

Canadian Considerations of *In re Netsmart Technologies Inc.*

The statements made by Vice-Chancellor Leo Strine of the Delaware Chancery Court in the recent March 14, 2007 decision *In re Netsmart Technologies Inc.* may have important ramifications for those in Canada who advise public company boards, their financial advisors, and independent committees, in the context of "friendly" takeovers of small cap public companies.

Netsmart Technologies Inc., a leading supplier of enterprise software to behavioural health and human services organizations, was a micro-cap company whose shares were listed on NASDAQ.

Netsmart had entered into a merger agreement with two private equity firms that, if approved by Netsmart's shareholders, would result in Netsmart shareholders receiving U.S. \$16.50 per share, and Netsmart becoming private.

A group of plaintiffs sought to enjoin the merger, arguing that: (i) the merger agreement flowed from a poorly-motivated and tactically flawed sale process during which Netsmart had made no attempt to generate interest from strategic buyers; and (ii) the proxy statement failed to disclose all necessary material information by omitting important information regarding Netsmart's prospects. The plaintiffs argued, among other things, that management favoured a sale transaction to private equity buyers that would allow them to continue to be employed as executive officers, and to obtain an equity stake in the business going forward.

Vice Chancellor Strine granted an injunction pending the disclosure by Netsmart to its shareholders of "more complete and accurate information about the board's decision to rule out exploring the market for strategic buyer's and about the company's future expected cash flows". The required disclosure was made, and the shareholders of Netsmart voted to approve the merger on April 5, 2007.

While Vice Chancellor Strine goes on at some length about the failure of the Netsmart board to seek strategic buyers, and the influence of the CEO on the sale process, in the final analysis he refused to enjoin the sale on that basis and granted it on a temporary basis only, until the required financial and other information was distributed to shareholders. Accordingly, as a technical matter, Vice Chancellor Strine's comments about the issue of not seeking out strategic buyer interest may be viewed as obiter dictum, and not binding precedent.

Having said that, however, Vice Chancellor Strine is very well respected in the U.S. and his views carry a great deal of weight. He took the opportunity in this case to lay out at length his reasoning and his views. Although Delaware law and the decision of the Delaware Chancery Court is not binding on Canadian courts, we feel that it will likely be of persuasive value in Canada, and taken note of, in particular, by class action counsel in Canada.

Vice Chancellor Strine distinguished the "mega" public M&A transaction completed in the U.S., from the micro-cap public company, the latter of which is more frequently found in Canada. Advisors to Canadian boards and special committees should be mindful of this persuasive decision,

as it relates to the advisability of conducting an appropriate canvassing of all alternatives, including both financial as well as strategic buyers.

Without reviewing in any further detail the facts of the case, which are necessarily relevant, some observations can be made and certain guidance can be drawn:

1. Notwithstanding the current climate, where private equity firms are routinely outbidding strategic buyers in auctions for public companies, absent a very good reason, which should be carefully minuted, boards and financial advisors who are seeking to maximize shareholder value for a public company that is "in play" should not restrict their market canvas to a consideration of only private equity purchasers, but should consider conducting a "discreet, targeted, and controlled marketing effort directed towards select [potential] strategic buyers." The record should perhaps reflect that there was a "serious sifting of the strategic market to develop a core list of [industry-specific] players for whom an acquisition of [the target] might make sense."
2. Since strategic buyers generally fire all or most of the old management team in order to obtain synergies, whereas private equity buyers tend to retain management and offer them equity stakes as an incentive, boards of public companies should be particularly sensitive to the basis for there being a potential bias of management to favour a purchase by a financial purchaser, as opposed to a strategic purchaser.
3. In light of this potential for conflict between the interests of the shareholders and the interests of management, the board of a public corporation that is "in play" should establish a process that recognizes and manages this conflict. Normally, a Special Committee is constituted. The Special Committee in this case appears to have been constituted only after the strategic decision had effectively been made to restrict a market canvas to only financial purchasers.
4. The Special Committee should have the authority to take control of the sale process. While management's involvement is key to parts of the sale process, such as setting up the data room and data briefings, Vice Chancellor Strine stated that it was critical to make certain that special committees have "real teeth" and that they, and not management, are directing the sale and due diligence process.

In this case, Vice Chancellor Strine found that the Special Committee allowed the due diligence process to be driven by management. He states that: "In easily imagined circumstances, this approach to due diligence could be highly problematic. If management had any incentive to favour a particular bidder (or type of bidder), it could use the due diligence process to its advantage, by using different body language and verbal emphasis with different bidders. 'She's fine' can mean different things depending on how it is said."

5. The Special Committee negotiated for a customary "fiduciary out" and a relatively modest 3% break fee, by which means the Board enabled a post-signing, implicit market check. The public announcement of the merger agreement, without any higher bids emerging was

evidence, the Board argued, that these accepted techniques had fulfilled the Board's obligations to maximize shareholder value.

Mr. Justice Strine stated, however, that the problem with this argument was that "it depends on the rote application of an approach typical of large-cap deals in a micro-cap environment. The "no single blueprint" mantra is not a one way principle. The mere fact that a technique was used in different market circumstances by another board and approved by the court does not mean that it is reasonable in other circumstances that involve very different market dynamics."

In emphasizing that the reasonableness of a board's decision in the public M&A context depends on the circumstances, Mr. Justice Strine went on to state: "Precisely because of the various problems Netsmart's management identified as making it difficult for it to attract market attention as a micro-cap public company, an inert, implicit post-signing market check does not, on this record, suffice as a reliable way to survey interest by strategic players. Rather, to test the market for strategic buyers in a reliable fashion, one would expect a material effort at salesmanship to occur. To conclude that sales efforts are always unnecessary or meaningless would be almost un-American, given the sales oriented nature of our culture. In the case of a niche company like Netsmart, the potential utility of a sophisticated and targeted sales effort seems especially high."

Mr. Justice Strine stated that any potential strategic buyer would face a number of disincentives, starting with the high legal and financial costs of coming into the process so late. He stated that "It seems doubtful that a strategic buyer would put much energy behind trying a deal jump in circumstances where the cost-benefit calculus going in seems so unfavourable. Analogizing this situation to the active deal jumping market at the turn of the century, involving deal jumps by large strategic players of deals involving their direct competitors in consolidating industries is a long stretch."

6. Mr. Justice Strine, in declining to grant a temporary injunction, ordered Netsmart to disclose the financial projections underlying the discounted cash flow analysis used in reaching a fairness opinion. Mr. Justice Strine stated "When stockholders must vote on a transaction in which they would receive cash for their shares, information regarding the financial attractiveness of the deal is of particular importance. This is because these stockholders must measure the relative attractiveness of retaining their shares versus receiving a cash payment, a calculus heavily dependent on the stockholders' assessment of the company's future cash flows. . . . Faced with the question of whether to accept cash now in exchange for forsaking an interest in Netsmart's future cash flows, Netsmart stockholders would obviously find it important to know what management and the company's financial adviser's best estimate of those future cash flows would be. . . . It would therefore seem to be a genuinely foolish (and arguably unprincipled and unfair) inconsistency to hold that the best estimate of the company's future returns, as generated by management and the special committee's investment bank, need not be disclosed when stockholders are being advised to cash out. That is especially the case when most of the key managers seek to remain as executives and will

receive options in the company once it goes private. Indeed, projections of this sort are probably among the most highly-priced disclosures by investors. . . ."

7. In this case, the Special Committee was formed to oversee the sale and protect the interests of shareholders only after there was a de facto impetus to focus upon a rapid auction process involving only a discrete number of possible private equity buyers. The Special Committee worked very closely with management, allowing Netsmart's CEO to be part of its meetings, and also retaining the same investment bank that had been advising the company and which had had a historically close relationship with management. Independent legal counsel to the Special Committee seemed to have been retained quite late in the process. Minuting of meetings was sometimes absent entirely.

What is clear from this case, and applicable to Canadian public M&A practice, is that there is no one blueprint or manual to follow, each transaction and process must be tailored to the specific facts and circumstances. It is not enough to simply follow the precedent of prior deals (particularly U.S. large cap, "mega deals"), such as ensuring that a break fee is in "the normal range", that a fairness opinion is delivered, that a Special Committee is appointed and that independent counsel is selected. The underlying dynamics of the transaction, while generally familiar and often similar, are also always unique, and require creativity and judgement, and a clear appreciation of directors' duties.

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