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[Delaware Chancery Court Provides Further Clarification as to When the "Entire Fairness" Standard of Review is Appropriate and How It Will Be Applied](#)

On January 14, 2011, the Delaware Chancery Court issued an opinion in *In re John Q. Hammons Hotels Shareholder Litigation* that a merger transaction in which a controlling stockholder received consideration different than that received by the minority stockholders met the “entire fairness” standard. This opinion followed the Court’s determination in October 2009 that “entire fairness,” was the appropriate standard of review in this case.

Factual Background

The lawsuit arose following a going private transaction involving the merger of John Q. Hammons Hotels, Inc., a publicly traded Delaware corporation, with and into an unaffiliated third party. In early 2004, Mr. Hammons (the Chairman, CEO and controlling stockholder of JQH) informed the Board that he had begun discussions with third-parties regarding a potential sale of JQH or his interest in JQH. The Board thereafter formed a special committee of the Board to evaluate and negotiate a proposed transaction on behalf of the minority stockholders and to make a recommendation to the Board regarding any such transaction.

After nine months of negotiations and deliberations between potential acquirors and the special committee, the Board (without the vote of Hammons who recused himself from the Board vote) approved an offer from an unaffiliated third party for \$24 per share for shares of Class A common stock. JQH stock had been trading at \$4 - \$7 per share prior to the rumors of the merger. Pursuant to the terms of the merger agreement, the merger was conditioned on a waivable requirement that the merger agreement be adopted by the affirmative vote of a majority of the shares of Class A common stock held by unaffiliated holders. At a duly held stockholder meeting, more than 72% of the outstanding shares of Class A common stock voted to adopt the merger agreement.

After the consummation of the merger, a group of minority Class A stockholders brought a class action suit against Hammons for, among other things, allegedly breaching his fiduciary duties by negotiating an array of private benefits for himself that were not shared with the minority stockholders.

Standard of Review/Ruling

In an earlier ruling, the Court determined that “entire fairness” is the proper standard of review for this transaction, and not the less onerous business judgment rule favored by the defendants. The Court noted that the business judgment rule would have been appropriate but for certain procedural deficiencies in the approval of the transaction. The Court stated that in a case where the controlling stockholder and the majority are in a sense “competing” for portions of the consideration, there must be “robust procedural protections in place to ensure that the minority stockholders have sufficient bargaining power.”

The Court ruled that the business judgment rule would have applied if the merger was (1) recommended by a disinterested and independent special committee of the board and (2) approved by a majority of all minority stockholders by a vote that is not waivable. In *Hammons*, the transaction was approved by a majority of the minority of stockholders voting on the matter, but such vote could have been waived by the special committee.

On the first factor of the "entire fairness" analysis, i.e., "fair dealing", the Court based its opinion on the following factors:

1. the special committee that negotiated and approved the transaction satisfied the threshold requirements for independence (e.g., it retained independent and skilled legal and financial advisors, held dozens of meetings over the 9 month period leading up to the merger and negotiated with several interested parties, all resulting in a transaction in which the unaffiliated Class A stockholders ultimately received \$24 per share, an 85% increase over the initial offer);
2. members of the special committee were highly qualified and had extensive experience in the hotel industry;
3. members of the special committee understood their authority and duty to reject any offer that was not fair to the unaffiliated stockholders as evidenced by their rejection of the initial offer from a separate third party;
4. evidence at trial demonstrated that the members of the special committee were thorough, deliberate and negotiated at arm's length with both competing potential acquirors over a nine month period to achieve the best deal for the minority stockholders.

Moreover, as to the plaintiffs' claim that Hammons coerced or strong-armed the special committee, the Court noted that the plaintiffs provided no credible evidence at trial demonstrating any improper conduct on the part of Hammons and stated that "plaintiffs have not come close to showing the Merger resulted from an unfair process."

On the second factor of the "entire fairness" review, i.e., "fair price", the Court analyzed the testimony made by the valuation experts from both sides. Ultimately, the Court found the defendants' valuation expert to be more credible, believable and well-reasoned.

Finally, as to the issue of whether Hammons breached a fiduciary duty to the minority stockholders, the Court found that because he did not participate in the approval of the merger as a director, he was not on both sides of the merger, he did not make an offer as a controlling stockholder and he did not engage in any conduct that adversely affected the merger consideration obtained by the unaffiliated minority stockholders, he did not breach any fiduciary duties to the minority stockholders.

For companies with controlling stockholders that engage in M&A transactions, this case illustrates the importance of establishing an independent and disinterested special committee of the board and giving the committee the power to negotiate the transaction. In addition, potential targets should note the importance of procedural safeguards in approving transactions, such as a non-waivable vote of a majority of all of the minority stockholders. Such safeguards will help boards

of directors preserve the protections afforded by the business judgment rule and help to avoid challenges to their decisions by disgruntled stockholders.

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