

## Entire Fairness, *Revlon* Standards When Control Group Is Involved

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In a recent opinion granting in part and denying in part a motion for summary judgment, Vice Chancellor John W. Noble provided guidance in *Frank v. Elgamal*, 2014 Del. Ch. LEXIS 37 (Del. Ch. Mar. 10, 2014), on what constitutes a control group in the context of a merger transaction and how the entire fairness and *Revlon* standards apply when there is a control group.

### Background

In the transaction at issue, American Surgical Holdings Inc. merged with an affiliate of Great Point Partners I LP. As a result of the merger, four employees of American Surgical who collectively held a majority of American Surgical's stock (referred to as the rollover group) received cash and equity in the surviving entity, while other stockholders received only cash. The plaintiff, Richard Frank, a stockholder who was not part of the rollover group, filed suit alleging breaches of fiduciary duty by both the rollover group and American Surgical's board.

### What Constitutes A Control Group

Because "the existence of a controlling stockholder may affect the court's standard of review of the

business decisions of a corporation's board of directors" and a group of stockholders "may collectively be considered a control group that is analogous, for standard-of-review purposes, to a controlling stockholder," the plaintiff argued that the rollover group was "functionally" a control group.

Noble explained that "the existence of a control group typically depends on factual issues related to the significance of relationships among stockholders," which could change over time. In addition, Noble explained that mere "parallel interests" among individuals are insufficient to establish a control group. Instead, the individuals must be "connected in some legally significant way—e.g., by contract, common ownership, agreement or other arrangement—to work together toward a shared goal."

Noble considered whether a control group existed during "two distinct periods of time": (1) when American Surgical's board decided to put the company up for sale; and (2) when the merger consideration offered by Great Point was selected. During the initial sale process, No-



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ble found "no evidence" of a control group because the members of the rollover group did not dictate the timing of the decision to sell the company or "condition the terms of any possible transaction on rolling over a portion of their interest in American Surgical into equity in the surviving entity." During the process of selecting the merger consideration, however, Noble found an issue of material fact because the rollover group "may have been united in interest" and "may have exercised its control" in selecting the merger consideration that was most favorable to its members.

### Entire Fairness Standard When Control Group Is Involved

Because there was an issue of material fact as to the existence of a control group during the process of selecting the merger consideration,

Noble identified two scenarios under which the entire fairness standard might apply due to the presence of a control group.

First, consistent with *Kahn v. Lynch Communication Systems*, 638 A.2d 1110 (Del. 1994), the entire fairness standard could apply if the rollover group was found to have stood on both sides of the challenged transaction, which would depend on “the context in which the transaction [wa]s proposed to and negotiated on behalf of the minority stockholders.” In this regard, the court noted that although there was a special committee of independent directors formed to take over the sale process, it could be determined that the minority stockholders were not adequately represented if the special committee was not fully informed about the different options for merger consideration. Second, consistent with *In re John Q. Hammons Hotels Shareholder Litigation*, 2009 Del. Ch. LEXIS 174 (Del. Ch. Oct. 2, 2009), the entire fairness standard could apply if the rollover group was “competing for the consideration of the acquirer,” which could be found if it were demonstrated that American Surgical’s minority stockholders received consideration that was less favorable than the consideration received by the rollover group.

Under *Lynch* and *Hammons*, a plaintiff may bear the burden to prove that a challenged transaction was not fair if the transaction was either recommended by a special committee or approved in a nonwaivable majority-of-all-the-minority vote. Noble explained

that he could not conclude as a matter of law that the plaintiff should bear this burden because the special committee formed by American Surgical’s board did not negotiate directly with the acquirer and there was “conflicting testimony” as to whether the special committee was adequately informed about the different options for merger consideration.

### **Revlon Standard When Control Group Is Involved**

Because the plaintiff asserted that American Surgical’s board breached its fiduciary duties by failing to “maximize the value” of American Surgical stock, Noble also addressed the application of *Revlon* when a possible control group is involved: “The requirement that a board discharge its fiduciary duties toward the goal of obtaining the best price reasonably available for stockholders under *Revlon* has a different characteristic when the corporation up for sale has a controlling stockholder or, by extension, a control group. ... Where a controlling stockholder proposes a cash-out merger between it and the corporation, *Revlon* may not be implicated if the corporation is not otherwise up for sale. However, that a board decides to sell the entire corporation to a third party, such as at the controlling shareholder’s suggestion or direction, does implicate *Revlon*. In that situation, the concomitant goal of the directors is then to determine if the sale to the third party ‘will result in a maximization of value for the minority shareholders.’”

Because Noble found “no evidence” of a control group when American Surgical was first put up for sale, the duty of American Surgical’s board during the initial sale process was to find the best price reasonably available to all stockholders. If the existence of a control group during the process of selecting the merger consideration is established at trial, the board’s duty during that period would have shifted to finding the best price reasonable available for the minority shareholders.

### **Conclusion**

Parties negotiating a merger transaction should be mindful of whether and when a control group might be deemed present and, if one might be found to exist, consider implementing procedural safeguards to protect the interests of minority stockholders, such as review of the transaction by a disinterested and fully informed special committee of independent directors or approval of the transaction in a nonwaivable majority-of-all-the-minority vote.

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