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Major Trouble In Del. Minority Buyouts

Law360, New York (March 31, 2014, 1:18 PM ET) -- For majority stockholders in Delaware companies, the complications and added expenses often caused by minority stockholders may result in a decision to buy out that minority, simplify the company's capital structure and potentially inject additional capital into the company to fund future growth.

At this point, you might view this as just another deal — analogous in many ways to the original purchase of your majority position. In fact, you may think completing the transaction is as simple as rounding up a few of the largest stockholders and negotiating terms with them.

However, for majority stockholders whose majority interest equates to a controlling position, buying out the minority is complicated by the fact of majority control and the resulting fiduciary duties a controlling stockholder may owe to the minority. Controlling stockholders who are not cognizant of these issues could end up in court despite the seemingly ordinary nature of these transactions.

A recent case from the Delaware Court of Chancery, In Re Orchard Enterprises Inc. (Del. Ch. Feb. 28, 2014), provides a vivid reminder of what can go wrong when a majority stockholder attempts to buy out the minority. Among other things, the Orchard court found fault with a number of issues raised in the proposed buyout, including raising one issue that many investors may find counterintuitive to the proposition of "freedom of negotiation."

In Orchard, the controlling stockholder, a holder of approximately 42 percent of common stock and 99 percent of convertible preferred stock for total voting power of approximately 53.3 percent wanted to buy out the minority holders of common stock. Faced with the possibility of such a transaction, the company's board of directors established a special committee to negotiate the buyout. At the time of such negotiations, the company had also received interest from potential third-party buyers for an acquisition of the entire company.

In light of these competing offers, the special committee discussed a potential third-party sale with the controlling stockholder, and the controlling stockholder indicated that it would only do a deal with a third party if the controlling stockholder received the full liquidation preference for its preferred stock in the transaction.

Because the controlling stockholder had a sufficiently large ownership position to block a third-party sale, the special committee referred the potential third-party buyer to the controlling stockholder for direct negotiations. In these negotiations, the controlling stockholder ultimately demanded a significant premium over the face value liquidation preference of the preferred stock (a more aggressive position than was represented to the special committee). The negotiations eventually fell apart.

Left with no clear third-party alternative, the special committee and the controlling stockholder negotiated a buyout transaction subject to a go-shop period and a condition that a majority of the minority approve the transaction. Following distribution of a proxy and a vote of the stockholders, the controlling stockholder and special committee completed the buyout transaction.

Although a controlling stockholder might think that it is free to take any position it wants in negotiations and reserves the right to change its mind and demand a higher price from a third party than it originally indicated, the court thought differently. The court suggested that if a controlling stockholder misrepresents its willingness to sell (and the applicable terms on which it would sell) to the company and the special committee, then such misrepresentations can completely undermine an otherwise appropriate special committee process.

Although the court did not make any factual determinations, the court suggested that the controlling stockholder's alleged misrepresentations (1) removed the special committee's reasons to oppose the controlling stockholder's influence or get involved in the third-party negotiations to ensure proper representation of the minority stockholders' interests and (2) lessened the ability of the special committee to rely on a go-shop provision in the eventual buyout, which the special committee relied on as evidence of satisfaction of its fiduciary duties.

While many majority stockholders find the procedural issues associated with minority buyouts to be frustrating, they can be avoided with proper planning. At the outset of an investment, consider negotiating the specific terms of a buyout or repurchase of minority stockholders, including a mechanism for such a repurchase and an agreed valuation method for such repurchase.

In particular, when the future minority investors agree to those contractual provisions in an arm's-length negotiation prior to a majority investment and the existence of a controlling stockholder, the eventual buyout process is simplified and avoids the myriad of troubles described above.

Similarly, in a minority investment situation, a "drag-along" right with an agreed valuation method can also be very useful for the controlling stockholder, because the controlling stockholder can sell to a third party without the added uncertainty that the minority would bring to negotiations.

Finally, an anticipated controlling stockholder should consider if it makes sense to use a limited liability company with an agreed waiver of fiduciary duties, because that would provide the controlling stockholder with the more intuitive "freedom of negotiation."

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