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Cross-Border Carve-Out Transactions

This article is Part 1 of a series of 3

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Globalization and technology continue to drive companies of all sizes to discover and unlock value in ways previously considered unconventional or impracticable. One notable trend witnessed in today's M&A marketplace has been the significant uptick in international business separation "carve-out" transactions.

Multi-jurisdictional elements invariably complicate these transactions, but market participants are nonetheless increasingly choosing to brave the potential complexities of these deals as they reach deeper into more remote and tangled baskets of assets in search of enhanced value. While there is much literature on the topics relating to sound carve-out deal execution in a single-jurisdiction vacuum, this series of articles addresses several important issues and considerations that are relevant to an international carveout deal.

This first installment will review current market trends for cross-border carve-out deals, and it will also highlight the importance of both understanding the scope of each deal and assembling the key team members necessary for a smooth closing of the transaction.

State of the Market for Cross-Border Carve-Outs

Let us begin with a few observations on the current state of play in this space in both the large cap and micro-cap segments of the market. At the top of the market, large multinational strategics, as buyers, are looking to expand their offerings, market share and reach.

As rapidly scaling major technology companies such as Amazon loom over unwary strategic companies in unrelated verticals, some buyers are playing both offense and defense with cross-border carve-out deals. And as sellers, many times under pressure from activists who are urging focus on core competencies, large multinational strategic companies are looking to shed "non-core" assets.

Meanwhile, global private equity funds, with very large amounts of dry powder, are beginning to chase new carved-out global platforms in an ecosystem where traditional standalone acquisition targets continue to fetch some of the highest multiples on record. We have also been seeing private equity funds bid with fervor on business divisions for which they do not have a current portfolio framework at the time of an auction process, opting instead to source the organizational infrastructure and management team for the to-be-acquired business during the interim period between signing and closing.

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And at the bottom of the market, even simple businesses with best-in-class offerings are more commonly utilizing international features (most commonly sales or distribution presence) to boost top-line revenue, many times with non-U.S. facilities, office locations or staff. Thus, even for micro-cap sponsors and other less cash-rich bidders focused on "regional" assets, it is more common to encounter a situation with a crossborder element today than it was even just five years ago.

Against this backdrop, it is important for practitioners in all segments of the M&A market to be fluent—or at least conversant—in these issues, as their prevalence will only increase as global deal-making accelerates and attractive standalone targets become more scarce. Effectively executing a cross-border transaction of any size is complex for many reasons, and this article does not purport to describe all of the issues that deserve due care when negotiating and closing a cross-border carve-out transaction.

M&A lawyers should also review the ample materials available regarding garden variety carve-out deal points in tandem with this article—such as regulatory concerns, carve-out financial statement preparation, treatment of commingled assets and shared contracts, the "your watch, our watch" indemnity construct (and alternatives), tax-free spin structuring matters, operational integration issues, and others.

Understanding the Deal Scope

Cross-border carve-outs are especially challenging because they require that two onerous work streams be completed in parallel—a separation of the target business from its parent and ensuring that such separation complies with the laws of each country involved. When a client calls with a mandate for a new cross-border carve-out deal, the appropriate next move depends entirely on the scope and scale of the proposed transaction—the identities of the parties, the jurisdictions involved, the deal value, and the thesis underlying why *this* transaction (and not another strategic alternative) is on the table.

When the deal at hand is one involving two multinational public companies operating in the same or similar sectors, it's wise to first discuss the deal with your tax partner and antitrust partner, after clearing conflicts. Whether a tax-free transaction structure is accessible and whether your deal will pass regulatory muster are threshold questions that will inform your next steps.

Other key questions to ask and research include:

- How "material" to the target business is each jurisdiction involved?
- How much revenue is derived from each country in which target assets are located?
- What types of assets are housed there?
- What is the employee headcount in each country involved?

A twoperson independent contractor sales team with a vanilla office lease and some computers in the Netherlands will entail a much different conceptual approach than would the presence of over a dozen manufacturing plants used in disparate product lines that are distributed on all continents.

Another relevant question for client and counsel to consider is how much time remains on the proverbial shot clock. The delta anticipated between signing and closing circumscribes the scope of work and study that can be undertaken by you and your client.

For example, if it is suspected that your crossborder carve-out deal will receive a HartScott-Rodino Act "second request", then you have temporal flexibility to conduct more thorough diligence, arrange financing, negotiate certain key ancillaries (such as pre-closing reorganizational documents to consolidate the target business or transition services agreements and reverse transition services agreements) and mutually establish a comprehensive closing process during the interim period between signing and closing.

Parties may not enjoy as much flexibility, however, in the context of an international competitive multi-bidder private equity auction for a small-cap target that is financed with cash on hand or that otherwise may contemplate a simultaneous sign-and-close feature. Cross-border carveout deals populate each point along this continuum; accordingly, no two deal processes will be identical.

Assembling & Guiding Cross-Border Deal Teams

It generally takes a substantial team to negotiate and close a cross-border carve-out deal. Your client's board of directors will need to be equipped with all of the requisite information to fulfill its duties while at the same time avoiding becoming overwhelmed by a tidal wave of process points.

It is not possible for managing deal counsel for both buyer and seller to be masters of the universe on all issues, at all times and in all places. Creating a roster of team players and outside advisors will be critical to maintaining sanity on the path to closing. Where practicable, engage external advisors that have global reach and expertise, such as "Big Four" accounting firms for financial due diligence.

If employee benefits or labor advisors are necessary, make sure you select an advisor that has deep experience in the labor and benefits laws of the jurisdictions involved. As in any M&A transaction, thoroughly vet your client's financial advisor for conflicts of interest, and consider whether it makes sense to engage a second advisor to protect the propriety of your deal process and the reputation of your client's board.

Solicit local counsel recommendations and be judicious in counsel selection if your client defers to your decision. The scope of your deal will necessitate varying levels of engagement with lawyers around the world, who can either make the process demonstrably easier or demonstrably worse. Effective and proactive local counsel will free up your valuable time to meaningfully interact with your client, its board, and opposing deal counsel, so that you and your colleagues can remain focused on the negotiations and the key issues.

It has been our experience that busy clients prefer inbound contact to come from one centralized point of command, as opposed to piecemeal from each outside law firm from Algeria to Zimbabwe. "Over-visibility" of local counsel, especially with respect to small-dollar items, can distract your client's team from critical deal points and foster a "too many cooks in the kitchen" sentiment.

For the big deals where international assets and operations are material and numerous, you may consider engaging a global firm as "project management" counsel—in charge of the various distributions of timely critical information, commissioning jurisdiction-specific due diligence memos or disclosure schedule riders, shepherding and consolidating jurisdiction-specific comments to the acquisition agreement, scheduling telephone conference calls across time zones and more.

For smaller cross-border deals, solicit recommendations from inside and outside of your firm and ask for references from prospective local counsel on a case-by-case basis where appropriate. Where a single local firm can handle multiple jurisdictions in a given geography without compromising quality, consolidate your local counsel and encourage appropriate regularly-scheduled collaboration between teams.

Consider fee caps for each country, and, where you have your client's consent, allow local counsel to submit invoices to your firm only and roll those smaller balances up into your firm's ultimate invoice for ease of payment.

In all cases, clearly explain the task to be performed by each advisor and negotiate a clear budget in each jurisdiction that is tailored to the corresponding scope of work. Ask your client whether itemization of fees by jurisdiction would be helpful. Make the effort necessary to prime local counsel to deliver actionable and helpful work product by giving them examples and using clear instructions.

Consider preparing an omnibus transaction background memorandum (containing info on the parties, the key transaction documents in existence, annual reports and other material securities filings, target profiles, acquirer financing papers, banker materials, and other commonly referenced documents) that can be readily shared with each local advisor. You may consider designating an appropriately junior team member to the sole function of process management, cross-team communication, scheduling and logistics of execution.

Finally, for team leaders on these matters, build trust within your internal and external teams to execute each smaller assignment with quality, and aim to spend most of your time with the client's general counsel, Board and management, focusing on the larger architecture of the overall transaction.

Takeaways

- For several reasons, we are witnessing a notable proliferation of cross-border carve-outs. These types of transactions are likely to increase in frequency going forward, and practitioners who are not prepared for the intricacies of these deals will be severely disadvantaged should their client pursue a cross-border carve-out opportunity.
- "Failing to prepare is preparing to fail." The process for swiftly and effectively executing a cross-border carve-out transaction will vary dramatically based on the scope of the deal. Taking the time to understand the scope of the deal at the front end lessens the likelihood of unanticipated consequences and sub-optimal outcomes.
- An effective deal team on a cross-border carve-out deal must be selectively commissioned and thoughtfully primed to make the process simple for the client and to consistently deliver reliable client service.

The Odd Couple: Indemnification and R&W Insurance

By William Henry, Partner, and Jim Brown, Associate, of Thompson Hine LLP

The increasing prevalence of representation and warranty (R&W) insurance in M&A transactions in the last 10, and especially five, years is well understood. What is less well understood is how its application works in the context of the M&A transactions in which it is used as it relates to the buyer's access to the remedy of indemnification against the seller (target company).

This article offers a brief description of the interplay between a representation and warranty policy on the one hand, and the use of a basket and a cap on the other (as well as a few other special considerations).

The Role of R&W Insurance

R&W insurance is, in its most common form, obtained by the buyer in an M&A transaction as a means of seeking recourse against the policy, instead of the seller, in the event of a breach by the seller of the seller's representations and warranties in the transaction's main purchase agreement.

For instance, if the seller breaches the financial statements representation in the purchase agreement, in a no-R&W insurance transaction (we'll call this "ordinary" for purposes of further discussion in this article), the buyer would seek indemnification recourse against the seller, while in an R&W insurance transaction, the buyer would seek indemnification recourse primarily against the policy, not the seller.

R&W Insurance and Baskets

In an ordinary M&A transaction, there is usually only one basket—basically a deductible that protects the seller against de minimis claims. An R&W insurance transaction introduces further complexity by adding a separate, second basket: the "retention," which is a higher amount (usually two times the basket) that further limits the responsibility of the insurer to pay out on a typical R&W policy, by being essentially a second, higher deductible that must be met before the insurer will pay on a claim.

The retention is the responsibility of the policy holder, meaning it is then up to the buyer and seller in a transaction to negotiate between the two of them who will be responsible for the retention. Note, importantly, that the basket "overlaps" with the retention: so, if the basket is satisfied, then the amounts satisfying the basket also count toward satisfying the retention. Often, an escrow/holdback will be used to account for the amount by which the retention exceeds the basket (so if the basket is $300,000 and the retention is $500,000, a $200,000 escrow might be used to account for the difference, as further illustrated below).

R&W Insurance and Liability Caps

Likewise, in an ordinary M&A transaction, there is usually a cap—often around 10 percent for general representations and warranties, with a higher cap (or no cap!) for "fundamentals" or other key representations. In an R&W insurance transaction, there is much greater latitude for the parties to stipulate what the caps might be—which is great—but, practically, there is usually a hard cap (the policy "limit"), no matter whether the representations are general or fundamental.

Note here that there are effectively two caps: the seller will expect that its liability is capped at the retention, while the insurer will only care about the overall policy limit. Correspondingly, the survival period for claims under representations and warranties policies can be lengthier, but will almost always (as must be actuarially true) have a defined time limit (often six years).

The Interplay Between R&W Insurance, Deductibles and Retentions

Here's how the deductible and the retention might work in a standard ("market") transaction nowadays (understanding that the math may change as the market shifts and R&W policies become cheaper over time). Let's suppose a $50 million transaction, with a basket of $250,000 and a retention of $500,000. Policy limits can vary, but let's also assume a 10 percent ($5 million) policy limit. Now let's assume that the seller breached a representation, and map it out through three common scenarios:

- Scenario 1: $300,000 loss asserted. Here, the basket "eats up" $250,000 of that loss—so the buyer bears the cost. However, only $50,000 of the remaining $250,000 retention has been satisfied, so the buyer would look to the seller directly for indemnification (and the buyer would be wise to have had an escrow of $250,000 for the purpose).
- Scenario 2: $1.7 million loss asserted. Here, the basket has been satisfied, as has the retention, and in fact, losses exceed the retention by $1.2 million, which is the amount that the buyer would look to recover from the insurer.
- Scenario 3: $6.2 million loss asserted. Here, again, both the basket and the retention have been satisfied, but losses exceed the retention by $5.7 million, which exceeds the $5 million policy limit. As such, the buyer can recover only $5 million from the R&W policy.

Two points in this third scenario to keep in mind: first, the policy limit is, as with an escrow, an aggregate limit—so the buyer would not be able to make any further claims under the policy, no matter the origin. Second, the buyer can try, but is not likely to, prevail in purchase agreement negotiations against the seller if it asks the seller to "cover" any excess over the policy—here, $700,000—because while economically the request makes intuitive sense, such exposure defeats much of the purpose of an R&W policy in limiting the seller's overall exposure.

R&W Insurance in "No-Recourse" Deals

Before concluding, we do want to identify a few variations we've seen in our transactions. The first is the rise of the "no-recourse" deal in which the seller refuses to assume any indemnification obligations—that is, where there is no indemnification available from the seller in favor of the buyer, and instead, the buyer looks only to the representation and warranty policy (effectively, the basket equals the retention).

This type of transaction is more likely to exist in auction contexts, as in most instances, the buyer likes knowing that the seller has some, even if modest, "skin" in the indemnification game. The second is how to mitigate against "known" liabilities—of no surprise, R&W insurance will not pick up the costs of existing issues (and usually includes "anti-sandbagging" language to this effect)—such as environmental exposures uncovered in diligence or pending lawsuits. In those scenarios, a buyer would do well to seek a line-item indemnity and an associated special escrow to recover directly from the seller for these items.

The R&W insurance market is increasing and steadfastly evolving, which may date this article quickly. The themes as it evolves, though, are timeless. The beauty of R&W insurance is that it facilitates the buyer and seller customizing the baskets, caps and survival periods in both the purchase agreement and the R&W policy, in each case, to address and allocate unknown risk.

The interplay between the purchase agreement and the R&W policy is vital in that regard. Indeed, though one may think that obtaining an R&W policy is a panacea for the lengthy discussions around indemnity, understanding the baskets, retentions, caps and related remedies is essential to a thoughtful negotiation for all parties.

Fairness Opinions: How to Avoid Provider Conflicts

By Chad Rucker, Managing Director of Valuation Research Corporation

Fairness opinions have become a standard tool used in merger and acquisition transactions since *Smith v. Van Gorkom,* 488 A.2d 858 (Del. 1985). In *Van Gorkom,* the Court was highly critical of TransUnion Chairman and CEO's acceptance of a merger offer without consulting outside financial advisors.

The Court found that TransUnion's directors were grossly negligent because they quickly approved the merger without an in-depth inquiry or expert advice. After *Van Gorkom*, the fiduciary duty of care required that boards be fully informed, and one of the ways that they could provide evidence of this is a fairness opinion.

Fairness opinions potentially provide substantial benefits if the opinion process is performed correctly. In this article, we focus on strategies for dealing with conflicts that may exist when a fairness opinion provider also receives an M&A success fee.

In a typical M&A assignment, the board of directors hires an investment bank to provide advisory services, and the investment bank is also paid a success fee upon the consummation of the transaction. Often, that investment bank will also provide the board with a fairness opinion for a fixed fee. Many potential conflicts exist in such an arrangement, two of which we will discuss:

The M&A Advisor's Success Fee is Substantially More than the Opinion Fee

In a typical M&A advisory assignment, the investment advisor will often receive a success fee, which is many times greater than it will receive on the fairness opinion. It is not uncommon for an advisor to be paid a $15 million success fee and only a $1 million fee for the fairness opinion. In this arrangement, if the transaction is found to be fair and it successfully closes the advisor would earn $16 million in total fees. If the transaction does not close, the advisor would only receive the $1 million fee.

There is a definite economic incentive for the advisor to make sure the transaction closes, even if it is not in the client's or the shareholders' best interest. In fact, in VRC's experience with M&A transaction valuations, we have come across numerous situations where the success fee has clouded an M&A advisor's advice. Too often the advisor's motivation to earn their fee overrides their fiduciary duties to the corporation and its shareholders.

The conflict here is apparent, and boards must be vigilant when such conflicts exist.

The M&A Advisor May Be Too Invested in the Deal

The M&A advisor and management team have likely been intimately involved in originating the M&A transaction over some years; the M&A advisor may be too vested in successfully closing the transaction to be unbiased.

The M&A process takes a long time. Before acting upon an actual acquisition target, the M&A advisor and management team have often spent years looking at and bidding on potential targets. In VRC's experience, once there is a probability that a potential target may be in play, all energy focuses single-mindedly on successfully closing the transaction. Crowd behavior takes over, and there is very little room for dissent. Once the M&A train has left the station, it is a challenge to stop it.

In these cases, it is difficult for an M&A advisor to find that a transaction is not unbiased. Consider this: the M&A advisor has likely been advising the management team for several years and now has a potential deal that will close; how can they now say the price paid or price received is unfair? In our view, the M&A advisor and management team are often too vested in the transaction to determine its fairness. Further, the M&A advisor may be too close to the management team to look at the deal objectively.

How to Address Potential Provider Conflicts

To overcome these two conflicts, boards should start by appointing an independent fairness opinion provider that is only paid a fixed fee for delivering an opinion, regardless of the success of the transaction. However, this alone is not sufficient. We recommend that the board also take the following steps:

- Designate at least one independent director to whom the fairness opinion provider will report.
- Have a conversation with the independent fairness opinion provider (without the management team present) before the opinion advisor is engaged and stress the following:
  - The independent fairness opinion provider works for the board and no one else, including management.
  - The board should be informed if there are problems with the transactions and it is appropriate to raise doubts.
  - The board will expect answers to the questions listed below:
    - Is there anything you discovered that made you uncomfortable with the board going through with this transaction?
    - Is there anything that any team member discovered that made you uncomfortable with the company going through with the deal?
    - How would you rate this transaction for us on a scale of 1 to 10?
    - Tell us some reasons (there are always some) why we should not do this transaction?
    - Has anyone (including people at your firm or management) put undue pressure to give an answer that is contrary to your personal belief?
- Ask the opinion provider if there is any reason whatsoever they will not be able to abide by these expectations.
- During the board presentation, encourage the independent fairness opinion provider to raise any potential negatives that they have discovered and discuss weaknesses in their analysis.

Although adding an independent fairness opinion provider will not solve all of the conflicts of working with an interested M&A advisor, it may mitigate some of the problems and improve the overall result of the transaction.

Standards of Review: When the Controlling Shareholder Isn't a Buyer

***By John Jenkins, Editor, DealLawyers.com*[1]**

When a controlling shareholder stands on the buy-side of a deal, Delaware law says that "entire fairness" is the default standard of review, with a path to business judgment review potentially available if the controller is willing to meet the procedural requirements laid out in *Kahn v. MF&W Worldwide*.[2]

But a sale to a controlling shareholder is far from the only—or even the most common—transaction that a company with a controlling shareholder will have to navigate. A review of Delaware case law suggests that when dealing with other kinds of transactions, the standard of review that Delaware courts apply depends on whether they believe a conflict of interest exists between the controller and the minority shareholders, the nature of that conflict, and the type of transaction involved.

Third-Party Sales for Same Consideration

A sale of a company to an unaffiliated third party in which the controlling shareholder receives the same consideration as the minority shareholders presents very different issues than a merger with a controlling shareholder. In these settings, controlling shareholders generally have the same incentives to maximize the value of their shares as other shareholders do—a point that the Chancery Court recognized in its decision in *In re Synthes*.[3]

In that case, then-Vice Chancellor Strine rejected the plaintiffs' contention that a merger with an unaffiliated third-party buyer in which the controlling shareholder received the same consideration per share as the minority shareholders should be evaluated under the entire fairness standard.

In so doing, he suggested there was usually little reason to subject a transaction like this to heightened scrutiny, and that providing minority shareholders same consideration as the controller creates a "safe harbor":

> Controlling stockholders typically are well-suited to help the board extract a good deal on behalf of the other stockholders because they usually have the largest financial stake in the transaction and thus have a natural incentive to obtain the best price for their shares. As a general matter, therefore, if one wishes to protect minority stockholders, there is a good deal of utility to making sure that when controlling stockholders afford the minority pro rata treatment, they know that they have docked within the safe harbor created by the business judgment rule.[4]

Strine left open the possibility that in "very narrow circumstances" a controlling stockholder's immediate need for liquidity could result in a disabling conflict of interest despite pro rata treatment. He noted that those circumstances would have to involve a "fire sale" in which the controller agreed to sell without any effort to obtain a price that reflected the fair market value of the corporation.[5]

So, entire fairness—with the possibility of *MFW's* path to the business judgment rule—is the standard that applies to a merger with a controlling shareholder. At the other extreme, when a third party acquires a company with the controlling shareholder, it appears that Delaware will apply the business judgment rule, absent evidence of a "fire sale" by the controller. But what about transactions where the controlling shareholder tries to extract a control premium?

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[1] John is also a partner of Calfee, Halter & Griswold LLP

[2] *Kahn v. MF&W Worldwide Corp.*, 88 A.3d 635 (Del. 2014)

[3] *In re Synthes, Inc. S'holder Litig.*, C.A. No. 6452 (Del. Ch. Aug. 17, 2012)

[4] *Id.* at 22.

[5] *Id.* at 23, citing *N.J. Carpenters Pension Fund v. Infogroup, Inc.*, 2011 WL 4825888, at *4, *9-10 (Del.Ch. Sept. 30, 2011) (holding that plaintiff sufficiently alleged a disabling conflict of interest where a director/major shareholder desperately needed liquidity to satisfy personal judgments, repay debt and fund a new venture under circumstances where the defendant had no other sources of cash and threatened other board members with a lawsuit if they did not sell."

Third-Party Sales for Disparate Consideration

Delaware courts have long recognized that control has value, and have even accepted the premise that, to at least some extent, the controlling shareholder has a right to it.[6] So how do they deal with efforts to extract that value?

As this Kirkland & Ellis memo notes, when it comes to evaluating controllers' efforts to extract disparate value in a deal, the short answer is that Delaware courts look for procedural protections similar to those found in *MFW*:

> The procedural protections required to gain business judgment review bear many similarities to the *MFW* test and were spelled out in the 2009 *John Q. Hammons* decision. The court looks for approval by an independent special committee of the board, a non-waivable requirement for approval by a majority of the disinterested and fully informed stockholders, and the absence of threats or coercion.[7]

The *Hammons* case involved a sale of a company with a dual class capital structure. The Class A shares received $24 per share in cash, while the holder of the high-vote Class B shares separately negotiated with the buyer to receive a 2% equity interest in the surviving company, along with $335 million in preferred stock, a $300 million line of credit, and certain other benefits in exchange for those shares and a limited partnership interest.[8]

Pointing to the fact that the unaffiliated buyer had negotiated its deal with the Class A holders through the board's independent special committee, Chancellor Chandler determined that the controlling shareholder did not stand on "both sides" of the transaction, so *Kahn v. Lynch* did not apply.[9]

In fact, he concluded that business judgment would be the applicable standard of review if the transaction were preconditioned upon the recommendation of a disinterested and independent special committee, and approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.[10]

The Court applied the entire fairness standard because it did not think the procedural protections were sufficiently robust, but in a subsequent, post-trial opinion, the Court held that because the transaction was approved by an independent and disinterested special committee, the burden shifted to the plaintiffs to prove the transaction was unfair. It ultimately concluded that the transaction was entirely fair.[11]

Disparate consideration cases can arise in any situation in which a controlling shareholder is alleged to receive a unique benefit in a transaction that is not shared with other holders. While that may involve different consideration for the holders of different classes of stock, as in *Hammons*, it may also involve efforts by a controlling shareholder in a corporation with only a single class of stock to extract a control premium from a buyer.[12]

Disparate consideration may also involve more intangible benefits—for example, in *In re Primedia*, the Chancery Court held that plaintiffs could challenge the fairness of a merger based on a claim that the target

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[6] *Mendel v. Carroll*, 651 A.2d 297, 305 (Del. Ch. 1994) ("The law has acknowledged, albeit in a guarded and complex way, the legitimacy of the acceptance by controlling shareholders of a control premium. See *Cheff v. Mathes*, Del.Supr., 199 A.2d 548, 555 (1964); *Hecco Ventures v. Sea-Land Corp.*, Del.Ch., C.A. No. 8486, 1986 WL 5840, Jacobs, V.C. (May 19, 1986); *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y.2d 684, 421 N.Y.S.2d 877, 878, 397 N.E.2d 387, 388-89 (1979)")

[7] Kirkland & Ellis LLP, *"Controlling Stockholder M&A Does Not Equal (Automatic) Entire Fairness Review,"* (Dec. 2016) https://www.deallawyers.com/member/docs/firms/Kirkland/12_16_MA.pdf

[8] *In re John Q. Hammons Hotels S'holder Litig.*, C.A. No. 758-CC (Del. Ch. October 2, 2009)

[9] *Id.* at 29.

[10] *Id.* at 29.

[11] *In re John Q. Hammons Hotels S'holder Litig.*, C.A. No. 758-CC (Del. Ch. January 14, 2011)

[12] In many instances, the efforts of a controlling shareholder to extract a control premium in a non-dual class structure may involve an outright sale of its controlling interest to a potential buyer—something that it is generally free to do. See *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 759 (Del. Ch. 2006). However, if board approval of a particular transfer is required, entire fairness review may be implicated in some circumstances. See *In re Digex Inc. Shareholder Litigation,* C.A. No. 183366, (Del. Ch. 2000).

board of directors failed to obtain sufficient value for pending derivative claims that were extinguished by the merger.[13]

More recently, the Chancery Court held that *MFW* could be applied to disparate consideration cases. In the *Martha Stewart Living Omnimedia* case, the plaintiffs contended that the entire fairness standard to an employment agreement and intellectual property licenses negotiated between the target's unaffiliated third-party buyer and its controlling shareholder.[14]

The transaction was structured to comply with *MFW's* requirements, and Vice Chancellor Slights ultimately held that the business judgment standard applied to the transaction.

In addition to concluding that there was no evidence that the side deals with the controlling shareholder diverted proceeds from the minority shareholders, the Vice Chancellor held that while compliance with *MFW's* procedural protections was required from the outset of a transaction, in disparate consideration claims arising in connection with third party sales, the "outset" of the transaction occurs when the controller and the potential buyer begin negotiations for disparate treatment—not when the initial approach by the buyer is made.[15]

Disparate Consideration to Preferred Stock

One area that is particularly interesting when it comes to disparate consideration is different treatment of common and preferred stock. In the *Trados* case, the Chancery Court held that the business judgment rule did not apply to a board's decision to sell the company in a transaction in which all of the proceeds were paid to the holders of the company's preferred stock.

Instead, the court applied the entire fairness standard, noting that the board's fiduciary duties to the common shareholders outweighed its purely contractual duties to the preferred shareholders:

> [T]he standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of its contractual claimants. In light of this obligation, 'it is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred.'"[16]

Delaware courts have long held that when the interests of the holders of common and preferred stock diverge, the board's fiduciary duties run to the common, while the preferred has to look to whatever contractual rights it may have.

But the Chancery Court's recent decision in the *ODN Holding* case shows that when the going gets tough, even the most well-crafted contractual protections may not accomplish what the preferred holders intended. That's because if there's an opportunity for an "efficient breach", a board's fiduciary obligations to the common may require it breach the company's contractual obligations to the preferred.

ODN Holding involved claims that directors breached their fiduciary duties by selling off pieces of the company to fund a mandatory redemption of the controlling stockholder's preferred stock, thus impairing the company's ability to generate long-term value for its common stockholders. Vice Chancellor Laster refused to dismiss the claims, noting that while the contractual obligations to the preferred holders may be valid, the board's fiduciary duties required it to consider the possibility of an "efficient breach" of its obligations:

> Even with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach. Under that doctrine, a party to a contract

[13] *In re Primedia, Inc. Shareholders Litigation*, 2013 WL 2169415 (Del. Ch. May 10, 2013)
[14] *In re Martha Stewart Living Omnimedia S'holders Litig.*, C.A. No. 11202-VCS (Aug. 18, 2017)
[15] *Id*. at 52.
[16] *In re Trados Inc. Shareholder Litigation*, C.A. No. 1512-VCL (Del. Ch. Aug. 16, 2013) at 40-41.

may decide that its most advantageous course is to breach and pay damages. Just like any other decision maker, a board of directors may choose to breach if the benefits (broadly conceived) exceed the costs (again broadly conceived).[17]

While the *ODN Holding* Court suggested that *MFW* might apply to a decision not to breach preferred stock contractual rights if its procedural conditions were satisfied, commentators have noted that these conditions are unlikely to be satisfied in connection with a preferred stock redemption, because there is typically no shareholder approval requirement.[18]

[17] *Hsu Living Trust v. ODN Holding*, C.A. No. 12108-VCL (Del. Ch. April 14, 2017) at 48.
[18] Fried Frank Private Equity Briefing, *"Potential Liability for PE Firms and Directors When Preferred Stock Owned by a Controller-Sponsor is Redeemed by a Non-Independent Board,"* (May 2017) at 2.

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