
CASE LAW / DELAWARE

Toys “R” Us Sale Process Meets With Court Approval

The Delaware Court of Chancery has declined to second-guess a sale process conducted by a diligent and well-informed board, including high break fees it found reasonable under the circumstances.

The ruling by Vice Chancellor Strine denied a motion by unhappy shareholders of Toys “R” Us, Inc. (“Toys” or “the Company”) for a preliminary injunction that would have halted a \$6.6 billion deal to sell the Company to a private equity investor “club” that includes Kohlberg Kravis Roberts & Co., Bain Capital Partners and Vornado Realty Trust (collectively, “KBV”).

The process that the Toys board had followed in seeking potential purchasers was one of the main points of contention. The Company’s investment bankers, CSFB, had initially contacted 29 potential buyers. Upon reviewing the resulting preliminary bids, the Board concluded that shareholder value would be maximized if the Company sold its toy store division (“Global Toys”) but kept the much smaller “Babies ‘R’ Us”. After considerable due diligence, the field of bidders was narrowed to four: KKR alone, Bain and Vornado together, and groups led by Apollo and Cerberus. Although the bids were supposed to be for Global Toys alone, Cerberus jumped in, late in the game, with a bid for the whole Company. The Toys board suddenly found itself in a difficult position: how to pursue the possibility of selling the whole Company without risking the loss of some promising bids for Global Toys alone.

Determining that time was of the essence, the board decided to ask the existing bidders to bid on the whole Company, with a tight eight-day deadline. This decision was influenced by earlier due diligence that had suggested that the universe of potential buyers for the whole Company was small—an understanding that seemed to have been confirmed (in Strine VC’s view) by the absence of any new inquiries when *The Wall Street Journal* reported that the whole of Toys “R” Us was in play. In the end, KKR teamed up with Bain and Vornado to make a \$6.6 billion bid for the whole Company. At \$26.75 per share this was a full \$1.50 above Cerberus’ final bid and at or beyond the top end of the valuation ranges that the board had received for the Company. The board decided to accept the bid, including a 3.75% break fee that was somewhat higher than the current standard, a “no shop” provision, a provision that the board could entertain a superior proposal provided that it was for at least 50% of the Company, and a right to match any competing offer.

The case raised important questions relating, among other things, to the board’s possible breach of its *Revlon* duty to maximize shareholder return and with respect to the “deal protection” provisions. In a forthright and entertaining opinion Strine VC makes a number of important points, while dismissing every argument the plaintiff shareholders raised:

- The Delaware courts will not invoke *Revlon* to undermine a reasonable sale process executed in good faith by a well-informed board. Throughout his ruling, Strine VC emphasized the “real world” realities of the board’s situation and the lengths to which it had gone to decide what was best for the shareholders. He rejected the plaintiffs’ main complaint—that offers for the whole Company had been solicited from four potential bidders only—in light of the circumstances in which the directors had found themselves. They had acted reasonably to protect the existing bids while seeking new ones.
- There is no “bright line” test for break fees. A high fee was acceptable in this case because the board had concluded, after much due diligence, that the KBV offer was a good one, hundreds of millions better than Cerberus’, and thus unlikely to be significantly bettered. Strine VC noted that the 3.75% fee would

economically inhibit only those potential bidders who might have planned to top the KBV offer by 20 cents or less. To jeopardize a bid that had topped all others by \$1.50 in order to preserve the faint hope that another 10 or 20 cents might materialize from some unknown quarter would not have been reasonable. Strine VC observed that the purpose of *Revlon* is to “ensure the fidelity of fiduciaries”, not to attempt to push bids right up to, or beyond, the upper bound of economic rationality, adding: “For society as a whole, there are real economic and social costs to the acquisition of healthy, profitable companies at an excessive price. Creditors, consumers, workers, and communities can suffer when that happens.”

- The plaintiffs argued that the “no shop” provision—which allowed consideration of superior offers only where they were for 50% or more of the Company—constituted a violation of the board’s duties in virtue of the fact that it precluded bids for Babies “R” Us alone. Strine VC declared that this argument failed the “straight face test”, since there was no evidence that a standalone “Babies” was of any interest to anyone.
- Some U.S. commentators have noted that Strine VC appears to endorse the use of enterprise value (basically being the market capitalization plus long-term debt less cash and investments) as an alternative basis for the calculation of break fees in certain circumstances (although not in this particular case). As this would be a marked departure from the current understanding of Delaware law, making it simpler to negotiate deal protection for highly leveraged targets, it will be interesting to see whether subsequent practice, or subsequent decisions, pick up on the remarks made here by Strine VC.
- Strine VC found nothing wrong with the board’s decision to permit KKR and the Bain-Vornado team from forming a private equity club part way through the process. He dismissed the plaintiffs’ claim that this amounted to “collusion”, calling this “a naked attempt to use inflammatory words to mask a weak argument” and noting that it made more sense to suppose that there would have been no bid at all in the absence of the club.
- A final point is the tone of the decision, which is notably unsympathetic to recent calls to step up the judicial scrutiny of board decision making. That trend is exemplified by the 2002 *Omnicare* decision, which purported to clamp down on deal protection mechanisms. According to Strine VC, *Omnicare* was “an aberrational departure from [the] long accepted principle” that the court must look at board decisions primarily from the point of view of the directors at the time. Strine VC also repeatedly makes rather sarcastic remarks about the plaintiffs, whom he clearly regards as opportunists, noting (for instance) that they had “hedged their bets” by selling a large number of shares for less than the price offered by KBV and that they had somewhat hypocritically demanded that KBV be required to maintain its offer during the period in which, if this motion had succeeded, the board would have had to look around for more bids.

In re Toys “R” Us, Inc. Shareholder Litigation, 2005 WL 1587416 (Del. Ch.), June 22, 2005

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