

Controlling Stockholders May Face Liability if Found to have Acted in Coercive Manner in Exit Sale

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One benefit that controlling stockholders often seek in an exit transaction is the ability to negotiate a control premium which is not shared with minority stockholders. This ability has been generally upheld by Delaware courts as, with limited exceptions, Delaware typically permits a controlling stockholder to act in its own self interest when determining whether, and at what price, to sell its shares, without considering the interests of minority stockholders. *See, e.g., Abraham v. Emerson Radio Corp.*, 901 A.2d 751 (Del. Ch. 2006) and *In re John Q. Hammons Hotels, Inc. Shareholder Litigation*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

In the recent case of *In re Delphi Financial Group Shareholder Litigation*, the Delaware Court of Chancery (the "Court") was confronted with the issue of whether a controlling stockholder breaches his fiduciary duties to minority stockholders when he conditions his consent to a merger transaction upon his receipt of a control premium for his shares, notwithstanding a provision in the charter explicitly prohibiting such a control premium. Even though Vice Chancellor Glasscock ultimately denied the minority stockholders' motion for a preliminary injunction to enjoin a vote on the merger, the Court cleared the path for the minority stockholder plaintiffs to pursue damage claims against the controlling stockholder, as well as certain executives who assisted him. *In re Delphi Financial Group Shareholder Litigation* is an important reminder that courts can be expected to closely examine alleged conflicts of interest, and that controlling stockholders and those who assist them may face liability when they are found to have acted in an inequitable or coercive manner in an exit sale context.

Background

Since its initial public offering in 1990, Delphi Financial Group, Inc. ("Delphi") had two classes of authorized capital stock: Class A, which was largely held by the public, and Class B, which was held solely by one of the Defendants, Robert Rosenkranz ("Rosenkranz"). While Rosenkranz only held approximately 12.9% of Delphi's outstanding capital stock (based on number of shares), each share of Class B stock was entitled to ten votes (versus one vote per share of Class A stock), providing Rosenkranz with a 49.9% stake for voting purposes (the voting stake was capped at 49.9% pursuant to a voting agreement). Significantly, as part of Delphi's initial public offering and the concurrent creation of Delphi's dual-class capital structure, Delphi's charter was amended to require that, upon a merger involving payments on the shares of Class A stock and/or Class B stock, each share of Class B stock would be converted to one share of Class A stock so that all shares of capital stock would be entitled to receive the same per share consideration from such sale.

Tokio Marine Holdings, Inc. ("TMH") approached Rosenkranz in 2011 regarding a possible acquisition of Delphi. Rosenkranz, as Delphi's CEO and Chairman, commenced negotiations with

TMH on Delphi's behalf. According to the Court, Rosenkranz did not inform Delphi's Board of Directors (the "Board") of his desire for disparate consideration for the Class B stock until a few months into the discussions, although he and other Delphi executives used company resources to analyze how a division of merger proceeds might be accomplished. When he later informed the Board that he would not consent to the sale of Delphi unless he received a control premium for his Class B stock, the Board was initially reluctant to consider a price differential for the Class B stock, but eventually recognized that TMH was offering a well above-market price for both classes of Delphi's capital stock (even factoring in a differential for the Class B stock) and that Rosenkranz was unlikely to consent to the transaction without a differential. Therefore, the Board formed a special committee to consider the merger transaction with TMH and a separate sub-committee to negotiate with Rosenkranz the price differential between the Class A stock and the Class B stock. Despite the apparent conflict of interest between the Class A stockholders and Rosenkranz, the special committee determined that it was in the best interest of Delphi as a whole that Rosenkranz continue to negotiate with TMH on behalf of Delphi because of his intimate knowledge of Delphi's business and concerns that TMH would be alerted to an internal conflict if Rosenkranz was replaced. Contemporaneously with the TMH negotiations regarding the merger consideration, Rosenkranz and the sub-committee continued to negotiate the price differential between the classes of capital stock. The special committee ultimately agreed to accept TMH's offer of \$46 per share (without distinction between the Class A stock and Class B stock). Meanwhile, the results of the negotiation between the sub-committee and Rosenkranz resulted in a price allocation between the two classes of capital stock of \$44.875 per share of Class A stock and \$53.875 per share of Class B stock. The Board approved the merger conditioned upon the approval of a majority of the disinterested Class A stockholders (excluding Class B stockholders and their affiliates), and an amendment to Delphi's charter to remove the prohibition on classes of stock receiving different consideration, which charter amendment required approval by a majority vote of all stockholders. Certain of the minority stockholders subsequently brought an action to enjoin the stockholders' vote on the merger.

Court's Analysis

The plaintiff minority stockholders asserted various legal claims against Rosenkranz and the other defendants (including members of the Board), but the Court analyzed most closely and found most persuasive the claim that Rosenkranz breached his contractual and fiduciary duties to the minority stockholders by seeking and obtaining a control premium for his Class B stock.

While affirming that a controlling stockholder is generally permitted to negotiate and receive a control premium for its shares, the Court indicated that Rosenkranz had already received such a premium for his Class B stock in connection with the 1990 initial public offering and related charter amendment, surmising that the stockholders who acquired shares of Class A stock in or after the initial public offering "in return for the protection against differential merger consideration found in the charter paid a higher price for their shares." The court continued that "though Rosenkranz retained voting control, he sold his right to a control premium to the Class A stockholders via the charter" and that to permit a second control premium on the Class B shares would render the minority stockholders' charter rights illusory and could likely result in "a wrongful transfer of merger consideration from the Class A stockholders to Rosenkranz." The Court was critical of the fact that Rosenkranz had interests that were not aligned with those of the Class A stockholders on whose behalf he was negotiating, as he "knew he was negotiating a price which he, as controlling stockholder, would not accept for his stock."

Although the Court noted that the plaintiffs' claims were reasonably likely to succeed, it denied the plaintiffs' motion for preliminary injunction, thereby permitting a vote on the merger and charter amendment. The Court reasoned that any damages suffered by the stockholders would be easily determinable and remediable through money damages, based on the price differential between the

two classes of capital stock. The Court also was concerned that the stockholders might lose the existing deal, especially given that there were no other bidders and the deal under consideration would still pay the minority stockholders a 76% premium to market price.

Because the Court determined that it was reasonably likely that Rosenkranz had breached his fiduciary duties, the Court did not address the question of whether Rosenkranz's actions were also reasonably likely to represent a breach of contract, noting simply that Rosenkranz had violated duties to stockholders, either contractual or fiduciary. However, the Court did suggest that it may have been sympathetic with the plaintiffs' position with respect to this question:

[A] corporate charter, along with its accompanying bylaws, is a contract between the corporation's stockholders. Inherent in any contractual relationship is the implied covenant of good faith and fair dealing. A party breaches the covenant by taking advantage of its position to control implementation of the agreement's terms, such that its conduct frustrates the overarching purpose of the contract.

Vice Chancellor Glasscock went on to note that while "clear of any impending sale," Rosenkranz presumably could have purchased the right to a control premium back through a negotiated vote for a charter amendment, to allow him to coerce such an amendment in the sale context would render the charter rights illusory.

Conclusion

In re Delphi Financial Group Shareholder Litigation emphasizes the risk of coercive behavior by controlling stockholders against minority stockholders in the sale context, even where the procedures surrounding the negotiation of the transaction are not in themselves unreasonable. While the general rule that controlling stockholders may negotiate a control premium for their shares and/or exercise their voting rights independently is undisturbed, *In re Delphi Financial Group Shareholder Litigation* is an important reminder that actions by controlling stockholders in the sale context are not completely immune from judicial review, and that desired amendments of the type at issue may be best pursued well in advance of any impending sale process.



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