Hammons Decision Underscores Business Judgment in M&A

By Stephen P. Lamb

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The Court of Chancery recently decided a case that marks a key development in Delaware's M&A jurisprudence. For the first time, in the *John Q. Hammons Hotels Inc. Shareholder Litigation* decision, a Delaware court stated that business judgment will be the applicable standard of review in a transaction where a controlling stockholder receives consideration different from the minority stockholders, but only if the transaction is recommended by a well-functioning, disinterested, and independent special committee and approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.

Hammons provides important guidance in structuring the sale of a corporation where a controlling stockholder insists on receiving different consideration than the other stockholders. It also concludes that such a transaction may nevertheless qualify for business judgment review where it is approved by a properly functioning committee of disinterested directors and is made subject to a strict majority-of-the-minority stockholder vote requirement.

A controlling stockholder is often unwilling to contemplate a sale of the company unless it receives different consideration for various reasons, including tax considerations or even a desire to be compensated for control. *Hammons* identifies a set of procedural safeguards that allow properly motivated outside directors to negotiate the terms of the transaction and allow minority stockholders to determine for themselves whether or not to accept the terms proposed. It is to be expected that, where parties employ them, these powerful procedural mechanisms will produce fair outcomes without the need for prolonged litigation over the "entire fairness" of the transaction.

A Prized Chateau

The *Hammons* case arose out of the sale of John Q. Hammons Hotels, Inc. (JQH) to an acquisition vehicle indirectly owned by Jonathan Eilian, a private investor who had a role in the creation of Starwood Hotel and Resorts Worldwide. JQH was founded and controlled by John Q. Hammons, who held approximately 76 percent of the total voting power in JQH by virtue of his ownership of 5 percent of JQH's Class A common stock and all of JQH's super-voting Class B common stock. Hammons was also JQH's chairman and CEO and, over the years, engaged in numerous related-party transactions with JQH, including owning and developing hotels managed by JQH.

In 2004, Hammons informed the board that he had begun discussions with third parties about a potential sale of JQH. The transactions considered by Hammons contemplated that he would receive different consideration from JQH's other stockholders due to personal tax considerations and other personal objectives such as obtaining financing to continue his hotel development activities. Recognizing the potential conflict between his interests and those of the minority stockholders, the board formed a special committee to negotiate a transaction on behalf of the minority stockholders. Its role in the sale process was limited, however, because Hammons retained the power to reject any sale he did not favor.

Hammons and the special committee negotiated with several bidders and ultimately cut a deal with Eilian. The special committee negotiated a price of $24 per share of Class A common stock on behalf of JQH's minority stockholders. Hammons, however, negotiated with Eilian to receive different consideration including an equity interest in the acquiring company; preferred stock with a liquidation preference of $335 million; a $300-million credit line; JQH's prized Chateau on the Lake Resort; and other contractual benefits and salary. The special committee received an opinion from Lehman Brothers that the $24 share price was fair to the minority stockholders and that the alloca-

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tion of consideration between Hammons and the stockholders was reasonable.

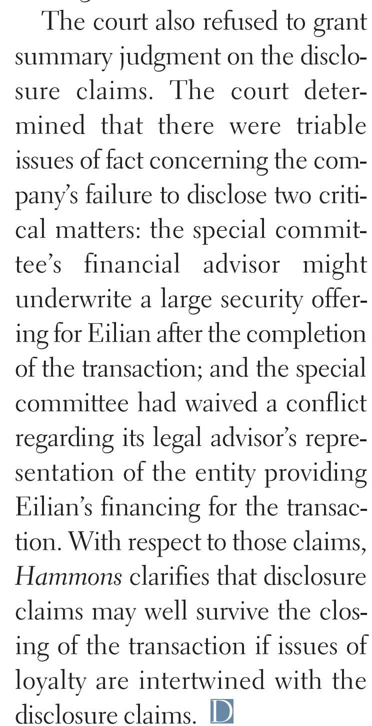
The transaction was approved by the special committee, JQH's board, and more than 89 percent of the Class A stockholders that voted on the transaction. Nevertheless, a stockholders' class action suit was filed, alleging that the price paid for the publicly held Class A shares was inadequate.

The class action proceeded to summary judgment, where the critical issue became whether the court would apply the deferential business judgment standard or the searching entire fairness standard. The entire fairness standard encompasses two factually intensive, interlinked components: fair dealing and fair price. As a practical matter, the detailed factual inquiry required by the entire fairness standard almost ensures that a case will proceed past the pleading stage and often to trial. The result is costly litigation in which the defendants run the risk of an adverse judgment.

Whether entire fairness would apply to a disinterested third-party transaction where the controlling stockholder receives different consideration was an undecided issue under Delaware law. The plaintiffs in the *Hammons* case contended that the Delaware Supreme Court's decision in *Kahn v. Lynch Communications Systems, Inc.* mandated the application of entire fairness. *Lynch* held that a controlling stockholder is required to prove entire fairness from the outset of the case in a transaction where the controlling stockholder effects a cash-out of the minority stockholders. Under *Lynch*, the use of an effective safeguard to mitigate the risk of overreaching by a controlling stockholder—the negotiation and approval of the transaction by a disinterested and independent special committee or the approval of the transaction by a majority of the disinterested shares—shifts the burden of proving entire fairness to the plaintiff but does not save the transaction from a searching judicial review.

The court distinguished the *Hammons* transaction from *Lynch* because the controlling stockholder wasn't cashing out the minority—Eilian, an independent third-party, was. Thus, the policy considerations underlying *Lynch* were not fully implicated and the application of entire fairness was not mandated. Most importantly, the court noted that business judgment would be the applicable standard of review in a transaction involving a sale to a third party where a controlling stockholder receives consideration different from the minority stockholders if the transaction were both recommended by a well-functioning, disinterested, and independent special committee and approved by stockholders in a non-waivable vote of the majority of all the minority stockholders. The court reasoned that both of those procedural protections were necessary because, although the controlling stockholder was not on both sides of the transaction, the controlling stockholder and minority stockholders were competing for the total consideration that the third-party bidder was willing to pay.

Notwithstanding its new pronouncement of law, the court determined that the deficiencies in the specific procedures in *Hammons* were too great to permit the application of the business judgment standard. The majority-of the-minority vote was insufficient because it could be waived by the special committee and because it required only a majority of those minority stockholders who voted on the transaction. Beyond that, the court was unconvinced that the special committee functioned properly. Thus, the entire fairness standard applied and the court did not grant a motion for summary judgment as to the factual disputes over whether the fair price and fair dealing test was satisfied.



The court also refused to grant summary judgment on the disclosure claims. The court determined that there were triable issues of fact concerning the company's failure to disclose two critical matters: the special committee's financial advisor might underwrite a large security offering for Eilian after the completion of the transaction; and the special committee had waived a conflict regarding its legal advisor's representation of the entity providing Eilian's financing for the transaction. With respect to those claims, *Hammons* clarifies that disclosure claims may well survive the closing of the transaction if issues of loyalty are intertwined with the disclosure claims. D

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Hammons Takeaways

- Structure the special committee so it can function independently, with the goal of protecting the minority stockholders' interests.
- *Hammons* invigorates the utility of a majority-of-the-minority vote, which, up until this point, may have been seen by practitioners as superfluous because it resulted in the same benefit as a well-functioning special committee.
- *Hammons* confirms that failure to disclose advisors' compensation and potential conflicts remains an area of emphasis by the Delaware courts.

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