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Controlling Stockholder Liability: Is There a Safe Harbor?

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It should be no surprise that change of control transactions involving companies that have controlling stockholders are highly susceptible to litigation and in many instances are subject to heightened standards of review. While litigation is highly likely, it should also be no surprise that companies undertaking these types of transactions are usually prepared to navigate these risks. These risks are not as obvious, however, in transactions where the controlling stockholder is participating in the sale alongside the minority stockholder on an equal basis, or where the controlling stockholder, without using any corporate resources or diverting any corporate opportunities, wishes to sell its stake in a transaction not involving the minority stockholders. On their face, these types of transactions may seem unlikely to trigger heightened standards of review, as controlling stockholders are generally free to decide when and how to sell their stake; however, in certain circumstances, particularly where it appears that the minority stockholders need protecting, courts may be more willing to find potential sources of liability. For this reason, boards of directors and controlling stockholders would be wise to exercise caution whenever engaging in sale of control transactions.

Whole Company Transactions

In transactions involving a sale of the company in which the controlling stockholder is participating on the same basis as all other stockholders, Delaware courts generally have held that the controlling stockholder's interest in the transaction, as a stockholder, does not by itself create a disabling conflict of interest that would trigger an entire fairness standard of review. Nor is a controlling stockholder obligated to accept worse terms than the minority stockholders, or vote in favor of a transaction it does not support. Indeed, in the recent *In re Synthes, Inc. Shareholder Litigation* case, the Delaware Chancery Court affirmed that "Delaware does not require a controlling stockholder to penalize itself and accept less than the minority, in order to afford the minority better terms. *Rather, pro rata treatment remains a form of safe harbor under our law*."[1]

However, courts may take a strict view of what constitutes "pro rata treatment," and look not only to whether the stockholders share equally in the merger consideration, but also to whether the controlling stockholder "benefits" from the transaction in ways that the minority stockholders do not. In *Synthes*, for example, the court noted that in very limited circumstances, as when a controlling stockholder with an urgent need for cash effects a fire sale, a transaction providing for pro rata treatment among all stockholders could nevertheless result in disparate "benefits" being received by the controlling stockholder. Looking to such subjective "benefits", beyond the merger consideration, no doubt provides opportunities for courts to apply a higher standard of review.

The *Synthes* case involved the founder, Chairman of the Board and controlling stockholder of Synthes, Hansjoerg Wyss. Wyss had retired as CEO in 2007 and according to the plaintiffs, was past retirement age and interested in divesting his interest in Synthes. Given the size of his stake (38.5%, with an additional 13.25% owned by family members and trusts), selling his shares in the public market was not practicable. In 2010, as part of the board of directors' ongoing review

[1] *In re Synthes, Inc. Shareholder Litigation*, 50 A.3d 1022 (Del. Ch. 2012) (emphasis added).

of strategic alternatives, the board determined to undertake a sale process.

The company's sale process involved both financial and strategic buyers. The bid that emerged from a private equity consortium would have required Wyss to roll over a substantial portion of his equity investment in Synthes. A competing bid from Johnson & Johnson involved consideration comprised of a mix of cash and Johnson & Johnson stock. During the negotiations, the private equity consortium indicated that it could not raise its CHF 151 per share cash bid further, at which point the company focused its efforts on increasing the Johnson & Johnson bid, with the final Johnson & Johnson bid price at CHF 159 per share.

The complaint alleged that Wyss' ''unique'' liquidity problem ''infected'' the sale process, rendering this a conflicted transaction that should be subject to the entire fairness standard of revie[2] Among other things, the plaintiffs alleged that Wyss was anxious to sell his stake rapidly, that he was improperly driven by his own retirement objectives and that he caused the board of directors to cease discussions with the private equity group because he wanted to cash out with the minority, rather than having an illiquid block of stock in the acquired company.

The court first noted that where a controlling stockholder is receiving materially different terms under a merger, an analysis needs to be made as to whether the controlling stockholder ''unfairly diverted proceeds that should have been shared ratably with all stockholders.''[3] But where the controlling stockholder is receiving the same benefits as the minority stockholders, then the controlling stockholder's interest in the transaction does not establish a conflict of interest that would deprive the board of directors of the protection of the business judgment rule. The court indicated that there may be certain limited exceptions to this rule where a transaction providing for pro rata treatment among all stockholders nevertheless results in disparate ''benefits'' being received by the controlling stockholder. The court noted that these circumstances ''would have to involve'' a crisis fire sale effected as a result of an urgent need for cash by the controlling stockholder, where the board's sale process does not involve any effort to seek fair market value for the corporation.[4] The *Synthes* court found that there were no well-pled facts to suggest that the sale was being undertaken to satisfy an urgent need for cash. Moreover, even if Wyss had needed the liquidity, the *Synthes* court found that the process conducted by the board of directors (which spanned roughly seven months) did not suggest that he was in a rush to sell.

In looking at Wyss' need for cash and his reasons for supporting the transaction, the court contrasted the allegations in *New Jersey Carpenters Pension Fund v. infoGROUP, Inc.*[5] There, the company's founder and controlling stockholder, Vinod Gupta, was found to have a significant liquidity need, and as such, liquidity could be viewed as a benefit unique to Gupta because the minority stockholders already held small, liquid positions. The court found that in light of Gupta's allegedly desperate financial situation, as well as his large, illiquid stake,[6] it was reasonable to infer that he suffered a disabling conflict of interest when considering how to cast his vote in the merger.

The court also dismissed the plaintiffs' argument that Wyss was conflicted because he would only accept a transaction where he would receive liquidity for his shares, noting that Wyss' interests were aligned with the plaintiffs', who conceded that they also wanted liquidity for their shares. The court further clarified that Wyss was not obligated to support a deal that might have delivered more liquidity to the minority stockholders but would have required Wyss to roll over his equity because ''Delaware law does not . . . impose on controlling stockholders a duty to engage in self-sacrifice for the benefit of minority shareholders,'' and ''the fact that the controller would not accede to [a deal that provides for better terms for the minority stockholders than for the controller] does not create a disabling conflict of interest.''[7] Accordingly, the court concluded that the board of directors was entitled to the protections of the business judgment rule.

Sale of Control Stake at a Premium

Under Delaware law, assuming that they do not divert corporate opportunities or misuse their corporate office or corporate assets, controlling stockholders are generally free to sell their stake at a control premium, leaving the minority stockholders behind with the new buyer.[8] However, particularly in situations in which minority stockholders are left with a valueless or greatly impaired ownership stake, courts may work to find sources of liability to provide some benefit or protections for minority stockholders. As noted in *Mendel*, ''[t]he law has acknowledged, *albeit in a guarded and complex way*, the legitimacy of the acceptance by controlling shareholders of a control premium,'' with ''[a] number of liability creating doctrines . . . applied which have the effect of creating risks to the controlling shareholder who attempts to realize a control premium.''[9]

In addition to protections such as Section 203 of the DGCL and provisions restricting the sale of corporate office and the sale of corporate opportunity, Delaware courts have sought to protect minority stockholders where the controlling stockholder sells to a buyer that intends to loot the corporation or that otherwise has improper motives that may adversely affect the minority stockholders. The exact scope of the duty, and whether it imposes an obligation to investigate the buyer, remains unsettled. In a 1990 decision, the Delaware Chancery Court established a negligence-based stan-

[2] *Id.* at 1026.
[3] *Id.* at 1033.
[4] *Id.* at 1036.
[5] No. Civ.A. 5334-VCN, 2011 BL 260352 (Del. Ch. Oct. 6, 2011).

[6] Gupta held approximately 37% of the company and received over $100 million in cash for his shares in connection with the merger.
[7] *Synthes*, 50 A.3d at 1041.
[8] *Cooke v. Oolie*, No. CIV. A. 11134, 2000 BL 669 (Del. Ch. May 24, 2000).
[9] *Mendel v. Carroll*, 651 A.2d 297, 305 & n.18 (Del. Ch. 1994) (emphasis added). The *Synthes* court also noted that ''[i]t is, of course, true that controlling stockholders are putatively free under our law to sell their own bloc for a premium or even to take a different premium in a merger. . . [but as] a practical matter, however, that right is limited in other ways that tend to promote equal treatment. . . These realities not only make it riskier for a controller to seek a premium but limit buyers' willingness to pay one.'' *Synthes*, 50 A.3d at 1040.

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dard, holding that ''when the circumstances would alert a reasonably prudent person to a risk that his buyer is dishonest or in some material respect not truthful, a duty devolves upon the seller to make such inquiry as a reasonably prudent person would make, and generally to exercise care so that others who will be affected by his actions should not be injured by wrongful conduct.''[10]

On the other hand, dicta in a 2006 Delaware Chancery Court case casts doubt as to whether a controlling stockholder has a duty of inquiry. In *Abraham*, the court noted that ''*[e]ven assuming*. . . that a controlling stockholder can be held liable for negligently selling control to a buyer with improper motives (as opposed to when it *knows* it is selling to a looter or an otherwise dishonest and predatory buyer),'' the controlling stockholder at issue would not have violated even the lower standard.[11] The court further noted that it was ''dubious that our common law of corporations should recognize a duty of care-based claim against a controlling stockholder for failing to . . . examine the bona fides of a buyer, at least when the corporate charter contains an exculpatory provision . . .''[12] The court was careful to preserve some minority protections, noting that failing to find a duty of care-based standard ''would do nothing to immunize a selling stockholder who sells to a known looter or predator, or otherwise proceeds with a sale conscious that the buyer's plans for the corporation are improper. But it would impose upon the suing stockholders the duty to show that the controller acted with scienter and did not simply fail in the due diligence process.''[13] In *Abraham*, the plaintiff argued that statements made by a strategic buyer of the control stake regarding synergistic benefits flowing from the transaction should have put the controller on notice that the buyer had improper plans to use the corporation's assets for its benefit. The court rejected these claims, noting that such statements are common in acquisitions by strategic buyers and do not necessarily indicate that the strategic buyer has improper motives with respect to the minority stockholders' interests in the corporation.

Conclusion

In fact patterns that otherwise would not suggest the presence of a conflict of interest but that may represent an unfavorable result for minority stockholders, courts may work to find ways to protect minority stockholders, notwithstanding the general principle that a controlling stockholder may freely sell, or not sell, its stake. Accordingly, even outside of the traditional related party transaction context, controlling stockholders and boards of directors should be aware of the increased risks associated with transactions involving controlling stockholders and take appropriate measures, where practicable, to reduce those risks.

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[10] *Harris v. Carter*, 582 A.2d 222, 235 (Del. Ch. 1990).

[11] *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 752 (Del Ch. 2006) (emphasis added). In both *Harris* and *Abraham*, the purchase agreement required the controlling stockholder to cause its director designees to resign in a manner that facilitated the buyer's assumption of the vacant board seats. Although the *Harris* decision highlights this aspect of the purchase agreement, it is difficult to imagine a situation in which a controlling stockholder would transfer its stake but not be required to cause its directors to resign; accordingly, it is unlikely that this aspect of a sale of control heightens liability for the controlling stockholder.

[12] *Id.* at 759.

[13] *Id*. (footnote omitted).