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Delaware Chancery Criticizes Auction Process for Focus on Private Equity Buyers, Among Other Issues

The Delaware Chancery Court recently faulted the board of directors of Netsmart Technologies, a provider of enterprise software solutions to healthcare businesses, for running a shoddy auction of the company. While the Court ultimately refused to grant a broad injunction against the pending acquisition of Netsmart by Insight Venture Partners, a private equity firm, the Court was very critical of the board's exclusive focus on private equity buyers and other aspects of its auction process. The opinion is rich with lessons that should be reviewed by any Delaware company considering strategic alternatives, including the following:

- *Once a company has decided to sell itself, the board must act "reasonably" and conduct a "logically sound process to get the best deal that is realistically attainable." Central to the creation of an appropriate marketing process specific to each company is an "actual consideration of the M&A market dynamics relevant to the situation" being faced by that company.* The Netsmart board argued that its settling quickly and exclusively on private equity buyers was justified because (i) it had canvassed strategic buyers about a possible transaction in the past without success, (ii) it believed that the minuses of conducting such a canvas now, such as possible harm to its customers and confidentiality leaks, outweighed the pluses and (iii) it believed that a financial buyer would provide a more lucrative deal. The board also believed that announcing a deal would stimulate topping bids and thus, there would be an effective, post-signing "market check."

  The Court strongly disagreed with the board and found that the board's Revlon duties may have been violated because it did not have a reliable basis to conclude that the Insight deal was the best when they failed to take any reasonable steps to explore strategic buyers. While there is no "judicially prescribed checklist of sales activities," the board must act "reasonably, by undertaking a logically sound process to get the best deal that is realistically attainable." According to the decision, this reasonableness review by the Court is "more searching than rationality review," but "there is less tolerance for slack by the directors." The Court agreed with plaintiffs that there was no serious examination of strategic buyers, instead finding the process haphazard and insufficient. The Court felt that past marketing efforts had no relevance to the current market for Netsmart because (i) the sporadic and poorly focused contacts (consisting of Netsmart's CEO calling about six companies over a seven-year period and its financial advisors "cold calling" companies without consideration to strategic fit) would probably be poor generators of interest and (ii) the distant time period during which the prior efforts were made meant that they had

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little bearing on a much changed healthcare information technology industry and Netsmart business. The Court also believed that the minuses of conducting a current canvas of strategic buyers were manageable. The Court stated its belief that contacting a targeted group of strategic buyers posed no colorable threat to potential or existing Netsmart customers and that the risk of a confidentiality leak could be limited by "discreet and professional overtures to select strategic players" and at any rate was no higher with strategic buyers than with financial ones.

In this regard, the Court ordered Netsmart to include a "fuller, more balanced description of the board's actions" in finding a strategic buyer, since without such changes, the proxy statement gave the impression that a "more reasoned and thorough decision-making process had been used."

- *The board must consider current market circumstances unique to each company when determining the appropriate marketing and deal protection techniques. For instance, techniques that work in large-cap deals may not work in micro-cap deals.* The Court faulted the board's assumptions that private equity buyers would provide more value and that the announcement of the deal would generate topping bids. The presence of a "current market trend" towards financial buyers in the large-cap arena does not mean that this should be the case for micro-cap deals or for a company with Netsmart's particular business. The Court clearly thought that Netsmart's niche business could potentially generate more value among strategic buyers than with financial buyers.

  Also, the Court disagreed with the board's belief that the non-preclusive, "typical" set of deal protections to which it had agreed (including a fiduciary out, a "window shop" provision that allowed the company to entertain unsolicited superior proposals and a 3% break-up fee payable if Netsmart terminated the agreement to pursue a superior proposal) would support topping bids. Again, the Court noted that the high rate of topping bids in the context of large-cap deals in consolidating industries would not apply to Netsmart. Also, the Court felt that Netsmart's niche business might generate less gain for the acquirer and thus the existence of any deal protections would chill counteroffers.

- *The auction process should not give the inference of being unduly influenced by management.* While the Court ultimately did not find that management exerted undue influence over the auction process, the Court nevertheless noted several process points that invited suspicion, including:

  - *Management's possibly driving the board towards a private equity deal.* The Court stated that the "directional force of management's desires was manifest," citing a much more fulsome board presentation on the benefits of a private equity deal as opposed to a deal with a strategic buyer.

  - *Management's presence at special committee meetings.* The fact that the special committee meetings at which the merger terms were considered were held in executive session without management participation was helpful to the Netsmart board. However, the Court faulted the special

committee for giving the CEO unlimited access to their deliberations otherwise.

- *Management's control of the due diligence process.* The Court noted that the due diligence process could be used by management to favor a particular bidder or bidder type, but ultimately, the Court found no negative effects in this case on the bidding process.

We suggest that when a board is considering multiple bidders, it should be careful to avoid the inference of undue favoritism, particularly towards management-led bidding parties. Special procedures regarding management oversight of due diligence and contact with bidders may be appropriate in certain instances.

- *The company disclosure must provide a "balanced," "truthful" and "materially complete" account of all of the matters addressed.* The Court found that Netsmart should have disclosed (i) the final projections used by William Blair in issuing its fairness opinion, notwithstanding the fact that such projections were not provided to bidders during the auction, and (ii) as already mentioned above, a more balanced picture of the board's actions vis a vis finding a strategic buyer. In holding that the financial advisors' projections must be disclosed, the Court notes that the cursory nature of fairness opinions is why the disclosures of the advisors' actual analysis is important since shareholders could "make no sense of what the bank's opinion conveys" otherwise.

- *The board should ensure that an accurate and complete record is maintained.* Underlying all of the foregoing was particularly sloppy record keeping with respect to board meetings, which proved problematic for Netsmart because the incomplete history left it without credible support for its arguments. In particular, the Court noted that no less than ten sets of board minutes were created and ratified by the board after this lawsuit was filed. While the Court did not explicitly invalidate the post facto, en masse creation of such a record, the Court did note that this "tardy, omnibus consideration of meeting minutes is, to state the obvious, not confidence-inspiring."

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. If you have questions regarding the foregoing, please contact any of the following:

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