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PERSPECTIVE

The battle of business judgment and entire fairness

By Marc Boiron

In *Corwin v. KKR Financial Holdings LLC*, 629, 2014 (Oct. 2, 2015), the Delaware Supreme Court affirmed the Court of Chancery's decision that the approval of the board of directors of a Delaware corporation will be reviewed under the business judgment rule where a merger that is not subject to the entire fairness standard of review is approved by a fully informed, uncoerced vote of a majority of the minority stockholders of the corporation.

The Delaware Supreme Court noted that it would have reached the same conclusion even if the merger had been subject to the enhanced scrutiny standard of review under *Revlon v. MacAndrews & Forbes Holdings Inc.* Moreover, the Delaware Supreme Court concluded that control over the day-to-day operations of a company is insufficient to find that a stockholder is controlling.

The case arose out of the acquisition by KKR & Co. L.P. (KKR) of KKR Financial Holdings LLC (KFH) in a stock-for-stock merger. KKR and KFH both were publicly-traded companies. KKR owned less than 1 percent of KFH, and an affiliate of KKR, pursuant to a management agreement, managed the day-to-day operations of KFH.

The management responsibilities involved, among other things: (i) providing executive and administrative personnel, office space and office services to KFH; (ii) performing and supervising the performance of certain administrative functions of KFH; (iii) selecting, purchasing and selling KFH's investments; (iv) managing KFH's financing and risk; and (v) providing investment and advisory services to KFH.

The management agreement renewed automatically by its own terms and could be terminated only under limited circumstances, with nearly six month's advance notice and with the payment of a significant termination fee. Notwithstanding the

operational control of KFH, KKR's affiliate was subject to the oversight of KFH's board of directors. KKR had no right to appoint any members of KFH's board of directors or to veto any of its decisions.

KKR and KFH conditioned adoption of the merger agreement on the vote of a majority of KFH's shares held by persons other than KKR and its affiliates, which included investment funds, other investment advisory vehicles and portfolio companies of investment funds. A majority of such shares adopted the merger agreement in April 2014.

In this action, the plaintiff-stockholders alleged, among other claims, breaches of fiduciary duties against KKR and the members of KFH's board of directors.

To impose liability and the burden of proving entire fairness (Delaware law's strictest standard of review) on KKR, the plaintiff-stockholders argued that KKR was a controlling stockholder. The argument was based on the breadth of the management services that KKR's affiliate provided to KFH under the management agreement. The court decided that "a combination of potent voting power and management control such that the stockholder could be deemed to have effective control of the board" is necessary to impose fiduciary duties on a stockholder that does not own a majority of the company's stock. Given that neither KKR nor its affiliate had any veto rights or any right to appoint members of KFH's board of directors, the existence of pre-existing contractual obligations with KKR's affiliate that constrained KFH's business and strategic options did not require the court to impose fiduciary duties on KKR.

The court next addressed the effect of a fully informed, uncoerced stockholder vote on the standard of review applied in a case where the entire fairness standard of review did not apply. After the Delaware Supreme Court's decision in *Gantler v. Stephens* in 2009, there was uncertain-

ty in Delaware law as to whether a difference existed between the effect of a fully informed, uncoerced stockholder vote in a transaction that does not involve a controlling stockholder where a stockholder vote is statutorily required and one where the stockholder vote is voluntary. The court resolved the uncertainty by affirming the Court of Chancery's conclusion that, regardless of whether a statutory stockholder vote is required, approval of a transaction by a fully informed, uncoerced stockholder vote invokes the business judgment standard of review.

In addition, such vote invokes the business judgment rule even if a majority of the board of directors is not independent and disinterested or the transaction would otherwise be subject to the enhanced scrutiny standard of review under *Revlon*. The court concluded that KFH's stockholders received all material information regarding the board of directors' and KFH's interests and the negotiation process prior to the vote to approve the merger; therefore, the business judgment rule applied.

This decision highlights several areas of Delaware law that are relevant in the context of public and private company transactions. First, attention must be paid to disclosures made to stockholders. In addition to potential claims under Delaware law as a result of the board of directors' failure to disclose material information to stockholders, failure to disclose material information to stockholders may result in the board of directors having the burden to prove entire fairness or that it obtained the best price reasonably available, rather than the plaintiff-stockholders having the burden to rebut the presumption of the business judgment rule.

Second, a stockholder will owe fiduciary duties only if the stockholder owns a majority of the stock of a corporation or the stockholder has both "potent" voting power and management control. Therefore, under the right circumstances, it may

be preferable for a stockholder to contractually agree to limited veto or other voting rights that do not permit the stockholder to control the board and do not create potent voting power and management control, rather than acquiring a majority of the corporation's stock and having the ability to elect and remove directors. The contractual agreement is less likely to give rise to fiduciary duties as a controlling stockholder.

Third, where both properly motivated members of the board of directors and fully informed, independent and disinterested stockholders approve a transaction, Delaware courts strive to give effect the business decisions that led to approval of the transaction.

Lastly, the default fiduciary duties owed in the context of limited liability companies generally are the same as in the context of corporations, but the enforcement of such duties may differ. As the court noted, the greater contractual flexibility that limited liability companies have to limit or eliminate fiduciary duties (other than the implied covenant of good faith and fair dealing) may change the analysis of whether any members of a board or a controlling member breached his, her or its fiduciary duties.

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