
I. INTRODUCTION

This action arises out of the merger (the “Merger”) of American Surgical Holdings, Inc. (“American Surgical” or the “Company”) with […] an affiliate of Great Point Partners, I LP (“Great Point” […]).* Plaintiff Richard Frank brought this purported class action to challenge the Merger. Frank alleges that American Surgical’s Board of Directors (the “Board”), and the Company’s control group (the “Control Group” and collectively, with [Great Point] and the Board, the “Defendants”) breached their fiduciary duties in connection with the Merger. […]

II. BACKGROUND

[…] Frank was, at all relevant times, the owner of shares of American Surgical common stock. […] Defendants Zak W. Elgamal, Jamie Olmo–Rivas, Charles Bailey, Michael Kleinman, and Henry Y.L. Toh were, at all relevant times, the members of the Board. Elgamal also was Chairman of the Board, as well as American Surgical's President and Chief Executive Officer.

Before the Merger, Elgamal owned 27.53% of American Surgical's common stock. Olmo–Rivas was the Company's Chief Operating Officer, and, before the Merger, he owned 27.58% of the Company's common stock. Until the Merger, Defendants Jose Chapa Jr. and Bland E. Chamberlain III were surgical assistants employed with American Surgical. In addition, Chapa was one of the Company's most highly compensated executive officers, and he owned 8.04% of American Surgical's common stock. Chamberlain owned 8.04% of the Company's common stock. Elgamal, Olmo–Rivas, Chapa, and Chamberlain make up the Control Group. Immediately before the Merger, the Control Group held 71.19% of American Surgical's common stock. […]

On August 12, 2009, the Board created a mergers and acquisitions committee (the “M&A Committee”), consisting of directors Toh, Elgamal, and Olmo–Rivas, to explore strategic opportunities for the Company. Soon after it was formed, the M&A Committee hired the Polaris Group (“Polaris”) to serve as the Company's financial advisor. On December 2, 2009, the Board designated directors Bailey and Kleinman as a special committee (the “Special Committee”). The purpose of the Special Committee was to “negotiate the terms and conditions of any potential transaction involving the sale of the Company,” but the Complaint alleges that “the members of the Special Committee engaged in little, if any, negotiations.”

From August 2009 through December 2009, Polaris solicited potential business combinations for American Surgical. “After various rounds of information sharing involving many strategic and financial entities, four parties emerged as having a continued interest in discussing a possible transaction.” The Complaint alleges that a company, described as Private Equity Firm A, proposed a strategic transaction to American Surgical that was superior to the Merger […]

* Great Point used affiliated companies to acquire American Surgical, in a transaction called a ‘reverse triangular merger’. We will discuss such transactions and understand why they are used in Section 4a (Mergers & Acquisitions Mechanics). To simplify the facts, I will refer here to the affiliated companies also as “Great Point”. 
The Special Committee, however, determined that the Merger “represented the most favorable transaction for the Company's shareholders” and “retained a separate financial advisor – Howard Frazier Barker Elliott, Inc. [“HFBE”] – to render a fairness opinion with respect to a possible transaction with Great Point.”

On December 20, 2010, after months of negotiations between American Surgical and Great Point, American Surgical entered into an agreement and plan of merger (the “Merger Agreement”) with [Great Point]. […] Under the terms of the Merger Agreement, each share of American Surgical common stock was converted into a right to receive $2.87 in cash. The Merger Agreement also provides that “[t]he affirmative vote of the holders of a majority of the outstanding Common Shares on the record date for the Company Meeting is the only vote of holders of securities of the Company which is required to approve and adopt this Agreement… [and] the Merger....” […]

On December 20, 2010, three sets of agreements, in addition to the Merger Agreement, were entered into in connection with the Merger. First, each member of the Control Group executed a stockholder voting agreement (the “Voting Agreements”) with [Great Point]. In the Voting Agreements, each member of the Control Group agreed to vote all of the American Surgical common shares he owned in favor of the Merger. At that time, the members of the Control Group owned about 64% of American Surgical's common stock, but by the record date of the Merger, they owned 71.19% of the Company's common stock.

Second, each member of the Control Group entered into an exchange agreement (the “Exchange Agreements”) with [Great Point]. In the Exchange Agreements, each member of the Control Group agreed to exchange, immediately before the effective time of the Merger, some of his American Surgical common shares for shares [in Great Point]. Collectively, the members of the Control Group agreed to, and subsequently did, exchange 2,234,707 shares of American Surgical common stock (about 17.4% of American Surgical's common stock) for a 14.9% ownership interest in [Great Point]. Thus, although American Surgical's minority shareholders would be cashed-out in the Merger, the Exchange Agreements, which were executed on the same day as the Merger Agreement, provided that the members of the Control Group would retain an interest in the Company following the Merger.

Third, each member of the Control Group signed an employment agreement with Great Point (the “Employment Agreements”), which became effective at the effective time of the Merger. “Elgamal and Olmo–Rivas were each provided with a base annual salary of $386,250, an annual incentive bonus up to 100% of their base salary, and an additional annual bonus of 12.5% of any EBITDA generated in excess of certain set target EBITDA amounts for the 2010 and 2011 calendar year…. [Great Point] also granted to Defendants Elgamal and Olmo–Rivas performance-based stock options equal to 1.75% of the fully diluted shares of… [Great Point] …, which options would vest based on the achievement of certain EBITDA targets…. Defendants Chapa and Chamberlain were provided with a base annual salary of $250,000 and $175,000 respectively, [and] with discretionary bonuses of $100,000 and $50,000, respectively.”

On December 19, 2010, the day before the Merger Agreement was executed, HFBE stated its
opinion that “the [Merger] consideration, without interest, to be received by the Company's stockholders (other than the ... [Control Group] ) was fair, from a financial point of view, to such holders.” The Complaint, however, takes issue with HFBE's fairness opinion. The Complaint alleges that the opinion was based, in part, on a flawed comparable company analysis. [...] The Complaint further contends that, even assuming HFBE's comparable company analysis was properly performed, [the Merger price was on the low end of the valuation range]. Moreover, the Complaint asserts that not all aspects of the fairness opinion were fairly disclosed to American Surgical's shareholders [specifically, certain synergies from the Merger were anticipated by HFBE but not disclosed in the proxy sent to the shareholders].

[...] On February 23, 2011, at a special meeting of American Surgical's common stockholders gathered for the purpose of voting on the Merger, 86.6% of the Company's common stock was voted, and 99.9% of those shares voted were cast in favor of the Merger. [...]  

III. CONTENTIONS  

[...] [Plaintiff] alleges that the Merger “is an attempt to deny Plaintiff and the other members of the Class their right to share proportionately in the true value of the Company, while usurping the same for the benefit of the... [members of the Control Group] who will maintain an interest in American Surgical on terms that were unfair and inadequate to Plaintiff and the members of the Class.” [...]  

The Defendants have filed a joint motion to dismiss the Complaint [...]. The Defendants argue that the arguments made [by Plaintiff] are insufficient to rebut the presumptions of the business judgment rule. The Defendants admit that a control group may, necessarily, have to show the entire fairness of a transaction that it stands on both sides of, but the Defendants argue that here, the Control Group did not stand on both sides of the Merger. The Defendants argue that [Great Points, a third party] with no affiliation to any member of the Control Group, structured the terms of the Merger, and that “none of the alleged controllers in this case – individually or as a group – negotiated the part of... [the Merger] that involved the... [minority shareholders’] deal compensation.”

Moreover, the Defendants argue that the members of the Control Group “were net sellers of American Surgical's shares in the Merger....” “The... [members of the Control Group] sold 75% of their shares for the same Merger consideration as all of the other stockholders, and “rolled over” only 25% of their shares. Moreover, while the shares they rolled over represented nearly 18% of the outstanding stock of American Surgical, they were exchanged for only 15% of the acquiring company—a correspondingly smaller percentage of the acquiring company's shares.... In these circumstances, the Rollover Defendants would always be better off if a higher price were paid in the Merger.”

Because, according to the Defendants, the allegations [...] are insufficient to overcome the presumptions of the business judgment rule, the Defendants argue that [Plaintiff] fails to state a claim that the members of the Control Group breached their fiduciary duties. The Defendants also dispute that Chamberlain and Chapa were part of the Control Group—“[w]ithout allegations that Chapa and Chamberlain were somehow needed to secure dispositive control over the trans-
action, they are not accused of violating any specific duties to the class shareholders and must be dismissed.” […]

IV. ANALYSIS

[...] When a corporation with a controlling stockholder merges with an unaffiliated company, the minority stockholders of the controlled corporation are cashed-out, and the controlling stockholder receives a minority interest in the surviving company, the controlling stockholder does not “stand on both sides” of the merger. Therefore, in that type of transaction, Kahn v. Lynch Communication Systems, Inc. “does not mandate that the entire fairness standard of review apply notwithstanding any procedural protections that were used.”

“[I]t is nonetheless true that... [the controlling stockholder] and the minority stockholders... [are] in a sense ‘competing’ for portions of the consideration ... [that the unaffiliated company is] willing to pay to acquire... [the corporation] and that... [the controlling stockholder], as a result of his controlling position, could effectively veto any transaction. In such a case it is paramount – indeed, necessary in order to invoke business judgment review – that there be robust procedural protections in place to ensure that the minority stockholders have sufficient bargaining power and the ability to make an informed choice of whether to accept the third-party's offer for their shares.”

Specifically, “business judgment would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent special committee, and (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.” If a transaction is not conditioned on “robust procedural protections,” “entire fairness is the appropriate standard of review.”

[...] The Complaint pleads facts which suggest that the Control Group was American Surgical's controlling stockholder, that the Merger was a transaction between unaffiliated parties, and that the terms of the Merger granted the members of the Control Group a minority interest in the surviving company while American Surgical's minority stockholders were cashed-out. Therefore, because the Merger was not conditioned on “robust procedural protections,” the Merger will be reviewed for entire fairness.

1. The Control Group was American Surgical’s Controlling Stockholder

Although a controlling shareholder is often a single entity or actor, Delaware case law has recognized that a number of shareholders, each of whom individually cannot exert control over the corporation (either through majority ownership or significant voting power coupled with formidable managerial power), can collectively form a control group where those shareholders are connected in some legally significant way – e.g., by contract, common ownership, agreement, or other arrangement – to work together toward a shared goal. “If such a control group exists, it is accorded controlling shareholder status, and its members owe fiduciary duties to the minority shareholders of the corporation.”

Although there was no one person or entity that controlled American Surgical, the Complaint
sufficiently alleges that Elgamal, Olmo–Rivas, Chapa, and Chamberlain, the members of the Control Group, were connected in a legally significant way. The Complaint alleges that the members of the Control Group, “as majority shareholders of the Company acting in concert, owed fiduciary duties to the public shareholders of the Company....” Moreover, the Complaint outlines how all of the members of the Control Group contemporaneously entered into the Voting Agreements, the Exchange Agreements, and the Employment Agreements. Specifically, the Complaint describes that on December 20, 2010, each member of the Control Group (1) agreed to vote his shares of American Surgical common stock in favor of the Merger, (2) exchanged some of his American Surgical common stock for an interest in the post-Merger entity, and (3) accepted employment with the post-Merger entity. It can reasonably be inferred, from that conduct, that the members of the Control Group were acting as American Surgical's controlling stockholder. Therefore, for purposes of a motion to dismiss, the Control Group was American Surgical's controlling stockholder.57

2. American Surgical's Minority Stockholders were Cashed–Out in the Merger while the Control Group Retained an Interest in the Surviving Company

Although the Defendants try to distinguish this case from [In re John Q. Hammons Hotels Shareholder Litigation] and In re LNR Property Corp. Shareholders Litigation, the facts here are strikingly similar to the facts in each of those cases. In Hammons, a corporation with a controlling stockholder merged into an unaffiliated company, and the corporation's minority stockholders were cashed-out. The controlling stockholder, however, was not cashed-out. Rather, in return for his shares of the corporation's stock, the controlling stockholder received a 2% interest in the surviving company, as well as certain other benefits. The Court, in Hammons, recognized that the unaffiliated purchaser “made an offer to the minority stockholders, who were represented by the disinterested and independent special committee,” but the Court still determined that the merger would be subject to entire fairness review unless it was conditioned on “robust procedural protections.”

Similarly, in LNR, a corporation with a controlling stockholder merged with an unaffiliated company and the corporation's minority stockholders were cashed-out. In connection with the merger, however, the controlling stockholder and other members of the corporation's management obtained an ownership stake in the surviving entity. The LNR Court, addressing a motion to dismiss, was required to accept the allegation in the complaint that the controlling stockholder sold a portion of his stockholdings “for a significant sum yet still retained the ability to participate in

57 The Defendants argue that even if Elgamal and Olmo–Rivas are considered to be a control group, Chapa and Chamberlain should not be considered to be part of that group because “Elgamal and Olmo–Rivas certainly possessed a majority interest in American Surgical without Chapa and Chamberlain.” A person is part of a control group when he is connected to the other members of the control group in some “legally significant way.” Chapa and Chamberlain are alleged to have entered into Voting Agreements, Exchange Agreements, and Employment Agreements at the same time that Elgamal and Olmo–Rivas entered into those agreements. And the Complaint alleges that Elgamal, Olmo–Rivas, Chapa, and Chamberlain acted together to attain unique benefits for themselves at the expense of American Surgical's other stockholders. Thus, at this procedural stage, the Court will view Chapa and Chamberlain as members of the Control Group. If later in this litigation, Chapa and Chamberlain can show that they were not members of the Control Group, then they will obviously not be liable as controllers. […]
the Company's future profits and growth” by acquiring a 20.4% interest in the surviving entity. The Court determined that that allegation, “if true, could support a reasonable inference that... [the controlling stockholder] was sufficiently conflicted at the time he negotiated the sale that he would rationally agree to a lower sale price in order to secure a greater profit from his investment in... [the surviving entity].” The Court further stated that “[i]f this is shown to be the case, the transaction will be subject to entire fairness review.”

This case, as in Hammons and LNR, involves a corporation with a controlling stockholder that entered into a merger with an unaffiliated company, and in the Merger, the minority stockholders were cashed-out while the controlling stockholder retained the ability to participate in the corporation's future profits and growth. Although the Defendants correctly contend that there is no allegation in the Complaint that the Control Group negotiated the compensation that the minority stockholders received in the Merger, the Court in Hammons determined that even when an independent and disinterested special committee negotiates on behalf of the minority, a merger will still be subject to entire fairness review unless it is conditioned on “robust procedural protections.”

Moreover, although the Defendants contend that the members of the Control Group were “net sellers” in the Merger, the Court, in LNR, made clear that when a corporation's minority stockholders are being cashed-out in a transaction, and the corporation's controlling stockholder will have a continued interest in the surviving entity, it is reasonable to infer that the controlling stockholder might “agree to a lower sale price in order to secure a greater profit from his investment in... [the surviving entity].” [...] In short, the Merger is analogous to the transactions at issue in Hammons and LNR, and thus, the Merger is subject to entire fairness review unless it was conditioned on “robust procedural protections.”

3. The Merger was not Conditioned on Robust Procedural Protections

The Merger was not conditioned on a non-waivable vote of the majority of all the minority stockholders. Rather, the Merger Agreement provides that “[t]he affirmative vote of the holders of a majority of the outstanding Common Shares on the record date for the Company Meeting is the only vote of holders of securities of the Company which is required to approve and adopt this Agreement... [and] the Merger...” Moreover, the Defendants do not argue that the Merger was conditioned on some other shareholder-protective mechanism that would satisfy Hammons.71 Thus, the Merger is subject to entire fairness review.

71 The Defendants do argue that a majority of American Surgical's minority stockholders voted to approve the Merger. A majority of the minority vote, however, only serves as a robust procedural protection when it is a non-waivable pre-condition to a transaction. Only when a transaction is conditioned on a vote of the majority of all minority stockholders will the minority stockholders know that they have real power. The fact that a majority of American Surgical's minority stockholders eventually voted to approve the Merger is not a robust procedural protection; it is something that occurred after the Merger was a foregone conclusion. The one actual procedural protection that the Defendants point to is the Special Committee, and under Hammons, that is not enough to invoke the presumptions of the business judgment rule in this setting.
“[W]hen the entire fairness standard applies, controlling stockholders can never escape entire fairness review, but they may shift the burden of persuasion....” The one way that the Control Group could shift the burden of persuasion is by showing “that the transaction was approved... by an independent board majority (or in the alternative, a special committee of independent directors).” The Defendants claim that the Merger was approved by both an independent majority of the Board, and the Special Committee, which, they argue, was composed of independent and disinterested directors. The Defendants might be correct as to one or both of those claims, but a motion to dismiss is not the proper vehicle for deciding whether the burden of proof under entire fairness should be shifted.\footnote{See Orman (“Once the business judgment rule presumption is rebutted, the burden of proof shifts to the defendant, who must either establish the entire fairness of the transaction or show that the burden of disproving its entire fairness must be shifted to the plaintiff. A determination of whether the defendant has met that burden will normally be impossible by examining only the documents the Court is free to consider on a motion to dismiss—the complaint and any documents it incorporates by reference.”).} The Merger will be reviewed for entire fairness, and therefore, the Defendants’ motion to dismiss […] is denied.\footnote{The Court is aware that purchasers of companies, especially private equity funds, often condition a transaction on the continued employment of critical members of management. Moreover, purchasers will sometimes structure a transaction so that the managers who continue with the company receive an equity stake in the company. Presumably, transactions are structured in this way so that the managers have “skin in the game.” Moreover, this Court has suggested that, at least in some circumstances, it is permissible to structure transactions in this way. The problem of applying that reasoning to this case is that when the managers who are being given an on-going interest in the company are also members of the company’s control group, it is reasonable for the Court to infer not only that the purchaser wants the managers to have “skin in the game,” but that the managers/control group members are using their control to acquire a unique benefit for themselves at the expense of the minority stockholders. Delaware’s corporate law is primarily process-based — “the foundational principle of Delaware corporate law [is] that the directors, and not the court, properly manage the corporation.” Hammons clearly laid out a process-when a corporation with a controlling stockholder merges with an unaffiliated company, the minority stockholders of the controlled corporation are cashed-out, and the controlling stockholder receives a minority interest in the surviving company, the merger will be subject to entire fairness review unless there are robust procedural protections in place. The Merger Agreement did not contain robust procedural protections. Thus, it is subject to entire fairness review.}