

**Milbank**

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# Corporate Governance Group

# Client Alert

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## DELAWARE COURT DETERMINES THAT CONTROLLING STOCKHOLDER HAS NO DUTY OF SELF-SACRIFICE FOR THE BENEFIT OF MINORITY STOCKHOLDERS

*Also Discusses Applicability Of Revlon Standard To 35% Cash/65% Stock Merger*

In *In Re Synthes, Inc. Shareholder Litigation*,<sup>1</sup> the Delaware Court of Chancery refused to impose the more exacting entire fairness standard of review based on the allegation that the controlling stockholder was conflicted in a merger transaction because the target company executed a merger agreement with Johnson & Johnson that consisted of 65% stock and 35% cash for all of the target's outstanding shares instead of pursuing an all-cash private equity consortium bid that would have only cashed out the minority stockholders but required the controlling stockholder to roll substantially all of his equity into equity of the surviving company. The Court based its decision on the "basic understanding that when a stockholder who is also a fiduciary receives the same consideration for her shares as the rest of the shareholders, their interests are aligned" and therefore the controlling stockholder would not have "a conflicting interest in the Merger in the sense that he derived a personal financial benefit 'to the exclusion of, and detriment to, the minority stockholders'". Additionally, the Court also held that the mixed merger consideration failed to qualify as a "change of control" subject to the enhanced scrutiny of a *Revlon*<sup>2</sup> analysis because the control of the corporation post merger would remain "in a large, fluid market" and that the mix of 65% stock and 35% cash was nearly equivalent consideration to binding Delaware Supreme Court precedent that held consideration of 33% cash and 67% stock did not trigger enhanced scrutiny review under *Revlon*. Accordingly, the Court granted the defendants' motion to dismiss on all counts.

### **Background**

Synthes, Inc. "was a global medical device company incorporated in Delaware with its headquarters in Switzerland, whose common stock traded on the SIX Swiss Exchange, and at the end of the 2010 fiscal year, had a market

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<sup>1</sup> C.A. No. 6452 (Del. Ch. August 17, 2012).

<sup>2</sup> *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

capitalization exceeding \$15 billion. The largest stockholder of Synthes was Swiss billionaire Hansjoerg Wyss, who directly held 38.5% of the Synthes' stock, and according to the plaintiffs', controlled approximately another 13.25% through his control of shares owned by family members and trusts.

In April 2010, as part of its ongoing review of strategic initiatives, the Board decided, with the support of Mr. Wyss, to explore the possibility of a potential sale of the company. The Board appointed an independent lead director to lead such process and hired Credit Suisse Securities (USA) LLC as its financial advisor. The Company proceeded to conduct what the Court characterized as "an open-ended and deliberative sales process" in which nine "logical strategic buyers with the financial capacity to acquire a company of Synthes' large size" were contacted in September 2010, followed by six private equity firms being contacted in November 2010. Of the strategic bidders, only J&J emerged, submitting an initial non-binding offer to acquire all of Synthes at an indicative price range of CHF (Swiss Franc) 145-150 per share, with at least 60% of the consideration to be in the form of J&J stock. Of the six private equity firms, only three firms remained through the bidding stages, with each indicating an unwillingness to independently finance the transaction. Attentive to this concern, in January 2011, Synthes determined to permit the three remaining private equity firms to club for bidding purposes. On February 9, 2011, the private equity consortium submitted an all cash bid of CHF 151 per share to acquire Synthes but their bid was subject to Mr. Wyss converting a substantial portion of his equity into equity of the surviving company. While recognizing that the consortium's all-cash bid represented greater value certainty, the Board also recognized that such bid was riskier because the ability to finance such transaction would depend on the financing markets and require Mr. Wyss to roll substantially all of his equity into a less liquid investment.

Accordingly, beginning in February 2011, at the Board's direction, the lead independent director negotiated with J&J exclusively, initially informing J&J that Synthes had received a competing bid in amounts higher than J&J's initial bid. Following several months of due diligence review, J&J increased its offer in April 2011 to CHF 159, with 65% being in J&J stock, which implied a 26% premium to Synthes' average trading price during the preceding month and an implied equity value of \$21.3 billion. The merger agreement was approved by Synthes' Board on April 25, 2011, with Synthes' stockholders approving the transaction on December 15, 2011.

From making its initial bid in February 2011 through December 2011, the private equity consortium remained silent; moreover, at no time did a third party interloper emerge.

### *The Court's Analysis*

#### *Plaintiffs' Allegations*

The plaintiffs challenged the fairness of the transaction to the minority stockholders on three related grounds, alleging that the J&J transaction (i) was a conflicted transaction subject to entire fairness review because the controlling stockholder, based on financial motives adverse to the interests of the minority stockholders, unfairly prevented Synthes from pursuing the all-cash bid from the private equity consortium, (ii) was an "end stage" transaction following which Synthes stockholders would never be able to receive a control premium for their shares, and as a result, should be subject to enhanced scrutiny under a *Revlon* analysis and (iii) contained unreasonable deal protections precluding more attractive third-party bids, and as a result, should be subject to enhanced scrutiny under a *Unocal*<sup>3</sup> analysis.

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3 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

*The Business Judgment Rule applies to a merger resulting from an open and deliberative sale process when a controlling stockholder shares the control premium ratably with the minority*

The Court noted that one way for a plaintiff to rebut the presumption that a board's decision is entitled to the protection of the business judgment rule is to "allege that...the controlling stockholder received materially different terms from the third party in the merger than the minority stockholders", and as a result, the transaction should be subject to an entire fairness review. The basis for such an argument is that the "controller used its power over the company to cause the company to enter into a transaction that was not equal to all the stockholders, and unfair to the minority because the controller unfairly diverted proceeds that should have been shared ratably with all stockholders to itself."

The Court viewed the plaintiffs' allegations as unconvincing and "ginned up" when plaintiffs asserted that "Wyss received liquidity benefits that were not shared equally with the rest of the stockholders and colored his decision to support the Merger and to supposedly improperly reject further consideration of the Partial Company Bid."

In the Court's determination, "Wyss' supposed liquidity conflict was not really a conflict at all because he and the minority stockholders wanted the same thing: liquid currency and, all things being equal, at the highest dollar value amount of that currency. If there is anything even more liquid than J&J stock, it's cash...Wyss had little reason not to prefer an all-cash deal if the PE Club was willing to out-bid J&J on terms equally available to all shareholders." To the Court, this logically explained why Wyss supported a consortium private equity bid. Putting this all into context, the Court noted a controlling stockholder, given its large financial stake, would have a "natural incentive" to obtain the best price for its shares, and therefore, as "a general matter,...if one wishes to protect minority stockholders, there is a good deal of utility to making sure that when controlling stockholders afford the minority pro rata treatment, they know that they have docked within the safe harbor created by the business judgment rule."

In summation, the Court stated that "Delaware law does not...impose on controlling stockholders a duty to engage in self-sacrifice for the benefit of minority shareholders. That is, the duty to put the 'best interest of the corporation and its shareholders' above 'any interest ... not shared by the stockholders generally' does not mean that the controller has to subrogate his own interests so that the minority stockholders can get the deal that they want."

*Revlon does not apply, and even if it did, the Board did not breach its Revlon duties*

The Court noted that "under binding authority of our Supreme Court..., *Revlon* duties only apply when a corporation undertakes a transaction that results in the sale or change of control. Putting aside the reality that the plaintiffs...were moving from a company under the control of Wyss to receiving stock in company that had no controlling stockholder, and thus is already an odd case to apply *Revlon*, the mixed consideration Merger does not qualify as a change of control under our Supreme Court's precedent. A change of control 'does not occur for purposes of *Revlon* where control of the corporation remains, post-merger, in a large, fluid market.' Here, the Merger consideration consists of a mix of 65% stock and 35% cash, with the stock portion being stock in a company whose shares are held in large, fluid market...[The] Supreme Court held that a merger transaction involving nearly equivalent consideration of 33% cash and 67% stock did not trigger *Revlon* review when there was no basis to infer that the stock portion of that consideration was stock in a controlled company. That decision is binding precedent." Moreover, even if

*Revlon* did apply, the Court cited numerous actions taken by Wyss and the Board – including the duration of the sale process and its open-ended, deliberative, and non-discriminatory nature – to suggest that Wyss and the Board likely chose a reasonable course of action to achieve the highest value reasonably attainable for Synthes stockholders.

*The deal protections were not reasonable and not preclusive*

The Court characterized the plaintiffs’ allegations in this context as “half-hearted”, noting that the plaintiffs failed to make any colorable argument as to why the J&J deal protections would have unreasonably precluded a third party interloper from making a higher bid. Although Wyss had entered into a voting agreement and there was a “force the vote” provision that required Synthes’ Board to submit the merger proposal to its stockholders despite the Synthes Board having changed its recommendation with respect to the J&J merger, the Court noted that if “a better topping bid was available, Synthes’ stockholders could have voted down the Merger and opened the door to that better bid...[B]ecause the Board had deliberately searched the market and was seeking to close a favorable deal with the last remaining bidder, it had a firm market basis to make the decision about how likely a later emerging bid was and to judge what concessions in terms of deal protections were necessary in order to land the one huge fish it actually had on the hook. This court should be particularly reluctant to deem unreasonable a board’s decision to use deal protections as part of the negotiating strategy to pull the best bid from the final bidder or bidders who emerge from an open process on the theory that some party that has already had a chance to make a real bid without having to hurdle any deal protection barrier at all will somehow come to a different realization of the company’s value, or that some unexpected bidder will emerge from an unexplored and overlooked dusty corner of our well-scoured capital markets.”

***Conclusion***

The Court’s rejection of the various alleged fiduciary breaches suggested by plaintiff stockholders, including the controlling stockholders’ and the Board’s decision to deal exclusively with an attractive strategic bidder and to agree to typical deal protection measures, demonstrates, even under a *Revlon* and *Unocal* analysis, the continued deference shown to independent boards who diligently supervise a sale process and do not discriminate against any particular buyer or buyer class. The *Synthes* decision is also useful in that reinforces the bounds of when *Revlon* scrutiny would not apply in mixed consideration mergers.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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