Client Alert

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Delaware Court Dismisses Merger Suit Involving Externally Managed Company

In *In re KKR Fin. Holdings LLC S'holder Litig.*, C.A. No. 9210-CB (Del. Ch. Oct. 14, 2014), the Court of Chancery issued a noteworthy decision applying the business judgment rule to a challenged stock-for-stock merger. The decision is significant because, even assuming a majority of the directors lacked independence, the court found that a fully-informed stockholder vote resulted in the protection of the business judgment rule. In addition, the court held that the company's external manager was not a "controlling stockholder" because it did not dominate and control the board. This aspect of the court's holding is particularly important for many real estate investment trusts and other externally managed entities.

Background

KKR Financial Holdings LLC (the "Company") was a publicly traded entity established by KKR & Co. L.P. ("KKR") that invested in sub-investment-grade corporate debt securities. It was managed on a day-to-day basis by an affiliate of KKR (the "Manager") pursuant to a management agreement. The Manager and its affiliates owned less than 1% of the Company's stock. Although two of the Company's 12 board members were affiliated with the Manager, the Manager did not have any contractual right to appoint directors or veto board action of the Company. In late 2013, the Company and KKR announced a $2.6 billion stock-for-stock merger. The merger agreement was negotiated by a special committee of the board, and the transaction ultimately was approved by a majority of the Company's disinterested stockholders.

Opinion

The Manager and its Affiliates were not a "Controlling Stockholder"

Plaintiffs argued that the merger was subject to heightened scrutiny under the "entire fairness" standard because KKR, through the Manager, was a controlling stockholder. Although KKR owned less than 1% of the Company's stock, plaintiffs argued that the Manager's role gave KKR sufficient control to justify heightened scrutiny. Among other things, plaintiffs alleged that KKR created the Company, all of the Company's officers were employees of KKR and its affiliates, the Company admitted that it was "highly dependent" on the Manager, the Company's primary asset was a portfolio that financed leveraged buyout activities of KKR, and the Company could not terminate the management agreement without paying the Manager a significant fee.

The court rejected plaintiffs' argument, holding that, in the absence of majority share ownership, the "operative question under Delaware law" was whether KKR dominated and controlled the board of directors such that the directors "could not freely exercise their judgment in determining whether or not to approve and recommend" the merger. It then found that, although two board members were affiliated with the Manager, the plaintiffs failed to allege that the Manager or its affiliates dominated or controlled a majority of the board. Among other things, the court noted that the Company's directors were elected by the stockholders and thus could not be removed by the Manager if they rejected the proposed merger.

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The court also held that the Manager's contractual rights to manage the Company were insufficient to demonstrate the requisite level of control, observing that the management agreement did not allow the Manager to dictate any action of the board or prohibit the Company from hiring advisors and gathering information to be fully-informed.

Stockholder Approval Results in Business Judgment Rule Review

The court also held that, even if a majority of the Company's directors lacked independence, the merger would be reviewed under the business judgment rule because it was approved by a majority of disinterested stockholders. In so holding, the court rejected plaintiffs' disclosure claims challenging whether there was a fully informed vote.

Implications

The court's holding that a stockholder is not a "controlling" stockholder by virtue of a managerial role (in this case, through an affiliate's external management agreement) is significant. Many real estate investment trusts and other investment vehicles utilize the external-management structure. Relying on prior cases, the *KKR Financial* court said that stockholders that lack majority ownership must have such "formidable voting and managerial power that they, as a practical matter, are no differently situated than if they had majority voting control."

Here, the Company did not have any officers, employees or facilities of its own, and the Manager had complete managerial control over the Company's operations. The court further observed that, under the management agreement, the Company was under "pre-existing contractual obligations" that "constrain[ed] the business or strategic options available to the corporation." Nevertheless, a majority of the board was independent of the Manager, and the board had the authority to approve any merger. The opinion thus indicates that if the external manager lacks significant share ownership and the company has a majority of disinterested and independent directors, the transaction will not be treated as a "controlling stockholder transaction" potentially subject to entire fairness review. This is a narrow view of what constitutes control for purposes of triggering heightened scrutiny.

The court's holding regarding the effect of stockholder approval is also important. Specifically, the court held that the business judgment rule applies to a non-controlling stockholder transaction if it is approved by the disinterested stockholders — *even if the board approving the transaction consisted of directors who were not independent*. Several years ago, in *Gantler v. Stevens*, 965 A.2d 695 (Del. 2009), the Delaware Supreme Court created some uncertainty on this issue by holding that stockholder "ratification" was limited to instances in which the stockholder vote was not legally required. Subsequent cases, however, have held that disinterested stockholder approval still triggers the business judgment rule.[1] In addition, Vice Chancellor J. Travis Laster recently wrote a law review article distinguishing between ratification under *Gantler* and the effect of stockholder approval on the court's standard of review. He concluded that "[i]f a fully informed and disinterested stockholder majority votes in favor of a transaction otherwise subject to enhanced scrutiny, then the business judgment rule should become the operative standard of review."[2]

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[1] *See, e.g., Chen v. Howard-Anderson*, C.A. No. 5878-VCL, mem. op. at 33 (Del. Ch. Apr. 8, 2014); *In re Morton's Rest. Group, Inc. S'holders Litig.*, 74 A.3d 656, 663 n.34 (Del. Ch. 2013); *In re S. Peru Copper Corp. S'holder Deriv. Litig.*, 52 A.3d 761, 793 n.113 (Del. Ch. 2011); *see also In re Wheelabrator Techns., Inc. S'holder Litig.*, 663 A.2d 1194 (1200 (Del. 1995); *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879 (Del. Ch. 1999).

[2] J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 WM. MITHCELL L. REV. 1443, 1491 (2014).

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In *KKR Financial*, Chancellor Bouchard likewise took the position that *Gantler* did not intend to foreclose the business judgment rule in such cases. To the contrary, transactions approved by the disinterested stockholders on a fully informed basis will trigger business judgment review regardless of whether the vote was required by law (as in a merger) or purely voluntary.

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