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Delaware Chancery Reiterates Reasonableness in Application of Revlon; Perfection Not Required

The recent *In re Lear Corp.* decision shows that the Delaware Chancery Court will continue to defer to board judgment even under the enhanced judicial standard required by *Revlon* where there is a record of reasoned board decision. As Chancellor Strine states, under *Revlon*, "[r]easonableness, not perfection, measured in business terms relevant to value creation, rather than by what creates the most sterile smell, is the metric." As we discuss below, what is particularly interesting in this opinion is Chancellor Strine's discussion of the Lear board's process, the factors that the directors considered in agreeing (without a pre-signing market check) to the proposed merger with American Real Estate Partners, LP (a Carl Icahn-controlled entity), the post-signing go-shop process and why the board's decision was reasonable under *Revlon*.

Background

In *Lear*, on plaintiffs' motion for a preliminary injunction against the proposed merger between Lear and AREP, the Chancery Court found that there was no reasonable likelihood of ultimate success on all but one limited disclosure claim relating to management's interests in the deal. On the plaintiffs' broader claims of a breach of fiduciary duty under *Revlon*, the Court, while recognizing that the Lear board could have improved upon its sale process, ultimately found that no breach likely occurred.

The imperfection of the Lear board's process surrounded the special committee's designation of Robert Rossiter, the CEO, as Lear's lead negotiator, and the committee's subsequent hands-off approach to the negotiations notwithstanding possible conflicts of interest between Rossiter and the public shareholders. The terms of the Icahn deal gave Rossiter and other members of management financial benefits that were unavailable to the public shareholders and that Rossiter would not have if the deal failed, including allowing Rossiter to liquidate his existing equity holdings while affording him a continued equity stake in the future company, to accelerate and cash-out his retirement benefits and to continue his managerial position with the company. The record shows that, at the very least, the acceleration and cashing-out of his retirement benefits were clearly on Rossiter's mind as he had discussed this option with the Lear compensation committee shortly before Icahn first approached Rossiter about a deal. In addition, Rossiter's delay in informing the board about Icahn's initial approach indicated to the Court that he may have indeed harbored conflicts about the deal, since the delay cost the board precious "deliberative

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and tactical time" and essentially forced the board into a situation where it had to rely so heavily on Rossiter.

In spite of the foregoing, the Court found that the board likely met its *Revlon* duties, pointing to other facts that showed that the board and indeed Rossiter himself acted reasonably and sought to secure maximum value for the shareholders in light of the particular facts and circumstances surrounding Lear and the proposed transaction. While Rossiter would have personally benefited from a deal with Icahn at less than the agreed $36 per share, he repeatedly sought concessions, eventually extracting a price increase of $1 per share (from $35 to $36 per share) and other benefits, such as a 45-day go-shop (although subject to a matching right), a two-tiered break-up fee structure ($73.5 million plus up to $6 million in expenses during the go-shop period and $85.225 million and up to $15 million in expenses thereafter), a reverse break fee of $250 million and an agreement from Icahn to vote for any alternative deal that the Lear board found superior.

With respect to the break-up fees, the Court analyzed the reasonableness of their levels by comparison to the equity value and the enterprise value of the proposed transaction. The approximately $80 million go-shop break-up fee amounted to about 2.8% of the equity value and 1.9% of the enterprise value of the deal, while the approximately $100 million post-go-shop break-up fee amounted to about 3.5% of the equity value and 2.4% of the enterprise value of the deal. The Court found that these break-fee levels were not a deterrent to rival bids in this context and therefore were reasonable. Interestingly, in what may be a nod to the importance that debt refinancing is playing in the current M&A market, Chancellor Strine states "it is arguably more important to look at the enterprise value metric because, as is the case with Lear, most acquisitions require the buyer to pay for the company's equity and refinance all of its debt."

The Court also suggested that the reasonableness of the board's actions should be viewed in light of the fact that Lear had in many ways put itself up for sale without success before accepting the Icahn offer by, among other things, (i) eliminating its poison pill in 2004, (ii) being open to Icahn's initial open-market purchases of 4.9% of Lear stock in early 2006 and (iii) conducting a secondary offering in 2006, pursuant to which it offered $200 million of common stock to three large shareholders, including Icahn, who ultimately acquired all of the $200 million after the other shareholders declined to purchase due to what they perceived as the overly high $23 per share price. Although not a substitute for a full and meaningful pre-signing market check, Lear's particular history and the fact that Lear was a large company with deep analyst coverage made it so that the "market for corporate control knew Lear was essentially in play". This market presence was key to differentiating *Lear* from the recent *Netsmart* decision since "unlike in *Netsmart*, no one had to discover Lear; they were invited by Lear to obtain access to key information and decide whether to make a bid."

Finally, the board's concerns about the disruption to the company's business and customer relationships, and Icahn's repeated threats to withdraw his bid, if the company conducted a full auction, and the board's conduct of a solid post-signing market check also played into the Court's decision. With respect to the go-shop, the board took full advantage of that option by, among other things, tasking its financial advisors with finding alternative bidders immediately after signing and even expanding the engagement of one of its advisors so that it could help find competing proposals. 41 possible buyers (including a mix of strategic and financial players) were contacted, eight executed a confidentiality agreement and three entered negotiations with the company, but ultimately no alternative offers were received. As mentioned earlier, the board had also negotiated deal provisions to protect the efficacy of its go-shop right, including the Icahn voting agreement and a relatively low go-shop break-up fee.

Given the foregoing, the Court found that the only claim with likely success on its merits was the failure properly to disclose the possible economic motivations of Rossiter in his negotiating and supporting the Icahn deal. This is of particular importance given his role as chief Lear negotiator. The Court recognized that Rossiter had "powerful interests to agree to a price and terms suboptimal for public investors" so long as his economic interests were protected and believed that shareholders would find this material. As such, the Court enjoined the Lear shareholder meeting until supplemental disclosure could be made.

Practice Pointers

While the actual holding in this decision is quite narrow, there are some pointers that M&A practitioners can take away, including the following:

- The Chancery Court continues to be on the watch for bias and conflicts of interest in the merger process, although a reasoned approach taking into consideration the business and other circumstances facing the bidder will continue to protect boards against fiduciary breach claims. The Court clearly thought that the special committee should have participated, or should have had its financial advisors participate, more actively in the merger negotiations and that allowing Rossiter to conduct the negotiations so autonomously unnecessarily raised concerns about the integrity of the process. Thus, companies active in the merger market should continue to have as active a special committee as possible and make special effort to eliminate conflicts and other appearances of impropriety.

- As it has in a number of recent cases, such as *Netsmart* and *Caremark*, the Chancery Court focuses on the very fact intensive nature of what constitutes a "reasoned" sale process for each company. In *Lear*, the Court looked at a broad range of facts, including the state of the industry of the company, the market presence of the target, attitude of the board and management towards a sale, other strategic options available, the past business history of the buyer and whether the deal protections were indeed bid-chilling (including an analysis of the break-up fees in comparison to the enterprise value of the transaction). Thus, what is reasonable for one company (whether from a board process, deal protection or other perspective) may not be reasonable for another. Remember that "it's market" is not generally sufficient by itself to support board action.

- Under Delaware law, go-shops (even with a matching right for bidder) are valid to show board reasonableness in certain circumstances and so long as the board negotiates terms that give real opportunity for a post-signing market check. The Court found that Icahn's matching right even when coupled with termination fees were of a limited enough nature that it only served to require that bidders top Icahn's offer in a material way, rather than preventing bids altogether. Icahn's agreement to vote for superior deals also helped bolster the effectiveness of the go-shop and was not overlooked by the Court.

- The Court thought that the Lear board's elimination of its poison pill in 2004, signaled a "willingness to ponder the merits of unsolicited offers". Companies deciding whether to adopt, renew or let lapse a shareholder rights plan primarily for corporate governance or other purposes should consider this signal when weighing the proper course of action.

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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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