Fiduciary Duties and Procedural Safeguards in Going Private Transactions

A Practical Guidance® Practice Note by Michelle Heisner, Baker McKenzie, LLP

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This practice note discusses the legal framework, with a focus on Delaware corporate law, for reviewing going private transactions, and discusses how corporate boards can demonstrate procedural fairness in the event of shareholder litigation.

A "going private" or "take private" transaction is commonly understood to mean a transaction or series of related transactions that results in (i) the termination of a public company's reporting requirements under the Securities Exchange Act of 1934 and the delisting of the company's stock from the relevant stock exchange and (ii) the company being owned by a person or group of persons with some prior "control" relationship with the company. Unlike other M&A transactions in which a public company is deregistered or delisted, going private transactions present unique fiduciary duty issues because of the insider relationship between the acquirer and the target. Since the acquirer essentially stands on both sides of the transaction, it could potentially structure the transaction to give itself more favorable terms or to coerce the unaffiliated stockholders into selling their shares.

For a discussion of the heightened disclosure obligations under federal securities laws for a company going private, as well as other deal-structuring considerations, see Going Private Transactions: Structuring and Planning.

Heightened Scrutiny in Going Private Deals

In their management of a corporation's business and affairs, directors and officers owe fiduciary duties to the corporation's stockholders. Stockholders generally do not owe fiduciary duties to each other, but a stockholder may owe fiduciary duties to other stockholders if it owns a majority interest or otherwise exerts control over the corporation. See Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110 (Del. 1994). Going private transactions implicate the duty of loyalty because of the inherent conflict of interest that exists when management or controlling stockholders are on both sides of a transaction.

Generally, courts review corporate actions by management using the business judgment rule. The business judgment rule is a presumption in favor of the validity of a business decision, which can be rebutted only by a showing of gross negligence on the part of the directors or officers. In the absence of such a showing, the business judgment rule protects the directors or officers from any liability that might arise from a protested decision and protects the business decision itself from being overturned by judicial action.

To rely on the business judgment rule, however, the management must have fulfilled their two principal fiduciary duties: the duty of care and the duty of loyalty. If such party breaches (or cannot comply with) either of these duties, courts will generally refuse to apply the business judgment rule and require the party to prove that it acted in the best interests of the stockholders.

In going private transactions, management or controlling stockholders may be in a position to dictate all of the terms of the transaction or receive a benefit to the exclusion of - and at the expense of - the unaffiliated stockholders. Where such a conflict of interest exists, courts (particularly in Delaware) may scrutinize the transaction under the "entire fairness" standard rather than the business judgment rule.

For a general discussion of fiduciary duties of directors and officers, see Fiduciary Duties of Board of Directors and Fiduciary Duties of Officers (DE Corporation), respectively; see also Fiduciary Duties of the Board of Directors (Delaware).

Mitigating Litigation Risk

Given the heightened litigation risk in engaging in a going private transaction, the consequences of failing to meet the entire fairness standard can be significant. M&A attorneys should advise their clients of the fiduciary duties that may be implicated in a take private deal, understand the entire fairness analysis, and implement procedural safeguards that will help to establish fairness in the event of a stockholder challenge.

- In particular, because a Delaware court will review a going private transaction with a controlling stockholder (or, in certain situations, that involves participation by members of the target company's board or senior management) or both using the heightened scrutiny of entire fairness rather than the more deferential business judgment rule unless certain procedural safeguards are implemented, the bidder should carefully consider conditioning its initial offer on approval by ***both*** (i) an independent special committee empowered to negotiate and choose to reject the deal and (ii) an informed and uncoerced vote of the majority of the unaffiliated minority stockholders in order to avoid the burden of proving that the transaction was fair to such stockholders. See When is the Entire Fairness Standard Applied? below.
- If the bid is not conditioned at the outset on the approval of both an empowered and independent special committee and the majority of the unaffiliated minority stockholders, the burden of proving that entire fairness does not exist can nonetheless be shifted to plaintiffs by approval by ***either*** (i) an independent special committee empowered to negotiate and choose to reject the deal or (ii) an informed and uncoerced vote of the majority of the unaffiliated minority stockholders in order to avoid the burden of proving that the transaction was fair to such stockholders. See Burden of Proof on Controlling Stockholder or Board below.

This practice note summarizes the following issues that commonly arise when courts analyze entire fairness and discusses the following key procedural safeguards:

- Establishing Entire Fairness of a Take Private Deal
- When is the Entire Fairness Standard Applied?
- Establishing a Special Committee
- Requiring "Majority of the Minority" Stockholder Approval
- Additional Steps to Ensure Independence

Establishing Entire Fairness of a Take Private Deal

In analyzing the entire fairness of a transaction, courts consider two elements of fairness—fair dealing and fair price.

- Fair dealing, also known as procedural fairness, focuses on the process by which the going private transaction was negotiated and approved.
- Fair price, also known as substantive fairness, is concerned with the economic and financial aspects of the transaction.

It is important to note that entire fairness is not a strict binary test. Rather, courts evaluate the overall fairness of the going private transaction in light of the concerns for substantive and procedural fairness.

Fair Dealing

Two ways in which the parties to a going private transaction can establish fair dealing are by (i) creating a special committee of the target's independent board of directors to negotiate and evaluate the transaction and (ii) requiring approval of the transaction by an informed and uncoerced majority of the minority or unaffiliated stockholders. These and other procedural safeguards are discussed in further detail in Procedural Safeguards in Going Private Transactions below.

Fair Price

With respect to fair price, the price offered in the transaction does not necessarily have to be the highest possible price for the target. Rather, the price must fall within a range of prices that the target could reasonably accept. There is no single approach to determining fair price, and the factors reviewed and the relative weight given each factor in the analysis will vary from one transaction to another. The Delaware Supreme Court has provided some guidance, suggesting the following factors as potentially relevant to a fair price analysis:

- Assets;
- Market value;
- Earnings;
- Future prospects; and
- Any other elements that affect the intrinsic or inherent value of a company's stock.

See Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994). To further ensure that it is getting a fair price for unaffiliated stockholders, the target's board or special committee may perform a "market check" or consider alternative transactions. With a controlling stockholder, however, a market check is generally a futile exercise and the controlling stockholder will respond with a perfunctory "not interested in any alternative transactions" letter.

Burden of Proof on Controlling Stockholder or Board

As an initial matter, the controlling stockholder or board of directors has the burden of proof to demonstrate the entire fairness of a transaction. As discussed below, the controlling stockholder or board of directors will have a limited ability to shift the burden of proof to the plaintiff to demonstrate that the transaction was unfair when the transaction is approved by ***either*** (i) an independent special committee empowered to negotiate and choose to reject the deal or (ii) an informed and uncoerced vote of the majority of the unaffiliated minority stockholders in order to avoid the burden of proving that the transaction was fair to such stockholders. See Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994). If the controlling stockholder or board cannot meet its burden (or if the plaintiff proves that the transaction was unfair), then the controlling stockholder or the board will be found in breach of its fiduciary duties.

Consequences of Failing to Meet Entire Fairness Standard

If a going private transaction does not meet the entire fairness standard, the court will typically have a variety of remedies at its disposal, including injunctive relief (most often in the case where the transaction has not yet closed) and damages to be paid by the acquiring party equal to the fair price (as determined by the court) minus the actual purchase price paid. Thus, it is extremely important for the parties in a going private transaction to be mindful of the requirements of the entire fairness standard and strive to ensure that their transaction will withstand such scrutiny.

When is the Entire Fairness Standard Applied?

Squeeze-Out Transactions. When a controlling stockholder seeks to acquire all of the remaining shares held by the public, an inherent conflict of interest exists. Traditionally, courts have applied the entire fairness standard (and the potential outcome for the failure to meet the standard) to any transaction as the default operative standard for transactions where a controlling stockholder effectively stands on both sides of a transaction (i.e., not just a going private transaction). However, the Delaware Supreme Court held that a merger involving a controlling stockholder will be entitled to the more deferential business judgment rule if certain procedural safeguards are implemented. See Kahn v. M&F Worldwide Corp., 2014 Del. LEXIS 115, *22 (Del. Mar. 14, 2014) (hereinafter "MFW"). The six-factor test requires that "(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." Id. at *22. Importantly, the controlling stockholder must condition its offer on the key MFW protections "at the germination stage of the Special Committee process, when it is selecting its advisors, establishing its method of proceeding, beginning its due diligence, and has not commenced substantive economic negotiations with the controller." See Flood v. Synutra Int'l, Inc., 195 A.3d 754 (Del. Oct. 9, 2018).

Controlling Stockholder and Minority Holders Receive Different Consideration. The Delaware Chancery Court has also held that the entire fairness standard of review can apply to a transaction with an unrelated third party in which the controlling stockholder receives different consideration from the minority stockholders. See In re John Q. Hammonds Hotels S'holder Litig., 2011 Del. Ch. LEXIS 1 (Del. Ch. Jan. 14, 2011). A conflict of interest arises when the controlling stockholder is seen as competing with the minority stockholders for consideration, attracting a heightened scrutiny level. However, if the controlling stockholder enters a third-party transaction and receives identical consideration as the minority holders, there is no conflict of interest, and the transaction can be reviewed under the business judgment rule. See In re Synthes, Inc. S'holder Litig., 50 A.3d 1022 (Del. Ch. 2012) and In re Morton's Rest. Gp. Inc. S'holders Litig., 74 A.3d 656, 662 (Del. Ch. 2013). Furthermore, the court in In re John Q. Hammonds did recognize that similar transactions with differential consideration could invoke the business judgment standard through the use of property procedural protections.

Controlling Stockholder has Continuing Stake. In a third-party transaction, if all or a portion of the controlling stockholder's stake is exchanged for a future stake in the merged entity, the transaction could be subject to heightened scrutiny. Traditionally, these transactions are viewed as hybrid transactions: a combination of both squeeze-out transactions, and transactions involving different consideration. Courts have not been clear on defining the portion of the controller's stake that needs to be "rolled over" in order for the entire fairness standard to apply. In *In John Q. Hammons*, the court applied entire fairness where the controller received a small amount of roll-over equity; however, the controller also received a large amount of other consideration unavailable to the minority holders. There is also evidence that courts are willing to consider procedural safeguards to protect the transaction from being subject to heightened scrutiny. See e.g., In re LNR Prop. Corp. S'Holders Litig., 896 A.2d 169 (Del. Ch. 2005).

Tender Offer Followed by a Short-Form Merger. Historically, a going private transaction effected as a unilateral tender offer (i.e., without first negotiating a merger agreement with the target's board of directors) followed by a short-form merger would be subject to the business judgment rule, and not entire fairness, as long as it is non-coercive to the minority stockholders. See In re Pure Resources S'holders Litig., 808 A.2d 421 (Del. Ch. 2002). However, there is now uncertainty as to how Delaware Courts will review these going private transactions. A 2010 Delaware Court of Chancery decision suggested the courts follow a more "unified standard" of review for going private transactions structured as a tender or exchange offer. See In re CNX Gas Corp. S'holders Litig., 4 A.3d 397 (Del. Ch. 2010). The court followed a similar analysis to the MFW framework where the transaction will only be subject to the business judgment rule, and not entire fairness, if it is conditioned on outset by both the (i) negotiation and approval by an independent Special Committee, and (ii) approval by the majority of the minority shareholders.

While the structuring of a going private transaction should always be determined based on the particular facts and circumstances, it seems clear that controlling stockholders and target management are well-advised to carefully consider the potential benefits of implementing procedural protections to meet the MFW test in connection with their transaction planning. Special committees and majority-of-the-minority voting requirements are discussed in further detail below in Establishing a Special Committee and Requiring "Majority of the Minority" Stockholder Approval.

Procedural Safeguards in Going Private Transactions

The mechanics of executing a going private transaction are no different from those of an arm's-length transaction.

The steps that need to be taken, the consents and approvals that must be obtained, and the overall timeline will generally be the same.

Going private transactions do differ from arm's-length transactions in two significant respects.

- *Heightened Disclosure Requirements.* First, going private transactions are subject to the heightened disclosure requirements under Exchange Act Rule 13e-3. These requirements are discussed in detail in Going Private Transactions: Structuring and Planning — Schedule 13E-3 Disclosure Requirements.
- *Procedural Safeguards.* Second, going private transactions typically include certain procedural safeguards to protect the integrity of the negotiations process. As noted above, going private transactions involve unique fiduciary duties issues and are very likely to generate minority stockholder litigation. Procedural safeguards such as special committees and majority-of-the-minority approval requirements have become common features of going private transactions because they have been effective in demonstrating procedural fairness when implemented correctly. These and other measures to foster procedural fairness are discussed below.

Establishing a Special Committee

A common approach for establishing procedural fairness in a going private transaction is the establishment of a special committee of independent directors to negotiate and evaluate the transaction.

- *Negotiated Transactions.* In a one-step merger or a two-step merger with a negotiated merger agreement, the special committee negotiates the transaction on behalf of the corporation (and, indirectly, the minority stockholders) and considers whether to recommend approval of the transaction by the stockholders.

- *Non-Negotiated Transactions.* In a two-step merger without a negotiated merger agreement, the special committee evaluates the offer and makes a recommendation to the unaffiliated stockholders as to whether the stockholders should tender their shares.

Either way, the intention is to create an arm's-length process, in which a committee comprised of directors with no interest in the transaction can exercise genuine bargaining power against the controlling stockholder or affiliated acquirer. When a special committee is properly formed and properly discharges its duties, a court will generally shift the burden of proof with respect to entire fairness to the plaintiffs. The complaining stockholder plaintiffs must then demonstrate that the transaction was not entirely fair.

Independence of the Members

In order to receive the burden-shifting benefit, a special committee must be both properly formed and well-functioning. To meet both criteria, the independence of the members of the special committee is of critical importance. Each member of the special committee should have no direct or indirect interest in the proposed transaction which is inconsistent with the interests of the minority stockholders, and no relationships with the target's controlling stockholder or anyone else driving the transaction. The special committee also should have its own legal and financial advisors. The special committee's advisors generally should not have any significant past or present relationship with any of the principal deal parties or any direct or indirect stake in the transaction. The special committee's financial advisor will typically be asked to render an opinion that the consideration being offered by the acquirer is fair from a financial point of view to the stockholders of the corporation (other than the acquirer and its affiliates).

Early Involvement of the Committee

The special committee should be established early in the process and its legal and financial advisors should be involved in the initial stages of structuring and negotiating a transaction. In order for a special committee to be well-functioning, it is not enough for the committee simply to engage in pro forma negotiations and "bless" or "rubber stamp" a pre-packaged transaction. The committee must exercise real bargaining power against the acquirer. See Ams. Mining Corp. v. Theriault, 51 A.3d 1213 (Del. 2012). The minutes (or "record") of the special committee's deliberations and negotiations are thus of critical importance. In most cases, it is in the interests of all deal parties (including the potential acquirer) that the special committee reject the initial offer and that the record shows material movement on the proposed deal terms in favor of the minority stockholders.

Full Power and Authority of the Board

While practitioners have generally agreed that a special committee must have a clear mandate and be empowered to actively negotiate to achieve the best price reasonably available to the minority stockholders under the circumstances (including having the ability to say "no"), some Delaware Chancery Court cases have indicated that the committee must have the full power and authority of the board of directors in order to receive the intended legal benefit. See, e.g., Ams. Mining Corp.v. Theriault, 2012 Del. LEXIS 459 (Del. Aug. 27, 2012); In re CNX Gas Corp. S'holders Litig., 4 A.3d 397 (Del. Ch. 2010). This could conceivably include the ability to adopt a stockholder rights plan (or "poison pill"), institute litigation against the controlling stockholder, and pursue alternative transactions. At a minimum, these cases endorsing so-called "strong form" special committees stand for the proposition that courts expect that special committees should actively negotiate in a manner that would be reasonably expected from an arm's-length counterparty.

Value of Potential Burden-Shifting Benefit

Historically, the potential burden-shifting benefit of a special committee received significant attention and focus from deal parties and their advisors. However, caselaw over the past several years has highlighted that whether the burden can be shifted is a fact-intensive inquiry and thus may not be able to be resolved at the pleadings or preliminary injunction stage. Furthermore, it is now generally understood that the burden-shifting benefit is "modest" and "not practical." See Ams. Mining Corp, v. Theriault, 2012 Del. LEXIS 459 (Del. Aug. 27, 2012). Nevertheless, the proper formation and use of special committees remains an important part of satisfying the fair dealing or "process" component of the entire fairness standard for going private transactions and other interested party transactions.

When (and When Not to) Use a Special Committee

It should be noted that a special committee is not necessarily appropriate in every going private transaction (particularly a "technical" going private transaction, as discussed in Going Private Transactions: Structuring and Planning — Applicability of Rule 13e-3). In the case where the majority of the board of directors is disinterested in the transaction and does not otherwise have a conflict of interest, the interested directors can simply recuse themselves from the consideration and vote regarding the proposed transaction. In fact, the use of a special committee when not required could have significant unintended consequences -- for example, a transaction that would have otherwise been reviewed under the business judgment rule and not been closely followed by plaintiffs' attorneys could receive unwelcomed scrutiny.

Requiring "Majority of the Minority" Stockholder Approval

An additional process item that is sometimes utilized is to require that the going private transaction be approved a majority of the minority or unaffiliated stockholders. Many controlling stockholders or other acquirers will resist this condition on the grounds that they would be unnecessarily ceding control to potential activist stockholder groups who will seek to veto the transaction and "extort" a higher price. However, the Delaware Supreme Court held that a merger involving a controlling stockholder will be entitled to the business judgment rule (and not the entire fairness standard) if "(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." Kahn v. M&F Worldwide Corp., 2014 Del. LEXIS 115, *22 (Del. Mar. 14, 2014).

Importantly, the majority-of-the-minority condition must be:

- non-waivable;
- proposed as part of the deal from the outset; and
- based on the number of outstanding shares (as opposed to a majority of the votes cast or some other mechanism).

The condition can be applied to a going private transaction regardless of whether it is structured as a one-step or two-step merger. In a one-step merger, the condition would require a majority of the minority stockholders to vote in favor of the merger. In a two-step merger, the condition would require a majority of the outstanding shares held by minority stockholders to be tendered in the tender offer.

Additional Steps to Ensure Independence

Officers and directors who expect to directly or indirectly appear on the other side of the company in a going private transaction must be mindful of their individual duties, particularly in the preliminary stages of formulating a proposed transaction before the establishment of a special committee of independent directors.

The following are guidelines such participants should typically consider:

- Avoid disclosing or making use of nonpublic documents prepared by or on behalf of the company.
- Be mindful of Schedule 13D reporting obligations, including in connection with the formation of a "group" or in connection with the purchase of any securities.
- Avoid devoting any time to the development of the going private proposal during normal business hours.
- Avoid even the appearance that participation in any potential going private transaction is affecting the quality or quantity of the participants' services to the company.
- Avoid using the company's resources in connection with preparing any transaction proposal, including computers, secretarial time or other support facilities or functions.
- Review any non-disclosure or performance obligations in individual employment agreements and act accordingly.
- Refrain from open market purchases of the company's securities due to possession of material, nonpublic information.
- The company should suspend any share repurchase programs and any sales of company securities under "shelf" registration statements.

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