

Corporate Finance/M&A - USA

Fairness claim involving management rollover in private equity buy-out proceeds

Contributed by [Ropes & Gray LLP](#)

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Introduction

A recent decision of the Delaware Court of Chancery illustrates the litigation risks that can arise in the context of a private equity buy-out when managers holding a controlling share of a target roll over equity into the new company while minority stockholders get cashed out. In *Frank v Elgama*(¹) the plaintiffs brought an action alleging that the board of directors of American Surgical Holdings, Inc had breached their fiduciary duties by approving a sale to a private equity fund, Great Point Partners, a private equity fund. The plaintiffs alleged that a group of management stockholders with a controlling interest in the company had induced the board of directors to accept a deal that benefited management at the expense of the minority stockholders. The court denied the defendants' motion for summary judgment, allowing some of the plaintiffs' claims to proceed to trial.

Facts and decision

American Surgical began exploring a possible sale of the company in Summer 2009 after receiving an expression of interest from Great Point Partners. The board formed an M&A committee and retained a financial adviser to solicit offers. By late 2009 three potential acquirers, including Great Point Partners, had submitted non-binding indications of interest. After the board received those bids, it formed a special committee of independent, non-executive directors to oversee the negotiation process. The special committee decided to proceed to negotiate a merger with Great Point Partners.

In February 2010, in the course of its diligence, Great Point Partners received notice of accounting problems with American Surgical's 2009 financial statements. Consequently, Great Point Partners sought to renegotiate the terms of the merger. Great Point Partners presented the company with three choices with varying mixes of cash and equity to be provided to the rollover stockholders. Significantly, the option that would have provided the greatest ratio of cash to equity to the rollover stockholders provided slightly less overall consideration to the minority stockholders (\$0.04 a share) than if the rollover stockholders took more equity. The special committee and the board of directors ultimately chose the option that was the least favourable to the minority stockholders. This choice, combined with the evidence presented as to the special committee's decision-making process, led Vice Chancellor Noble to dismiss in part the defendants' motion for summary judgment.

In particular, the court noted that it was unclear whether the special committee was informed of the three options and their varying levels of compensation for minority stockholders. One board member testified that the financial adviser had told the special committee about the three options, but the minutes of the special committee meeting in which the new terms with Great Point Partners were adopted reflected no such discussion. This procedural defect, coupled with the fact that the management stockholders and the minority stockholders had a direct conflict of interest, led the court to conclude that the 'entire fairness' standard – under which the controlling stockholders must prove that the transaction was fair to the minority stockholders – could apply to this transaction.

Comment

This case demonstrates that boards and their advisers should be vigilant in addressing any potential conflicts of interest between insider stockholders – such as managers rolling over their equity into the post-merger entity – and other stockholders.

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Failure to recognise that a given option deprives minority stockholders of even a few cents per share of merger consideration can lead to a lawsuit in which the burden lies on the board of directors to prove that the merger price was entirely fair.

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Endnotes

(1) *Frank v Elgamal*, CA 6120-VCN (Del Ch March 10 2014).

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