CHAPTER

3

Identifying and Managing Conflicts of Interest

Introduction

Directors owe a duty of loyalty to stockholders; thus, decisions of the board are to be made without the taint of any personal interests of directors that may be in conflict with the interests of stockholders. Therefore, when a board of directors assesses strategic alternatives, conducts a sales process or negotiates a business combination, one of its most important functions is to identify and manage conflicts of interest to prevent them from compromising the board’s objective judgment and impairing its decision-making process.

A board’s failure to recognize and properly address conflicts of interest on the part of directors, officers, a controlling stockholder or board advisors can lead a court to find that directors or officers have breached their fiduciary duties, possibly resulting in an injunction against completing a business combination or personal liability for the conflicted persons or,
in certain limited circumstances, the entire board. The mere presence of a conflict of interest will not inevitably lead to a breach of directors’ fiduciary duties. Conflicts that are not properly addressed, however, may result in director or controlling stockholder liability, and conflicts on the part of directors or a controlling stockholder may subject a transaction to judicial review under the stringent entire fairness standard. Even where the deferential business judgment rule applies, conflicts that are not disclosed to the board or properly managed can lead to findings of breach of fiduciary duty, although directors who are wholly unaware of the conflicts would not likely face personal liability. Moreover, if stockholders are asked to vote on a transaction or make other decisions, such as whether to exercise appraisal rights, the failure to disclose material conflicts to the stockholders can constitute a separate breach of the directors’ duty of disclosure and compromise the potential insulating effects of a stockholder vote in favor of the transaction.

It is good practice for a board to ensure that any conflicts of interest or potential conflicts are identified, evaluated and disclosed; take steps reasonably designed to ensure that conflicts do not adversely affect the board’s decision-making process or the terms or price of any deal that is reached; and make a record of having done so. There is no one-size-fits-all way to manage conflicts of interest, and the approach or approaches that are appropriate under a particular set of circumstances will depend on factors such as the nature of the transaction, who is conflicted, the nature of the conflict, the composition of the board and other practical considerations. The bottom line is that conflicts often occur, and while

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1 Conflicts of interest on the part of advisors, such as legal or financial advisors, are beyond the scope of this chapter. Financial advisor conflicts are discussed in Chapter 6, Engagement and Use of the Financial Advisor. Legal advisors are subject to strict canons of ethics governing conflicts of interest, which are beyond the scope of this Handbook. See ABA Model Rules of Prof’l Conduct, especially Rules 1.7–1.11.  

2 See In re El Paso Corp. S’holder Litig., 41 A.3d 432, 443-44 (Del. Ch. 2012) (“El Paso”) (finding “a reasonable probability of success on a claim that the Merger is tainted by breaches of fiduciary duty,” based in part on the CEO’s failure to disclose to the board his effort, concurrent with negotiating the merger, to negotiate for himself together with other management members to buy one of the company’s businesses from the acquirer following the merger). Further discussion of this case can be found at note 24. In El Paso, however, the court held it was unlikely the independent directors could be held liable in monetary damages as they were unaware of the conflict. El Paso, at 448.  

conflicts do not inevitably taint the directors’ decision-making process, they need to be managed carefully.

This Chapter examines three categories of conflicts: (1) director conflicts of interest (and the related issue of lack of independence); (2) conflicts of officers and other members of management; and (3) controlling stockholder conflicts. In each category, the Chapter describes how such conflicts can be identified and how they can be addressed and mitigated.

**Director Conflicts of Interest and Lack of Independence**

*What Are They?*

The threshold step in identifying and properly managing director conflicts of interest and issues concerning director independence is to understand how courts define these concepts and how such conflicts or lack of independence could adversely affect a sales process or the terms of a business combination.

Although often conflated, conflicts of interest and lack of independence are related but distinct concepts. 4

**Conflicts of Interest**

A director will have a conflict of interest when he or she personally receives a benefit (or suffers a detriment) from a transaction, the benefit is not generally shared (or detriment suffered) with other stockholders, and the benefit “is of such subjective material significance to that particular director that it is reasonable to question whether that director objectively considered the advisability of the challenged transaction to the corporation and its shareholders.”5 An interest is considered “material” for this purpose if it is significant enough, “in the context of the director’s economic circumstances, as to have made it improbable that the director could perform her fiduciary duties to the . . . shareholders without being influenced by

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4 See Orman v. Cullman, 794 A.2d 5, 25 n.50 (Del. Ch. 2002) (“Orman”) (noting that, unlike a conflict of interest, “[i]ndependence’ does not involve a question of whether the challenged director derives a benefit from the transaction that is not generally shared with the other shareholders. Rather, it involves an inquiry into whether the director’s decision resulted from that director being controlled by another.”) (emphasis in original).

5 Orman, at 25 n.50.
her overriding personal interest." A director will also have a conflict of
interest when he or she stands on both sides of a transaction, and in that
situation no showing of materiality is required.  

Circumstances in the M&A context that may give rise to a conflict of
interest on the part of a director include the following:

- A business combination in which a director is on both sides of the
  transaction, including a going-private transaction in which one or
  more directors are part of the acquisition group.  
- Serving as a director or officer of a potential counterparty.
- A director’s (or a director’s employer’s) significant ownership of a
  particular class or series of stock where the interests of holders of such
  class or series are not aligned with the interests of holders of other
  classes or series (for instance, where a director owns preferred stock,
  and preferred stockholders would rather see the quick consummation
  of a cash-out merger at a price that will return their investment,
  whereas common holders would prefer a stand-alone strategy, a stock
  transaction in which they can participate in future upside, or further
  shopping to generate a higher deal price), or in rare cases where the
  director has special liquidity needs not shared by other stockholders.  

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6 In re Gen. Motors Class H S’holders Litig., 734 A.2d 611, 617 (Del. Ch. 1999) (citing
As explained in Chapter 2, Fiduciary Duties of Directors Generally in a Business
Combination, in assessing whether a particular benefit or detriment is material,
Delaware courts utilize a subjective, “actual person” standard. See Cinerama, Inc. v.
II, 634 A.2d at 363-64.
7 See Technicolor III, at 1167; Technicolor II, at 363-64; Orman, 794 A.2d at 24 n.50
(citations omitted).
8 E.g., Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (“UOP”) (criticizing the
fact that the members of the subsidiary’s board of directors who were also officers or
directors of the parent company participated in deliberations of the subsidiary’s board
on a proposed merger in which the parent would acquire the publicly held shares of the
subsidiary).
9 E.g., In re Trados Inc. S’holder Litig., 73 A.3d 17, 52-54 (Del. Ch. 2013) (“Trados”)
(finding non-employee directors who were nominees of venture capital investors
conflicted because the venture capital investors who appointed them to the board,
under their specific appointment right to do so in the charter, stood to benefit from the
transaction by achieving an exit from their investment regardless of impact on common
stockholders). See also note 12 and further discussion in Chapter 16, Private
Company Issues.
10 New Jersey Carpenters Pension Fund v. Infogroup, Inc., 2011 WL 4825888, at
*9-10 (Del. Ch. Sept. 30, 2011, revised Oct. 6, 2011) (“Infogroup”) (holding that
Chapter 3: Identifying and Managing Conflicts of Interest

• For a director who is also an officer, the prospect of losing employment as a result of the transaction, receiving significant severance payments or other change of control benefits, receiving material compensation under a consulting or non-compete agreement entered into as part of the transaction, or the right to roll over equity into a new entity.11

• For non-employee directors, change of control benefits adopted with reference to a transaction, or the prospect of material compensation under a consulting or non-compete agreement entered into as part of the transaction, or other benefits, such as the right to roll over equity into a new entity.

Lack of Independence

Even if a director does not have a conflict of interest with respect to a transaction, he or she still may be deemed incapable of making an independent judgment if the director lacks independence from a person or entity that does have such a conflict. A director will lack independence if he or she is “‘beholden’ to or under the control, domination or strong influence of a [person or entity] with a material financial interest in the transaction under attack, which interest is adverse to that of the corporation.”12

the complaint adequately pleaded a claim that a director had a material conflict of interest in voting to approve a merger due to his personal need for liquidity; Chen v. Howard-Anderson, 87 A.3d 648, 671 (Del. Ch. 2014) (noting that “liquidity is one ‘benefit that may lead [stockholder-directors] to breach their fiduciary duties,’” and that such directors may breach their duty of loyalty where the “‘desire to gain liquidity . . . caused them to manipulate the sales process . . . .’” (quoting In re Answers Corp. S’holder Litig., 2012 WL 1253072, at *7 (Del. Ch. Apr. 11, 2012) (“Answers”))); cf. In re Synthes, Inc. S’holder Litig., 50 A.3d 1022, 1035-36 (Del. Ch. 2012) (“Synthes”) (explaining that generally speaking, a controlling stockholder’s financial interest in receiving liquidity through a transaction does not establish a disabling conflict of interest when all stockholders are treated equally, but noting that there may be “very narrow circumstances in which a controlling stockholder’s immediate need for liquidity could constitute a disabling conflict of interest irrespective of pro rata treatment”).

11 E.g., Oliver v. Boston Univ., 2006 WL 1064169, at *27 (Del. Ch. Apr. 14, 2006) (holding that a CEO/director was conflicted because “every dollar the minority common shareholder received was likely to reduce the Asset Value Realization Bonus that he would receive as a consequence of the merger”).

12 Friedman v. Beningson, 1995 WL 716762, at *4 (Del. Ch. Dec. 4, 1995); see also Trados, at 54-55 (stating that even though a director was neither an officer of the company nor a representative of a conflicted venture capital preferred stockholder, his “current and past relationships with [the venture capital firm and one of its principals] resulted in a sense of ‘owingness’ that compromised his independence”);
Such influence might exist where there is a close personal, employment or familial relationship, or where a person or entity has the unilateral power to decide whether a director continues to receive a material benefit.\textsuperscript{13} Keep in mind also that although a director might not currently depend on a person for additional wealth or status, if that director has been so dependent in the past on a person, there could be an appearance of a “quid pro quo.”

Following are examples of relationships that might give rise to a lack of independence on the part of a director.

- A material business relationship with a counterparty to the transaction (including a member of the acquisition group), such that the director would be deemed “beholden” to the counterparty.
- A close familial relationship or close, long-standing friendship with a counterparty to the transaction.
- A close familial relationship or close, long-standing friendship with a person who otherwise has a conflict of interest with respect to the transaction (such as an officer who might lose employment as a result of the transaction).\textsuperscript{14}
- Being dependent on a conflicted party for a material part of the director’s compensation or net worth.

\textit{Goldman v. Pogo.com, Inc.}, 2002 WL 1358760, at *3-4 (Del. Ch. June 14, 2002) (finding reasonable doubt as to the independence of a director from a venture capital firm with a financial interest in the challenged transaction, because he “previously served on the board of directors of at least two other [venture firm portfolio] companies, coupled with the allegation that [the venture capital firm] used him as a short-term high-ranking executive in companies in which [the firm] invested”).

\textit{Orman}, at 25 n.50. Notably, whether a director is considered independent for stock exchange listing purposes is not necessarily relevant for determining whether he or she will be considered independent with respect to a particular transaction for purposes of fiduciary duty analysis. \textit{In re Oracle Corp. Deriv. Litig.}, 824 A.2d 917, 942 n.62 (Del. Ch. 2003) (“Oracle”) (finding that the ties between certain directors who were professors at Stanford University and other interested directors who were also the most senior officers who served on an advisory board at, and made substantial gifts to, that same university (along with gifts by the company itself) were significant enough to create lack of independence for service on a special litigation committee).

\textsuperscript{13} “If a director indicates that he is a ‘friend’ of the CEO, the thickness of that friendship needs to be explored. A couple of rounds of golf a year is one thing, shared family vacations every year for a decade is quite another, because the friendship may be more in the nature of a familial one.” Leo E. Strine, Jr., \textit{Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-making and Reduce the Litigation Target Zone}, 70 BUS. LAW. 679, 689 n.19 (Summer 2015) (“Documenting the Deal”).
• Other relationships that will likely produce a bias in favor of a person with an interest in conflict with the interests of stockholders generally.15

On the other hand, the courts have identified a variety of common situations that will not, standing alone, establish a finding of conflict of interest or lack of independence on the part of a director. Examples include the following:

• The receipt of director fees paid in accordance with the corporation’s compensation policies.

• A social relationship with a conflicted party, including shared memberships in country clubs or other social or alumni organizations.16

• A business relationship, without further evidence that the relationship would affect the director’s ability to exercise independent judgment.17

15 E.g., Sandys v. Pincus, 152 A.3d 124, 126 (Del. 2016) (“[T]he controlling stockholder and the director and her husband co-own an unusual asset, an airplane, which is suggestive of an extremely intimate personal friendship between their families.”).

16 See Orman v. Cullman, 2004 WL 2348395, at *5 n.54 (Del. Ch. Oct. 20, 2004); see also Beam v. Stewart, 845 A.2d 1040, 1050 (Del. 2004) (finding in the context of demand futility that “[a]llegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director’s independence”); but see Oracle, at 942-45 (finding, in the context of a special litigation committee, that the ties between certain directors who were professors at a university and other interested directors who served on an advisory board at, and made substantial gifts to, that same university (along with gifts by the company itself) were significant enough to create an independence concern); Biondi v. Scrushy, 820 A.2d 1148, 1150 (Del. Ch. 2003) (noting the “troubling composition” of a special committee helped undermine its independence: two of three members serve with Scrushy, the CEO accused of wrongdoing, on the board of the National Football Foundation and College Hall of Fame, of which one of them is the chairman, plus the long-standing personal ties between them and Scrushy, who are both large contributors to college sports programs in Alabama, indeed a stadium at a college in Alabama is named after them). In short, it takes further outside interactions and relationships to produce a lack of independence, as discussed above, e.g., at notes 9, 12 and 13 and related text.

17 But see Kahn v. Tremont Corp., 694 A.2d 422, 429-30 (Del. 1997) (“Tremont”) (holding that pre-existing business relationships of special committee members with a controlling stockholder (a prior but recent consulting relationship and prior but recent positions on boards of companies of the controlling stockholder) disqualified them and their special committee from functioning independently).
The Role of Directors in M&A Transactions

• Nomination or election of the director by a stockholder who has a conflict of interest.\(^{18}\)

• Ownership of target stock that would benefit from the proposed business combination pro rata with the corporation’s stockholders generally.\(^{19}\)

Concealment by a director of a relationship that may subject the director to undue influence with respect to a decision before the board is a breach of the duty of loyalty by that director, just like the failure to disclose a director’s own conflict of interest.

Impact of Director Conflict or Lack of Independence

While an M&A transaction has many players, the board of directors is the key decision-maker, and in the case of litigation, the courts will carefully scrutinize the relationships and financial motivations of each member of the board of directors to determine if there has been a breach of loyalty. The decision-making process of the board may be tainted by the participation of a director who has a conflict or lacks independence as to the issue being discussed, unless the director’s conflict or relationship is disclosed and managed. Thus, where a director has a conflict of interest or lacks independence from a conflicted controlling person, the board is expected to take steps to avoid that director tainting the board’s decision-making process or otherwise affecting the sales process.

Even where a majority of the board is disinterested and independent, the entire fairness standard of review could still apply if even a single director fails to disclose a material conflict or lack of independence to his or her fellow directors.\(^{20}\) Without such disclosure, there can be no

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\(^{18}\) See Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984) (“It is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of the corporate election. That is the usual way a person becomes a corporate director.”); Andreae v. Andreae, 1992 WL 43924, at *4-5 (Del. Ch. Mar. 3, 1992, revised Mar. 5, 1992) (noting that Delaware courts have consistently rejected the argument that a director cannot act independently of the entity that appointed him or her to the board); Stein v. Orioff, 1985 WL 11561, at *3 (Del. Ch. May 30, 1985) (finding that directors appointed by controlling stockholder were not necessarily beholden to the controlling stockholder); Kaufman v. Belmont, 479 A.2d 282, 287 (Del. Ch. 1984) (noting that a court will not assume that a director designated by a dominant stockholder will fail to perform his fiduciary duties).

\(^{19}\) See Orman, at 26-27.

\(^{20}\) See, e.g., Technicolor III, at 1168 (approving the Court of Chancery’s holding that “a material interest of ‘one or more directors less than a majority of those voting’
assurance that disinterested and independent directors were not influenced by a conflicted director’s statements or recommendations, while unaware of the conflict and unable to appreciate what influence that conflict might have had. A court will apply entire fairness review in such circumstances if a reasonable board member would have considered the conflict or lack of independence a significant fact in evaluating the proposed transaction. Moreover, where the entire fairness standard applies, the failure of a director to disclose a conflict or lack of independence, or the failure of the board to properly address such conflict or lack of independence to ensure it does not negatively influence a transaction process, may be evidence of lack of fair process.

Likewise, when enhanced scrutiny review under Revlon or Unocal applies, the failure to disclose or properly manage a conflict or lack of independence, even on the part of a single director, could potentially be evidence that the board did not conduct a reasonable process and thus lead to an injunction or personal liability for the conflicted director and for directors aware of the conflict who did not address it. For example, if a director of a corporation who negotiates the sale of the company fails to disclose to the other directors that he was concurrently negotiating with the purchaser for himself together with other members of management to acquire a business from the purchaser after the merger, that failure to disclose a personal interest will lead a court to conclude that the merger is tainted by breach of fiduciary duty.

would rebut the application of the business judgment rule if the plaintiff proved that “the interested director controls or dominates the board as a whole or that the interested director failed to disclose his interest in the transaction to the board and a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction” (emphasis in original).

See HMG/Courtland Props., Inc. v. Gray, 749 A.2d 94, 113 (Del. Ch. 1999) (“HMG/Courtland”) (stating that a plaintiff can rebut the application of the business judgment rule by “producing evidence that a director had a non-disclosed, material interest in the challenged transaction and ‘a reasonable director would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction’”).

HMG/Courtland, at 116 (concluding that a director’s failure to disclose his conflicting interest rendered the process “anything but fair”).

These standards of judicial review are discussed in Chapter 2, Fiduciary Duties of Directors Generally in a Business Combination.

El Paso, at 447 (finding that a CEO/director’s interest in negotiating a post-merger management buyout of assets from the combined company created an incentive to seek less than maximum value in the merger for stockholders generally, and the
Below we discuss means of identifying and managing director conflicts of interest, and for this purpose the term “conflicts of interest” will include lack of independence unless the context makes clear otherwise.

**Identifying Director Conflicts of Interest**

What steps can directors take to help identify potential director conflicts or lack of independence? The goal of the inquiry, at all stages of a transaction, is to identify all present, past or likely future professional, financial, employment or personal relationships (with particular attention to relationships with all likely counterparties, investment bankers, counsel and other interested parties in the transaction) that might compromise a director’s objectivity in evaluating or supervising the development of a business combination. The directors should make a record, through minutes or some form of report to the board, to show the steps that were taken to identify potential conflicts and possible lack of director independence, and the results of those steps.

Many corporations ask directors to complete annual independence questionnaires. While these questionnaires can help determine directors’ independence under stock exchange and federal securities law rules, they can also be helpful in identifying potential conflicts in connection with a sales process or merger transaction. These questionnaires, however, are only the beginning of the inquiry with respect to any particular business combination transaction. The idea is to use a process that will result in full disclosure to the board of potential conflicts and allow the board to assess their significance and craft an appropriate mitigating response.

Additionally, the board should consider the impact of the terms of director compensation, including equity compensation arrangements, and how director compensation might be affected by a particular transaction in a way that might create conflicts. The board should understand that directors who are also officers or employees of the corporation are almost always subject to conflicts, given the effect of any transaction on their employment status and their compensation arrangements. 25

Board members should be provided with the names of potential counterparties as they become known to the board. Directors should be
asked to identify any relationships with these counterparties. Even though a mere social or past employment relationship may not generally be enough to create a disabling interest or suggest controlling influence, directors are well advised to disclose any past or present relationships with counterparties or their management or board members so the board can consider the potential that a particular director favors or disfavors a particular bidder. It is wise to err on the side of over-disclosure in identifying past, present or likely future relevant relationships that might suggest to a third party that a director may not be completely objective with respect to the outcome because of the relationship. It is potentially embarrassing or worse for the board to learn of a relevant relationship after the fact.

If a director is employed by, or has a familial or other material relationship with, a significant stockholder of the selling company, it is important for the board to carefully assess the situation if there is any possibility of a conflict on the part of that stockholder. For example, such a director might be deemed to lack independence in connection with a sales process if the stockholder is considering an offer to buy the balance of the company. Similarly, if a director is affiliated, or has a material relationship, with a major customer or supplier that might be affected by a proposed sales transaction, the director should disclose such a relationship to the board. Customers, suppliers, or service providers may have contracts with the company that could be jeopardized by a change of control transaction, or that may result in benefits to the customer, supplier or service provider, such as a change of control termination right or change of control payment.

Often the discussion about relationships with counterparties takes place at a board meeting. In some cases, it is advisable to have an initial meeting between counsel and each individual director, outside of a formal board or committee meeting, about relationships that the director may have with various counterparties, so that the director and counsel have time to think about the relationships, past and present, that might be significant. The goal is not to put directors on the spot, but rather to make sure there is full disclosure of any relationships that might create a conflict for that director or call into question his or her independence. When a preliminary, private conversation about relationships takes place, however, it is critical that any significant relationships be disclosed on the record at a board or committee meeting, to protect the board by showing that the inquiry was

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26 If, however, the stockholder advises the board that it is merely a seller and is willing to take the same consideration offered to the other stockholders, then the director may be deemed not to lack independence in that circumstance.
made and the board had knowledge and took any appropriate steps to address any potential conflicts.

**Judging the Materiality of Relationships and Interests**

As noted above, not every relationship or interest creates a disabling conflict; rather, the relationship or interest must be financially or otherwise material to that director. To determine materiality, a court or the directors making the determination must have all material information bearing on the matter. Accordingly, one must know the material terms of any financial or other relationship, as well as facts regarding the individual director’s personal financial or other circumstances.

For example, it is necessary to know the nature and amount of any benefit received by the director, and to compare that benefit with the director’s net worth and annual income to determine if the benefit is material to the director.27 If, however, a director acknowledges that she has a conflict or lacks independence with respect to a particular transaction and the board proceeds on that assumption, it ordinarily would not be necessary for the board to examine every detail of the conflict or the relationship. In such circumstances, it is generally sufficient for the director to alert the board and generally describe that conflict or relationship and for the directors to manage the conflict as described below.

**Managing Director Conflicts of Interest**

*In General*

Fortunately, neither a material conflict of interest nor a lack of independence on the part of a director, or even on the part of a majority of the board, will result automatically in a finding of breach of fiduciary duty. Once the board identifies a questionable influence on a director, it is in a position to consider the effect of this influence—including the possible taint on the decision-making process from that director’s participation—and the

27 See *In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531, 536 (Del. Ch. 2003) (finding that the compensation received by certain directors was not “a material part of their annual incomes or net worth”) (emphasis added); *Goodwin v. Live Entm’t, Inc.*, 1999 WL 64265, at *20 (Del. Ch. Jan. 22, 1999) (finding that a complaint did not adequately allege that a director was interested in a transaction because the complaint failed to indicate that potential sums received in the transaction would have, in the context of director’s “annual income and net worth,” been of such a value to the director as to make it difficult for the director to evaluate the potential transaction on its merits to the corporation’s stockholders) (emphasis added).
value of the director’s input, and can craft appropriate mitigation strategies, as discussed below. There is no one-size-fits-all means of managing director conflicts and independence concerns, and the steps a board takes will necessarily depend upon specific facts and circumstances. Keeping in mind that the ultimate goal is demonstrating the integrity of the board’s decision-making process in the face of the influence, it is often better to exclude a director or otherwise limit his or her participation in the process by one of the mechanisms discussed below, out of caution and a desire for the board to arrive at a decision not subject to question or reproach.

As facts about prior and current relationships or other relevant facts about interest or influence as to one or more directors are disclosed, the board members who are deemed independent and disinterested should discuss the facts and determine what if any steps are warranted to address the situation. The particular steps to ensure that the conflict is managed effectively will necessarily be based on a “facts and circumstances” assessment. Mitigation should be tailored to the particular influence or interest disclosed. For example, even if a director has a significant relationship with one potential counterparty, that fact would not necessarily mean that the director should be recused from all discussions about the ongoing sales process, particularly if the counterparty has not yet indicated serious interest in a transaction or is unlikely to bid or to be the winning bidder. The director would, however, owe a duty of confidentiality regarding the company’s strategies and plans, and steps would need to be taken to confirm that confidentiality is preserved. As the sales process develops, the board must remain vigilant as to any existing or developing conflicts of interest and their potential impact; as the process evolves, additional counterparties may appear, or other relationships with customers, suppliers or other persons may become relevant.

Techniques to protect the integrity of the board’s decision-making process generally range from use of an independent board committee and/or a vote of a majority of unaffiliated stockholders to recusals or abstentions. In addition, retaining independent legal and financial advisors to assist in negotiating and documenting the transaction and obtaining a fairness opinion from the independent financial advisor(s) are helpful to demonstrate

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28 The Chief Justice of the Supreme Court of Delaware, Leo E. Strine, Jr., has observed that “if conflicts were surfaced, contained and addressed, and a strong hand was given to the impartial members of the board, the plaintiffs’ ability to suggest that those conflicts infected the why [of a particular deal] is impaired.” Documenting the Deal, at 681.
reasonableness and overall fairness of the process or transaction. These techniques are discussed briefly below.

**Use of an Independent Board Committee**

Where the entire fairness test is potentially applicable because a majority of the board is actually or potentially conflicted or lacks independence, the most common—and perhaps the most effective—means of managing conflicts is to appoint a special committee of independent and disinterested directors to evaluate alternatives, negotiate, and approve a transaction (or, in circumstances where the law does not permit a committee to take the action itself, recommend the transaction to the full board for approval). The courts have recognized that such a committee, if sufficiently empowered and properly functioning, can approximate the role of an entirely independent board of directors and of arm’s-length negotiations by insulating from the process those directors whose self-interest or lack of independence might conflict with the best interests of the corporation and all of its stockholders.29 The use of a special committee process can also constitute strong evidence that an otherwise conflicted transaction satisfies the test of entire fairness.30 Moreover, the use of a well-functioning independent committee of directors could potentially invoke the protections of the business judgment rule31 and/or shift the burden of proof back to a stockholder plaintiff to establish the unfairness of the transaction.32 See Chapter 8, Special Committees, for more information about the functioning of a special committee.

Even where a special committee comprised of entirely independent and disinterested directors does not have the full powers of a burden-shifting special committee as discussed in Chapter 8, the use of such a committee can mitigate conflicts of interest of other directors by allowing the independent directors to review information, deliberate, discuss strategy,
Chapter 3: Identifying and Managing Conflicts of Interest

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direct negotiations and formulate recommendations for the full board without the participation of the conflicted directors. Thus, even where a particular transaction is not one that will be subject to entire fairness review, or where the use of a full-fledged special committee process as described in Chapter 8 is impractical, the use of a special committee of disinterested and independent directors can isolate conflicted directors from deliberations, negotiations and confidential information and can be an appropriate means to manage director conflicts to ensure that these do not negatively influence the outcome.

The board of directors may also form a transaction committee to assist the board of directors in running a sales process or negotiating and evaluating a transaction. Boards sometimes form transaction committees in circumstances where the transaction is not one that requires an entire fairness review, or where use of a full-fledged special committee as described in Chapter 8 is not needed or is not practicable. Such a committee can provide benefits of procedural convenience and can also be used in the same manner as the special committee to ensure that conflicts do not potentially taint a process, even if the transaction committee process may not bear all the hallmarks of the type of special committee process needed to obtain the cleansing or burden-shifting effect in the entire fairness context as discussed in Chapter 8.

Thus, a transaction or special committee comprised of disinterested and independent directors, perhaps initially formed for convenience, can also be used as an appropriate means to address conflicts, where using recusals or abstentions would be awkward or impractical, or where a conflicted director declines to recuse or abstain, by allowing the independent directors to deliberate and review information without the participation of the conflicted directors. The use of such a committee will also eliminate opportunities for conflicted directors to improperly influence (or be perceived as having improperly influenced) the process and without the need for those directors to recuse themselves from the meetings, or portions of them. Likewise, a committee can provide a means of keeping confidential information and deliberations from being conveyed to conflicted board members, who might intentionally or inadvertently convey such information to their favored counterparty.

33 Some practitioners will choose to call this a “transaction committee” in order to avoid an implication that the entire fairness standard applies.

34 See Chapter 5, Board Process in Considering Sales Transactions.
The Role of Directors in M&A Transactions

While the use of either a transaction committee or a special committee with a limited mandate might have certain similarities to a full-fledged burden-shifting special committee process, as described in Chapter 8, Special Committees, it will lack certain attributes required for a special committee process to cleanse a transaction that would otherwise be subject to review under the entire fairness standard (as, for example, having the power to reject or recommend the transaction or the ability to retain independent advisors). Thus, a board might choose to give the transaction or special committee a less robust mandate than would be required in order for a committee process to have a cleansing effect in the entire fairness setting. Still, the fact that a committee of entirely independent and disinterested directors has deliberated in confidence outside the presence of conflicted directors can be strong evidence of a well-run and reasonable process.

Majority of the Unaffiliated Stockholder Vote

Another technique to address director conflicts of interest or lack of independence is to condition the authorization of the transaction on the affirmative vote of stockholders who hold a majority of the outstanding voting power not held by conflicted directors, their affiliates, or persons or entities who exercise control over the conflicted directors. This type of unaffiliated stockholder vote is referred to as a “majority of the minority” stockholder vote, and is sometimes used to help ensure the fairness of controlling stockholder transactions. In circumstances involving a conflicted board majority (and no controlling stockholder conflict), the effect of such disinterested stockholder approval, if fully informed and uncoerced, should be to re-invoke the protections of the business judgment rule and “as a practical matter, insulate[] the transaction from revocation and its proponents from liability.”

See note 58.

See discussion below regarding controlling stockholder conflicts. See also Chapter 9, Conditioning the Deal on the Approval by a Majority of the Unaffiliated Shares (discussing the effect of a “majority of the minority” vote).

In re PNB Holding Co. S’holders Litig., 2006 WL 2403999, at *14 (Del. Ch. Aug. 18, 2006) (“PNB”); see Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304 (Del. 2015) (“Corwin”); Larkin v. Shah, 2016 WL 4485447, at *10 (Del. Ch. Aug. 25, 2016) (“[T]he only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving a controlling stockholder.”); Chester County Ret. Sys. v. Collins, 2016 WL 7117924, at *2 (Del. Ch. Dec. 6, 2016) (“[W]hen a transaction has been approved by a majority of the disinterested stockholders in a fully informed and uncoerced vote, the business judgment rule applies.”); In re Merge Healthcare Inc. S’holders Litig., 2017 WL 395981,
Recusals and Abstentions

Even where less than a majority of the board suffers from conflicts of interest or a lack of independence, the special committee and unaffiliated stockholder vote procedures can still be effective ways to address any director conflicts that exist. Those methods are not always practical or cost-effective when a majority of the board is free from conflicts and independent and there is no controlling stockholder conflict, however. In such situations, the board may determine that it is sufficient to employ means to minimize or avoid the role that conflicted directors may otherwise have in board deliberations to ensure that such a director is not in a position to misuse confidential information (whether deliberately or inadvertently) or to subtly (or not so subtly) influence board deliberations. Two common means of insulating a conflicted director from deliberations are recusals and abstentions.

“Recusal” involves a director removing himself or herself from a meeting or portions of a meeting, not just refraining from active participation. Recusals protect the confidentiality of information conveyed during meetings, and also avoid putting the director in the position of having divided loyalty regarding confidential information that could be of interest to the other party with whom the director has a relationship, such as the board’s views on various counterparties or negotiation strategy. A recusal, however, does not necessarily require the conflicted director’s complete absence from meetings: the director may appropriately participate in a portion of the meeting to provide his or her viewpoint or material information not known by the other directors, as long as there is sufficient time for the independent and disinterested directors to deliberate in the absence of conflicted directors.

“Abstention” involves a director choosing voluntarily not to vote on a matter, whether due to a perceived conflict, lack of information or other reason. A conflicted director might choose to abstain to avoid any appearance of influencing a vote on the matter for which he or she has a conflict. Abstention alone does not address influence over the deliberations,

at *9 (Del. Ch. Jan. 30, 2017) (holding that, despite a less than pristine sale process, the fully informed and uncoerced vote of the minority stockholders approving the transaction cleansed any fiduciary violations); City of Miami Gen. Empl. & Sanitation Empl. Ret. Trust v. Comstock, 2016 WL 4464156, at *1 (Del. Ch. Aug. 24, 2016) (granting a motion to dismiss based on the presumption articulated in Corwin after finding that none of plaintiff’s disclosure-related allegations had merit and the stockholder vote was fully informed).
However; to avoid allegations of undue influence, a director would recuse himself or herself entirely from any discussions of the transaction.

Note, however, that a conflicted or potentially conflicted director may have a right under applicable law to attend board meetings and might technically be entitled to all of the information provided to board members generally. Thus, to effect either recusal or abstention, the conflicted director must *volunteer* to remove him- or herself from the meeting and/or to abstain from voting. Moreover, neither abstention nor recusal from the deliberations will adequately address confidentiality or privilege concerns, unless the conflicted director also agrees to waive the right to receive and review board books, fairness presentations and other information distributed to directors regarding the process or transaction under consideration. See Chapter 5, *Board Process in Considering Sales Transactions* for further discussion of process issues raised by abstentions and recusals.

Often a director who recuses himself or herself from the deliberations about a topic simply chooses not to be present at the meeting or portion of the meeting at which the matter comes to a vote. A director who recuses himself or herself from deliberations might lack sufficient information to form a reasoned business judgment about the decision, and will abstain. Sometimes, however, the vote of a conflicted director is necessary to comply with legal requirements. For example, applicable law may require a particular type of transaction to be approved by the board rather than a committee, and might further require approval by a majority of directors present at a meeting at which there is a quorum. Thus, if a majority of directors are conflicted or lack independence, it is possible that the vote of some or all of these conflicted directors could nevertheless be required to approve a transaction. A question then arises as to how to enable those conflicted directors who have recused themselves from all deliberations to form a business judgment. In such circumstances, it may be helpful to rely upon the deliberations and recommendations of a committee comprised of independent directors, such as a transaction committee or special committee of the board. As discussed above, directors who have recused themselves from relevant deliberations likely could rely on the deliberations and recommendation of the committee in casting their vote.\(^{38}\)

\(^{38}\) Section 141(e) of the Delaware General Corporation Law expressly permits such reliance.
Chapter 3: Identifying and Managing Conflicts of Interest

Officer and Management Conflicts of Interest

Corporate officers and other members of management, whether directors or not, play important roles in any M&A process. Conflicts of interest and lack of independence on the part of management are therefore at least as important to identify and manage as those of directors. This section examines the reasons for that importance, some of the circumstances in which such conflicts may arise, situations to watch for where such conflicts are especially likely to impair the M&A process if not appropriately managed, and common ways to manage such conflicts.

Importance of Management

Officers and other members of management exercise critical influence over the M&A process. Among other things, they are an important source of information for directors about the company’s business and prospects. Management plays a major role in formulating corporate strategy, preparing and maintaining financial information and forecasts, and running any due diligence process. They consult with, and may provide input into the choice of, the company’s legal and financial advisors. Their continued service may be important to potential bidders (some more than others), and their availability and compensation for such service may significantly affect one or more potential bidders’ interest in acquiring the company. Finally, the most senior officers—particularly the CEO—may be instrumental in conducting negotiations with potential bidders. Each of these important functions in the M&A process can be compromised by conflicts of interest on the part of officers and other members of management.

Where conflicts are present, members of management could potentially steer the process toward a particular alternative or type of transaction that

39 Note, however, that courts will be concerned about management’s influence on the selection of advisors for a special committee. See In re Fort Howard Corp. S’holders Litig., 1988 WL 83147, at *12 (Del. Ch. Aug. 8, 1988) (noting in response to the selection by the company’s interested CEO of committee’s legal counsel, “[a] suspicious mind is made uneasy contemplating the possibilities when the interested CEO is so active in choosing his adversary”); Tremont, at 429 (refusing deference to a determination by a special committee, due in part to the fact that the company’s “General Counsel suggested the name of an appropriate legal counsel to the Special Committee, and that individual was promptly retained,” and “the Special Committee chose as its financial advisor a bank which had lucrative past dealings” with the controlling stockholder). For a discussion of the process of engaging legal advisors, see Chapter 5, Board Process in Considering Sales Transactions. For a discussion of best practices in relation to engagement and use of financial advisors, see Chapter 6, Engagement and Use of the Financial Advisor.
is beneficial to management, take steps that adversely affect the directors’ ability to pursue other alternatives or attract competing proposals, fail to take a hard line in negotiations with a favored bidder, or use the due diligence or negotiating process to management’s advantage. For example, the due diligence or negotiating process can be influenced by disclosing or emphasizing (or failing to disclose or emphasize) particular information to particular bidders or even using different body language and verbal emphasis with particular bidders.\footnote{See In re Lear Corp. S’holders Litig., 926 A.2d 94, 117-118 (Del. Ch. 2007) (“Lear”); In re Netsmart Techs., Inc. S’holders Litig., 924 A.2d 171, 193-94 (Del. Ch. 2007); In re SS & C Techs., Inc., S’holders Litig., 911 A.2d 816, 820 (Del. Ch. 2006) (“SS & C”).} Or, by way of a more extreme example, management might engage in improper tipping of a favored bidder.\footnote{Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1264-65 (Del. 1988) (enjoining an acquisition because during an auction process the CEO, unbeknownst to the board, tipped off a favored bidder about the terms of a hostile bidder’s acquisition proposal).} Even where independent directors are actively engaged in a sales process or merger negotiations, conflicted members of management could potentially exploit the informational disparity between management and directors to their advantage. Courts have been particularly skeptical of actual and potential management conflicts in the process leading to a business combination, and have expressed concern that conflicted management, if not properly supervised by the board, might be in a position to taint a sales process.

**How Management Conflicts Arise**

Before cataloguing the most common types of management conflicts, it is important to understand how those conflicts arise. Most obviously, management directors are generally always deemed “interested” in a transaction involving the sale of the company for the simple reason that their compensation may be affected, their employment relationship with the company may be altered, and different counterparties may be more or less favored by management as a result of their views on compensation and future employment prospects. Thus, the CEO director and any other members of management who serve as directors should ordinarily be viewed from the outset as having actual or potential conflicts of interests (that is, personal interests different from the ordinary stockholder) with respect to a potential sale or merger. Similar considerations apply to all officers who play a significant role in the M&A process.

Finally, and as discussed previously in this chapter with respect to non-officer directors (“— Identifying Director Conflicts of Interest”), members
of management may have present, past, or likely future professional, financial, employment or personal relationships (including relationships with likely counterparties, investment bankers and counsel) that might compromise their objectivity in evaluating or supervising the development of a business combination.

Identifying Officer and Management Conflicts

Courts generally apply the same standards applied to directors for determining if officers who are not directors and other members of management are conflicted or lack independence. Accordingly, directors supervising the M&A process, and the lawyers assisting them, should be particularly attentive to common situations in which management conflicts or lack of independence might arise due to incentives not shared pro rata with stockholders generally. Such situations include the following:

- A management buyout or leveraged buyout in which members of management are part of the buyout group and therefore appear on both sides of the transaction.
- A transaction in which officers are asked by a buyer to roll over a portion of their shares and thus will have an ongoing equity interest in the company post-merger.
- A transaction in which members of management may retain employment or lose their employment as a result of a transaction. For example, management might have an incentive to favor particular bidders or types of bidders (e.g., financial buyers who will retain their services versus strategic buyers who do not need them).
- Situations in which members of management stand to gain severance benefits, acceleration of equity awards, or retention or other compensation as a result of a transaction, either immediately or post-termination, which can create an incentive to favor or disfavor an acquisition or a particular bidder or form of acquisition.
- Situations in which key officers are asked to sign, and will be compensated for signing, non-competition agreements or consulting agreements.

42 See Gantler v. Stephens, 965 A.2d 695, 708-09 (Del. 2009) (holding that officers of a Delaware corporation have the same fiduciary duties of care and loyalty as directors).
• Circumstances in which an officer has a close familial, personal, or business relationship with a person on the other side of a potential transaction.

• Any other situation in which an officer or member of management will receive a material benefit from a transaction (or suffer a material detriment as a result of a transaction) where such benefit (or detriment) is not shared generally with stockholders. This includes any other situation where members of management are in a position in which they are effectively competing with the stockholders for the overall consideration that a buyer is willing to offer.

In such situations, a board of directors is well advised to identify and take appropriate steps to supervise, and mitigate the potential consequences of, conflicts on the part of officers and other members of management beginning at an early stage of a sales process or the consideration of potential strategic alternatives.

Not all potential conflicts on the part of management will be obvious. The board should request and evaluate, with the assistance of counsel, information pertaining to management’s compensation arrangements, equity positions (including terms of options and other equity incentive awards) of key members of management, and other facts and circumstances that might influence management’s incentives and possible motivations as they relate to any sales process or merger negotiations. The board should also solicit information from management concerning any personal, familial or business relationships they may have with potential bidders, as well as any recent discussions they have had with potential bidders concerning a potential transaction. Because the motivations of management may evolve as a transaction process unfolds and certain types of transactions, or transactions with certain bidders, become more or less likely, it is also important for the board, with the assistance of counsel, to assess potential management conflicts on an ongoing basis.

**Properly Handling Officer and Management Conflicts**

Given the critical role of management, the board must identify, understand and appropriately address conflicts and potential conflicts on the part of officers and management and put in place effective safeguards so that the board can properly assess information and recommendations provided by those individuals and ensure that conflicted members of management do not have an opportunity to improperly influence the process or outcome. The board itself (or a committee) should retain ultimate responsibility
for selecting the alternative or alternatives to be pursued, and implement processes and procedures to ensure that the board plays a central role in evaluating opportunities, supervising discussions or negotiations, and directing the sales process.

Importantly, it is not necessary—and in most cases likely not even advisable—that management be excluded from an active role in a strategic process. Indeed, the participation of management generally will be important to an effective process in light of management’s knowledge of the business, expertise and skills. The board should carefully evaluate the appropriate role of management in the process, and in all events should take steps to ensure that management is given appropriate direction and remains subject to active supervision by the board.

Generally speaking, the board should take steps to ensure that conflicted management is adequately supervised, implement appropriate procedures and controls to ensure that potential conflicts do not improperly influence the process, and, if appropriate, take steps to insulate or limit the role of conflicted management as to decision-making, the due diligence process, negotiations relating to their individual compensation or other personal interests, and negotiations relating to the transaction on behalf of all stockholders. Forming a committee of the independent directors of the board to actively supervise and direct a sale process or merger negotiations is one potential means of providing adequate supervision over management and otherwise mitigating the potential effect of management conflicts.43 Directors are not, however, required to follow a particular “blueprint” to fulfill their fiduciary duties in this regard, and a board’s decision whether to appoint a committee to address management conflicts will be a function of a variety of legal and practical considerations. It may also be important to implement procedures to protect confidential information, both by shielding conflicted management from access to certain information and by implementing procedures to ensure that management does not inappropriately disclose confidential information to bidders.

Because management always has conflicts of interest relating to a sale of control, directors should remain sensitive at all times to the potential for those conflicts to undermine the fairness and objectivity of a sales process or merger negotiations. Thus, it is ordinarily advisable that the board, a board committee or specific directors charged by the board actively supervise and provide guidance to management in management’s dealings with third

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43 See Chapter 5, Board Process in Considering Sales Transactions—Use of Transaction Committee.
parties. In some cases, the presence of independent financial advisors who report directly to the board or a committee can provide transparency and a useful check on management, but active supervision by directors remains key. In addition, the board, not conflicted management, should ideally identify, interview and retain legal and financial advisors or confirm that such advisors are independent of management. To the extent questions may exist as to the independence of advisors partly due to their selection by or relationships with management, the board should consider engaging other independent advisors and actively supervise them.

While there is no one-size-fits-all approach to handling conflicts on the part of management, following are a number of ways to ensure that the board (or a committee) maintains appropriate supervision and control over any actions taken by management:

- A board can implement policies to require that it be immediately notified when a member of management is approached regarding a potential transaction and to make clear that before the board is advised of a potential transaction, discussions with unsolicited bidders or other potential buyers should be limited to gathering sufficient information to enable the board to adequately evaluate the opportunity and determine the most appropriate path forward.

- A CEO or other members of management should not begin negotiations with a potential buyer unless and until the board has discussed the inquiry or offer and directed a member of management, as appropriate, to commence negotiations.44

- The board should consider having counsel prepare and provide to management a “Rules of the Road” memorandum explaining the board’s expectations regarding management’s role in a sales process and rules and procedures the board expects management to follow, including any restrictions on management’s ability to take certain actions without prior board or committee approval or outside of board or committee supervision.

- If conflicts on the part of particular members of management raise potential issues that do not apply to all members of management

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44 The Delaware courts have expressed skepticism as to the integrity of a sales process where management has carried out substantive negotiations, possibly even committing the company to particular courses of action, before informing the board or without adequate direction and oversight by the board. See, e.g., Lear, at 117-18; SS & C, at 820; Answers, at *7.
Chapter 3: Identifying and Managing Conflicts of Interest

(e.g., certain members of management will participate in a buyout group or will receive lucrative severance benefits), the board might consider whether there are key members of management who do not share such conflicts and who could be tasked with taking the lead role in the due diligence process, communicating with counterparties, and providing information to the board and its advisors.

• The board should implement policies and procedures to ensure that no discussions take place between a potential buyer and members of management pertaining to management’s post-transaction employment, other post-transaction compensation arrangements, or any rollover or other equity interest in the post-closing company until the material terms of the transaction, including price, have been negotiated, or until such other time, and under such conditions, as the board (or a committee) may direct in writing.

• In certain circumstances, the board might also consider mandating that any discussions between the CEO or other members of management and potential counterparties involving confidential company information or the substantive terms or strategies must be “chaperoned” by an independent director and/or the board’s legal and financial advisors.

Identifying and Managing Controlling Stockholder Conflicts

When Do They Arise?

If a corporation has a controlling stockholder, the board should take steps to identify and carefully manage any conflicts the controlling stockholder may have to ensure that the controller cannot use its influence to favor its interests at the expense of the corporation’s minority stockholders. A stockholder will be considered controlling not only if the stockholder owns more than 50 percent of the corporation’s outstanding stock, but also if the stockholder exercises “actual control” over the corporation.45

45 In re KKR Fin. Holdings LLC S’holder Litig., 101 A.3d 980, 991-92 (Del. Ch. 2014) ("KKR") ("[T]he ‘actual control’ test ‘is not easy to satisfy,’ and can only be met where ‘stockholders who, although lacking a clear majority, have such formidable voting and managerial power that they, as a practical matter, are no differently situated than if they had majority voting control.’") (quoting PNB, at *9). See also In re Tesla Motors, Inc. S’holder Litig., 2018 WL 1560293, at *19 (Del. Ch. Mar.
Controlling stockholders often, but not always, possess the ability to adopt or reject corporate transactions and elect directors. In determining whether a person is a controlling stockholder, the “operative question” is whether that person controls the board of directors, in the sense that the directors cannot freely exercise their judgment due to that person’s influence.\footnote{KKR, at 993 (noting that although plaintiffs’ allegations indicated that “KKR, through its affiliate, managed the day-to-day operations of KFN, they do not support a reasonable inference that KKR \textit{controlled the KFN board}—which is the operative question under Delaware law—such that the directors of KFN could not freely exercise their judgment in determining whether or not to approve and recommend to the stockholders a merger with KKR’); see also \textit{In re Morton’s Rest. Grp., Inc. S’holder Litig.}, 74 A.3d 656, 665 (Del. Ch. 2013) (“[A] minority blockholder is not considered to be a controlling stockholder unless it exercises ’such formidable voting and managerial power that it, as a practical matter, is no differently situated than if it had majority voting control.’ Accordingly, the minority blockholder’s power must be ’so potent that independent directors . . . cannot freely exercise their judgment, fearing retribution’ from the controlling minority blockholder.”).}

A controlling stockholder conflict could arise at any point during a sales process or negotiation of a transaction if the controlling stockholder’s interests diverge from the interests of the stockholders unaffiliated with the controller. Generally, there are two circumstances in which a controlling stockholder may be considered conflicted. A controller may be conflicted with respect to a transaction if the controller or the controller’s affiliate stands on both sides of the transaction, or if the stockholder receives a material benefit from a transaction that is not shared generally with the other stockholders.\footnote{See \textit{In re EZCORP Inc. Consulting Agreement Deriv. Litig.}, 2016 WL 301245, at *11-12 (Del. Ch. Jan. 25, 2016) (“EZCORP”); KKR, at 990.} Such conflicts might arise in a transaction where:

- the controlling stockholder acquires 100 percent of the corporation and “squeezes out” the minority stockholders, either by a merger or tender offer;
• the controlling stockholder receives different consideration than other stockholders such that “the controller competes with the [other] stockholders for consideration,” including:
  • an equity interest in the surviving company while the minority stockholders receive only cash consideration;
  • additional monetary consideration as a control premium for the controller’s shares;
  • an extra premium for high-vote stock not shared with low- or no-vote stock;
  • the impetus for the transaction was the controlling stockholder’s urgent need for liquidity, resulting in a “fire sale” of the corporation;
  • the controlling stockholder has a desire for a specific type of consideration (e.g., cash, stock, or a particular mix of cash and stock) in view of circumstances facing the controller that do not apply to stockholders generally;
  • the corporation sells assets to or purchases assets from the controlling stockholder;
  • the corporation repurchases shares from a controlling stockholder; or
  • the controlling stockholder receives unique benefits not shared with the minority stockholders, such as seats on the board of directors of the acquiring company, compensation for entering into a non-compete agreement or consulting agreement, “even if the controller nominally receives the same consideration as all other stockholders.”


49 See Synthes, at 1035-36 (explaining that a controlling stockholder’s financial interest in receiving liquidity in a transaction generally does not establish a disabling conflict when all stockholders are treated equally, but noting that there may be “very narrow circumstances in which a controlling stockholder’s immediate need for liquidity could constitute a disabling conflict of interest irrespective of pro rata treatment”); N.J. Carpenters Pension Fund v. infoGROUP, Inc., 2011 WL 4825888, at *2-4 (Del. Ch. Sept. 30, 2011 (“Infogroup”)) (observing that a desperate need for liquidity by the largest shareholder/director combined with his bullying and pressure on other board members, which included threatening lawsuits, influencing the list of potential bidders, conducting unsupervised negotiations and leaking information, raised an issue of the duty of loyalty and a lack of independence of other board members, resulting in denial of the motion to dismiss and followed by entire fairness review).

50 Crane, at *6 (quoting Crimson, at *13-14).
For a number of reasons, conflicts on the part of controlling stockholders have the potential to adversely affect the fairness of a transaction to the minority. Controlling stockholders are often represented on a corporation’s board or management team, a position that a conflicted controller could potentially use to manipulate or influence the board’s decision-making process. Controlling stockholders might also be in a position to improperly restrict the flow of information to the board or, in extreme cases, provide false or misleading information to the board or its advisors.\(^{51}\) In addition, conflicted controlling stockholders with the capacity to retaliate against directors who do not bend to their will—for example, by removing such directors, thereby depriving them of ongoing compensation and other benefits—may be in a position to improperly pressure directors.\(^{52}\) If a conflicted controlling stockholder engages in rogue negotiations or improperly shares confidential corporate information with potential bidders, that too could cast doubt on the fairness of a transaction to minority stockholders.\(^{53}\)

For these and other reasons, a “controlling stockholder occupies a uniquely advantageous position for extracting differential benefits from the corporation at the expense of minority stockholders.”\(^{54}\) The courts, therefore, will closely scrutinize transactions in which controlling stockholders have

\(^{51}\) See *In re Dole Food Co., Inc. S’holder Litig.*, 2015 WL 5052214, at *18 (Del. Ch. Aug. 27, 2015) (“Dole Food Co.”) (finding a controlling stockholder and a director who was beholden to the controlling stockholder personally liable for breaches of the duty of loyalty after providing false financial information to the independent special committee and its advisors).

\(^{52}\) See *EZCORP*, at *20 (noting the controlling stockholder removed three board members after two such board members terminated a contract with an affiliate of the controlling stockholder); *Dole Food Co.*, at *13 (relying upon evidence indicating that, after a disagreement, a controlling stockholder and the director beholden to the controlling stockholder left several threatening messages for a director, who resigned as a result of such threats).

\(^{53}\) See *Infogroup*, at *6 (discussing allegations that a significant stockholder, after a request to desist, continued to contact bidders without supervision of the board, the board’s M&A Committee, or the financial advisor retained by the independent directors and noting that the stockholder threatened the board with lawsuits if they did not take actions to sell the company).

\(^{54}\) *EZCORP*, at *11; see also *PNB*, at *9 (noting that Delaware courts invoke the entire fairness review due to “the notion that when a controller wants the [transaction], the controller’s power is so potent that independent directors and minority stockholders cannot freely exercise their judgment, fearing retribution from the controller”).
a conflict of interest, often employing the stringent entire fairness standard of review.\textsuperscript{55} This is not to say that the mere presence of a controlling stockholder will invariably trigger an entire fairness review. For example, if a corporation engages in a transaction with an independent third party and the controlling stockholder receives the same consideration as other stockholders and does not otherwise have a conflict of interest with respect to the transaction, the transaction likely will be reviewed under the business judgment rule.\textsuperscript{56} Nonetheless, if a corporation has a controlling stockholder (or group of stockholders who might collectively be considered controllers), it is extremely important that the board identify potential conflicts on the part of the controller and take steps to appropriately manage those conflicts.\textsuperscript{57} Otherwise, a conflicted transaction is unlikely to survive judicial scrutiny and could either be enjoined or result in liability for the controlling stockholder and, potentially, members of the board of directors.

**Managing Controlling Stockholder Conflicts**

*Special Committees and “Majority of the Minority” Stockholder Votes*

When a controlling stockholder stands on both sides of a transaction or otherwise has a material conflict of interest with respect to a transaction, the board should take steps designed to ensure that the controlling stockholder does not improperly influence the transaction outcome. In such circumstances, the use of a well-functioning special committee of independent directors and/or approval by a fully informed, uncoerced “majority of the minority” stockholder vote can shift the burden of proof

\begin{itemize}
  \item \textsuperscript{55} See Chapter 2, *Fiduciary Duties of Directors Generally in a Business Combination*.
  \item \textsuperscript{56} See *Synthes*, at 1033.
  \item \textsuperscript{57} See *In re Martha Stewart Living Omnimedia, Inc. S’holder Litig.*, 2017 WL 3568089, at *2 (Del. Ch. Aug. 18, 2017) (applying the business judgment rule standard of review to a transaction where the controlling stockholder received the same consideration as other stockholders in a third-party deal but purportedly received additional benefits related to certain employment agreements and IP-related contracts, but the transaction had been conditioned prior to the commencement of economic negotiations on approval by a fully functioning and empowered special committee and non-waivable approval by the fully informed, uncoerced majority of the minority of outstanding shares).  
\end{itemize}
under the entire fairness test to the challenging stockholders and, in some instances, can even alter the applicable standard of review.\textsuperscript{58}

Courts have indicated that these measures, either alone or in combination, can help replicate arm’s-length bargaining.\textsuperscript{59} Moreover, each mechanism—use of a special committee and obtaining “majority of the minority” stockholder approval—can be a powerful indicator of fairness.\textsuperscript{60} Even where a controlling stockholder does not stand on both sides of a transaction, in some circumstances, such as where the controlling stockholder receives transaction consideration or benefits different from other stockholders, it may be advisable for the board to utilize either a special committee process or a “majority of the minority” stockholder approval mechanism, or both, to help satisfy or avoid “entire fairness” review of a transaction involving a controlling stockholder conflict of interest.

\textit{Practical Guidance}

While utilization of a special committee process or a “majority of the minority” approval mechanism is not technically a requirement to prove fairness in all situations involving controlling stockholder conflicts, those are the most commonly used and most effective means to manage and mitigate the potential issues resulting from controlling stockholder conflicts. In fact, courts have indicated that the absence of a special committee or “majority of the minority” vote in a controlling stockholder conflict transaction may constitute evidence of the transaction’s unfairness.\textsuperscript{61} Thus, where possible, a board should ordinarily seek to utilize one or both of those approaches to manage conflicts in settings involving controlling stockholder conflicts.

Where a special committee process and/or “majority of the minority” approval mechanism is not used, a board may take other steps in an effort to ensure fairness, but the effectiveness of such means will be uncertain in the absence of one or both of the more traditional approaches. Such other

\textsuperscript{58} See Chapter 8, \textit{Special Committees}, and Chapter 9, \textit{Conditioning the Deal on Approval of the Majority of Unaffiliated Shares}. As discussed in Chapter 8, to be effective in the context of a controlling stockholder conflict, a special committee must be fully informed and well-functioning, with the power to reject or recommend the transaction and the ability to retain independent advisors. As discussed in Chapter 9, to be effective, a “majority of the minority” stockholder vote must be uncoerced and fully informed.

\textsuperscript{59} See \textit{Kahn v. Lynch Commc’n Sys. Inc.}, 638 A.2d 1110, 1119 (Del. 1994) (“\textit{Kahn}”).

\textsuperscript{60} \textit{Kahn}, at 1113-14.

\textsuperscript{61} \textit{EZCORP}, at *41 n.47; \textit{Infogroup}, at *6.
Chapter 3: Identifying and Managing Conflicts of Interest

steps might include engaging independent financial and legal advisors and obtaining a fairness opinion. A fairness opinion rendered by an independent financial advisor may provide evidence of the fairness of the price in a transaction involving a controlling stockholder conflict, presuming that the fairness opinion results from a diligent analysis based on complete and accurate information.62 Similarly, a board could take steps, short of establishing a special committee, to insulate members of the board who are affiliated with the conflicted controlling stockholder from the board’s process, such as having those members recuse themselves from deliberations and abstain from voting.

Other mechanisms might be available to help enhance fairness where a controlling stockholder has a conflict of interest in connection with a transaction involving a third party buyer. For example, excluding the controller from negotiations and restricting communications between the controller and buyer might be a means of mitigating any improper influence on the negotiations. Similarly, precluding the controlling stockholder from discussing or negotiating matters such as rollover equity or consulting agreements with a third party buyer until the material terms of the transaction (including price) have been negotiated can help prevent the controller from being perceived as actively competing with the minority for an increased share of the overall merger consideration.

Whether or not the board utilizes a special committee process, any measures it implements to help ensure fairness may be for naught if the quality of information provided by the controlling stockholder is deficient.63 For any procedural protections to be effective, the controlling stockholder must fully disclose to the board, committee, or unaffiliated stockholders, as applicable, all material facts known to the controlling stockholder pertaining to the transaction, including the material terms of the transaction, the value of the assets at issue to the controlling stockholder, and the market value of such assets.64 In addition, the controlling stockholder cannot purposely omit information that may make previously disclosed information incomplete or misleading. Accordingly, a board (or committee) should take appropriate steps to ensure that a controlling stockholder has provided all material

62 See Dole Food Co., at *35. For more information regarding the use of financial advisors, see Chapter 6, Engagement and Use of the Financial Advisor.
63 Dole Food Co., at *35.
64 Dole Food Co., at *35. Importantly, the disclosure obligations of controlling stockholders do not require the disclosure of the controller’s reserve price or a “play-by-play” description of each action taken by the controlling stockholder.
information that the board (or committee) may need to negotiate and assess a conflict transaction with the controller.

It also warrants mention that a controlling stockholder is not required to sacrifice its own interests to benefit the minority stockholders. While such self-sacrifice might provide evidence of fairness to the minority, it is not required to establish fairness.

**Conclusion—Making a Record**

One of the most important roles for the board in any M&A process is to identify and appropriately manage conflicts on the part of directors, officers, and controlling stockholders so that they do not adversely affect the evaluation of potential transactions or the transaction outcome. Conflicts are not inherently bad and are likely to be present in one form or another in many transactions.

Directors can best protect themselves from potential liability (and also criticism) by implementing procedures to identify conflicts and manage them carefully. Equally important is documenting the steps directors have taken. As discussed in more detail in Chapter 5, *Board Process in Considering Sales Transactions*, because board decisions in connection with M&A transactions are often subject to judicial scrutiny, it is imperative that directors and their counsel make a clear record (through board minutes and otherwise) of the steps taken to identify conflicts, the nature of any conflicts or potential conflicts that were identified, and the manner in which the board addressed those conflicts to ensure the integrity, reasonableness, and fairness of the process.

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