The M&A LAWYER

July/August 2007 ■ Volume 11 ■ No. 7

Go-Shops Follow-Up: Lear & Topps Decisions Hone Delaware Courts' View

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Over the last two years, go-shop provisions have appeared with increasing frequency in definitive acquisition agreements. A go-shop provision enables a target board to lock up a deal on price and contract terms and then shop the deal for a finite period of time in an effort to secure either a superior deal or confirm that the board has obtained the best price possible for the shareholders. Target boards are relying on these provisions, in part to satisfy their duty under *Revlon v. MacAndrews & Forbes Holdings, Inc.* to conduct a sale process that is reasonably designed to maximize price.[1]

In an article that appeared in last month's edition of *The M&A Lawyer*,[2] we analyzed the use of go-shops and observed that the Delaware courts had not yet examined any of the recent transactions in which target boards had used go-shop provisions to satisfy their *Revlon* duty. That has now changed. In June, Vice Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery issued opinions in two cases where go-shops featured prominently: *In re: Lear Corporation Shareholder Litigation*[3] and *In re: Topps Company Shareholder Litigation*.[4] These decisions indicate that a target board may rely in part on the post-signing market check contemplated by a go-shop provision to satisfy its *Revlon* duty. The decisions also suggest, however, that the courts will carefully scrutinize the decision to use a go-shop in light of all of the facts and circumstances. They will insist that the target board have a reasonable basis for its decision to rely on this approach, and that the target board deal appropriately with any bidders who emerge in the post-signing process.

Moreover, in each of *Lear* and *Topps* the Chancery Court examined the target's proxy statement disclosures regarding the target board's sales process, its interaction with bidders, management's potential conflicts and issues of valuation. In finding that deficient disclosure of these issues warranted the granting of preliminary injunctions, the Court sends a strong signal to targets of its willingness to examine thoroughly the details of the transaction process and to delay transactions when disclosure comes up short.

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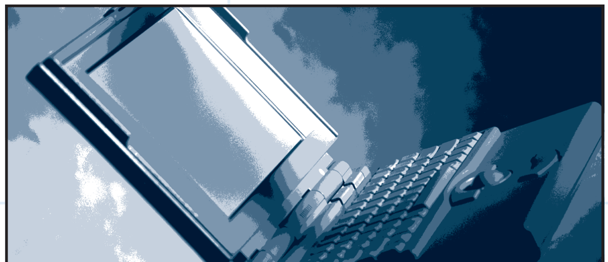

The M&A Lawyer
West Legalworks
395 Hudson Street, 6th Floor
New York, NY 10014

One Year Subscription ■ 10 Issues ■ $444.00
(ISSN#: 1093-3255)

Please address all editorial, subscription, and other correspondence to the publishers at west.legalworksregistration@thomson.com

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The Story of Lear and its Sales Process

Over the course of 2005 and 2006, investor Carl Icahn acquired a significant equity stake in automotive systems supplier Lear. In January 2007, Icahn met with several members of Lear's senior management, including the CEO, and broached the idea of a going-private transaction. Over the following week, the parties discussed this possibility and Icahn expressed his interest in retaining management and his disinclination to proceeding with a hostile bid. After a week of discussions, the CEO informed the board of Icahn's interest and the existence of discussions.

The board formed a Special Committee to expedite responses to deal-related issues and tasked the CEO with leading the negotiations with Icahn. The Special Committee did not perceive the CEO to be conflicted in this role and as a result did not participate directly in the discussions. As Vice Chancellor Strine emphasized, however, shortly before Icahn broached the idea of a going-private transaction, the CEO had expressed to the board his desire to alter his employment arrangements to allow him to cash in his retirement benefits while continuing to manage Lear. The CEO had been with Lear for 35 years and a significant amount of his assets were locked-up in retirement accounts that could not be accessed until retirement and in Lear stock that could not easily be liquidated because of trading blackouts and the negative market response likely to result from the CEO of a troubled business liquidating his equity position. Given Lear's recent history, the CEO was particularly concerned with the possibility that if Lear were to enter bankruptcy he would be treated as an unsecured creditor with respect to his retirement accounts. The CEO and the board decided not to adjust the arrangements because of their fear of a negative investor response. Thus, when discussions with Icahn began, the CEO's problem had not been resolved.

Icahn made an opening bid of $35 per share. The CEO persuaded him to increase his bid from $35 per share to $36 per share, after which he refused to go any higher. During the negotiations, Icahn vowed to withdraw his offer if Lear decided to conduct a pre-signing auction, and that if the auction failed he would return to make a new offer at a much lower level. In lieu of a pre-signing auction, though, Icahn indicated that he would accept a go-shop arrangement under which the board could actively attempt to sell the company after signing a definitive agreement. Lear's financial adviser conducted a limited pre-signing market canvass which did not result in any indications of interest. The contacts included private equity group Cerberus, which had expressed an interest in acquiring the company in 2006, when the stock was trading at much lower levels.

The target board feared that if it did not acquiesce, it would lose Icahn's $36 per share bid. It also believed that a pre-signing auction would be very disruptive, and might not produce an alternative bid. It therefore decided to accept Icahn's offer and enter into a definitive agreement that contained a go-shop provision. The go-shop was fairly typical, providing for a 45-day shopping period, and a fiduciary out that gave the board the right to consider unsolicited proposals after the 45-day period expired. It established a two-tiered termination fee structure, under which a lower fee would be payable if Lear entered into an alternative transaction during the shopping period. The provision gave Icahn the right to match alternative proposals. During the go-shop period, Lear contacted 24 financial buyers and 17 strategic buyers, but did not receive any preliminary indications of interest.

Plaintiffs' *Revlon* Claim

The plaintiffs sought to preliminarily enjoin the consummation of the acquisition by Icahn, alleging, in part, that the Special Committee failed to satisfy its *Revlon* duty because it (1) improperly delegated to the CEO the task of negotiating the acquisition and (2) failed to conduct a sales process reasonably designed to obtain the highest price. Vice Chancellor Strine rejected both of these claims and refused to grant a preliminary injunction on these grounds.

With respect to the first claim, the plaintiffs argued that the CEO was incapable of taking the actions necessary to reasonably obtain the best price for the Lear shareholders because he had conflicts of interest that might cause him to favor a deal with Icahn over potentially higher priced deals. They argued that under the agreement with Icahn, the CEO would achieve his own financial goals – he could accelerate payment of his retirement benefits, liquidate his Lear equity position without causing negative market reaction, and maintain his management position with Lear with the opportunity to acquire a significant equity stake.

In considering whether the Special Committee improperly delegated to the CEO the task of negotiating the acquisition, the Court recognized, in plaintiffs' favor, that the actions of the Special Committee were less than perfect. Specifically, the Court faulted the Special Committee for failing to recognize that in negotiating the merger, the CEO had powerful interests to agree to a price and terms suboptimal for public shareholders and for failing to properly control and oversee the negotiation process by not involving members of the Special Committee or its advisors. However, the Court noted that conflicts in and of themselves are not sufficient to support a *Revlon* claim. Rather, to support a Revlon claim, the conflicts must inhibit the sales process from being able to reasonably obtain the highest possible price for shareholders.

In its examination of the sales process, the Court faulted the CEO for discussing with Icahn a possible deal for a week prior to informing the board. The Court noted that this "deprived the board of important deliberative and tactical time, and, as a result, caused it to quickly decide on an approach to the process" similar to the approach used in situations where there are no conflicts."[5] However, given the relatively limited scope of the discussions (for instance there was no discussion of price or any agreement on key terms of a deal), the Court determined that the delayed disclosure to the board, while less than ideal, did not render the overall sales process ineffectual in obtaining the highest possible price.

The plaintiffs also argued that the Special Committee's sales process was deficient because to the Committee did not conduct a full auction, the go-shop provision was too restrictive to facilitate an effective post-signing market check and the deal protections were preclusive of alternative bids. On these issues, the Court said that it would review the sales process in its entirety to determine whether the board's actions were reasonable. "Reasonableness, not perfection, measured in business terms relevant to value creation, rather than by what creates the most sterile smell, is the metric."[6]

In addressing the plaintiffs' assertion that the Special Committee was required to conduct a full auction, the Court recognized a number of countervailing factors that made it reasonable for the board to favor a post-signing market check. First, the market widely perceived Lear as being open to a sale because in 2004 it had allowed its poison pill to lapse and because Icahn is well-known to the market to be both a buyer and a seller of his investments. Second, there were significant risks associated with conducting a full auction. Icahn had vowed to Lear to withdraw his offer, let the stock price fall to lower levels and then return to do a deal at a price much lower than $36 per share. This was a real possibility because the success of any auction was in doubt. Lear had been known to be open to a sale for years but had only received an overture from Cerberus at a price around $16 to $17 per share, the pre-signing market canvass conducted by Lear's financial advisor did not produce any serious indications of interest, and other large shareholders had recently expressed no interest in expanding their equity position. And third, the existence of the go-shop provision enabled the board to comfortably address these risks by securing a deal with Icahn at a floor price of $36 per share and using the deal to actively prospect for more.

In addressing the plaintiffs' assertion that the go-shop provision itself was preclusive because of its structure, the Court recognized that indeed "[t]he go-shop period was truncated and left a bidder hard-pressed to do adequate due diligence, present a topping bid with a full-blown draft merger agreement, have the board make the required decision to declare the new bid a superior offer, wait Icahn's 10-day period to match, and then have the board accept that bid, terminate its agreement with Icahn, and 'substantially concurrently' enter into a merger agreement with it."[7] The Court did not find plaintiffs' argument persuasive, however, because the no-shop period following the expiration of the go-shop allowed the board to consider unsolicited proposals and because the deal protections in the no-shop period were not preclusive. The Court noted that the deal protections were "hardly of the magnitude that should deter a serious rival bid"[8] and that the existence of a termination fee and matching rights has previously been found by the Court not to act as a serious barrier to any bidder willing to pay materially more for the target.[9] Vice Chancellor Strine was not impressed with the argument that the termination fee served to chill potential bidders and he noted that the matching rights were crafted to be value enhancing by providing incentives to potential bidders to bid materially higher than Icahn.[10] In the event of a bid over $37 per share, Icahn could only match one time.

In addition, plaintiffs also argued that the very fact that the initial acquiror was Icahn was also bid-chilling because potential bidders would be afraid of crossing an investor with the power and acumen of Icahn. Vice Chancellor Strine dryly noted that this argument was closer to "mirth-producing" than "injunction-generating." Contrary to plaintiffs' arguments, Vice Chancellor Strine found little reason to believe that professionals would be scared off by the presence of Icahn and noted that topping bids were made in five of the 10 acquisition attempts made by Icahn since 2000. He also noted Icahn's history of "happily stepping aside and cashing in his equity stake at a substantial profit when other bidders submit more attractive offers."

The Disclosure Claims

Plaintiffs had more success with their claim that Lear's proxy statement failed to disclose material facts related, in part, to the potential conflicts of interest of the CEO. Vice Chancellor Strine was persuaded by these arguments and ordered Lear to amend its proxy statement to expand the disclosure. He reasoned that "a reasonable stockholder would want to know an important economic motivation of the negotiator singularly employed by a board to obtain the best price for the stockholders, when that motivation could rationally lead that negotiator to favor a deal at a less than optimal price, because the procession of a deal was more important to him, given his overall economic interest, than only doing a deal at the right price."[11]

Based on the facts and circumstances of the Lear case, the Court determined that the following facts were material and required to be disclosed in the proxy statement:

- the CEO discussed a going private transaction with Icahn for more than a week before he disclosed Icahn's expression of interest to the board;
- the board thereafter permitted the CEO to negotiate the key terms of the merger with Icahn outside the presence of any independent director or the Special Committee's investment banker without any specific pricing guidance from the Special Committee;
- the merger allows the CEO to cash out all of his equity stake in Lear in one lump sum; and
- Icahn agreed to employment terms with the CEO that allowed the CEO to secure a short-term schedule for the payout of his retirement benefits, obtain an improved salary and bonus package, and secure a large grant of options giving him a lucrative upside if Lear performed well after the merger.

The Court's decision on the disclosure arguments reflects a very high level of sensitivity to the impact of potential management conflicts, and serves as an important reminder to targets that are structuring a sales process and making disclosure decisions.

The Topps Saga

The Topps Company, Inc. has two lines of business, baseball and other cards and old-style confections such as Bazooka bubble gum. In 2004, dissatisfied with its lackluster financial performance, the Topps board undertook a strategic review of the business and determined that the principal problem was the confectionary business. In April of 2005, in order to settle a proxy contest for the election of directors by a hedge fund, the board agreed to intensify its review of strategic alternatives and agreed not to adopt a poison pill without shareholder approval. The board determined to conduct a sale of the confectionary business because it believed, although it is not clear from the record why, there would be no buyer for the entire company. The auction was an unmitigated disaster: only two non-binding preliminary indications of interest were proffered, each at low valuations, and both parties exited the process following initial due diligence.

On several occasions, including the time of the auction for the confectionary business, Upper Deck Co., Topps' principal competitor in the sports card business, made overtures to the company about a possible acquisition. Discussions with Upper Deck never progressed past the preliminary stage, however.[12] In May 2006, two private equity firms, one led by Michael Eisner, expressed an interest to the Topps CEO in a potential going-private transaction. The CEO directed Eisner to a long-time independent director for further discussion. By March of the next year, over the objection of dissident directors, the board approved a merger agreement with the Eisner group. The deal price was $9.75 per share and included provisions for a 40-day go-shop period and a subsequent no-shop period.

Pursuant to the agreement, Topps was permitted at the end of the go-shop period to continue talks with a potential bidder only if such bidder had already submitted a "Superior Proposal," or the Topps board determined that the bidder was an "Excluded Party," which was defined as a potential bidder that the board considered reasonably likely to make a Superior Proposal. A Superior Proposal was defined as a proposal to acquire at least 60% of Topps that would provide more value to Topps stockholders than the Eisner Merger. Topps was also permitted to consider an unsolicited bid after the expiration of the go-shop period if the unsolicited bid constituted a Superior Proposal or was reasonably likely to lead to one. Topps could terminate the Merger Agreement in order to accept a Superior Proposal, subject only to Eisner's right to match any other offer to acquire Topps. The agreement also contained a two-tier termination fee.

In the go-shop period, the board's financial advisor contacted over 100 strategic and financial bidders, out of which only one, Upper Deck, made a serious offer. To gain access to confidential information during the go-shop period, Upper Deck entered into a non-disclosure agreement, which included a standstill provision that prohibited Upper Deck from making a tender offer for Topps shares without the company's consent and from making public statements about its bid. Despite Upper Deck's higher bid of $10.75 per share, the board determined not to declare Upper Deck an "Excluded Party," which would have enabled the board to continue negotiating with Upper Deck, or a "Superior Proposal." The board based its decision on Upper Deck's failure to show it could finance the deal, antitrust concerns and the small size of the reverse termination fee. Following the board's decision, Upper Deck made an unsolicited bid for $10.75 per share, supplied a letter from its banker to the effect that it was highly confident in Upper Deck's ability to finance the deal, and also offered to be flexible on antitrust issues, including divesting key assets if necessary. In connection with its bid, Upper Deck requested a waiver of the standstill provision. The board determined the unsolicited bid was not a "Superior Proposal" for similar reasons and rejected Upper Decks' request for a waiver of the standstill.

Plaintiffs' *Revlon* Claim

Similar to the Lear case, plaintiffs (which included Upper Deck and Topps shareholders) sought to preliminarily enjoin the consummation of the acquisition and the standstill provision on the basis, in part, of an alleged breach by the board of its *Revlon* duty. Plaintiffs based their claim on (1) the board's failure to conduct a full auction; (2) the allegedly preclusive terms of the definitive agreement, including the go-shop provision, the termination fee and the matching rights; and (3) the board's actions with respect to its decision not to deem Upper Deck an "Excluded Party" and its unsolicited proposal a "Superior Proposal." Vice Chancellor Strine rejected the first two arguments but accepted the third and granted injunctive relief.

In assessing whether the board was obligated to conduct a full auction to satisfy its *Revlon* duty, the Court, as in *Lear*, found a number of countervailing factors that made the decision to forego an auction reasonable. It noted that the market was well aware that Topps was open to a sale because of its public dispute with the hedge fund investor, its failed auction for the confectionary business and its agreement not to adopt a poison pill without shareholder consent.[13] It also noted that under the circumstances it was reasonable for the board to consider the risks associated with another failed auction and Eisner's vow to withdraw his bid when deciding whether to conduct another auction.

In assessing whether the definitive agreement was preclusive and favored the deal with Eisner over other bidders the Court found the existence of the go-shop and its interplay with the no-shop provision to be critical to its determination. It noted that:

> **"[a]lthough a target might desire a longer go-shop period or a lower break fee, the deal protections the Topps board agreed**

> **to in the agreement seem to have left reasonable room for an effective post-signing market check. For 40 days, the Topps board could shop like Paris Hilton. Even after the go-shop period expired, the Topps board could entertain an unsolicited bid, and, subject to Eisner's match right, accept a Superior Proposal. The 40-day go-shop period and this later right work together, as they allowed interested bidders to talk to Topps and obtain information during the go-shop period with the knowledge that if they needed more time to decide whether to make a bid, they could lob in an unsolicited Superior Proposal after the period expired and resume the process."[14]**

Lastly on this point, the court recognized as part of its analysis the role the go-shop plays in allowing the board to set a floor price and the favorable psychological impact that has on future bidders. "Human beings, for better or worse, like cover. We tend to feel better about being wrong, if we can say others made the same mistake. Stated more positively, recognizing our own limitations, we often, quite rationally, take comfort when someone whose acumen and judgment we respect validates our inclinations. A credible, committed first buyer serves that role."[15]

In reviewing the board's actions with respect to its decision not to deem Upper Deck an "Excluded Party" and its unsolicited proposal a "Superior Proposal," the Court found sufficient support to buttress the granting of a preliminary injunction. According to Vice Chancellor Strine, the board's actions suggest that it simply preferred to do a deal with Eisner as opposed to with Upper Deck. Specifically, the Court noted the difficult position the board put itself in by not declaring Upper Deck an "Excluded Party." While it may have had legitimate concerns about the risks associated with Upper Deck's bid, the Court noted that it could have done more to address those risks by continuing to negotiate with Upper Deck. By not declaring Upper Deck an "Excluded Party," the board unnecessarily relinquished its ability to negotiate with Upper Deck. Also important to the Court's decision was the board's refusal to grant a waiver to Upper Deck of the strictures of the standstill provision. According to Vince Chancellor Strine, the record suggests that Topps was not using the standstill to extract more value from Upper Deck. Rather, Topps seemed to be using the standstill to fend off a higher bidder in order to entrench management. Under the Eisner merger, the senior management (one of the founder's sons and his son-in-law) would be able to retain key positions at the company, attractive compensation packages and freedom from the dissident hedge fund shareholder.

Plaintiffs' Disclosure Claims

As in *Lear*, plaintiffs also asserted a bevy of disclosure claims. In reviewing the record, the Court determined that several material facts were omitted from or misstated in the proxy statement, including:

- that (1) "Eisner specifically stated that his proposal was 'designed to' retain 'substantially all of [Topps'] existing senior management and key employees,"[16] and (2) Eisner repeatedly made assurances about management's likely future.
- that the board's financial adviser had provided an earlier set of valuations than those disclosed in the proxy, and that the earlier valuations suggested that Topps should be valued at higher levels;
- that the CEO had made statements that were potentially bid-chilling; and
- various facts that bear on Upper Deck's credibility as a bidder, including that Upper Deck had submitted an indication of interest before the go-shop period had begun, that Upper Deck's proposal was not contingent on financing, that the letter from Upper Deck's lender was conditional in part because of Topps' refusal to share certain information with it, that Upper Deck had proposed a strong "hell or high water" antitrust provision in its unsolicited bid, that Topps' had prevailed in antitrust proceedings in the past, and that the terms of the standstill prevented Upper Deck from making a tender offer or publicly discussing its bid.

Conclusion

Lear and *Topps* provide the first direct guidance on state-of-the-art go-shop provisions. The decisions suggest several factors that should be taken into account in deciding whether to rely on a go-shop, and also provide some guidance on how to use the go-shop during the post-signing period.

- Do prospective buyers already know that the company might be for sale, or that the board might consider unsolicited offers in the past? Has it recently eliminated its poison pill – a fact that Vice Chancellor Strine believes sends a message to the marketplace? Has it publicly announced that it is conducting a strategic review? Are potential buyers already making overtures? Has the company recently attempted to sell some or all of its businesses? If the answer to any of these questions is yes, the case for a go-shop becomes stronger.
- Was the target board able to conduct at least a limited pre-signing market check? A pre-signing check may not be mandatory, but it will certainly strengthen the case for reliance on a post-signing go-shop.
- Is the target board concerned that a pre-signing auction will disrupt the business or damage customer and employee relations? This concern helps lay the foundation for a post-signing market check.
- Has the bidder threatened to withdraw its offer if the target conducts a pre-signing auction? Is this threat credible? Both *Lear* and *Topps* emphasize this fact.
- Does the go-shop give the target an adequate opportunity to shop the company after signing? The *Lear* and *Topps* decisions suggest that a shopping period of 40 or 45 days is short but acceptable – particularly if there is an opportunity to continue to negotiate with alternative bidders who make attractive offers during the shopping period. They also suggest that a structure under which the initial bidder has the right to match an offer made by a new bidder is not unnecessarily preclusive. And they indicate that the go-shop may be coupled with reasonable termination fees.
- Has the target board played fair in using the go-shop and related provisions? In *Topps*, even though Vice Chancellor Strine approved the decision to rely on a post-signing market check, he concluded that the target board had violated its *Revlon* duty because it did not give Upper Deck, the alternative bidder, an adequate opportunity to negotiate. Stated another way, it did not take advantage of the flexibility that the go-shop provided.

The *Topps* and *Lear* decisions also provide a reminder that the Delaware courts will pay very close attention to target management's role in the negotiations, and whether conflicts of interest or entrenchment motives may have tainted the process, regardless of whether the target chooses to rely on a pre-signing auction or a post-signing market check.[17] The decisions highlight the need to ensure that the board is directly involved in the acquisition negotiations and in decisions about how to design and manage the sales process. And they provide a reminder that even if potential flaws in the process are not sufficiently serious to lead to the conclusion that the target board violated its fiduciary duties, the target should think carefully about whether the flaws should be disclosed in the proxy statement so that target shareholders have a thorough understanding of how the negotiations unfolded.

NOTES

1. Once a target board has decided to sell control of the target, Delaware law imposes upon the board a fiduciary duty to conduct a sales process reasonably designed to achieve the highest possible price for the target's shareholders. This duty is referred to as the board's *Revlon* duty in reference to the landmark case of *Revlon v. Mac Andrews & Forbes Holdings, Inc.,* where the Delaware Supreme Court held that once directors have determined to sell control of a company, "[t]he directors' role changes from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders." 506 A.2d 173, 183 (Del. 1986).
2. Glover, Stephen I. & Goodman, Jonathan P., "Go-Shops: Are They Here to Stay?" *The M&A Lawyer* (vol. 11, no. 6); June 2007, page 1; © Thomson West LegalWorks.
3. C.A. No. 2728-VCS (Del. Ch. June 15, 2007).
4. C.A. No. 2786-VCS (Del. Ch. June 14, 2007). *See also Berg v. Ellison*; C.A. No. 2949-VCS (Del. Ch. June 12, 2007) (Transcript).
5. *Id.* at 44.
6. *Id.* at 45.
7. *Lear* at 47.
8. *Id.* at 48.
9. *In re: Toys "R" Us Shareholder Litigation*, 877 A.2d 975 (Del. Ch. 2005). *See also Berg v. Ellison,* C.A. No. 2949-VCS (Del. Ch. June 12, 2007) (Transcript)

(noting that the combination of a match right, a termination fee of approximately $5 of equity value and a restrictive 25-day go shop is a "potent combination of deal protection" and something the Court "should at least look at the reasonableness of … on an expedited basis.").

10. Vice Chancellor Strine was also not impressed with Lear's argument that the two tier termination structure would encourage bids during the go-shop period. He pointed out that a bidder would get the benefit of the lower fee only if it were to finalize a deal with the company during the short shopping period, which he believed would be extremely difficult. Vice Chancellor Strine in *Berg* also gave little attention to arguments based on the two-tier termination fee structure in that deal.
11. *Lear* at 37.
12. Around the time of the auction, the company also received unsolicited non-binding bids from two private equity firms for the entire company (the bids ranged from $9 to $9.75 and $9.50 to $10). After initial due diligence, these bidders also moved on.
13. *Compare In re: Netsmart Technologies, Inc. Shareholder Litigation*, C.A. No. 2563-CVS (Del. Ch. 2006) (finding that in the context of a micro-cap company with limited analyst coverage, the market would be unlikely to be aware that the company was open to a sale and therefore a robust canvass of potential financial and strategic buyers would be necessary to satisfy the board's *Revlon* duty).
14. *Topps* at 53.
15. *Id.* at 54.
16. *Id.* (quoting the record).
17. *See e.g., In re: SS&C Technologies, Inc. Shareholder Litigation* (Del. Ch. Nov. 29, 2006) and *The Need for Careful Choreography in LBOs,* by Ethan Klingsberg, *The M&A Lawyer*, April 2007.