KIRKLAND & ELLIS

KIRKLAND **M&A UPDATE**

December 15, 2016

Controlling Stockholder M&A ≠ (Automatic) Entire Fairness Review

Delaware courts have outlined a "taxonomy" of controller transactions so that dealmakers can, with the benefit of a nuanced analysis of the specific facts and circumstances at hand, properly match the appropriate procedural protections to the degree of inherent conflict.

Two years ago we highlighted a string of Delaware cases that addressed the question of whether a stockholder is deemed to be "controlling," observing that the Delaware approach was nuanced with a focus on both the ownership percentage and exercise of actual control. But a finding that there is a controlling stockholder of a target company is just the first part of the analysis in determining the applicable standard of review that the court will use in assessing an M&A transaction involving that target. As a number of recent cases have shown, the contours and terms of the M&A transaction are as important as the question of whether the stockholder is "controlling" to the court's determination of whether — and to what extent — heightened scrutiny will be applied. Understanding the dual aspects of the court's inquiry allows dealmakers to ensure that necessary procedural safeguards for the benefit of the minority stockholders are implemented where appropriate and achievable, and that excessive and unnecessary procedural protections are avoided.

Transactions involving targets with controlling stockholders have been divided by the courts into four primary categories that focus on the degree of conflict inherent in the transaction:

Squeeze/freeze-out transactions. At one extreme is a transaction where a controlling stockholder seeks to acquire the remaining shares held by the public. There is natural sensitivity to the inherent conflict of interest and the default for judicial review is the heightened scrutiny of the entire fairness standard (which requires proof of the fairness of both price and process and almost always results in a full trial).

However, in the landmark 2013 *MFW* decision, the Delaware Supreme Court endorsed a set of procedural protections which, if followed, offer a pathway for the transaction to benefit from review under the more deferential business judgment rule. The six-part test requires that (i) from the outset the controller conditions the transaction on the approval of both a special committee of the board and approval by a majority-of-the-minority stockholders; (ii) the special committee is independent of the controller; (iii) the special committee is empowered to freely select its own legal and financial advisors and to definitively reject the controller's offer; (iv) the special committee meets its duty of care in negotiating a fair price for the minority; (v) the minority stockholders are fully informed; and (vi) the stockholder approval is uncoerced.

A recent Delaware Chancery Court decision (*Books-A-Million*) emphasizes the benefits of properly following the *MFW* prescription. Dispelling doubts left by a footnote in the original *MFW* decision, VC Laster granted the defendants' motion to dismiss the fiduciary duty claims without requiring a costly and time-consuming discovery process or a trial. In addition, the *Books-A-Million* decision confirmed two other key principles that apply when a controller is pursuing a squeeze-out transaction — (i) the controller is free to reject any competing third-party offer that would require that the controller sell its shares even if the minority stockholders would be better off under the competing offer, and (ii) the legitimacy of a "minority discount" in pricing a squeeze-out transaction (i.e., a controller's offer can be reasonable and fair to the minority in certain cases even if the offer is made in the shadow of a higher offer from a third party because the controller already "owns" the control premium).

Pro-rata consideration transaction. At the other extreme sits a second category of transactions where the controlling stockholder sells its whole stake to an unaffiliated third-party buyer, receiving identical consideration alongside the minority stockholders. Our 2012 note highlighted the *Synthes* decision that a controlling stockholder and its affiliated directors could fully participate in such a sale process without any particular procedural protections and still avoid enhanced judicial scrutiny. Absent extreme circumstances, the business judgment rule

Attorney Advertising

will apply because the controller's sale of its stake for identical consideration to the minority stockholders creates maximum alignment of interest with that minority. Heightened scrutiny will only apply in cases like *infoGroup* where the controller forced an inopportune "fire sale" to address a personal crisis requiring immediate liquidity. The recent *Larkin* decision builds on the *Synthes* principles, holding that the venture capital/private equity investment model, which is predicated on an exit after a certain investment period, does not by itself create a conflict if controlling financial sponsors pursue and achieve a sale for the same consideration as all other stockholders.

Differential consideration transaction. In between the two extremes rests a third category where the controller is a seller along with the minority stockholders but receives different consideration for its stake. While Delaware has repeatedly accepted (*Emerson Radio*; *Sea-Land*) that a controller is legally permitted to receive a greater share of the consideration (a "control premium") when an unaffiliated third party acquires a controlled company, such a transaction will be reviewed under the more searching entire fairness standard unless certain procedural protections are implemented. Even though not literally standing on the opposite side of the transaction as a buyer, the controller is viewed as conflicted by competing with the minority stockholders for consideration.

The procedural protections required to gain business judgment review bear many similarities to the *MFW* test and were spelled out in the 2009 *John Q. Hammons* decision. The court looks for approval by an independent special committee of the board, a non-waivable requirement for approval by a majority of the disinterested and fully informed stockholders, and the absence of threats or coercion.

Differential consideration can take one of two forms. The first is "disparate consideration" where the controller receives greater monetary consideration for its shares than is received by the minority, which could be viewed as the controller taking a disproportionate share of a finite amount of consideration offered by the buyer. While more common in the sale of dual class companies (such as *TCI* where the controller's high-vote stock received $376 million more than the low-vote public minority), a controller of a target with a single class might also seek greater per-share consideration for its control stake.

The second kind of differential consideration is reflected in the "unique benefit" cases where the controller receives some additional benefit beyond simply incremental cash per share. An example is the *John Q. Hammons* case where the controller received a variety of financial benefits (including a preferred interest with a significant liquidation preference, ownership of one of the target's key assets, and certain other contractual rights). Other examples include the *infoGroup* case mentioned above where satisfaction of the controller's extreme liquidity needs, and *Primedia* where the merger's extinguishment of a potential derivative suit against the controller, were each deemed a "unique benefit."

Continuing stake transactions. Also sitting between the two extremes is a fourth category where, in connection with the cash acquisition of the controlled company by an unaffiliated third party, all or a portion of the controller's stake is exchanged for a future stake in the combined entity in the form of equity or debt interests. Historically, the Delaware courts have treated these transactions as hybrids, exhibiting elements of both a squeeze-out transaction (and the associated concern about the controller standing on both sides) and a differential consideration transaction (with concerns about competing for consideration and unique benefits).

Some of the uncertainty as to treatment results from a lack of clear guidance as to what portion of the controller's stake needs to be "rolled over" in order for the transaction to be deemed subject to heightened scrutiny, as well as whether conflict concerns are implicated if the rollover opportunity is in substitution for, rather than incremental to, a portion of the cash consideration the controller was otherwise entitled to receive as a stockholder. In *John Q. Hammons* where the court applied entire fairness, the controller received only a small continuing equity stake; however, the controller also received a basket of other "unique benefits" leaving it unclear whether the small continuing stake alone would have triggered the entire fairness review. Some older cases (*Orman*; *LNR Property*) show that, at least where the rollover includes a meaningful portion of the controller's pre-transaction stake, the court will look for procedural protections similar to the *John Q. Hammons* models (including an independent special committee and approval by a majority-of-the-minority stockholders) in order to preserve the benefits of the business judgment rule (but note that then-VC Strine in a transcript ruling in the *Ancestry.com* case suggested that business judgment would apply in a deal where, at the request of the buyer, an existing sponsor rolled over 25% of its equity into a take-private).

* * *

When confronted with a target company with a controlling stockholder, there is a tendency to immediately assume that the transaction is intrinsically conflicted and that procedural protections that remove or isolate the controller and its representative directors are mandatory to attempt to avoid application of the more onerous entire fairness standard. As noted in the recent *iHeartMedia* ruling, "entire fairness, however, 'is not implicated solely because a company has a controlling stockholder.' Rather, entire fairness will govern only when 'the controller . . . engage[s] in a conflicted transaction.'" In addition to detailed guidance on determining whether a stockholder is controlling, the Delaware courts have outlined a "taxonomy" of controller transactions so that dealmakers can, with the benefit of a nuanced analysis of the specific facts and circumstances at hand, properly match the appropriate procedural protections to the degree of inherent conflict.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

Daniel E. Wolf, P.C.
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dwolf
+1 212-446-4884

Gilad Zohari
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/gzohari
+1 212-909-3321

This communication is distributed with the understanding that the author, publisher and distributor of this communication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this communication may constitute Attorney Advertising.

© 2016 KIRKLAND & ELLIS LLP. All rights reserved.

www.kirkland.com