Corporate Counseling and Corporate & Business Litigation
Alert
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MORRIS NICHOLS ARSHT & TUNNELL

Court of Chancery Provides Guidance on When a Less-Than-Majority Stockholder May Be Deemed a Controlling Stockholder

Under Delaware law, a less-than-majority stockholder may be deemed a controlling stockholder if it "exercises control over the business affairs of the corporation." Two recent opinions from the Court of Chancery provide helpful guidance as to how the Court will apply this standard.

First, in *In re KKR Financial Holdings LLC Shareholder Litigation*, the Court of Chancery held that a limited liability partnership (KKR) whose affiliate managed the operations of a limited liability company (KFN) was not a controller of that limited liability company. Although (i) all of KFN's officers were employees of KKR, (ii) KFN was "completely reliant" on KKR's affiliate for its everyday management under a management agreement that required a significant fee to terminate and (iii) KFN's primary assets were debt securities used to finance KKR's leveraged buyouts, the Court held that KKR, which owned less than 1% of KFN's equity, was *not* a controller. (Although involving alternative entities, the Court's analysis appears applicable to the determination of the existence of a controller in a corporate setting as well.) In doing so, the Court emphasized that the "operative question under Delaware law" was whether the holder "controlled . . . the board" so that the directors "could not freely exercise their judgment." Thus, although the allegations in *KKR*, if true, would demonstrate that "pre-existing contractual obligations" (i.e., the management agreement between KKR and KFN) "constrain[ed] the business or strategic options available to" KFN, they would not demonstrate KKR had "any coercive power" over "the board's ability to independently" make decisions.

Second, in *In re Crimson Exploration Inc. Stockholder Litigation*, the Court of Chancery held that a 33.7% stockholder and large creditor of a corporation, which allegedly designated a majority of the board as well as senior management of that corporation, and which had three employees sitting on that corporation's seven-member board, was not a controlling stockholder. Once again, the Court stated that "the focus in a control analysis is on domination of the board with regard to the transaction at issue," and found allegations of such control lacking. *Crimson* is especially helpful in that it contains (i) a detailed survey of cases in which the Delaware courts have considered whether a less-than-majority stockholder was a controlling stockholder, (ii) an analysis of which transactions involving a controlling stockholder trigger entire fairness review and (iii) a discussion of when stockholders might be grouped together to determine the existence of control.

Delaware law regarding the standard of review and standard of conduct in transactions involving controlling stockholders has developed significantly over the past few years. For example, with respect to the sale of controlled companies to third parties, the Court of Chancery has (i) reaffirmed that the duty of directors is to "determine if the sale to the third party 'will result in a maximization of value for the minority stockholders'" (*Frank v. Elgamal*) and (ii) stated that, absent extraordinary circumstances, "pro rata treatment" of a controlling stockholder and the minority stockholders is "a form of safe harbor" under Delaware law (*In re Synthes, Inc. Shareholder Litigation*). With respect to controlling stockholder squeeze out transactions the Delaware Supreme Court has provided a six-prong test for application of the business judgment rule (*Kahn v. M&F Worldwide Corp*). *KKR* and *Crimson* together provide welcome guidance on when these developments may come into play.

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