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Delaware Court of Chancery Holds Controlling Stockholder Merger May Have Violated Section 203; Stockholders May Enforce Related Standstill

Recently in *Arkansas Teacher Retirement System v. Alon USA Energy, Inc.*, the Delaware Court of Chancery (in an opinion by Vice Chancellor McCormick) held, on a motion to dismiss, that Delek US Holdings, Inc.'s acquisition of Alon may have violated Section 203 of the Delaware General Corporation Law, Delaware's anti-takeover statute. The Alon board had exempted Delek from Section 203's restrictions on business combinations, subject to a standstill provision. However, Delek later allegedly breached the standstill provision, and the court ruled that the breach may have "vitiating the Alon board's Section 203 approval and restored the protections of Section 203." The court further ruled that Alon stockholders had standing to directly enforce the standstill as third party beneficiaries. Finally, the court ruled that the merger was not entitled to business judgement review because the parties negotiated substantive deal terms before committing to use the procedural protections required by *Kahn v. M&F Worldwide Corp.* in controlling stockholder transactions, among other things.

The *Alon* decision recounts allegations of a less-than-pristine process for negotiating a controlling stockholder merger, as well as what the court characterized as "creative" theories of the stockholder-plaintiff in challenging that process, especially regarding Section 203 of the DGCL. Due to the high stakes involved in controlling stockholder mergers, the opinion serves as an important reminder of the types of process issues (whether real or only alleged) of which merger parties and their counsel should be mindful, and of the willingness of Delaware courts to hold parties to terms to which they have agreed.

Background

Section 203 of the DGCL generally prohibits any owner of 15% or more of a corporation's voting stock from engaging in a business combination with the corporation within three years after the person acquired such ownership, unless, among other options, the board approved the transaction that resulted in the person exceeding 15% ownership or the business combination is approved by 66 $\frac{2}{3}$ % of the outstanding voting stock not owned by that person. In 2015, Delek acquired 48% of Alon's outstanding shares at a price of approximately \$16.99 per share after receiving pre-approval of its initial stock acquisition from the Alon board, which the board granted on condition that Delek enter into a stockholder agreement. The final stockholder agreement replicated "anti-takeover protections like those imposed by Section 203," including a standstill provision that prohibited Delek and its affiliates from acquiring or seeking to acquire majority control of the company and from entering into or seeking to enter into a merger with Alon. Delek could, however, *confidentially* propose mergers to Alon's independent directors.

In late 2015 and early 2016, before the standstill period expired, Delek's CEO stated on a Delek earnings call that "obviously. . . we are not in the business of holding 48% in a company," and Delek released an investor presentation publicly disclosing plans to either acquire the remaining 52% of the Alon shares it did not already own or increase its stake to 51% of the company. Also, during the standstill period, Delek's CEO and the chair of Alon's special committee had several discussions regarding structure and terms of a potential merger, including that Delek would not agree to a stock-for-stock transaction at a premium to Alon's trading price. Only months later did the special committee propose, and Delek ultimately accept, the *MFW* conditions, namely approval by both a special committee of independent directors and a majority of the minority stockholders.

Negotiations continued through the fall of 2016 and, in early January 2017, the parties announced a definitive merger agreement providing for Delek to acquire the remaining Alon shares in a stock-for-stock deal. The merger was later approved by approximately 89% of Alon's outstanding shares, including a supermajority of the outstanding shares not owned by Delek.

Analysis

The complaint asserted claims against Delek, Alon and all Alon directors for breaching the stockholder agreement, violating Section 203 and engaging in a controlling stockholder merger following an unfair process and at an unfair price. The court largely denied the defendants' motion to dismiss the claims.

- *Plaintiff adequately alleged that Delek breached the stockholder agreement and that Alon's stockholders had standing to enforce its terms as intended third party beneficiaries under that agreement.* The court found that the broad terms of the standstill provision, including its prohibitions on "seeking" to acquire additional shares or enter into a merger, may have been breached during the standstill period based on Delek's public statements, its entering into a confidentiality agreement with Alon and its negotiations and discussions with representatives of Alon's special committee. Further, although only Delek and Alon were parties in fact to the stockholder agreement, the court found that Alon's unaffiliated stockholders had standing to sue Delek directly for its alleged breaches because the agreement's replication of the restrictions of Section 203 showed the parties' intent to benefit Alon's unaffiliated stockholders and therefore conveyed standing to enforce its terms.
- *Breach of conditions on which Section 203 approval was granted may reinstate Section 203's restrictions, and with restrictions restored, an uninformed stockholder vote may not satisfy Section 203.* Although noting that the plaintiff's argument took "many logical steps, which might not ultimately land," the court ruled that it was reasonably conceivable that by violating the stockholder agreement, Delek "vitiating" Alon's Section 203 approval, thereby restoring Section 203's restrictions on business combinations with Delek. The court further held that the unaffiliated stockholder approval may have been ineffective to cure such Section 203 violation because of alleged disclosure deficiencies in the proxy statement, ruling that "for stockholder approval of any corporate action to be valid, the

vote of the stockholders must be fully informed.” This is an unusual ruling in that, while disclosure deficiencies may support standalone equitable claims for breach of directors’ fiduciary duties, they usually do not undermine the legal “validity” of the corporate action approved unless the statute requires a specific disclosure that was omitted (such as the statutory requirement to include a copy of the appraisal statute in appraisal notices).

- *It was reasonably conceivable that Delek was a controlling stockholder and, therefore, the transaction was subject to the entire fairness standard.* Based on Delek’s large equity bloc and employment of five of the 11 Alon directors (with influence over a sixth director), the court found it reasonably conceivable that Delek may be a controlling stockholder of Alon, despite not owning a mathematical majority of the outstanding shares. As a result, the entire fairness standard of review applied by default to claims against Delek. The business judgment standard of review was not restored under *MFW* because the parties had engaged in substantive negotiations before agreeing to condition the merger on the required procedural protections. The court emphasized the following key allegations as sufficient at the pleading stage to state a claim that the merger was not entirely fair: the authority of the special committee to solicit alternatives and definitively reject a proposal from Delek was unclear at the outset of the process and had to be clarified mid-negotiation; the chair of the special committee’s independence from Delek was questionable based on his negotiating tactics and the fact that he and his daughter received salaries from an Alon subsidiary and “thereby indirectly benefit[ed] from Delek’s position as Alon’s controlling stockholder”; and Delek’s public statements may have suppressed Alon’s trading price and, in turn, the exchange ratio under the merger agreement.
- *Recusal and exculpatory provisions were insufficient to dismiss post-closing claims against any of the directors.* The proxy stated that all of the Delek-affiliated directors recused themselves from the committee and board votes on the merger. Nonetheless, the court refused to dismiss the post-closing claims against the Delek-affiliated directors because “merely recusing oneself from the ultimate decision does not absolve a director of his or her fiduciary duties,” and, in this case, the allegations supported an inference that each Delek-affiliated director may have been involved in the process leading up to the final approvals. In addition, the provision in Alon’s charter exculpating its directors from monetary damages for breaches of the duty of care, but not the duty of loyalty, did not serve to dismiss any members of the special committee from the lawsuit, as the plaintiff adequately alleged that the special committee members breached their duty of loyalty. The court ruled that the negotiation process flaws, the fact that the ultimate merger price was below the range of fair value indicated by some of their financial advisor’s fairness analyses, and the disclosure violations conceivably stated claims that the special committee members acted in bad faith.
- *Among others, the court found that each of the following may have been a material misstatement or omission from the company’s proxy statement:*
 - Descriptions of the stockholder agreement did not fully describe its broad terms or the extent

of conduct that Delek was prohibited from taking during the standstill period, nor were cross-references to the full documents as attached to other filings sufficient because “[d]isclosures are not supposed to take the form of a scavenger hunt.”

- The special committee’s financial advisor and its affiliates allegedly purchased a significant amount of Delek stock while representing the Alon special committee in its negotiations, ultimately acquiring approximately 2.5% of Delek. The proxy disclosed that the advisor “may” trade in the merger parties’ securities, but did not disclose this actual trading.
- While the proxy disclosed that two special committee members would be appointed to Delek affiliates post-closing, it failed to disclose the compensation they would receive for their post-closing board service. Relatedly, the proxy failed to disclose that the chair of the special committee would remain in his current, salaried position with an Alon subsidiary.

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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