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M&A Transactions Involving Controlling Stockholders

A recent Delaware Court of Chancery decision may be the definitive source of guidance for structuring third-party acquisitions of companies with controlling stockholders. These transactions can pose complex issues of corporate governance due to the controlling stockholder's ability to direct the outcome of the transaction or seek a control premium or other disparate consideration relative to the minority stockholders. The decision, *In re John Q. Hammons Hotels Inc. S'holder Litig.*, provides a roadmap for avoiding heightened judicial scrutiny under the "entire fairness" test. The court held that, so long as there are "robust procedural protections in place," including an independent special committee and a non-waivable majority-of-the-minority stockholder approval condition, such transactions will be entitled to the protections of the business judgment rule. In light of the importance of this decision, we have set forth below an analysis of its facts and holding along with a summary of the law governing controlling-stockholder transactions generally.

Background

Hammons involved the sale of John Q. Hammons Hotels, Inc. In 2004, the company's founder and controlling stockholder announced his interest in selling his shares. The board of directors then formed a special committee to review any potential transaction. The controlling stockholder refused to deal with certain potential buyers, however, and thus limited the field of potential players. Ultimately, the controlling stockholder negotiated directly with a third-party acquiror regarding the treatment of his shares in a merger, while the special committee negotiated separately with the acquiror with respect to the minority stockholders. As a result of the dual-track negotiations, the minority stockholders received $24 per share in cash while the controller received (a) a small equity interest in the surviving entity, (b) a preferred interest with a large liquidation preference, (c) an in-kind distribution of one of the target's premier hotel properties, and (d) various other contractual rights.

Throughout the negotiations, the special committee was advised by an outside financial advisor and separate legal counsel. It also successfully negotiated for a majority-of-the-minority stockholder approval condition ("MOM"). The special committee had the ability to waive the MOM, but it did not do so. The merger was approved and closed in 2005. A minority stockholder brought a class action charging breach of fiduciary duties against the directors and the controlling stockholder.

Controlling Stockholder Transactions

Courts have established different standards of review for different types of controlling stockholder transactions. Under the Delaware Supreme Court's decision in *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110 (Del. 1994), a freeze-out merger in which the controlling stockholder acquires all of the outstanding minority shares is automatically subject to "entire fairness," which involves a strict judicial review for "fair price" and "fair dealing." Courts have reasoned that a controlling stockholder's ability to coerce directors and minority stockholders justifies heightened scrutiny. As a result, under the *Lynch Communication* line of cases, the presence of a properly functioning special committee or a MOM will shift the burden of proof to the plaintiff, but neither will avoid an entire fairness review. Moreover, because "entire fairness" necessarily entails a factual inquiry into the merger, these claims have significant "settlement value"

because they cannot be dispensed with on a motion to dismiss.[1]

Under the Court of Chancery's decision in *In re Pure Resources, Inc. S'holder Litig.*, 808 A.2d 421 (Del. Ch. 2002), however, a freeze-out structured as a two-step transaction in which the controlling stockholder makes a tender offer followed by a short-form merger may be subject to the deferential business judgment rule, provided that (1) minority stockholders were represented by a properly functioning special committee, (2) the offer was subject to a non-waivable MOM, (3) the controlling stockholder committed to consummate the back-end merger promptly and at the same price as the tender offer, and (4) the controlling stockholder refrained from making any retaliatory threats or disclosure violations. *Pure Resources* reasoned that a tender offer is a voluntary transaction between stockholders and does not justify heightened judicial scrutiny so long as certain safeguards are in place. To date, the Delaware Supreme Court has not applied the *Pure Resources* standard.

Transactions in which a controlling stockholder initiates or directs the sale of a company to a third party raise different issues. In its capacity as stockholder, a controlling stockholder can unilaterally approve a transaction or veto the company's alternatives. As a result, Delaware courts have accepted the reality that boards are limited in how they conduct a sale process. But directors must play an active role in the sale and determine whether it maximizes value for minority stockholders. In *McMullin v. Beran*, 765 A.2d 910 (Del. 2000), the Delaware Supreme Court refused to dismiss breach of loyalty claims where the board of directors allegedly delegated the sale process to the controlling stockholder and "rubberstamped" the merger, even though all stockholders were treated equally in that transaction.

Third-party transactions like *Hammons*, in which the controlling and minority stockholders receive disparate consideration, raise additional issues. If all stockholders receive the same consideration, then their interests would presumptively be aligned. The right of a controlling stockholder to receive a control premium under Delaware law, however, has been long established. Nevertheless, decisions in *Levco v. Reader's Digest*, 2002 WL 1859064 (Del. 2002), and *In re Telecommunications, Inc.*, 2005 WL 3642727 (Del. Ch. 1995) ("*TCI*"), require a board of directors to determine that "the relative impact of a preference to one class be fair to the other class." *TCI* also created confusion regarding a controlling stockholder's right to a control premium by suggesting that the controlling stockholder, "if [he] wished to be fair, … could have shared some part of the value of his own stock holdings."

The *Hammons* Decision

Hammons rejected *Lynch Communication*'s per se rule of entire fairness. First, the court reasoned that receiving disparate consideration did not make the controlling stockholder stand "on both sides of the transaction." Rather, the controlling stockholder was dealing with a third party that had "no prior relationship" with the controlling stockholder or the company. Second, the court distinguished prior entire fairness cases like *TCI*, explaining that in *TCI* "the evidence suggested that a majority of the board of directors was interested because they received material personal benefits from the transaction they approved."

The *Hammons* court then held that a third-party merger in which a controlling stockholder receives disparate consideration will be entitled to deferential business judgment review "if the transaction were (1) recommended by a disinterested and independent special committee, *and* (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders." Under the facts, however, the *Hammons* special committee failed this requirement in two respects. First, its ability to waive the MOM was fatal because, according to the court, a waivable MOM would not increase the "likelihood that those seeking the approval of the minority stockholders will propose a transaction that they believe will generate the support of an actual majority of the minority stockholders." Moreover, a non-waivable MOM makes the minority stockholders "aware of the importance

[1] An exception to the *Lynch Communication* merger rule arises in short-form mergers, in which the controlling stockholder owns at least 90 percent of each class of the target's stock. In that scenario, the Delaware Supreme Court ruled in *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001), that appraisal is the exclusive remedy for minority stockholders, provided that the controlling stockholder complies with its disclosure obligations.

of their votes and their ability to block a transaction they do not believe is fair."

Second, the MOM should have been based on a majority of the *outstanding* minority shares, not a majority of the shares actually voted. The court felt that minority abstentions should be treated as "passive dissent." Although some might argue that abstentions extend from stockholder apathy, the court's position is consistent with dicta in Vice Chancellor Leo E. Strine, Jr.'s 2006 decision in *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, *15 (Del. Ch. Aug. 18, 2006).

Finally, the court refused to dismiss a claim based on the fact that the proxy statement failed to disclose potential transactions in which the special committee's legal and financial advisors were to engage in with the buyer's proposed lenders. Although the special committee was fully aware of, and waived, the conflicts, the court explained that "the compensation and potential conflicts of interest of the special committee's advisors are important facts that generally must be disclosed … before a vote."

Conclusion

Hammons confirms that third-party transactions involving controlling stockholders may be protected by the business judgment rule even when the controlling and minority stockholders receive disparate consideration. On a doctrinal level, *Hammons* refused to extend *Lynch Communication*'s per se rule of entire fairness. Instead, it followed the reasoning in *Pure Resources*, applying a lower standard of judicial review to transactions that have proper procedural protections in place. The end result is to give directors and officers greater protection and reduce the settlement value associated with lawsuits challenging these transactions.

Hammons may signify a larger movement by Delaware courts to relax the standard of review applied to controlling stockholder transactions. In 2005, for example, the Court of Chancery suggested in *In re Cox Communications, Inc. S'holders Litig.*, 879 A.2d (Del. Ch. 2005), that Delaware courts unify their treatment of freeze-out mergers by moving toward the more deferential test set forth in *Pure Resources*. Several academics and practitioners have similarly argued that the entire fairness standard should be used more sparingly in reviewing controlling stockholder transactions.

Under *Hammons*, the key to avoiding entire fairness review is to structure a proper process. Specifically, *Hammons* requires an effective special committee comprised of disinterested and independent directors, full disclosure of potential conflicts of interest, and a non-waivable MOM. Another important factor is the role both the controlling stockholder and the independent directors play in negotiating the transaction. In *Hammons*, the controlling stockholder negotiated separately with the buyer regarding the treatment of his own shares and let the special committee negotiate on behalf of the minority stockholders. Special committees should resist a controlling stockholder's attempt to negotiate on behalf of the company or with respect to the consideration payable to the minority. The controlling stockholder's representatives on the board should also recuse themselves as appropriate during the sale process.

Notwithstanding careful planning, there are other significant legal issues that must be considered. The *Hammons* decision is on appeal, giving the Delaware Supreme Court the final word on whether the business judgment rule applies. The Supreme Court could reject the lower court's holding or perhaps fashion an intermediate level of review to judge the directors' actions. In a typical third-party transaction, directors must fulfill their so-called "*Revlon* duties" to obtain the best price reasonably available. Although a controlling stockholder may prevent a true market check, the Delaware Supreme Court's decision in *McMullin* makes clear that the board's objective is still the same: to maximize value for the minority stockholders.

In addition, nothing in *Hammons* relieves the board from its duty to consider the premium being paid to a controlling stockholder. As noted above, *Reader's Digest* and *TCI* require directors to consider whether the consideration paid to minority stockholders is fair relative to that paid to the controlling stockholder. Few financial advisors are willing to issue "relative fairness" opinions, particularly in high-profile transactions. Delaware courts should not require such opinions per se, however, but instead should look to whether directors, working closely with their financial and legal advisors, adequately considered the issue.

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