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Delaware Chancery Affirms that Entire Fairness Applies to a *Hammons*-Type Merger Involving a Control Group

A recent decision by the Delaware Court of Chancery in *Frank v. Elgamal* held that entire fairness review would apply to a *Hammons*-type minority cash-out transaction, pursuant to which an affiliate of Great Point Partners acquired American Surgical Holdings, Inc. In its opinion, the court held that four American Surgical shareholders who received an interest in the post-transaction entity acted in concert, and therefore constituted a control group owing fiduciary duties to the minority shareholders. No member of the control group individually held more than 30% of American Surgical's common stock, but the members collectively held more than 70% of the common stock. The four shareholders were also key employees of American Surgical. Even though the control group did not "stand on both sides" of the merger, which would have mandated the application of entire fairness under *Kahn v. Lynch Communication Systems, Inc.*, the court held that because the control group and the minority shareholders were "competing" for consideration to be paid in the transaction, *In re John Q. Hammons Hotels Inc.* required that entire fairness apply unless the merger was conditioned on "robust procedural protections." Because consummation of the merger did not require approval by a majority of the minority shareholders, the court determined that entire fairness would apply.

In August 2009, American Surgical's board of directors created a mergers and acquisitions committee (the "M&A Committee") consisting of three directors, including the company's Chief Executive Officer and the Chief Operating Officer, to explore strategic opportunities. The M&A Committee retained Polaris Group to serve as the company's financial advisor. In December 2009, the Board formed a special committee, consisting of two outside directors, to negotiate any potential transaction involving the sale of the company. Polaris solicited potential transactions, and four parties emerged as having an interest in the company, including at least one party proposing a transaction that would have permitted the company's minority shareholders to continue their investment in American Surgical. The Special Committee determined, however, that the transaction with Great Point represented the most favorable and retained another financial advisor, Howard Frazier Barker Elliott, Inc., to provide a fairness opinion on this transaction, which it ultimately did render.

After several months of negotiations, in December 2010, American Surgical entered into a merger agreement pursuant to which each share of American Surgical common stock would be converted into the right to receive \$2.87 in cash plus additional consideration (a pre-closing cash dividend and non-transferable interests in a special-purpose vehicle that would own rights to certain pending litigation), the value of which was not ascertainable prior to consummation of the merger. The only shareholder approval required under the terms of the merger agreement was that of a majority of the outstanding shares of common stock on the record date. The merger agreement also contained several defensive measures, including a termination fee, a match right and a no-shop clause.

American Surgical's CEO and COO and two additional key employees (one of whom was among the most highly compensated executive officers of the company) together owned

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approximately 71% of American Surgical's common stock (the "Control Group") and entered into a series of agreements with Great Point in connection with the proposed merger. The agreements consisted of (1) shareholder voting agreements, pursuant to which each Control Group member agreed to vote all of his shares of common stock in favor of the merger and (2) exchange agreements, pursuant to which each Control Group member agreed to exchange, immediately before the merger, some of his common stock for preferred shares of the acquisition vehicle. As a result, even though American Surgical's minority shareholders would be fully cashed-out in the merger, the Control Group would retain a 14.9% aggregate interest in American Surgical post-merger. Finally, each Control Group member also signed a new employment agreement with the acquisition vehicle.

The plaintiff shareholder, in a class action complaint, asserted four causes of action against the Control Group, the Board and Great Point. In the first cause of action, the plaintiff alleged that members of the Control Group were together controlling shareholders acting in concert, and violated their duties of loyalty and care owed to the minority shareholders of the company by denying the minority shareholders their right to share proportionately in the true value of the company, while maintaining for themselves an interest in the surviving entity on terms that were unfair to the other shareholders. The court agreed with the plaintiff on this point, and held that entire fairness should apply based on the Court of Chancery's prior decisions in *Hammons* and *In re LNR Property Corp.* *Hammons* and *LNR* held that where a corporation with a controlling shareholder merges with an unaffiliated company, the minority shareholders are cashed-out, and the controlling shareholder receives a minority interest in the surviving company, the controlling shareholder and the minority effectively are "competing" for portions of the consideration, thereby warranting "robust procedural protections" for the minority. Entire fairness would thus be the applicable standard of review for such transaction unless it is both (1) recommended by a disinterested and independent special committee, and (2) approved by a non-waivable vote of the majority of all the minority shareholders.

In the case at hand, the court held that plaintiff's complaint sufficiently alleged that the merger was a *Hammons*-type transaction because it reasonably could be inferred, for purposes of a motion to dismiss, that the Control Group acted as a controlling shareholder, as each member of the Control Group agreed to vote his common stock in favor of the merger, exchanged some of his common stock for an interest in the post-merger entity, and accepted employment in the post-merger entity. Thus, the merger would be subject to entire fairness under *Hammons* and *LNR* unless it was conditioned on "robust procedural protections." Although the merger was recommended by American Surgical's Special Committee, because the merger was not also conditioned on a non-waivable majority of the minority vote, it would be subject to entire fairness review.

Plaintiff's second and third causes of action alleged that the Control Group was unjustly enriched as a result of the merger and that the American Surgical Board, as well as the two non-Board members of the Control Group, breached their fiduciary duties to ensure that the merger was fair to the minority shareholders. The court, based on its earlier findings described above, denied the defendants' motion to dismiss these causes of action.

Fourth and finally, plaintiff alleged that Great Point aided and abetted the alleged breaches of fiduciary duty committed by members of the Control Group and the Board. The plaintiff alleged that Great Point was intimately involved in the negotiation of the merger and was aware that the Control Group and the minority shareholders were competing for consideration. Moreover, plaintiff alleged that Great Point demanded deal protections, while enticing the company's management to enter into a deal with them through equity offerings and lucrative salaries and bonuses. The court granted the defendants' motion to dismiss as to the aiding

and abetting claims, noting that no acquirer could ever complete an acquisition without being involved in the negotiations. Moreover, the court noted that while Great Point knew that the Control Group and the minority shareholders were competing for consideration, the plaintiff did not suggest that Great Point attempted to exploit that competition. In addition, the court noted that nearly every third party bidder seeks deal protection devices, and the fact that Great Point was able to obtain a few does not suggest anything other than that the parties were bargaining at arm's-length.

Frank represents a unique instance of a Delaware court's evaluation of a *Hammons*-type transaction, and its willingness to apply entire fairness review to transactions in which several non-controlling shareholders act together as a control group and compete for differential consideration with minority shareholders.

For the *Frank* opinion, see <http://www.paulweiss.com/files/upload/Opinion6120-VCN.pdf>

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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