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Private Equity Newsletter

November 12, 2014

Controlling Stockholders in Delaware – More Than a Number

PENpoints

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 involving public companies with significant ties to a private equity sponsor, *Crimson Exploration* and *KKR Financial*, confirm that Delaware takes a flexible and fact-specific approach when determining whether a stockholder has "control" for purposes of judicial review of a transaction. This determination is important because the presence of a controlling stockholder can trigger judicial review of a transaction under the more exacting entire fairness standard rather than 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. 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.

In recent years, allegations that a target has a controlling stockholder involved in a sale transaction have become a popular litigation tactic for plaintiffs in hopes that a court will review the transaction under the entire fairness standard. However, 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.

What Constitutes Control?

Delaware courts have consistently found that ownership of 50% of the outstanding shares constitutes control, but they have reached varying conclusions when evaluating ownership levels below that bright-line, even at percentages generally understood to represent control for SEC purposes. These cases below the 50% threshold are, consistent with other Delaware jurisprudence, based on fact-specific inquiries focusing 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 dismissed 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

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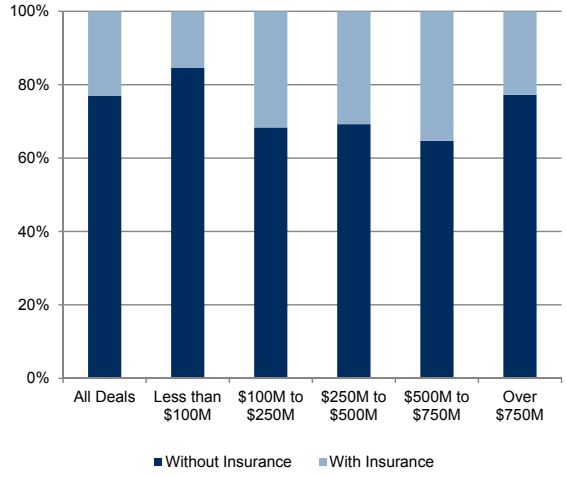

Excludes deals for which use of M&A insurance is unknown.The chart was generated from data in CTRAN, Kirkland's proprietary database of more than 1,050 private-target M&A transactions closed since 2008 in which Kirkland represented a transaction party.

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absence of "any sort of linear, sliding scale approach." Noting that control was found to reside in the hands of a 35% shareholder in one case while no control was found in the case of a 46% holder in yet another, the vice chancellor focused on the fact-intensive examination of the other indicia of actual control beyond percentage ownership. He noted that the decisive factual inquiry for large but less-than-50% holders was whether they "actually control the board's decisions about the challenged transaction." While VC Parsons ultimately decided *Crimson* on alternative grounds, he 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, requiring instead a "legally significant" actual agreement to "work together toward a shared goal" in order to entertain such aggregation.

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, not KKR. The existence of KFN contractual obligations (including a large fee for early termination of KKR's management 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.

When Does Entire Fairness Apply?

The mere existence of a controlling stockholder is not enough to implicate the entire fairness standard; 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 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, is offered the opportunity to take a significant continuing stake in the buyer, or receives a meaningful "unique benefit" not offered to other shareholders.

By contrast, where the controlling stockholder receives the same consideration as every other shareholder, entire fairness will not apply 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. Consequently, 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" triggering entire fairness review.

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

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PENbriefs

Individual Liability for Violation of U.S. Import Laws

A U.S. court recently ruled that a company president may be held personally liable under U.S. import laws for gross negligence in connection with undervaluing merchandise imported by the company. This decision makes clear that an individual acting for or on behalf of a company can face civil liability if merchandise is imported in violation of U.S. laws. To learn more, see our recent *Alert*.

DOJ Requires Disgorgement of Profits for Gun-Jumping Violations in Abandoned Transaction

The U.S. Department of Justice recently settled allegations that two parties engaged in illegal pre-merger coordination in connection with a now-abandoned transaction, imposing a fine on both parties and requiring one party to disgorge profits earned from sales to customers acquired from the other party. This settlement is notable because it marks only the second time DOJ has ordered disgorgement of profits resulting from a violation of antitrust laws. To learn more, see our recent *Alert*.

EU and United States Broaden Sanctions Targeting Russia

The European Union and the United States recently imposed additional sanctions targeting Russia. Current sanctions do not prohibit all trade or other transactions with Russia, but rather comprise an increasingly broad and complex set of restrictions, so companies with existing or potential business with Russia should consult appropriate experts to avoid potentially costly mistakes. To learn more, see our recent *Alert*.

U.S. Department of Justice Urges Companies to Provide Evidence Against Their Employees to Obtain Cooperation Credit

The U.S. Department of Justice recently announced an important change in the way it will evaluate whether a corporate defendant or target will receive credit for cooperating with the government in a criminal investigation: whether the corporation provides evidence against culpable employees "as far up the corporate ladder as the misconduct goes." To learn more, see our recent *Alert*.

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9th Annual Kirkland Real Estate Private Equity Symposium
New York, New York
November 19, 2014

The 9th Annual Kirkland Real Estate Private Equity Symposium, titled "Looking Over the Crest: Tomorrow's Investment Risks and Opportunities," will be hosted in Kirkland's New York office. Kirkland welcomes Sam Zell, Founder and Chairman of Equity Group Investments, as the keynote speaker. Click here for more information.

Private Equity Transactions Symposium 2014
London, England
November 20, 2014

The Private Equity Transactions Symposium is presented by the Private Equity Subcommittee of the IBA Corporate and M&A Law Committee, supported by the IBA European Regional Forum. The conference is intended for law firm partners and associates, in-house counsel, regulators and trade association representatives, academics, private equity investors and other professionals interested in joining leading private equity lawyers to discuss current legal and policy issues in the private equity industry. Kirkland partners Jay Ptashek and David Patrick Eich will speak at the conference. Click here for more information.

RR Donnelley SEC Hot Topics Institute
Chicago, Illinois
November 20, 2014

RR Donnelley will host its annual SEC Hot Topics Institute in Chicago. Renowned experts will examine the latest developments and trends, provide insight into what lies ahead and impart practical, actionable guidance on the crucial issues facing today's corporate and securities law practitioners and finance professionals. Kirkland partner Robert Hayward will be co-chairing the event and will be speaking at the event along with Stephen Fraidin. Click here for more information.

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Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013 and 2014 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland & Ellis was named "Law Firm of the Year" in Mergers and Acquisitions Law by U.S. News Media Group and Best Lawyers in their 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance*'s 2014 Legal Awards, "Law Firm of the Year in North America: Fund Formation" at Private Equity International's 2013 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012 and 2013*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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