CADWALADER

Quorum
Insights Into Corporate Governance, M&A and Securities Law

Private Equity Controller-Led Sale Transactions Found Not to Involve Liquidity-Driven Conflict of Interest


By **William Mills**
Partner | Corporate


By **Edward Ernst**
Associate | Corporate

On January 7, 2025, the Delaware Court of Chancery issued a post-trial opinion in *Manti Holdings, LLC v. Carlyle Group. Inc.*, finding that the sale of a portfolio company by a controlling stockholder was not the result of a liquidity-driven conflict, in part because the controlling stockholder "did not extract a non-ratable benefit from the sale." The opinion, written by Vice Chancellor Glasscock, features three key points:

- Plaintiffs have a high bar to successfully demonstrate a liquidity-driven conflict;
- A well-documented, robust sale process provides a strong defense against charges of conflict; and
- A negative ruling at the pleading stage is not outcome-determinative for defendants.

This case arose from the 2017 sale of Authentix Acquisition Company, Inc. ("**Authentix**") to Blue Water Energy LLP. At the time of the sale, The Carlyle Group Inc. and its affiliates (collectively, "**Carlyle**") owned 70% of Authentix' preferred stock and 52% of the common stock. The plaintiff minority stockholders asserted that Carlyle was a controller of Authentix and that the sale was a conflicted transaction. Plaintiffs' argued that Carlyle was conflicted because of its business model and certain contractual provisions in its fund documents – which prevented the fund from raising additional capital after 10 years and included a "clawback provision" that required the fund to return to limited partners the 7% preferred return on Carlyle's interest in Authentix for so long as it retained the investment. According to the plaintiffs, Carlyle was motivated by its fund lifecycle and desire to increase its carried interest by cutting off the 7% clawback, which drove Carlyle to sell Authentix prematurely via a sales process that disadvantaged minority stockholders. Plaintiffs asked the court to apply the entire fairness standard because Carlyle's financial interests created a liquidity-driven conflict in respect of the sale.

Liquidity-Driven Conflicts Will be Found Only in Limited Circumstances

Plaintiff stockholders argued that Carlyle was a controller of Authentix and that because it had a liquidity-driven conflict (because of the 10-year fund life and clawback provision) it caused Authentix to be sold at a discounted price "unfair to the stockholders, but from which Carlyle extracted a unique benefit." The Court held that, while the 10-year investment and clawback provisions may have incentivized the sale and caused Carlyle to want the sale to occur in 2017, there was no crisis-driven "fire sale" nor did Carlyle receive any benefit not shared pro rata by all stockholders. The Court noted that the 10-year lifecycle prevented Carlyle from making further investments, including into Authentix, but did not expressly mandate a sale and that this, together with the desire to eliminate the 7% clawback, may have incentivized Carlyle to sell, but did not otherwise result in a conflict.

Looking to prior Delaware precedent (*In re Synthes, Inc., S'holder Litig.*), the Court explained:

[T]here are very narrow circumstances in which a controlling stockholder's immediate need for liquidity could constitute a disabling conflict of interest . . . . Those circumstances would have to involve a crisis, fire sale where the controller, in order to satisfy an exigent need (such as a margin call or default in a larger investment) agreed to a sale of the corporation without any effort to make logical buyers aware of the chance to sell, give them a chance to do due diligence, and to raise the financing necessary to make a bid that would reflect the genuine fair market value of the corporation.

Here, rather than being driven by an exigent need, the Court found that the timing of the sale was motivated by the "volatility of Authentix' business" and that Carlyle's evaluation of the question, "To sell now or wait for a better opportunity later?" fell squarely within the realm of business judgment.

The Importance of a Robust Sale Process

Although the Court stated its decision was based on the fact that neither the 10-year term of the fund nor the clawback provision mandated a sale and that a preference by the controlling stockholder, without more, does not create a conflict necessitating entire fairness review, Vice Chancellor Glasscock's opinion itemizes (twice) the key steps Authentix' board took in their marketing and sales process. The opinion looked favorably on the auction process: contacting 127 potential buyers (including 27 financial buyers), 18 preliminary meetings with potential buyers, and, when the representative of one of the plaintiffs expressed interest in submitting a bid, the board accommodated them. Additionally, the opinion notes that the process – beginning in September 2016 and concluding in September 2017 – took a full year, longer than both the nine-month process in *In re Morton's Rest. Gp., Inc. S'holder Litig.* and the seven-month process in *Synthes*, two prior Delaware cases the Court looked to as precedent.

Recognizing that neither the number of contacts with potential buyers nor the length of the sales process was dispositive that a conflict did not exist, the Court was persuaded that the "vigorous" negotiations represented that an arms'-length transaction had occurred and found the process was "indicative that Carlyle was not driven by a liquidity pressure to sell off Authentix for less than fair value." This underscores the importance of engaging in, and documenting, a thorough sales process – particularly where a controlling stockholder is involved.

A Negative Pleading Outcome Can Be Overcome

Of note, the litigation first arose in 2022 when, at the pleading stage, the Court found that plaintiffs had presented sufficient evidence to support "a reasonable inference that Carlyle derived a unique benefit from the timing of the [s]ale not shared with other common stockholders, rendering [Carlyle] conflicted." As a result, the Court rejected Carlyle's motion to dismiss and permitted the case to proceed to trial. However, following the trial, the Court ruled in Carlyle's favor, finding no conflict of interest that would trigger entire fairness, and instead applying the business judgment standard.

While it may have been common for a defendant in Carlyle's position to look to settle the matter once the motion to dismiss was denied, Carlyle elected to stand firm and ultimately obtained its desired result at trial. A key takeaway for potential future defendants is that a ruling against them at the pleading stage does not necessarily mean defeat. As the Court noted, the legal standards at the motion to dismiss stage and at trial are significantly different. In certain circumstances, a controlling stockholder, by having engaged in a thorough, non-crisis driven sales process, has the ability to resist the pressure to settle after losing at the motion to dismiss stage of litigation.

* * * *

Fiduciary duty claims often ratchet up the pressure and are a serious concern in transactions involving controlling stockholders. Although there have been several recent high-profile conflicted transaction cases in Delaware, the Court in *Manti v. Carlyle* demonstrates that there is a true distinction between a controller-led sales process and a conflicted transaction, and that a well-handled and well-documented sales process remains a powerful defense to charges of conflict.