KIRKLAND & ELLIS LLP

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Revlon — Different Strokes for Different Folks?

Recent Delaware cases suggest that courts may apply a different yardstick in evaluating a target board's satisfaction of its Revlon *duties in a change of control transaction depending on whether the acquirer is a financial buyer or a strategic player.*

Scenario #1 – The board of directors of Target #1 signed up a predominantly cash deal with Buyer X at a marginal premium to market, announcing the sale right before Target #1 reported record earnings. The merger agreement contained a strict no-shop with a fiduciary out, recurring matching rights and a break-up fee of at least around 4%. There was only one other logical acquirer for Target #1 (Buyer Y), and Buyer Y had engaged in repeated discussions over the past few years about acquiring Target #1. In fact, Buyer Y had reached out to Target #1 in the days leading up to the announcement and at least hinted at interest in re-engaging in discussions; however, Target #1 did not seek any indication of whether Buyer Y may be interested in bidding at that time for Target #1. Among the justifications for its actions advanced by the board of Target #1 was Buyer X's threat to walk away from the deal if a deal was not signed within days on the terms of its final offer and the board's financial advisers' dismissive views of the ability of Buyer Y to in fact finance a bid. Following announcement of the agreement with Buyer X, Buyer Y quickly protested its exclusion from the sale process and later went public with a competing bid for Target #1 at a significant premium to the Buyer X offer. Allegations were made in litigation about relationships affecting the independence of Target #1's financial advisers and CEO. Eventually, shareholders of Target #1 decisively rejected a sweetened offer from Buyer X.

Scenario #2 – The board of directors of Target #2 announced an all-cash deal with Buyer Z at a 29% premium to market. Similar to Scenario #1, the merger agreement contained a strict no-shop with a fiduciary out and recurring matching rights, but the termination fee was 3.25%. There were no financing contingencies and Target #2's financial adviser told the board that its general market discussions indicated that there was no interest among any strategic buyers to acquire Target #2. Buyer Z threatened to walk away from the deal or significantly reduce its offer if it was forced to participate in a pre- or post-signing auction. Following announcement of the agreement with Buyer Z, there was no public or private interest in acquiring Target #2 expressed by any other potential bidders. Although the CEO of Target #2 knew a senior executive of Buyer Z for a number of years prior to announcing the deal, their contact was limited and there were no discussions about the CEO's post-closing equity rollover and/or compensation. In fact, Buyer Z had in-house management resources capable of running the acquired business. Shareholders strongly supported the offer from Buyer Z at the original price, with the tender offer closing with 86% participation.

In both of these situations, plaintiffs brought "kitchen-sink" cases in Delaware court seeking to block the transactions and alleging breaches of fiduciary duties. Decisions were rendered within days by the same judge — in one case, the actions of the board of directors were resoundingly vindicated; in the other case, the court found that the plaintiffs had a reasonable probability of success on the merits of their claims. Perhaps surprisingly, the judicial vindication came in Scenario #1 while the adverse decision came in Scenario #2.

Dealmakers may recognize Scenario #1 as the recent decision in litigation brought by Dollar Thrifty shareholders relating to the proposed sale of Dollar Thrifty to Hertz and Scenario #2 as the bench decision relating to the sale of Health Grades to Vestar.

Recent Delaware cases have strongly endorsed the long-standing Delaware principle that, notwithstanding *Revlon* duties applicable in a sale of control of a company that require that the target board pursue the best transaction reasonably available, "there is no single path that a board must follow in order to reach the required destination of maximizing stockholder value."

Given that principle and the relevant fact patterns, one must wonder about the widely-divergent outcomes in the court cases. While every decision is highly fact-specific (and the summaries above do not, by necessity, capture all of the salient factors), it is hard to ignore that the primary difference between the cases was the identity of the buyer — in Dollar Thrifty, the buyer was a strategic player, while in Health Grades the buyer was a private equity firm. This pattern has played itself out in recent years in Delaware decisions in *Revlon* cases. Despite cash being the currency in all of these cases (therefore eliminating the possibility that an opportunity for target shareholders to share in the future upside of the strategic combination is a distinguishing factor), targets selling to strategic buyers seem invariably to be given the benefit of the doubt about the conduct of their sale processes and potentially questionable relationships (see, e.g., the recent decision in *Cogent* where the court supported the board's decision to sign a deal at $10.50 with one strategic bidder even while entertaining a perhaps less-certain bid of $11.00 to $12.00 from another strategic bidder), while sellers to financial buyers appear to receive much less deference and face greater scrutiny. In fact, in recent years, it seems like the few *Revlon* cases with results adverse to the target board have come in deals with financial buyers (e.g., *Netsmart*).

This is not intended as a criticism of any one decision or the discernible pattern described above. Reasonable people can disagree as to whether the conduct of a target board in a sale to an unaffiliated private equity buyer should be greeted with the same skepticism that some courts have applied in management buyout (MBO) cases. One reason advanced by some for such skepticism is the assertion that financial buyers are "just bidding IRR" (i.e., any other private equity firm is positioned to bid higher than the first if it is willing to accept a lower return on its investment exit) as compared to strategic buyers who arguably may have a unique ability to pay a premium based on potential synergies. Others attribute the skepticism to the contention that executives may be incentivized to favor a particular financial buyer in the hopes of obtaining a lucrative incentive package that was characteristic of historical LBOs to manage the business for the private equity buyer post-closing (a potentially pertinent concern with *Revlon*'s focus on the target's motivations).

Rather, the intention here is to identify this pattern as one to which market participants should pay close attention. Targets, buyers and their respective advisers should be mindful of the tendencies of the Delaware courts described above when crafting a process and merger agreement to effect a sale, particularly where the intent is to engage only with a single bidder. Deal protections that may breezily survive challenge in a sale to a strategic buyer (e.g., absence of a go-shop after no meaningful pre-signing market-check) may not be upheld in a deal with a financial buyer. Relationships that are dismissed as largely unimpactful in a sale to a strategic buyer may be scrutinized and treated as disabling in a sale to a private equity firm. But the fact that the ultimate verdict rests with the market, not the courts, also bears mentioning — ironically, the Hertz deal, despite its judicial imprimatur, was roundly rejected by Dollar Thrifty shareholders even after a significant price increase while the original Health Grades offer received overwhelming shareholder support.

While it remains true that there is no one roadmap for satisfying the value-maximizing obligations of *Revlon*, dealmakers should not overlook the fact that the yardstick used to measure the adequacy of the path taken in a particular situation may vary depending on the identity of the relevant buyer.

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