DUTIES OF CONTROLLING STOCKHOLDERS

Murky Waters: Tread Carefully

Kerry E. Berchem
Ron E. Deutsch
Nicholas J. Houpt

Fiduciary duties of directors are fairly clear and well established. For controlling stockholders, however, the water is murky. The determination as to which duties apply and the analysis thereof in the context of business combinations, mergers or related party transactions often depend on facts and circumstances; unique facts tend to influence the outcome of litigation, resulting in little guidance to the practitioner seeking to construct a problem-free transaction. Previously clear areas of the law, such as tender offers by controlling stockholders, have become murkier as recent cases have undermined old precedents and practices. Even seasoned practitioners and scholars struggle with the unsettled character of the law. Chancellor Leo E. Strine, Jr. wrote in a recent case: "To my mind, which has pondered the relevant cases for many years, there remains confusion." In re Southern Peru Copper Corporation Shareholder Derivative Litigation, 30 A.3d 60, 89 (Del. Ch. 2011) (referring to burden-shifting analysis under the entire fairness standard for controlling stockholder transactions that potentially violate the duty of loyalty). When addressing controlling stockholder issues, experience, judgment, acumen and familiarity with the particular facts are of paramount import.

This memorandum provides a brief overview of the basic fiduciary duties of directors and addresses the application of such standards and how the law might be different for controlling stockholders. In addition, this memorandum addresses the following issues often addressed by practitioners when faced with controlling stockholder transactions: self-dealing analysis for contractual rights, invoking corporate machinery, the entire fairness standard and the use of special committees, as well as the various standards governing different methods of selling or acquiring a company.

1) **Basic Fiduciary Duties**

The duties discussed below apply to directors, but where a stockholder controls the conduct of the corporation similar to board control, the law of fiduciary duties logically can extend to the controlling stockholder. For instance, the Chancery Court in Abraham stated that "the premise for contending that the controlling stockholder owes fiduciary duties in its capacity as a stockholder is that the controller exerts its will over the enterprise in the manner of the board itself." Abraham v. Emerson Radio Corp., 901 A.2d 751, 759 (Del. Ch. 2006). How the case law extends those duties to controlling stockholders is not, however, as clear as this simple substitution of terms.

Practitioners and scholars generally think of a triad of core director fiduciary duties: care, loyalty and good faith. Cede & Co. v. Technicolor, 634 A.2d 345, 361 ("A plaintiff can rebut the presumption of the business judgment rule by showing that the board of directors. . . violated any one of its triad of fiduciary duties: due care, loyalty, or good faith.") (Del. 1993). The duty of loyalty and the duty of good faith often blur together. In re Walt Disney Co. Derivative Litigation, 906 A.2d 693, 753 (Del. Ch. 2005) (It is "far from clear. . . whether there is a separate fiduciary duty of good faith."), aff'd 906 A.2d 27 (Del. 2006). Recent cases have also implicitly added a fourth duty: the duty of disclosure.

a) **Duty of Care** – The duty of care is the duty of a director to make an informed and deliberate business decision. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985). This duty could apply to controlling stockholders in situations where the controlling stockholder has the power to make a business decision for the controlled entity, such as a parent corporation causing its subsidiary to act. Dicta in recent case law suggests that Delaware's general doctrines relating to exculpation of directors under the duty of care would also extend to controlling stockholders, and that duty of care claims will likely fail against controlling stockholders. Abraham, 901 A.2d at 759 ("Although Emerson has not raised the issue, I am dubious that our common law of corporations should recognize a duty of care-based claim against a controlling stockholder for failing to (in a court's judgment) examine the bona fides of a buyer, at least when the corporate charter contains an exculpatory provision authorized by 8 Del. C. § 102(b)(7).").

b) **Duty of Loyalty** – The duty of loyalty requires that directors make decisions in the best interests of the company and its stockholders, and not base those decisions on personal interests. "Self-dealing" transactions are the prototypical situations where duty of loyalty issues arise for directors, and violations of the duty are most often found in this context. There are comparable duty of loyalty issues for controlling stockholders, and they arise when a controlling stockholder stands on both sides of the transaction and receives a special benefit. For example, a controlling stockholder might cause the company to contract with another entity in which the controlling stockholder has an interest, but on terms greatly favorable to the other entity and benefitting the controlling stockholder. Sinclair Oil Corporation v. Levien, 280 A.2d 717, 723 (Del. 1971).[1]

---

[1] Sinclair Oil is a seminal case on the duty of loyalty of controlling stockholders that involved several claims by the minority against the controlling stockholder, including (i) breach of the duty of loyalty for causing the company to pay out excessive dividends because the controlling stockholder needed cash, (ii) violation of the corporate opportunity doctrine by reorganizing subsidiaries in a way to better serve

c) **Duty of Good Faith** – The duty of good faith requires that a director not consciously disregard his or her duties, intentionally violate the law or intentionally act with a purpose other than the best interests of the corporation. Disney, 906 A.2d at 755 ("A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.")

d) **Duty of Disclosure** – Directors have a fiduciary duty to make full and fair disclosure of material facts when seeking stockholder approval of a transaction. In re Lear Corporation Shareholder Litigation, 926 A.2d 94 (Del. Ch. 2007) (duty violated where proxy statement failed to disclose CEO's personal financial interest in a proposed merger). Controlling stockholders also have a duty to disclose material facts regarding transactions that affect minority stockholders. Lynch v. Vickers Energy Corp., 383 A.2d 278 (Del. 1977) (controlling stockholder did not reveal estimates on asset-value and initiated a tender offer for a price that undervalued the assets). This duty not only covers intentional omissions, but also careless errors that amount to a material misstatement. Shell Petroleum v. Smith, 606 A.2d 112 (Del. 1992) (computer error in financial statements improperly discounted a company's cash-flow and was held to be a breach of the duty of disclosure).

---

the controlling stockholder's other business interests, and (iii) causing the company to execute a one-sided contract with an affiliate of the controlling stockholder. The court held in favor of the controlling stockholder on (i) and (ii), finding that there was no self-dealing and that entire fairness did not apply. But the court held against the controlling stockholder on (iii), finding self-dealing and an unfair transaction.

e) **Standards of Review**

i) **Business Judgment Rule** – The business judgment rule is the default rule for evaluating decisions of directors when no self-dealing or bad faith is present. When the business judgment rule applies, it is the plaintiff's burden to rebut the presumption by showing that the board action was grossly negligent, uninformed or in bad faith. Van Gorkom, 488 A.2d at 869-72 (Plaintiff rebutted the business judgment rule where directors approved a merger after a two-hour discussion and without reading the underlying documentation.) This rule uses a presumption of proper action to prevent courts from second-guessing business decisions with the advantage of hindsight. Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985). This standard of review is very generous to the transaction in question, and settlement discussions for transaction-related litigation, but it appears to be limited to cases in which the controlling stockholder does not dictate the terms of the transaction or otherwise engage in self-dealing. Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970); Sinclair Oil, 280 A.2d at 721-22 (applying the business judgment test to a controlling stockholder's action of causing a dividend payment after finding that there was no self-dealing); Solomon v. Armstrong, 747 A.2d 1098, 1113 (Del. Ch. 1999) ("In a situation where a parent company merges with a less-than-wholly owned subsidiary, if allegations of self-dealing arise, the transaction may not be afforded the protections of the business judgment rule.")

ii) **Entire Fairness** – The business judgment rule is cast aside if the plaintiff can establish a prima facie case that there is a breach of a fiduciary duty. Cede & Co., 634 A.2d at 361 ("A plaintiff can rebut the presumption of the business judgment rule by showing that the board of directors. . . violated any one of its triad of fiduciary duties: due care, loyalty, or good faith.") (Del. 1993); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (plaintiff rebutting the business judgment rule in the duty of loyalty context).

Once a prima facie case for breach of a fiduciary duty is established, the burden shifts to the controlling stockholder to show the "entire fairness" of the transaction. Cede & Co., 634 A.2d at 361. A transaction satisfies entire fairness: (A) if it is the product of fair dealing and (B) if it has a fair price. Delaware courts do not separate these concepts into two separate inquiries, but instead look holistically at the fairness of the transaction.

A controlling stockholder can shift the burden of proof back to the plaintiff (to prove that the transaction in question was unfair) by taking certain other steps, including obtaining approval of the transaction by an independent special committee of directors and obtaining approval by a majority of the minority stockholders.

2) The Controlling Stockholder and the Duty of Loyalty

a) **Definition of Controlling Stockholder** – A stockholder owes a fiduciary duty to other stockholders "only if it owns a majority interest in or exercises control over the business affairs of the corporation." Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987). A stockholder with less than a 50% stake in the corporation can still be considered controlling if it somehow controls corporate conduct, such as through its relationships with directors or through threats of retaliation on other transactions. Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110, 1113-15 and 1121-22 (Del. 1994) (finding that a 43% stockholder was a controlling stockholder where that stockholder threatened to vote down other issues if the board did not approve the merger that the controlling stockholder desired, applying entire fairness and finding that the controlling stockholder did not shift the burden to the plaintiff).

b) **Self-dealing** – The controlling stockholder's duty of loyalty is most often invoked in the context of self-dealing. There are two basic elements in the self-dealing analysis:

(i) The controlling stockholder is on both sides of the transaction and dictated its terms; and

(ii) There is a special benefit to the controlling stockholder in which the minority stockholders do not share.

Sinclair Oil, 280 A.2d at 720-22; Gilbert v. El Paso Co., 490 A.2d 1050 (Del. Ch. 1984), aff'd, 575 A.2d 1131 (Del. 1990).

If the benefit is shared with the minority, self-dealing generally will not be found, even if the controlling stockholder acted to advance its own interests. For example in Sinclair Oil, the controlling stockholder needed cash and caused the company to issue large dividends, which were proportionately shared with the minority stockholders. Although this action drained the company of some cash and hurt expansion opportunities, no self-dealing was found because there was no detriment to the minority stockholders as they shared in the dividend proportionately. Id. at 720-22 ("The dividends resulted in great sums of money being transferred from Sinven to Sinclair. However, a proportionate share of this money was received by the minority shareholders of Sinven. Sinclair received nothing from Sinven to the exclusion of its minority stockholders. As such, these dividends were not self-dealing.")

The entire fairness standard also applies when a controlling stockholder invokes corporate machinery for self-dealing. For example, controlling stockholders who are also directors might adopt charter and by-law amendments that entrench their directorships and make it difficult for minority stockholders to nominate and elect opposing candidates. Stroud v. Grace, 606 A.2d 75, 83-84 and 93-96 (Del. 1992) (where plaintiff contested the fairness of amendments to the certificate of incorporation that were proposed by controlling-shareholder directors, entire fairness applied, but the court ultimately found that the controlling stockholder shifted the burden to the plaintiff by obtaining approval by a majority of the minority stockholders and found that the transaction was fair). Merely proposing a separately negotiated transaction for approval by the board or other stockholders does not trigger self-dealing, assuming there is no separate disclosure violation. Odyssey Partners, L.P. v. Fleming Companies, Inc., 735 A.2d 386, 412-13 (Del. Ch. 1999) (the court found that there was no violation of a fiduciary duty by the controlling stockholder where the controlling stockholder wanted to buy a loan from a third party and sought board approval to do so).

c) **Special Committees**

i) **When a Special Committee is Recommended** – A special committee should be used when the entire fairness standard may apply and the controlling stockholder wants to shift the burden of proof to the plaintiff. Kahn v. Lynch, 638 A.2d at 1117. A special committee should consist of independent directors, and those independent directors should not have a conflict of interest in the transaction. For example, a special committee with three outside directors was found to be not independent where one director, though independent, had a longstanding relationship with the company and seemed to take the company's cues in selecting advisors and negotiating the deal. Kahn v. Tremont, 694 A.2d 422, 429-30 (Del. 1997).

ii) **Proper Authority and Proper Negotiation** – The special committee should be authorized to and should negotiate the terms of the transaction, have access to all relevant information and the ability to reject the transaction or take appropriate defensive measures. For burden-shifting under the entire fairness standard, the special committee must "function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at an arms-length.'" Kahn v. Tremont, 694 A.2d at 429.

This standard requires not just a proper set-up of an independent special committee, but making sure that the special committee actively negotiates the deal. Southern Peru, 30 A.3d at 89-90. In Southern Peru, Chancellor Strine identified a shift from setting up a special committee properly to also evaluating whether the special committee was substantively effective in its negotiations. Whether a special committee negotiated properly is "fraught with factual complexity" and difficult to plan for. Id. at 92. Chancellor Strine walks through the entire negotiation process, analyzes several negotiated terms in the purchase agreement and also analyzes practical leverage as the parties' circumstances changed. It remains to be seen whether this analysis is tied to the unique facts of the case, or whether it represents a trend of intense scrutiny of negotiations processes. Id. at 97-114.

iii) **Special Committees and Minority Votes** – In appears that in some circumstances, the controlling stockholder may shift the burden under entire fairness to the plaintiff without using a special committee by, instead, obtaining a majority of the minority vote approving the transaction. Kahn v. Lynch, 638 A.2d at 1115-16. Other situations, such as two-step tender offers with squeeze outs or third-party merger transactions, discussed below, may require both a special committee and majority of minority vote condition, but that instance appears to place the transaction under the business judgment rule instead of merely shifting the burden under entire fairness. Having such a condition presents a risk that the minority will vote against the deal and prevent the transaction from moving forward. To protect themselves against this risk, controlling stockholders might consider bargaining for the minority vote by providing them some additional consideration in the transaction, but there are issues with this approach.

In Southern Peru, the controlling stockholder negotiated with some minority stockholders, hoping to trade registration rights for minority votes. These minority stockholders wanted a demand registration right so that they could liquidate their holdings. There is a possibility that these registration rights improved the overall well-being of the company by improving its float and liquidity, but the minority stockholders were also advancing their own interests. The parties eventually agreed to include these registration rights, but the promised minority votes were conditioned upon the special committee's recommendation of the transaction. One of the minority stockholders also held a seat on the special committee, and, to avoid the appearance of a tainted transaction, this member abstained from voting on the transaction. The special committee recommended the transaction, including the stockholders' agreement that it had not negotiated.

Chancellor Strine found that the entire special committee was beholden to the controlling stockholder and had failed to test the transaction rigorously and negotiate it well. The court evaluated this transaction, which included several other egregious problems, under entire fairness review and found that the transaction was unfair.[2] Southern Peru, 30 A.3d at 114.

Query whether Southern Peru will be cabined to its particular facts, including the presence of a large minority stockholder on the special committee who negotiated with the controlling stockholder for certain rights and tainted the transaction, keeping the transaction under entire fairness review and the burden on the controlling stockholder. Chancellor Strine was floored by the lengths the special committee and its advisors went through to rationalize a deal that, in the perfect hindsight of

[2] Southern Peru's facts also included an initial valuation by the financial advisor that was $1 billion off of the proposed $3 billion purchase price, followed by significant contortions in the financial analysis to help the special committee get comfortable with approving the transaction.

post-trial opinion, seemed absurd. Perhaps a case with less egregious facts would not receive the same scrutiny. By focusing so much on flawed negotiations, one might make the negative inference that arm's length negotiation with a controlling stockholder would provide some protection. On the other hand, in CNX Gas, the controlling stockholder negotiated with a minority stockholder and gave additional consideration in exchange for a promise to tender. This fact played a role in the Chancery Court's conclusion that entire fairness applied to the transaction and that the burden was not shifted to the plaintiff, but there were additional issues involved that may have affected the Chancery Court's analysis. In re CNX Gas Corp. Shareholders Litigation, 2010 WL 2291842, C.A. No. 5377-VCL (Del. Ch. 2010) (In a two-step tender offer with a squeezeout, the controlling stockholder appointed a special committee to evaluate the tender offer, but the committee did not have authority to negotiate the terms of the offer or to consider alternatives to the offer. The Chancery Court found that the special committee was not sufficiently independent and that entire fairness review applied.)

iv) **Additional Protections**

A) **External Fairness Opinion** – A fairness opinion is an analysis done by an independent financial advisor that states that the conflicted transaction at issue is for a fair price. Obtaining a fairness opinion further bolsters the independence of the special committee. In re Cysive, Inc. Shareholders Litigation, 836 A. 2d 531, 545 and 554-558 (Del. Ch. 2003) (discussing the fairness opinion provided by independent financial advisors and later citing to the financial advisors and their liquidation analysis to determine that the transaction was entirely fair). Southern Peru stated that fairness opinions can become stale and bring-down fairness opinions should be requested if there is a substantial change in circumstances or facts related to the transaction, such as a large increase in the acquirer's stock price in a stock deal. Southern Peru, 30 A.3d at 83-84.

B) **Independent Advisors** – Independent advisors can assist the special committee in evaluating a transaction and suggesting legal alternatives to various negotiated terms or transaction structures, which is a positive factor in fairness analysis. Cysive, 836 A. 2d at 554 (citing the use of qualified, independent advisors as a positive factor in ultimately finding that a merger transaction was entirely fair). However, note that bad or conflicted independent advisors can be harmful to the independence and effectiveness of the special committee, frustrating the entire purpose of using the special committee to show that the transaction was independently negotiated. In Re Loral Space and Communications Inc. Consolidated Litigation, 2008 WL 4293781, *2 (Del. Ch. 2008) (citing an outgunned financial advisor as a factor in the failure of the special committee to negotiate effectively).

C) **Go-Shop, Market check, and Fiduciary Out** – A go-shop provision allows the special committee to court other buyers after the proposed transaction has been announced. This process provides a market check on the fairness of the transaction, which generally bolsters the effectiveness of the independent committee. Cysive, 836 A.2d at 553-54 (citing a thorough market check as a positive factor in ultimately finding that a merger transaction was entirely fair). In re Openlane, Inc. Shareholders Litigation, Consolidated C.A. No. 6849-VCN, *14-15 (Del. Ch. 2011). A fiduciary out provision allows a special committee or board a right to exit the purchase agreement if a competing offer is deemed superior and the special committee is bound by its fiduciary obligations to accept that competing offer. Id. (finding a lockup arrangement unfair where there was no fiduciary out for the board of directors). These provisions are most often found in public-company deals.

3) **Contractual Rights of Controlling Stockholders**

a) **Controlling Stockholder as Creditor** – A controlling stockholder, when acting in a non-stockholder role, appears to have no duty to consider the interests of minority stockholders. For example, a controlling stockholder who was also a major debtholder of a company could foreclose on the company's debt, collect all of the proceeds it was owed as a creditor, and wipe out the minority stockholders. Odyssey Partners. But see Gentile v. Rosette, C.A. No. 20213-VCN, *7-9 (Del. Ch. 2010) (controlling stockholder also owned company debt and negotiated a one-sided debt conversion agreement, which was found to be unfair). The distinction between the two cases seems to be that the first case involved exercise of a contractual right which was fairly obtained through an arm's length negotiation, whereas the second case involved a contractual right that was only obtained in a self-dealing transaction with dictated terms. Where the controlling stockholder dictates the terms of the contract and then uses that unfair contract to its own advantage, Delaware courts will use the contract as evidence and not mitigation of self-dealing.

b) **Negotiated Charters** – A controlling stockholder may also receive some protection by having arm's length negotiations over certain provisions of organizational documents in a merger context. Solomon, 747 A.2d at 1124-25 (Del. Ch. 1999). This case concerns a parent company that wanted to split off a subsidiary and renegotiate several contracts and intercompany claims with that subsidiary. Plaintiff raised some concerns about the transaction being analogous to a freeze-out and being unfair, as the parent might have been able to retaliate if the negotiations went sour. Chancellor Chandler noted that "[a]s a matter of common practice a literal arm's-length negotiation happens when a soon-to-be-subsidiary tracking stock company is first merged into another company (*e.g.,* when EDS first became part of the GM corporation)." Id. at 1124. When the subsidiary originally joined the corporate family, the subsidiary negotiated for protective terms in parent's certificate of incorporation. The subsidiary received shares of a separate class of tracking stock that was tied to the subsidiary's earnings, and the charter included certain veto rights related to that subsidiary's business line and protections related to dividend distributions. These protective terms anticipated the conflicts of interest that arose in this case, and Chandler deferred to that negotiation, rejected entire fairness review, and reviewed the transaction under the business judgment rule.

c) **Shareholders Agreements** – Even when controlling stockholders negotiate at arm's length for certain contractual rights, there is still a risk that entire fairness review will apply when those rights are exercised. For instance, eBay involved several fiduciary duty claims against a controlling stockholder's contractually permitted actions, and the Chancery Court found that a self-dealing action involving a financial benefit merited entire fairness review, whereas a similarly interested action without such a financial benefit received business judgment review. eBay Domestic Holdings, Inc. v. Newmark, 16 A. 3d 1 (Del. Ch. 2010). The case involved Craigslist, which was a company in which eBay Domestic Holdings, Inc. ("**eBay**") was the minority stockholder and had the right to nominate one of three directors, and in which Craig Newmark and James Buckmaster, acting together under a voting agreement, were the controlling stockholders and the other two directors. Mr. Buckmaster was also the CEO of the company.

These three parties negotiated a shareholders agreement when eBay invested in the company, in which eBay negotiated for consent rights over charter amendments and new share issuances, among other things, which, by their terms, fell away if eBay chose to compete with Craigslist. Id. at 11-13. eBay, Mr. Buckmaster and Mr. Newmark also each had a right of first refusal ("**ROFR**") over each other's shares, but, if eBay competed, eBay would lose its ROFR over the other parties' shares, but its shares would become unencumbered. Id. at 13 (If it competes, "eBay loses (1) its consent rights, (2) its preemptive rights over the issuance of new shares, and (3) its rights of first refusal over Jim and Craig's shares. Concomitantly, however, eBay is freed of the rights of first refusal Jim and Craig hold over eBay's shares in craigslist, making those shares freely transferable.") eBay, in fact, decided to compete by launching a similar website. In response, the majority stockholders adopted a staggered board, which effectively prevented the minority from using its cumulative voting to elect a director. The majority also caused a dilutive issuance of shares with a right of first refusal in favor of the corporation. Under the ROFR, a stockholder could receive one new share of stock if it granted the corporation a ROFR over five already-owned shares of stock.

The Chancery Court reviewed the staggered board amendment under the business judgment rule because there was no special financial benefit to the controlling stockholders as a result of this action and hence no self-dealing. Id. at 37-38 ("Jim and Craig did not realize a financial benefit by approving the Staggered Board Amendments so there was no self-dealing on the basis of financial considerations.") The Chancery Court also found that there was no entrenchment motive here, because the majority could already seat two of the three directors, and the staggered board provision did not change that outcome. eBay argued that removing the minority's ability to elect one of the three directors unfairly benefited the majority, but this benefit was apparently not enough to be considered self-dealing. After finding that there was no self-dealing, the Chancery Court applied the business judgment rule and found that the controlling stockholders had a valid business purpose. Id. at 40-41 (finding that preventing eBay, a competitor, from placing a director on the board and having access to valuable confidential information was a valid business purpose). Where a valid business purpose is found, the plaintiff may still allege general inequity, but here, eBay had specifically negotiated for that provision and forfeited its protection by competing with the corporation and the conduct was not found to be inequitable. Id. at 35-41 (". . .the Staggered Board Amendments cannot be inequitable because they were exactly the sort of consequence eBay accepted would occur if eBay decided to compete with craigslist.")

The Chancery Court reviewed the dilutive issuance under entire fairness and found that the transaction was unfair, even though eBay had negotiated for and subsequently forfeited its protections against such an action. Id. at 41-46. The trigger for entire fairness review was the presence of self-dealing with financial harm to the minority stockholder. The majority stockholders stood on both sides of the transaction: they signed as stockholders and Mr. Buckmaster signed as CEO on behalf of the corporation. Each person in the controlling group already had a ROFR on the other's shares under the shareholders agreement, whereas eBay was no longer encumbered by that ROFR. Therefore, the majority got a better price in the dilutive issuance: the majority could give a ROFR on already encumbered shares in exchange for new shares, but the minority would have to encumber freely-transferable shares for new shares. This economic detriment was sufficient to make the transaction unfair. Id. at 44 (". . .the price of the ROFR/Dilutive Issuance is not fair because it requires eBay, the minority stockholder, to give up more value per share than either Jim or Craig, the majority stockholders and directors. This disproportionate "price" is sufficient, standing alone, to render the ROFR/Dilutive Issuance void.") When controlling stockholders have the opportunity to exercise contractual rights, they should be wary of doing so where they stand on both sides of the transaction and the action would result in disproportionate financial harm to the minority. It appears that the act of the dilutive issuance was not the problem, but the disproportionate effect on the minority stockholder that triggered entire fairness review and rendered the transaction unfair.

4) **Mergers, Changes of Control and Tender Offers**

In the area of mergers and acquisitions, it appears that the form of the transaction may dictate some of the rules and analysis that apply to the review of fiduciary duties in connection with the transaction. A few recent cases seem to have increased scrutiny of various types of transactions, and the law does not seem to be settled. For instance, a one-step cash-out merger appears to apply entire fairness review if the controlling stockholder is on both sides of the transaction, but the burden can be shifted to the plaintiff if either a special committee approves the transaction or the transaction is approved by a majority of the minority stockholders. Kahn v. Lynch, 638 A.2d at 1115. On the other hand, a two-step tender offer with a squeezeout merger might apply entire fairness, but, instead of merely shifting the burden, will apparently switch to business judgment review if both a special committee is used and a majority of the minority tender condition is used. CNX Gas, C.A. No. 5377-VCL. Even in the context of a merger transaction between a company owned by a controlling stockholder and an unaffiliated third-party, the presence of a third-party buyer does not automatically avoid application of entire fairness. Under a recent case, Hammons, discussed below, the business judgment rule will only be applied if both a special committee is used and a majority of the minority vote condition is used. In re John Q. Hammons Hotels Inc. Shareholder Litigations, 2009 WL 3165613, *29 (Del. Ch. 2009).

a) **Heightened Scrutiny (Revlon Duties)**

i) **Directors' Duties** – In sales of control without controlling stockholders, directors are typically subject to the heightened scrutiny of Revlon duties, which fall under the business judgment standard of review but require the directors to obtain the best value reasonably available for the corporation's stockholders. Revlon, Inc. v. MacAndrews & Forbes, Inc., 506

A.2d 173 (Del. 1986) ("**Revlon**"); Paramount Communications v. QVC Network, Inc., 637 A.2d 34, 44 (Del. 1994) (The duty is "to secure the transaction offering the best value reasonably available for the stockholders.")

In the context where a controlling stockholder is involved in the sale of control, the directors may receive a benefit of relaxed Revlon duties. But note that this benefit to the directors might be outweighed by the potential entire fairness review of the controlling stockholder's role in the transaction. If the controlling stockholder merely proposes the sale, but the board initiates the sale process, then Revlon duties are triggered. McMullin v. Beran, 765 A.2d 910, 918-20 (Del. 2000) ("When the entire sale to a third-party is proposed, negotiated and timed by a majority shareholder, however, the board cannot realistically seek any alternative because the majority shareholder has the right to vote its shares in favor of the third-party transaction it proposed for the board's consideration. Nevertheless, in such situations, the directors are obliged to make an informed and deliberate judgment, in good faith, about whether the sale to a third party that is being proposed by the majority shareholder will result in a maximization of value for the minority shareholders.") The Revlon duties of the board are relaxed if the controlling stockholder negotiates the entire deal and then offers it up to the board, with the implication being that the controlling stockholder will impose its will and approve the transaction (such that the board, de-facto, has a more limited role in approving the transaction). The board still has a responsibility to negotiate and get the best deal it can, but the price concern may be less salient (in part, because there is no first time "sale of a control" where there was no controlling stockholder previously—but rather a scenario in which a controlling stockholder is making a decision to obtain its control premium.

Revlon duties are not triggered at all where the controlling stockholder forces a merger of the company into the controlling stockholder entity, as with a subsidiary merging into a parent.

Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 844-45 (Del. 1987) (finding that no Revlon duties were triggered in a parent-subsidiary merger where the company was not otherwise up for sale and any attempt to auction the company would have been "futile" because of the controlling stockholder, and finding that the controlling stockholder did not breach the duty of loyalty where the special committee and a majority of the minority stockholders approved the transaction, shifting the burden of proof to the plaintiff). The reasoning behind this result is that although there is a technical "sale of control," it is not a "sale of control" in the Revlon sense, since the control person is the same on both sides of the transaction.

ii) **Controlling Stockholder Selling Its Shares** – As for the self-dealing analysis that applies to controlling stockholders in such situations, the control premium received for selling a control block of shares is not considered a special benefit, even if the minority stockholders do not share in that control premium. Abraham, 901 A.2d at 758-59.

b) **Transactions with a Third-Party Buyer**

i) **The Hammons Case** – Due to recent case law, and unlike the traditional self-dealing analysis, the presence of a third party and negotiations with that party do not remove the transaction from entire fairness review. A recent case, which was issued only in a memorandum opinion, but which reverberated throughout the corporate law bar, applied entire fairness to a third-party transaction. Based on this case, even for transactions in which the controlling stockholder does not stand on both sides and there is an unaffiliated third party, the entire fairness standard will govern the transaction unless two procedural hurdles are met:

A) The transaction is recommended by a special committee; and

> B) The transaction is approved by a non-waivable vote of the majority of all outstanding minority stockholders.
>
> <u>Hammons</u> at *29.

In Hammons, a third-party buyer negotiated with the target and the target's controlling stockholder for a proposed cash merger. The target set up a special committee to negotiate on behalf of the minority, but the controlling stockholder was still involved in the negotiations. As part of that deal, the third party gave additional consideration to the target's controlling stockholder in exchange for the controlling stockholder's super-voting shares. This additional consideration included an equity interest in the surviving entity and some contractual arrangements to provide the controlling stockholder a line of credit for other development opportunities and to help the controlling stockholder avoid triggering tax liability on the sale.

So far, the transaction would appear to be governed by the business judgment rule, as there is no self-dealing (but rather consideration for the controlling shareholder's high voting shares). The Chancery Court applied entire fairness review, not because it found self-dealing, but because it found that the special committee had procedural defects in its negotiations. First, the transaction was conditioned upon an approval of a majority of voting minority stockholders, not the total outstanding minority stockholders. Second, the special committee had a right to waive that minority voting requirement and proceed with the transaction even if the minority voted against the transaction. This potential waiver was a deficiency even though the special committee chose not to waive the requirement. Had both of these deficiencies been addressed, the court stated that there would not merely be a burden-shifting effect under the entire fairness review, but, instead, an application of the more-lenient business judgment rule. <u>Id.</u> Query whether the controlling stockholder's special consideration is the key fact in this case, and whether a third-party transaction without such a fact would be reviewed under entire fairness. It remains to be seen how the Delaware courts will rule on this issue in future cases.

The logical implications of the decision in Hammons appear to be at odds with the analysis of one-step cash-out mergers, discussed below, in that, on its face, Hammons appears to apply entire fairness unless *both* a special committee and a majority of the minority stockholders condition are used. In one-step cash-out mergers, which seem to be more fraught with self-dealing issues and in need of procedural protections, entire fairness appears to apply, but the controlling stockholder may shift the burden to the plaintiff by using *either* a special committee or approval by the majority of the minority vote. It appears that Hammons requires more stringent procedural protections for a less problematic situation. It remains to be seen how this apparent tension will be resolved in future Delaware cases. As relating to one-step cash-out mergers by controlling stockholders, it appears that Kahn v. Lynch still applies. Cox Radio, discussed below, was decided after Hammons and, in distinguishing between standards for tender offers and negotiated mergers, reaffirmed the application of Kahn v. Lynch and its burden-shifting analysis in one-step cash-out mergers. In re Cox Radio, Inc. Shareholders Litigation, C.A. No. 4461-VCP, *26-29 (Del. Ch. 2010).

c) **One-step cash-out mergers** – The entire fairness standard will apply if the controlling stockholder is on both sides of the transaction. Kahn v. Lynch, 638 A.2d at 1115 ("A controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness.") An example of such a transaction is a parent-subsidiary merger. Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990). In such a transaction, entire fairness review will apply, but the controlling stockholder may shift the burden to the plaintiff by either establishing an independent committee to negotiate the transaction or by obtaining approval by a majority of the minority stockholders.

Recently, Southern Peru, decided after Hammons and Cox Radio, involved a negotiated merger in which the controlling stockholder was on both sides (a situation akin in analysis to a one-step cash-out merger), and Chancellor Strine appeared to require that the transaction be conditioned up-front on the majority of minority vote for burden shifting under entire fairness. Southern Peru, 30 A.3d at 93 ("[I]n a situation where the entire fairness standard applies because the vote is controlled by an interested stockholder, any burden-shifting should not depend on the after-the-fact vote result but should instead require that the transaction has been conditioned up-front on the approval of a majority of the disinterested stockholders.")

One exception to the Kahn v. Lynch fairness analysis above is the short-form merger. Delaware law provides for a simple short-form merger without the need for a shareholder vote if the parent company owns 90% of the subsidiary, in which case no fiduciary duties apply and the minority stockholders' only remedy is appraisal rights. Delaware General Corporation Law § 253; Glassman v. Unocal Exploration Corp., 777 A. 2d 242, 248 (Del. 2001).

d) **Two-step tender offers with squeezeouts** – The old standard applied business judgment review when a controlling stockholder took a company private by using a two-step tender offer with a short-form merger, so long as the tender offer was non-coercive and conditioned upon tenders by a majority of the minority. Non-coercion required the same consideration to be offered for the short-form merger step, no threats of retribution for failure to tender and adequate time and information for the board and minority shareholders to consider the offer. In re Pure Resources Shareholders Litigation, 808 A.2d 421, 445 (Del. Ch. 2002).

e) **Recent developments in tender offers**

i) **CNX Gas** – This case calls into question the tried and true procedure of going private through a two-step tender offer. Here, the controlling stockholder did such a tender offer, but was nevertheless subjected to entire fairness review. First, the controlling stockholder entered into a tender agreement with a substantial minority stockholder. Second, the controlling stockholder appointed a special committee to evaluate the tender offer, but the committee did not have authority to negotiate the terms of the offer or to consider alternatives to the offer. Vice Chancellor Laster ruled that for the business judgment rule to apply in such a case, the tender offer must be:

> (A) recommended by a special committee of independent directors which possesses the same authority as a board facing a third-party transaction; and
>
> (B) conditioned on tendering by a majority of the minority stockholders.
>
> CNX Gas at *1.

Here, Vice Chancellor Laster found that the tender agreement with the large minority holder undermined the majority-minority approval and took the transaction into entire fairness review. Also, the weakness of the special committee alone would trigger entire fairness review. CNX Gas at *28-29.

ii) **Cox Radio** – This case involved a controlling stockholder initiating a tender offer for the shares that it did not own, seeking to take the company private. The controlling stockholder negotiated with a special committee on the terms of the tender offer and related disclosures. The Chancery Court affirmed the Pure Resources standard for two-step tender offers, requiring non-coercion and a majority of the minority tender condition to avoid application of the entire fairness standard. The Chancery Court also clarified that Kahn v. Lynch's application of entire fairness and burden-shifting analysis was limited to negotiated mergers and did not apply to tender offers. Cox Radio at *26-29.

Practitioners facing a potential two-step tender offer and squeezeout situation will have to consider the legal uncertainty created by these recent cases and the risks presented by the different tender offer structures that they contemplate. Under both CNX Gas and Cox Radio, controlling stockholders face the risk that the majority of the minority stockholders will not tender and the transaction will fail because that condition was not satisfied. The difference between the two cases is that CNX Gas requires the use of a special committee to obtain business judgment review, whereas Cox Radio requires non-coercion. If a controlling stockholder appoints a special committee, the controlling stockholder will lose some control over the tender offer process, and the special committee may negotiate for a price that the controlling stockholder is not willing to pay. If approved, the transaction may receive business judgment review, but minority stockholders could also litigate issues related to the independence and process of the special committee. On the other hand, a controlling stockholder could avoid using a special committee, which would allow the controlling stockholder to retain control over the terms of the tender offer. Here, the controlling stockholder could satisfy Cox Radio (assuming non-coercion and tender by a majority of the minority) and receive business judgment review, but, if CNX Gas governs the transaction, then entire fairness review would apply. If a controlling stockholder does not want to risk the majority of the minority vote, query whether a one-step cash-out merger with a special committee is a better option. The controlling stockholder rescinds some control over the terms of the transaction and can only achieve burden shifting under entire fairness, but those risks may be outweighed by the risk that a majority of the minority stockholders vote against the deal.

5) **Conclusion**

There appears to be a trend of increasing scrutiny of transactions involving controlling stockholders, and this increased scrutiny has taken several forms. First, Southern Peru scrutinized the negotiation process of the special committee. Practitioners cannot merely check off items on a list and establish an independent special committee; that committee must also actively negotiate the deal and question whether it should happen at all. Moreover, Southern Peru appears to require that when a majority of the minority vote is used, the transaction must be conditioned up-front on obtaining such vote in order to receive a burden-shifting benefit. Additionally, fairness opinions obtained prior to signing might go stale at some point, which increases the burden on the controlling stockholder and its counsel throughout the transaction, because they must now determine when a new fairness opinion is desirable. Second, in Hammons, even in third-party deals, the procedural burdens appear to have increased. To obtain business judgment review under Hammons, the controlling stockholder must establish a special committee and a majority of the minority vote condition. Third, CNX Gas appears to increase the burden in tender offer situations by requiring the use of a special committee (in addition to a condition that a majority of the minority stockholders tender) to obtain business judgment review. It remains to be seen whether more certain legal standards develop in these areas, but the general trend appears to be clear: assume a controlling stockholder transaction will be scrutinized. The water is murky; tread carefully.