Controlling Stockholders in Delaware – More Than a Number

Recent cases show that Delaware courts will set a high bar for a finding of actual control at ownership levels below 50%.

Two recent Chancery Court decisions, *Crimson Exploration* and *KKR Financial*, confirm that Delaware takes a flexible and fact-specific approach to determining whether a stockholder is deemed to be "controlling" for purposes of judicial review of a transaction. It is important for dealmakers to understand when the courts may make a determination of control, both to properly craft a defensible process and to understand the prospects for resulting deal litigation.

Not surprisingly, ownership of 50% of the outstanding shares invariably has been found by the Delaware courts to constitute control (*Kahn*). But courts have come to varying conclusions in cases where they have been asked to evaluate ownership levels below that bright-line, even at percentages practitioners may generally understand to represent control for SEC purposes. These cases below the 50% threshold are, consistent with other Delaware jurisprudence, based on fact-specific inquiries that focus on other indicia of actual control. *Crimson Exploration* and *KKR Financial* confirm that the courts will not presume control, or absence thereof, at any specific ownership level, although it is probable that larger stakes make it more likely that control will be found.

In *Crimson Exploration*, VC Parsons granted a motion to dismiss plaintiff shareholder claims relating to a stock-for-stock sale, and provided a valuable primer on control cases in Delaware. The court reviewed the outcomes in a string of cases with ownership percentages ranging from the high-20s to as much as 49 and commented on the absence of "any sort of linear, sliding scale approach." Noting that control was found to reside in the hands of a 35% shareholder in *Cysive*, while no control was found in the case of a 46% holder in *Western National,* he focused on the fact-intensive examination of the other indicia of actual control beyond percentage ownership. He highlighted as the decisive factual inquiry for large blockholders below 50% whether they "actually control the board's decisions about the challenged transaction." In the *Crimson* case, VC Parsons, while ultimately deciding the case on alternative grounds, expressed doubts that there was sufficient evidence to suggest that Oaktree, which owned approximately 34% of Crimson and was a large creditor, actually "dominated" the board's decision to sell. While three of seven directors were Oaktree employees, he noted the alignment of interest between Oaktree and the rest of Crimson's shareholders in seeking to maximize the deal price. In addition, the court rejected the assertion that the holdings of an independent 15% shareholder should be aggregated with Oaktree's to find a "control group" merely based on a "concurrence of self-interest" among the stockholders. A "legally significant" actual agreement to "work together toward a shared goal" would be required before such an aggregation would be entertained.

Chancellor Bouchard undertook a similar analysis in his recent decision granting a motion to dismiss in *KKR Financial*, where plaintiffs alleged that KKR, a 1% owner of KKR Financial's (KFN) stock, should be deemed a controlling stockholder because of a management agreement under which KKR's affiliate managed the day-to-day operations of KFN. The court again applied an "actual control" test, noting that this bar was "not easy to satisfy," and focused on the same key factual inquiry as in *Crimson* – control or domination of the board as to the transaction decision. Although KKR nominated all of the directors of KFN and exercised "total managerial control," which made KFN "operationally dependent" on KKR, Chancellor Bouchard held that KKR's inability to remove or appoint directors or to block board decisions, including engaging advisers, meant that ultimate control relating to the challenged merger transaction resided with the board of KFN and not KKR. The existence of KFN contractual obligations (including a large fee for early termination of KKR's manage-

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ment agreement) that might affect the range of strategic options available to KFN did not make KKR a controlling stockholder, especially given the prior full disclosure of these arrangements to shareholders.

The importance of this determination – whether or not there is a controlling stockholder – resides in the fact that control can trigger judicial review under the more exacting entire fairness standard as compared to the more lenient business judgment rule. Courts will generally defer to the board's decision-making under business judgment and "litigants challenging a board's decision [under business judgment review] will face an uphill battle," while entire fairness can mean greater procedural and substantive litigation exposure for defendants. The mere existence of a controlling stockholder is not enough to implicate the entire fairness standard – rather, the controller must also engage in a conflicted transaction. VC Parsons explained in *Crimson* that a "conflicted transaction" may be found in two broad circumstances – where the controller stands on both sides of a transaction (such as a parent buying in a subsidiary) or where the controller "competes with the common stockholders for consideration" by receiving additional or different consideration. This second category includes situations where the controlling stockholder receives more per share than others (*TCI*), is offered the opportunity to take a significant continuing stake in the buyer (*John Q. Hammons* and other "rollover cases"), or receives a meaningful "unique benefit" not offered to other shareholders (*Primedia*). By contrast, where the controlling stockholder receives the same consideration as every other shareholder, entire fairness will not apply (*Synthes*) except in a narrow set of circumstances where the plaintiff can prove that exigent liquidity needs drove the controlling stockholder to drive a "fire sale" outcome (*infoGROUP*). In *Crimson*, VC Parsons held that a post-signing agreement by the buyer to prepay at a premium target debt owed to Oaktree and Oaktree's receipt of a registration rights agreement relating to its post-closing stake in the buyer was insufficient to constitute a conflicting "unique benefit" to trigger entire fairness review.

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In recent years, allegations that the target has a controlling stockholder involved in a sale transaction have become a popular litigation tactic for plaintiffs given the resulting prospect that entire fairness review may be applied. In the event entire fairness review applies, failure to implement additional process protections (such as a special committee and/or a disinterested shareholder vote) could expose the target board to extended litigation and potential liability. Recent cases show that Delaware courts will set a high bar for a finding of actual control at ownership levels below 50% and that, even if control is found, plaintiffs will be required to demonstrate that the resulting transaction was conflicted before the higher review standard will apply.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

Daniel E. Wolf
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dwolf
+1 212-446-4884

David B. Feirstein
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dfeirstein
+1 212-446-4861

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