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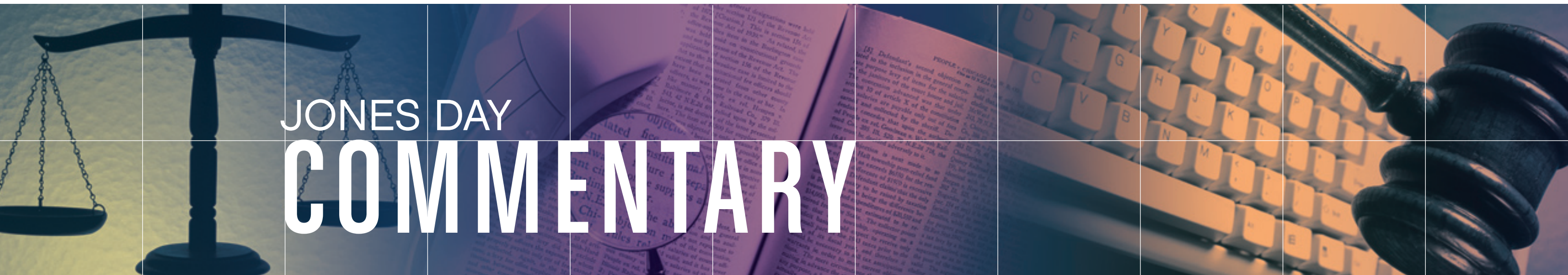

MERGERS & ACQUISITIONS

TOY STORY: DELAWARE REAFFIRMS DIRECTOR CONTROL OVER SALE PROCESS

Chancellor Leo E. Strine, Jr., one of the leading judges in the country in the corporate governance area, has become an advocate for judicial restraint and traditional, principle-based review of director conduct by the Delaware courts. His June 2005 decision dismissing shareholder attacks on the Toys "R" Us going-private transaction[1] not only provides specific guidance on the proper conduct of auctions and the boundaries of permissible deal protections, but also is the latest, and perhaps strongest, reaffirmation by the Delaware courts that boards of directors have the authority to oversee the corporate sale process in the manner in which they see fit, without risk of the judicial nitpicking and second-guessing that were evident in the immediate post-Sarbanes-Oxley period.[2]

THE PATH TO THE SALE

Times were tough for Toys "R" Us in January 2004. The company had disappointing sales for the just-ended holiday season, and the business was thought to be facing serious structural challenges. Not surprisingly, the company's stock price was depressed. Under the leadership of the company's chairman and CEO, the Toys board decided shortly thereafter to consider its strategic alternatives, commencing what would be

1 *In re Toys "R" Us, Inc. Shareholder Litigation*, 2005 WL 1587416 (Del. Ch. June 22, 2005) (referred to herein as "*Toys*").

2 *See*, *e.g.*, *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2002), in which a split Delaware Supreme Court announced specific rules purporting to prohibit the utilization of certain lock-up provisions.

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many months of meetings and deliberations as the board considered how best to deliver more value to the company's stockholders.

Many alternatives were considered. The board ultimately decided to pursue a strategy in which the company's flagship global toy business would be sold at auction, and the company would retain certain other of its businesses, including its baby products division.

Beginning in the fall of 2004, the company, with the help of its investment banking firm, conducted a typical strategic assessment process over a period of months. Although several bidders had made attractive offers for the global toys division, one made an attractive offer for the company as a whole. The board instructed the company's financial advisor to seek whole-company bids from the remaining bidders. Because of the time pressures and the fact that the bidders had at that point already invested nearly six months of effort in the process, the time made available to the other bidders for due diligence on the remainder of the company was kept short.

Two of the remaining bidders banded together to present a joint bid for the entire company. This consortium, which included Kohlberg Kravis Roberts, ultimately submitted the highest bid for the entire company, which the board approved in March 2005.

Strike suits were filed, making, in essence, two arguments: (1) that the board acted too hastily once it decided to consider the sale of the entire company and should have spent more time giving more bidders a chance to submit bids, and (2) the board compounded its error by agreeing to deal protection measures that went too far in precluding the emergence of a superior bid.

Both arguments were rejected.

HOW *REVLON* SHOULD BE APPLIED (*OMNICARE* NOTWITHSTANDING)

The court interpreted its *Revlon*[3] mandate as being two-fold: (1) Once directors decide to sell the company, they must maximize price, and (2) for these purposes, a court must examine whether the decision-making process of the directors was adequate and whether the directors' actions were reasonable in light of the circumstances. However, unlike other recent post-Sarbanes-Oxley signals from the Delaware courts,[4] the *Toys* court predicated its review on long-standing business judgment rule principles. The "enhanced judicial review *Revlon* requires is not a license for law-trained courts to second-guess reasonable, but debatable, tactical choices that directors have made in good faith."[5] In so doing, Chancellor Strine reviewed, in a respectful manner, the business experience of various members of the company's board and was clearly cognizant of the practical difficulties faced by the board in overseeing negotiations with bidders and the danger of losing bids by holding out for better terms.

The *Toys* court was also notably uncharitable to the arguments advanced by the expert witnesses for the plaintiffs, two law school professors. The expert witnesses argued that the deal protections negotiated by the board went too far toward precluding topping bids. In addition to openly criticizing the merit of the experts' contention that a 3.75% termination fee posed a significantly greater barrier to a topping bid

3 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

4 *See*, *e.g.*, *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003); *MM Companies, Inc. v. Liquid Audio, Inc., et al.*, 813 A.2d 1118 (Del. 2003).

5 *Toys*, 2005 WL 1587416 at *21. Chancellor Chandler took a similar approach in the recent *Disney* severance payment litigation. *See In re Walt Disney Company Derivative Litigation*, Civ. No. 15452 (Del. Ch. Aug. 9, 2005).

than a 2.50% termination fee (which was advanced by the experts as reasonable), Chancellor Strine also suggested that the experts were not being properly mindful of the risks associated with negotiations. In this regard, Chancellor Strine used a colorful hypothetical[6] to make the point that a company can be in a precarious position of potentially losing the already attractive bids that had been received, and that it is not always practical for companies to attempt to wring out every last quantum of potential surplus in a transaction during negotiations.

The overall tone of the opinion makes *Toys* particularly noteworthy. Chancellor Strine emphasizes that judicial scrutiny of a board's action is not meant to be a hindsight-driven evaluation of whether the board made a good decision: "what matters is whether the board acted reasonably based on the circumstances facing it."[7] In so doing, the court struck another blow at "aberrational" *Omnicare* (two words that seem to be appearing together with increasing consistency): "*Omnicare* represents, one senses, an aberrational departure from that long-accepted principle."[8]

THE AUCTION PROCESS

The *Toys* court provided guidance on several key issues that regularly arise in auctions:

Process Is Key. The company conducted a now-typical strategic assessment process, with the active involvement of an outside financial advisory firm that conducted serious negotiations with multiple bidders. Chancellor Strine noted with approval that the board had access to its own counsel (in addition to the separate deal counsel, which represented the company in the negotiations) and two financial advisory firms. For better or worse, "face time" (or at least meeting time) also matters: The court noted that the board met 14 times during the strategic review process, with several of these meetings going on for hours.

Management Retention May Be Negotiated Subsequent to Striking a Deal for the Company. The board did not appoint a special committee to evaluate the transaction (although the nine independent members of the 10-person board did meet in executive session periodically). Instead, the company specified in the process that it would not negotiate and would not permit its executives to negotiate, provisions for post-acquisition employment or stock ownership arrangements for managers (which are common accompaniments to going-private transactions with financial buyers) until key deal terms (price and any atypical closing conditions) were set. This is important in an era in which private equity buyers can be expected to participate in most auctions. *Toys* clearly supports the emerging practice of not moving to the typically cumbersome special committee process with separate financial and legal advisors (who frequently view their role as protecting the special committee members personally rather than maximizing shareholder value) so long as all credible bidders are kept on a more or less level playing field.

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6 Suggesting that the plaintiffs were not being sufficiently mindful that an effort by the company to negotiate down the 3.75% termination fee could lead to adverse consequences, the court spun the following hypothetical:

> Let's plausibly imagine how that exceedingly awkward negotiating session that the plaintiffs desire might have gone:
>
> [Advisors for company]: The board wants 3.0% on the termination fee and to get rid of the matching right.
> [Bidder]: Fine, you can have $25.75 per share and the 3.0% or the $26.75 with 3.75% protection for our trouble. And we want the match in either case.
> [Advisors for company]: No, no. We demand 3.0% and the $26.75; take it or leave it.
> [Bidder]: What did [the other bidders] bid?
> [Advisors for company]: We can't comment.
> [Bidder]: I think we're done.
> [Advisors for company]: (with panicky overtones) Please don't go….
> [Bidder]: (*Click*.)
> [Advisors for company]: [Expletive deleted.]

Toys, 2005 WL 1587416 at *37.

7 *Id.* at *36.

8 *Id.* at *36 (see footnote 68).

Equity Compensation Does Not Necessarily Create a Conflict of Interest. Chancellor Strine rejected the argument that the Toys CEO had a disabling conflict of interest because he stood to make $60 million for his stock from the sale of the entire company, which amount would presumably be less, at least initially, if only the global toys business was sold. Chancellor Strine noted that in this regard none of the facts suggested that the CEO tilted the auction process toward any particular bidder or reflected any attempt by him to enrich himself at the expense of the public shareholders. Indeed, in this case, the CEO's investments and equity participation in the company had their desired effect: to align his interests with the shareholders. "Here, the plaintiffs essentially accuse Eyler of the status crime of being a CEO."[9]

Revisions to Strategy Mid-Stream Do Not Mean That the Board Must Start Over. Chancellor Strine also rejected the notion that, once it decided to consider offers for the entire company, the board needed to re-open the bidding process, invite new bidders, and extend the due diligence periods. He accepted as reasonable the board's conclusion that the patience of those bidders who had stayed in the hunt for many months was potentially wearing thin, and if the company extended the bidding process, there was no guarantee that the offers they already had would continue to be there. In addition, the company had been very publicly considering its strategic alternatives for over a year, and Chancellor Strine found it likely that if other bidders had been interested, they would have come forward by that point.

The Acquisition Price Does Not Need to Be at the Top of the Fair Range to Be Fair. Chancellor Strine addressed in detail the plaintiffs' arguments that the board failed to negotiate a fair price for the company. In the final analysis, the price the group led by KKR agreed to pay was near the top of, or above, the range of fair value in many of the valuation methodologies employed by the company's financial advisors and was in the middle of the valuation presented by the plaintiffs. This is sufficient. Chancellor Strine noted that the plaintiffs' valuation assumed that a number of key business risks were successfully navigated, and that boards are not required to make such assumptions.[10]

Providing Acquisition Financing Can Create the Appearance of Impropriety by the Financial Advisor to the Target. Chancellor Strine noted with disapproval the provision of acquisition financing by Credit Suisse First Boston to the group led by KKR (even though this financing was not negotiated until two months after the execution of the merger agreement). This was not fatal, however: "[the court's] job, however, is not to police the appearances of conflict that, upon close scrutiny, do not have a causal influence on the board's process."[11] This issue is potentially important as private equity firms remain active and investment banks target the lucrative acquisition finance market. One possible solution is the practice, which is already becoming increasingly prevalent, of offering so-called staple financing upfront in the auction process—*i.e.*, the financial advisory firm (or other financial institution) offers the same financing package to all potential bidders. Potential bidders are frequently encouraged to submit initial indications of interest based on the staple financing so that the board can have apples-to-apples comparisons, but they normally are not required to use the staple. This helps guard against the risk of a leak. Moreover, because all bidders have access to the financing, in the normal case, there will be no basis for it to create an appearance of impropriety.

DEAL PROTECTIONS

Toys also provided guidance on the scope of permissible deal protections:

A 3.75% Termination Fee Is Okay (At Least in This Case). Chancellor Strine found that the 3.75% termination fee that was negotiated in this case was not unduly preclusive. This conclusion is well in line with past precedent as well as market practice, where 3% seems to be the approximate median for termination fees. Chancellor Strine noted that there is no

9 *Id.* at *24.
10 *Id.* at *33-34.
11 *Id.* at *27.

bright line threshold for what is and is not permissible; in certain circumstances, it is even possible that fees lower than 3% may be unreasonable. But in this case, "[i]t would be hubris in these circumstances for the court to conclude that the board acted unreasonably by assenting to a compromise 3.75% termination fee in order to guarantee [the negotiated purchase price] to its stockholders."[12] One side note: Chancellor Strine emphasized the fact that the company had negotiated the termination fee down from 4% to 3.75%. The implication for future transactions is clear: It is better (at least from the standpoint of optics) to start out of the gate with a higher termination fee and negotiate it down than to start with a lower termination fee and stand pat.

A Matching Right Is OK. The "fiduciary out" provision in the merger agreement also provided the KKR Group with an opportunity to match an interloping offer. This is a common feature, and Chancellor Strine found that it, together with the 3.75% termination fee, did not unduly preclude any materially higher topping offer.

CONCLUSION: *OMNICARE* R.I.P.

The significance of *Toys* is not really the guidance that it provides to boards and companies conducting auctions (most of which is not new), but rather what its tone and language signal: that there is some undercurrent within the Chancery Court away from the hindsight-aided *ex post* analysis of board decisions exemplified by *Omnicare* and other post-Sarbanes-Oxley cases and the somewhat sterile and simplistic view of what is attainable in negotiations that is championed by members of the academic community. Provided that the process is typical and involves experienced financial and legal advisors, it is now safer for boards to proceed with the assumption that decisions made in good faith, even in transactions in which *Revlon* scrutiny is applied, will not be second-guessed by the Delaware courts.

12 *Id.* at *39.

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