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MERGERS AND ACQUISITIONS

The Shops Are Open: Delaware's New Take on Go-Shop Provisions under *Revlon*

In three recent cases, the Delaware Chancery Court provides significant guidance regarding the review and effectiveness of "go shop" provisions, which generally permit target boards of directors to solicit competing bids for a specified period of time following the execution of a merger agreement.

by John Mark Zeberkiewicz and Blake Rohrbacher

Under *Revlon*, once a board has decided to sell the company, the board's duties involve "getting the best price for the stockholders."[1] The courts scrutinize the process by which boards enter into and finalize merger agreements to determine whether the boards have fulfilled those duties, commonly known as "*Revlon* duties." In three recent cases decided by Vice Chancellor Strine, the Delaware Court of Chancery reiterated that a board of directors may enter into a binding merger agreement before conducting a full-scale public auction without violating its *Revlon* duties, so long as the board retains the flexibility to shop the company (and in fact does shop the company) for a reasonable period post-signing. The three cases are *Lear*,[2] decided June 15; *Topps*,[3] decided June 14; and *Berg*,[4] a transcript ruling from June 12. In these cases, the Court provided significant guidance regarding the review and effectiveness of "go shop" provisions, which generally permit target boards to solicit competing bids for a specified period of time following the execution of a merger agreement.

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Background

Although the general principles of a board's *Revlon* duties are well known, lack of guidance on the exact method by which a board contemplating a cash-out transaction secures the best price possible and on how much information a board needs prior to entering into a merger agreement still gives practitioners cause for concern. *Revlon* does not dictate one particular process. That is, "there is no single blueprint that a board must follow to fulfill its [*Revlon*] duties."[5] Likewise, *Revlon* "does not require, for example, that before every corporate merger agreement can validly be entered into, the constituent corporations must be 'shopped' or, more radically, an auction process undertaken, even though a merger may be regarded as a sale of the Company."[6] But directors cannot enter into a merger agreement without relevant information about other potential transactions. "There must be a reasonable basis for the board of directors involved to conclude that

the transaction involved is in the best interest of the shareholders. This involves having information about possible alternatives. The essence of rational choice is an assessment of costs and benefits and the consideration of alternatives."[7]

Thus, if a board opts to forgo an auction before approving a merger agreement, it may wish to insist on a go-shop provision in the merger agreement allowing it to shop the company freely, looking for a better deal. Go-shop provisions are of relatively recent vintage, and the Delaware Court of Chancery has not, until now, given much guidance on their use.

The Cases

Topps

In *Topps*, the Court granted plaintiffs' motions for a preliminary injunction, blocking stockholders of The Topps Company from voting on a merger with private-equity buyers aligned with Michael Eisner, Disney's former CEO. After a process criticized by three directors (insurgents elected in a prior proxy contest), Topps entered into a merger agreement at $9.75 per share with Eisner's group; the merger agreement provided for a 40-day go-shop period.[8] Upper Deck (Topps' chief rival) offered an unsolicited $10.75 per share at the end of the go-shop period.[9] Upper Deck was, however, constrained by a previously executed standstill agreement from commenting on its bid or from launching a tender offer.[10] The Topps board opted not to release Upper Deck from the standstill agreement, and Upper Deck sued to enjoin the Topps–Eisner merger, arguing that the Topps board had violated its fiduciary duties on disclosure and *Revlon* grounds and had breached the standstill agreement.

Topps stockholders also sued to enjoin the merger on disclosure and *Revlon* grounds, challenging Topps's proxy statement and claiming that the Topps board (led by Arthur Shorin, son of a Topps founder) had been motivated to take the Eisner deal because, as a financial buyer, Eisner was planning to leave existing management (including Scott Silverstein, Shorin's son-in-law) in charge at Topps.[11]

In addressing the plaintiffs' *Revlon* claims, the Court found that, although the company had entered into a definitive merger agreement before conducting a public auction, the board left itself "reasonable room for an effective post-signing market check" by negotiating for a deal protection package that included the unfettered right to shop the company during a 40-day period.[12] Notably, the go-shop provision in *Topps* was "open" (*i.e.*, the company could continue to negotiate with competing bidders identified by the board during that period as having submitted, or as being reasonably likely to submit, a superior proposal, and such bidders were not required to have in place a signed agreement prior to the expiration of the go-shop period to qualify for the reduced break-up fee).[13]

The Court also held that the "match right" given to Eisner was similar to match rights that have "frequently been overcome in other real-world situations."[14] Though the Court found the post-go-shop termination fee a bit high—at around 4.3 percent of the total deal value[15]—the Court explained the high fee by the inclusion of the bidder's expenses and by the "relatively small size of the deal."[16] Ultimately, the Court found that a termination fee of 42 cents per share was not likely to have deterred an interested bidder.[17]

The sticking point in *Topps* was the standstill agreement between Topps and Upper Deck prohibiting Upper Deck from announcing any information regarding its discussions with Topps or proceeding with a tender offer for Topps's common stock without the Topps board's permission. The Court held that Upper Deck was likely to succeed on its claims that the Topps board had breached its fiduciary duties by failing to negotiate a better deal with Upper Deck, to release Upper Deck from the standstill, or to give the Topps stockholders a choice between the Eisner transaction and the Upper Deck proposal.[18] Because the Topps board had decided to sell the company and was not using the standstill agreement for a legitimate purpose, the board's refusal to release Upper Deck from the standstill justified an injunction.[19] Moreover, the Topps board's use of the standstill to prevent Upper Deck from telling its side of the story also justified an injunction because it

threatened the stockholders with making an important decision on an uninformed basis.[20]

The Court therefore held that a preliminary injunction should issue to stop the vote on the Eisner merger until: (1) the Topps board discloses the material facts omitted from the proxy; and (2) Upper Deck is released from its standstill so that it may publicly comment on its negotiations with Topps and make a non-coercive tender offer for Topps on conditions at least as favorable as the ones it has already offered to Topps.[21]

Lear

In *Lear*, plaintiffs sought a preliminary injunction of the merger between Lear Corporation and an entity controlled by investor Carl Icahn, arguing that Lear's board breached its *Revlon* duties and failed to disclose certain material facts.[22] The Court denied plaintiffs' motion as to the *Revlon* claims, finding that, although Lear's board had caused the company to enter into a merger agreement without engaging in a full pre-signing auction, the plaintiffs were unlikely to succeed on those claims.[23] The Court also issued a preliminary injunction preventing the vote on the merger until certain supplemental disclosure was made regarding the negotiations between Lear's board and its CEO over his retirement plans and equity stake.

The proposed merger between Lear and Icahn traces its roots to a strategic planning process that Lear initiated in 2005.[24] In early 2006, when the stock trading was at roughly $16–17 per share, Icahn made his first investment in Lear, acquiring approximately 4.9 percent of its outstanding common stock.[25] Icahn continued to increase his stake in the company, making open market purchases that brought his holdings to nearly 10 percent and ultimately increasing his holdings to 24 percent in connection with an October 2006 secondary offering of common stock at $23 per share.[26]

In January 2007, Icahn indicated to Lear's CEO that Icahn might be willing to take Lear private and retain the existing management team.[27] Icahn initially offered to acquire Lear at $35 per share, which the CEO and the special committee rejected as inadequate, and then ultimately raised his bid to $36 per share. In presenting this final offer, Icahn indicated that he would agree to a reverse break-up fee and would be flexible in negotiating a go-shop period and a termination fee, but made clear that he would pull his offer if the board decided to conduct a pre-signing auction.[28]

Lear's board debated whether to engage in a formal sale process or public auction but determined that, although such a process could generate a premium bid, it could also disrupt Lear's business and result in the loss of Icahn's $36 per share offer. The offer represented a significant premium over the stock's average trading price during the period beginning with the board's decision to initiate the strategic planning process. The board concluded that the best way to maximize stockholder value was to enter into a merger agreement with Icahn, with the understanding that the agreement would contain a go-shop provision. As part of the deal, the board required Icahn to agree to vote his entire 24 percent interest in favor of a superior proposal. In addition, the special committee negotiated for a favorable two-tier termination fee providing that (1) if the termination of the agreement was followed by a competing agreement signed within the go-shop period, the fee would be 2.79 percent of the equity value of the transaction (or 1.9 percent of the enterprise value), and (2) if the termination of the agreement was followed by a competing agreement signed after the expiration of the go-shop, the fee would be 3.52 percent of the equity value (or 2.4 percent of the enterprise value).[29] Icahn, however, retained a broad match right: If Lear received a potential superior proposal, it was required to notify Icahn, who would then have 10 days to make a competing offer (though if the proposal was more than $37 per share, Icahn had only one chance to match).

Several key facts and circumstances seemed important to the Court's analysis in *Lear*. First, the Court essentially found the board's decision not to conduct an auction to be reasonable, considering that a pre-signing market check had yielded no serious bids, and given the board's assessment of the potentially thornier problems

that could arise if Icahn were to pull his bid.[30] Second, the Court found that the break-up fee, which in its highest possible formulation still represented only 3.5 percent of the equity value, was within the range of reasonableness.[31] Interestingly, in discussing the termination fee, the Court suggested that, when considering the size of a termination fee, enterprise value is more meaningful than equity value.[32] Third, the Court viewed favorably Icahn's agreement to vote his 24 percent interest in Lear's stock to approve any unmatched superior proposal. Finally, calling such a right "hardly novel," the Court found no fault with Icahn's match right, stating that it "was actually a limited one that encouraged bidders to top Icahn in a material way."[33]

In all, the Court held that the board's "post-signing market check was a reasonable one,"[34] although it did express concern about the go-shop provision's terms. The Court indicated that the go-shop provision, which it referred to as "truncated," was of limited value because it provided for the reduced break-up fee only where a competing bidder had entered into a definitive agreement within the 45-day period.[35] That is, the go-shop in *Lear* was "closed," unlike the open go-shop in *Topps* requiring only that the existing agreement be terminated prior to the expiration of the go-shop period in order for the competing bidder to qualify for the reduced break-up fee. The Court noted the practical difficulties that a competing bidder would encounter in seeking to satisfy the requirements of the *Lear* go-shop provision (*i.e.*, conducting adequate due diligence, presenting a superior bid along with a near-final merger agreement, having the board declare the competing proposal to be a superior proposal, waiting for Icahn's 10-day matching period to expire, having the board accept the superior proposal and terminate the existing merger agreement, and, finally, entering into a definitive merger agreement).[36] Because the go-shop was closed, the Court noted, only a "Kobayashi-like buyer," that is, "a ravenous bidder [who] had simply been waiting for an explicit invitation to swallow up Lear," would even have had a chance to fulfill its terms.[37] Nevertheless, the Court held that the plaintiffs had not demonstrated a reasonable probability of success on the *Revlon* claims and denied the preliminary injunction as to those claims.

Berg

In *Berg*, the Court decided a motion for expedited proceedings in connection with the proposed acquisition of Vertrue Incorporated by a private-equity investor group. Plaintiffs had brought disclosure claims and *Revlon* claims. Because the Court believed that the disclosure claims were weak and that plaintiffs could have asserted them earlier, the Court focused on the *Revlon* claims for purposes of the motion to expedite.[38] The Court denied the motion to expedite but expressed the view that a 25-day go-shop provision closed, as in *Lear,* would be of limited value.[39] As in *Lear*, the Court noted the practical difficulty for a competing bidder to enter into a definitive agreement within a 25-day period, calling it "almost impossible to do" given the time delays accompanying that process, namely, allowing the initial bidder to match the alternate proposal, causing the board to terminate the existing agreement, conducting due diligence, and negotiating the terms of the definitive agreement.[40]

Implications for Practitioners

In each case of the above cases, the Court evaluated the deal protection measures as a whole, carefully analyzing the interaction of the measures, when determining whether the boards satisfied their *Revlon* duties.[41] Along with go-shop provisions, the merger agreements in all three cases contained: match rights, providing that the initial bidder would have a chance to match the bid of a competing bidder; two-tiered termination fees, in which the target company could pay a lower fee if it terminated the merger agreement during the go-shop period; and reverse break-up fees, payable by the initial bidder to the target company in the event that the initial bidder breached the merger agreement. The Court's analyses of the entire deal protection package in these cases provide helpful guidance for deal planners.

Open v. Closed Go Shop Provision

An "open" go-shop is likely to receive less scrutiny than a "closed" go-shop of the same duration (though it should still be of sufficient duration to

enable competing bidders to make a proposal that would result in the termination of the existing agreement), and "closed" go-shop periods of less than 30 days, though not necessarily unreasonable, may receive extra scrutiny from the courts.

In *Topps*, the Court discounted any need for an auction because Topps had secured a 40-day "open" go-shop.[42] The Court called the period "reasonable"[43] and noted that the post-go-shop period in which the Topps board could accept unsolicited offers entered into its findings.[44] Although the 45-day go-shop period in *Lear* was ostensibly longer than the 40-day period in *Topps*, the Court's scrutiny of the former provision was more exacting. In *Lear*, the Court seemed unimpressed with the 45-day go-shop period because it "essentially required the bidder to get the whole shebang done within the 45-day window."[45] Likewise, in *Berg*, the Court suggested that, with 25 days, only a bidder ready with a bid could even have a chance to secure the lower termination fee.[46]

Match Rights

Match rights are not deal-chilling *per se*,[47] but they further diminish the utility, for *Revlon* purposes, of "closed" go-shop provisions. In all three cases, the Court gave short shrift to plaintiffs' arguments that match rights inhibited competing bids.[48] The significance of the match right in *Berg* and *Lear* arose in the context of the comparatively more restrictive nature of a closed go-shop. With a 10-day match right, for example, a 25-day closed go-shop really only gives a competing bidder 15 days. The match right therefore cuts into a competing bidder's time in a closed go-shop, leaving it "hard-pressed" to jump through all the hoops necessary to garner the lower termination fee.[49]

Termination Fees

While there is no "bright line" at any particular percentage, and all termination fees must be carefully scrutinized in light of the size of the deal and the other deal protection measures,[50] fees at or above 3.5 percent of the equity or enterprise value may need to be approached with caution. *Lear* also indicates that enterprise value may arguably be a more important metric when considering termination fees than equity value.[51]

Two-tiered termination fees may not help satisfy a board's *Revlon* duties if the go-shop period is of customary length (*e.g.*, 45 days) but is "closed." That is, if a court finds that the go-shop was closed and too short, it may give little weight to the size of the termination fee applicable during the go-shop period.

The Court addressed termination fees in all three cases. In *Topps*, the Court approved of a 4.3 percent post-go-shop termination fee, prompted in part by the deal's "relatively small size" and by the fact that the fee included the buyer's expenses.[52] In the cases involving closed, and what the Court viewed as "short," go-shops, however, the Court made clear that boards would get little *Revlon* credit by securing a low termination fee for the period during the go-shop. Though the Court in *Lear* stated that it would be unlikely to find the two-tiered termination fee (2.8 percent of the equity value during the go-shop period and 3.5 percent thereafter) unreasonable, it also gave "relatively little weight to the two-tiered nature of the termination fee."[53] Because the go-shop required bidders to complete everything, including executing a definitive agreement, within 45 days, the Court seemed to find it unlikely that any bidder could take advantage of the lower termination fee.[54] In *Berg*, the Court also gave little weight to the two-tiered nature of the termination fee, finding it unlikely that a competing bidder could sign a merger agreement within the 25-day go-shop period.[55] With a closed go-shop, only what the Court in *Lear* termed a "Kobayashi" could take advantage of the low termination fee. And if such a bidder had existed, the Court noted in *Lear*, it probably would have already made a bid before the merger agreement was signed.[56]

The Court's principal concern in *Berg* was the plaintiffs' incorrect assertion that the termination fee was around 5 percent.[57] As the Court stated, "the amount of the [miscalculated] termination fee plus the combination of the match rights . . . and the short period of the go-shop provision, struck me as . . . a pretty potent combination of deal protections."[58] Upon learning that the fee was actually

closer to 3.5 percent of equity value, the Court's concern appeared to dissipate, and the Court denied expedition.[59]

NOTES

1. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) ("The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.").
2. *In re Lear Corp. S'holder Litig.*, — A.2d —, 2007 WL 1732588 (Del. Ch. June 15, 2007).
3. *In re The Topps Co. S'holders Litig.*, — A.2d —, 2007 WL 1732586 (Del. Ch. June 14, 2007).
4. *Berg v. Ellison*, C.A. No. 2949-VCS (Del. Ch. June 12, 2007) (TRANSCRIPT). *Berg* involved the acquisition of Vertrue Incorporated by an investor group consisting of One Equity Partners, Oak Investment Partners, and Rho Ventures.
5. *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989). For example, not "every change in the control of a Delaware corporation [need] be preceded by a heated bidding contest." *Id.*
6. *City Capital Assocs. Ltd. P'ship v. Interco Inc.*, 551 A.2d 787, 802 (Del. Ch. 1988), *appeal dismissed*, 556 A.2d 1070 (Del. 1988) (TABLE).
7. *Id.*
8. *Topps*, 2007 WL 1732586, at *1–2.
9. *Id.* at *2.
10. *Id.* at *3.
11. *See id.*
12. *Id.* at *26.
13. *See* The Topps Company, Inc., Proxy Statement (DEFM 14A), at A-26–27, A29, A40–41 (May 21, 2007). Section 8.2 of the merger agreement generally provided that, if Eisner terminated the agreement as a result of a change of recommendation by Topps, or if Topps terminated the agreement upon receiving a superior proposal, and the termination occurred prior to the go-shop end date, the break-up fee would be $8,000,000, and further provided that if Eisner or Topps terminated the merger agreement in those and certain other circumstances after the go-shop end date, the break-up fee would be $12,000,000. In each case, Eisner's reasonable out-of-pocket expenses, up to a specified amount, would be added to the amount determined to be the break-up fee.
14. *Topps*, 2007 WL 1732586, at *25 (*citingAce Ltd. v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999)).
15. Although the Court referred to the termination fee in relation to "total deal value," without referring specifically to equity value or enterprise value, it appears from the Topps Proxy Statement that the Court's calculation of the termination fee was based on equity value. Without including the maximum expenses allowed, the fee payable upon a termination of the agreement after the go-shop period would have been 3.1 percent of the equity value.
16. *Topps*, 2007 WL 1732586, at *25. The total purchase price was $385 million. *Id.* at *5.
17. *Id.* at *25.
18. *Id.* at *31.
19. *Id.*
20. *Id.*
21. *Id.* at *31–32.
22. *Lear*, 2007 WL 1732588.
23. *Id.* at *1–2.
24. *Id.* at *3
25. *Id.*
26. *Id.* at *4. In connection with this investment, Icahn requested and received a waiver of the restrictions on business combinations set forth in Section 203 of the DGCL.
27. Although Lear's board formed a special committee to oversee the process, the special committee was not a "substitute for conflicted management" and because the committee did not view the CEO as conflicted, negotiations on behalf of Lear were largely directed by the CEO. *Id.* at *6.
28. *Id.* at *8–9.
29. *Id.* at*12.
30. *Id.* at *23 ("If the response to the auction was underwhelming, [Icahn] might then pick up the company at a lower price.").
31. *Id.* at *24 ("The termination fee in [the post-go-shop scenario] amounts to 3.5 percent of equity value and 2.4 percent of enterprise value. . . . [But] the percentage of either measure the termination fee represents here is hardly of the magnitude that should deter a serious rival bid.").
32. *Id.* at ("For purposes of considering the preclusive effect of a termination fee on a rival bidder, 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.").
33. *Id.* at *25.
34. *Id.* at *2.
35. *Id.* at *24.
36. *Id.*
37. *Id.* Takeru Kobayashi is a famous competitive eater, holder of many world records. *Seehttp://en.wikipedia.org/wiki/Takeru_Kobayashi* (last visited June 25, 2007).
38. *Berg*, C.A. No. 2949-VCS, at 3.
39. *Id.* at 5.
40. *See id.* at 5–6.
41. *Lear*, 2007 WL 1732588, at *23 ("To fairly determine whether the defendants breached their *Revlon* obligations, I must consider the entirety of their actions in attempting to secure the highest price reasonably available to the corporation."); *see also In re Netsmart Techs., Inc. S'holders Litig.*, — A.2d —, 2007 WL 1576151, at *19 n.80 (Del. Ch. Mar. 14, 2007) (re-emphasizing that "the reasonableness of a board's decisions in the M & A context turns on the circumstances"); *In re Toys "R" Us, Inc. S'holder*

Litig., 877 A.2d 975, 1015 (Del. Ch. 2005) ("It is no innovation for me to state that this court looks closely at the deal protection measures in merger agreements.").

42. *SeeTopps*, 2007 WL 1732586, at *25.

43. *Id.* at *26 ("For 40 days, the Topps board could shop like Paris Hilton.").

44. *Id*.

45. *Lear*, 2007 WL 1732588, at *24.

46. *SeeBerg*, C.A. No. 2949-VCS, at 5.

47. *See alsoToys "R" Us*, 877 A.2d at 1017 ("As the plaintiffs must admit, neither a termination fee nor a matching right is per se invalid. Each is a common contractual feature that, when assented to by a board fulfilling its fundamental duties of loyalty and care for the proper purpose of securing a high value bid for the stockholders, has legal legitimacy.").

48. *Lear*, 2007 WL 1732588, at *25; *Topps*, 2007 WL 1732586, at *25; *Berg*, C.A. No. 2949-VCS, at 16.

49. *Lear*, 2007 WL 1732588, at *24; *see alsoBerg*, C.A. No. 2949-VCS, at 6 (noting that, if a match right must be met, "that's a lot of stuff to happen in a 25-day period").

50. *See also Netsmart*, 2007 WL 1576151, at *29 ("The 3 percent termination fee in the Merger Agreement is 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."); *La. Mun. Police Employees' Ret. Sys. v. Crawford*, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007) ("Th[e analysis of deal protection measures] will, by necessity, require the Court to consider a number of factors, including without limitation: the overall size of the termination fee, as well as its percentage value; the benefit to shareholders, including a premium (if any) that directors seek to protect; the absolute size of the transaction, as well as the relative size of the partners to the merger; the degree to which a counterparty found such protections to be crucial to the deal, bearing in mind differences in bargaining power; and the preclusive or coercive power of all deal protections included in a transaction, taken as a whole."); *Toys "R" Us*, 877 A.2d at 1016 ("In the [reasonableness] inquiry, the court must attempt, as far as possible, to view the question from the perspective of the directors themselves, taking into account the real world risks and prospects confronting them when they agreed to the deal protections.").

51. *Lear*, 2007 WL 1732588, at *24. *But cf. In re Pennaco Energy, Inc. S'holders Litig.*, 787 A.2d 691, 702 n.16 (Del. Ch. 2001) ("While Delaware cases have tended to use equity value as the benchmark for measuring a termination fee, no case has squarely addressed which benchmark is appropriate. Each benchmark has analytical arguments in its favor.").

52. *Topps*, 2007 WL 1732586, at *25.

53. *Lear*, 2007 WL 1732588, at *24.

54. *Id.* ("This was not a provision that gave a lower break fee to a bidder who entered the process in some genuine way during the go-shop period—for example, by signing up a confidentiality stipulation and completing some of the key steps toward the achievement of a definitive merger agreement at a superior price. Rather, it was a provision that essentially required the bidder to get the whole shebang done within the 45-day window.").

55. *Berg*, C.A. No. 2949-VCS, at 14–15.

56. *Lear*, 2007 WL 1732588, at *24 ("But if that sort of Kobayashi-like buyer existed, it might have reasonably been expected to emerge before the Merger Agreement with Icahn was signed based on Lear's lack of a rights plan and the publicity given to Icahn's prior investments in the company.").

57. *Berg*, C.A. No. 2949-VCS, at 12.

58. *Id.* at 6–7.

59. *Id.* at 7, 16.

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