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# Corporate Law for the Tax Advisor

**By Steven E. Hollingworth • Wood & Porter • San Francisco**

Tax advisors, tax lawyers in particular, are often accused of being impractical, even deal killers. Tax advisors are often presented with draft corporate acquisition documents along with the key question, "Are there any tax issues?" Equally often, you may spot some problems that will require some adjustment to the structure. What solutions should you suggest?

In these situations it can be very helpful for a tax lawyer to be aware of the nontax considerations that affect the scope of workable alternatives. After all, the business world does not revolve (entirely) around the tax law. Accordingly, a tax lawyer would be well advised to view the Practicing Law Institute's seminar entitled *Mergers & Acquisitions 2010: What You Need to Know Now,* held on September 23–24, 2010, in Chicago and on October 7–8, 2010, in San Francisco. The program focuses on the current legal and financial environment surrounding M&A.

Among many other topics of interest was a panel discussion entitled "Cutting Edge Issues in Public Company Sale Transactions." The panelists were Jed Zobitz of Cravath Swaine & Moore LLP, Bill Kelly of Davis Polk & Wardwell LLP, Mark Solomons of J.P. Morgan, and moderator R. Scott Falk of Kirkland & Ellis. The discussion addressed current trends and issues arising from publicly traded companies that go private.

The most common types of going-private transactions are (1) acquisitions by a controlling stockholder (commonly referred to as squeeze-out mergers); (2) acquisitions by a significant but noncontrolling shareholder; and (3) leveraged buyouts by a private equity fund or other third party. Many going-private transactions are challenged in court. Minority stockholders often claim that the board of directors or the acquirer breached fiduciary duties in compelling them to sell stock for an unfair price.

The courts generally review these transactions under an "entire fairness" standard. That shifts the burden to the acquirer or the board

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to show that the minority shareholder was treated fairly and received a fair price. However, if the acquirer follows certain procedures, the courts will not apply the stringent "entire fairness" standard, but will defer to the terms of the transaction under the business judgment rule. The procedures to be followed depend on the transaction.

## Controlling Shareholder

In the case of an acquisition by a controlling shareholder, the controlling shareholder has a conflict of interest. On one hand, it holds the power to control approval of the transaction for its own benefit, while on the other, it owes fiduciary duties to the minority shareholders. In these circumstances, Delaware law will apply a deferential business judgment standard if the target company appoints a special committee of independent directors to negotiate with the controlling shareholder.

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In *Kahn v. Lynch*, 638 A.2d 1110 (1994), the Delaware Supreme Court held that if a merger initiated by a controlling stockholder is approved either by a special committee *or* by a majority of the minority shareholders (who are adequately informed), the burden shifts to the complaining minority shareholder to demonstrate the deal was unfair. However, more recent decisions by the Delaware Chancery Courts have held that business judgment deference applies if the transaction is approved by both the special committee *and* an informed majority of the minority shareholders. [*See In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005); *In re CNX Gas Corporation Shareholders Litigation*, C.A. No. 5377-VCL (May 25, 2010).]

## Procedural Dilemma

Which procedure should a prudent acquirer use, the disjunctive test from *Kahn v. Lynch* or the Chancery Court's "unified" standard? Panelist Bill Kelly pointed out that the unified standard has not yet been adopted by the Delaware Supreme Court, and that if an acquirer commits to that procedure now, it is handing a lot of negotiating leverage to the special committee. On the other hand, Mr. Kelly believes there is a strong bias in favor of the unified standard. This seems so in spite of the more lenient standard of *Kahn v. Lynch*.

## Noncontrolling Shareholders and Private Equity Funds

What about going-private transactions that are initiated by a noncontrolling shareholder or a private equity fund? In these instances, the acquirer owes no fiduciary duty to the other stockholders. Accordingly, the Delaware courts generally apply business judgment deference, rather than entire fairness scrutiny.

However, the board of the target company still owes fiduciary duties to the shareholders. To minimize the possibility of successful legal challenge, the target may consider utilizing a special committee to negotiate with the acquirer. Furthermore, the board may have the duty to conduct an auction or solicit other purchasers in order to maximize shareholder value.

Indeed, the panelists noted that, if the board decides not to run an auction, it must have a good reason for its decision. For example, the courts may be sympathetic to the argument that a prospective buyer has a history of walking away from transactions if an auction is held. In addition, the sale process itself can be subject to challenge.

The panelists pointed out that management will invite judicial scrutiny if, in order to enable them to continue as executives, the process favors targeting private equity buyers. Similar concerns are raised if the board negotiates post-transaction employment arrangements before the acquisition terms are final. The panelists agreed that the courts seem to have a natural distrust of private equity buyers, and that private equity firms are taking this bias into account.

It can be equal parts bewildering foray and enlightening exercise for tax advisors to take a break from poring over the tax code and view corporate transactions from a broader perspective. Often, one can get a glimpse of the complexities and evolving strategies in the corporate world. Video and printed materials of the PLI Mergers & Acquisitions 2010 conference are available at *www.pli.edu/product/clenow_detail.asp?id=59923.*