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Court of Chancery Enhances Standard of Review for the Sale of a Controlled Company to a Third-Party

By Richard S. Horvath

Eight years ago in *In re Synthes Shareholder Litigation*,[1] then-Chancellor Strine found that the sale of a controlled company to a third-party was not governed by entire fairness, but rather fell within the safe harbor of the business judgment rule, when the controller was equally aligned with the minority stockholders to obtain the best value reasonably available for the company. A recent decision from the Court of Chancery in *Firefighters' Pension System of the City of Kansas City v. Presidio, Inc.*,[2] however, closes this *Synthes* safe harbor, and indicates that third-party sales of controlled companies will be subject to enhanced judicial scrutiny in the future.

The *Synthes* Safe Harbor.

In *Synthes*, Chancellor Strine held that the sale of Synthes, Inc. to Johnson & Johnson was governed by the safe harbor of the business judgment rule because Synthes was under the control of a 52% stockholder, the controlling stockholder received the same *pro rata* consideration as every other stockholder in the merger, and the controlling stockholder could be expected to obtain the best price reasonably available because the controller was not under a pressing liquidity need. In such circumstances, the Court held that "*pro rata* treatment remains a form of safe harbor under [Delaware] law" through the business judgment rule.[3] In reaching this result, the *Synthes* safe harbor offered incentives while recognizing practical realities.

First, Delaware law permits a controlling stockholder to obtain a control premium for its shares, which premium the controller does not need to share with the minority stockholders in a sale of the company.[4] If the controller elects to keep this premium, however, then the controller would need to prove the sale was fair to the minority stockholders in any post-closing litigation.[5]

Second, through the safe harbor of the business judgment rule, *Synthes* incentivized a controlling stockholder to forego a control premium and to agree to a *pro rata* share of the merger consideration.[6] When the business judgment rule applies, it is likely a court would dismiss any litigation challenging the sale at the pleading stage.

Third, the *Synthes* safe harbor recognizes that a controlling stockholder who is not under the threat of a pressing liquidity need could be expected to obtain the best price reasonably available in a sale of the

company.[7] Thus, the Court could avoid conducting an after the fact inquiry into the reasonableness or fairness of the merger by relying on the controlling stockholder's own desire for lucre.

The Court of Chancery Closes the *Synthes* Safe Harbor.

On January 29, 2021, Vice Chancellor Laster issued an Opinion in *Presidio* that would close the *Synthes* safe harbor.

Departing from *Synthes*, the *Presidio* decision holds that the sale of a controlled company to a third party would still be reviewed under the enhanced scrutiny standard articulated in *Revlon*, *Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), and its progeny. As corporate practitioners are aware, enhanced scrutiny review forgoes the deference applied by courts under the business judgment rule and instead imposes on directors the burden of demonstrating that their actions to maximize stockholder value were reasonable.

To restore the safe harbor of the business judgment rule, *Presidio* would require approval of the sale from the affirmative vote of a majority of the disinterested shares pursuant to *Corwin v. KKR Financial Holdings, LLC*.[8] While *Presidio* does not address the issue directly, the decision raises the question whether such approval must come from the minority stockholders. Indeed, if *Presidio* and *Corwin* would provide safe harbor protection for the sale of a controlled company when the transaction is approved by the controlling stockholder, then that result is no different form the *Synthes* safe harbor. But because *Presidio* rejects the *Synthes* safe harbor, the *Presidio* decision could be read as requiring the informed vote of a majority of the minority stockholders.

Interestingly, both the *Synthes* decision and the *Presidio* decision cite to the Delaware Supreme Court's decision in *McMullin v. Beran*.[9] In *McMullin*, the Supreme Court held that directors of a controlled company must still satisfy *Revlon*'s mandate of owing their "ultimate fiduciary dut[ies] . . . to focus on whether shareholder value has been maximized."[10] In *McMullin*, the Supreme Court held that the complaint sufficiently alleged that the target board improperly delegated the negotiation of the merger to the controlling stockholder who had a short term need to raise capital to fund a $3.3 billion merger, that the target board met only once to consider the transaction that the controller had negotiated, and that half of the target board was comprised of directors dominated by the controlling stockholder with a liquidity need.[11] The Supreme Court held these allegations were sufficient to rebut the presumption of the business judgment rule.[12] In the *McMullin* decision, the Supreme Court made no reference to enhanced scrutiny review.

In *Synthes*, Chancellor Strine both noted that *McMullin* was a controversial decision at its time and questioned the holding in that decision.[13] In *Presidio*, the Vice Chancellor Laster held that because *Revlon* offers a standard of review and *McMullin* recognizes that *Revlon* applies to a third-party sale of a controlled company, then enhanced scrutiny under *Revlon* must apply.[14]

Ultimately, as *Synthes* and *Presidio* demonstrate, the standard of review applicable to a third-party sale of a controlled company, and how *McMullin* impacts that standard, will need to be decided by the Delaware Supreme Court.

How Will *Presidio* Impact Third-Party Sales of Controlled Companies?

Until the Delaware Supreme Court addresses the standard of review, one can expect the *Presidio* decision will lead to increased litigation risk for sales of controlled companies to third-parties.

Time will tell what impact this increased litigation risk has. Will controlling stockholders view the *Presidio* decision as sufficiently increasing the risk of post-closing merger litigation that the controller would be better off to insist on a premium for its own shares? Or will Delaware courts apply a healthy degree of skepticism with respect to complaints challenging such transactions, dismissing those complaints at the pleading stage? The answers to these questions may take time, subject to whether the Delaware Supreme Court has an opportunity soon to resolve the standard of review applicable to third-party sales of controlled companies.

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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings San Francisco lawyer:

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[1] 50 A.3d 1022 (Del. Ch. 2012).

[2] 2021 WL 298141 (Del. Ch. Jan. 29, 2021).

[3] *Synthes*, 50 A.3d at 1024.

[4] *Id.* at 1039.

[5] Id.

[6] *Id.* at 1035–36.

[7] *Id.* at 1040 ("when a controlling stockholder . . . shares its control premium evenly with the minority stockholders, courts typically view that as a 'powerful' indication 'that the price received was fair'" (citations omitted)).

[8] 125 A.3d 304, 213 (Del. 2015); *see also Presidio*, 2021 WL 298141, at *30.

[9] 765 A.2d 910 (Del. 2000).

[10] *McMullin*, 765 A.2d at 920.

[11] *Id.* at 921–24.

[12] *Id.* at 917, 920.

[13] *Synthes*, 50 A.3d at 1041, n.91.

[14] *Presidio*, 2021 WL 298141, at *29–30, n.13.