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Mind the Gap (in Interest Alignment): Potential Issues in Portfolio Company Sales

Quick Takes

While private equity activity bounced from month to month in 2022, there was a general downward trend over the course of the year, culminating in a steep decline in the number of deals in December. The total value of deals both globally and in the U.S. peaked in April and May, respectively. While it is unclear if December is a bellwether for 2023, tight credit markets and proactive regulatory regimes seem poised to dampen enthusiasm in the immediate term.

In this issue, we discuss litigation risk in private equity exits that may become more prevalent in challenging markets.

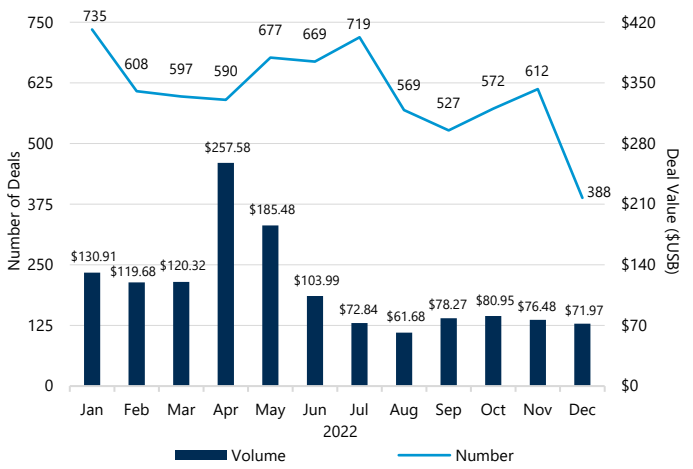
Sales of portfolio companies by a controlling stockholder, a critical component of private equity sponsor strategies, can pose litigation risk under certain circumstances. This includes the risk of claims brought by minority stockholders alleging that a controlling stockholder or its board affiliates forced a sale in violation of fiduciary duties. Below we discuss certain key considerations for private portfolio company sales in view of recent Delaware Court of Chancery decisions.[1]

When Might a Stockholder Owe Fiduciary Duties and to What Extent?

Generally, a corporation's board of directors and officers, not its stockholders, owe fiduciary duties to the corporation and its stockholders, and a controlling stockholder may vote its shares in its own self-interest and is not required to self-sacrifice. A controlling stockholder also generally has the right to negotiate a control premium for its shares.

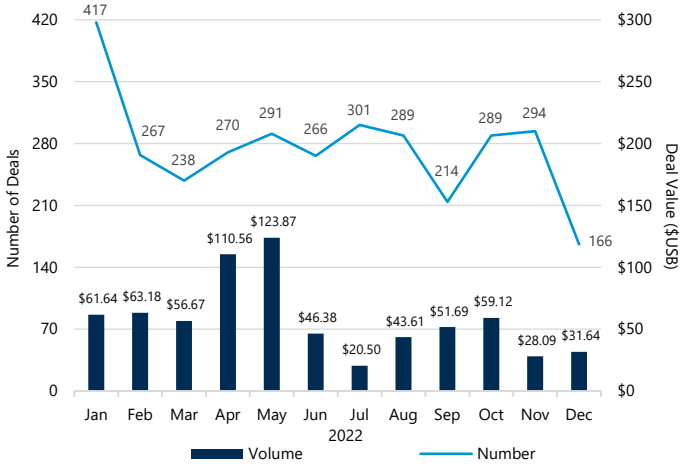
However, a controlling stockholder may not use its control over the corporate machinery to the detriment of the minority stockholders. In this regard, where there is a controlling stockholder and that stockholder is exercising its control to cause the board or the corporation to act, the controller owes a fiduciary duty of loyalty to the company's minority stockholders. In a sale transaction to a third party, a controlling stockholder's duty of loyalty is most often implicated when a plaintiff alleges that the controlling stockholder has caused the corporation to engage in a transaction in which the controller extracted additional value at the

Global Sponsor-Related M&A Activity



Source: Cortex[2]

U.S. Sponsor-Related M&A Activity



Source: Cortex[2]

expense of the minority stockholders, *e.g.*, by receiving either different consideration than the minority stockholders or something that is uniquely valuable.[3]

To be clear, a stockholder will only owe these fiduciary duties if deemed a *controlling* stockholder.[4] The determination of whether a stockholder is a controller can be an easy one – such as where the stockholder owns a majority of the company's voting stock – or it may be less so – such as where the stockholder owns a minority, but still significant bloc, of the outstanding shares of stock and exercises effective control over the company.[5]

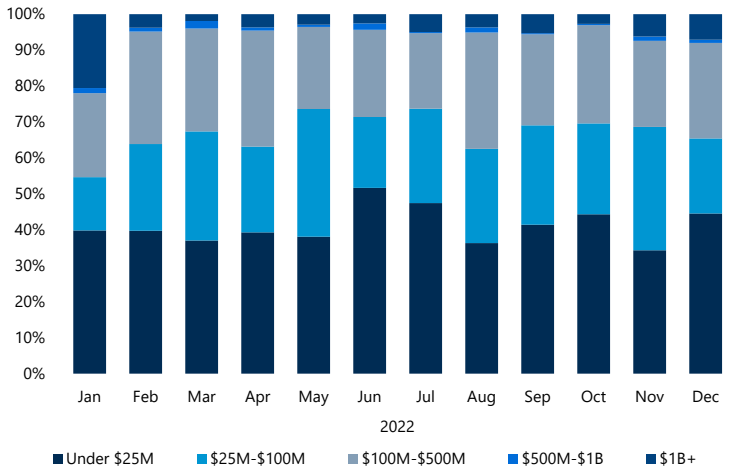
When are Delaware Courts Likely to Apply the Entire Fairness Standard, as Opposed to Business Judgment Protection, to a Sale Where There is a Controlling Stockholder, and What are the Consequences?

Assuming the sponsor is a controller and, therefore, owes fiduciary duties to the minority stockholders, the courts may review a sale of control transaction implicating the corporate machinery (including other actions taken in connection therewith)[6] under the entire fairness standard or the more deferential business judgment standard, depending on a number of factors. Unlike business judgment review, which defers to the board if there is a rational basis for the action, entire fairness review is a fact-intensive inquiry that requires the controlling stockholder or the board to prove both fair price and fair process. Practically speaking, the requisite factual inquiry for entire fairness review means that claims involving such standard almost always survive a motion to dismiss and therefore are more costly to resolve.

Generally, assuming the sale is to a third party and the controller receives the same consideration as, and no unique benefit different from, the minority stockholders, business judgment protection will likely apply.[7] Moreover, once such a transaction has been approved by a majority of the minority stockholders in an informed and uncoerced vote (commonly known as *Corwin* cleansing), business judgment review applies to the exclusion of other standards of review.

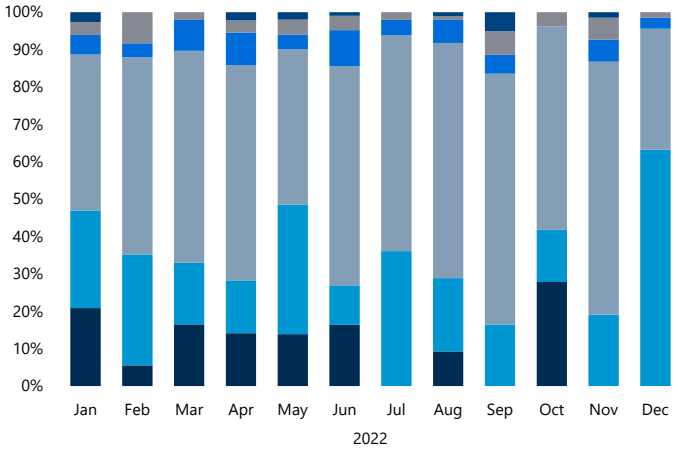
However, if the controlling stockholder stands on both sides of a transaction or receives differing or unique benefits in the transaction, entire fairness presumptively will apply to that transaction.[8] This would be automatic in the prototypical interested transaction (*i.e.*, a minority squeeze-out), but may also be the case where the stockholder uses its control to cause the corporation to enter into a transaction that benefits the controlling stockholder in a way that differs from the minority stockholders. In this latter instance, the controlling

U.S. Sponsor-Backed M&A by Size



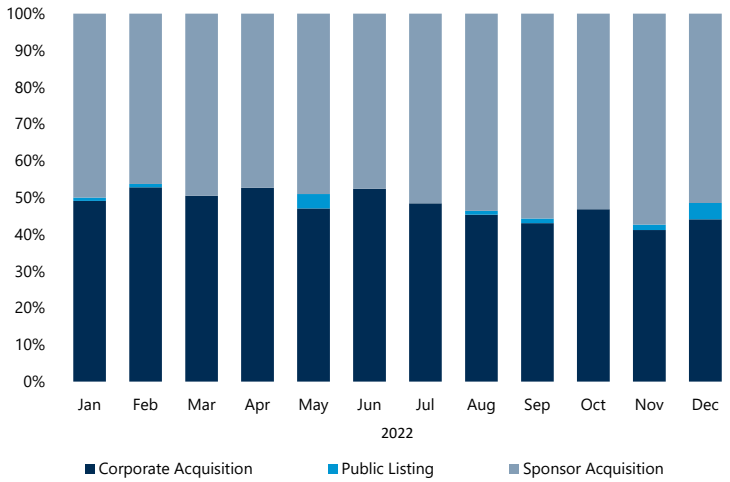
Source: PitchBook Data, Inc.[9]

U.S. Sponsor-Backed Exits by Size



Source: PitchBook Data, Inc.[9]

U.S. Sponsor-Backed Exits by Type



Source: PitchBook Data, Inc.[9]

stockholder (along with directors) may be liable for breach of the duty of loyalty if the plaintiff is able to show that the transaction was interested, or that the directors lacked independence from, the controlling stockholder. If not, the exercise of a drag-along right by the controlling stockholder, rather than by a corporation's board of directors, is less likely to be subject to fiduciary duty claims because the controlling stockholder is not causing the corporation or its board of directors to take any action; instead, the controlling stockholder is solely exercising its contractual rights, which it generally may do in its self-interest.

Can Meeting a Controller's Liquidity Needs Be a Special Benefit?

Satisfying a controller's specific liquidity needs has been argued as conferring a special benefit to the controlling stockholder. Though such theories of conflicts are difficult to plead, Delaware courts recognize that rational economic actors sometimes do place greater value on being able to access their wealth than on accumulating their wealth. While it may seem intuitive that a controlling stockholder would be incentivized to maximize consideration received in a sale, it can be rational to accept a lower sale price when one has pressing liquidity needs. Nonetheless, plaintiffs must offer specific evidence supporting this claim. In rare instances, plaintiffs have met this burden, and Delaware courts have found that a stockholder's liquidity needs rendered the transaction conflicted. For example, plaintiffs have found success by providing evidence of specific statements by controlling stockholders or their affiliate directors indicating a need for liquidity.[10] Such rulings may heighten minority stockholders' appetite to litigate, especially when sales are occurring at lower-than-expected valuations.

What Should a Controlling Stockholder Consider When Holding Securities That Will Receive More Value in a Transaction as Compared to Other Securities?

A private equity sponsor should consider the potential conflicts that can arise if its securities will receive more value in a transaction as compared to other securities (such as when it holds preferred securities with a priority liquidation preference).[11] Whenever controlling stockholders hold a different class or series of stock than the minority, the potential for conflict issues sharpens significantly, and the court has focused on the particular liquidity needs of preferred stockholders as compared to other stockholders in sale transactions.[12]

How Can Controlling Stockholders Mitigate Litigation Risk?

- Plan ahead.
  - Regular, well-supported valuations may help speed up a sale transaction.
  - Truncated timelines may more easily be portrayed as crisis or fire sales and be subject to more scrutiny.
- Consider the structure of the portfolio company holding at formation.
  - For example, if negotiating a stockholders' agreement with drag-along rights, consider whether the board or the controlling stockholder can exercise the drag-along.
    - While many factors may influence the structure of a drag-along provision, granting the controlling stockholder the right to exercise the drag directly may limit the ability for minority stockholders to successfully argue a breach of fiduciary duty. As discussed above, this is because the controlling stockholder would not have caused the corporation to act in an interested manner, since board action is not required for the stockholder to exercise its drag rights. The controlling stockholder, meanwhile, does not have a fiduciary duty to refrain from exercising its contractual rights.
  - Consider including independent directors on a board. Adding independent directors before conflicts arise permits directors to have enhanced knowledge and background regarding the company in the event they are needed to navigate a conflict.
- Be cautious of actual and perceived conflicts in the sale process.
  - Maintain a level playing field for bidders (*e.g.*, same due diligence process and timing) absent business reasons.
  - Of course, a deliberate single-bidder strategy designed to extract a higher sale price may be reasonable; however, consider the appropriate background valuations and procedures.

  - Consider whether material facts have been disclosed to the board and other stockholders. Disclosure (both within the boardroom and to minority stockholders) of conflicts or other facts material to board decision-making is important as that helps establish a fair process.

- Maintain record-keeping discipline.
  - Remember that notes, personal texts and internal emails are usually discoverable in any litigation.
  - Beware of off-the-cuff remarks that may be misinterpreted in litigation, *e.g.*, short-hand statements by the controlling stockholder and its board affiliates inconsistent with maximizing stockholder value.
- Remember that sponsor-designated directors face dual fiduciary obligations vis-à-vis the portfolio company and the sponsor. Consider what procedures (at the portfolio company and the fund) may be needed to contain this conflict, *e.g.*, recusal of a conflicted director (from the vote, deliberations or both, as the facts and circumstances may require).[13]
- Consider contractual protections vis-à-vis minority shareholders, *e.g*., receipt of releases in connection with transaction bonuses.

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1 Although much case law in this area relates to public company transactions, the precedents would similarly apply to private companies in similar situations.

2 Sponsor categorization determined by Cortex; as of January 10, 2023. Deal volume by dollar value is calculated from the subset of deals that include a disclosed deal value. Paul, Weiss has not reviewed data for accuracy.

3 If the subject entity is a limited liability company or a limited partnership the control person can limit or eliminate such obligation by unambiguous provisions to that effect in the governing agreement.

4 For purposes of this article, we assume the sponsor is a controlling stockholder.

5 To determine whether a stockholder exercises effective control over a company, the Delaware Court of Chancery will evaluate a variety of factors to assess whether stockholders "have such formidable voting and managerial power that they, as a practical matter, are no differently situated than if they had majority voting control." *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006).

6 *E.g.*, the board exercising a "drag-along right".

7 Under certain circumstances, enhanced scrutiny under *Revlon* and/or *Unocal* may apply, each of which may entail some level of analysis of the reasonableness of the board action taken.

8 Through what is often referred to as the "*MFW* Roadmap," business judgment protection can still be invoked if the transaction is conditioned on two protections "*ab initio*" (*i.e.*, before the start of substantive economic negotiations). *See Kahn* v. *M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014). The first required protection is approval by a special committee—the committee must (i) be independent, (ii) have a proper mandate (including the ability to say no definitively, freely select its own advisors and evaluate alternatives), and (iii) otherwise function properly. The second required protection is approval by a majority of the minority stockholders in an informed and uncoerced vote. *See, e.g.*, *Sciabacucchi* v. *Liberty Broadband Corporation* (PW Client Alert) and *In re Saba Software, Inc. Stockholder Litigation* (PW Client Alert).

9 Data provided by PitchBook Data, Inc. as of January 19, 2023. PitchBook's current data methodology includes all announced and completed deals for sponsor-backed M&A, but announcements only for exits. Sponsor and exit type categorizations determined by PitchBook. Paul, Weiss has not reviewed data for accuracy.

10 *See, e.g., In re Mindbody, Inc.*, S'holders Litig., 2020 WL 5870084 (Del. Ch. Oct. 2, 2020); *N.J. Carpenters Pension Fund* v. *infoGROUP, Inc.*, 2011 WL 4825888 (Del. Ch. Oct. 6, 2011).

11 *See e.g., In re Trados Inc. S'holder Litig.*, 73 A.3d 17 (Del. Ch. 2013); *In re Trados Inc. S'holder Litig.*, 2009 WL 2225958 (Del. Ch. July 24, 2009). Here, Trados's common stockholders objected to a merger that, as a result of the preferred stockholders' liquidation preference, resulted in consideration of approximately $52 million to Trados's preferred stockholders and none to common stockholders. Although there was no controlling stockholder, four of the seven directors were deemed conflicted due to their affiliation with the preferred stockholders. While the Delaware Court of Chancery ultimately held that the merger was entirely fair due to the fact that the common stock had no economic value prior to the merger, the court reviewed, among other things, the different economic incentives of its preferred stockholders including that they may "favor immediate 'liquidity events'. . . even if operating the firm as a stand-alone going concern would generate more value for shareholders". *In re Trados Inc. S'holder Litig.*, 73 A.3d at 49.

12 *Id.*

13 While the *MFW* roadmap discussed above is the most effective way to protect against controlling stockholder conflicts, setting up a special committee or having a majority of the minority vote may not be practicable or desirable in private company sales.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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