

INSIGHTS

Delaware Court Establishes "Taxonomy" For Controlling Stockholder Claims

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In a recent decision, the Delaware Court of Chancery (Parsons, V.C.) dismissed a shareholder class action complaint alleging that a target company's board of directors and private equity firm controlling stockholder breached their fiduciary duties by approving a merger that allegedly conferred side-benefits on the private equity firm at the expense of maximizing the sale price. *In re Crimson Exploration Inc. Stockholder Litig.*, No. CV 8541-VCP, 2014 WL 5449419 (Del. Ch. Oct. 24, 2014). In assessing the claims against the private equity firm, the Court established a useful "taxonomy" for analyzing whether alleged controlling stockholder conflicts of interest trigger entire fairness review.

Case Background

The lawsuit arose following a stock-for-stock merger (the "Merger") between Contango Oil & Gas Co. ("Contango") and Crimson Exploration, Inc. ("Crimson"). *Id.* at *1. On April 30, 2013, following negotiations that began in early 2013, Crimson and Contango announced the Merger. *Id.* at *5-6. Under the terms of the Merger, Contango acquired each Crimson share in consideration for 0.08288 shares of Contango. *Id.* at *6. As a result, Crimson's stockholders received a 7.7% premium and owned 20.3% of the combined entity. *Id.* Prior to approving the Merger, Barclays Capital Inc. ("Barclays"), Crimson's financial advisor, opined that the exchange ratio was fair to Crimson stockholders. *Id.*

On September 13, 2013, various Crimson stockholders ("Plaintiffs") filed suit challenging the Merger. *Id.* at *7. Plaintiffs alleged, *inter alia*, that (i) the Board members breached their fiduciary duties by approving the Merger, which significantly undervalued Crimson; (ii) Oaktree Capital Management, L.P. (together with its affiliated entities, "Oaktree") was a controlling stockholder of Crimson and breached its fiduciary duty by selling Crimson "below market value for self-serving reasons" and receiving several side benefits; and (iii) Contango and the merger subsidiary aided and abetted the breaches. *Id.* at *1, 7.

Was Oaktree a Controlling Stockholder?

The Court began by assessing Plaintiffs' contention that Oaktree was a controlling stockholder because, *inter alia*, (i) Oaktree owned 33.7% of Crimson's common stock; (ii) Oaktree and Crimson President, CEO, and Board member Allan Keel ("Keel") had a close relationship; (iii) three of Crimson's seven directors worked for Oaktree; (iv) the remaining Board members were nominated after Oaktree invested \$40 million in Crimson in 2005, and thus were approved or picked by Oaktree; and (v) various Crimson executives joined after Oaktree's 2005 investment. *Id.* at *3-4.

The Court began by reiterating the well-established principle that a stockholder that owns over 50% of a company's stock is, by definition, a controlling stockholder under Delaware law. *Id.* at *10. The Court then analyzed ten significant Delaware cases where the plaintiffs alleged control by non-majority stockholders (owning from 27.7% to 49+% of shares). *Id.* The Court concluded that "the cases do not reveal any sort of 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. Instead, the scatter-plot nature of the holdings highlights the importance and fact-intensive nature of the actual control factor." *Id.* (noting that in *In re Cysive, Inc. S'holder Litig.*, 836 A.2d 531 (Del. Ch. 2003), then-Vice Chancellor Strine held that a 35% stockholder was controlling, while in *In re W. Nat'l Corp. S'holder Litig.*, 2000 WL 710192 (Del. Ch. May 22, 2000), Chancellor Chandler held that a 46% stockholder lacked control). The Court stated that these cases "show that a large blockholder will not be considered a controlling stockholder unless they actually control the board's decisions about the challenged transaction." *Id.* at *12.

Turning to the allegations against Oaktree, the Court dismissed "hint[s]" in the complaint that Oaktree and other defendants, through voting agreements and other aligned interests, represented a control group that exceeded 50% of the stockholder vote. *Id.* at *15. The Court noted that Plaintiffs did not allege any specific instances of control by Oaktree, but rather promoted "an overarching theory that Oaktree sought to exit its investment in Crimson and, thus, was willing to undersell its shares." *Id.* at *16. Although the Court expressed skepticism that the allegations supported a reasonable inference that Oaktree colluded with company management to advance their interests at the expense of common stockholders, the Court was "hesitant to conclude that Plaintiffs could not conceivably make that showing," and thus assumed for the sake of analysis that Oaktree was a controlling stockholder. *Id.* at *16-17.

Was Entire Fairness Triggered?

Assuming that Oaktree was a controlling stockholder, the Court turned to the question of whether the allegations regarding its involvement in the Merger triggered entire fairness review. *Id.* at *17. The Court began by setting out a helpful "taxonomy" of the kinds of conflicted controlling stockholder transactions that have been held to automatically trigger entire fairness under Delaware law: (i) the controller is on both sides; and (ii) the controller competes with common stockholders for consideration. *Id.* at *12, 17. Because Oaktree did not have a relationship with Contango prior to the Merger, the Court held that there was no basis to conclude that it stood on both sides of the transaction, thus leaving the "competing with the common" theory as the only possible path to entire fairness review. *Id.* Under that theory, Delaware courts have identified three circumstances where entire fairness review may be triggered: "(1) the controller receives disparate consideration, which the board approves; (2) the controller receives a continuing stake in the surviving entity, whereas the minority is cashed out; and (3) the controller receives a unique benefit, despite nominal pro rata treatment of all stockholders." *Id.* at *14.

Turning to the complaint, the Court perceived that Plaintiffs' allegations asserted a combination of the "disparate consideration" and "unique benefit" categories. *Id.* at *17. The alleged disparate consideration came in the form of Contango's agreement to pay off Crimson's entire \$175 million Second Lien Credit Agreement (of which Oaktree held a significant portion), including a 1% prepayment penalty (the "Prepayment"). *Id.* at *6, 17. The alleged unique benefit was Oaktree's receipt of a Registration Rights Agreement ("RRA") to sell its stock in the

merged entity in a private placement, which allegedly allowed Oaktree – lacking liquidity and wanting to dispose of its investment – to divest its stock on better and easier terms. *Id.* at *6, 17, 19.

Evaluating Plaintiffs' claims against this backdrop, the Court emphasized that stockholders are presumed to have an incentive to seek the highest price possible for their stock, and that this inference is even stronger in the case of a larger stockholder like Oaktree. *Id.* at *17-19. Thus, in order to state a claim, Plaintiffs needed to plead facts or theories specific enough to permit the Court to disregard this natural inference. *Id.* at *17. As to the Prepayment, the Court reasoned that “the lack of allegations that Crimson was in financial straits, that Oaktree feared non-payment of its debt, or that the terms of the Second Lien otherwise were unfavorable to Oaktree” rendered it “unreasonable to infer that Oaktree preferred the Prepayment to a better deal price.” *Id.* at *18. As to Plaintiffs' “rather general and conclusory” unique benefit allegations, the Court found Plaintiffs' contention that Oaktree was “motivated by a need for liquidity” to be unconvincing. *Id.* at *19. The Court clarified that “for liquidity to be a driving motivation, there would need to be circumstances involving ‘a crisis, fire sale’ of the company,” which were not present in this case. *Id.* (quoting *In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1036 (Del. Ch. 2012)). The Court also distinguished two prior unique benefit cases that applied entire fairness where the controller removed something harmful to it but good for other stockholders, see *In re Primedia, Inc. Shareholder Litigation*, 67 A.3d 455 (Del. Ch. 2013) (elimination of a derivative suit), and where there was a poor price but the controller obtained cash for a unique, idiosyncratic liquidity problem, see *N.J. Carpenters Pension Fund v. infoGROUP, Inc.*, 2011 WL 4825888 (Del. Ch. Oct. 6, 2011). *Id.* at *20. Because Oaktree received merger consideration pursuant to the same exchange ratio as all stockholders, did not face a “severe liquidity problem” and the side-benefits “had no value to the widely dispersed public stockholder,” the Court concluded that Plaintiffs' allegations were insufficient to trigger entire fairness review. *Id.*

Flowing from that conclusion, the Court also rejected Plaintiffs' contention that entire fairness should apply because a majority of the Board was interested in the Merger or not independent. *Id.* at *21. Just as the Court concluded that Plaintiffs failed to show that Oaktree lacked an incentive to seek the highest price for its stock, the Court found that Oaktree's director designees also were aligned with common stockholders in a shared desire to maximize stock value. *Id.*

Applying the business judgment rule, the Court dismissed Plaintiffs' complaint in its entirety with prejudice.

Takeaways

This decision provides significant guidance to private equity firms that take large equity positions in portfolio companies, as well as corporations and their fiduciaries seeking to avoid the pitfalls of shareholder M&A litigation. To begin, a significant equity position – even one in excess of 40% – in and of itself does not confer controlling stockholder status and the fiduciary duty that goes along with it. Rather, the hallmark of controlling stockholder status is control over the board's decision-making in connection with a challenged transaction. The absence of a bright line rule means that significant equity holders should be mindful that minority stockholders will scrutinize their conduct in connection with an M&A transaction for any hint of self-interest.

This decision makes clear, however, that not every incidental benefit conferred on a controlling stockholder will be sufficient to trigger review under the exacting entire fairness standard. This is key because entire fairness review usually forecloses early dismissal of a shareholder action, while review under the deferential business judgment rule standard often provides an avenue to seek dismissal before expensive and intrusive discovery. This decision illustrates that, even under Delaware's lenient "reasonable conceivability" pleading standard, generalized and conclusory allegations that a controlling stockholder received side-benefits will be insufficient to trigger entire fairness review absent a basis to infer that such side-benefits outweighed its incentive to maximize the value of its shares.

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