims of unpaid creditors of the spun-off company to recover their losses from the failed company's former parent, where the spun-off company was found to be solvent and adequately capitalized on the spin-off date based on the market's valuation of it. It gave short shrift to the creditors' claim that market evidence should be disregarded in favor of the testimony of the plaintiff's trial experts. *VFB LLC v. Campbell Soup Company.*[1] The Third Circuit's decision in *VFB* provides needed judicial guidance in the law of business valuation, and enhances protection from subsequent litigation challenge for corporate transactions whose financial soundness is supported by market values at the time they are effectuated.

The Challenged Spin-off Transaction

A spin-off is a familiar form of corporate transaction through which a public company may divest

itself of a subsidiary or division by transferring certain of its businesses and assets into a new public company, and then distributing the shares of the newly-created corporation to the stockholders of the parent in the form of a dividend. As a result of a spin-off transaction, the parent's shareholders continue to own essentially the same basket of assets, but in the form of two separate companies.

In March of 1998, Campbell Soup Company (Campbell) executed a leveraged spin-off of a newly-created subsidiary known as Vlasic Foods International, Inc. (VFI). Campbell contributed nine of its underperforming specialty foods businesses to VFI, principally among them Vlasic pickles and Swanson frozen foods. Campbell's executives and outside advisors believed that in the hands of new management having an exclusive focus on the non-core businesses included in the spin-off, those companies could be turned around and made more valuable than when operated with Campbell's core brands.

In exchange for the transferred businesses, VFI assumed $500 million in bank debt that Campbell had incurred in connection with the spin-off. Campbell retained the cash proceeds of the $500 million new credit facility, which in effect constituted the consideration for the businesses that Campbell transferred to VFI. Such an assumption of debt by the newly-created subsidiary is a common feature in a spin-off—giving rise to the term "leveraged spin-off"—and reflects the propriety of allocating the parent corporation's total debt among the businesses being divided by means of the spin-off.

Following the spin-off transaction, VFI's shares were publicly listed and traded on the New York Stock Exchange. Based upon its stock price on the date of the spin-off, VFI had an equity market capitalization of approximately $1.1 billion. When added to the $500 million amount of its bank debt, VFI's market capitalization yielded a value of $1.6 billion for the new company. That valuation was consistent with the views of other contemporaneous participants in, and observers of, the new company, including both the outside advisors to Campbell and VFI in the spin-off transaction and the independent stock analysts who covered VFI following the spin-off.

Almost immediately after the spin-off, VFI encountered substantial operating and financial difficulties. According to the Third Circuit, VFI's pre-spin-off sales and earnings figures had been materially overstated, and quickly corrected themselves after the spin-off. As a result, VFI required a restructuring of its bank debt within six months after the spin-off transaction closed.

However, "[d]espite these very public problems, VFI did not fold. The price of its shares on the New York Stock Exchange remained essentially steady. Indeed, VFI outperformed the S&P mid-cap food index from the time of the spin, March 30, 1998, through January 1, 1999."[2] Moreover, in June of 1999—fifteen months after the spin-off—VFI successfully accessed the capital markets by issuing $200 million of unsecured bond debt purchased by sophisticated institutional investors, principally large insurance companies.

Following the bond offering, VFI continued to struggle financially and operationally, and in January 2001—nearly three years after the spin-off—VFI filed for chapter 11 protection and sold all of its remaining businesses during its bankruptcy proceedings. VFI's asset sales generated an aggregate purchase price that, at present value, was approximately $115 million less than the $500 million in debt that VFI had assumed in the spin-off. The proceeds of VFI's liquidation proved insufficient to satisfy the claims of its unsecured creditors, principally the institutional investors who had purchased VFI's $200 million of unsecured bond debt, either initially or in later claims-trading.

In February 2002, a limited liability company established under VFI's chapter 11 plan to pursue VFI's litigation claims, an entity known as VFB LLC (VFB), sued Campbell, alleging *inter alia* that the spin-off was a fraudulent transfer. Under New Jersey fraudulent transfer law, a transfer made for less than reasonably equivalent value may be avoided if the debtor was insolvent, was undercapitalized, or intended to incur debts beyond its ability to pay at the time of the challenged transfer. VFB further alleged that Campbell had aided and abetted alleged breaches of fiduciary duties by Vlasic's pre-spin directors, all of whom were senior Campbell executives prior to the spin-off. The alleged fiduciary breach by the pre-spin directors was their approval of the spin-off transaction, which VFB said rendered VFI insolvent and inadequately capitalized.

After a lengthy bench trial, Judge Kent A. Jordan of the United States District Court for the District of Delaware ruled in favor of Campbell on all of VFB's claims.[3] The District Court ruled that VFB's fraudulent transfer claim failed because VFB had failed to prove that VFI received less than reasonably equivalent value in the spin-off, or that VFI was insolvent or inadequately capitalized. Rather, the District Court concluded that the businesses transferred to VFI were worth "greatly in excess" of the $500 million in debt that VFI assumed in the spin-off.[4] Likewise, VFB's claim for aiding and abetting breaches of fiduciary duty also failed because, in the absence of insolvency, VFI's pre-spin directors owed no fiduciary duties to VFI's creditors. VFB appealed, and the Third Circuit unanimously affirmed in a published opinion.

Significance of the *VFB* Decision

The Third Circuit's ruling in *VFB* carries significant implications for public companies contemplating leveraged spin-offs, leveraged acquisitions or divestitures, and similar corporate transactions.

In rejecting VFB's fraudulent transfer claim, the Court of Appeals ruled that the trial court was correct to base its determinations of solvency, reasonably equivalent value and capital adequacy on the objective evidence of VFI's market capitalization. Because VFI's stock was publicly traded on the New York Stock Exchange and its market capitalization substantially exceeded the borrowing proceeds and other consideration received by Campbell in connection with the spin-off, the appellate court agreed that there was no fraudulent transfer to Campbell and no breach of fiduciary duty to VFI or its creditors in the transaction.

The Third Circuit first rejected as "clearly wrong" the plaintiff's contention that a court should never measure the value of a business by its market capitalization because the market price of a corporation's stock is based upon projections of future income that may turn out to be inaccurate: "Equity markets allow participants to voluntarily take on or transfer among themselves the risk that their projections will be inaccurate; fraudulent transfer law cannot rationally be invoked to undermine that function."[5] To the contrary, the appellate court held that a public company's market capitalization represents a "classic example" of a projection anchored in past performance, because the stock price "reflects all the information that is publicly available about a company at the relevant time of valuation."[6]

In so ruling, the Third Circuit reaffirmed its earlier decisional law rejecting "[t]he use of hindsight to evaluate a debtor's financial condition."[7] At trial, plaintiff's valuation experts had attempted to assign much lower values to the VFI businesses than did the market, based upon expert valuation analyses performed with the benefit of selective hindsight. The Court of Appeals expressly affirmed the District Court's refusal to credit this testimony. The court specifically rejected VFB's attempted reliance on the experts' use of VFI's "actual post-spin performance" figures to "purport to reconstruct a reasonable valuation of the company" using discounted cash flow analysis, reasoning that the use of discounted cash flow analysis is "imprecise" and has value "only 'in certain limited situations.'" [8] Although the District Court had granted VFB leave to present testimony by up to five expert valuation witnesses, the Third Circuit observed that "basically the district court regarded the hired expert valuations as a side-show to the disinterested evidence of VFI's capitalization in 'one of the most efficient capital markets in the world.'"[9] According to the Third Circuit, "[a]bsent some reason to distrust it, the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'"[10]

The plaintiff in the *VFB* case attempted to convince both the District Court and the Court of Appeals that VFI's stock and bond trading prices should be disregarded due to negative information that VFB contended had not been disclosed by Campbell at the time of the spin-off. The District Court found, however, that even when each piece of information concerning VFI that was alleged to have been undisclosed at the time of the spin-off had indisputably become known to the market, VFI's stock and bond prices continued to demonstrate solvency by a wide margin. In its lengthy opinion, the District Court examined the impact of each alleged non-disclosure on the public stock price, and concluded that none of the alleged omissions or misstatements at the time of the spin-off transaction had any appreciable effect on the market's valuation of VFI.[11] The Third Circuit expressly approved the District Court's disclosure analysis as having "me-

ticulously and accurately" considered "the evolving facts" concerning the spin-off.[12]

The *VFB* decision is important in that it effectively establishes a rebuttable presumption that, absent a showing that the market was deceived and that the deception caused a quantifiable inflation of the subject company's stock price, the market price is conclusive evidence of value. In *VFB*, the Third Circuit has now given precedential weight to its prior articulation of this evidentiary presumption in *In re PHP Healthcare Corp.*: "In the absence of any evidence of manipulation or bad faith we are comfortable presuming that stock the New York Stock Exchange values at $17.50 per share is . . . of a value reasonably equivalent to $17.50 per share . . . ."[13] The Seventh Circuit has similarly embraced a presumption in favor of contemporaneous market evidence as proof of value: "[T]he price of stock in a liquid market is presumptively the one to use in judicial proceedings" because "[t]he price at which people actually buy and sell, putting their money where their mouths are, is apt to be more accurate than the conclusions of any one analyst."[14]

The Third Circuit's decision in *VFB* expands upon an existing body of case law that gives "significant deference to marketplace values"[15] in performing judicial valuations. For example, in *Matter of Prince*, the Seventh Circuit ruled that "[t]he collective appraisal of market participants" as reflected in a stock's market price is the most reliable measure of a stock's value.[16] The Fourth Circuit voiced similar criticisms of expert valuation evidence, and a preference for contemporaneous market-based evidence instead, in *In re Morris Communications NC, Inc*. There, the Court of Appeals found clear error by the trial court judge in relying principally on the "general opinion testimony" of three expert valuation witnesses in reaching a determination that the price paid for stock did not represent a reasonably equivalent value of such stock at the time of the transfer.[17] And in a lengthy opinion that the Third Circuit summarily affirmed, the District Court for the District of Delaware ruled that "[w]hen sophisticated parties make reasoned judgments about the value of assets that are supported by then prevailing marketplace values and by the reasonable perceptions about growth, risks and the market at the time, it is not the place of fraudulent transfer law to reevaluate or question those transactions with the benefit of hindsight."[18]

The Third Circuit's embrace of contemporaneous, objective market evidence, and its affirmance of the fact finder's refusal to substitute the judgment of hired expert trial witnesses for the informed judgment of the market at and near the time of the challenged transaction, are welcome developments in the law of business valuation. Expert valuations readily fall victim to hindsight bias and are, to a great extent, subjective exercises dependent upon the assumptions employed by the expert. Discounted cash flow valuations in particular "are highly sensitive to assumptions about the firm's costs and rate of growth, and about the discount rate. It is a simple matter to increase or reduce the outcome of a cash flow analysis by 200% by making changes in assumptions that appear by themselves to be insignificant."[19] As a result, such evidence created "after-the-fact and for the purpose of proving a point in an adversarial proceeding [is] too subjective and too subject to manipulation" to displace contemporaneous market evidence.[20]

The *VFB* decision provides assurance that corporations and their managers and directors may "rely on the objective evidence from the public equity and debt markets" at the time of a leveraged transaction, thereby reducing the risk that contemporaneous evidence of market value will be second-guessed by "subjective estimates of one or two expert witnesses" prepared in hindsight for purposes of litigation.[21] The case significantly raises the bar on constructive fraudulent transfer claims challenging public company transactions where the contemporaneous evidence from the stock and debt markets at and shortly after the transaction took place indicated that the company was solvent and adequately capitalized.

As well, the *VFB* decision is significant in that it reaffirms fundamental principles of fiduciary duty law as applied to spin-off transactions. The Third Circuit rejected VFB's argument that New Jersey courts would not follow *Anadarko Petroleum Corp. v. Panhandle Eastern Corp*., in which the Delaware Supreme Court held that the directors of a wholly-owned, solvent subsidiary must act in the best interests of the parent corporation and its shareholders, and do not owe separate fiduciary duties to the pre-

spin subsidiary or its present or future creditors.[22] Because VFI was solvent at the time of the spin-off, Campbell's pre-spin directors owed no fiduciary duties to VFI's creditors, and the litigation LLC's claim against Campbell for aiding and abetting breach of fiduciary duty failed.[23]

The Third Circuit's valuation analysis in *VFB* should prove equally applicable not only to spin-off transactions in particular, but to judicial valuations of similar types of leveraged public company transactions. However, the *VFB* case may have important near-term implications for at least two other pending lawsuits challenging spin-off transactions on fraudulent transfer and breach of fiduciary duty grounds.[24] In both cases, as in *VFB*, creditors of failed spun-off subsidiaries—satellite telephone manufacturer Iridium LLC, and energy trading concern Mirant Corporation—have asserted fraudulent transfer and fiduciary breach claims against their former parent corporations, respectively Motorola, Inc. and The Southern Company.

In the *Motorola* case, a recent trial phase devoted to the solvency inquiry, which presently awaits decision by the United States Bankruptcy Court for the Southern District of New York, featured extensive debate over the reliability of contemporaneous market-based valuation evidence, as well as competing testimony by expert valuation witnesses. And while the *Southern Company* case remains in its discovery phase, the pleadings filed by the parties indicate that the plaintiff will need to overcome significant market-based valuation evidence in order to prevail on fraudulent transfer or breach of fiduciary duty grounds.

The *Motorola* and *Southern Company* lawsuits, as well as other future judicial challenges to public company transactions on valuation-based grounds, provide additional opportunities for courts to follow the Third Circuit's valuation approach in *VFB*, thus enhancing protection and certainty for corporations and their managers and directors in evaluating and effectuating leveraged corporate transactions that are supported by informed contemporaneous market-based evidence of value.

NOTES

1. 482 F.3d 624 (3d Cir. 2007).
2. *Id.* at 628.
3. 2005 WL 2234606 (D. Del. Sept. 13, 2005).
4. *Id.* at *23.
5. 482 F.3d at 631.
6. *Id.*
7. *In re R.M.L., Inc.*, 92 F.3d 139, 155 (3d Cir. 1996).
8. 482 F.3d at 633.
9. *Id.* at 629.
10. *Id.* at 633.
11. 2005 WL 2234606.
12. 482 F.3d at 634.
13. 128 Fed. Appx. 839, 848 (3d Cir. 2005).
14. *Metlyn Realty Corp. v. Esmark, Inc.*, 763 F.2d 826, 835 (7th Cir. 1985).
15. *Peltz v. Hatten*, 279 B.R. 710, 738 (D. Del. 2002), *aff'd mem.*, 60 F. Appx. 401 (3d Cir. 2003).
16. 85 F.3d 314, 320 (7th Cir. 1996).
17. 914 F.2d 458, 475 (4th Cir. 1990).
18. *Peltz*, 279 B.R. at 738; *see also Metlyn*, 763 F.2d at 836 ("The process of valuation by testimony may obscure rather than illuminate the value under study, while market processes overcome personal biases, quirks and errors.").
19. *Metlyn*, 763 F.2d at 835.
20. *Peltz*, 279 B.R. at 742.
21. 482 F.3d at 633.
22. 545 A.2d 1171 (Del. 1988).
23. 482 F.3d at 634-36.
24. *Statutory Committee of Unsecured Creditors v. Motorola, Inc.*, No. 01-02952 (Bankr. S.D.N.Y.); *MC Asset Recovery, LLC v. The Southern Co.*, No. 06-00417 (N.D. Ga.).

Judicial Scrutiny of Deal Protection Measures

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Recent Delaware decisions have put deal protection measures back in the spotlight. In *Louisiana Municipal Police Employees' Retirement System v. Crawford*, for example, the Delaware Court of Chancery was sharply critical of the deal protections in a merger agreement between CVS Corporation and Caremark

RX, Inc.[1] Although many of the deal protections in *Crawford*—including a 3% termination fee—might be viewed as common, the court made clear that there are no bright-line rules in determining their coercive and preclusive effects. Subsequent decisions, however, upheld the validity of higher termination fees that were coupled with matching rights. Read together, these decisions emphasize the context-specific analysis of deal protections and are a poignant reminder that practitioners must be able to articulate to their clients the various justifications for deal protections in specific circumstances.

The Caremark-CVS Merger Agreement

Crawford involved a "merger-of-equals" between CVS and Caremark. The merger agreement contained a force-the-vote provision requiring each company to hold a stockholder vote. The merger agreement also contained reciprocal no-shop provisions that prohibited solicitation of third-party proposals, subject to a customary fiduciary out allowing either board to respond to an "unsolicited bona fide written Acquisition Proposal" that it "determined in good faith (after consultation with its outside legal counsel and financial advisors) constitutes or is reasonably likely to lead to a Superior Proposal."[2] Before accepting a superior proposal, the company had to comply with a five-day matching rights or last-look provision.[3] The merger agreement also contained reciprocal termination fees of $675 million, or 3% of Caremark's equity value and, given Caremark's negligible debt, essentially the same percentage of enterprise value. The termination fees were payable upon a change in board recommendation or a no-vote by the stockholders followed by another transaction within twelve months.

The *Crawford* Decision

After the CVS-Caremark merger was announced, Express Scripts, Inc. made an unsolicited offer to acquire Caremark and litigation ensued. In temporarily enjoining the Caremark stockholders meeting until certain supplemental disclosures were made,[4] Chancellor William B. Chandler III made some critical observations of the deal protections in the merger agreement. In particular, he referred to the no-shop provisions as a "road map by which a competing bidder may tiptoe around termination fee landmines in order to make a hostile offer."[5] He also referred to the 3% termination fee as the "foundation" of the "intricate barricade" of deal protection provisions in the agreement.

The court unequivocally rejected Caremark's argument that a 3% termination fee was reasonable *per se*. This was so despite prior Delaware decisions characterizing 3% termination fees as "traditional" and "modest and reasonable."[6] Indeed, in *McMillan v. Intercargo Corp.* the Court of Chancery referred to a 3.5% termination fee as an "insubstantial obstacle" and noted that it was "difficult to see how a 3.5% fee would have deterred a rival bidder."[7] Nevertheless, *Crawford* made clear that any attempt to "build a bright line rule" would be done "upon treacherous foundations."[8] Chancellor Chandler continued that, "[t]hough a '3% rule' for termination fees might be convenient for transaction planners, it is simply too blunt an instrument, too subject to abuse, for this Court to bless as a blanket rule."[9] Although its sharp tone may have been influenced by alleged process flaws and Caremark's decision not to negotiate with Express Scripts, the court nevertheless went out of its way to comment on the deal protections and its dicta must be taken seriously.

Subsequent Delaware Decisions

Since *Crawford*, the Court of Chancery has issued three other decisions relevant to deal protection measures, each written by Vice Chancellor Leo E. Strine, Jr. The first was *In re Netsmart Technologies, Inc.*, which involved the auction of a small-cap company to private-equity buyers. Although the court concluded that the auction process was flawed, it observed that a 3% termination fee based on equity value was "not unreasonable, especially given the size of the transaction and the fact that upon triggering more than a third of the fee would simply go to repay Insight's actual expenses."[10] According to the defendants, the termination fee was equal to $0.43 per share on a fully-diluted basis. It also bears noting that the merger agreement did not contain matching rights.

The second, *In re The Topps Company Shareholders Litigation*, addressed a termination fee and matching rights in a merger agreement that contained a go-shop clause. The *Topps* fee represented

4.3%–4.6% of equity value, including expenses. Vice Chancellor Strine observed that a matching right was "a useful deal protection for [a buyer], but one that has frequently been overcome in other real-world situations."[11] He then continued that, while a 4.3% termination fee was "a bit high in percentage terms, it includes [the buyer's] expenses, and therefore can be explained by the relatively small size of the deal. At 42 cents a share, the termination fee (including expenses) is not of the magnitude that I believe was likely to have deterred a [rival] bidder…."[12] At least in the context of a go-shop provision, the *Topps* combination of deal protections still "left reasonable room for an effective post-signing market check."[13] Important to the court's analysis, however, was the fact that the topping bidder, Upper Deck, did not stress the termination fee in requesting an injunction from the court.

Finally, the Court of Chancery upheld a termination fee equal to 3.5% of equity value and a ten-day matching right that were combined with a 45-day go-shop period in *In re Lear Corporation Shareholders Litigation*.[14] The termination fee, including maximum out-of-pocket expenses, was equal to 2.4% of Lear's $4.1 billion enterprise value, which included $2.5 billion of debt. Vice Chancellor Strine then offered insight into an issue that practitioners have long debated: whether termination fees should be judged based on equity or enterprise value. Vice Chancellor Strine observed that in assessing a termination fee's preclusive effect:

> **it is arguably more important to look at the enterprise value metric because, as is the case with Lear, most acquisitions require the buyer to pay for the company's equity and refinance all of its debt.[15]**

The court then held that the termination fee was "hardly of the magnitude that should deter a serious rival bid."[16] The court also observed that the matching right—a "hardly novel" concept—provided for a single last-look right if a topping bid exceeded the merger consideration by $1.00 per share, thus giving an incentive to third parties to materially outbid the initial buyer.[17]

Revisiting the Justifications for Deal Protection Measures

Crawford stands as a conscious reminder from the Delaware courts that deal protection measurers must be assessed in a context-specific manner. Although Delaware courts have consistently recognized the utility of deal protections, there is no customary combination or bright-line rule that will always carry the day. Under *Revlon*, deal protections are permissible so long as the board acted reasonably in obtaining the best value for stockholders. But even outside *Revlon*, deal protection measures are subject to *Unocal* review as defensive measures. Delaware courts therefore will still examine "the preclusive or coercive power of *all* deal protections included in a transaction, taken as a whole."[18]

This string of recent Delaware decisions is a reminder of the various justifications used for deal protections. *Crawford* specifically stated that the court's analysis includes:

- the overall dollar-size of the termination fee, perhaps suggesting that even a low-percentage fee might be impermissible due to its sheer size;
- the size of the termination fee in percentage terms (equity and enterprise);
- the size of the termination fee relative to the benefit to shareholders, including the size of any premium being offered;
- the absolute size of the transaction, as well as the relative size of the partners to the merger; and
- the degree to which a counter party found the deal protections to be crucial to the deal, bearing in mind differences in bargaining power.[19]

Other factors traditionally have included the initial buyer's opportunity costs as well as any reputational loss resulting from a successful topping bid. Delaware courts also are mindful of give-and-take during negotiations: a higher termination fee may be justified, for example, in return for a broader post-signing market check or an increase in the purchase price.

Topps and *Lear* also suggest that the board's market-check activities can influence the appropriateness of deal protections. While *Crawford* was critical of a 3% termination fee in a strategic merger-of-equals that was concluded without any pre-signing market check or post-signing go-shop period, *Topps* and *Lear* approved significantly higher fees (4.3% and

3.5%, respectively) in conjunction with deals that were subject to go-shop provisions.[20] At the same time, practitioners must be sure that the deal protections do not impede the utility of post-signing market checks.

Vice Chancellor Strine's comment in *Lear* on the use of enterprise value versus equity value indicates that practitioners and directors should evaluate termination fees using both metrics. As Vice Chancellor Strine notes, the size of the fee as a percentage of enterprise value should be considered in evaluating the fee's preclusive effects under *Unocal*, which tests whether a competing bidder could top the deal as a whole. Using enterprise value is generally appropriate in this context if the acquirer must assume the target's debt, pay it off, or otherwise refinance it. The size of the fee therefore must be judged in light of the overall transaction cost to the acquirer, not just in terms of equity value.

A *Unocal* analysis also looks to whether the termination fee is "coercive," which considers the impact of the fee on the stockholders' ability to vote down the deal. Although not discussed by Vice Chancellor Strine, equity value is likely the correct measure for this analysis, because the question from the stockholders' standpoint is "what value will the equity have if I vote down this deal." The answer to this question is only affected by the value of the equity, not the value of its debt. Because *Unocal* involves both a preclusiveness and a coerciveness analysis, practitioners and directors should examine both issues.

The final step in the *Unocal* analysis is whether the fee falls within a "range of reasonableness." There is not yet any guidance on which measure should be used to judge "reasonableness," so the prudent course is to consider both enterprise and equity value, including maximum expenses payable to the buyer.

Enterprise as opposed to equity value also seems like the correct measure if a termination fee is structured as a liquidated damages provision. Practitioners have the flexibility to structure a termination fee in this manner, in which case the fee is not reviewed under *Unocal* but rather is examined to determine whether the amount is either "unconscionable" or "not rationally related to any measure of damages a party might conceivably sustain."[21] A low percentage fee is unlikely to be "unconscionable," so the question instead will be whether the amount is "rationally related" to a damages measure. From the acquirer's perspective, the loss of a target is best represented by the enterprise value of the target as a whole, not merely its equity value. It follows that enterprise value is the more appropriate measure for a liquidated damages analysis.

Crawford and subsequent decisions can be squared only by looking to the fact-dependent judicial analysis of deal protections. M&A practitioners must be prepared to articulate to their clients why various combinations of deal protection measures are being employed. In *Netsmart*, Vice Chancellor Strine warned that various M&A techniques cannot be applied in rote fashion and, instead, have to be justified based on the circumstances. This is consistent with *Crawford*, where Chancellor Chandler cautioned against any presumptions of reasonableness. In the current market, one consequence is that practitioners must consider whether traditional deal protection justifications are readily applicable to, for example, financial buyers. More generally, practitioners must determine what combination of deal protections—including matching rights, force-the-vote provisions, no-shops, and termination fee and expense reimbursements—is appropriate in light of a target's pre-signing market check and its ability to conduct a post-signing market check through a fiduciary out or a go-shop provision.

NOTES

1. La. Mun. Police Employees' Ret. Sys. v. Crawford, C.A. Nos. 2663 & 2635, 2007 WL 582510 (Del. Ch. Feb. 23, 2007).
2. Agreement and Plan of Merger, dated as of Nov. 1, 2006, among CVS Corp., Caremark RX, Inc. and Twin MergerSub Corp., at § 8.07(b). A "Superior Proposal" was defined as a written proposal for at least a majority of either company's common stock that was determined to be more favorable "from a financial point of view" to the stockholders and for which financing was "fully committed or reasonably determined to be available." *Id.* § 8.07(f).
3. *Id.* § 8.07(d).
4. *See generally* J. Travis Laster & Steven M. Haas, *Caremark Stockholders Meeting Temporarily Enjoined Over Disclosures*, Wall Street Lawyer, Apr. 2007, at 9 (discussing the disclosure rulings in *Crawford*).

5. *Crawford*, 2007 WL 582510, at *4.
6. *In re* Pennaco Energy, Inc., 787 A.2d 691, 702, 707 (Del. Ch. 2001).
7. McMillan v. Intercargo Corp., 768 A.2d 492, 505–06 (Del. Ch. 2000).
8. *Crawford*, 2007 WL 582510, at *4 n.10.
9. *Id.*
10. *In re* Netsmart Techns., Inc., C.A. No. 2563, 2007 WL 926213, at *29 (Del. Ch. Mar. 14, 2007).
11. *In re* Topps Co. S'holders Litig., C.A. Nos. 2786 & 2998, 2007 WL 1732586, at *25 (Del. Ch. June 14, 2007).
12. *Id.*
13. *Id.* at *26.
14. *In re* Lear Corp. S'holder Litig., C.A. No. 2728, 2007 WL 1732588 (Del. Ch. June 15, 2007).
15. *Id.* at *24.
16. *Id.*

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