KIRKLAND & ELLIS

KIRKLAND **M&A UPDATE**

October 18, 2012

Synthes-is: Some *Answers* on Controlling Stockholder Liquidity

As shown in the recent Synthes *decision, Delaware legal doctrine regarding controlling stockholder liquidity in the absence of differential treatment seems to follow common sense, in that the size of a controlling stockholders' stake in a target in all likelihood creates the most powerful alignment of interest with the balance of the stockholder body possible — the desire to maximize the economic outcome.*

The long-held view of deal practitioners has been that, absent differential consideration or a rollover of all or a part of its shares, the size of a significant stockholder's stake in a target should not affect its (and its affiliated directors') ability to participate in a sale process or represent a conflict of interest that requires specific procedural protections. In late 2011, the Delaware Chancery Court issued the *infoGroup* decision, followed by the *Answers* decision in early 2012, the combination of which raised some level of concern among dealmakers that a large stockholder's desire for liquidity, and therefore a sale of the business, may create a conflict of interest even when the large stockholder is treated equally with other stockholders. As we discussed in previous *M&A Update*s, available here and here, we did not believe that *infoGroup* and *Answers* (both of which were at a preliminary stage of litigation on a motion to dismiss) should be viewed as a paradigm shift in doctrine applicable to large stockholder liquidity. The recent *Synthes* decision is supportive of this conclusion, suggesting that *infoGroup* and *Answers* were in fact narrow fact-specific holdings.

In *infoGroup*, the CEO and 37% shareholder was suffering a severe personal liquidity crunch and allegedly engaged in a pattern of intimidating and bullying the board to push through a sale of the business. Some directors exchanged emails referencing the "pain, [and] trauma" caused by the controlling shareholder in the sale process and a desire to "dump the company and run". VC Noble found that the CEO and the "dominated" directors were subject to a disabling conflict by virtue of the incremental and unique "material benefit" of needed liquidity deemed received by the CEO. In *Answers*, a 30% stockholder was seeking an exit from the target's thinly traded equity and had appointed three members of the target's board, including the CEO. With a stalling sale process, the large stockholder allegedly threatened to fire the entire management team, including the CEO, if the sale process failed and exerted significant influence over the conduct of the other directors. More specifically, it was alleged that the board of directors of the target, at the behest of the controlling shareholder, agreed to a perfunctory and rushed market check designed to lead to a signing of a sale agreement ahead of the public announcement of improved operational performance which may have put the market price above the offer price. In both cases, the court found that the "liquidity conflict" (*i.e.*, the alleged control and manipulation of the sale process by a large stockholder whose strong need/desire for liquidity could only be achieved by a sale given the size of its stake relative to the available stock market liquidity), along with other damaging facts (*e.g.*, the CEO's dominance of the board in *infoGroup* and the alleged apathy of unconflicted board members in *Answers*), were sufficient at the dismissal stage to support a reasonable inference that a breach of fiduciary duties had occurred.

Synthes involved a founder and chairman who exercised control over 52% of the target's shares (including through family members and trusts) as well as its board of directors. The plaintiffs contended that the controlling stockholder, seeking personal liquidity, favored a stock-and-cash sale of the company to J&J over other possible transactions (including a sale to private equity firms where he would be required to roll over all or part of his stake), resulting in financial motives that were adverse to the interests of other stockholders. Chancellor Strine dismissed this argument, calling the assertion that large stockholder liquidity on equal terms with all other stockholders is in and of itself a conflict a "chutzpah version" of the reasonable theory that such stockholders have a conflict when they are seeking an unequal deal favoring themselves. To quote Chancellor Strine, "[g]enerally speaking, a fiduciary's financial interest in a transaction as a stockholder (such as receiving liquidity value for her shares) does not establish a disabling conflict of interest when the transaction treats all stockholders equally". Moreover, the court described the notion that a controlling stockholder has a duty to subrogate its own interests so that minority shareholders can obtain a more favorable deal at the expense of the controlling stockholder as "a misguided view of the duties of a controlling stockholder under Delaware law".

It is important to note that, in contrast to the sale processes in *infoGroup* and *Answers*, the conduct in the *Synthes* transaction was more in line with Delaware courts' expectations of an appropriate process. Chancellor Strine, likely acknowledging the unique facts in *infoGroup* and *Answers*, pointed out that there "are very narrow circumstances in which a controlling stockholder's immediate need for liquidity could constitute a disabling conflict of interest irrespective of pro rata treatment" such as a "personal need for immediate cash". He went on to clarify that, "those circumstances would have to involve a crisis, fire sale where the controller, in order to satisfy an exigent need… agreed to a sale of the corporation without any effort to make logical buyers aware of the chance to sell, give them a chance to do due diligence, and to raise the financing necessary to make a bid that would reflect the genuine fair market value of the corporation."

Although the *Synthes* decision reiterated the notion that "pro rata treatment remains a form of safe harbor under [Delaware] law", dealmakers should remain mindful of situations where large holders, and even independent directors, may be at risk of allegations of divergent incentives. The *infoGroup* and *Answers* decisions, building on the 2000 *McMullin* decision, as well as the recent decision on a summary judgment motion in the *Trados* case, show that it may prove challenging to obtain dismissal of these allegations at the all-important preliminary litigation stages before a full trial on the facts. This is particularly true when, as appears in all three of these recent cases, the allegations are arguably supported by evidence such as shorthand emails among the directors which are inevitably susceptible to misinterpretation and being taken out of context. In addition, the *Trados* case shows the incremental risk presented when a contingent of venture capital shareholders with board representation supports a sale of the company in which they received a meaningful liquidation preference (to which they were inarguably entitled) for their preferred stock with the common stockholders receiving nothing over an alternative "stay the course" (but perhaps wing-and-a-prayer) business plan. In such a situation, the court is more likely to closely scrutinize the potential conflicts inherent in the varying interests and outcomes of the two classes of stockholders.

* * * *

As is usually the case, Delaware legal doctrine regarding controlling stockholder liquidity in the absence of differential treatment continues to generally comport with basic common sense. The size of a controlling stockholders' stake in a target in all likelihood creates the most powerful alignment of interest with the balance of the stockholder body possible — the desire to maximize the economic outcome. Although the recent cases we describe do evidence the Delaware courts' propensity for a facts and circumstances approach, they nonetheless offer some generally applicable cautionary guidance for dealmakers. Factors such as true equal treatment, the absence of unusual pressing cash needs of the large stockholder, meaningful control over the sale process by the full board rather than abdication of responsibility to the controlling stockholder, and avoidance of intemperate comments that may be judged in hindsight will all be important elements in achieving an early and successful outcome in inevitable plaintiff litigation.

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.

David Fox
http://www.kirkland.com/dfox
+1 212-446-4994

Daniel E. Wolf
http://www.kirkland.com/dwolf
+1 212-446-4884

Joshua M. Zachariah
http://www.kirkland.com/jzachariah
+1 212-446-6450

David B. Feirstein
http://www.kirkland.com/dfeirstein
+1 212-446-4861

Kirkland & Ellis LLP, 601 Lexington Avenue, New York, NY 10022