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Deal Commentary

Latham & Watkins LLP has created this new occasional publication to provide a discussion of noteworthy transactions, case law and current events that impact the Mergers and Acquisitions market and the conduct of your business. We hope that our new M&A Deal Commentary will be a useful resource for all participants in the M&A market, including acquisitive public and private companies, investment bankers and private equity firms.

Highlights

- VC Strine cuts fee for plaintiffs' lawyers in going private case by 75 percent.
- VC Strine questions role of "knee jerk" lawsuits filed before a special committee is formed.
- As a result, settlement value of plaintiffs' litigation in entire fairness going private deals is likely to decline.
- VC Strine in dicta proposes major reformulation of Delaware law on going private deals.
- VC Strine proposes that judges review all going private deals (whether by merger or tender offer) under the business judgment rule, so long as a properly functioning special committee and a majority of disinterested shares approve the deal. Otherwise, entire fairness review would apply no matter how the transaction is structured.
- It is unlikely that VC Strine's reforms will become law because mounting a test case would not benefit most controlling stockholders engaged in going private transactions.

In re Cox Communications, Inc. Shareholders Litigation

Nearly three years ago, Delaware Vice Chancellor Leo Strine included a footnote in his decision in *In re Pure Resources, Inc. Shareholders Litigation* that proposed a new standard of judicial review for traditional going private mergers sponsored by a controlling stockholder: where the merger is subject to approval by a special committee **and** a majority of the minority shares, Strine proposed that the transaction should be reviewed under the deferential business judgment rule, rather than the stringent entire fairness standard.

In the interim, no controlling stockholder has accepted the invitation to test Strine's proposed standard. In his June 6, 2005 decision in *In re Cox Communications, Inc. Shareholders Litigation*, Strine emphatically reiterated his proposed re-ordering of the standards for judicial review of going private deals. Implying that his view is shared by others on the Delaware Chancery Court, Strine set the stage for a significant change in the law governing going private transactions. This leaves the M&A community to confront the question of whether Strine's proposals will ever become law. At this point in time, the answer is unclear. However, as we analyze the situation, the tactical disadvantages of accepting a majority of the minority

condition, combined with the cost and uncertainty of mounting a judicial test case, suggest that, if there is to be a test case, it will be brought either by a quixotic champion of doctrinal reform, or by a controlling stockholder who has failed to take into account the tactical pitfalls of pursuing the deal structure suggested by Strine.

The Cox Family Makes an Offer

On August 1, 2004, the Cox family submitted a negotiable merger proposal to acquire, for \$32 per share, the 26% of the voting power of Cox Communications, Inc. that it did not own. As typically occurs, before the board could even appoint a special committee to consider the family's proposal, numerous stockholder lawsuits were filed challenging the fairness of the deal under Delaware's entire fairness standard.

After a lengthy negotiating process with the special committee, the Cox family reached an agreement at \$34.75 per share, contingent upon approval of a majority of the minority shares and settlement of all outstanding lawsuits. The plaintiffs' attorneys, who had no involvement in the negotiation process with the special committee, agreed to settle the litigation upon presentation of the family's final offer price. As part of the settlement, the family agreed not to oppose an award of attorneys' fees of up to \$4.95 million.

An agreement to pay significant attorneys' fees to plaintiffs' counsel as part of a settlement of a lawsuit involving no change in the price or other deal terms approved by the special committee has become typical in going private mergers. It amounts to a "deal tax" that controlling stockholders pay in order to complete going private transactions without litigation risk. In *Cox*, however, a group of stockholders, led by University of Arizona Law School professor Elliott Weiss, filed an objection to the fee request. The objection claimed that the lawsuits were frivolous, and added little, if any, value to the final offer price. To the objectors, Delaware law was allowing "the plaintiffs' bar to reap profits by filing cases that have no benefit to stockholders."

The court in *Cox* was unwilling to conclude that the *Cox* lawsuits did not contribute (at least a little bit) to the \$2.75 per share price increase, and thus rejected the objectors' position that the plaintiffs' lawyers should get nothing. However, the Court observed that in cases involving a typical fairness challenge to a fully negotiable

Going Private Transactions

Strine's opinion in *Cox* goes to great lengths to reiterate and amplify the suggested reform of judicial review for going private transactions that he first proposed in *Pure Resources*. To understand Strine's proposed reform, a little background of the Delaware law for going private transactions may be helpful.

There are two mechanisms available to a controlling stockholder for a going private transaction – a merger or a unilateral tender offer.

When reviewing a going private merger, Delaware courts start with the assumption that the controlling stockholder board representatives have an inherent conflict of interest and unavoidably divided loyalties. This means that the public stockholders will not be adequately protected by ordinary board approval and a subsequent stockholder vote, particularly where the controlling stockholder has a majority voting interest. In these circumstances, Delaware courts have held that that a stringent entire fairness standard of review applies to any lawsuit challenging a going private merger.

Under the entire fairness standard, the court will examine both the fairness of the process leading up to the merger and the fairness of the price paid (see, for example, *Kahn v. Lynch Communications, Inc.*). Moreover, the burden of proof on whether the transaction meets the entire fairness standard ordinarily rests on the controlling stockholder; however, if the going private merger is (i) negotiated and approved by a special committee of independent directors; or (ii) conditioned on approval by a majority of the disinterested shares, the court will shift the burden on the issue of fairness from the defendants to the plaintiffs.

On the other hand, if a controlling stockholder structures its going private transaction as a tender offer, rather than a

merger proposal, plaintiffs' lawyers take no appreciable risk because it is usually certain from the outset of the litigation that a special committee will negotiate the price upward. In such cases, the court held, plaintiffs' lawyers should not be rewarded with any risk premium. Accordingly, the court cut the plaintiffs' lawyers' fee award by 75% (from \$4.95 million to \$1.275 million) and told the plaintiffs' lawyers to consider that generous.

merger, Delaware courts have held in a long line of cases – culminating in the *In re Siliconix, Inc. Shareholders Litigation* and *Pure Resources* decisions – that the entire fairness standard of review is inapplicable. The rationale for the very different treatment of unilateral tender offers is that a tender offer is made directly to the public shareholders and the conflicted board is not involved in the transaction. The traditional business judgment standard of review will be used so long as the offer is non-coercive (including being conditioned on approval of a majority of the minority shares) and there is full disclosure of all material facts.

Application of the entire fairness standard, as opposed to the business judgment rule, has a substantial impact on the settlement value of a lawsuit. Under the *Lynch* decision, a suit involving the entire fairness standard cannot be dismissed on the pleadings so long as the complaint alleges that the transaction is not “fair,” because the allegation raises a triable issue of fact and there is no requirement to plead particularized facts evidencing unfairness. Because dismissal on the pleadings or on summary judgment is not available, defendants are motivated to settle to avoid the costs associated with discovery and trial, and to secure a general release of claims. By contrast, under the business judgment rule in Delaware, a complaint must plead particularized facts evidencing alleged violations of law, and cases are often dismissed at the pleading stage or on summary judgment.

The *Lynch* and *Siliconix* lines of cases thus create inconsistent standards for transactions involving controlling stockholders: (i) structure the offer as a merger, and face entire fairness review in any lawsuits, or (ii) use a non-coercive tender offer, and escape the entire fairness review while minimizing litigation expense and risk.

Vice Chancellor Strine Proposes Reforms

Strine uses *Cox* as an opportunity to repeat his criticism of the conceptual flaws he sees in Delaware's law governing going private transactions (see, for example, *In re Pure Resources Shareholders Litigation* and *In re Cysive, Inc. Shareholders Litigation*) and to propose a new regime that would bring the *Lynch* and *Siliconix* lines of cases into total doctrinal harmony.

Strine hinges his proposed integration of the two decisional lines of going private cases on his observation that neither the *Siliconix* nor the *Lynch* line has been effective in causing going private transactions to best mirror the statutory and real-life process followed in arms-length mergers – that is, (i) negotiation and approval of the transaction by disinterested directors, and (ii) subsequent approval by disinterested stockholders. Strine translates this paradigm for arms-length Delaware mergers into the going private context by equating a truly independent special committee to the normal disinterested board of directors, and by equating a vote of a majority of disinterested stockholders to the normal vote of a majority of all stockholders.

Strine then observes that under *Siliconix* and *Pure Resources* an entire fairness review can be avoided even where a special committee recommends that stockholders not tender their shares. This, of course, means there is no legal incentive to avoid a negative recommendation from the special committee and thus no legal incentive to negotiate with the committee. Similarly, Strine notes that under *Lynch*, approval of a merger agreement by **either** an independent committee **or** a majority of the disinterested stockholders suffices to gain the modest (but best available) procedural benefit of shifting the burden on the fairness issue to the plaintiff. Thus controlling stockholders have no legal incentive in a going private merger transaction to agree to a majority

of the minority voting condition in their initial proposal. Instead, controlling stockholders usually hold this procedural concession for use as a bargaining chip when negotiating with the special committee.

Strine's proposed solution seeks to create a meaningful legal incentive for use of the majority of the minority vote condition by altering the *Lynch* rule to provide that where a going private transaction is structured as a merger and the controlling stockholder's initial proposal requires **both** approval of a special committee of independent directors **and** a majority vote of the minority stockholders, then the transaction will be judged under the business judgment rule. As a result, meritless lawsuits, like those filed in *Cox*, would not withstand motions for dismissal. Such suits would become rare, rather than commonplace, because the anticipated settlement value would be reduced significantly. Equally important, application of the business judgment standard would drastically reduce the litigation risk for the controlling stockholder in cases where the plaintiff's case was sufficiently well-pleaded to survive dismissal prior to discovery and trial.

Strine also proposes a significant revision of existing Delaware law governing the standard of review for tender offers. To continue to enjoy judicial review under the business judgment standard, rather than an entire fairness review, the tender offer would not only have to disclose all material facts and be non-coercive in the manner articulated in *Pure Resources*, but would also have to be recommended by an independent special committee.

Under these proposed changes, regardless of the form of the going private transaction, a controlling stockholder could avoid entire fairness review if (and only if) it conditions the deal on approval of both a special committee of disinterested directors and a majority of disinterested stockholders.

Implications

Dealing with *Lynch* lawsuits after *Cox*

Regardless of whether Strine's proposed rules become law, his holding in *Cox* regarding the inappropriateness of a risk premium on plaintiffs' attorneys fee awards will likely shift negotiating power from plaintiff's counsel to controlling stockholders in traditional going private merger transactions.

As a result, some plaintiffs' counsel may altogether abandon filing cases challenging the fairness of negotiable going private mergers. Because plaintiffs' lawyers will have a more difficult time convincing a court to allow a fee award that includes a risk premium, some may decide that their time is better spent elsewhere. However, it is unlikely that all plaintiffs' lawyers will give up this particular ghost, given the continuing (albeit lower) settlement value of these cases.

Another effect of *Cox* may be that the plaintiffs' counsel who continue to file these cases will litigate them more vigorously and seek a more active role in the purchase price negotiations. If plaintiffs' lawyers can fashion a larger role in negotiating the final deal price, they will have a better argument that their efforts created value for the plaintiff class and a stronger claim to a significant attorneys' fee award. In the aftermath of *Cox*, the only incentive for the controlling stockholder to allow the plaintiffs' lawyers a separate seat at the negotiating table is to create an appearance that the plaintiffs' attorneys have conferred a benefit on the class. That way, the plaintiffs' attorneys will be able to claim – and receive court approval for – a fee award that is sufficiently attractive to induce a settlement of the plaintiffs' claims.

If the controlling stockholder refuses to negotiate above the price agreed upon by the special committee, the plaintiffs' lawyers only leverage to negotiate higher fee awards would be to proceed with the lawsuit through discovery and possibly trial. This presupposes a commitment of time and money that presumably would survive the plaintiff's attorneys' cost-benefit analysis only in cases they perceive as meritorious. Fishing expeditions and litigation solely for "hold-up" value should be significantly reduced, although probably not wholly eliminated.

Will Strine's Doctrinal Proposals Ever Become Law?

Despite Strine's advocacy for reform, he recognizes that controlling stockholders are unlikely to seek judicial modification of the standard applicable to going private mergers. To do so would require a controlling stockholder to incur substantial costs to achieve legal reform by refusing to settle with plaintiffs at the price accepted by the special committee. The controlling stockholder would have to litigate a contested motion to dismiss and would face an uncertain fate in the Chancery Court, which would be bound by *Lynch*, even if it is inclined to follow Strine's reform proposal in *Cox*. Only after weeks or months of briefing and argument before the Delaware Supreme Court would the defendant know whether its effort to reform the law would succeed. As Strine so succinctly recognizes, "[m]eanwhile, the business decision that animated the lawsuit will have been long ago faded from sight of the rear-view window."

Some have speculated that a repeat player in the going-private game, such as a private equity fund which is frequently involved in going private transactions, may conclude that the one-time costs of a test case are worth it. Such a financial buyer could save substantial sums in the long term and reduce lost management time by avoiding future lawsuits brought under current law.

Of course, a financial sponsor (or any other proponent of a going private transaction) would only challenge the current rule if the proposed reforms actually reduced the overall costs of the transaction, of which litigation is typically a small part. It will be a rare case in which it costs the controlling stockholder nothing to give a majority of the minority approval condition in its initial proposal solely in order to avoid frivolous lawsuits challenging the deal.

If a controlling stockholder owns less than 50% of the voting shares, conditioning a going private deal on approval by a majority of the disinterested shares increases the stockholder's risk of loss of control of the company to a competing bidder. Failure of a majority of the disinterested shares to approve would not only kill the deal, but might open the company up for a takeover by a competing strategic or financial bidder willing to pay even a marginally higher price. Because a special committee (and subsequently the full board) would have already approved a merger at a lower price, it would be difficult for the committee to reject the new offer as unfair.

A controlling stockholder who owns more than 50%, by contrast, does not face the same problem. With the ability to block a competing deal simply by stating unequivocally that it is not a seller, it is not likely that a competing bidder will appear.

Nevertheless, a majority controlling stockholder has other issues to consider. First, by conditioning the deal on majority of the minority approval, a controlling stockholder loses certainty that the deal will close because it cannot control the vote with its shares. Many controlling stockholders would be more than willing to spend significant sums settling lawsuits to avoid a majority of the minority condition and preserve deal certainty.

Second, a controlling stockholder will weaken its negotiating posture with the special committee by offering a majority of the minority vote in an initial merger proposal. Acceptance of a majority of the minority condition could easily cost a controlling stockholder considerable value in the bargaining dynamic. Pennies saved on deal price can easily dwarf the cost of settling frivolous litigation. For example, in *Cox*, a deal involving approximately 250 million publicly traded shares, an increase of a nickel a share on the 26% not owned by the Cox family adds \$12.5 million to the purchase price (more than twice what the plaintiffs' lawyers asked for in *Cox*, and about ten times what they received). If the controlling stockholder had given the concession up front, it would have had nothing left to trade for that proverbial last nickel, and might have wound up paying a higher price.

Accordingly, even if there were a majority controlling stockholder who was willing to give up certainty of closure and incur the expense of litigating its case through the Delaware Supreme

Court, it would be unlikely to give up the majority of the minority bargaining chip at the outset, as required to test Strine's proposals. Ironically, because the most immediate and enduring effect of *Cox* is likely to be a substantial reduction in the settlement value of *Lynch* suits challenging going private transactions, there will be even less incentive for a controlling stockholder to accept Strine's invitation to seek a change in the existing law. To the extent *Cox* reduces the "deal tax" imposed by class action litigation, it also makes it less attractive to take on the burdens of refusing to settle and advancing Strine's proposals to the Delaware Supreme Court.

It is, of course, possible that a controlling stockholder will be motivated by non-economic reasons to bring a test case (e.g., one who, like Strine, is concerned about the integrity of the representative litigation process), or that a controlling stockholder will be naive and not recognize the cost of giving up the majority of the minority condition at the outset. Additionally, changes in the plaintiffs' bar's behavior (e.g., holding out after final price negotiation with the special committee, refusing to settle, or insisting on going to trial), which increase litigation costs and risks, might sufficiently motivate a future controlling stockholder to adopt Strine's approach and create a test case.

In the end, however, absent extraneous factors like a significant change in plaintiffs' lawyers litigation tactics, it is unlikely that a case attempting to bring Strine's proposals to the Delaware Supreme Court will materialize, especially since *Cox* will likely decrease the litigation settlement costs associated with traditional going private merger transactions. This may leave Strine's doctrinal proposal where it has been since he first raised the notion in the *Pure Resources* footnote – in the land of *dicta*.

Cases referred to herein include:

- *In re Pure Resources, Inc. Shareholders Litigation*, 808 A. 2d 421 (Del Ch. 2002).
In re Cox Communications, Inc. Shareholders Litigation, 2005 Del. Ch. LEXIS 79 (June 6, 2005).
- *Kahn v. Lynch Communications, Inc.*, 638 A.2d 1110 (Del. 1994).
- *In re Siliconix, Inc. Shareholders Litigation*, 2001 WL 716787 (Del. Ch. June 19, 2001).
- *In re Cysive, Inc. Shareholders Litigation*, 836 A. 2d 531 (Del. Ch. 2003).]

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