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Irreconcilable Differences: Director, Manager and Shareholder Conflicts in Takeover Transactions

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SYMPOSIUM INTRODUCTION

IRRECONCILABLE DIFFERENCES: DIRECTOR, MANAGER AND
SHAREHOLDER CONFLICTS IN TAKEOVER TRANSACTIONSSTEVEN M. DAVIDOFF¹CAROLINE M. GENTILE²PAUL L. REGAN³

Agent-principal conflicts constitute one of the thorniest and oldest corporate law problems.

The Delaware courts have grappled with these conflicts for almost a century, but Delaware doctrine on the matter is anything but settled, particularly in the context of takeover transactions. In recent years, Delaware courts have issued decisions regarding the appropriate standard of review for controlling shareholders receiving differential consideration,⁴ appropriate steps a controlling shareholder must take to qualify for deferential review of a freeze-out transaction,⁵ propriety of, and penalties for, investment banker misconduct during a takeover,⁶ and the constraints bounding a board's adoption and triggering of a shareholder rights plan.⁷ These multiple decisions illustrate that doctrine addressing conflicts in takeover transactions continues to evolve, raising fundamental issues concerning the scope and parameters of Delaware law.

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⁴*See, e.g., In re John Q. Hammons Hotels Inc. S'holder Litig.*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

⁵*See, e.g., In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397 (Del. Ch. 2010).

⁶*See, e.g., In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).

⁷*See, e.g., Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586 (Del. 2010); *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010); *Yucaipa American Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310 (Del. Ch. 2010).

Chancellor Chandler's recent decision in *Air Products and Chemicals, Inc. v. Airgas, Inc.*,⁸ a case decided on this conference's eve, is yet another opinion which raises these issues. The *Airgas* case addresses a fundamental principal in corporate law: who decides when conflicts arise—shareholders or directors? If directors are the appropriate deciding body, is the adoption of procedural protections, particularly reliance on independent directors, sufficient to resolve conflicts? The *Airgas* case also raises the long-simmering tension in Delaware courts over whether and how Delaware should differentiate between long- and short-term shareholders. Airgas' stock had turned over substantially as long-term shareholders sold to hedge funds and arbitrageurs upon Air Products' announcement of a hostile offer. Airgas' attorneys argued that the court should not defer to the will of Airgas' shareholders since, among other reasons, Airgas' new shareholder base consisted of a majority of short-term investors.

The study of takeover conflicts is thus not only ripe for exploration, but also a project that addresses metaphysical issues concerning the fundamental structure and governance of the public corporation. It appears that as markets become more complex, old methods of reviewing and ameliorating conflicts may no longer be efficient. Substitutes for judicial monitoring may exist in the form of independent directors or more activist shareholders. Although the Delaware courts have yet to explore fully this possibility, academics are studying these topics both empirically and theoretically, providing another reason for this symposium.

We were thus happy to invite scholars, judges, attorneys, investment bankers, and other industry participants for an in-depth discussion of Delaware law and takeover conflicts. The conference took place over a day on April 11, 2011 at Widener University School of Law in Wilmington under the aegis of the *Delaware Journal of Corporate Law*. The papers resulting from the conference, as well as a practical and historical overview and the transcript from a roundtable discussion, are collected in this symposium issue and reflect the vigorousness of the debate.

Professors Claire Hill and Brett McDonnell address the adjudication of conflict of interest transactions.⁹ They argue that Delaware has "overshot the mark" in regulating interested transactions and become "too lenient." Expressing skepticism about Delaware's increasing reliance on independent

⁸ *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011).

⁹ Claire Hill & Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903 (2011).

directors, Professors Hill and McDonnell agree that Delaware courts fail to properly scrutinize the subtle influences conflicted parties have over so-called independent directors. Instead, Professors Hill and McDonnell would "require defendants to first show that the approving disinterested directors were informed and exercised independent business judgment."

Professor Sam Thompson is also skeptical of the existing role of independent directors, focusing his analysis on the undue influence brought upon them in takeover transactions.¹⁰ He writes that Delaware's multiple standards of review in merger transactions "are cumbersome, a source of needless litigation, and economically inefficient." Moreover, these standards are implemented by sitting directors who may not be truly independent. Professor Thompson's proposes to amend the Delaware General Corporation Law to permit shareholders to adopt a provision providing that, in the event a company receives a bona fide acquisition proposal, the Delaware Court of Chancery would appoint a committee of new disinterested directors. These directors would have complete power to decide whether or not the company is to be sold and at what price.

Lewis Lazarus and Brett McCartney closely examine Delaware's existing approach to addressing conflicts.¹¹ These two members of the Delaware bar review and analyze recent cases involving interested directors and controlling shareholders to provide guidance to practitioners on the type of factual pleadings that will survive a motion to dismiss under the enhanced scrutiny applicable to conflict transactions, noting the uncertainty surrounding change-of-control transactions.

Suneela Jain, Ethan Klingsberg, and Neil Whoriskey complete this quartet of pieces by studying the recent efforts of the Court of Chancery to develop a unified standard for reviewing transactions in which controlling shareholders acquire the shares that they do not already own.¹²

After reviewing the structural features of approximately thirty controlling shareholder buyout transactions over the four-year period ending December 31, 2010, these three members of the New York bar conclude that market forces, rather than existing case law, are the participants' primary drivers when deciding how to structure these types of transactions

¹⁰Samuel C. Thompson, Jr., *Change of Control Special Committee: Breathing Life Into CNX*, 36 DEL. J. CORP. L. 1053 (2011).

¹¹Lewis H. Lazarus & Brett M. McCartney, *Standards of Review in Conflict Transactions on Motions to Dismiss: Lessons Learned in the Past Decade*, 36 DEL. J. CORP. L. 967 (2011).

¹²Suneela Jain, Ethan Klingsberg & Neil Whoriskey, *Examining Data Points in Minority Buy-outs: A Practitioners' Report*, 36 DEL. J. CORP. L. 939 (2011).

and how to respond to related litigation.

Takeover issues loom large in the other papers included in this symposium issue. Professors Matthew Cain and Steven Davidoff conduct a study of management buy-outs (MBOs).¹³ They empirically examine whether procedural devices can ameliorate the conflicts of interest inherent in these transactions. Professors Cain and Davidoff find that independent committees of directors bargain effectively for shareholders in MBO transactions, so long as the directors provide shareholders the ability to reject underpriced transactions, increasing shareholder value. Soberingly, Professors Cain and Davidoff also find that management can steer the MBO process to their undue advantage by taking steps to prevent other bidders from emerging, preserving management's own lower-priced takeover.

Professor Brian Quinn discusses matching rights, a controversial innovation in deal protection devices which has developed over the last decade.¹⁴ This particular device provides an initial bidder the contractual right to match any offer made by a subsequent bidder. Professor Quinn argues that Delaware courts are too dismissive of matching rights' deterrent effect. Drawing upon auction theory, he argues that courts should more closely scrutinize uses of matching rights particularly in areas ripe for conflict, such as in common value auctions and sales to financial buyers.

Professor Charles Whitehead addresses sandbagging, a heated issue in takeover negotiations involving private companies.¹⁵ He concludes that a seller can more efficiently allocate the risk of sandbagging through negotiation over other provisions in the agreement, such as the indemnities. Professor Whitehead thus argues for an anti-sandbagging rule rebutting the common claim that a buyer's "'purchase' of warranties includes a sandbagging right."

Two roundtable discussions enhanced the presentations of these articles. Robert Kindler, the global co-head of mergers and acquisitions at Morgan Stanley and a former member of Cravath, Swaine & Moore LLP, introduced these discussions, providing both a useful transition from the academic debate and an enlightening perspective on the nature and resolution of conflict transactions that reflects his vast experience in both

¹³Matthew D. Cain & Steven M. Davidoff, *Form Over Substance? The Value of Corporate Process and Management Buy-Outs*, 36 DEL. J. CORP. L. 849 (2011).

¹⁴Brian JM Quinn, *Re-Evaluating the Emerging Standard of Review for Matching Rights in Control Transactions*, 36 DEL. J. CORP. L. 1011 (2011).

¹⁵Charles K. Whitehead, *Sandbagging: Default Rules and Acquisition Agreements*, 36 DEL. J. CORP. L. 1081 (2011).

law and investment banking. A transcript of his remarks is included in this symposium issue.¹⁶

During the first roundtable, The Honorable Leo E. Strine, Jr., Chancellor, Delaware Court of Chancery; Randall J. Baron, Esq., Robbins Geller Rudman & Dowd LLP; Lucian A. Bebchuk, Professor, Harvard Law School; Chris Cernich, Director of M&A and Proxy Contest Research, ISS Governance; Issac D. Corré, Eton Park Capital Management; William J. Haubert, Esq., Richards Layton & Finger, P.A.; Mark Lebovitch, Esq., Bernstein Litowitz Berger & Grossmann LLP; William Savitt, Esq., Wachtell, Lipton, Rosen & Katz; Neil Whoriskey, Esq., Cleary Gottlieb Steen & Hamilton LLP; and James C. Woolery, JP Morgan Chase, engaged in a lively debate concerning the doctrinal implications of the *Airgas* ruling and the validity of the Chancery Court's refusal to order the *Airgas* shareholder rights plan redeemed.

In the second roundtable, the transcript of which is provided in this issue,¹⁷ members of the Delaware bar offered overviews of their areas of expertise. The participants in this roundtable were Kevin F. Brady, Esq., Eckert Seamans Cherin & Mellott, LLC; Lewis H. Lazarus, Esq., Morris James LLP; Martin S. Lessner, Esq., Young Conaway Stargatt & Taylor LLP; Edward B. Micheletti, Esq., Skadden, Arps, Slate, Meagher & Flom LLP; Mark A. Morton, Esq., Potter Anderson & Corroon LLP; Kenneth J. Nachbar, Esq., Morris, Nichols, Arsht & Tunnell LLP; and Francis G.X. Pileggi, Esq., Eckert Seamans Cherin & Mellott, LLC.

In addition to these informative discussions, the conference was privileged to have Chancellor William B. Chandler III deliver the keynote address. Chancellor Chandler gave a dynamic and informative speech discussing these topics in the context of the *Airgas* litigation.

It is our hope that the pieces included in this symposium issue, as well as the discussions and debates that occurred during the conference, will assist the Delaware courts as they continue to update and revise the doctrine applicable to conflict of interest transactions, particularly in the area of takeover transactions.

¹⁶See *infra* pages 1117-22.

¹⁷See *infra* pages 1123-44.

