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M&A Update

New Delaware Guidance on Conducting a Sale Process

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A recent Delaware Court of Chancery opinion has identified some pitfalls to avoid in conducting a proper sale process. It also breaks new legal ground by requiring that certain management projections be disclosed to stockholders. Vice Chancellor Strine's opinion in the In re: Netsmart Technologies case (Del. Ch. March 14, 2007, C.A. No. 2563-VCS) enjoined the $115 million all-cash acquisition of Netsmart Technologies by two private equity firms until corrective disclosures are made regarding the conduct of the sale process and certain management projections are disclosed.[1]

This opinion is being closely followed by M&A practitioners and will have a significant influence on the way transactions are negotiated. Some of the key take-away points from the 75-page opinion are:

- **Management Bias in Favor of Private Equity.** V.C. Strine observed that company insiders might have a bias towards selling to a private equity fund because the insiders are more likely to keep their jobs than is the case when a company is sold to a strategic buyer in the same industry. It was also noted that target company executives also typically get a "second bite at the apple" through new equity incentives offered by private equity sponsors. In that context, the failure to actively pursue other alternatives, including potential strategic bidders, could implicate conflicts of interest.
- **Casting a Wider Net Before Signing a Merger Agreement.** The court was unconvinced by the argument that widening the net to approach at least a few well-chosen potential strategic bidders would seriously harm Netsmart's business interests. The court was also critical of relying on informal, uncoordinated and sporadic past contacts with other companies in the industry as a basis for concluding that a strategic bidder was unlikely to be interested in the target. A focused up-to-date effort in which potential bidders understand the target is truly "in play" might be advisable unless there are compelling reasons not to do so in the particular context.
- **Post-Signing "Window Shopping" Not Always Sufficient.** A "window shop" or "passive market shop" provision typically prohibits the target from actively shopping for topping bids, but allows the target to respond to unsolicited bids if one emerges after signing the merger agreement. V.C. Strine noted that a small-cap company might not be deemed a sufficiently attractive prize to warrant the costs and uncertainties of making a hostile bid. A company undergoing a sale process should carefully consider its particular circumstances and market dynamics before concluding that it is wise or appropriate to rely too heavily on a passive market check to maximize shareholder value. In cases where a thorough pre-signing market check is problematic, target companies may negotiate more strenuously for "go shop" provisions, which allow them to actively solicit topping bids for a limited time after signing a merger agreement, sometimes accompanied by relaxation of the break-up fee obligation if a bid does emerge in that period.
- **Keeping Minutes.** The opinion found fault with the failure to type up and formalize minutes of special committee meetings until after a lawsuit was filed and then doing so all at once. The circumstances of their preparation prompted the court to find the minutes to be an unreliable indicator of what was discussed at the meetings and even cast doubt on whether some of the meetings had occurred at all. Best practice in this regard would seem to be to keep careful minutes during meetings, type them up with reasonable promptness afterwards and circulate them for ratification at subsequent meetings on an ongoing basis.
- **Managing the Due Diligence Process.** V.C. Strine was critical of allowing company management to run the due diligence process without board supervision under circum-

[1] Netsmart subsequently distributed updated disclosures and rescheduled the shareholders meeting for April 5, 2007.

stances where management might have a bias towards a particular bidder or type of bidder (e.g., private equity). Where there might be a material conflict of interest, it may be appropriate for the board or a special committee of the board to supervise the due diligence process more closely than would otherwise be the case.

- **Disclosing Projections.** The failure to disclose the projections underlying the discounted cash flow analysis used in reaching the fairness opinion described in the proxy statement was found to be a material omission. Those projections were described by the court as "the best estimate of the company's future cash flows as of the time the board approved the Merger" and the court concluded that the entire projection model needed to be disclosed in order for shareholders to be fully informed. The court was not swayed by the argument that the fairness opinion provider had put little emphasis on the discounted cash flow analysis. This is a significant new development in the law.

Perhaps the most important general lesson to draw from this case is that the vigor and integrity with which the sale and negotiation process is pursued can be at least as important as the particular results achieved. The actions of directors in critical situations tend not to be judged by the courts using rote rules of thumb (e.g., "a post-signing market check is sufficient"—"break-up fees between 3–4% are always appropriate"), but rather through analysis of how they went about their work on behalf of the shareholders' interests under the unique facts and circumstances of each particular case.

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