Chancery Court Addresses *Revlon* Duties and Deal Protection Measures in Small-Cap Transaction

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In *In re Answers Shareholders Litigation,* the Delaware Court of Chancery declined to preliminarily enjoin the acquisition of Answers Corp. and, in so doing, made several important observations regarding the board of directors' management of the sales process and negotiation of the definitive merger agreement, many of which are of particular significance to smaller corporations and their advisers.

According to the opinion, Answers Corp., an operator of an online answer-based search service, was 30 percent owned by venture fund Redpoint Ventures, which had two designees on Answers' seven-person board of directors. Of the remaining five directors, one was Answers' chief executive officer and four were outside independent directors.

In March 2010, AFCV Holdings Inc., a portfolio company of private equity firm Summit Partners, approached Answers' board concerning a potential business combination. The board rejected the initial offer, but proceeded with negotiations. During this time, the board received an indication of interest from another private equity firm. In response, AFCV improved its offer and requested exclusivity. On two subsequent occasions, the board rejected AFCV's request for exclusivity, ultimately agreeing instead to reimburse AFCV's expenses if Answers were to enter into a deal at a higher valuation.

The board then contacted 10 other parties that, with input from its financial adviser, it identified as likely buyers. Three entered into confidentiality agreements; none submitted an offer. The board continued negotiations with AFCV, and in late December 2010, with Answers' performance and forecasts on the rise, the board secured another price increase and signed a deal with AFCV.

In approving the merger with AFCV, the board considered several factors, including the possibility of remaining independent, the threat of increased competition from larger companies, the lack of interest from other acquirers, and its financial adviser's fairness opinion. In addition, as is not uncommon with small or early-stage companies, the board considered the uncertainty of Answers' forecasts. Because Answers' performance was heavily dependent on traffic directed to its site from Google — and because the algorithms that Google employs to direct users to Answers' content change unpredictably — it was difficult to prepare reliable projections for Answers.

The plaintiffs' preliminary injunction motion challenged the transaction on the grounds of price and process. The plaintiffs claimed that the board allowed conflicted directors to lead the negotiations, that the market check was too limited, that the board had agreed to preclusive deal protection devices, and that the board had relied upon a flawed fairness opinion. The court rejected these claims.

Independence and Disinterestedness

Boards of smaller corporations, particularly early-stage corporations, often have one or more directors designated by a venture fund or other significant investor. Plaintiffs often challenge the independence and disinterestedness of these designees in mergers and other exit transactions, alleging claims similar to those made in the Chancery Court's opinion in *In re Trados*.

In that case, the court declined to dismiss a claim that the director-designees of Trados' preferred stockholders breached their fiduciary duties by approving a cash-out merger that their respective funds allegedly desired to recapture their preference, without regard to the fact that, although Trados' performance and prospects were apparently on the rise, the merger would deliver no value to the common stockholders. In *Answers*, plaintiffs claimed that designees of Redpoint Ventures — investors with a 30 percent stake in the company — were motivated to approve the deal solely to meet Redpoint's desire to exit the investment. Without expressly citing *Trados*, the court dispensed with the claim, noting that it was unclear whether Redpoint's desire to sell resulted from "a product of its own needs and self-interest or was the result of its assessment that the company's better times were behind it." Moreover, there was no indication that the two Redpoint designees controlled the negotiations. In any event, the court found that the full board — four of seven members of which were independent and disinterested — was actively engaged in the process.

Market Check

The court also rejected plaintiffs' claims that the market check was too limited. Pointing to the original concerns underlying *Revlon* scrutiny — which, as the Chancery Court in its recent opinion in *In re Dollar Thrifty* stated, is "that the board might harbor personal motivations in the sale context that differ from what is best for the corporation and its stockholders" — the court found no reason to conclude that the board unfairly favored AFCV over other bidders. In fact, the board rejected AFCV's requests for exclusivity and reached out to a targeted group of likely bidders. While the court noted that the board could have cast a wider net in its search for potential suitors, it ultimately found that the board's focus on "'priority buyers ... most likely to be able to pay a comparable or higher price' than ACFV" was reasonable.

In a subsequent letter to counsel, the court addressed whether the emergence of a facially higher offer, which the court had not considered in ruling on the motion for preliminary injunction, "materially changed the mix of facts that informed the exercise of the court's equitable discretion" and warranted an additional delay of the meeting date beyond the two-day period provided by the board. Here, the court gave substantial discretion to the board's decision to reject the offer, noting the board's reliance on its legal and financial advisers in determining, among other things, that there were serious concerns over the financing of the alternative bid, as well as questions over the timing and certainty of that bid and the credibility of the bidder. The court noted that three days separated the announcement of the bid and the meeting date and found that, in light of the deficiency of the bid, such period was sufficient.

Deal Protection

Finally, the court found that the deal protection terms — a termination fee and expense reimbursement totaling 4.4 percent of the equity value, a standard "no shop" clause, matching rights and a force-the-vote provision — were not unreasonable under the circumstances. While noting that the termination fee was "near the upper end of a 'conventionally accepted' range," the court recognized that it was not "atypical" for relatively small deals to include higher termination fees as a proportion to equity value. The court also confirmed that, absent a compelling reason, it would not deviate from the approach of relating the fee to equity value, rather than enterprise value, in analyzing the termination fee.

As is often the case in transactions involving smaller corporations, the buyer requested voting agreements covering a relatively significant portion of the shares. These arrangements raise concerns under *Unocal* and *Omnicare* and are typically subject to intense negotiation, particularly when they are coupled with a force-the-vote clause. Here, the court found "unconvincing" plaintiffs' argument that the voting agreements, which locked up 27 percent of the vote, ensured that no other bid would receive a vote. The court stated, first, that voting agreements are "perfectly legal" and, second, that the voting agreements, in combination with the other protective devices, did not render the transaction a "fait accompli." The court emphasized that deal protection measures must be viewed as a whole — and that plaintiffs must demonstrate that the combined effect of those provisions is in fact preclusive.

While the court indicated that each deal will be reviewed on its own terms, and that the deal protection measures will be reviewed as a package and in light of the overall process, its statements in *In re Answers* provide significant guidance to smaller corporations and their advisers in managing a sales process and negotiating the terms of the definitive agreement.

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