

PERSPECTIVES

CONTROLLING
TRANSACTIONS WITH
A CONTROLLING
STOCKHOLDER

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Whether a large stockholder is a controlling stockholder is an important consideration when evaluating the viability or desirability of pursuing 'interested' transactions with controllers. Transactions with controllers are not prohibited, but generally they are subject to Delaware's highest standard of judicial review: entire fairness, which requires proof of fair dealing throughout the transaction and fair price. However, "where the (transaction) is conditioned *ab initio* upon both the approval of an independent, adequately-empowered special committee that fulfils its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders", Delaware courts may apply deferential business judgment

review when considering challenges from minority stockholders. *Kahn vs. M&F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014). This article discusses recent developments in Delaware law explaining when a stockholder becomes a controller and how companies considering transactions with controlling stockholders can increase their chances of surviving judicial scrutiny.

When a stockholder becomes a 'controlling stockholder'

Under Delaware law, a stockholder becomes a controlling stockholder by owning a majority of the company's shares or maintaining 'actual control' over the business affairs of the company. Whether

a stockholder maintains actual control over the company may require a complex analysis. In 2014, several Delaware decisions examined when a minority stockholder becomes a controller. *Hamilton Partners, L.P. vs. Highland Capital Management, L.P.*, 2014 WL 1813340 (Del. Ch.); *In re KKR Financial Holdings LLC Shareholder Litigation*, 101 A.3d 980 (Del. Ch. 2014); *In re Crimson Exploration Inc. Stockholder Litigation*, 2014 WL 5449419 (Del. Ch.); *In re Sanchez Energy Derivative Litigation*, 2014 WL 6673895 (Del. Ch.); *In re Zhongpin Inc. Stockholders Litigation*, 2014 WL 6778537 (Del. Ch.). These rulings show that one's status as a controller depends on the acts he takes or influence he exerts to prevent the board from acting independently.

Crimson

In *In re Crimson Exploration Inc. Stockholder Litigation*, plaintiffs alleged that Oaktree Capital Management, L.P. (Oaktree) was a controlling stockholder of Crimson Exploration Inc. (Crimson) and purportedly breached its fiduciary duties by approving Crimson's merger with Contango Oil & Gas Co. (Contango). 2014 WL 5449419. Oaktree moved to dismiss the complaint. The Court reviewed nine 'significant cases' where large stockholders disputed the 'actual control' issue. *Id.* at *10. The Court's review revealed that there is no "linear, sliding scale

approach whereby a larger share percentage makes it substantially more likely that the court will find the stockholder was a controlling stockholder". *Id.* The Court also noted the "importance and fact-intensive nature" of assessing a stockholder's actual control over a company. *Id.* The Court did not find that Oaktree controlled Crimson, notwithstanding that

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Oaktree controlled more than one-third of Crimson's common stock, stood as a large Crimson creditor, had three employees on Crimson's board, and maintained the power to designate a majority of the board and senior management. *Id.* at *16.

Sanchez

In re Sanchez Energy Derivative Litigation gave the Court another opportunity to determine on a motion to dismiss whether a large stockholder constituted a controller. 2014 WL 6673895. Stockholders of



Sanchez Energy Corporation (Sanchez) challenged a transaction in which Sanchez purchased assets from Sanchez Resources, LLC. Although two members of Sanchez's five member board, A.R. Sanchez Jr. and A.R. Sanchez III (defendants), together owned 21.5 percent of Sanchez, and A.R. Sanchez III served as chief executive officer (CEO) of the company, the plaintiffs could not demonstrate that the defendants actually controlled the corporation. *Id.* at *9. The independent stockholders retained nearly 80 percent of the voting control of Sanchez and the defendants

could not remove a dissenting director on their own. The plaintiffs also did not allege that A.R. Sanchez III maintained any greater control than would a typical CEO, or that he employed aggressive tactics to maintain control. *Id.* Thus, the defendants were not controllers and the Court dismissed the suit. *Id.* at *10.

KKR Financial Holdings

In *In re KKR Financial Holdings LLC Shareholder Litigation*, Chancellor Bouchard granted the

defendants' motion to dismiss, finding that KKR & Co. L.P. (KKR) did not control KKR Financial Holdings LLC (KKN). 101 A.3d 980. The plaintiffs alleged that KKR, a less than 1 percent KKN stockholder, controlled KKN because of a management agreement in which a KKR affiliate managed the day-to-day KKN's business. *Id.* at 983. The plaintiffs failed to show that due to KKR's control, KKN could not "freely exercise their judgment in determining whether or not to approve and recommend to the stockholders a merger with KKR". *Id.* The Court also highlighted that KKR had no right to appoint directors or dictate board action. *Id.* at 994.

Zhongpin

In *in re Zhongpin Inc. Stockholders Litigation*, the Court found that a stockholder may be "controlling" even though it only owned approximately 17.3 percent of the stock of the company. 2014 WL 6778537. Xianfu Zhu (Zhu) was CEO, chairman of the board of directors, and a stockholder of Zhongpin Inc. (Zhongpin). *Id.* at *1. Zhu proposed to purchase the outstanding shares of Zhongpin's common stock in a going-private transaction. *Id.* The Court found the plaintiffs pled facts sufficient to raise the inference that Zhu could control Zhongpin. The Court considered Zhongpin's 10-K, which provided that Zhongpin relies "substantially on [Zhu], and our executive vice president, [Ben], to manage our operations... The loss of any one of [our key personnel], in particular Mr Zhu or Mr Ben, would

have a material adverse effect on our business and operations". *Id.* at *8. Thus, Zhu maintained latent and active control over Zhongpin through his stock ownership and control over the daily operations of the company. *Id.* Accordingly, the Court denied the defendants' motion to dismiss.

Hamilton Partners

In *Hamilton Partners, L.P. vs. Highland Capital Management, L.P.*, 2014 WL 1813340 (Del. Ch.), the Court considered whether the defendant Highland Capital Management, L.P. (Highland), which owned 48 percent of American HomePatient, Inc. (AHP) and was a substantial creditor of AHP, was a controller of AHP. 2014 WL 1813340. The Court concluded that one could reasonably infer that Highland was a controller of AHP due to Highland's willingness to enter into a forbearance agreement and Highland's later efforts to prevent AHP from refinancing its defaulted debt. *Id.* The Court denied Highland's motion to dismiss.

These cases show that Delaware courts will not lightly find a large, albeit minority, stockholder constitutes a controller absent extenuating circumstances. A large stockholder with board representation becomes a controlling stockholder only upon a showing of dominance over the company's affairs – e.g., the ability to retaliate against other board members, or exhibiting hostile behavior. Likewise, a significant stockholder who is also an officer does not control the business affairs of the company simply by virtue of his officership.

Unless a minority stockholder's influence over the company is so strong that the stockholder could essentially act as though he was a majority stockholder, the Court will not likely find that the stockholder is a controller.

What a controller and his company can do to protect themselves in interested transactions

A company that engages in an interested transaction with its controlling stockholder may protect itself from higher judicial scrutiny by, prior to negotiating the terms of the transaction, establishing an independent special committee to review and negotiate the terms of the transaction and requiring the controller to relinquish his voting power for purposes of the interested transaction to a majority of the minority stockholders. *M&F Worldwide*, 88 A.3d 635. In *Kahn vs. M&F Worldwide*, minority stockholders of M&F Worldwide Corp. (MFW) challenged a going-private merger initiated by MacAndrews & Forbes Holdings, Inc. (M&F), a 43 percent stockholder of MFW, and accepted by the MFW board of directors. *Id.* at 688.

The Court of Chancery granted the defendants' Motion for Summary Judgment; the plaintiffs appealed. *Id.* at 639. In a question of first impression, the Delaware Supreme Court affirmed the Court of Chancery's holding and adopted business judgment review where: (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 advisers 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. *Id.* at 645.

While approving a transaction with a controlling shareholder exposes directors to risk, the relationship with the controller is further complicated by the board's competing obligation to consider such a transaction, creating the potential for liability either way. Delaware courts have recognised that a transaction involving a controller may be the only way to maximise shareholder value. *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, 2014 WL 4418169, at *11 (Del. Ch.). *M&F Worldwide* is important for board members considering an interested transaction because the Court's analysis suggests that business judgment rule review may apply to non-going-private transactions involving controlling stockholders, so long as adequate protections are in place to protect the minority stockholders. The key to these protective measures is that independent, disinterested directors who are fully qualified and informed decide whether to recommend a transaction with a controller, and that the controlling stockholder relinquishes all voting power for purposes of the interested transaction.

Conclusion

Because transactions involving controlling stockholders give rise to greater judicial scrutiny, large stockholders negotiating a transaction with the company they control should consider the impact that their controller status may have on the transaction. To avoid controller status, a large stockholder should refrain from discussing the transaction with board members and segregate himself when possible from the company-side negotiations regarding the transaction. If a plaintiff succeeds in proving that a large stockholder is a controller, *M&F Worldwide* teaches that at the outset of the negotiations, the board should establish a special committee comprised of qualified, independent, and disinterested directors, and empower the special committee to be able to make an informed decision regarding the transaction.

Further, the board should require the controller to relinquish at the outset all voting power regarding the interested transaction. These protective measures will increase the company's chances of surviving judicial scrutiny. 



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