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Forging ahead with "entire fairness," or playing it safer (procedurally speaking)

Controlling stockholder buyouts of Delaware corporations are generally scrutinized under the lens of "entire fairness" to determine whether the transaction was the product of fair dealing and fair price. Notably, however, under *M&F Worldwide*,[1] the Delaware Supreme Court confirmed that a target corporation's use at the outset of a transaction of a special committee of disinterested directors and an informed vote of a majority of the minority of the target's stockholders, among other factors, will result in a transaction that would be reviewed under the deferential business judgment rule instead of the stringent entire fairness test. The burden of proving entire fairness and the perception of a significant risk of a negative outcome under an entire fairness review frequently results in deal participants allowing the fate of the transaction to be determined not only by a special committee, but, even more critically, by the majority of the minority stockholder vote. However, the recent Delaware Chancery Court decision in *ACP Master, Ltd. v. Sprint Corp. / ACP Master, Ltd. v. Clearwire Corp.* highlights that entire fairness may not be fatal, and that a finding of entire fairness may overcome earlier instances of conduct or process that may fall short or that otherwise had "flaws" and "blemishes."

In *ACP Master*, the Delaware Chancery Court acknowledged instances of alleged unfair conduct of Sprint Nextel Corporation (the controlling stockholder) and Softbank Corp. (the proposed acquirer of Sprint) in connection with an attempted buyout of Clearwire Corporation, including, among others: obstructing several material business opportunities of Clearwire (including the potential sale of spectrum); vote buying; making retributive threats to Clearwire's minority stockholders; and insisting on dilutive conversion pricing in bridge financing. The Chancery Court noted that "[i]f Clearwire's stockholders had approved the original merger at $2.97 per share . . . this array of misconduct would have resulted in a finding of unfair dealing and a damages award in the form of a fairer price." Notwithstanding, the Chancery Court found that such instances of alleged unfair conduct "made little difference" after Clearwire's stockholders refused to support Sprint's initial $2.97 per share offer and an interloper, DISH, drove the deal price up in an arm's-length process and at a price of $5.00 per share that the Chancery Court found to be fair. The Chancery Court noted that "[t]he stockholders' refusal to take [the $2.97 per share] price, and DISH's intervention in the sale process, freshened the atmosphere and created a competitive dynamic . . . [that] led to the $5.00 per share merger consideration, independent of the earlier acts of unfair dealing by Sprint and Softbank." The transaction presumably did not qualify for business judgment rule review under *M&F Worldwide* because Sprint and Softbank did not propose the transaction with the procedural protections of a special committee and informed majority of the minority vote at the outset.

In *ACP Master*, Vice Chancellor Laster accepted, without deciding, that Sprint was Clearwire's controlling stockholder. Under Delaware law, a controlling stockholder exists when a stockholder: (1) owns more than 50% of the voting power of a corporation; or (2) exercises control over the business and affairs of the corporation. Vice Chancellor Laster noted that Sprint owned a majority of Clearwire's equity, which "traditionally sufficed to confer controlling stockholder status and concomitant fiduciary duties." Sprint, however, argued that it was not a controlling stockholder because certain governance provisions in an equityholders agreement had prevented it from exercising effective control over Clearwire, and, as a result, it did not owe fiduciary duties to Clearwire and its minority stockholders. In other words, Sprint attempted to argue that, while it was a majority stockholder of Clearwire, it did

[1] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

not exercise *actual* control over Clearwire because of contractual provisions that neutered its controller status. While there may be some appeal to Sprint's position, Vice Chancellor Laster did not ultimately rule on Sprint's argument because he found that, in any event, the Clearwire-Sprint merger was entirely fair and Sprint did not breach its fiduciary duties.

Although the Chancery Court found that Sprint's and Softbank's alleged misconduct was later "cleansed" by DISH's intervention in the sale process, *ACP Master* provides important lessons for a controlling stockholder on actions that it could take, or should avoid taking, when negotiating a transformative transaction with its controlled affiliate to reduce the risk of a Delaware court finding that the controlling stockholder cannot satisfy procedural fairness.

- ***Interfering Actively with Potential Alternatives.*** A controlling stockholder may be permitted to veto any sale to a third party; however, where the controlling stockholder holds more than 50% of the voting equity, the controlling stockholder runs substantial risks, if it uses its control position to foreclose or deter alternatives that may be available to the target company (e.g., the potential sale of Clearwire spectrum to either Qualcomm or Google). With regard to the spectrum sale to Qualcomm, Vice Chancellor Laster concluded that the effect of Sprint's and Softbank's alleged interference on Clearwire's ultimate bargaining position with Sprint was unclear. However, Vice Chancellor Laster noted that the Qualcomm incident would have provided some evidence of unfairness if the final deal price had remained at $2.97 per share. Sprint and Softbank also allegedly interfered with a potential sale of spectrum to Google. After DISH intervened and the merger consideration increased to $5.00 per share, the Google incident diminished in importance because, even if Clearwire's Special Committee had known about Google's interest, it might have enabled them to bargain for a transaction above $2.97 per share, but it could not have led to the realization of value exceeding the final deal price of $5.00 per share.
- ***Fiduciary Duty of Candor.*** The plaintiffs criticized the negotiations between Clearwire's Special Committee and Sprint by arguing that Sprint deprived the Special Committee of material information by failing to disclose its projections for its use of Clearwire's spectrum. Vice Chancellor Laster rejected the plaintiffs' claim, observing that "the controller's duty of disclosure stops at the point when forcing disclosure would undermine the potential for arm's-length negotiations to take place." Thus, he concluded that a controller is not required to disclose private information that reveals how a controller values the company and hence what the controller is willing to pay.[2]
- ***Vote-Buying and Coercion.*** Vice Chancellor Laster noted that, if the transaction had been approved at $2.97 per share, Sprint could have been liable for fiduciary duty breaches for an array of alleged conduct, which included securing support from a block of minority stockholder votes by promising a broader commercial arrangement and the lack of fulsome disclosure of that side deal and the threat to exercise a conversion right under a note purchase agreement that would have resulted in substantial dilution of the minority stockholders of Clearwire if the Clearwire-Sprint merger was not approved.
- ***Pre-emption Ultimatum***. While plaintiffs complained that Sprint's demand, as a condition for its offer of $5.00 per share, that Clearwire terminate all discussions with DISH had cut short a potential bidding war between DISH and Sprint that might have yielded a higher price for Clearwire, Vice Chancellor Laster found that Sprint's alleged demand was not unduly coercive or otherwise out of bounds. He noted that the Special Committee's acceptance of Sprint's offer and its decision to not go back to DISH was not evidence of unfair dealing. Controlling stockholders thus remain unfettered by their fiduciary duties from demanding exclusivity or other pre-emptive concessions.

[2] Note, however, that Schedule 13E-3 may require the controller to disclose, after the deal has been signed, any projections that were prepared in connection with the transaction, and would seem to potentially create an interesting dynamic in post-signing appraisal arbitrage claims.

Having found the transaction to be entirely fair, the Chancery Court then determined that, in the related appraisal action, the fair value for Clearwire's shares on the date of the merger was $2.13 per share—an amount significantly lower than the initial negotiated deal price of $2.97 per share. The Chancery Court adopted Sprint's expert's discounted cash flow (DCF) analysis in full, which relied on projections prepared by Clearwire's management team in the ordinary course of business. In contrast, the petitioners' expert's DCF analysis relied on unrealistic projections that were prepared by Sprint's management team and were created for a specific purpose (namely, to help convince Softbank to increase its offer). Because those projections were not prepared in the ordinary course, and included assumptions that were not fully supported by the evidence, they did not reflect the operative reality of Clearwire on the date of the merger. Thus, *ACP Master* demonstrates the importance of ordinary-course management projections to support a meaningful DCF analysis to determine fair value.

Notably, Vice Chancellor Laster observed that there was no evidence that anyone at Sprint or SoftBank "believed that Clearwire was worth $5.00 per share [on a standalone basis]. Rather, they agreed to pay that price because of the massive synergies from the transaction and the threat that DISH posed as a hostile minority investor." Indeed, Sprint estimated potential synergies of the merger ranging from $1.5 to $2 billion, Softbank's financial adviser estimated synergies between $3 to $5 billion, and Clearwire's own estimate was over $3 billion in synergies. Although Vice Chancellor Laster did not ultimately determine the value of these synergies, the Chancery Court's decision remains an additional reminder—following on the Delaware Supreme Court's decision in *DFC Global* [3] and Vice Chancellor Laster's prior decision in *Lender Processing Services*[4]—that Delaware courts are keenly aware of the central role that synergies play in competitive strategic transactions. However, such synergies are appropriately excluded from the calculation of fair value in an appraisal proceeding. *ACP Master* suggests that respondents in appraisal actions arising out of competitive strategic transactions are well positioned to litigate synergies in appraisal actions, provided they have adequately documented the role synergies played in the transaction and that the seller successfully extracted the lion's share of the synergies that the buyer hoped to achieve.

In addition, *ACP Master* demonstrates how events occurring after questionable negotiations, such as an interloper proposing a topping bid, have the potential to cleanse prior unfair conduct. While no controlling stockholder ever hopes for a topping bid on its transaction, it is instructive that subsequent conduct and changes in deal landscape can shift in a way that ultimately changes the result of the entire fairness assessment. Similarly, it would seem plausible, by the Chancery Court's reasoning, that the occurrence of other events—such as a broader market sell-off, or a substantial decline in the target corporation's business—could serve as the basis for a transaction that initially appeared unfair to become entirely fair at a later point in time.

ACP Master also illuminates the potential effect of including a majority of the minority stockholder vote as a condition to a controlling stockholder buyout or in an entity's governing documents. By repeatedly threatening to vote down the deal at $2.97 per share, Clearwire's minority stockholders leveraged the required majority of the minority vote to extract a meaningfully higher final offer from Sprint and Softbank. In light of the Chancery Court's decision that the transaction was ultimately entirely fair, and the resurgence of "bumpitrage," with activist investors threatening to engineer "no" votes on deals unless the acquirer increases the deal price, deal participants would be well-advised to carefully consider the desired benefits of a majority of the minority vote provision against the potential and very real downside of being "held hostage" by activist investors.

Of course, nothing in M&A should ever be done in a vacuum, and there is certainly no "one size fits all" strategy. Deal participants should carefully weigh whether the transaction would benefit more from proceeding without a majority of the minority vote (and therefore having greater deal certainty) and facing entire fairness review if, for example, there are (or are expected to be) stockholders in the target's stockholder base who may use the majority of

[3] *DFC Global Corp. v. Muirfield Value Partners, L.P.*, No. 518, 2016 (Del. Aug. 1, 2017).
[4] *Merion Capital L.P. v. Lender Processing Services, Inc.*, C.A. No. 9320-VCL (Del. Ch. Dec. 16, 2016).

the minority vote to extract a higher price, or instead, requiring both a special committee and a majority of the minority vote at the outset to benefit from the more deferential business judgment rule review of the transaction.

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