

October 27, 2014

In re KKR Financial Holdings LLC Shareholder Litigation

Delaware Chancery Court Rejects Claim that Manager Is a Controlling Stockholder; Applies Business Judgment Review to Merger Approved by Independent Board and Fully Informed Stockholders

SUMMARY

In an October 14, 2014 [decision](#)¹ on a motion to dismiss, the Delaware Court of Chancery (C Bouchard) held that business judgment review applied to breach of fiduciary duty claims asserted against directors in connection with a stock-for-stock sale of KKR Financial Holdings LLC (“KFN”) to KKR & Co. L.P. (“KKR”), an entity which held 1% of KFN’s stock and whose affiliate managed KFN’s day-to-day operations under a management agreement having terms making it difficult for KFN to sell to anyone other than KKR. The Court held business judgment to be the appropriate standard of review because (i) the contractual arrangements did not make KKR a controlling stockholder of KFN, (ii) a majority of the directors of KFN were disinterested and independent and (iii) even if the KFN board was not independent, the merger was approved by a fully informed majority of disinterested stockholders. The Court found that Revlon duties did not apply because the merger involved two widely held public companies.

The opinion, in addition to being an affirmation of the power of the business judgment standard of review in a stock-for-stock acquisition transaction, emphasizes the Delaware law requirement that, to be “controlling,” a less than 50% stockholder must be shown to exercise “actual control with respect to the particular transaction that is being challenged”² and that the “actual control” test “is not easy to satisfy.”³ The decision also clarifies that an informed shareholder vote will permit business judgment judicial review of interested director actions even when the shareholder vote is required to effect the underlying transaction rather than taken for the purpose of shareholder ratification.

BACKGROUND

In December 2013, KKR, which owned less than 1% of the shares of KFN, agreed to acquire KFN, a publicly listed specialty finance company that primarily invested in sub-investment grade corporate debt securities, many of which financed KKR's leverage buyout activities, at a 35% premium to market. KFN delegated responsibility for its day-to-day operations to an affiliate of KKR pursuant to a management agreement that subjected the overall management of KFN to the supervision of KFN's board. The merger was subject to a requirement that a majority of the shares not held by KKR and its affiliates vote in favor of the merger. On April 30, 2014, KFN's stockholders voted in favor of the proposed merger.

The plaintiff stockholders of KFN brought suit, alleging that (1) the members of KFN's board breached their fiduciary duties of care and loyalty by agreeing to the merger, (2) KKR breached its fiduciary duty of loyalty as a controlling stockholder of KFN by causing KFN to enter into the merger agreement at an unfair price and after an unfair process, and (3) KKR and two affiliates party to the merger agreement aided and abetted the KFN board's breaches of fiduciary duty. The defendants filed a motion to dismiss.

THE COURT'S DECISION

The Court concluded that the plaintiffs failed to educe facts sufficient to make a reasonable inference that KKR exercised sufficient actual control over the Board's decisions with respect to the merger to be a controlling stockholder of KFN.⁴ Noting that the "actual control" test requires control over the board of directors,⁵ the Court stated that the operative question was whether KKR controlled the board of KFN such that the directors of KFN "could not freely exercise their judgment"⁶ in determining whether to approve a merger with KKR. Because KKR had no power to remove directors, to appoint any directors, to dictate or veto any action by the KFN board, or to prevent the board from hiring advisors and being fully informed, the Court rejected the plaintiffs' request to treat KKR as a controlling shareholder (with resulting fiduciary duties) because of contractual obligations that constrained KFN's business and strategic options.

Absent a controlling stockholder, the Court concluded that business judgment review applied in the first instance because the plaintiffs failed to allege sufficient facts to show that a majority of the board was not independent. Examining the challenged independence of four directors, the Court found that none of the following were sufficient to show that directors were interested: a director had originally been nominated by KKR to the board of KFN's predecessor, another director was the CEO of a company on which KKR-affiliated directors sat (but which KKR did not control), a director had worked with a KKR-affiliated director of KFN at Wells Fargo 12 years previously, and another director years before had been EVP of a KKR-portfolio company.

Moreover, the Court stated that business judgment review would apply even if the KFN board was not independent since the merger was approved by a majority of disinterested stockholders; as a result,

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based on *In Re Wheelabrator*,⁷ the stockholder vote would insulate the KFN board's approval of the merger from all attacks other than on the grounds of waste. In so holding, the Court rejected the notion that the *Wheelabrator* rule only applies where the stockholder vote is voluntary rather than where it is statutorily required as was the case with the KKN merger vote; instead, the Court noted that the Delaware Supreme Court's statements in previous cases⁸ did not change the *Wheelabrator* rule but merely clarified that the term "ratification" was apt only when the stockholder vote is voluntary.

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ENDNOTES

- ¹ *In re KKR Financial Holdings LLC Shareholder Litigation*, C.A. No. 9210-CB slip op. (Del. Ch. Oct. 14, 2014) (hereinafter, “Slip Op.”).
- ² Slip Op. at 17 (quoting *Williamson v. Cox Commc’ns Inc.*, 2006 WL 1586375, at *4 (Del. Ch. June 6, 2006)).
- ³ *Id.* at 18 (quoting *In re PNB Holding Co. S’holders Litig.*, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006)).
- ⁴ Quoting the Delaware Supreme Court case *Kahn v. Lynch Commc’ns Sys., Inc.*, 638 A.2d 1110, 1113-14 (Del. 1994), the Court stated that there were two scenarios in which a stockholder could be deemed a controller: “where the stockholder (1) owns more than 50% of the voting power of a corporation or (2) owns less than 50% of the voting power of the corporation but ‘exercises control over the business affairs of the corporation.’” Slip Op. at 17.
- ⁵ In *In re Morton’s Restaurant Group, Inc. Shareholders Litigation*, 74 A.3d 656, 664-65 (Del. Ch. 2013), the Court stated: “When a stockholder owns less than 50% of the corporation’s outstanding stock, a plaintiff must allege domination by a minority shareholder through actual control of corporate conduct. The bare conclusory allegation that a minority stockholder possessed control is insufficient. Rather, the Complaint must contain well-pled facts showing that the minority stockholder exercised actual domination and control over the directors.”
- ⁶ Slip Op. at 21-22.
- ⁷ In *In re Wheelabrator Technologies, Inc. Shareholders Litigation*, 663 A.2d 1194, 1200 (Del. 1995), the Delaware Supreme Court held that the effect of the shareholder vote in a case involving a duty of loyalty claim challenging an interested transaction was to “invoke the business judgment standard, which limits review to issues of gift or waste with the burden of proof resting upon the plaintiffs.”
- ⁸ See *Gantler v. Stephens*, 965 A.2d 695, 713 (Del. 2009) (stating that “the scope of the shareholder ratification doctrine must be limited to its so-called ‘classic form’; that is, to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective”).

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