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DELAWARE CHANCERY COURT PROVIDES GUIDANCE ON ACCEPTABLE LEVEL OF BREAK-UP FEES IN *REVLON* DEALS

In its recent ruling in *In Re Toys "R" Us, Inc. Shareholder Litigation,* the Delaware Chancery Court held that, in connection with the sale of the Company, the Toys "R" Us board acted reasonably under *Revlon* in agreeing to a break-up fee of 3.75% of equity value and giving the buyer the right to match a topping offer within three business days.

The sale of Toys "R" Us was the result of a lengthy search for strategic alternatives that began in January 2004, when, following a disappointing 2003 holiday season, the Company began to consider ways to deliver more value to its stockholders. In order to do so, the Toys "R" Us board retained an investment banking team to help it develop and evaluate its options. At the time, the Company's common stock was trading for $12.00 per share. Following frequent meetings to evaluate the Company's strategic alternatives, the Board, based on the advice of its bankers and outside counsel, settled on the sale of the Company's most valuable asset, its toy retailing business ("Global Toys"), as its preferred option. After several rounds of bids for Global Toys, one of the bidders, Cerberus, expressed a serious interest in buying the whole Company. Recognizing that the Cerberus bid for the entire company was attractive compared to the Board's chosen strategy to sell only Global Toys, the Board decided to solicit bids for a limited time for the entire Company from the final bidders for Global Toys. When the bids for the whole Company came in, a group led by Kohlberg Kravis Roberts & Co. (the "KKR Group") bid $26.75 per share, topping the Cerberus bid by $1.50 per share. Cerberus did not increase its $25.25 per share bid and the Board decided to accept the KKR bid.

In negotiating the terms of the merger agreement, KKR requested a termination fee of 4% of the equity value of the transaction. The Company negotiated the termination fee down to 3.75% of equity value. The KKR Group also asked to be paid $50 million in expense reimbursements in the event of a so-called "naked no vote", i.e., a shareholder vote to decline the

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merger agreement that is not followed by the acceptance of an alternative transaction. The Company negotiated this amount down to $30 million in documented expenses.

The final merger agreement contained four deal protection provisions:

1) A fixed termination fee of $247.5 million, equal to 3.75% of equity value (3.25% of enterprise value) payable to the KKR Group for the most part only if the Company terminated the merger agreement in order to sign up another acquisition proposal within a year;

2) An agreement by the Company to reimburse the KKR Group for up to $30 million in documented expenses after a naked no vote;

3) A no-shop clause that allowed Toys "R" Us to consider unsolicited bids; and

4) The right for the KKR Group to match any topping bid within three business days.

The plaintiffs, Iron Workers of Western Pennsylvania Pension and Profit Plans and Jolly Roger Fund LP, sought to enjoin a vote of the stockholders of Toys "R" Us to consider the merger, arguing that the Toys "R" Us board had failed to fulfill its *Revlon* duty to act reasonably in pursuit of the highest attainable value for the Company's shareholders. They claimed that the Board's decision to conduct a brief auction for the full Company from the final bidders for Global Toys was unreasonable, and that the Board should have taken the time to conduct a new, full-blown search for buyers. In addition, the plaintiffs' complain that the Board unreasonably locked up the KKR Group's bid by agreeing to draconian deal protection provisions that preclude any topping bid.

Examining the process that led to the sale to the KKR Group, the Court subjected the Board's actions to the "enhanced scrutiny" prescribed by *Revlon* and rejected both elements of the plaintiffs' *Revlon* claim.

As to the adequacy of the auction process, the plaintiffs contended that the Board acted too hastily once it recognized that a sale of the whole Company, rather than the sale of just Global Toys, was the best strategic option. They argued that by restricting the opportunity to bid for the whole company to only the final four bidders for Global Toys, the Board unreasonably narrowed the universe of bidders, thereby preempting a more competitive auction process that might have yielded a higher price than $26.75 per share. The Court rejected those arguments, noting that any buyer who was seriously interested in the whole Company would likely have had a serious interest in Global Toys. Moreover, the Court observed, "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" in order to express its interest. In addition, the Court noted that the decision to time limit the final auction process was reasonable given the length of the process to date and the risk of losing one of the finalists.

The second part of the plaintiffs' Revlon claim was that the Board acted unreasonably in agreeing to deal protection measures that precluded the emergence of a later, topping bid because the cumulative effect of the termination fee and matching rights created an unreasonable advantage for KKR that dissuaded any other bidder from presenting a topping offer. Plaintiffs claim that 3.75% of equity value and 3.25% of total transaction value exceeds what is typical for deals this size (the total equity value of the transaction was approximately $6.6 billion and the enterprise value was approximately $7.6 billion) and 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 was not in a position to demand a substantial reduction in the termination fee and that doing so would have put them at risk of losing the KKR Group's bid. The Court pointed out that the deal protection package would not deter a bidder willing to pay materially more than the KKR Group although it conceded that it would deter someone who would want to make a bid that was "trivially" larger than the KKR bid. The Court cited Delaware precedents such as *McMillan* v. *Intercargo*[1] and *Pennaco Energy*[2], in which the Delaware Chancery Court approved deal protection measures in the *Revlon* context that were nearly as substantial.

While acceding 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, pointing 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*[3] that … present a more than reasonably explicable barrier to a second bidder", and was not prepared to say that "fees lower than 3% are always reasonable".

In Re Toys "R" Us, Inc. Shareholder Litigation, Del. Ch., C.A. No. 1212-N, June 22, 2005.

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1 768 A.2d 492 (Del. Ch. 2000)

2 787 A.2d 691 (Del. Ch. 2001)

3 *Phelps Dodge Corp. v. Cyprus Amax Minerals Co*., No. C.A. 17398 (Del. Ch. Sept. 27, 1999).

This memorandum constitutes only a general description of the *Toys "R" Us* opinion. It is not intended to provide legal advice and no legal or business decision should be based on its contents. Any questions concerning the foregoing should be addressed to any of the following members of our Mergers and Acquisitions Group:

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