dri™
The Voice of the Defense Bar

Riding the E&O Line
The Newsletter of the Professional Liability Committee

September 2, 2014 Volume 5 | Issue 3

Continuing Down the Road of *Revlon*: A Review of the Duties of a Target Company's Board of Directors in a Change-of-Control Transaction in Light of Two Recent Decisions from the Delaware Court of Chancery

by Paul E. Pakidis

The board of directors of a target company in a change-of-control transaction has the burden of proving that it was adequately informed and acted reasonably in seeking the best value reasonably available to the shareholders (commonly referred to as the board's "*Revlon* duties"). Once *Revlon* duties are triggered, Delaware courts review the board's conduct under enhanced scrutiny by reviewing the adequacy of the board's decision-making process (including the information the board relied on) and the board's actions in light of the circumstances.

The Delaware Court of Chancery's recent decisions in *In re Plains Exploration & Production Co. Stockholder Litigation*, No. 8090-VCN, 2013 WL 1909124 (Del. Ch. May 9, 2013), and *Koehler v. NetSpend Holdings, Inc.*, No. 8373-VCG,2013 WL 2181518 (Del. Ch. May 21, 2013), highlight that there are no bright-line rules that show whether a target company's board has satisfied its *Revlon* duties. Instead, whether a board has satisfied its *Revlon* duties remains heavily dependent on the facts and circumstances surrounding the transaction.

I. ***In re Plains Exploration & Production Company Stockholder Litigation***

In *Plains*, the target company's stockholders sought a preliminary injunction to enjoin a merger, alleging that the target company's board violated its *Revlon* duties by (1) allowing its CEO to lead negotiations without establishing a special committee despite the CEO's conflict of interest, (2) failing to conduct a pre-market check or shop the company while agreeing to onerous deal-protection provisions in the merger agreement, and (3) failing to negotiate a collar or other provision to protect against a decline in the price of the stock that the target company's shareholders would receive as part of the purchase price. The Delaware Court of Chancery denied the motion, holding that the allegations were insufficient in light of the circumstances.

A. Background

Freeport–McMoran Copper & Gold Inc. ("Freeport"), an international mining company, entered into a merger agreement to acquire Plains Exploration & Production Company ("Plains"). In the first quarter of 2012, Plains' CEO began preliminary discussions with the chairman of Freeport's board about a potential transaction between the two companies. Plains' CEO notified Plains' board, and the board brought on Barclays PLC ("Barclays") so that it could rely on Barclays' expertise if the transaction were to move forward.

In early May, Barclays gave a presentation to Plains' board about the potential transaction. Then, in late May, Freeport's board appointed a special committee for the purpose of reviewing the possible deal with Plains. Plains' board did not appoint a special committee. Plains' board allowed its CEO to continue managing the negotiations but it remained informed throughout the process.

Freeport and Plains went back and forth with offers and counteroffers with respect to the share price, and Freeport notified Plains that it would retain Plains' management as part of the transaction. Under the proposed arrangement, the Plains' CEO would serve as the CEO of oil and gas operations and would receive a substantial salary increase. Barclays opined that a fair price would be around $50.00 per share, and Freeport and Plains eventually agreed to that price in a combination of cash and Freeport stock. Plains' board never sought out or discussed a potential transaction with any companies other than Freeport. On December 5, 2012, the parties executed the merger agreement and announced the deal. No third party emerged with a competing bid subsequent to the execution of the merger agreement.

B. Analysis

1. *CEO Led Negotiations Despite Conflict of Interest; No Special Committee Formed*

A special committee is a committee of independent and disinterested directors formed to act on matters that may involve a conflict of interest for a member (or members) of the board. Here, the court stated that the need for a special committee was obviated because seven out of the eight directors on Plains' board were independent and disinterested. The court noted that Plains' CEO was an appropriate person to negotiate the transaction given his knowledge of the company and that the CEO kept the board informed throughout negotiations and often sought pre-approval from the board to take specific actions. In addition, the CEO's conflict of interest with respect to his potential employment arrangement with Freeport was fully disclosed to the board and carefully reviewed and discussed in numerous board meetings.

2. *Target Company Agrees to Onerous Deal-Protection Provisions*

Although the board did not perform a pre-agreement market check, the court noted that Plains' board relied on sophisticated financial advisors and further noted that a post-agreement market check can be an effective way to ensure that the board is obtaining the best price for the shareholders so long as the board does not bind its hands by agreeing to the deal-protection provisions in the merger agreement. The court noted that the "fiduciary out" clause permitted Plains' board to respond to unsolicited bids that could be expected to lead to a superior proposal. The court also noted that the 3% termination fee was not unreasonable and that the "matching rights" provision would not have deterred a bidder intent on paying a materially higher price for the company. In sum, the court concluded that the deal-protection provisions included in the merger agreement were reasonable as they would not deter a serious alternative bidder.

3. *Failing to Negotiate a Collar*

The court noted that the decision whether to negotiate a collar to protect against stock price fluctuations during the deal fell within the business judgment of Plains' board. The court stated that even if in hindsight the decision to receive a combination of cash and stock was a "bad" one, it was not necessarily unreasonable at the time it was made.

II. ***Koehler v. NetSpend Holdings, Inc.***

In *NetSpend*, a shareholder of the target company sought a preliminary injunction to enjoin a proposed merger, alleging the target company's board acted unreasonably by (1) failing to perform a market check, (2) relying on what the court characterized as a "weak" fairness opinion, (3) agreeing to onerous deal-protection provisions in the merger agreement and (4) failing to waive the "Don't Ask, Don't Waive" standstill provisions that it had in place with other potential bidders. The Delaware Court of Chancery held that the sales process was unreasonable and that the board would likely fail at trial to satisfy its burden of proving that it acted reasonably; however, the court determined that a balance of the equities weighed in favor of allowing the stockholders to vote on the merger, so the court did not enjoin the transaction.

1. Background

NetSpendHoldings, Inc. ("NetSpend") was formed in 2004 and went public in 2010. In 2012, NetSpend's largest stockholder, JLL Partners and affiliated funds ("JLL"), informed NetSpend that it wanted to sell its interest in the company. NetSpend did not want JLL to sell its shares in the open market and sought to assist JLL in finding a buyer. NetSpend approached two separate private equity groups and executed confidentiality agreements with both that contained "Don't Ask, Don't Waive" standstill provision.

While in negotiations with the private equity funds for the sale of JLL's interest, NetSpend began negotiating a complete sale of the company with Total System Services, Inc. ("TSYS"). Throughout the negotiations, NetSpend's board insisted that it was not for sale and that it would not conduct a pre-agreement market check to seek out other bidders.

One of the two private equity firms eventually came forward with an offer of $12.00 per share for JLL's interest in NetSpend. TSYS then came forward with a proposal to conduct a tender offer for 100% of NetSpend at a price of $14.50 per share—NetSpend's stock had closed at $11.65 on the previous trading day. In response to the proposal, NetSpend maintained that it was not for sale but nevertheless engaged Bank of Americaas its financial advisor.

Bank of America prepared a fairness opinion in connection with the merger agreement. The opinion contained several common analyses, including a comparable-companies analysis, a comparable-transactions analysis, and a discounted cash flow analysis. The $16.00 per share price was within the range of the first two analyses; however, the discounted cash flow analysis produced a price range from $19.22 to $25.52.

Concerned that its *Revlon* duties had been triggered, NetSpend's board contacted a strategic bidder with which it had discussions about a potential transaction before its public offering to notify the bidder that it was considering a change-of-control transaction. NetSpend did not hear back from the potential bidder and accepted the non-response as a lack of interest in the company. NetSpend did not pursue any other companies.

The merger agreement included the following key terms: a purchase price of $16.00 per share, a 3.9% termination fee, a "no-shop" clause with a fiduciary out, matching rights, and a restriction on NetSpend's ability to waive any existing standstill provisions. Following the announcement of the merger, the private equity firm that offered $12.00 per share congratulated NetSpend on obtaining a purchase price of $16.00 per share.

2. Analysis

a. *Failure to Shop the Company or Conduct and Pre- or Post-Agreement Market Check*

The court noted that although a pre-agreement market check can be useful in ensuring that the board has secured the best price available for the stockholders, such pre-agreement market check is not necessary under all circumstances. Here, the court noted thatthe board was knowledgeable in dealing with potential bidders and understood the financial side of the deal given its experience in seeking out strategic buyers before the company went public. The court did note, however, that the absence of a broad pre-agreement market check placed the board's other decisions under greater scrutiny. The court also highlighted that the board intended to move quickly to closing and that there would be an insufficient amount of time to conduct a post-agreement market check.

b. *Reliance on a Weak Fairness Opinion*

In examining the fairness opinion, the court highlighted the following deficiencies: the companies that were included in the comparable-companies analysis were not at all comparable to NetSpend, the comparable-transactions analysis relied entirely on pre-financial crisis transactions, and the discounted cash flow analysis indicated that the $16.00 per share purchase price was grossly inadequate. The court noted that the weak fairness opinion was "a poor substitute for a market check."

c. *Agreeing to Onerous Deal-Protection Provisions in the Merger Agreement*

The plaintiff conceded that courts have held the deal-protection provisions contained in the merger agreement permissible in other merger contexts. The plaintiff argued, however, that given the facts and circumstances of this transaction, the total package of deal-protection provisions was inappropriate. In its review, the court upheld some provisions while rejecting others as unreasonable.

The court held that the "matching rights" provision and the 3.9% termination fee were reasonable as neither would deter a serious bidder offering a materially superior price and that the termination fee fell within the range of fees held reasonable in the past. The court held the board's decision to agree to a "no-shop" was unreasonable given its failure to conduct a pre-agreement market check and the short duration of the pre-closing period.

d. *"Don't Ask, Don't Waive" Standstill Provisions*

The court came down most heavily on the board's use of the "Don't Ask, Don't Waive" standstill provisions in the confidentiality agreements with the two private equity groups and the provision in the merger agreement that prevented NetSpend from waiving the standstills with the private equity groups.

Although the private equity firms were barred from requesting a waiver of the standstill provision, NetSpend had the ability to unilaterally waive the standstill provisions up until the point at which it executed the merger agreement as the merger agreement contained a provision stating that NetSpend would not alter, amend, or waive any standstill provisions that it then had in place. The court noted that when NetSpend entered into the standstill provisions with the private equity firms, the original goal was to assist JLL in the sale of its interest and not the entire company. The court held that once the board determined that it was likely that TSYS would acquire NetSpend, the board's *Revlon* duties applied and that the board had blinded itself to any potential interest from the private equity firms by not waiving those provisions. The court found this process to be unreasonable even if the likelihood that either private equity firm would come forward with an offer was small.

III. Conclusion

The Delaware Court of Chancery's decisions in *Plains* and *NetSpend* reiterate its long-standing view that there is no set blueprint for how directors must conduct themselves to satisfy their *Revlon* duties. Directors should be mindful of their responsibility to be adequately informed and act reasonably in obtaining the best value for the company's stockholders in a change-of-control transaction as their conduct is subject to enhanced scrutiny by the courts.

Paul E. Pakidis *is an associate at Hill Ward Henderson in Tampa, Florida and can be reached at (813) 222-3195 or ppakidis@hwhlaw.com.*

This article was submitted on behalf of the Directors & Officers SLG for the DRI Professional Liability Committee.

Chair, John C. Minett, Endurance Services Ltd., New York, New York

Vice Chair, Joshua C. Webb, Hill Ward Henderson, Tampa, Florida

http://portal.criticalimpact.com/newsletter/newslettercontentshow1.cfm?contentid=15679&id=1881