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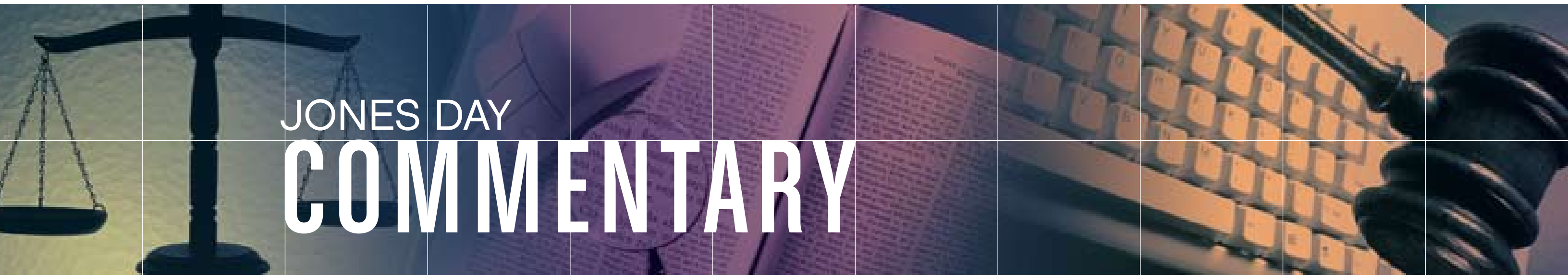


GOING PRIVATE TRANSACTIONS: DELAWARE REVISITS NEGOTIATED MERGERS AND TENDER OFFERS INVOLVING CONTROLLING STOCKHOLDERS

Delaware courts have traditionally applied differing standards to review the propriety of a going private transaction involving a controlling stockholder.[1] On the one hand, absent coercion or faulty disclosure, courts have traditionally applied the business judgment rule—coupled with traditional common law fiduciary duty concepts—to review tender offers (*Siliconix* transactions).[2] On the other hand, regardless of the procedural safeguards used, courts have traditionally utilized the more stringent entire fairness standard—requiring fair price and fair dealing—to evaluate negotiated mergers (*Lynch* transactions).[3] This led to the peculiar situation where different transaction structures having the same functional result (taking a company private) are challenged by plaintiffs and reviewed by the courts under divergent standards.

In *In re Cox Communications, Inc. Shareholders Litigation*, Vice Chancellor Strine of the Delaware Chancery took the opportunity to review the *Lynch* and *Siliconix* standards and propose revisions to each in an attempt to harmonize the two strands.[4] While Vice Chancellor Strine's proposal to subject *Lynch* transactions to the lower business judgment rule if certain procedural safeguards are employed makes sense, we believe Vice Chancellor Strine is off the

1 Throughout this *Commentary*, a going private transaction refers to a transaction with a controlling stockholder or management, as opposed to a third-party transaction.

2 *See In re Siliconix Inc. Shareholders Litigation*, 2001 WL 716787 (Del. Ch. Jun. 21, 2001).

3 *See Kahn v. Lynch Communications Systems, Inc.,* 638 A.2d 1110 (Del. 1994).

4 *See* 879 A.2d 604 (Del. Ch. 2005).

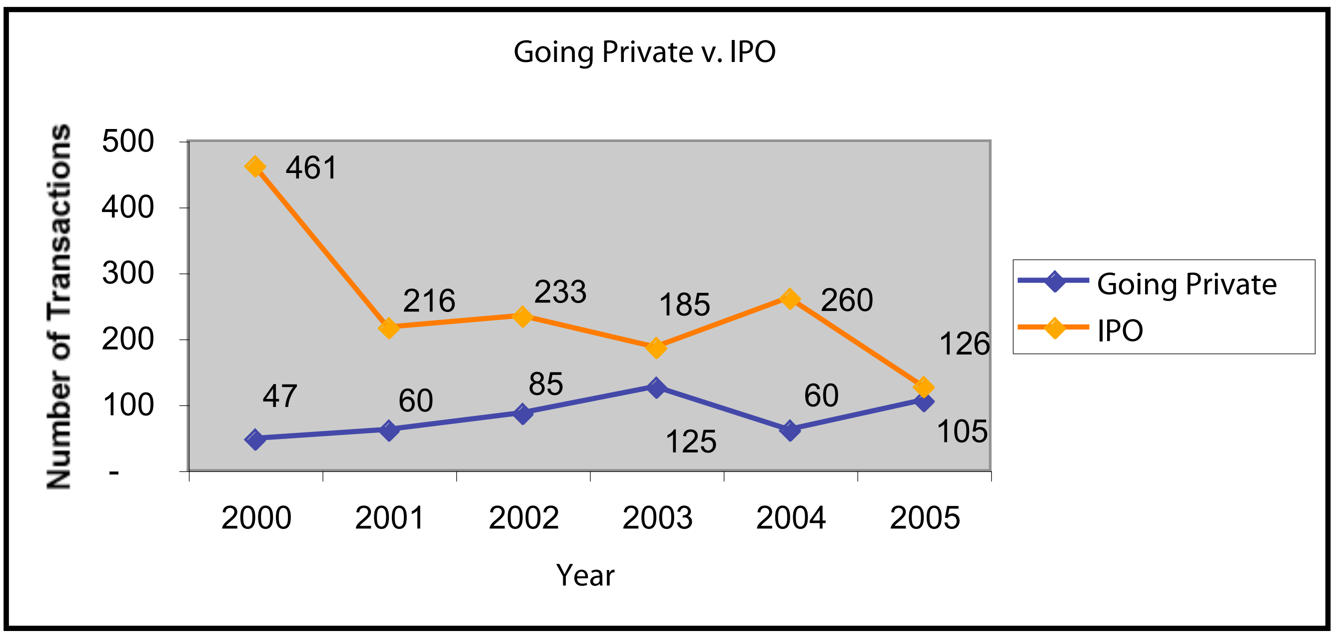
mark in proposing that Siliconix transactions be subject to entire fairness unless an independent special committee of the target approves the tender offer.

The following discussion explores (i) the current going private landscape, (ii) Delaware's differing view of negotiated mergers and tender offers in *Lynch* and *Siliconix*, and (iii) Vice Chancellor Strine's proposed revision of these differing standards of review in *Cox Communications*.

CURRENT GOING PRIVATE LANDSCAPE

From January 2000 through December 2005, there were, on average, 80 going private transactions per year. In contrast, there were, on average, 247 completed initial public offerings (IPOs) per year during the same period. While the number of going private transactions decreased from a high of 125 in 2003 to 60 in 2004, the number of such transactions increased during the past year and reached 105 deals by the end of 2005. Conversely, the number of completed IPOs has steadily declined from a high of 461 in 2000 to a low of 126 by the end of 2005. In short, current market conditions are creating an environment where the number of companies entering the public market is approaching the number of participants leaving the public stage through going private transactions.[5]

Directors and management of small and mid-cap public companies continue to cite a similar litany of rationales for going private. First, these companies have limited analyst coverage and research, which adversely affects both their stock prices and trading volumes.[6] Second, Sarbanes-Oxley continues to impose disproportionately increased compliance costs on these smaller companies (*e.g.,* internal compliance expenses, auditing fees, investor disclosure, and public relations costs). Third, directors and officers of public companies continue to be exposed to increased personal liability (*i.e.,* continuing corporate scandals involving AIG, Healthsouth, and Refco). Fourth, a continued marketplace focus on short-term results restricts management's ability to enact long-term strategies.[7] These factors continue to compel the management of many public companies to consider going private in order to reduce their financial and legal risks.



5 Statistical information available from Global Securities Information, Inc. The total number of companies leaving the public markets by means other than going private transactions may in fact be higher than the presented data.

6 From August 2001 to August 2003, companies with market capitalizations of less than $1 billion experienced a decrease in analyst coverage. For example, companies with market capitalizations of $500 million to $1 billion saw analyst coverage decrease 18% during this period. Further, companies with market capitalizations of less than $50 million experienced a decrease in analyst coverage during this same period of approximately 200%. See Frank Fernandez, "Going Private: Responding to the Small Cap Dilemma," *Securities Industry Association Research Reports*, Vol. IV, No. 8, p. 11 (Aug. 21, 2003).

7 *See* "Creating Value in Middle-Market Companies: Going Private Transactions," *The Deal*, Nov. 24, 2003, pp. 38-39.

DIFFERING TREATMENT OF NEGOTIATED MERGERS AND TENDER OFFERS

Various mechanisms are available for public companies to go private (*i.e.,* reverse stock splits, asset dispositions, bankruptcy-related acquisitions, etc.); however, negotiated mergers and tender offers remain the predominant structures. While the end result of each of these structures is the same, the Delaware courts have traditionally applied different standards in reviewing the propriety of these structures when they involve a controlling stockholder.[8]

NEGOTIATED MERGERS

In negotiated mergers, a controlling stockholder, management group, or third party will negotiate a merger agreement with the target company whereby the company will be merged into an acquisition subsidiary with the existing public stockholders receiving cash for their shares. This merger will require board and stockholder approval in accordance with applicable Delaware statutes.

In *Kahn v. Lynch Communications Systems, Inc.*, the Delaware Chancery held that "the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness."[9]

> "The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness."[10]

The *Lynch* Court went on to clarify that the controlling stockholder has "[t]he initial burden of establishing entire fairness… However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff."[11]

It is important to note that utilizing procedural safeguards like approval by an independent committee or an informed majority of the minority merely shifts the burden of persuasion to the plaintiff to prove that the transaction was not entirely fair. However, such safeguards do not lower the standard of review to the business judgment rule, which would, in effect, remove the fair price component of the entire fairness test. "All in all, the [*Lynch*] Court was convinced that the powers and influence possessed by controlling stockholders were so formidable and daunting to independent directors and minority stockholders that the protective devices like special committees and majority of minority conditions (even when used in combination with the statutory appraisal remedy) were not trustworthy enough to obviate the need for an entire fairness review."[12]

TENDER OFFERS

In tender offers, a controlling stockholder, management group, or third party will make a tender offer for all of the outstanding publicly held shares of an issuer with the goal of

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8 Investment banking and private equity sources cite the need to obtain stockholder approval and control (both achieved with a controlling stockholder) as desirous in pursuing going private transactions. *See id.*

9 638 A.2d at 117 (citing *Weinberger v. UOP, Inc.,* 457 A.2d 701, 710-711 (Del. 1983)).

10 *Id.* at 1115 (citing *Weinberger,* 457 A.2d at 711).

11 *Id.* at 1117 (citing *Weinberger,* 457 A.2d at 710-11).

12 *In re Pure Resources, Inc. Shareholders Litigation,* 808 A.2d 421, 436 (Del. Ch. 2002).

obtaining at least 90% of the total outstanding shares. Once 90% of the shares of the target company are obtained, the acquiror can effect a short-form merger and cash out the remaining stockholders.

As stated in *In re Siliconix Inc. Shareholders Litigation*, Delaware courts should *not* apply the entire fairness standard to tender offer transactions involving a controlling stockholder unless the tender offer (i) is coercive or (ii) contains disclosure violations.[13] Accordingly, the default standard for such transactions is the business judgment rule, coupled with traditional common law fiduciary duty concepts. While the *Siliconix* Court did not specify the factors for determining whether a tender offer is coercive, Vice Chancellor Strine in *In re Pure Resources, Inc. Shareholders Litigation* articulated that an acquisition tender offer by a controlling stockholder *would not* be considered coercive only when:

"(1) it is subject to a non-waivable majority of the minority tender condition;

(2) the controlling stockholder promises to consummate a prompt … [short-form] merger at the same price if it obtains more than 90% of the shares; and

(3) the controlling stockholder has made no retributive threats."[14]

It is interesting to note that in both *Siliconix* and *Pure Resources*, the respective Courts specifically rejected the idea that the entire fairness test be applied to tender offers. The Court in *Siliconix* noted that "as long as the tender offer is pursued properly, the free choice of the minority shareholders to reject the tender offer provides sufficient protection."[15] In particular, the Court noted that the controlling stockholder is under no obligation to offer any particular price for the minority-held stock.[16] Similarly, Vice Chancellor Strine in *Pure Resources* acknowledged that so long as the tender offer is non-coercive and the independent directors of the target are permitted to make an informed recommendation and provide fair disclosure, "the law should be chary about superimposing the full fiduciary requirement of entire fairness on top of the statutory tender offer process."[17]

The Court in *Siliconix* acknowledged that it may seem strange that a tender offer is given less scrutiny than a merger transaction. From the standpoint of the stockholder, there is little substantive difference between a tender offer followed by a back-end merger and a one-step merger transaction. Vice Chancellor Noble, however, identified two simple concepts for this difference in judicial approach. First, accepting or rejecting a tender offer is a decision to be made by the individual stockholder.[18] Second, in negotiated mergers the target company enters into the merger agreement with the controlling stockholder, but in the tender context, the target company does not confront a comparable corporate decision because the target of the tender offer is the stockholders, not the corporation.[19] From a statutory perspective, the legislature has imposed specific duties on directors of corporations entering into merger agreements, but it has not chosen to impose comparable statutory duties on directors of companies that are targets of tender offers.[20]

Vice Chancellor Strine is not as sanguine about this discrepancy.

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13 2001 WL 716787, 6 (Del. Ch. Jun. 21, 2001); *see also Solomon v. Pathe Communications Corp.,* 672 A.2d 35 (Del. 1996).

14 808 A.2d at 445 (citing 8 Del. C. § 253).

15 *Siliconix* at 6.

16 *Id.* (citing *In re Ocean Drilling & Exploration Co. Shareholders Litigation,* Del. Ch., Consol. C.A. No. 11898, Chandler, V.C., mem. op. at 6-7 (Apr. 30, 1991)). *See also Solomon,* 672 A.2d at 40.

17 808 A.2d at 446. To reconcile this position with his proposal in *Cox Communications,* discussed below, that basically imposes entire fairness on tender offers, Vice Chancellor Strine argues in *Cox Communications* that "[i]t was thought preferable in *Pure Resources* to keep the strands separate until there is an alteration in *Lynch,* lest the less than confidence inspiring pattern of '*Lynch* litigation' replicate itself across-the-board in all going private transactions, thereby deterring the procession of offers that provide valuable liquidity to minority stockholders and efficiency for the economy in general." 879 A.2d at 646.

18 *See Siliconix* at 7.

19 *See id.*

20 *See id.* In addition, the Delaware courts have found that the entire fairness test does not apply to a short-form merger under § 253 of the Delaware General Corporation Law. *See Cox Communications,* 879 A.2d at 623 (citing *In re Unocal Exploration Corp. Shareholders Litigation,* 793 A.2d 329 (Del. Ch. 2000), *aff'd,* 777 A.2d 242 (Del. 2001)).

COX COMMUNICATIONS

Cox Communications originally arose from challenges to the efforts of the Cox family, owners of approximately 74% of Cox Communications, Inc., to take the company private during the summer of 2004 by means of a negotiated merger.[21] The initial claims in the case principally contested the value offered by the family for the public's shares. However, these claims were settled by the parties and the remaining issue heard by the Court was an objection to the award of stipulated attorney fees. In the context of describing why he was slashing the fees awarded to plaintiffs' counsel, Vice Chancellor Strine took the opportunity to review "the non-coincidental relationship between the premature filing of cases like this and the [entire fairness] standard of review articulated in… *Lynch*."[22]

BACKGROUND

On August 1, the Cox family presented Cox's board with "its intention to offer to pay $32 per share as an initial bid in a merger transaction whereby the Family would acquire all of the public shares of Cox…."[23] This proposal specifically required the approval of a special committee of independent Cox directors who would respond to and negotiate the family's proposal.[24] Following the public announcement of the family's proposal on August 2, a dual process ensued with (i) Cox's special committee negotiating the merger with the family and (ii) 13 plaintiffs' groups filing "premature, hastily-drafted, makeweight complaints" challenging the family's proposal as undervaluing Cox and containing other "strained accusations of wrongdoing."[25] As noted by the Court, it is typical for plaintiffs to challenge such a transaction before a controlling stockholder executes a merger agreement with the target company.[26] Accordingly, defense counsel then attempts to bring the two separate tracks of resolving both the proposed merger and the plaintiffs' challenges to conclusion at the same time.[27]

Through tandem negotiations between the family and each of Cox's special committee and the plaintiffs, on October 18 the family and the Cox special committee reached an agreement on the merger contract pursuant to which the family agreed to pay $34.75 per share for the public's outstanding shares.[28] On the same day, this proposal was recommended by Cox's special committee and approved by the full board.[29] Also on the same day, representatives of the plaintiffs and the family reached an agreement pursuant to which the plaintiffs' actions would be settled in exchange for the family recognizing that "the efforts of the plaintiffs' counsel in this action were causal factors that led to the Family increasing its bid to $34.75, and agreeing that… [the merger be subject to a non-waivable majority of the minority approval condition]."[30] Further, the family agreed not to oppose the plaintiffs' requests for attorney fees of up to $4.95 million and that any awarded fees would be paid directly by the family.[31]

The resulting case arose from a challenge to the stipulated attorney fees by an objecting stockholder. In reducing the award of attorney fees from the agreed upon $4.95 million to $1.275 million, Vice Chancellor Strine outlined how *Lynch* makes it impossible for a controlling stockholder ever to structure a transaction in a manner that will enable it to obtain a dismissal of a complaint challenging a transaction. Thus, each *Lynch* case has a settlement value not necessarily because of its merits, but because it cannot be dismissed.[32]

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21 *See* 879 A.2d at 607.
22 *Id.* at 605.
23 *Id.* at 607.
24 *See id.*
25 *Id.* at 605, 608.
26 *See id.* at 621.
27 *See id.*
28 *See id.* at 612.
29 *See id.*
30 *Id.*
31 *See id.*
32 *See id.* at 605.

CONSEQUENCES OF THE *LYNCH* STANDARD

As previously discussed, the underlying proposition of *Lynch* is that "regardless of the procedural protections employed, a merger with a controlling stockholder would always be subject to the entire fairness standard."[33] Even if the transaction were approved by a special committee of disinterested directors and subject to approval by a majority of the disinterested stockholders, the most that could be achieved would be to shift the burden of persuasion on the issue of fairness from the defendants to the plaintiffs.

Vice Chancellor Strine acknowledged that "*Lynch* created a strong incentive for the use of special negotiating committees in addressing mergers with controlling stockholders."[34] "Independent directors have… aggressively undertaken the burdens of acting as a guarantor of the minority's interest…" by in-depth examination of the underlying economics and the retention of experienced financial and legal advisors.[35]

Lynch, however, has made the use of a majority of the minority approval condition less prevalent because of the absence of any standard of review-affecting benefit for using it.[36] Vice Chancellor Strine observed that the inclusion of a majority of the minority approval condition in a negotiated merger only minimally reduced the legal risk of plaintiffs' challenges (*e.g.*, by simply shifting the initial burden of proof to the plaintiffs), but created substantial transaction risk for the controlling stockholder (*e.g.*, the possibility that the minority stockholders would vote against the transaction).[37] Accordingly, a controlling stockholder was only likely to accept this provision either at the request of the special committee or in order to settle the plaintiffs' suit.[38] As a practical matter, the effect of *Lynch* was to generate the use of special committees alone.[39]

The most problematic feature of *Lynch* for Vice Chancellor Strine, however, is the incentive system it created for plaintiffs' lawyers. Unlike even *Revlon* transactions, it was impossible after *Lynch* to structure a deal with a controlling stockholder that could be dismissed on the pleadings. Therefore, the entire fairness standard incentivizes plaintiffs, target companies, *and* controlling stockholders to settle "non-meritorious, premature suits" resulting in (i) the plaintiffs collecting their attorney fees, (ii) the target companies avoiding disruptive litigation, and (iii) controlling stockholders gaining a greater certainty of closing.[40]

REFORMATION OF THE *LYNCH* STANDARD

In response to these consequences, Vice Chancellor Strine proposes to reform the *Lynch* standard in order to enhance the protections for minority stockholders and ensure the integrity of the litigation process.[41] He proposes that in a going private merger with a controlling stockholder, the business judgment rule (rather than the entire fairness standard) should apply where the transaction includes both approval by a majority of the disinterested directors *and* approval by a majority of the disinterested stockholders.[42] Further, a controlling stockholder or the directors of a target company

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33 *Id.* at 616.
34 *Id.* at 618.
35 *Id.*
36 *See id.*
37 *See id.*
38 *See id.*
39 *See id.* at 619.
40 *Id.* at 605. Vice Chancellor Strine also noted that in no instance have the plaintiffs' counsel concluded that the price obtained by the special committee was sufficiently unattractive to warrant continued litigation. In other words, plaintiffs have never demanded a higher price than that agreed to by a special committee. *See id.* at 621, 631.
41 *See id.* at 643.
42 *See id.* Vice Chancellor Strine acknowledges that another plausible argument would be to allow the business judgment rule to apply upon the use of a special committee alone. Then, the special committee could trade a higher price for more deal certainty by giving up the majority of the minority condition. "Because of the sharp conflict that going-private transactions involve and the informational advantages that controllers often possess, however, the possibility that special committees might occasionally drive better deals if they can trade closing certainty (*i.e.,* because the controller can use its own votes to accomplish the merger) for price seems to me to be outweighed by the general utility of ensuring that controllers and special committees both know that the transactions they agree upon will be subject to approval by the disinterested minority (or entire fairness review)." *Id.* at 644 (fn. 82).

should be able to dismiss the plaintiffs' complaint unless "1) the plaintiffs plead particularized facts that the special committee was not independent or was not effective because of its own breach of fiduciary duty or wrongdoing by the controller (*e.g.*, fraud on the committee); or 2) the approval of the minority stockholders was tainted by misdisclosure, or actual or structural coercion."[43]

The Court concluded that this revision would more closely replicate the elements of an arm's-length merger by requiring the approval of both the independent directors *and* the minority stockholders to invoke the business judgment rule.[44] In addition, controlling stockholders would have an incentive to utilize negotiated mergers with the knowledge that potential litigation could be dismissed at the pleadings stage.[45]

IMPACT ON THE *SILICONIX* STANDARD

Recognizing the "jarring doctrinal inconsistency" between the differing standards utilized to evaluate negotiated mergers and tender offers, Vice Chancellor Strine completed his analysis with a suggested revision of the *Siliconix* standard for reviewing tender offers involving controlling stockholders.[46] "In the case of a tender offer by a controlling stockholder, the controlling stockholder could be relieved of the burden of proving entire fairness if: 1) the tender offer was recommended by an independent special committee; 2) the tender offer was structurally non-coercive in the manner articulated by *Pure Resources*; and 3) there was a disclosure of all the material facts."[47] Thus, the transaction would be immune from challenge unless the plaintiffs pled particularized facts from which it could be inferred that the committee's recommendation was tainted by a breach of fiduciary duty or there was a failure in disclosure.

With this proposed strengthening of the standard of review in *Siliconix* transactions, together with Vice Chancellor Strine's proposed alteration of the standard of review for *Lynch* transactions, there would no longer be a disparity of treatment between tender offer and merger transactions. In both cases, controlling stockholders would have a strong incentive to afford minority stockholders the dual protections of special committee review and a majority of the minority approval.

ANALYSIS

Vice Chancellor Strine's proposal to revise *Lynch* as it applies to going private transactions structured as mergers makes sense for all of the reasons he articulates in *Cox Communications*. But, while his proposed harmonization of the *Lynch* and *Siliconix* standards appears elegant at first glance, we believe his suggested revision of the *Siliconix/Pure Resources* standard of review (*e.g.*, to apply entire fairness unless an independent special committee recommends the tender offer) goes too far.

As articulated by Vice Chancellor Noble in *Siliconix*, and acknowledged by Vice Chancellor Strine in *Pure Resources*, a controlling stockholder has no obligation to pay the minority stockholders any particular price for their shares. The procedural limitations of non-coercion and adequate disclosure, as articulated in *Siliconix* and *Pure Resources*, largely apply the fair dealing prong of the entire fairness test to tender offers (*i.e.*, how the transaction was timed, initiated, structured, negotiated, and disclosed, and how the approval of the stockholders was obtained). Thus, to impose the further requirement that a special committee of independent directors must recommend the tender offer to avoid the application of the entire fairness test is, in effect, to read a fair price requirement into tender offers.

In light of the already existing procedural protections required to invoke the business judgment rule under *Pure Resources*, it is unclear what additional procedural protections an independent special committee would provide. In addition, given that the target company board is already required to make a

43 *Id.* at 644.
44 *See id.* at 644.
45 *See id.*
46 *Id.* at 646.
47 *Id.*

recommendation on the tender offer under Rule 14e-2 of the Securities Exchange Act of 1934 (and any recommendation by the target company or solicitation by the controlling stockholder is subject to the disclosure requirements of Rule 14d-9), it is unclear how the involvement of an independent special committee strengthens the disclosure requirements of *Siliconix*. Thus, the special committee recommendation requirement could not fairly be considered a procedural requirement. At this point, then, the only facet left for the special committee to pass on is price. Therefore, to require the special committee to recommend the tender offer in order to avoid the application of the entire fairness test is to, in effect, impose the fair price provisions, and thus the entire fairness test, on tender offers.

One may argue, however, that this is appropriate. Treat tender offers and mergers the same. This point of view, however, ignores the well-articulated argument in *Siliconix* as to why tender offers are treated differently from mergers, namely, that the Delaware legislature has determined that directors must recommend a merger transaction to stockholders, but has not required that they make any recommendation with respect to tender offers. In other words, no corporate action is required for a tender offer. And, it is not appropriate for the courts to impose this requirement as the legislature has specifically determined that the target board need not act in a two-step acquisition.[48]

In conclusion, while Vice Chancellor Strine's modification of the *Siliconix* standard for reviewing tender offers may logically "complete the circle" of his reformation of the *Lynch* standard for reviewing negotiated mergers, the practical effect appears to be the addition of a fair price requirement for tender offers, a proposition that has been specifically rejected by the Delaware courts to date. We believe that the procedural safeguards articulated by Vice Chancellor Strine in *Pure Resources* provide the correct balance between *Lynch* and *Siliconix* transactions, and that his further refinement as proposed in *Cox Communications* goes too far.

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48 *See Cox Communications,* 879 A.2d at 615, fns. 18-20, *supra,* and related text. Contrast this fact with Ohio law, for example, which requires the parent and subsidiary corporations to enter into a plan of merger to effect short-form merger. Thus, in Ohio, the target board would still need to act to complete the acquisition.