

PROCEDURAL SAFEGUARDS IN A BUYOUT GET A BOOST

BY DOUG RAYMOND

Ed. Note: For this Year in Review special edition, we asked our “Legal Brief” columnist Doug Raymond to select a court ruling from 2009 that he felt is of particular consequence to a board’s decision-making considerations and fiduciary obligations. The case he selected, *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, is reviewed below. He is in good company with this selection, as this case also drew the attention of the *New York Times* “Dealbook” blog, which cited it for its “potential to bring about a revival” of management buyouts.

For a Delaware corporation, “entire fairness” is the test for going-private mergers with controlling stockholders. Under entire fairness, as enunciated in *Kahn v. Lynch*, the burden is on the board to demonstrate that the transaction is entirely fair to minority stockholders. The standard involves two prongs, fair dealing and fair price, and focuses intensely on the process used by the board during the transaction.

Since *Kahn*, the courts have gradually created exceptions to this standard, notably in *Pure Resources*, which applied the less onerous business judgment rule to acquisitions by controlling stockholders carried out by front-end tender offers followed by short-form mergers. The *Hammons* case continues this trend.

In *Hammons*, a third party bought out all of the hotel company’s stockholders, but in doing so negotiated heavily with the company’s controlling stockholder (founder John Q. Hammons), who obtained additional benefits that the minority did not receive. Even though the controlling stockholder was heavily involved, the court held that *Lynch* did not apply to situations where an unrelated third party purchases shares from minority stockholders because the third party, unlike controlling stockholders in going-private mergers, “does not stand on both sides of the transaction.”

Having decided not to apply the entire fairness doctrine, the Delaware Court of Chancery in *Hammons* instead applied the business judgment rule, which gives enormous deference to the board’s decision. However, the court imposed these conditions: First, that the transaction be recommended by a disinterested, independent special committee; and second, that it also be approved by a majority of all the minority stockholders through a non-waivable vote. Because a

controlling stockholder is able to scuttle any transaction and is competing with the minority for the consideration the third party is paying, the court imposed these procedural protections to guard against those risks and prevent the controlling stockholder from railroading the process.

Having established these conditions, the court concluded they had not been satisfied in *Hammons* because the special committee had retained the right to waive the approval by the majority of the minority stockholders and, in any event, the approval was conditioned on a majority of the minority actually voting, not all of the minority stockholders. Instead, the court applied entire fairness.

Despite the weakening of *Lynch*, most going-private transactions involving a controlling stockholder, including *Hammons*, are subjected to the high standard of entire fairness. *Hammons*, like *Pure Resources*, focused on the importance of robust procedural safeguards if the lesser standard of the business judgment rule is to apply. While the cases still are unclear about some aspects of these procedural safeguards, it is clear that the use of a non-waivable majority of the outstanding minority



Doug Raymond: A case of ‘balancing competing interests.’

approval requirement will go a long way in protecting a transaction from challenge. Furthermore, using an independent special committee with the power to negotiate and approve or reject a transaction is also recommended to avoid later headaches. Boards that do not take these steps may risk subjecting the transaction to entire fairness review, and potentially expensive and distracting litigation.

However, a special committee, if truly independent, may reach conclusions to which the controlling stockholder objects. For example, in *Hammons*, one bidder’s proposal reduced the price if the transaction was conditioned on majority of the minority approval. The key to effectively negotiating a buyout transaction is to balance the competing interests while employing those precautionary safeguards that are as protective as possible of the transaction. Even if successful at this, it will still be anyone’s guess as to the standard of review the courts will apply.

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