Alerts and Updates

DELAWARE CHANCERY COURT REFINES APPLICABILITY OF ENTIRE FAIRNESS AND BUSINESS JUDGMENT STANDARDS OF REVIEW FOR CERTAIN MERGER TRANSACTIONS

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In a recent decision, the Delaware Chancery Court provided new guidance on the standard of review to be applied to a merger in which a controlling stockholder participates and receives different aggregate consideration than minority stockholders, but does not stand on "both sides of the transaction."

In *In re John Q. Hammons Hotels Inc. Shareholder Litigation*,[1] while determining that the entire fairness standard of review applied to a transaction in which the minority stockholders were bought out by an independent third party and not by the controlling stockholder, the Chancery Court also ruled that the use of sufficient procedural protections could have resulted in the application of the business judgment standard of review, although the protections in this particular case were held to be insufficient.

Background

John Q. Hammons Hotels, Inc., (the "Company") was a publicly traded corporation controlled by John Q. Hammons. Hammons, the Company's chairman and chief executive officer, held 76 percent of the Company's total voting power through his ownership of 5 percent of the Company's publicly traded Class A common stock and all of its Class B common stock, shares of which were entitled to 50 votes per share, as well as a 72 percent economic interest in the Company's primary operating subsidiary. In early 2004, Hammons informed the Company's board of directors (the "Board") that he had begun discussions with third parties about a potential sale of the Company or his interests therein.

In October 2004, upon receipt of a merger proposal from an independent third party, the Board formed a special committee of independent directors to evaluate and negotiate the proposed transaction. The special committee retained Katten Muchin as counsel and Lehman Brothers ("Lehman") as its financial advisor. In December 2004, a second bidder controlled by Jonathan Eilian ("Eilian") also submitted a merger proposal to the special committee, which continued to evaluate these and other alternatives. In January 2005, Eilian proposed to acquire all the Class A stock for $24 per share in a transaction in which Hammons would have a substantial equity interest in the Company post-acquisition. After continued negotiations over a period of months, in June 2005, Hammons and Eilian reached certain agreements between themselves, providing

Hammons with, among other things, preferred stock in JQH Acquisition, the acquiring entity ("Acquisition"), and entitling him to a $335 million liquidation preference and access to short- and long-term lines of credit; and Eilian thereupon reaffirmed his offer of $24 per share for the outstanding Class A stock. Hammons negotiated directly with Eilian regarding Hammons' own interests in the transaction, and did not participate in the negotiations between Eilian and the special committee.

On June 14, 2005, the special committee met with its advisors, with Katten Muchin providing an overview of the Eilian offer and the various agreements between Hammons and Acquisition, and Lehman presenting the basis for its fairness opinion that the $24 per share price was fair to the minority stockholders from a financial point of view and that the allocation of the total consideration between Hammons and the minority stockholders was reasonable. Hammons advised the Board that he supported the transaction and recused himself, and the Board voted to approve the transaction.

The merger was conditioned on approval by a majority of the Company's minority stockholders voting on the merger; however, the special committee retained the power to waive that condition. At a special meeting of the Company's stockholders on September 15, 2005, over 72 percent of all the issued and outstanding shares of Class A stock were voted in favor of the merger, which number comprised 89 percent of the shares of Class A stock voted at the meeting, and the merger closed the following day.

The Claims

Certain of the Company's minority stockholders brought a class action lawsuit seeking damages for an allegedly inadequate price paid for their Class A shares. The plaintiffs contended that Hammons breached his fiduciary duties as a controlling stockholder by negotiating benefits for himself that were not shared with the minority stockholders and that the directors breached their fiduciary duties by allowing the merger to be negotiated through a defective process and by voting to approve the merger.

Plaintiffs and defendants filed cross-motions for summary judgment, and the threshold issue was whether the court would apply an entire fairness or business judgment standard of review to the actions taken by Hammons and the Board. The court concluded that, although *Kahn v. Lynch Communication Systems, Inc.*[2] did not mandate the application of the entire fairness standard in this case, and the use of sufficient procedural protections could have resulted in the application of the business judgment standard of review, the procedural protections in this case were insufficient and thus the entire fairness standard of review would be applied.

Discussion

In *Kahn v. Lynch*, the Delaware Supreme Court concluded that the entire fairness standard applies to judicial review of a cash-out merger transaction by a controlling stockholder, and that the initial burden of proving entire fairness rests with the party "who stands on both sides of the transaction," but that this burden of proof can be shifted if the transaction is approved by an independent committee of directors or an informed majority of the minority stockholders.

The Chancery Court in *Hammons* found that because the offer to the minority stockholders came not from Hammons, the controlling stockholder, but from Eilian, an unrelated third party, Hammons was not standing "on both sides of the transaction," and that the application of the entire fairness standard from *Lynch* was not required. However, despite the lack of such a mandate, the court found the procedural protections insufficient and determined to apply the entire fairness standard, and concluded that business judgment would have been the applicable standard of review if the transaction had been "(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."

In this instance, the court noted that while Hammons was not on both sides of the deal, he was in a real sense competing with the minority stockholders for portions of the aggregate consideration available, and that his controlling position afforded him effective veto power over the deal, as a result of which "robust" procedural protections would be required for the business judgment standard to apply—in this case, a non-waivable requirement that the transaction be approved by a majority of all the Class A stock, not just a majority of those voting. The court also determined that a lack of sufficient procedural protections could not be "cured" after the fact in that, had the protections been properly established, they would in the end have been satisfied.

The court found that material issues of fact remained regarding whether the financial advisor's fairness opinion properly accounted for the value to Hammons of certain lines of credit and tax benefits, and as to whether alleged self-dealing by Hammons artificially depressed the price of the Company's stock, effectively coercing the minority stockholders into accepting a deal to avoid being holders of undervalued shares. Accordingly, the court denied each party's motion for summary judgment on these points.

Consequences and Planning

After *Hammons*, corporations with a controlling stockholder that are involved in mergers and other business combination transactions with third parties would be well advised to utilize a truly disinterested and independent special committee to negotiate all elements of the transaction directly affecting the minority stockholders, as well as to strictly condition the transaction on the approval of a majority of all the votes held by the minority stockholders. Otherwise, the controlling stockholder and the directors may not be able to obtain the benefit of the business judgment standard of review, and indeed even the satisfaction of the requirements of procedural fairness and fair price required under the entire fairness standard may be more difficult to achieve.

Advisors should also consider carefully any factors that can affect committee independence or interfere with its authority and ability to bargain on behalf of the minority stockholders, such as the ability to hire independent legal and financial advisors, and whether factors such as threats, coercion or even fraud on the part of the controlling stockholder could be deemed to adversely affect the procedural protections normally provided by an independent committee and a separate minority stockholder vote.

For Further Information

If you have any questions regarding the issues or guidance described in this *Alert*, including how they may affect your company or its executives, please contact any member of the Corporate Practice Group or the attorney in the firm with whom you are mostly regularly in contact.

Notes

1. *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, C.A. No. 758-CC (Del. Ch. Oct. 2, 2009).
2. *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (1994).