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Delaware Supreme Court Affirms Business Judgment Rule in Third-Party Mergers Approved by Disinterested Stockholders

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Mergers & Acquisitions

The Delaware Supreme Court held last week in *Corwin v. KKR Financial Holdings LLC*[1] that the business judgment rule standard of review is the presumptively appropriate standard "for a post-closing damages action when a merger that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the disinterested stockholders."[2] This important decision, taken together with the Court's decision from May in *In re Cornerstone Therapeutics Inc., Stockholder Litigation*[3] (discussed in our prior alert), may be viewed as potentially providing meaningful, strengthened protections for independent, disinterested directors engaged in M&A transactions and may signal an effort in the Delaware courts to constrain the overwhelming tide of deal litigation. In *KKR Financial Holdings*, the Court also provided a further, helpful clarification of facts relating to a minority stockholder's ability to significantly influence a corporation that did not result in the stockholder being deemed to control the corporation's Board of Directors.

The *KKR Financial* Decision: An Overview

Background. Plaintiffs, stockholders of KKR Financial Holdings LLC ("KKR Financial"), challenged a stock-for-stock merger between KKR & Co. L.P. ("KKR") and KKR Financial, alleging breach of fiduciary duties by KKR and the board of directors of KKR Financial. The merger, which was priced at a premium of 35% to market, was approved by an independent board majority and by a majority of stockholders other than KKR and its affiliates. Based on a contractual management relationship and operational ties between KKR and KKR Financial, plaintiffs argued that KKR was its controlling stockholder and therefore the merger was subject to the entire fairness standard of review. The Chancery Court dismissed the complaint, and on appeal plaintiffs reiterated their argument regarding the control exercised by KKR. Alternatively, plaintiffs alleged that the Chancery Court had erred by not applying enhanced judicial scrutiny under the *Revlon* standard in reviewing the transaction and by finding that it was subject only to business judgment rule standard of review.

Opinion. Upholding the judgment of the Chancery Court, the Supreme Court held that in the absence of control of a majority of an entity's voting stock, the Court will look into a "combination of potent voting power and management control" to ascertain whether a particular stockholder exercises "effective control of the board."[4] The Court found that since KKR "owned less than 1% of Financial Holding's stock, had no right to appoint any directors and had no contractual right to veto any board

[1] *Corwin v. KKR Fin. Holdings LLC*, No. 629, 2014 (Del. Oct. 2, 2015) (en banc)
[2] *Id*. at 1
[3] *In re Cornerstone Therapeutics Inc., S'holder Litig.,* No. 564, 2014 (Del. May 14, 2015)
[4] *Corwin*, No. 629, 2014, at 3

action,"[5] KKR Financial's directors were capable of exercising independent judgment. The court also took note that the existence of a management agreement pursuant to which KKR managed KKR Financial's day-to-day operations was known to investors when acquiring KKR Financial's shares.

The Court went on to hold that the Chancery Court properly applied the business judgment standard of review because the transaction had been approved by a "fully informed, uncoerced vote of the disinterested stockholders."[6] The Court declined to review the Chancery Court's opinion on the non-applicability of *Revlon,* holding that, even if *Revlon* applied to the merger, voluntary approval by an informed majority of disinterested stockholders was sufficient to invoke the business judgment standard of review in the case. The Court explained: "*Unocal* and *Revlon* are primarily designed to give stockholders and the Court of Chancery the tool of injunctive relief to address important M & A decisions in real time, before closing. They were not tools designed with post-closing money damages claims in mind, the standards they articulate do not match the gross negligence standard for director due care liability under *Van Gorkom*, and with the prevalence of exculpatory charter provisions, due care liability is rarely even available."[7] Importantly, the Court emphasized that all material facts must be disclosed to the voting stockholders for the business judgment rule to apply, referencing the consequences of nondisclosure of "troubling facts"[8] regarding director behavior. Finally, in noting that there are strong policy reasons to refrain from engaging in enhanced judicial scrutiny of third party mergers that have been approved by disinterested stockholders, the Court explained that the "litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them."[9]

Conclusion

Corporate boards and practitioners should be encouraged by *KKR Financial*, which affirms the principles that the control of a corporation lies with its board of directors and that the ability of fully-informed stockholders to decide on the economic merits of a third-party transaction may obviate the need for judicial second-guessing. If you have any questions concerning the material discussed in this client alert, please contact the following co-authors or any other members of our Mergers & Acquisitions practice group:

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[5] *Id*. at 2
[6] *Id*. at 4
[7] *Id*. at 11
[8] *Id*.
[9] *Id*. at 12