Factors Court Finds "Troubling" When Selling a Company That Has a Controlling Stockholder—*Virtus v. Eastman Chemical*

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While the Delaware courts' recent trend of increased deference to independent directors' decisions has extended to situations where a controlling stockholder has been involved, *Virtus v. Eastman Chemical*[1] indicates the limits of the inclination to deference in a situation where a controller is involved in the sale of a company to a third party and the factual allegations raise serious issues about the controller's conduct.

The Chancery Court reached its decision on jurisdictional grounds without any finding on the fiduciary claims made. However, the court's tone in its gratuitous recitation of the detailed facts of the case is important in indicating the court's negative view of the target board's and bankers' conduct.

The company, which faced a liquidity crisis and ongoing financial deterioration, but which appeared to have reasonably good longer term prospects, was controlled by a private equity fund manager (the "Fund Manager"). The Fund Manager had already extended the fund's expiration twice (which was the maximum allowed under the fund's agreements), hoping for a turnaround of the company, which represented the fund's largest investment. The fund had held the investment for 12 years.

Generally, absent special circumstances, the courts have found no conflict of interest between a controller and the other stockholders, even when the controller seeks liquidity of its investment. The rationale has been that the controller may be more motivated than other stockholders to sell, but that, once the decision to sell is made, the controller has an identity of interest with the other stockholders in seeking to maximize the price. The only exceptions to the rule have been when the controller does *not* have an identity of interest with the other stockholders because the controller's need for liquidity is so extreme that it can be inferred that the controller would be willing to sell at a price below what other stockholders would accept, or when the controller will receive special benefits in the transaction that would outweigh its interest in obtaining a better price for the shares.

Here, the court indicated that the Fund Manager may not have had an identity of interest with the other stockholders because:

- there was strong evidence that he had reached the point that he wanted to sell at any price;

- he then actually controlled the board's decision to sell; and
- the sale was at a price that appeared to significantly undervalue the company because, the allegations suggested, the bankers work product (produced while they faced a conflict relating to their simultaneously discussing future engagement by the buyer) was poor.

Given these factors, *even though the board acted through a special committee of three directors who on their face were independent, and the sale process included a solicitation of interest from numerous parties, the court was critical of the board and the bankers*.

The court indicated that the following facts supported its critical view of the process:

- the Fund Manager appointed his personal friend to the board and directed him to ensure a sale at any price;
- there was strong evidence that it was not a good time to sell the company;
- the friend was appointed as lead negotiator and the liaison between the board and the bidders and the Fund Manager continually contacted the friend to confirm that he was following the plan to ensure a sale;
- the price was far below earlier indications of interest the company had received; and
- the valuation used by the board, and the bankers' work in general, was faulty.

The court criticized the bankers for:

- not valuing one asset that was of little value to the company or the other bidders but that was the primary asset that the acquiror wanted;
- using multiples and a discount rate that the court characterized as far outside the range of reasonableness;
- formulating a valuation that bore no relation to the comparables; and
- compromised independence—caused by the acquiror having contacted the bankers to speak about future work for the acquiror at the same time the bankers were being engaged by the target company. Even though once engaged the bankers disclosed the discussions to the target company board, the court emphasized its concern about the conflict created by the contacts. This concern appeared to be heightened by the court's view of the "unreasonable" work then performed by the bankers, as well as certain leaks of information to the acquiror from the bankers about the sale process.

The case underscores the court's general approach that, although a board is constrained when a controller is involved since a controller can block alternative transactions, the key is whether the board tried to achieve the best result possible for all of the stockholders.

NOTES

1. Feb. 11, 2015.