

1-1-2002

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Recommended Citation

Pat Vlahakis, *The Section 203 Waiver - A New Delaware Hazard?*, 10 U. Miami Bus. L. Rev. 49 (2014)

Available at: <http://repository.law.miami.edu/umblr/vol10/iss1/4>

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THE SECTION 203 WAIVER – A NEW DELAWARE HAZARD?

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In an opinion issued late in 2000, the Delaware Court of Chancery found that interested directors on the Board of a subsidiary, Digex, had breached their fiduciary duties to minority public stockholders when they forced a waiver of Section 203 of the Delaware General Corporation Law, to permit the acquisition of Intermedia, the subsidiary's parent, by WorldCom.¹ The Court declined to enjoin WorldCom's acquisition of Intermedia, but left open the possibility of monetary damages. The Court also declined to decide whether WorldCom would be subject to the three-year prohibition on transactions with Digex under Section 203.

The decision is not surprising in one respect because it involves one of those rare instances where the existence of conflicting interests between a parent and its controlled subsidiary is obvious, and a special committee of disinterested directors of the subsidiary is formed; but when the special committee does not approve what the majority holder wants, the interested directors overrule the special committee. Courts do not look favorably on such cases. In the Court's words: [T]he defendants' choice becomes whether they will proceed with a WorldCom-Intermedia merger knowing that this Court seriously questions the integrity of the Section 203 waiver decision, and knowing that certain of the defendant[s'] fiduciaries stand accused of faithless acts that under the stringent standard of the entire fairness test, could well give rise to a range of equitable remedies, including monetary remedies.²

The *Digex* decision is noteworthy in at least two respects. First, it involves a lengthy discussion, without a determination, on the necessity of a Section 203 waiver by a partially public subsidiary, in a situation involving the acquisition of the *parent's* shares. In the wake of the once-hot IPO market, many publicly traded companies today find themselves with publicly traded subsidiaries. The *Digex* decision highlights the hazards of dealing with Section 203 in that context. Second, the Court's view is that where there is leverage, there is a duty to use the leverage. Moreover, the Court clearly reserves the right to review the *way* in which the leverage is used. In light of the conflicts of interest present in the *Digex* case, the Court reviewed the Board's decision of whether to grant the Section 203 waiver under the entire fairness standard. It remains to be seen whether enhanced scrutiny of

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¹ *In re Digex, Inc. S'holder's Litig.*, C.A. 18336, 2000 WL 1847679 (Del. Ch. Dec. 13, 2000).

² *Id.*

Section 203 waivers in other contexts will ensue, and what impact it will have.

The difficulties faced by Intermedia in the *Digex* case were, in many respects, of Intermedia's own making. Intermedia initially undertook a sale of Digex, a company in which it had a 92% voting interest, a 52% equity interest, and a majority of the Board. Public stockholders held the remainder of the Digex equity. A special committee of the Digex Board, composed of directors not appointed by Intermedia, was established to review potential transactions involving Digex. While the special committee focus had been on acquisition of Digex, WorldCom changed its bid at the last minute and sought to acquire Intermedia instead, without acquiring the publicly traded stock of Digex. Because WorldCom might be viewed as an interested stockholder of Digex after its acquisition of Intermedia, WorldCom requested a waiver by the Digex Board under Section 203, although the special committee was given no role in negotiating the waiver. In the end, the interested Digex directors overruled a vote by the members of the special committee against granting the Section 203 waiver. The fact that the process started as a sale of Digex, and ended as a sale of Intermedia gave rise to a claim that Intermedia had usurped a control premium properly payable to the Digex stockholders. While the Court ruled that Intermedia had not misappropriated a corporate opportunity belonging to Digex, the flavor of the case might have been far different if the sale of Intermedia had been the only transaction ever contemplated.

The narrow issue that the Court examined at length, but ultimately declined to decide in *Digex*, was whether the so-called 85% exemption to the Delaware business combination statute was meant to apply where an interested stockholder owns more than 85% of the voting power, but less than 85% of the outstanding shares, of a company's common stock. Under the exemption, if an interested stockholder acquires more than 85% of the outstanding voting stock at the time, it becomes an interested stockholder; the three-year prohibition on mergers and similar transactions under Section 203 does not apply. The question regarding the 85% exemption arose because upon its acquisition of Intermedia, absent a waiver or an exemption under Section 203, WorldCom would have become an interested stockholder of Digex. While WorldCom believed, and argued to the Court, that the 85% exemption applied, at the time the transaction was negotiated, counsel could not opine definitively to that effect. As a result, WorldCom requested a waiver by Digex under Section 203. The Court's examination of the legislative history of Section 203 reveals a persuasive case that the exemption was intended to require ownership of at least 85% of the shares, not just 85% of the votes. The Court, however, found the issue unripe for decision. Instead, the Court found that the Section 203 waiver, which had been

granted over the objection of Digex's disinterested directors, was a breach of fiduciary duty.

The issue under Section 203 *not* decided by the Court is most relevant for a narrow group of companies: those with classes of common stock having different voting rights. The case does, however, highlight one anomaly of the Delaware business combination statute – not surprisingly – that Section 203 operates on a concept of beneficial ownership. Acquisitions of a parent are, secondarily, acquisitions of subsidiaries. In a world where publicly traded companies have wholly-owned subsidiaries, there is no issue. During the past few years, however, many public companies have sought to unlock the value of subsidiaries by causing them to go public. A common structure is that the subsidiary offers up to 19.9% of its shares, and the parent retains 80.1% in order to be able to continue to consolidate for tax purposes. Under such a structure, an acquirer of the parent would never be eligible for the 85% exemption under Section 203 with respect to the subsidiary. As the Court in *Digex* noted, the subsidiary could opt out of Section 203 before going public. Many such subsidiaries have not done so, however, in anticipation of being completely publicly traded at some point down the road.

Unlike the circumstances in *Digex*, where a potential sale of a subsidiary evolved into a sale of the parent, the more common scenario would be of an acquirer seeking – from the outset – to acquire a publicly traded parent. The acquirer could well be happy that the parent company has, as an asset, an 80.1% interest in a publicly traded company. The subsidiary could, however, be a small part of its parent, and might not be the driving force of the acquirer's interest in the parent company. Moreover, while the acquirer could have no present intention to affect the subsidiary, the acquirer could nonetheless seek to condition its deal on obtaining a Section 203 waiver from the subsidiary's Board, in order to preserve its ability to engage in the future in the types of transactions that otherwise would be prohibited under Section 203. The question under these facts is why the subsidiary's Board should have a say in the acquisition of parent. An acquisition of the subsidiary was never contemplated. Any control premium being paid to parent stockholders under these facts is attributable to control of parent, not the *de minimus* subsidiary. In effect, the only consequence of the Section 203 waiver under these facts is to give a subsidiary Board a potential veto over a transaction relating to its parent. Under these facts, the only jeopardy to the public stockholders of the subsidiary is the potential abuse of power by the new controlling stockholder in ways that were available to the former controlling stockholder, but not used.

Under the *Digex* decision, it would appear that the Board of a controlled subsidiary must always attempt to secure a benefit for the corporation and its

stockholders when granting a Section 203 waiver with respect to an acquirer of its parent. The same logic would require that the Board of any company in which a controlling block is being sold, must similarly seek to negotiate a benefit where the block is being sold, but the remaining shares are not. One question in each of these cases is what the Board should request. The Court applied the entire fairness test, part of which is to evaluate whether the benefit received by the corporation was a *fair price* for the waiver. The question is how a court or a Board can really evaluate the *value* of the benefit received. The Digex Board asked for, and received, a charter amendment limiting the ability of the new controlling stockholder to engage in transactions with Digex absent independent director approval. At least under the circumstances posed above, that would appear to be more than reasonable protection. Yet the very broad language of the *Digex* decision suggests that perhaps the subsidiary Board should have sought more:

The waiver appears to have been agreed to, in part, in exchange for an amendment to the Digex certificate of incorporation that would require the approval of independent directors of any material transaction between WorlCom and Digex after the merger. The record is silent as to exploration by the interested parties of any other options available to Digex. That is, as it appears that WorldCom insisted on the waiver, did any of the interested directors attempt to withhold this request in order to see what WorldCom might offer to Digex in return? Or, did the directors request concessions in addition to the certificate amendment that might benefit Digex or Intermedia?³

Clearly, the fact, which most troubled the Court, was that the disinterested directors did not participate in the negotiation with WorldCom and were, in the end, overruled by the interested directors. The process undercut any claim that WorldCom would not have agreed to further concessions: "Was this the best deal available? Because of the manner in which the negotiating process was handled, it is impossible to say. Perhaps Digex could have extracted something more from WorldCom, perhaps not."⁴

Perhaps if the Digex special committee had approved the waiver after due consideration of the benefits to Digex, the Court would have been satisfied. Yet, the Court's insistence on the use of leverage where leverage exists suggests that whenever a company is asked to grant a Section 203 waiver with

³ *Id.*

⁴ *Id.*

respect to a control block, it must at least go through the steps of requesting something in exchange, even if the acquirer never proposed to buy the remaining shares. Maintaining the status quo, in terms of protecting the public stockholders with an amendment to the certificate, may not suffice.

A further question that arises out of the *Digex* decision is what standard of review will be used when a Board grants a Section 203 waiver in contexts other than that of a controlled subsidiary. There are a number of very common cases where a stockholder seeks to sell its shares and, in that connection, seeks a Section 203 waiver from the Board. For example, a holder of 20% of a company's shares, who seeks to sell those shares in a transaction not otherwise involving a change of control of the company, may wish to deliver those shares to the buyer free of the three-year prohibition on transactions under Section 203. What standard of review applies to the Board's decision in this context? Absent a controlling stockholder, or a sale of control transaction, one would think the ordinary business judgment rule should apply. Yet, the Board has leverage. Under the theory of the *Digex* case, should the Board seek something in exchange for the waiver? If so, the question is what? The Board could seek to condition its waiver on the buyer's not acquiring additional shares without a further waiver under Section 203. This limitation might not, however, be acceptable to the buyer. It is difficult to envision what other benefit the corporation could seek, since it is unlikely, in this case, that the seller would be receiving a control premium, or other benefit, that the remaining shareholders could seek to share.

Another common circumstance in which a Section 203 waiver is sought is where there is a proposed merger and one of the parties has a significant stockholder. The other party typically seeks a *lockup* agreement from the stockholder. The stockholder either grants an option on its shares, or agrees to tender the shares, or to vote them in favor of the merger. Depending upon what rights the acquirer obtains in the lockup, the acquirer may be deemed to beneficially own those shares for purposes of Section 203, necessitating a waiver. The Section 203 waiver is separate from the waiver needed for the acquirer to consummate the merger. Assuming for the moment that the merger constitutes a sale of control, the Board's decisions in approving the merger, including decisions with respect to lockups and the like, would be reviewed under the *Revlon* standard, which obligates the Board to maximize value for all stockholders.⁵

Does this mean the Board is obligated to seek something separate in exchange for the Section 203 waiver with respect to the lockup? Presumably

⁵ See *Revlon v. MacAndrews & Forbes Holdings, Inc.*, Del.Supr., 506 A.2d 173 (1985).

the benefit of the overall transaction to the stockholders could justify the granting of a Section 203 waiver for a lockup on which the acquirer has conditioned its bid. Does the Board, however, have to condition the waiver on its continued approval of the transaction? Put differently, if the Board negotiates a right to terminate the merger agreement in favor of a superior transaction, should it condition its Section 203 waiver with respect to the lockup on the merger agreement remaining in effect?

If the concept of the duty to use leverage from *Digex* is imported into the context of a sale of control to which *Revlon* duties apply, the question is how a Court will review a Board's decision to grant a Section 203 waiver for a lockup on a stockholder's shares. The decision in *Ace Ltd. v. Capital Re Corp.*,⁶ suggests that the Board could well have to retain a string on the waiver, even in a case where *Revlon* duties do not apply. In *Ace*, Cap Re and Ace had agreed to a stock-for-stock merger. Nearly 46% of the Cap Re shares were committed in favor of the Ace deal. Ace sued Cap Re to prevent it from exercising a right to meet with XL, a competing bidder. The case focused on language in the contract that enabled the Cap Re Board to meet with a competing bidder, if required to avoid a breach of fiduciary duty. Instead of simply finding that the language of the merger agreement gave Cap Re a right to meet with the competing bidder and to terminate in favor of a better deal, the Court launched into some rather startling dicta concerning whether, even absent *Revlon* duties, a Board can contract away its right to terminate in favor of a better deal: "The fact that that board has no *Revlon* duties does not mean that it can contractually bind itself to sit idly by and allow an unfavorable and preclusive transaction to occur that its own actions have brought about."⁷ Further, "it is especially important that the board negotiate with care and retain sufficient flexibility to ensure that the stockholders are not unfairly coerced into accepting a less than optional exchange for their shares."⁸

Clearly the *Ace* Court was troubled by the thought that the Cap Re Board might not have reserved the right to terminate the merger agreement in a situation where 46% of the stock was committed to vote for the merger, absent such a termination. The same concern would appear to apply to the grant of a Section 203 waiver with respect to a lockup arrangement with a significant stockholder. Under the *Ace* Court's view, a Board may need to seek to limit a Section 203 waiver for a lockup to the situation where the Board continues to recommend the merger. Otherwise, depending upon the

⁶ *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999).

⁷ *Id.* at 108.

⁸ *Id.* at 109.

amount of stock locked up, the initial bidder could use the lockup to force a transaction on other stockholders in the face of a competing bid.

The implication of the *Digex* notion of a *duty* to use leverage, and the *Ace* precaution that a Board negotiate with caution and retain sufficient flexibility to secure the best transaction for stockholders, is that courts will closely review Section 203 waivers in all contexts, whether or not a sale of control is occurring, and that the standard of review may not be as clear as practitioners would desire. The Section 203 leverage – a creature of statute – may prove to be a newly hazardous tool for Boards of Delaware corporations.

