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**Thoughts on Deal Protection in Light of Toys “R” Us**

In In re Toys “R” Us, Inc. Shareholder Litigation, Vice Chancellor Strine responds to a request that the Court “provide guidance to transactional lawyers” on the “acceptable level of deal protections” in Revlon transactions. 2005 WL 1587416 (Del. Ch. Jun. 22, 2005) at \*35. Practitioners looking for bright lines will not find them, but the Vice Chancellor’s approach to this question does provide some helpful insights when considered in the context of other Delaware precedents that do provide some bright lines.

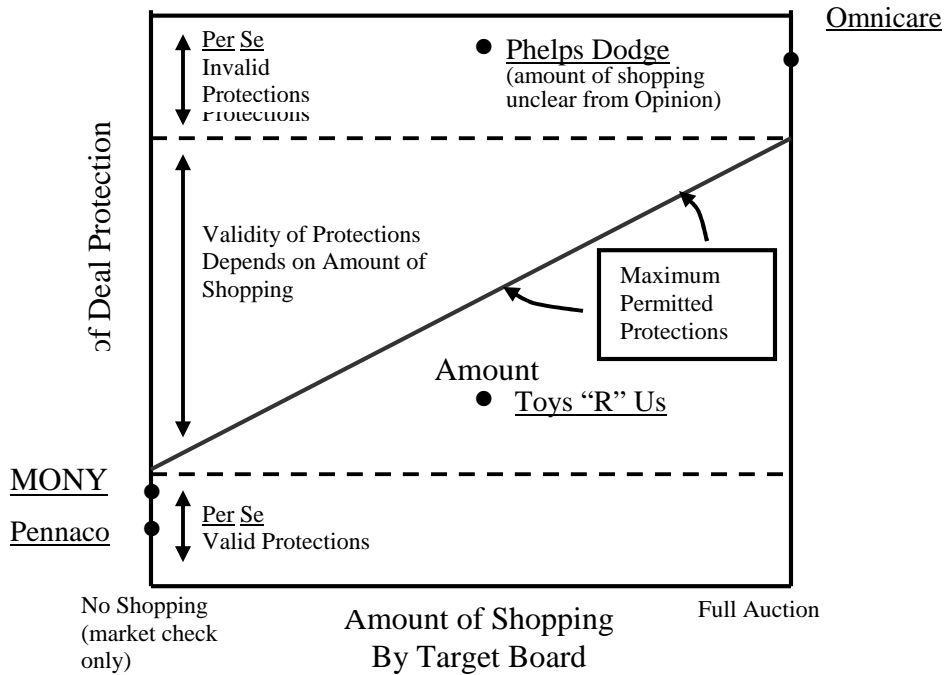
The Toys “R” Us opinion extends the “weak-deal-protection-can-substitute-for-shopping” premise that Vice Chancellor Strine first applied in In re Pennaco Energy, Inc. Shareholders Litigation, 787 A.2d 691 (Del. Ch. 2001), and which Vice Chancellor Lamb followed in In re the MONY Group Inc. Shareholder Litigation, 852 A.2d 9 (Del. Ch. 2004). Those cases held that, even where a target board focused on only one bidder, it satisfied its Revlon duties by limiting the deal protection and ensuring that the initial deal would not close for a period of time, thereby providing an effective post-signing market check. But, these cases hold, the target board can agree to some deal protection even in such a situation (a 3% equity value termination fee, a no-solicitation provision and matching rights in Pennaco, and a 3.3% equity value termination fee and a no-solicitation provision in MONY). Accordingly, the deal protection measures approved in Pennaco and MONY, where there had been no prior shopping, mark one end of the shopping spectrum and are, presumably, per se valid without regard to the degree of shopping so long as there remains a post-signing market check.

Omnicare, Inc. v. NCS Healthcare, Inc., is at the other end of the shopping spectrum. 818 A.2d 914 (Del. 2003). There, the Delaware Supreme Court suggested that, even in a fully shopped deal, there are limits to the level of deal protection permissible under Delaware law: the Court assumed that the board satisfied its fiduciary duties in shopping the company but nonetheless found the merger agreement per se invalid because controlling stockholders had irrevocably agreed to vote in favor of the agreement in advance of the stockholder meeting and the board did not reserve a right to terminate the agreement before that vote. In addition, after Phelps Dodge Corp. v. Cyprus Amax Minerals Co., most practitioners have regarded so-called no-talk provisions, which prevent a target board from having discussions with other bidders, as per se invalid because the Court in Phelps Dodge characterized such provisions as the “legal equivalent of willful blindness.” 1999 WL 1054255 (Del. Ch. Sep. 27, 1999) at \*2. But see, In re IXC Communications, Inc. Shareholders Litigation, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999) at \*6 (suggesting, in dicta, that such provisions are not per se invalid).

The Toys “R” Us sale falls in between a fully shopped (Omnicare-type) and an unshopped (Pennaco-type) transaction. The Vice Chancellor found that the Toys “R” Us board acted reasonably when, at the end of a lengthy auction to sell the company’s largest division, the board narrowed its focus to a few bidders in a final round of offers for the entire company. But, rather than basing his Revlon analysis on the reasonableness of the board’s shopping efforts, he suggested that, in such “in-between” cases, the Revlon inquiry must also focus on the deal

protection provisions in the agreement. More significantly, although he did not say so explicitly, his analysis suggests that there is a trade-off between shopping and deal protection for purposes of Revlon analysis: the more a deal is shopped, the greater the deal protection that will be permitted. In an “in-between” case, the Court will, he said, engage in a “nuanced” and “fact-intensive” inquiry to determine whether the target board “had a reasonable basis to accede to the other side’s demand [for deal protection] in negotiations.” Toys “R” Us, 2005 WL 1587416 at \*36. But the extent to which the target board will be permitted to accede to those demands will apparently be a function of the degree of prior shopping. (On the facts in Toys “R” Us, the Court concluded that a termination fee representing 3.75% of equity value and a matching right that the target board granted the winning bidder did not add significantly enough to the protections previously blessed in Pennaco and MONY to violate Revlon because the target board had conducted an extensive auction before entering into the agreement, even though it did not actively shop the entire company until the final stage of the sale.)

The graph below thus illustrates the current state of Delaware law, including Vice Chancellor Strine’s analysis of the trade-off between deal protection and shopping:



Based on Vice Chancellor Strine’s stated views on the relationship between Revlon and non-Revlon deals, he might well apply this type of analysis to non-Revlon deals as well – although this is an open question. See, e.g., Leo E. Strine, Jr., Categorical Confusion: Deal Protection Measures In Stock-For-Stock Merger Agreements, 56 BUS. LAW. 919 (May 2001).

Assuming Vice Chancellor Strine’s framework is adopted by the other Court of Chancery judges and by the Delaware Supreme Court, further case law will presumably answer the questions (1) whether the list of per se invalid provisions will expand or (as many have urged in the case of Omnicare) narrow, (2) whether the list of per se valid protections will expand and (3) how the Delaware courts will view the trade-off between shopping and deal protection in factual

contexts different from Toys “R” Us. As to (3), the graph illustrates that the area representing the permissible deal protection in the in-between case is currently a vast, open space in which Toys “R” Us is the only data point (and one that, from the tone of the opinion, the Vice Chancellor considered to be well within the boundary of permissible deal protection).

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