# BUSINESS LAW UPDATE

***A Publication of the Los Angeles County Bar Association Business & Corporations Law Section***
***Spring 2007***


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comply with these obligations.[1] Contracts waiving compliance with the Securities Act and the Exchange Act are void.[2] The California Corporation Code similarly provides that a purchaser cannot waive compliance with the provisions of the California securities law.[3] In adverse circumstances, investors may seek, among other remedies, rescission of contracts with pooled investment funds for failure to comply with the federal securities laws.[4]

## PRIVATE EQUITY BUYERS BEWARE? DELAWARE COURT ISSUES WARNING ON AUCTION PROCESS


**By David Grinberg**
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A well-settled principle of Delaware corporate law is that Delaware courts generally will not "second guess" the substantive merits of the actions of a board

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[1] See *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 Business Lawyer 959, at 959, 971-2 (May 2005) (Briefly stated, federal law and the law of every state prohibit a person from being engaged in the business of effecting transactions in securities, unless such person is licensed as provided by applicable laws. ... Unregistered broker-dealers can taint an offering by creating the basis for rescission rights, raise enforcement concerns, make fraudulent representations and engage in general solicitation).

[2] Section 14 of the Securities Act provides that any "condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void." Section 29 of the Exchange Act has a similar provision but adds that any waiver of compliance with "any rule of an exchange" shall be void.

[3] California Corporations Code Section 25701 provides that any "condition, stipulation or provision purporting to bind any person acquiring any security to waive compliance with any provision of this law or any rule or order hereunder is void." A California purchaser's agreement that his purchase of a limited partnership would occur in Colorado would be an agreement to waive compliance with the provisions of the law and therefore void under Section 25701. *Eisenbaum v. Western Energy Resources*, 218 Cal.App.3d 314 (1990).

[4] See, for example, *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.) (reversing trial court's dismissal of suit by investors to rescind agreements and recover investments in a real estate joint venture on grounds that joint venture interests were not "securities"), *cert. denied*, 457 U.S. 897 (1981); and *Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*, 752 F.2d 178 (5th Cir. 1985) (equitable defenses to rescission may not be asserted by unregistered broker with unclean hands).

of directors. This principle, commonly known as the business judgment rule, establishes a presumption that board members, in fulfilling their duties of care and loyalty, act on an informed basis, in good faith and in the honest belief that actions taken are in the best interests of the corporation and its shareholders. As a result, under "normal" circumstances, if a board's actions are challenged, the Delaware court will be hesitant to substitute its judgment for the board's judgment. The rationale for the business judgment rule is an acknowledgement by the law that directors, and not judges, are in the best position to evaluate the business and financial merits of a business decision.

However, in the context of a sale of a corporation, a Delaware court will apply an enhanced level of judicial scrutiny sometimes referred to as the "*Revlon* duty,"[1] which states that where a Delaware corporation is engaging in a "sale of control," the corporation's directors have a duty to obtain the best transaction reasonably available for shareholders and to undertake reasonable efforts to secure the highest price realistically obtainable in the market. Delaware courts recognize that there are a variety of approaches that could constitute "reasonable efforts" and therefore have held that "there is no single blueprint that a board must follow in order to satisfy its *Revlon* duties"[2] when it comes to such matters as how many potential buyers to approach, how long a process should last, whether a full-blown auction should be conducted and other structuring issues. In fact, to meet their fiduciary responsibilities, boards of directors have frequently relied on covenants that permit them to respond to unsolicited proposals post-execution of an agreement that could reasonably be expected to lead to a superior proposal and a "fiduciary out" that allows them to terminate the original agreement to accept such proposal, if it indeed is superior.

Against this backdrop of Delaware corporate law, Bessemer Venture Partners and Insight Venture Partners agreed in November 2006 to acquire Netsmart Technologies, a Nasdaq-listed enterprise software company, for $115 million, or $16.50 per share. Not long thereafter, as is often the case in a going-private transaction, Netsmart shareholders sought a preliminary injunction against the closing of the merger, claiming that the sale process undertaken by the Netsmart board of directors was flawed because Netsmart's financial advisor, William Blair & Co., had focused almost exclusively on finding a private equity buyer and had failed to contact and solicit interest from potential strategic buyers. The plaintiff shareholders argued that strategic buyers were excluded from the sale process as a result of Netsmart management's strong preference to only close a transaction in which they would continue as corporate officers and retain an equity stake on a going-forward basis. Private equity buyers presented such an opportunity, while a transaction with a strategic buyer could potentially result in the dismissal of the incumbent management team.

The plaintiffs also argued that Netsmart's proxy statement omitted vital information relating to Netsmart's financial prospects as a stand-alone company, including management's estimate and projection of the company's future cash flows that were used by the financial advisor to perform the discounted cash flow analysis supporting the fairness opinion.

Netsmart's directors put forth several unpersuasive arguments in response to the plaintiffs' allegations. First, they contended that they had acted within the bounds of discretion afforded them by Delaware law in connection with their responsibility and duty to decide on the method that would generate the highest value for their shareholders. The directors believed that

[1] *Revlon Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173 (Del. 1986).

[2] *Barkam v. Amsted Industries, Inc.*, 567 A.2d 1279, 1286 (Del. 1989).

they had "pursued a course that balanced the benefits of a discrete market canvas involving a select group of private equity buyers (e.g. greater confidentiality and the ability to move quickly) against the risks (e.g. missing out on bids from strategic buyers)." Second, the directors maintained that they had negotiated for relatively "light" deal protection provisions in order to facilitate a post-signing market check and that the failure of a more lucrative bid to emerge in three months since the transaction's public announcement confirmed that the original transaction was the highest and best for the shareholders. These "light" protective provisions included a break-up fee of 3%, a "window shop" provision that allowed the board to entertain unsolicited bids and a "fiduciary out" clause that allowed the board to recommend against pursuing the transaction if a superior offer surfaced. Finally, in relation to the plaintiffs' contention that the proxy disclosure had been deficient, the directors stated that they had disclosed the nature and existence of the "reliable" estimates.

In ordering that Netsmart delay its April 5 shareholder vote on the transaction until the Netsmart board supplemented the disclosure in the proxy statement regarding the sale process and the financial projections, Judge Leo Strine Jr. of the Delaware Chancery Court stated that the Netsmart board's "failure to engage in any logical efforts to examine the universe of possible strategic buyers and to identify a select group for targeted sales overtures was unreasonable and a breach of their . . . duties."

Emphasizing that the "no single blueprint" principle is a two-way street, the court directly confronted and refuted the directors' contention that a post-signing market check should be acceptable because it was a technique that had been accepted in prior cases. In other words, the flexibility and latitude that a board is given in satisfying its *Revlon* duty also imposes on the board an obligation to carefully select a technique and method appropriate to the specific circumstances and market dynamics facing an individual company at the time the board considers a sale. However, the mere fact that a certain sale methodology, such as the post-signing market check, is commonly used by other boards of directors in different market circumstances, and has been approved by courts, does not necessarily mean that such methodology will be considered reasonable in situations that involve dissimilar market dynamics and circumstances. The court emphasized that Netsmart's status as a micro-cap public company, and the resulting difficulty such status had on its ability to attract market attention, had the effect of rendering a post-signing market check unreliable as a method for surveying the interest of potential strategic buyers.

The court's opinion also exhibited skepticism that a strategic buyer would actually invest the resources necessary to make a hostile topping bid to acquire a micro-cap company with a value similar to that of Netsmart's, because the costs associated with a hostile bid greatly outweighed the benefits. The court differentiated Netsmart's situation from the large-cap arena where active deal-jumping is more typical, thereby enhancing the potential that the post-signing market check would be a proper technique with which a board could satisfy its *Revlon* duty. In fact, the court rejected the post-agreement market check as a viable method for maximizing value for a micro-cap company, noting that it has "little basis in an actual consideration of the M&A market dynamics relevant to the situation Netsmart faced" and would not have attracted topping bids "in the same manner it has worked . . . in large-cap strategic deals." As a result, the court noted that in the case of the sale of Netsmart, the board should have been more proactive, because the "potential utility of a sophisticated and targeted sales effort seems especially high"[3] in contrast to the more reactive "window-shop" market check that simply permitted the company to consider unsolicited topping bids.

The court also expressed skepticism that the current market trend in which private equity buyers seem to be outbidding strategic buyers could be used as a justification and/or excuse for the lack of surveying the realm of potential strategic buyers. In fact, in the case of Netsmart, a strategic buyer might well have been able to pay a higher price given the company's size and the potential synergies available to strategic buyers.

In determining that the proxy disclosure was inadequate, Judge Strine concluded that "Netsmart shareholders would obviously find it important to know what management and the company's financial advisor's best estimate of Netsmart's future cash flows would be" when deciding whether to accept cash now in exchange for an interest in those future cash flows. The court stressed that such disclosure seemed especially material to a shareholder's decision, given the fact that the company's key executives sought to remain as executives and would receive options in the company after the transaction.

The lasting effects of the *Netsmart* decision are still to be seen, especially on the ways that private equity buyers tempt management to support their proposed transactions. Most M&A practitioners do not believe that the *Netsmart* decision is an early indicator that the Delaware courts will start to erode the expansive leeway, or "no single blueprint" principle, given to boards in structuring and directing a company's sale process or that there will be an altering or modifying of the premise that structuring the appropriate method for the sale of a company is a board decision. In addition, it is doubtful that the *Netsmart* case should be interpreted as establishing a rule that all auctions and sale processes must include strategic buyers. In part, this is because of the extent to which the court's opinion stems from the fact that Netsmart was a micro-cap company. It remains to be seen whether the court's reasoning is limited to the particular fact pattern presented by Netsmart's stature as a small micro-cap company or whether it may be extended to other, larger transactions.

Nevertheless, the decision is another in a long line of Delaware cases that serve as a reminder that the Delaware judiciary will vigorously dissect and analyze the process undertaken by a board of directors in the sale of a company. Notwithstanding the "no single blueprint" mantra espoused by the Delaware courts, it is becoming increasingly apparent that the Delaware

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[3] In its opinion, the court suggested that Netsmart and its financial advisor could have taken the following steps: (1) assembled materials explaining the business and its attractive growth potential (2) tailored the materials for a few logical strategic buyers and (3) secured the attention, through William Blair's healthcare reputation, of certain key executives of the targeted strategic buyers.

courts will not rely on this principle to permit a board to utilize sale techniques and structures when the specific facts and circumstances inherent to a particular company cannot reasonably support the use of such techniques and structures, even if such techniques and structures have been sanctioned in other scenarios.

Boards should be very aware that each sale process is unique and depends upon an individual company's specific situation and state of affairs; robotically imitating past techniques is not acceptable when trying to maximize shareholder value. In other words, a board of directors should not buy a sale process "off the rack," but rather should have it "custom-made" to the particular characteristics of its company. A board should question its financial advisor about how the list of potential buyers was established, the reasons for inclusion and exclusion of certain buyers, and the basis for determining the sale options available to the company. In addition, a board should ask its legal advisors to explain how and why the specific deal protection mechanisms were chosen in light of the company's particular situation.

The court's critique of the board's lack of supervision of management during the due diligence process will undoubtedly have longer lasting effects. In situations where management has an incentive to favor a particular bidder or type of bidder, such as a going-private transaction where management may be asked to stay with the company post-closing and will receive equity and/or other incentives, management could use the diligence process to attempt to steer the company to that bidder. In these situations, the board must recognize that management's interests do not necessarily align with those of the other shareholders and procedures should be implemented to ensure that all potential bidders have an opportunity to conduct diligence. In addition, the court expressed its displeasure with the lack of minutes for board meetings relating to the sale. Furthermore, stating that the "omnibus consideration of meeting minutes is, to state the obvious, not confidence-inspiring," the court exhibited its discontent with the simultaneous approval of all of the existing board meeting minutes pertaining to the sale process.

Ultimately, though, the most important aspect of the *Netsmart* case may be that it serves as a stern reminder that the Delaware courts will continue to closely investigate both the process a board of directors undertakes when contemplating and reviewing a sale of the company and its eventual decision to approve a sale transaction, especially a sale where management interests seem to somewhat conflict with those of other shareholders. As a result, boards should make certain that the record of its decision-making process clearly articulates the reasons why it embarked on a particular approach to selling the company. This approach by Delaware reduces the helpfulness of precedent in structuring deals, and favors custom-tailored deal structures.

## HEIGHTENED SCRUTINY OF STOCK OPTION GRANT PRACTICES

**By Linda DeMelis**
**Heller Ehrman LLP**

During the past few years, the SEC has opened a number of investigations into the stock option grant practices of public reporting companies. The number of investigations significantly increased in 2006, after a series of articles in *The Wall Street Journal* and elsewhere indicated that the stock option exercise prices of executive grants were systematically lower than might be expected from randomly-selected dates. Many of the SEC investigations have resulted in claims that stock option grants were "backdated", given a purported grant date earlier than the actual grant date, in order to get a more favorable exercise price. Other practices the SEC is believed to be investigating in some cases include "spring-loading" (accelerating option grants to occur just before the release of favorable company news expected to drive up the price of the stock) and "bullet-dodging" (delaying option grants to occur just after the release of unfavorable news that is likely to depress the stock price). As of April 2007, there have been federal investigations at more than 140 companies, at least 70 top executives have lost their jobs and 10 former executives are facing federal or state criminal charges.[1] The options backdating scandal has also engendered more than 140 shareholder derivative lawsuits.[2]

Two recent Delaware Chancery Court decisions, both written by Chancellor Chandler and both released on the same day in February, have important implications for investigations and lawsuits concerning stock option grant practices. One of the two cases discussed below, the *Tyson* decision, is particularly important for potential cases based on allegations of "spring-loading."

In *Ryan v. Gifford* (C.A. 2213-N, Feb. 6, 2007), the court refused to dismiss a shareholder derivative suit that claimed that the board of directors of Maxim Integrated Products, Inc. had violated its fiduciary duties by intentionally backdating stock option grants. The backdated option grants had an exercise price lower than the fair market value on the actual grant date. Those grants are alleged to have violated the company's stock plan, which did not permit the issuance of discounted options. The court noted that the intentional violation of the company's stock plan, coupled with fraudulent disclosure about purported compliance with that plan, would constitute an act in bad faith. The court observed: "Backdating options qualifies as one of those 'rare cases (in which) a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.'"

In *In Re Tyson Foods, Inc. Shareholder Litigation* (C.A. 1106-N, Feb. 6, 2007), the court refused to dismiss a shareholder derivative suit that claimed, among other things, that the board of directors had violated its fiduciary duties by granting options to executives at a time when the board knew that material, positive information about the company had not been disclosed. The shareholders cited several instances in which the board had made significant option grants to senior executives a few days prior to the release of favorable information about merger transactions, or better-than-expected earnings. The court indicated that the practice of granting options just prior to the release of positive information, also known as "spring-loading," might implicate a director's duty of loyalty. Specifically, the court noted that a director who authorized option grants at a time when the director knew that the underlying shares were worth more than the market price might be deemed to have acted in "bad faith."

These decisions have important implications for pending actions concerning stock option grant practices.

Up until now, much of the litigation involving stock option backdating has focused on incorrect disclosure about the transaction, and not on the transaction itself. SEC complaints have alleged violations of the disclosure rules (for not reporting the correct option grant date), violations of tax and accounting rules (for failing to use proper accounting methods for "discount" grants), and falsification of corporate records, such as board minutes and employee offer

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[1] Emily Steele, "*Wall Street Journal* Wins Pair of Pulitzers," *The Wall Street Journal*, April 17, 2007.

[2] Kevin LaCroix, "Dismissal Denied in Delaware Chancery Options Backdating Lawsuits," *The D&O Diary*, February 7, 2007. http://dandodiary.blogspot.com/2007/02/dismissal-denied-in-delaware-chancery.html.

letters. These two Delaware decisions, issued by a court in a state influential for corporate governance matters, may help establish an important basis for potential liability for breach of a director's fiduciary duties. Of particular note is the court's observation in *Ryan* that issuing options in contravention of option plan terms might be a *per se* violation of a director's fiduciary duty.

The *Tyson* decision also deals directly with the practice of spring-loading, an issue that has not been addressed to date in the SEC actions. The court acknowledged that the practice did not directly violate the terms of the option plan, but observed, "(g)ranting spring-loaded options, without explicit authorization from the shareholders, clearly involves an indirect deception" which might be the basis for a breach of fiduciary duty claim. Although the facts of the case did not involve the practice known as "bullet-dodging," the court several times referred to "spring-loading or bullet-dodging" in discussing potential breaches of a director's fiduciary obligations. This language suggests that the court would apply a *Tyson*-type analysis to companies that delayed option grants in light of unfavorable news.

Certain procedural portions of the decision are also worth noting. In *Ryan*, the court denied the defendants' request to stay the case, despite the fact that nearly identical cases had been filed earlier in federal and state courts in California. This result exposes the company and the defendants to the burdens of duplicative lawsuits. The court also denied a motion to dismiss based on a failure to make a pre-suit demand on the board, holding that a board's knowing and intentional decision to exceed the limits of a shareholder-approved plan raises doubt regarding whether the decision was a valid exercise of business judgment, and was sufficient to excuse a failure to make the required demand. In both *Tyson* and *Ryan*, the court denied motions to dismiss based on the statute of limitations, holding that, when a plaintiff has alleged intentional falsification of public disclosures, the statute of limitations would not begin to run until the falseness of the filing had been revealed. These aspects of the decision may influence courts handling stock option cases across the country.

Both of these cases are still at a relatively early stage. If the cases proceed to trial, the plaintiffs will still need to prove that the directors did, in fact, act with the requisite knowledge and intent to constitute bad faith.

Nevertheless, these decisions are an important reminder that stock option grant practices are now the subject of heightened scrutiny by the courts. Companies should review their stock option grant policies to ensure that their procedures remain consistent with evolving best practices standards.

## In Memoriam

David Morgan recently passed away. David was a former chair of the Executive Committee of the Business & Corporations Law Section and a recipient of the Section's Marvin Greene award. Those of us who have been on the Committee for a few years will remember David with fondness and note his passing with sorrow.

# UPCOMING SECTION EVENTS

For more information and registration for any of the events listed in this newsletter, log on to www.lacba.org and click on the Business & Corporations Law Section under "Sections —Practice Areas."

***For the most up-to-date program information, please visit our website at www.lacba.org***

**UPCOMING PROGRAMS SCHEDULE** (all details tentative and subject to change)

## Intercreditor Agreements

*Co-Sponsored by the Commercial Law & Bankruptcy Section*

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| May 17, 2007 | 1.5 hours CLE credit |
| Speakers: | **Jennifer Yount**, Paul Hastings Janofsky & Walker LLP |
| | **Steven O. Weise**, Heller Ehrman LLP |
| Program: | 12:00 p.m. — 1:30 p.m. |
| Location: | LACBA/LexisNexis Conference Center, 281 S. Figueroa St., Los Angeles |

## Employment Issues Affecting California Employers

*Co-Sponsored by the Labor & Employment Law Section*

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|---|---|
| June 14, 2007 | 1.5 hours CLE credit |
| Program: | 8:00 a.m. — 9:30 a.m. |
| Location: | TBD |

For questions about programs or program registration, send an e-mail to our Member Service Department: msd@lacba.org

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