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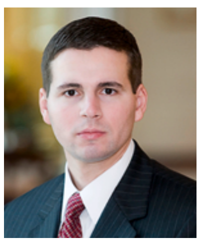
Recent Delaware Court of Chancery Decisions Address When A Non-Majority Stockholder Will Be Deemed a Controlling Stockholder



BY KEVIN R. SHANNON AND CHRISTOPHER N. KELLY

In three recent decisions,[1] the Delaware Court of Chancery reiterated that under Delaware law, a large, though not majority, stockholder of a corporation will not be considered a controlling stockholder (with the attendant fiduciary duties) unless that stockholder actually controlled the board of directors' decisions with regard to the transaction in question. In the first of these decisions, *In re KKR Financial Holdings LLC Shareholder Litigation*,[2] Chancellor Bouchard rejected the plaintiff-stockholders' novel claim that a 1 percent stockholder was a controlling stockholder because its affiliate managed the day-to-day business operations of the corporation pursuant to a management agreement. In the second decision, *In re Crimson Exploration Inc. Stockholder Litig.*,[3] Vice Chancellor Parsons rejected a claim that a 34 percent stockholder, which also was a large creditor of the corporation, was a controlling stockholder because the plaintiff-stockholders failed to allege facts sufficient to support a reasonable inference that the large stockholder actually exercised control over the corporation or the negotiation of the challenged merger. In the third decision, *In re Sanchez Energy Derivative Litigation*,[4] Vice Chancellor Glasscock held that a father and son, who together owned 21.5 percent of the corporation's stock and who both served on its board of directors, were not adequately alleged to be controlling stockholders of the corporation because there were no well-pled allegations indicating that the pair actually controlled the company's board of directors in connection with the transaction challenged in the litigation.

In a fourth case, *In re Zhongpin Inc. Stockholders Litig.*,[5] Vice Chancellor Noble, relying on perhaps the most "aggressive" Court of Chancery decision that a non-majority stockholder was a controller,[6] found that it was reasonably conceivable that a 17 percent stockholder, who also was the corporation's founder, chairman and CEO, could be a controlling stockholder.

The 'KKR' Case

In the *In re KKR Financial Holdings LLC Shareholder Litigation* case,[7] the Court of Chancery dismissed a purported class action by stockholders of KKR Financial

[1] *In re KKR Financial Holdings LLC Shareholder Litig.*, 101 A.3d 980 (Del. Ch. 2014) (12 CARE 1326, 10/17/14); *In re Crimson Exploration Inc. Stockholder Litig.*, 2014 BL 300486 (Del. Ch. Oct. 24, 2014) (12 CARE 1420, 10/31/14);*In re Sanchez Energy Derivative Litig.*, 2014 BL 332228 (Del. Ch. Nov. 25, 2014) (12 CARE 1622, 12/5/14).

[2] 101 A.3d 980 (Del. Ch. Oct. 14, 2014).

[3] 2014 BL 300486 (Del. Ch. Oct. 24, 2014).

[4] 2014 BL 332228 (Del. Ch. Nov. 25, 2014).

[5] 2014 BL 336534 (Del. Ch. Nov. 26, 2014).

[6] *In re Morton's Rest. Grp., Inc. S'holders Litig.*, 74 A.3d 656, 665 (Del. Ch. 2013) (characterizing *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531 (Del. Ch. 2003)).

[7] 101 A.3d 980 (Del. Ch. 2014).

Kevin R. Shannon is a partner, and Christopher N. Kelly is an associate, with the Wilmington, Del. law firm of Potter Anderson & Corroon LLP. The views expressed by the authors are not necessarily the views of Potter Anderson & Corroon LLP or any of its clients.

Holdings LLC (''KFN'')[8] challenging its acquisition by KKR & Co. L.P. (''KKR'') in a stock-for-stock merger,[9] rejecting the plaintiffs' novel claim that KKR, which held less than 1 percent of the shares of KFN stock, was nonetheless a controlling stockholder of KFN because an affiliate of KKR managed the day-to-day business operations of KFN pursuant to a management agreement.[10]

Under the terms of the management agreement, KFN delegated responsibility for its day-to-day operations to KKR Financial Advisors LLC (''KFA'').[11] According to plaintiffs, the management agreement made KFA responsible for, among other things, (1) selecting, purchasing and selling KFN's investments, (2) KFN's financing and risk management and (3) providing investment advisory services to KFN.[12] Plaintiffs also alleged that KFN was reliant on KKR to value its assets.[13] In exchange for the services they provided, KKR and its affiliates were entitled to a management fee.[14] The management agreement renewed automatically each year and could only be terminated by KFN with six months' advance notice and payment to KFA of a termination fee of four times the average management fee for the preceding two years.[15]

Notwithstanding KFN's reliance on KFA to manage its day-to-day operations, the management agreement explicitly provided that KFA would be subject to the supervision of KFN's board of directors and KFN's operating agreement empowered its board using language similar to § 141(a) of the Delaware General Corporation Law, stating that, except as otherwise provided therein, ''the business and affairs of [KFN] shall be managed by or under the direction of its [b]oard of [d]irectors.''[16]

The question whether a non-majority stockholder will be considered a controlling stockholder is an important one because controlling stockholders owe fiduciary duties to the corporation and its minority stockholders and, in certain transaction contexts, will be subject to the strict liability standard of entire fairness review.

On these alleged facts, the court dismissed the plaintiffs' claim that KKR breached its fiduciary duty of loyalty in its purported capacity as a controlling stockholder by allegedly causing KFN to enter into the merger at an unfair price after an unfair process.[17] The court rejected the plaintiffs' argument that KKR was a controlling stockholder of KFN, reasoning that the plaintiffs' allegations indicated only that KKR, through KFA, managed the day-to-day operations of KFN, and ''d[id] not support a reasonable inference that KKR *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.''[18] The court explained that:

> At bottom, plaintiffs ask the Court to impose fiduciary obligations on a relatively nominal stockholder, not because of any coercive power that stockholder could wield over the board's ability to independently decide whether or not to approve the merger, but because of pre-existing contractual obligations with that stockholder that constrain the business or strategic options available to the corporation. Plaintiffs have cited no legal authority for that novel proposition, and I decline to create such a rule.[19]

Accordingly, the court found that the plaintiffs' allegations did not support a reasonable inference that KKR controlled KFN's board of directors such that those directors could not freely exercise their judgment in determining whether to approve and recommend to the stockholders the merger with KKR,[20] or, as the court put it, ''that KKR had the power to exact retribution by removing the KFN directors from their offices if they did not bend to KKR's will in their consideration of the proposed merger.''[21] The court therefore dismissed the plaintiffs' breach of fiduciary duty claim against KKR for failure to state a claim.[22]

The 'Crimson Exploration' Case

In the *In re Crimson Exploration Inc. Stockholder Litigation* case,[23] the Court of Chancery dismissed a stockholder class action challenging the stock-for-stock merger of Crimson Exploration, Inc. (''Crimson'') and Contango Oil & Gas Co. (''Contango''), holding, in pertinent part, that there were no well-pled facts in the complaint from which it could reasonably infer that Oaktree Capital Management, L.P. and certain of its affiliates (collectively, ''Oaktree''), which owned about 34

[8] KFN's business was generating income and capital appreciation, primarily through investing in sub-investment grade corporate debt securities. *Id.* at 982. Its primary asset was a portfolio of subordinated notes in collateralized loan transactions that financed the leveraged buyout activities of KKR. *Id.* at 983.
[9] *Id.* at 981.
[10] *Id.*
[11] *Id.* at 983.
[12] *Id.*
[13] *Id.*
[14] *Id.* at 984.
[15] *Id.*
[16] *Id.*
[17] See *id.* at 990–92.
[18] *Id.* at 990.
[19] *Id.* at 991.
[20] The court also rejected the plaintiffs' contention that a majority of the KFN board of directors was not independent of KKR, finding that plaintiffs had alleged facts sufficient to call into question the independence of only four of the twelve board members. Two board members were high-level KKR employees at the time of the merger, but did not vote on the transaction. The court found that it was reasonably conceivable that two other directors would not be found independent of KKR because, according to the complaint, one had longstanding ties to KKR and served as a senior advisor to KKR and as chairman of a KKR affiliate, and another was Dean of Columbia Business School, which recently received a $100 million donation from KKR co-founder Henry Kravis. *Id.* at 992–95.
[21] *Id.* at 992
[22] *Id.*
[23] 2014 BL 300486 (Del. Ch. Oct. 24, 2014).

percent of Crimson's stock and was possibly its largest creditor, was a controlling stockholder of Crimson in the context of the third-party merger at issue.[24]

The court explained that ''to adequately plead that a non-majority blockholder was a controlling stockholder, a plaintiff would have to allege facts to show that the blockholder actually controlled the board's decision about the transaction at issue.''[25] Applying this standard, the court found that ''Plaintiffs' allegations simply do not support a reasonably coherent theory'' that Oaktree was a controlling stockholder in the context of Crimson's merger with Contango.[26] Although Oaktree controlled 34 percent of Crimson's stock, owned a significant portion of Crimson's debt, employed three of Crimson's seven board members, and allegedly designated a majority of Crimson's board and senior management, the court reasoned that ''the focus in a control analysis is on domination of the board with regard to the transaction at issue,'' and ''[t]here are no specific allegations from which a court reasonably could infer that Oaktree[ ] . . . actually exercised control over Crimson or the negotiation of the [m]erger.''[27] On the contrary, the court observed that Oaktree ''is an outside investment fund'' and that Crimson's lead negotiators with respect to the Contango merger ''were not employed by Oaktree.''[28] The court also recognized that ''Oaktree would suffer the most from a low merger price[.]''[29] In this context, the court concluded that ''Plaintiffs have failed to allege facts sufficient to support a reasonable inference that Oaktree was a controlling stockholder[.]''[30]

The court alternatively held that even if Oaktree were a controlling stockholder, the transaction still would be subject to the business judgment rule, not entire fairness review.[31] The court observed that entire fairness review has been applied to two types of conflicted controller transactions: (1) transactions where the controller stands on both sides; and (2) transactions where the controller competes with the minority stockholders for consideration by receiving disparate consideration or deriving some unique benefit from the transaction not shared with the other stockholders.[32] The court found that the plaintiffs had failed to allege facts sufficient for it to reasonably infer that Oaktree ''was conflicted in the Contango transaction, or that it received some benefit not shared with the common stockholders.''[33]

The court rejected the plaintiffs' contention that Contango's prepayment of the Crimson debt held by Oaktree, including a 1 percent prepayment penalty, constituted disparate consideration, explaining that ''at the time the merger was signed, there was no agreement to repay the debt early,'' and, therefore, ''the [p]repayment could not qualify as additional or different merger consideration.''[34] The court also recognized that ''side deals between an acquirer and a controller, which the board did not approve and to which the corporation is not a party, do not implicate entire fairness,'' and ''there [we]re no allegations that the Crimson Board was involved in negotiating or approved the debt repayment as part of the [m]erger [a]greement.''[35] The court also ''doubt[ed] that the 1% prepayment fee would compensate Oaktree sufficiently to cause it to take a lower price for its [Crimson] shares.''[36]

Finally, the court rejected the plaintiffs' argument that a registration rights agreement, which gave Oaktree the right to sell its stock in the combined entity in a private placement, constituted a sufficient benefit to warrant entire fairness review.[37] The court reasoned that ''[e]very stockholder received the same exchange ratio and Oaktree received something that would have had no value to the widely dispersed public stockholder,'' who ''presumably would sell their shares by way of a public market, rather than dispose of them in a private placement.''[38] The court also explained that contrary to the plaintiffs' allegations, Oaktree did not face a liquidity problem, which, in any event, could only constitute a conflict of interest where, unlike here, the transaction involved '' 'a crisis, fire sale where the controller, in order to satisfy an exigent need . . . agreed to a sale of the corporation' without performing the basic sale tasks necessary to achieve a price reflecting the corporation's market value.''[39]

The 'Sanchez Energy' Case

In the *In re Sanchez Energy Derivative Litigation* case,[40] the Court of Chancery dismissed pursuant to Rule 23.1 a consolidated stockholder derivative action asserting breach of fiduciary duty claims arising from a transaction in which the corporation, Sanchez Energy Corporation (''Sanchez Energy''), purchased assets from an entity controlled by two members of its board of directors, A.R. Sanchez Jr. and A.R. Sanchez III, who together owned 21.5 percent of the corporation's stock, whose family founded the corporation, and one of whom (Sanchez III) served as the corporation's president and CEO.[41]

[24] *Id.* at *1–*2.
[25] *Id.* at *16.
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.* In that regard, the court found persuasive the defendants' argument that ''[a] rational 33% stockholder and its board representatives would have the same interest as the public stockholders to obtain the highest price reasonably available for Crimson's shares.'' *Id.* at *21; *see also Iroquois Master Fund Ltd. v. Answers Corp.*, 2014 WL 7010777, at *1 n.1 (Del. Dec. 4, 2014) (''When a large stockholder supports a sales process and receives the same per share consideration as every other stockholder, that is ordinarily evidence of fairness, not of the opposite, especially because the support of a large stockholder for the sale helps assure buyers that it can get the support needed to close the deal.'').
[30] 2014 BL 300486 at *20.
[31] *Id.*
[32] *Id.* at *12.
[33] *Id.* at *20.
[34] *Id.* at *18.
[35] *Id.*
[36] *Id.*
[37] *Id.* at *20.
[38] *Id.*
[39] *Id.* at *14 (quoting *In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1036 (Del. Ch. 2012)). The court further noted that the merger would result in a ''dramatic[ ] increase'' in Oaktree's liquidity, as Oaktree, which owned about 34 percent of Crimson, would only own about 7 percent of the surviving company pursuant to the merger agreement's exchange ratio. *Id.* at *20.
[40] 2014 BL 332228 (Del. Ch. Nov. 25, 2014).
[41] *Id.* at *1. Specifically, the court determined that the plaintiffs had failed to establish demand futility under *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). *Id.* at *5–*13.

Citing the court's recent decisions in *In re KKR Financial Holdings LLC Shareholder Litigation* and *In re Crimson Exploration Inc. Stockholder Litigation* (among others), the court explained that a plaintiff must allege domination by a minority stockholder through "actual control over the corporation's *board of directors* in the transaction at issue."[42] That is, "actual board control in the transaction at issue is undoubtedly the defining and necessary feature of a minority controlling stockholder."[43] The plaintiffs' allegations—which, in addition to the above, included the assertion that the corporation has no employees and no directly managed operations, and that it was nothing more than a complex financial arrangement by which Sanchez Jr. was "handing over the reins" of an affiliated entity to Sanchez III—failed to satisfy this standard because those allegations did not support a reasonable inference that Sanchez Jr. and Sanchez III "actually controlled the Company's board in the Transaction."[44] In this regard, the court noted that the complaint contained no allegations that Sanchez III dominates or controls the board, nor any allegations indicating what role, if any, Sanchez Jr. and Sanchez III had in the negotiation of the transaction, which was approved by a disinterested and independent audit committee.[45] Thus, while the complaint alleged that "the Sanchez family has managerial control" over Sanchez Energy, it did not allege that Sanchez Jr. and Sanchez III had board control with respect to the transaction at issue.[46]

The 'Zhongpin' Case

In the *In re Zhongpin Inc. Stockholders Litigation* case,[47] the Court of Chancery denied a defense motion to dismiss a stockholder class action challenging Zhongpin Inc.'s going-private merger with its largest stockholder, Xianfu Zhu, who founded the company, owned 17 percent of its stock, and was its CEO and chairman of the board.[48]

Although the merger was negotiated by a special committee and approved by a majority of unaffiliated stockholders, and despite there being "no allegations that Zhu used his 17.3% stake in Zhongpin to force the Special Committee to accept his Proposal,"[49] the court found that the plaintiffs' complaint raised a reasonable inference that "Zhu could 'control the corporation, if he so wishe[d].' "[50]

In so ruling, the court relied on then-Vice Chancellor Strine's decision in *In re Cysive, Inc. Shareholders Litigation*,[51] wherein a 35 percent stockholder who was " 'the company's visionary founder, CEO, and chairman' " was held to be a controlling stockholder because he " 'exercised more power than a typical CEO' " due to "his 'influence over even the ordinary managerial operations of the company.' "[52] The court found Zhu's alleged influence to be just as pervasive as was the case in *Cysive*, based in large part on statements made by the company in its Form 10-K, in which the company referred to Zhu as "our controlling shareholder," stated that Zhu "exercise[d] significant influence over our company, including[ ] . . . mergers and acquisitions," and cautioned that the loss of Zhu "would have a material adverse effect on our business and operations."[53] Pertinently, the court explained as follows:

> The Complaint supports inferences that Zhu possessed both latent and active control of Zhongpin. The 10-K implies that Zhu possessed latent control; as a result of his stock ownership, he could exercise significant influence over shareholder approvals for the election of directors, mergers and acquisitions, and amendments to Zhongpin's bylaws. The 10-K also cites his stock ownership as a possible impediment to a potential acquirer's submission of a competing bid for the Company, with the effect of delaying or preventing a change in control. Plaintiffs have pled that Bidder A was only interested in a transaction in which Zhu, or at least the rest of Zhongpin's management, participated. Further, the fact that the Company received no bids during the go-shop period may imply that Zhu's grip on Zhongpin discouraged all potential acquirers from attempting to obtain control of the Company, just as the 10-K warned.

[54]

Based on these facts, the court determined that it was reasonably conceivable that Zhu "possessed active control over Zhongpin's day-to-day operations" and relied "heavily" on him to manage its business and affairs.[55] And, with respect to the issue whether Zhu exercised control over the transaction at issue, the court found it reasonably conceivable that "Zhu's dominance over Zhongpin left the Company with no practical alternatives other than to accept his Proposal,"[56] noting that the facts alleged in the complaint "imply that Zhu had at least the power to retaliate."[57]

The court also held that the entire fairness standard would apply to the going-private merger.[58] Although the merger involved the dual protective devices of a special committee and majority-of-the-minority voting condition, because "Zhu's Proposal did not include a majority-of-the-minority provision at the outset," entire fairness was the appropriate standard of review.[59]

Conclusion and Takeaways

The question whether a non-majority stockholder will be considered a controlling stockholder is an important one because controlling stockholders owe fiduciary duties to the corporation and its minority stock-

[42] *Id.* at *8 (emphasis in original).
[43] *Id.*
[44] *Id.* at *9.
[45] *Id.* at *10. The court found that the plaintiffs had failed to plead allegations sufficient to raise a reasonable doubt that the directors comprising the audit committee were disinterested and independent, as the complaint did not allege that any of the three committee members was financially interested in the transaction, nor did it contain any well-pled allegations indicating that the directors' personal or business relationships with Sanchez Jr. impacted their evaluation of the transaction. *Id.* at *5–*6.
[46] *Id.* at *9–*10.
[47] 2014 BL 336534 (Del. Ch. Nov. 26, 2014).
[48] *Id.* at *1.
[49] *Id.* at *8 n.27.
[50] *Id.* at *8 (quoting *Cysive*, 836 A.2d at 553).
[51] 836 A.2d 531.
[52] *Zhongpin*, 2014 BL 336534, at *7 (quoting *Morton's*, 74 A.3d at 665–66 (describing the facts of *Cysive*)).
[53] *Id.* at *7–*8.
[54] *Id.* at *9.
[55] *Id.*
[56] *Id.* at *8 n.31.
[57] *Id.* at *9 n.32.
[58] *Id.* at *10.
[59] *Id.*

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holders and, in certain transaction contexts, will be subject to the strict liability standard of entire fairness review.

The *KKR*, *Crimson Exploration* and *Sanchez Energy* cases illustrate the principle that a non-majority stockholder of a corporation will not be considered a controlling stockholder unless that stockholder actually controlled the board of directors' decisions with regard to the transaction in question such that the board of directors, fearing retribution from the stockholder, could not freely exercise its judgment in determining whether to approve and recommend to the stockholders the transaction. This ''actual control'' test ''is not easy to satisfy,''[60] and the *Zhongpin* decision comprises one of the few cases in which it could be satisfied (at least in the context of a motion to dismiss)—*e.g.*, a unique situation involving a large stockholder who also happens to be the company's founder and driving executive force, exercising significant managerial influence over the company's business and affairs.

In the event that a non-majority stockholder could be viewed as a controlling stockholder, then the question for transaction planners becomes whether the transaction being contemplated is of the type that could be subject to entire fairness review—*i.e.*, would the stockholder stand on both sides of the transaction or would it receive disparate consideration or derive some unique benefit from the transaction not shared with the other stockholders? On this point, it is important to keep in mind, first, that side deals to which the corporation is not a party generally do not implicate entire fairness, and, second, that recent decisions indicate that a controller's desire for liquidity will be deemed to constitute a conflict of interest only where the transaction involves ''a crisis, fire sale.''[61]

[60] *In re PNB Holding Co. S'holders Litig.*, 2006 BL 92554, at *9 (Del. Ch. Aug. 18, 2006).

[61] *Synthes*, 50 A.3d at 1036; see also *Answers*, 2014 WL 7010777, at *1 n.1.

If the non-majority stockholder could be viewed as a controller and the contemplated transaction could implicate entire fairness review, then it may be beneficial to consider conditioning the transaction from the outset on a special transaction committee and approval by a majority of the minority stockholders. In the event that these dual procedural protections are employed *ab initio*, then, under *Kahn v. M&F Worldwide Corp.*,[62] the transaction may be reviewed under the business judgment rule and not for entire fairness.[63]

[62] 88 A.3d 635 (Del. 2014) (12 CARE 320, 3/21/14).

[63] In *Kahn v. M & F Worldwide Corp.*, the Supreme Court held that the business judgment standard of review will apply to a controller buyout when: ''(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.'' 88 A.3d at 645. However, the court noted that the complaint at issue ''would have survived a motion to dismiss under this new standard,'' because its ''allegations about the sufficiency of the price call[ed] into question the adequacy of the Special Committee's negotiations, thereby necessitating discovery on all of the new prerequisites to the application of the business judgment rule.'' *Id.* at 645 n.14. The court further stated: ''If a plaintiff that can plead a reasonably conceivable set of facts showing that any or all of those enumerated conditions did not exist, that complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery. If, after discovery, triable issues of fact remain about whether either or both of the dual procedural protections were established, or if established were effective, the case will proceed to a trial in which the court will conduct an entire fairness review.'' *Id.* at 645 (internal footnotes omitted).