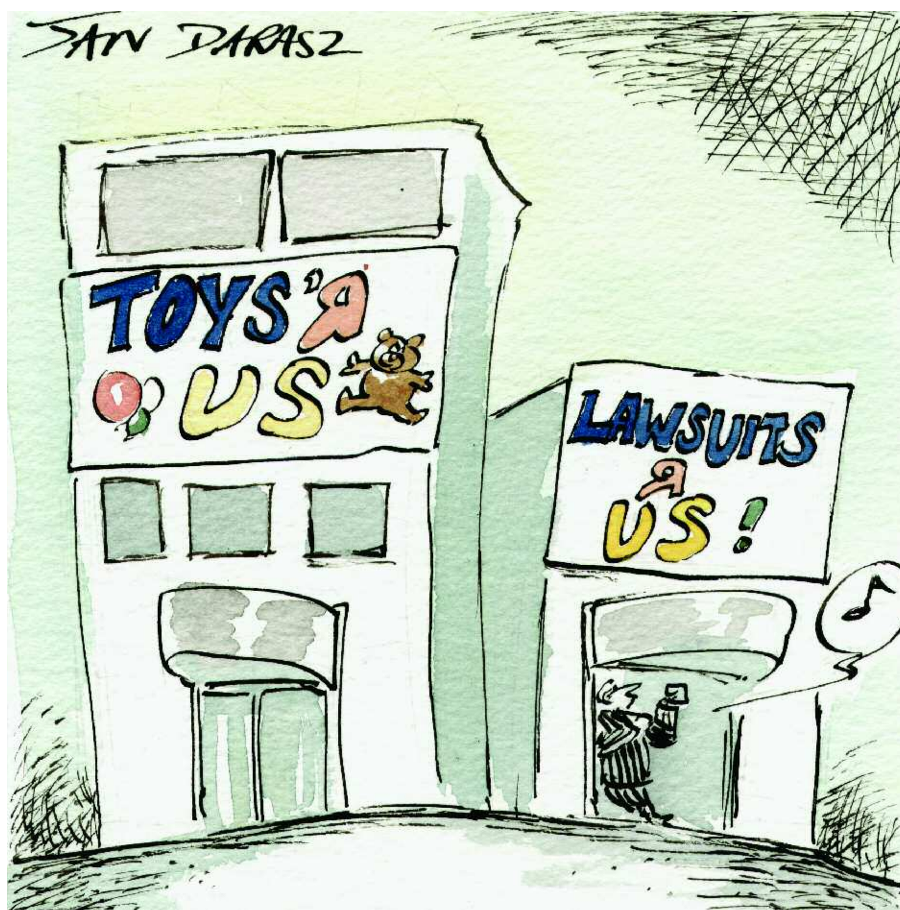
Delaware's standard for auction sales explained

The recent *Toys 'R' Us* ruling in Delaware gives clearer standards of care to directors who auction their companies. By Toby Myerson and Didier Malaquin



In June this year vice chancellor Leo Strine of the Delaware Chancery Court provided much-needed guidance on board approval processes and deal protections involving auction sales of Delaware public companies through his decision in *In re Toys 'R' Us Shareholders Litigation.*

It is nearly 20 years since the landmark decision *Revlon, Inc v MacAndrews & Forbes Holdings, Inc,* in which the Delaware Supreme Court held that directors have a fiduciary duty to obtain the highest value reasonably available for the stockholders in a sale of a company. Since then, mergers and acquisitions lawyers in the US and other countries have closely followed developments in Delaware law. Not only are almost 60% of the Fortune 500 companies incorporated in Delaware, but the state's corporate law has also set trends for other US jurisdictions and some foreign countries. The *Toys 'R' Us* decision expands and clarifies Delaware law in certain important respects.

The Toys 'R' Us auction

The sale of Toys 'R' Us was the result of a lengthy examination of strategic alternatives by the company's board. The process began in January 2004 when, after disappointing 2003 holiday season sales, the company decided to consider ways to deliver more value to its stockholders. At that time the company's common stock was trading at $12 a share. The board retained a team of investment bankers and lawyers to help it develop and evaluate its options. Financial advisers to the company performed extensive analyses and concluded the most effective way to maximize shareholder value would be to sell the company's toy retailing business, known as Global Toys, excluding the company's interest in the toy business in Japan, called Toys Japan.

After several meetings to evaluate the company's strategic alternatives, and based on the advice of its bankers and outside counsel, the board decided to sell the company's most valuable line of business, Global Toys. The plan was to auction Global Toys and retain the remainder of the business, consisting of Babies 'R' Us and Toys Japan. After a wide solicitation, several rounds of bidding and considerable contract negotiations with four separate groups, one of the bidders, the buyout firm Cerberus, submitted a bid to buy the whole company rather than Global Toys alone. Recognizing that this was potentially more attractive, the board decided to solicit bids for the entire company from the other final three bidders for Global Toys for a limited time. When these bids came in, a group led by Kohlberg Kravis Roberts & Co (KKR) bid $26.75 a share, topping the Cerberus bid by $1.50 a share and resulting in an offer that was $350 million higher. Cerberus did not increase its bid and the board decided to accept the KKR bid for the whole company. The $26.75 a share valuation was at the top, or above, the various valuation ranges for the company presented to the company's board by its investment bankers and was a 123% increase over the stock price when strategic process began.

After the agreement with KKR was announced, two of the company's institutional shareholders brought suit arguing that the company's board had failed to fulfill its fiduciary duty to act reasonably in the pursuit of the highest attainable value for stockholders. They argued that the decision to conduct a brief auction for the whole company from the bidders for Global Toys was unreasonable and that the board should have undertaken a new, full-blown auction. The shareholders also complained that the board unreasonably locked up the KKR transaction by various provisions in the merger agreement, precluding any topping bid. Vice chancellor Strine rejected those arguments and denied the shareholders' motion for a preliminary injunction. The KKR deal closed soon thereafter.

Stapled finance

While not central to the decision, vice chancellor Strine offered views on a practice frequently referred to as stapled finance. It has become common in auction situations for the sell-side financial adviser to seek and obtain approval from its sell-side client to offer acquisition financing to potential bidders. The advantage to a seller of this practice is that the seller can sit down with a pre-approved buyer financier in advance of the auction, discuss the company and its strategy, provide confidential information and thereby short cut potential buyers' and their lenders' due diligence processes. The seller can also become comfortable with the financier's valuation range and lending multiples. These arrangements are typically protected by firewalls, so that the investment bankers advising the seller do not interact with or provide unauthorized information to those working on the buy-side financing.

In this case, the investment bank requested permission from the company's board to offer buy-side financing in the bidding for Global Toys, which the board refused to give. Accordingly, the investment bank declined to discuss financing with bidders before the execution of the merger agreement. Almost two months after the execution of the merger agreement, the investment bank requested and the board approved the investment bank's offer of buy-side financing to the KKR. About this, vice chancellor Strine said, "[t]hat decision was unfortunate, in that it tends to raise eyebrows by creating the appearance of impropriety, playing into already heightened suspicions about the ethics of investment banking firms". Vice chancellor Strine went on to say that he was not making a bright-line statement, and that he could imagine scenarios when "roles on both sides for the investment banker would be wholly consistent with the best interests of the primary client company". In general, the vice chancellor suggested that it would be advisable for investment banks for sellers not to give the appearance that they want buy-side work on the same transaction.

Though this case does not create any prohibitions against stapled finance, the bar has been raised for companies and bankers to show a convincing rationale why the sell-side adviser will be adding to the auction process for the benefit of the seller by offering buy-side financing. The case can be made, but it needs to be made carefully.

The *Revlon* doctrine

Under Delaware law, a director must discharge his or her duties: (i) on an informed basis; (ii) in good faith; and (iii) in a manner that he or she honestly believes is in, or not opposed to, the best interests of the corporation. In the case of most actions by a board of directors, Delaware courts apply the *business judgment rule*, which presumes directors' decisions have been made in accordance with these standards unless a challenger demonstrates that the directors did not meet their duties of care or loyalty.

But when a board's decision involves the potential sale of control of a corporation, the business judgment rule gives way to *enhanced scrutiny* by the courts as to how the board has carried out its fiduciary duties of care and loyalty. In these cases, the court will consider the reasonableness of the actions taken by the board, and the directors have the burden of showing that they acted in a reasonable fashion to carry out their duties. If the process is found to have been reasonable, the Delaware courts will accept the substantive decisions of the board.

If a court finds that a board: (i) acted in bad faith; (ii) was conflicted; or (iii) was so uninformed that the directors could not meet their duty of care, the court can second-guess the substantive decisions of the board. The duty of care - the duty to use reasonable diligence - obligates the directors to avail themselves of all information reasonably available to them before making a business decision.

There is a difference between the duties of directors when a corporation is, and is not, for sale. Any transaction that will result in a change of control of a corporation (with certain exceptions) is considered to be a transaction involving a sale of the company. If a company is for sale, the directors' duty of care requires them to obtain the highest value reasonably available for the stockholders. This is known as the *Revlon* doctrine.

The analysis, however, is not necessarily only a question of price. Whether or not the price is *reasonably available* requires an analysis of the risk of non-consummation of the deal, including antitrust, governmental or third party approvals, financing risks and other conditions to consummating the transaction. In *Toys 'R' Us*, there was no issue regarding the duty of loyalty, since all the directors but one were outside, independent directors and there were no other indications of any conflicts of interest.

The board process

The record in *Toys 'R' Us* shows that the board, with qualified external advisers, reviewed the logical options for the company and came to a reasoned conclusion as to the best alternative to pursue. The board met 14 times and its executive committee met 18 times from the beginning of the process until an agreement with KKR was concluded. Although the transaction that resulted from the sale process was not the one originally envisioned, the vice chancellor concluded that the result was not a product of a flawed process.

Among the reasons for the decision, vice chancellor Strine concluded that it was not necessary to conduct a new full-blown auction for the whole company in addition to the auction previously run for Global Toys. The court cited an earlier Delaware case, *Barkan v Amsted Industries*, for the proposition that the law does not require a board to conduct an auction process or even a targeted market canvass - there being "no single blueprint" for fulfilling the duty to maximize value.

In addition, the vice chancellor noted that the strategic process had been publicized both in a press release by the company and in newspaper articles. He suggested that this publicity was an open invitation for qualified third parties to make proposals for the company or its businesses. He also observed that "capitalists are not typically timid, and any buyer who seriously wanted to buy the whole company could have sent a bear hug letter at any time".

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The court also suggested that, once it was clear the entire company could be sold and no bids for the company were likely to be received other than those from the bidders for Global Toys, it was reasonable for the board to conclude that prolonging the auction by opening it up to new parties could have jeopardized the receipt of the best bids. Accepting the KKR bid,

the court decided, was the reasonable thing to do.

In applying Delaware law, the vice chancellor concluded that the court's task is to examine whether the directors have undertaken reasonable efforts to fulfill their obligations to secure the best available price, and not to determine if the directors have performed flawlessly. An extensive and good faith process, run by independent directors with qualified and unconflicted advisers, were critical to the vice chancellor's decision.

Deal protection provisions

The second part of the plaintiffs' claim was that the board acted unreasonably in agreeing to deal protection measures that allegedly precluded the emergence of a later, higher bid. The plaintiffs argued that, although there was no higher or competitive proposal on the table, the cumulative effect of the termination fee and matching rights created an unreasonable advantage for KKR that dissuaded any other bidder from presenting a better offer. The final merger agreement with the KKR contained four deal protection provisions:

- a fixed termination, or break-up, fee of $247.5 million, equal to 3.75% of equity value (3.25% of enterprise value) payable to KKR if the company terminated the merger agreement in order to sign up another transaction or if KKR terminated the merger agreement because the company changed its recommendation to stockholders of the KKR transaction;
- an agreement by the company to reimburse KKR for up to $30 million in documented expenses if the shareholders voted down the transaction;
- a no-shop clause that prevented the solicitation of other competing proposals, but did allow the company to consider unsolicited bids; and
- the right for KKR to match any topping bid within three business days.

The plaintiffs claimed that a break-up fee of 3.75% of equity value and 3.25% of total enterprise value was excessive for a deal of this size (the total equity value of the transaction was about $6.6 billion). They argued that the board should have refused to sign the merger agreement with KKR until the break-up fee was reduced to a less onerous level and the matching rights were removed. The court, however, pointed out that Toys 'R' Us negotiated the break-up fee down from 4% to 3.75% and was not in a position to demand a further substantial reduction in the termination fee or elimination of the matching rights. If it had done so, the board would have risked losing KKR's bid.

On this point, vice chancellor Strine invented an illustrative hypothetical telephone negotiation between advisers to the company and KKR, with the company's advisers demanding the reduction in the deal protections and losing the KKR deal. The vice chancellor suggested the company did not need to take any such risk in the real world. The court also pointed out that the deal protection package would not deter a bidder willing to pay materially more than KKR, although it conceded that it would deter someone who would want to make a bid that was "trivially" larger than the KKR bid.

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While acceding in part to the plaintiffs' request that the court provide guidance to transactional lawyers on the "acceptable level of deal protections in *Revlon* deals", the court did not provide a bright-line test for the acceptable level of break-up fees. The vice chancellor pointed out that the "central purpose of *Revlon* is to ensure the fidelity of fiduciaries" and "is not a license for the judiciary to set arbitrary limits on the contract terms that fiduciaries acting loyally and carefully can shape in the pursuit of the stockholders' interest". However, the court suggested that the flexibility of the *Revlon* analysis of break-up fees has its limits, stating that it would not "turn a blind eye to the adoption of excessive termination fees, such as the 6.3% termination fee in *Phelps Dodge [Corp v Cyprus Amax Minerals Co*], that ... present a more than reasonably explicable barrier to a second bidder". The court was also unprepared to call "fees lower than 3% always reasonable". "Nor, I believe should we be entirely immune to the preclusive differences between termination fees starting with a 'b' [ie in the billions of dollars] rather than an 'm' [for millions]," added Strine in a footnote.

What follows for practitioners from the court's articulation of the law in this area is essentially a judgment of reasonableness. If a company has not been auctioned or the market for a sale tested, the judicial tolerance for deal protections will be lower. If, however, an extensive auction has been conducted, the court will favourably view deal protection measures of the type and range discussed in this case. ■

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