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M&A NOTES

June 2007

Are Broad Pre-Signing Market Checks Required? -- A Recent Delaware Case Objects to the Exclusion of Strategic Buyers in a Limited Sale Process

A recent Delaware Chancery Court case found that a board of directors' and its special committee's decisions to contact only potential private equity buyers and to not contact any potential strategic buyers prior to entering into a $115 million "going private" merger agreement was likely to be found to be unreasonable and a breach of Revlon duties. This case suggests that the process public companies employ in private equity transactions will be heavily scrutinized and, as a result, boards of directors of target companies and private equity buyers should more carefully analyze the process followed in connection with entering into these transactions.

The recent case, *In re Netsmart Technologies, Inc. Shareholders Litigation*, C.A. No. 2563-VCS, 2007 Del. Ch. LEXIS 35 (Del. Ch. Mar. 14, 2007), arose in connection with a relatively common fact pattern leading to a "going private" merger transaction. Netsmart is a small but successful NASDAQ-listed company that supplies enterprise software to behavioral health and human services organizations. In connection with considering a possible merger transaction following the receipt of expressions of interest from private equity buyers, the Netsmart board of directors and later a special committee of the Netsmart board following a plan initiated by the full board each authorized its financial advisor, William Blair & Co., L.L.C., to contact only potential private equity buyers to gauge their interest in a possible transaction. The board and the special committee determined that William Blair should not contact any potential strategic buyers to gauge their interest in a possible transaction. Following this process, Netsmart entered into a merger agreement to be acquired by funds affiliated with Insight Venture Partners and Bessemer Venture Partners for $16.50 per share in cash, or approximately $115 million in the aggregate.

Following the announcement of the transaction, Netsmart stockholder plaintiffs sought a preliminary injunction against the consummation of the merger and challenged the merger on two, separate grounds: (1) that the directors breached their fiduciary duties to stockholders by failing to explore interest in a transaction from strategic buyers before entering into the merger agreement and (2) that the failure to disclose certain financial projections and other information caused the proxy statement to be misleading.

Following an extensive review of the facts, Vice Chancellor Strine found that the plaintiffs would likely be successful on the merits of their claim that the directors did not have a reasonable basis for failing to undertake any exploration of interest by potential strategic buyers and in so doing likely breached their *Revlon* duties.

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Netsmart's directors had claimed that their decision to not solicit interest from potential strategic buyers was reasoned and was based upon several factors indicating that a transaction with a strategic buyer was unlikely, including that (i) William Blair had provided advice to that effect, (ii) management's contacts with strategic buyers and William Blair's cold calls to strategic buyers since the late 1990's had not resulted in any significant interest by strategic buyers in the acquisition of Netsmart, and (iii) Netsmart's narrow market segment and small scale were unlikely to be of interest to strategic buyers. The board also claimed that it had determined that the risk of contacting potential strategic buyers was high because Netsmart directly competes for customers with the most likely potential strategic buyers and the benefits of such contacts were not likely to outweigh this business risk. Finally, while the merger agreement did not permit Netsmart to solicit interest from competing bidders after the execution of the agreement, the agreement provided for (i) a "window shop" period during which the board could receive offers from interested competing bidders and (ii) a "fiduciary out" termination right permitting the board to terminate the merger agreement with Insight and Bessemer and accept a superior offer upon the payment of a 3% break-up fee (as well as other customary deal protection terms, including the absence of a break-up fee payment requirement upon a simple rejection of the transaction by Netsmart's stockholders).

In its analysis, the Court rejected each of the reasons put forth by the Netsmart directors for their decision to not solicit interest from potential strategic buyers. The Court found that the prior contacts with strategic buyers did not accurately gauge strategic buyers' current interest in acquiring Netsmart, in part because of the significant growth and change in the company in recent years. Specifically, management's discussions with potential strategic buyers were sporadic and covered a period of 7 years (averaging only one per year), the strategic buyers cold called by William Blair did not understand that Netsmart was "in play" and none of the contacts with strategic buyers had occurred since Netsmart had successfully completed a significant acquisition of its biggest competitor, which expanded Netsmart's scope and market position. The Court also found that there were not unique circumstances that would cause "discreet and professional overtures" to select strategic buyers to jeopardize Netsmart's ability to sell its products or that would create confidentiality issues. Finally, the Court rejected the board's rationale that in preserving a post-signing fiduciary out it could effectively perform a post-signing market check on the terms of the merger agreement. The Court did not find it reasonable to conclude that competing bidders with higher bids would necessarily emerge following the public announcement of the transaction when the transaction involved a "micro-cap" company like Netsmart. As a result, the Court found that a canvassing of potential buyers before signing a merger agreement was more important for such companies.

Based on its review of the facts, the Court concluded that the plaintiffs would likely be successful in showing that the Netsmart directors acted unreasonably and breached their *Revlon* duties by failing to make a reasonable effort to maximize the return to Netsmart's stockholders. The Court rejected all of the plaintiffs' other claims of breach of fiduciary duties and all but one of their claims of insufficient disclosure. However, despite its findings on the likely breach of the directors' *Revlon* duties, the Court found that the failure to enjoin the merger would not result in irreparable injury to the plaintiffs, in part because no rival bid had surfaced and monetary damages would suffice (including through the exercise of appraisal rights, which if successful would increase the effective cost of the acquisition to the buyer). Accordingly, the Court refused to enjoin the merger and permitted the stockholder vote on the merger to proceed once additional information on the Court's decision and previously undisclosed projections were provided to Netsmart's stockholders.

<u>Observations</u>

Need for Carefully Designed and Tailored Sale Process. One size <u>does not</u> fit all in structuring a sale process. The Netsmart opinion should not be read as creating a *per se* rule that strategic buyers <u>must</u> be sought out before a target company can enter into a merger agreement to sell itself. But the opinion should remind boards of directors and special committees that they should make careful, reasoned and well-documented decisions throughout a sale process. In particular, decisions that seem to favor a going private transaction, as opposed to staying independent or selling to a strategic buyer, must be carefully and thoughtfully evaluated and should not be based simply on a financial advisor's judgment, regardless of how correct that judgment may be. In addition, the opinion suggests that decisions about the sale process in a smaller transaction may be more heavily scrutinized than the sale process in a larger transaction and thus may need to be more carefully considered.

High Bar to Exclusion of Strategic Buyers on Competitive Grounds. The Court commented on the absence of circumstances that would jeopardize Netsmart's competitive position if strategic buyers

were included in the sale process. Those comments leave room for the existence of circumstances on which a board could reasonably determine not to contact strategic buyers in connection with a sale process because of competitive reasons or other business sensitivities. However, the Netsmart opinion suggests that a target company should reach that decision only on realistic, concrete and unique bases that should be carefully articulated and documented in advance of conducting the sale process.

Disapproval of Sale Processes and Over-Reliance on Post-Signing Market Checks. While the specific issues presented by the Netsmart case will not apply to all cases, the case seems to reflect a concern by the Delaware Chancery Court that recent deal practice may stray too far from the conduct expected of boards of directors with *Revlon* duties even if, as in this case, the special committee seemed to have selected the offer with the highest and best price. In particular, the case casts serious doubt on the ability of a board or special committee to rely on the existence of fiduciary out and break-up fee provisions in a merger agreement (which would permit competing bidders to top the value of the initial agreement) to satisfy its obligation to seek to obtain the highest and best price for stockholders. This is particularly true if the board or special committee has not conducted a reasonable pre-signing market check (even if not a full-fledged auction) before deciding to enter into the merger agreement. We note that the opinion does not address the extent to which boards or special committees can rely on "go shop" provisions in merger agreements to assist them in satisfying their *Revlon* duties.

Heightened Scrutiny of Private Equity-Sponsored Transactions. The Netsmart case may also reflect a concern by the Delaware Chancery Court with the current prevalence of private equity-sponsored "going private" transactions, referring to the case as "literally a microcosm of a current dynamic in the mergers and acquisitions market." Among other concerns of the Court about the private equity market noted in the opinion, the Court seems wary of the preference by management to sell a target company to a private equity buyer that is more likely to retain management and give management a "second bite at the apple" (using the language from a William Blair slide to the Netsmart board) through equity participation in the sponsor-backed company. While the opinion noted that there was not clear evidence that the Netsmart board's and special committee's decisions to not solicit interest from potential strategic buyers were based on a conflict of interest, the opinion suggests that courts are particularly focused on this risk to a sale process and may place additional scrutiny on such transactions.

Skepticism about Unsatisfactory Process. Given all of the other facts and results of the case (including that the transaction price seemed to be at the highest price obtainable, management was not found to have "tilted the competition" based on any conflicts of interest and the Court did not take issue with the other decisions made by the board or the special committee), the Court's strong objection to one judgment by the Netsmart directors is surprising. It should be noted that the Court took issue with the manner in which the board and special committee administered its processes, including practices for keeping management separate from special committee deliberations, retention of the special committee's financial advisors and the negotiation of management retention arrangements during the negotiation of the deal terms. In as much as the Court's skepticism about these processes and the record influenced its findings, the case is a reminder of the need to follow best practices during a sale process.

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