INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

Volume 22 Number 1, January 2008

STATE CORNER

The Implications of *Netsmart* for Private Companies

by John Mark Zeberkiewicz and Blake Rohrbacher

In its 2007 *Netsmart* opinion, the Court of Chancery held that, for "a micro-cap public company, an inert, implicit post-signing market check [may not] suffice as a reliable way to survey interest by strategic players."[1] Netsmart had agreed with its private-equity buyer on a "window shop" provision[2] that allowed Netsmart's board to "entertain unsolicited bids by other firms."[3] Netsmart's board had apparently been influenced by its financial advisor "into perceiving that all M & A situations were the same in the sense that the signing up of a publicly-announced deal for a micro-cap company like Netsmart would generate a reliable post-signing market check in the same way that similar announcements for large-cap companies . . . drew other interested strategic bidders into the process."[4]

Principles from *Netsmart*

The *Netsmart* Court held that the Netsmart board had been misinformed—a micro-cap public company such as Netsmart could not get by with a window-shop provision dependent on an implicit market check. In so doing, the Court of Chancery raised questions that may be applicable to private companies in certain circumstances.

First, it is clear after *Netsmart* that the Delaware courts' principle that *Revlon* does not prescribe a single method for seeking the best price available for the stockholders remains firmly in place. A technique approved by the courts for the boards of large public companies will not necessarily be sufficient for the board of a micro-cap public company or the board of a small- to mid-sized private company.[5]

Second, *Netsmart* contemplates an active post-signing market check for micro-cap public companies in Netsmart's situation. The Court suggested that "Netsmart and its financial advisor could have put together materials explaining Netsmart's business, why it had attractive growth potential, and how Netsmart's products and services fit within the broader healthcare IT space."[6] "Those materials could have been tailored for a few logical buyers," the Court continued, and Netsmart's financial advisor could have used its reputation in the industry "to secure the attention of the key executives at those firms, the ones with decision-making authority over acquisitions."[7]

Marketing Private Companies Post- *Netsmart*

But what does *Netsmart* mean for private companies? Specifically, does *Netsmart* require,

John Mark Zeberkiewicz and Blake Rohrbacher are associates at Richards, Layton & Finger, P.A., Wilmington, DE. Richards, Layton & Finger was involved in some of the cases discussed herein, but the opinions expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.

by implication or otherwise, that every private-company merger agreement contain a go-shop provision or some other provision expressly authorizing the target to disclose, at a minimum, the material terms of the deal and the window-shop provision to ensure that the target's board adequately surveys the interest of potential buyers (particularly strategic buyers)? Typically, of course, private companies selling themselves do not have to worry about *Revlon* in the same way that public companies do because the parties operate with the understanding that a few large stockholders will adopt the merger agreement shortly after it is executed.[8] That is, the requisite stockholders will adopt the merger by written consent,[9] thus eliminating the need for a stockholders meeting and eliminating the period between signing and stockholder approval where the board would otherwise be required to discharge its fiduciary duty to consider alternatives to the deal at hand.[10]

There are, however, occasions when a merger agreement with a private-company target is not adopted by written consent promptly after execution (*e.g.*, if there are no significant stockholders, if the charter prohibits action by written consent, or if the terms of a separate class or series of stock require advance notice prior to the submission of any matters to be voted on by the stockholders, etc.). It is in these situations that *Netsmart* 's discussion of post-signing market checks becomes relevant.

For public companies with reporting responsibilities, the fact and material terms of a merger agreement will be made known to the world at large. Because the merger agreement must be filed as an exhibit to the proxy statement, any bidder looking to launch a superior proposal for a public company target need only look to the window-shop provisions for a "roadmap" as to how it should proceed in making its bid.[11] Theoretically,[12] the market as a whole could be deemed to be on notice of the proposed merger, and would-be acquirors are alerted that they should consider a transaction with the target company. *Netsmart*, however, has held that mere disclosure may not be enough.

For private companies, the situation is very different. They have no reporting requirement, and the merger agreement typically will prohibit the target from disclosing the material terms of the transaction, because such disclosure could be viewed as "encouraging" or "facilitating" alternative transactions in contravention of the no-shop provision. Additionally, as is frequently the case with micro-cap public companies, market attention for private companies is often sparse. *Netsmart* could be read to suggest that private companies may bear the onus of special disclosure—of the material terms of the deal, including the total consideration and the break-up fee, and a copy of the window-shop provision or some other "roadmap" that would allow a bidder to make a superior proposal—and may even have to shop the company post-signing or engage in active post-signing market checks. That said, it is possible that *Netsmart* 's discussion on the post-signing window shop should be read more narrowly and should apply exclusively to micro-cap public companies, and not private companies of any size. (Arguably, *Netsmart* 's holding only applies to market checks for strategic buyers and does not suggest that private companies would have to shoulder this burden in an effort to find financial buyers.[13] Because private companies are under no obligation to disclose publicly their entry into a merger agreement, however, potential financial buyers generally would require information about the existing deal to launch an alternative bid).

Conclusion

It is, of course, too early to tell how the Delaware courts will react when faced with a private-company merger agreement with a window-shop provision but no go-shop provision. Although a Delaware court's decision in this context would likely be shaped by the nature of the target company's marketing process pre-signing (including the extent to which the board surveyed likely financial and strategic buyers), a court also could take into account the meaningfulness of the board's post-signing fiduciary out. Practitioners should consider the implications of *Netsmart* and plan accordingly.

NOTES

1. *In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171, 197 (Del. 2007).

2. A window-shop provision generally prohibits the target from soliciting, encouraging or facilitating alternative transactions, but allows the target's board to consider unsolicited proposals from third parties. *See, e.g.*, *id.* at 190.

3. *Id.* at 176.

4. *Id.* at 186.

5. *Id.* at 197 ("The mere fact that a technique was used in different market circumstances by another board and approved by the court does not mean that it is reasonable in other circumstances that involve very different market dynamics.").

6. *Id*.

7. *Id.* at 198.

8. As a technical matter, the adoption of the merger agreement by the stockholders may not precede the board's approval of the merger agreement and the execution of the agreement. *See* 8 *Del. C.* § 251; *Tansey v. Trade Show News Networks, Inc.*, 2001 WL 1526306, at *4 (Del. Ch. Nov. 27, 2001) (noting that Section 251 of the General Corporation Law of the State of Delaware "requires three different actions"—board approval of the merger agreement, execution of the agreement, and stockholder adoption of the merger agreement—"to occur in a specific sequence to approve and implement a merger"). In addition, an agreement requiring stockholders to execute consents with respect to a majority of the votes may not be enforceable. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 936 (Del. 2003) (noting, in the context of a merger agreement with a no-shop provision and an ancillary voting agreement that "made it 'mathematically impossible' and 'realistically unattainable'" for a superior proposal to succeed, that such deal protection measures were "not within a reasonable range of responses to the perceived threat" of losing the present deal because they were preclusive and coercive and accordingly finding such measures to be unenforceable).

9. Cf. 8 Del. C. § 228.

10. The Delaware courts have suggested that the fiduciary duties of directors continue from the execution of the merger agreement through the time at which the agreement is adopted by the stockholders. *See Omnicare*, 818 A.2d at 939 n.88 ("Merger agreements involve an ownership decision and, therefore, cannot become final without stockholder approval. Other contracts do not require a fiduciary out clause because they involve business judgments that are within the exclusive province of the board of directors' power to manage the affairs of the corporation.").

11. In *Louisiana Municipal Police Employees' Retirement System v. Crawford*, 918 A.2d 1172 (Del. Ch. 2007), the Court recognized that the public filing of the merger agreement is sufficient to enable a potential bidder to make a competing offer without running afoul of the terms of the existing agreement. "The 'no shop' provision contains what defendants characterize as a road map by which a competing bidder may tiptoe around termination fee landmines in order to make a hostile offer." *Id.* at 1181. A no-shop provision generally provides that the target board may not communicate with competing bidders unless an alternative proposal arrives without solicitation and is or is likely to be superior to the current agreement. *See, e.g.*, *id.* at 1180.

12. *Cf., e.g.*, *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997) (defining an efficient market as one in which "information important to reasonable investors (in effect, the market) is immediately incorporated into stock prices" (citation omitted)).

13. Cf. *Guttman v. McGinnis*, C.A. 3450-VCL, at 25–26 (Del. Ch. Jan. 14, 2008) (Transcript).

Reprinted from *Insights* January 2008, Volume 22, Number 1, pages 24-26,
with permission from Aspen Publishers, Inc., Wolters Kluwer Law & Business, New York, NY,
1-800-638-8437, www.aspenpublishers.com