Chancery Finds Allegations of 'Control Group' Sufficient to Invoke Entire Fairness Review of Merger

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In *Frank v. Elgamal,* C.A. No. 6120-VCN (Del. Ch. Mar. 30, 2012), the Delaware Court of Chancery held that the entire fairness standard would apply to the merger of American Surgical Holdings Inc. with an unaffiliated private equity purchaser. A key issue in the court's analysis was whether the plaintiff had adequately alleged that American Surgical had a "control group." Because the court concluded that a control group had been adequately alleged, the court found that the merger would be subject to entire fairness review under the standard set forth in *In re John Q. Hammons Hotels Inc. Shareholders Litigation,* WL 3165613 (Del. Ch. Oct. 2, 2009).

In August 2009, the American Surgical board created a mergers and acquisitions committee to explore strategic opportunities for the company. The committee retained the Polaris Group to serve as the company's financial adviser and to solicit potential business combinations for the company. In December 2009, the American Surgical board designated two directors as a special committee charged with negotiating the terms and conditions of any potential transaction involving the sale of the company, according to the opinion. The plaintiff alleged that the company had received a proposal from a private equity firm for a multimillion-dollar investment that would have allowed the company to fund its expansion plans and allowed the company's public stockholders to continue their investment in the company. However, this proposed investment was allegedly not as lucrative to the company's "control group" as a merger proposal from another unaffiliated private equity firm, Great Point Partners I. Accordingly, the plaintiff alleged that the control group pushed forward with a merger with Great Point's affiliate, AH Holdings Inc., and that the special committee acquiesced to the control group.

The merger was structured as a reverse-triangular merger, in which Holdings merged with American Surgical and American Surgical was the surviving entity. Under the terms of the merger agreement, each share of American Surgical common stock was converted into the right to receive $2.87 in cash. However, on the same day as the execution of the merger agreement, the members of the alleged control group entered into "exchange agreements" pursuant to which they would exchange, immediately prior to the merger, some of their American Surgical stock for shares of Holdings, according to the opinion. As a result, while all other stockholders would be cashed out through the merger, the members of the control group would retain an interest in the company. The members of the control group also entered into voting agreements, pursuant to which they agreed to vote all of their American Surgical common shares in favor of the merger. At the time the voting agreements were executed, the members of the control group held about 64 percent of American Surgical's common stock; by the record date for the merger, they owned approximately 71 percent of the company's common stock, according to the opinion. Finally, the members of the control group also each executed employment agreements, which became effective at the effective time of the merger.

In the complaint, the plaintiff asserted claims for (1) breach of fiduciary duty against the control group as controlling stockholders; (2) unjust enrichment against the control group; (3) breach of fiduciary duty against the entire board and two officers; and (4) aiding and abetting breach of fiduciary duty against the purchasing entities. The defendants moved to dismiss all claims.

Resolution of the defendants' motion to dismiss the breach of fiduciary duty claims turned largely on whether the plaintiff had adequately alleged the existence of a control group. In the absence of a control group, the merger with an unaffiliated third party would presumably be entitled to the protections of the business judgment rule. However, if the plaintiff had adequately alleged the existence of a control group, then the court would apply the analysis adopted in *Hammons* to determine whether the merger would be subject to entire fairness review.

In addressing this issue, the court began by noting that, although a controlling stockholder is often a single entity or person, Delaware case law has recognized that a number of stockholders could together constitute a control group "where those shareholders are connected in some legally significant way - e.g., by contract, common ownership, agreement or other arrangement - to work toward a shared goal." If such a control group exists, it is accorded controlling stockholder status and each of its members owe fiduciary duties to the minority stockholders of the corporation.

In the *Frank* case, the alleged control group included two directors, who also served as top managers of the company, and two other managers. Although none of these individuals owned more than 30 percent of the company's common stock, they collectively owned more than 70 percent of the common stock as of the record date for the merger, according to the opinion. Moreover, the complaint alleged that each member of the control group acted in concert and had contemporaneously entered into the voting agreements, exchange agreements and employment agreements.

The court concluded that, for the purposes of a motion to dismiss, these allegations were sufficient to establish the existence of a control group. The court noted that private equity purchasers often condition a transaction on the continued employment of key members of management and sometimes provide that those persons receive an equity stake in the company, presumably to ensure that they have "skin in the game." The *Frank* court recognized that, in other circumstances, the Court of Chancery had found it permissible to structure a transaction in this way. However, the court noted that where the complaint adequately alleges that the managers who will be given a continuing interest in the company are members of a control group, it is reasonable for the court to infer that the managers/control group members are using their control to acquire unique benefits for themselves at the expense of the minority stockholders. It is notable that earlier in March, in *Zimmerman v. Crothall,* C.A. No. 6001-VCP (Del. Ch. Mar. 5, 2012), the Court of Chancery similarly denied a motion for summary judgment on the grounds that the plaintiff had raised a genuine issue of material fact with respect to the existence of a control group.

Having concluded that the existence of a control group was adequately alleged, the *Frank* court explained that the merger presented a "*Hammons*-type" situation in which the controlling stockholders would have a continuing interest in the company following its merger with an unaffiliated third party, but the minority stockholders would be cashed out. Following the reasoning of *Hammons*, the court explained that, in such circumstances, the controlling stockholders and the minority are "competing" for portions of the consideration that the third party is willing to pay. In *Hammons*, the Court of Chancery held that the business judgment rule would apply to such a situation only if the merger was conditioned on "robust procedural protections," such as approval of a majority of the minority stockholders and a recommendation by a disinterested and independent special committee. Because American Surgical had not conditioned the merger on approval by a majority of the minority stockholders, the *Frank* court found that the transaction would be subject to entire fairness review. However, the court noted that if the defendants ultimately demonstrate that the merger was approved by either an independent special committee or an independent board majority, the burden of proof under the entire fairness standard could shift to the plaintiff.

The *Frank* opinion illustrates the Court of Chancery's approach to allegations of a control group when presented with a motion to dismiss, and highlights the significant effect that such allegations may have on the applicable standard of review. The opinion also serves as a word of caution to companies in structuring transactions in which certain managers will continue with the surviving entity, but the remaining stockholders are cashed out. In such circumstances, both the target and the acquirer should closely evaluate whether the factual circumstances may give rise to allegations of a control group and, if so, consider whether additional minority stockholder protections are warranted.

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