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Corporate Governance Group Client Alert

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DELAWARE COURT REFUSES TO ENJOIN MERGER DESPITE "MERITORIOUS ALLEGATIONS" OF FIDUCIARY IMPROPRIETY

Adopts analysis consistent with recent decision in El Paso Corp. Shareholder Litigation

In *In re Delphi Financial Group Shareholder Litigation*,[1] the Delaware Court of Chancery recently declined to preliminarily enjoin a pending merger despite its finding that plaintiff-stockholders were "reasonably likely to be able to demonstrate at trial that in negotiating for disparate consideration and only agreeing to support the merger if he received it," a controlling stockholder "violated duties to the stockholders." In so ruling, the Court focused on the facts that (i) monetary damages would be available as a satisfactory remedy to plaintiffs if they prevailed at trial, (ii) the transaction offered target stockholders a "substantial premium over market" and (iii) no other "suitor is in the wings." In light of the potential harm that issuance of an injunction could cause to target stockholders, the Court denied injunctive relief in order to allow the stockholders to vote on the merger.

Background

Delphi Financial Group, Inc. is an insurance holding company founded and taken public in 1990 by Robert Rosenkranz. At the time of the IPO, Delphi established two classes of stock: Class A, owned predominantly by the general public, and Class B, owned solely by Rosenkranz and his affiliates. Class B stock carried the right to ten votes per share, giving Rosenkranz effective control although he owned only 12.9% of the equity, and Class A stock carried the right to one vote per share. However, Rosenkranz's ability to exercise control was limited in two important respects: (i) a voting agreement, which capped his voting power at 49.9% and (ii) a "charter provision, which directed that, on sale of the company, each share of Class B stock would be converted to Class A, entitled to the same consideration as any other Class A stock" and thereby prohibited "disparate consideration."

1 C.A. No. 7144-VCG (Del. Ch. Mar. 6, 2012).

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Editor: Bob Reder

On July 20, 2011, Tokio Marine Holdings, Inc., a Japanese holding company engaged in the global property and casualty insurance, reinsurance and life insurance markets, approached Rosenkranz through its investment banker regarding a potential acquisition of Delphi. Throughout August, senior management from Delphi and Tokio held general discussions regarding a potential acquisition. At a Delphi board of directors meeting on September 16, 2011, Rosenkranz informed the directors that Tokio had offered $45 per share (at the time, a 106% premium to market price), but that he found this price to be inadequate and would not vote in favor of a merger at that price unless he received a control premium. Although the other directors were hesitant to recommend a transaction in which Rosenkranz obtained a premium, they appreciated the attractiveness of Tokio's offer and agreed to the creation of a special committee of independent directors to oversee Rosenkranz's negotiations with Tokio. In addition, a special sub-committee of the special committee was formed "to act on the Special Committee's behalf with respect to any matters related to Rosenkranz and differential merger consideration." The board's approval of the merger was conditioned on the special committee's recommendation of the merger, which recommendation in turn was conditioned on the sub-committee's favorable recommendation.

As part of its process, the "Sub-Committee reviewed comparable acquisitions of companies with dual-class stock, and, after hearing from its financial and legal advisors that disparate consideration in such cases is unusual and problematic, attempted to persuade Rosenkranz … to accept the same price as the Class A stockholders." Rosenkranz "remained obstinate, refusing to back down on his demand for some level of disparate consideration." The sub-committee concluded that Rosenkranz would torpedo the deal if he did not receive a premium and "not wanting to deprive the Class A stockholders of the opportunity to realize a circa-100% premium on their shares … decided to accept the idea of differential consideration but to fight for a reduction in the consideration differential."

After consulting with its advisors, and in view of the significant premium being offered by Tokio, the special committee decided *against* soliciting offers from other potential buyers to avoid the attendant risks associated with shopping Delphi, including a possible negative impact on the negotiations with Tokio and disruption of Delphi's business. Also, Rosenkranz was allowed to remain the "point person" in the negotiations with Tokio because he was "an effective negotiator" with "intimate knowledge of the business" whose interests were "aligned" with those of the Class A stockholders "with respect to securing the highest *total* offer from" Tokio.

Further negotiations led to a final Tokio offer of $46 per share. The special committees decided to finalize the terms of the differential consideration with Rosenkranz before responding to Tokio's improved offer. Rosenkranz proved to be a tough negotiator, and the parties eventually agreed to a $44.875/$53.875 split for the Class A and Class B shares, respectively.

Negotiations with Tokio over the remaining terms continued over the following months. The special committee was able to obtain a non-waivable condition that the merger would be subject to approval of a majority of the disinterested Class A stockholders. To allow Rosenkranz to receive his control premium, the merger also was conditioned on stockholder approval of an amendment to Delphi's charter to exempt the Tokio transaction from the prohibition against differential consideration. The special committees and the Delphi board approved the transaction and Delphi and Tokio signed a merger agreement on December 21, 2011.

The Plaintiffs' Claims

Class A stockholders filed a derivative action challenging the transaction on two grounds. *First*, plaintiffs claimed that Rosenkranz and the directors "breached their fiduciary duties … to obtain the best price reasonably available to the stockholders, in violation of their fiduciary duties under the *Revlon*[2] doctrine," due in part to Rosenkranz's key role in the negotiations with Tokio. Plaintiffs also contended that "by tying the vote on the Charter Amendment with the vote on the Merger," the directors sought "to coerce the Class A stockholders into amending the provisions of Delphi's Charter that prohibit … disparate consideration …." *Second*, plaintiffs alleged that the directors "breached their fiduciary duties to the Class A stockholders in approving the consideration differential."

The Court's Analysis

At the outset, the Court noted that "the entire fairness standard of review applies to the approval of the disparate Merger consideration." The Court explained that it "reviews transactions where a controlling stockholder stands on one side under entire fairness unless (1) a disinterested, independent, and sufficiently empowered special committee recommends the transaction to the board *and* (2) the majority of the minority stockholders approve the transaction in a non-waivable vote" so long as the controlling stockholder does not employ any "[t]hreats, coercion, or fraud …."[3]

Next, the Court explained that a preliminary injunction may be issued "only where … the moving party has demonstrated a reasonable likelihood of success on the merits, that failure to enjoin will result in irreparable harm to the moving party, and that a balancing of the equities discloses that any harm likely to result from the injunctive relief is outweighed by the benefit conferred thereby …." Taking all these factors into account, the Court determined that injunctive relief would not be appropriate.

Likelihood of Success on the Merits

With respect to plaintiffs' *Revlon* claim, the Court explained that its job was to examine "'the adequacy of the decision-making process' and 'the reasonableness of the directors' actions in light of the circumstances then existing.'" In this regard, the Court was not persuaded that Rosenkranz "lacked an incentive to extract the highest price from" Tokio. Instead, even though Rosenkranz's interests were not wholly in line with the Class A stockholders, the Court believed he nonetheless had an incentive to negotiate with Tokio for "a higher overall price" in order to create "a bigger pie from which Rosenkranz could cut an outsized slice."

With respect to plaintiffs' attack on the merger's disparate consideration, the Court assumed that "the stockholders, in return for the protection against differential merger consideration found in the Charter, paid a higher price for their shares" at the time of the IPO. Accordingly, "Rosenkranz cannot extract a *second* control premium for himself at the expense of the Class A stockholders" by structuring the merger with Tokio to provide for differential consideration between the Class A and Class B stockholders. While recognizing that "a controlling stockholder is, with limited exceptions, entitled under Delaware law to negotiate a control premium for its shares," the Court nevertheless concluded that plaintiffs were

2 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986).

3 For this purpose, the Court relied on *In re John Q. Hammons Hotels, Inc. Shareholder Litigation*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009); for a discussion of the *Hammons* decision, please *see* our Client Alert entitled "*Delaware Court Cites Inadequacy of Minority Protections in Applying Entire Fairness Standard to Third Party Buy-Out of a Controlled Corporation*," dated January 20, 2010. For reasons articulated in its opinion, the Delphi Court did not find it necessary to evaluate the procedural protections employed in connection with the Tokio transaction.

"reasonably likely to be able to demonstrate at trial that in negotiating for disparate consideration and only agreeing to support the merger if he received it, Rosenkranz violated duties to the stockholders."

Balancing the Equities

Turning to the other requirements for issuance of a preliminary injunction, the Court found that because:

(i) monetary damages could adequately compensate plaintiffs for their losses if proven at trial and "[a] harm that can be remedied by money damages is not irreparable," and

(ii) "in the context of a single-bidder merger, the Court … must be cognizant that if the merger is enjoined, the deal may be lost forever, a concern of particular gravity where, as here, the proposed deal offers a substantial premium over market price,"

a balancing of the equities argued against issuing an injunction. Rather, under these circumstances, "it is preferable to allow the stockholders to decide whether they wish to go forward with the Merger despite the imperfections of the process leading to its formulation."

Conclusion

One cannot help but to consider the *Delphi* decision with reference to the decision of the Court of Chancery in *In re El Paso Corporation Shareholder Litigation*[4] issued just one week earlier. In each case, even though the Court concluded that plaintiffs had established a reasonable probability of success in establishing that corporate fiduciaries had breached their duties due to conflicts of interest impacting the sale process, the absence of alternative bidders to an otherwise favorable transaction price convinced the Court that allowing stockholders to proceed to an up or down vote on the transaction in hand was preferable to potentially scuttling that deal by issuing an injunction.

Corporate boards and their advisors, however, really should not take any particular comfort from these decisions. If the Court had any doubt about the attractiveness of the deal terms, or if another attractive bidder had been waiting in the wings, the result likely would have been much different. And the Court's findings on the substance of plaintiffs' claims, even though it was reluctant to issue an injunction, do not auger well for Rosenkranz's chances of success at trial when damages is the available remedy. Accordingly, those involved in a sale process must be cognizant of any potential conflicts of interests among the deal participants, negotiators and advisors and take measures to make sure that those conflicts are effectively disclosed and cabined.

Further, the entire fairness standard of review – employed by the *Delphi* Court due to the disparate treatment of the public stockholders in the merger – is an exacting standard that, absent certain procedural protections, places a heavy burden on defendant directors to satisfy. Whenever disparate consideration is offered in a business combination transaction, therefore, the relative benefits and detriments of utilizing the procedural protections necessary *either* to gain the presumption of the business judgment rule or to shift the burden of proving entire fairness to the plaintiff stockholders must be carefully assessed.

4 C.A. No. 6949-CS (Del. Ch. Feb. 29, 2012); for a discussion of the *El Paso* decision, please *see* our Client Alert entitled "*Delaware Court Sharply Criticizes Conflicts of Interest in High-Profile Corporate Merger*," dated March 21, 2012.

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