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Delaware Insider:

Reining in the "Liquidity Conflict" under Delaware Law

By Jeffrey R. Wolters

Several recent decisions in Delaware have revived interest, particularly among plaintiffs' attorneys, in the so-called "liquidity conflict" – that is, a potential conflict of interest faced by a large stockholder due to a need to liquidate its stock. If simply selling into the market isn't feasible, the theory goes, then the large holder might advocate a sale of the entire company, even on sub-optimal terms. Further, the large holder's desire for immediate liquidity might motivate it to push for a quick sale to a first bidder rather than a market check to seek out higher offers.

Variations of this theory have had some success in recent Delaware cases. In *In re Synthes, Inc. Shareholder Litigation*, C.A. No. 6452 (Del. Ch. Aug. 17, 2012), however, Chancellor Strine sought to push the Delaware jurisprudence back onto the path laid 40 years ago in the famous case of *Sinclair Oil v. Levien*, 280 A.2d 717 (Del. 1971). In so doing, the Chancellor poured cold water on the liquidity conflict.

From *Sinclair Oil* to *McMullin*

The *Sinclair* case has been taught in law schools for decades. Sinclair Oil owned over 90 percent of its Venezuelan subsidiary, Sinven, and decided to pull cash out of Sinven to fund other ventures. It did so in a large dividend, which effectively transformed Sinven from a going concern into a company in liquidation. Minority stockholders brought suit, alleging that the extraordinary dividend was not in the best interest of Sinven or its minority stockholders, but rather was driven entirely by the cash needs of its controlling stockholder. The Delaware Supreme Court held that this motive was largely irrelevant because the result of the transaction was the payment of an equal per-share amount to all stockholders. There was no "self-dealing," and thus no wrong committed by the majority, when the minority received the same pro-rata liquidity.

Thirty years later, the Delaware Supreme Court arguably backtracked from *Sinclair* in *McMullin v. Beran*, 765 A.2d 910 (Del. 2000). This time, the court allowed minority stockholders to proceed with claims for breach of fiduciary duty notwithstanding that the transaction at issue, a sale of Arco Chemical to a third party, paid the minority stockholders the same per-share cash price that the majority stockholder received. Although the court's opinion focused on the fact that the sale process was directed by the majority stockholder rather than the board, the factual thrust of the lawsuit was that the parent ran the sale because it wanted liquidity.

Infogroup, Answers* and *Southern Peru

The underlying tension between *Sinclair Oil* and *McMullin* set the stage for a handful of recent cases that at first seemed to be pulling the law toward *McMullin*, or at least toward a rule that focused on the motive and conduct of the majority even if all shares were treated equally.

The first of these recent cases was *N.J. Carpenters Pension Fund v. Infogroup*, 2011 WL 4825888 (Del. Ch. Sept. 30, 2011). There, the Delaware Court of

Chancery declined to dismiss claims for breach of fiduciary duty brought against a controlling stockholder for orchestrating a sale of the company to a third party. All stockholders received the same per-share cash price. However, the plaintiff alleged that the sale was motivated by the controller's particular need for cash. Indeed, it was alleged that the controller, Gupta, was in desperate need of liquidity to satisfy personal judgments, repay personal loans, and start a new venture; that he had no source of cash inflow or liquid assets (other than his stock); and that he had threatened his fellow directors with lawsuits if they did not approve the sale. Faced with allegations of such self-interest, the court declined to dismiss the complaint.

Similarly extreme, although less colorful, allegations were made in *In re Answers Corp Shareholders Litigation*, 2012 WL 1253072 (Del. Ch. Apr. 11, 2012). There, a minority stockholder alleged that a venture capital firm owned 30 percent of Answers Corporation and decided to force a quick sale to meet its own liquidity needs, even though the company had strong projections and was about to announce a "blowout" quarter. Further, it was alleged that the independent members of the board had acted in bad faith (that is, conscious disregard of their fiduciary duties) in acceding to the sale. The Court of Chancery ruled that in light of the pleaded facts and Delaware's lenient standard for avoiding dismissal of a claim (which requires only that it be "reasonably conceivable" that the plaintiff could recover), the complaint could not be dismissed.

Finally, in *In re Southern Peru Copper Corp. Shareholder Derivative Litigation*, 30 A.3d 60 (Del. Ch. 2011), *aff'd* __ WL __ (Del. 2012), even Chancellor Strine recognized a variant of the liquidity conflict. The case, which resulted in the largest damages award in Delaware M&A history, involved a transaction between Southern Peru and its majority stockholder, Grupo Mexico. Because Grupo stood on both sides of the transaction, the court applied Delaware's exacting "entire fairness" test. The test was not satisfied, primarily because the court found that the price was unfair. However, the court was also critical of the process that led to the transaction, including the fact that a director on Southern Peru's independent committee that negotiated the transaction had a form of liquidity conflict. Specifically, that director was the designee of a large stockholder, which wanted to sell its stake and was negotiating (largely through its director designee) with the majority stockholder for registration rights to enable the sale. Chancellor Strine noted that while he was hesitant to regard this interest as a classic conflict in the sense of self-dealing, it nonetheless skewed the director's incentives – since he "was operating under a constraint that was not shared by all stockholders, which was his employer's desire to sell its holdings" – and cast doubt on whether he should have been on the committee.

The *Synthes* Decision: Reining in the Liquidity Conflict

Soon after *Southern Peru*, Chancellor Strine had another chance to consider the liquidity conflict, in *In re Synthes, Inc. Shareholder Litigation*. This time, the Chancellor rejected the theory in emphatic terms, moving the law back toward the *Sinclair* rule – i.e., that equal treatment of stockholders generally obviates any conflict – and stating that a liquidity conflict was likely to trigger the entire fairness test only in extraordinary circumstances.

The case involved the sale of Synthes, Inc., a global medical device company with headquarters in Switzerland, to Johnson & Johnson. Synthes' 76-year-old chairman controlled over 50 percent of Synthes' stock and, according to plaintiffs, wanted to divest to achieve estate planning and tax goals. The plaintiffs alleged that these interests created a unique "liquidity dilemma" that infected the sale process. Chancellor Strine dismissed the complaint.

Strictly speaking, the dismissal was based on the absence of well-pleaded facts indicating that the chairman was in a rush to sell or had instigated the sale process, or that the sale process was hurried or failed to check the market. More generally, however, the Chancellor also addressed the potency of the liquidity conflict as a theory under Delaware law.

Here he looked to the "venerable and sound" rule of the *Sinclair* case, that "pro rata treatment remains a form of safe harbor under our law." He elaborated that he foresaw only "very narrow circumstances" where a controlling stockholder's need for liquidity could create a disabling conflict of interest irrespective of pro rata treatment, such as (citing *Infogroup*) if the controller forced a "crisis, fire sale" without a market check to satisfy an "exigent need (such as a margin call or default in a larger investment)." The Chancellor added a colorful example of his own to drive home the point that, in his view, the liquidity conflict was more hypothetical than real:

> The world is diverse enough that it is conceivable that a mogul who needed to address an urgent debt situation at one of his coolest companies (say a sports team or entertainment or fashion business), would sell a smaller, less sexy, but fully solvent and healthy company in a finger snap (say two months) at 75% of what could be achieved if the company sought out a wider variety of possible buyers, gave them time to digest non-public information, and put together financing. In that circumstance, the controller's personal need for immediate cash to salvage control over the financial tool that allows him to hang with stud athletes, supermodels, hip hop gods, and other pop culture icons, would have been allowed to drive corporate policy at the healthy, boring company and to have it be sold at a price less than fair market value, subjecting the minority to unfairness.

At the same time, the Chancellor also acknowledged, less conspicuously in a

footnote, that the plaintiffs in *Synthes* had not relied on *McMullin*. That "controversial" case, the Chancellor wrote, offered some support for the liquidity conflict theory. It was inapposite in *Synthes*, however, because the alternative transaction advocated by the plaintiffs in *Synthes* would not have treated all stockholders (including the controller) on a pro rata basis. Thus, looking to the future, while Chancellor Strine is clearly skeptical of the liquidity conflict theory, the Delaware courts have probably not seen the last of it.

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