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COMMENT

The Right Solution to the Wrong Problem: The Status of Controlling Shareholders After *In re John Q. Hammons Hotels Inc.*

INTRODUCTION

In re John Q. Hammons Hotels Inc.[1] (*Hammons*), a recent Delaware Chancery Court decision, announced new requirements that corporations with controlling shareholders must meet to ensure deferential "business judgment" review of acquisitions by third-party acquirors. Now these corporations must secure the "(1) recommend[ation of] a disinterested and independent special committee, *and* (2) approv[al] by stockholders in a non-waivable vote of the majority of all the minority stockholders."[2] If both of these prerequisites are not met, the exacting "entire fairness" standard of review will govern. Because the standard of review often determines the outcome of litigation, corporations with controlling shareholders will now have little choice but to follow the procedures set forth by the *Hammons* court.[3]

1. *In re* John Q. Hammons Hotels Inc. S'holder Litig., Civil Action No. 758-CC, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).
2. *Id.* at *12.
3. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989) ("'[B]ecause the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation.'" (quoting AC Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986))). A further effect of applying entire fairness review is that courts cannot dismiss claims at the pleadings stage. This means that all claims will have some settlement value, regardless of merit. For a discussion of the inefficiencies associated with using entire fairness review as a default, see *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005) (Strine, V.C.).

This Comment argues that the *Hammons* decision places unwarranted and costly procedural prerequisites on corporations with controlling shareholders. Part I summarizes the facts of *Hammons* and analyzes the legal rule promulgated by the decision. Part II argues that the *Hammons* ruling represents a departure from prior Delaware doctrine that suggested that, in the third-party merger context, approval by *either* a special committee *or* a majority of minority shareholders would trigger deferential business judgment review. Part III situates the *Hammons* decision within the current debate over the standard of review for control transactions. Many commentators have urged adoption of the *Hammons* rule in the freezeout context—that is, for transactions in which a controlling shareholder acquires the minority stake in a corporation.[4] Part III argues that Chancellor William Chandler misapplied this reform proposal to a third-party merger in *Hammons*, which does not pose the same concerns as those associated with a freezeout transaction.

I. FACTS OF *HAMMONS*

In *Hammons*, Chancellor Chandler reviewed the merger of John Q. Hammons Hotels Inc. (JQH) into a corporation indirectly owned by Jonathan Eilian, an independent third-party acquiror. JQH was controlled by John Hammons, the company's founder.[5] In early 2004, Hammons told the board of JQH that he was contemplating a sale of the company. The board responded by forming a special committee to evaluate the fairness of potential transactions to minority shareholders and to engage in negotiations on their behalf. The special committee evaluated a number of offers and ultimately approved the merger between JQH and Eilian.[6] The merger agreement was

4. By contrast, in a third-party merger, an unrelated acquiror obtains control of the corporation.

5. Hammons held 76% of the voting power in JQH. He owned 100% ownership of JQH Class B common stock, which was entitled to fifty votes per share, and 5% of JQH Class A stock, which was entitled to a single vote per share. *Hammons*, 2009 WL 3165613, at *2.

6. It is important to note that Hammons received disparate consideration for his Class B shares. This may have been influential in Chancellor Chandler's decision to invoke entire fairness review. The terms of the JQH merger provided that holders of Class A stock would receive $24 per share. This was a significant premium to the market share price, which had been in the $4 to $7 range before rumors of a potential merger began circulating. Hammons's Class B stock was to be converted into a 2% interest in a limited partnership through which JQH conducted its operations. Hammons also received a $328 million liquidation preference for his preexisting interest in the partnership and a number of benefits negotiated in separate transaction agreements. The company's investment bank,

conditioned upon a majority of disinterested stockholders approving the transaction; however, this prerequisite could be waived upon the vote of the special committee.[7]

At the outset of his opinion, Chancellor Chandler discussed which standard of review should apply. In *Kahn v. Lynch Communication Systems, Inc.*,[8] the Delaware Supreme Court held that the exclusive standard of judicial review for freezeout mergers is entire fairness.[9] Chancellor Chandler distinguished the JQH merger from a freezeout merger, stating that "[u]nlike in *Lynch*, the controlling stockholder . . . did not make the offer to the minority stockholders; an unrelated third-party did."[10] Because Hammons did not stand "on both sides of the transaction,"[11] entire fairness review was not mandated.

Chancellor Chandler nevertheless decided to apply entire fairness review due to the potential for abuse of minority shareholders. Chancellor Chandler reasoned that entire fairness should apply because:

> Hammons and the minority stockholders were in a sense 'competing' for portions of the consideration Eilian was willing to pay[, and] Hammons, as a result of his controlling position, could effectively veto any transaction. In such a case it is paramount—indeed, necessary in order to invoke business judgment review—that there be robust procedural protections in place to ensure that the minority stockholders have sufficient bargaining power and the ability to make an informed choice of whether to accept the third-party's offer for their shares.[12]

Chancellor Chandler then stated that a "recommend[ation] by a disinterested and independent special committee, and . . . approv[al] by stockholders in a non-waivable vote of the majority of all the minority stockholders"[13] would provide sufficient procedural protections for minority shareholders, and thus the satisfaction of both of these conditions would result in the application of the business judgment rule. In the JQH merger, however, the majority-of-the-minority condition only required receipt of a majority of the disinterested

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Lehman Brothers, calculated the value of the consideration paid for the Class B shares to be between $11.95 and $14.74 per share. *See id.* at *7.

7. *Id.*

8. 638 A.2d 1110 (Del. 1994).

9. *Id.* at 1117.

10. *Hammons*, 2009 WL 3165613, at *10.

11. *Id.* (quoting *Lynch*, 638 A.2d at 1117).

12. *Id.* at *12.

13. *Id.*

shares actually voting and could be waived by the special committee. Thus, Chancellor Chandler held that entire fairness review applied.[14]

II. THE *HAMMONS* DECISION CONFLICTED WITH PRIOR DOCTRINE

Delaware courts typically apply the deferential business judgment rule when reviewing corporate decisions. In situations involving a potential conflict of interest, however, they will employ the more stringent entire fairness standard.[15] Change-of-control transactions involving companies with controlling shareholders give rise to possible conflicts of interest.[16] As such, in some circumstances, the judiciary has required procedural protections for minority shareholders or has engaged in more exacting review of these transactions. Judges have recognized that freezeouts present special concerns of potential minority abuse because, in freezeout transactions, a controlling shareholder liquidates the minority position in order to gain total control of the corporation. Consequently, the judiciary has required heightened procedural safeguards in freezeout transactions. The *Hammons* decision extended these requirements to third-party mergers, which do not present the same concerns as those associated with freezeouts, thereby promulgating a new set of costly and unnecessary procedures that companies with a controlling shareholder must follow in order to engage in a merger.

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14. When the JQH transaction was actually put to a vote, 72% of the outstanding Class A shares – 89% of those that voted – supported the merger. The *Hammons* opinion, however, dismisses the importance of the minority shareholders' ex post ratification, saying only that the majority-of-the-minority clause provides "stockholders [with] an important opportunity to approve or disapprove of the work of the special committee and to stop a transaction they believe is not in their best interests." *Id.* The opinion did not discuss why a determination by minority stockholders that the transaction was in their best interest did not remove the taint of self-interest.

15. Under the entire fairness standard of review, the burden is initially on the defendant to show fair dealing and fair price. This burden can be shifted to the challenging shareholder if either a special committee or a majority of minority shareholders approves the transaction. *See id.* at *14 n.48. The choice of which standard of review governs a transaction is crucial because, in practice, it often determines the outcome of litigation. *See supra* note 3 and accompanying text. Application of the business judgment rule will likely result in victory for the corporate fiduciaries, whereas entire fairness review will almost assure their defeat. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989).

16. *See, e.g.*, 1 LOU R. KLING & EILEEN T. NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 4.04 (2009).

A. Divergence in the Delaware Freezeout Jurisprudence

A brief examination of the evolution of Delaware law governing freezeout transactions is necessary to contextualize the *Hammons* decision. The hallmark of a freezeout transaction is that the controlling shareholder stands on both sides of the deal – making the offer to buy the company and accepting it on the corporation's behalf. The primary concern that arises in such a situation is that there is no opportunity for arm's-length bargaining, and consequently, the controlling shareholder may cash out the minority at an unfair price. To combat this potential problem, Delaware courts engage in a more exacting review of these transactions, requiring certain additional procedural protections to be in place in order for the standard of review to be lowered or the burden of proof to be shifted.

Delaware jurisprudence has drawn a formalistic distinction between freezeouts accomplished via merger and those pursued through a tender offer, even though they are economically similar transactions. In *Lynch*, the Delaware Supreme Court held that the exclusive standard of judicial review for freezeout mergers is entire fairness.[17] The burden of proving fairness initially lies with the controlling shareholder; however, it may be shifted to the challenging shareholders by securing "approval of [either] an independent committee of directors or an informed majority of minority shareholders."[18] However, even if the burden shifts, entire fairness review continues to apply.[19] By contrast, in *In re Pure Resources, Inc.*,[20] the Delaware Chancery Court held that the business judgment rule applies to freezeout tender offers so long as three procedural protections are in place: (1) a nonwaivable condition that a majority of the minority shareholders tender into the offer, (2) a promise from the controlling shareholder to consummate a short-form merger upon receipt of 90% of outstanding shares, and (3) the absence of retributive threats against the minority.[21]

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17. Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994). For an argument against the *Lynch* decision, see *infra* Part III.

18. 638 A.2d at 1117.

19. The *Lynch* decision clarified a previously ambiguous area of Delaware law and opted to apply what many commentators believe is an overly stringent standard for freezeout transactions. *See, e.g.*, Guhan Subramanian, *Post-*Siliconix *Freeze-Outs: Theory and Evidence*, 36 J. LEGAL STUD. 1, 11-12 (2007) (arguing that corporations are more likely to form a special committee because it is less onerous than obtaining approval from a majority of the minority and there is no added benefit from the latter course of action).

20. *In re* Pure Resources, Inc. S'holders Litig., 808 A.2d 421 (Del. Ch. 2002).

21. *See id.* at 445.

B. The Legal Distinction Between Freezeouts and Third-Party Mergers

While the *Lynch* decision mandates entire fairness review for freezeout mergers, it does not preclude application of the business judgment rule to mergers in which a controlling shareholder only has an interest in one side of the transaction, such as the merger at issue in *Hammons*.[22] This distinction accords with Delaware law governing the fiduciary obligations of controlling shareholders. In order to invoke entire fairness review for a breach of a controlling shareholder's fiduciary obligation, a challenger must show that the controlling shareholder engaged in self-dealing.[23] The Delaware courts have stated that "[t]raditionally, the term 'self-dealing' describes the 'situation when a [corporate fiduciary] is on both sides of a transaction.'"[24] Thus, in the context of a freezeout merger, a controlling shareholder may be accused of self-dealing, whereas in a third-party merger she may not.[25]

This principle was affirmed in *In re Compucom Systems, Inc.*,[26] when Vice Chancellor Stephen Lamb applied the business judgment rule to review the sale of Compucom, a company with a controlling shareholder, to Platinum, a third-party acquiror.[27] In determining which standard of review to apply, Vice Chancellor Lamb stated:

22. As noted above, in *Hammons* Chancellor Chandler held that *Lynch* did not control. *See supra* text accompanying note 10.

23. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("[Entire fairness review] will be applied only when the fiduciary duty is accompanied by self-dealing—the situation when a parent is on both sides of a transaction with its subsidiary."); 18A AM. JUR. 2D *Corporations* § 654 (2009) ("The invocation of the intrinsic-fairness standard is predicated upon the existence of two factors: (1) majority control and domination; and (2) majority self-dealing.").

24. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1169 (Del. 1995) (quoting *Sinclair*, 280 A.2d at 720).

25. The American Law Institute has affirmed the distinction between freezeout transactions and third-party mergers, noting that "[i]f the controlling shareholder will have no significant equity interest in the corporation's business after consummation of the transaction . . . , then no review for fairness is required." 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 5.15 cmt c.(1)(a) (2005).

26. *In re* Compucom Systems, Inc. S'holders Litig., No. Civ.A. 499-N, 2005 WL 2481325 (Del. Ch. Sept. 29, 2005).

27. In *In re Compucom Systems, Inc.*, the minority shareholders were represented by a special committee; however, the merger was not conditioned on approval by a majority of the minority stockholders. Therefore, according to the new *Hammons* framework, it should have been reviewed under the entire fairness standard.

> Generally speaking, a controlling shareholder has the right to sell his control share without regard to the interests of any minority shareholder, so long as the transaction is undertaken in good faith. *The same has long been true as a general proposition when a parent chooses to negotiate for the sale of a subsidiary corporation to an independent third party.* The reasons for the law's tolerance of such sales is clear—as the owner of a majority share, the controlling shareholder's interest in maximizing value is directly aligned with that of the minority.[28]

As this decision highlights, the presence of a controlling shareholder alone does not necessitate application of entire fairness review.

Challenging shareholders may still invoke entire fairness review in the third-party merger context by alleging that the controlling shareholder has created a conflict of interest for the board.[29] In order to prove such a breach, the challengers must show that the board was "dominated by the controlling shareholder, and [that] this domination led the board to accommodate the controller rather than act in the best interest of all the subsidiary's shareholders."[30] If a conflict of interest is alleged directly against the board, however, "approval by a special committee of independent directors *or* an informed majority-of-the-minority vote, [will] justify review under the business judgment rule."[31] Thus, contrary to the decision in *Hammons*, prior precedent suggests that the business judgment rule should apply to third-party mergers if *either* a special committee *or* a majority of the minority approved the transaction, but not both.

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28. *Compucom*, 2005 WL 2481325, at *6 (emphasis added).

29. *See, e.g.*, McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000).

30. *Compucom*, 2005 WL 2481325, at *6. In *Hammons*, this was not the case. Chancellor Chandler noted that the minority shareholders were "represented by [a] disinterested and independent special committee." *In re* John Q. Hammons Hotels Inc. S'holder Litig., Civil Action No. 758-CC, 2009 WL 3165613, at *10 (Del. Ch. Oct. 2, 2009). In applying the entire fairness standard the Chancellor instead relied on deficiencies in the majority-of-the minority voting provisions. *Id.* at *12.

31. *In re* PNB Holding Co. S'holders Litig., No. Civ.A. 28-N, 2006 WL 2403999, at *1 (Del. Ch. Aug. 18, 2006); *see also* DEL. CODE ANN. tit. 8, § 144 (2009) (discussing corporate transactions involving interested directors). *But see* Blake Rohrbacher, John Mark Zeberkiewicz & Thomas A. Uebler, *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719, 737-41 (2008) (arguing that application of section 144 should be limited to questions of voidability).

III. THEORETICAL CONCERNS RAISED BY TRANSACTIONS INVOLVING A CONTROLLING SHAREHOLDER

The doctrinal distinction between freezeout transactions and third-party mergers is rooted in the different theoretical concerns they raise. In a freezeout transaction, presence of the controlling shareholder on both sides of the transaction creates a heightened risk of opportunistic behavior in a number of circumstances. First, the controlling shareholder may use insider information to time the freezeout at a point when the stock price is depressed below intrinsic value.[32] Second, and more troublesome from an efficiency perspective, the controlling shareholder may wield its influence over the corporation to drive down the value of shares by, for example, putting off potentially profitable projects or even engaging in negative net present value projects.[33] Both of these concerns arise because, in a freezeout, the controlling shareholder retains an interest in the surviving corporation while the minority is cashed out based on the share price of the target corporation. This means that the controlling shareholder can privately appropriate the minority's share after the freezeout is completed by cashing out the minority at a depressed price.

Unlike freezeouts, third-party mergers do not give control of the surviving corporation to the controlling shareholder. Because the controlling shareholder will be cashed out along with the minority, the concerns about price manipulation that arise in the freezeout context are absent. The controlling shareholder does not have an incentive to depress share price or to put off profitable projects because she will not be able to privately appropriate these gains in the future. Instead, the primary concern that arises in a third-party merger is that the controlling shareholder will attempt to structure the merger in a way that provides her with excess consideration at the expense of the minority shareholders.[34]

The facts of *Hammons* provide an illustration of this concern. Because *Hammons* involved a dual-class capitalization, the calculus determining the allocation of consideration between Class A and Class B stock was appropriately described as a zero-sum game. As Chancellor Chandler noted, Hammons and the minority shareholders were competing for the consideration that Eilian was willing to pay. While this is a substantial threat for minority

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32. *See* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 31-32 (2005).

33. *Id.* at 32-34. The controlling shareholder will engage in negative net present value projects to the extent that the benefit accorded from the lower share price exceeds the controller's share of the cost of the project.

34. Although payment of a control premium is permissible, it should not come at the expense of the fair market value of the minority shares.

shareholders, it pales in comparison to the conflicts that arise in a freezeout.[35] In a third-party merger, the consideration being paid out is transparent, and courts must only assess the fairness of the payment to the controlling shareholder in relation to the minority.[36] By contrast, in a freezeout, the value being received by the controlling shareholder is opaque, and courts must attempt to determine whether the minority is being cashed out at a fair price. A further distinction is that, whereas in a freezeout the controlling shareholder is both setting the price and accepting the offer, in a third-party merger she is a price taker reacting to an offer from an independent acquiror. Thus, the concerns about structuring the transaction to benefit the controlling shareholder at the expense of the minority are greatly mitigated.

Because of the theoretical distinctions between freezeouts and other final-period transactions, in the absence of freezeout concerns, Delaware courts have historically been willing to treat transactions involving different classes of stockholders "competing" for portions of consideration as an ordinary conflict of interest for directors. In *In re PNB Holding Co.*,[37] the Delaware Chancery Court reviewed a board decision to cash out all but the sixty-eight largest stockholders of the company.[38] In reviewing the conversion, Vice Chancellor Leo Strine noted that the board was subject to a major conflict of interest: "By deciding to embark on the Merger, the PNB directors created a zero-sum game. Each of them . . . stood to gain by paying as little as possible to the departing PNB stockholders."[39] The reason for this is that whatever value was kept in the company would be shared by the owners of the surviving corporation—which, in this case, was largely comprised of PNB's board of directors. Chancellor Strine stated that,

> In this conflicted situation, the PNB directors are bound to show that the Merger was fair to the departing stockholders *or to point to the*

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35. Traditionally, Delaware courts have addressed the threat posed by minority shareholders competing for consideration by requiring procedural safeguards such as approval of *either* a special committee *or* a majority of the minority, in order to secure business judgment review. *See, e.g.*, *PNB Holding*, 2006 WL 2403999.

36. To this end, courts require a fairness opinion for the consideration being paid to the controlling shareholder and the minority shareholders, as well as a fairness opinion of the payments in relation to one another. *See In re* Tele-Commc'ns, Inc. S'holders Litig., No. Civ.A. 16470, 2005 WL 3642727 (Del. Ch. Dec. 21, 2005).

37. 2006 WL 2403999.

38. The directors and officers owned 33.5% of PNB's outstanding shares, and all of them were expected to be among the sixty-eight largest stockholders. Therefore they would have an interest in the new corporation.

39. *PNB Holding*, 2006 WL 2403999, at *1.

> *presence of a cleansing device, such as approval by a special committee of independent directors or an informed majority-of-the-minority vote*, in order to justify review under the business judgment rule.[40]

As this holding illustrates, when different classes of shareholders compete for consideration, the classic cleansing devices—approval of *either* a special committee *or* a majority of the minority vote—provide sufficient protection for minority shareholders to justify invocation of the business judgment rule.[41]

CONCLUSION

The *Hammons* decision has deepened a preexisting doctrinal schism over what procedural safeguards are necessary to protect minority shareholders in final-period transactions. As Part II described, the evolution of Delaware doctrine in the freezeout context has resulted in divergent treatment for controlling shareholders who cash out the minority in a merger and those who wrest control via tender offer. Commentators have argued that the current doctrinal system is inefficient and have advocated for convergence in judicial review of all freezeout transactions. More specifically, academics and practitioners alike have urged the Delaware Supreme Court to overrule *Lynch* and apply the business judgment rule to freezeout transactions that are approved by both a special committee and a majority of minority shareholders—the rule adopted in *Hammons*.[42] This proposal would bring consistency to the law governing freezeout transactions and require an optimally efficient level of procedural safeguards for minority shareholders.[43]

In the *Hammons* opinion, Chancellor Chandler stated that he was "cognizant of recent suggestions of ways to 'harmonize' the standards applied to transactions that differ in form but have the effect of cashing out minority stockholders."[44] As noted above, however, critics have called for harmonization in the context of freezeout transactions, not third-party mergers such as the

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40. *Id.* (emphasis added); *see* DEL. CODE ANN. tit. 8, § 144 (2009) (discussing corporate transactions involving interested directors).

41. Arguably, the facts of *PNB Holding* presented a greater threat to minority shareholders than a third-party merger because the directors had a continuing stake in the surviving corporation and thus had incentives to manipulate the market price.

42. *See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 643-44 (Del. Ch. 2005); Subramanian, *supra* note 32.

43. *See* Subramanian, *supra* note 32, at 49-64.

44. *In re* John Q. Hammons Hotels Inc. S'holder Litig., Civil Action No. 758-CC, 2009 WL 3165613, at *12 n.37 (Del. Ch. Oct. 2, 2009).

one at issue in *Hammons*. The *Hammons* decision thus represents the right reform applied in the wrong context and has the effect of further complicating an already opaque doctrine. Under Delaware law, the presence of a controlling shareholder alone has, until now, been insufficient to trigger entire fairness review. Instead, it is the presence of the controlling shareholder on both sides of a freezeout transaction that has resulted in increased judicial scrutiny. In a third-party acquisition such as the *Hammons* merger, the controlling shareholder is cashed out along with the minority, and many of the concerns that arise in the freezeout context are avoided. Indeed, the risk of minority manipulation that is present in a third-party merger mirrors the concerns that arise in classic director-conflict transactions and may be allayed by the same procedural protections that are put in place for those transactions.

In light of this theoretical framework, the *Hammons* decision's break from doctrine is unwarranted. *Hammons* requires an inefficient level of procedural safeguards in order to engage in third-party mergers, thereby potentially deterring socially beneficial transactions. Although the decision could be viewed as an attempt to harmonize the confused judicial doctrine governing mergers and acquisitions of controlled corporations, by dragging third-party mergers into a debate that previously focused on freezeouts, the court has unfortunately taken a step in the wrong direction.

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