

M&A Update

Fully Informed Vote of Disinterested Stockholders Results in Business Judgment Rule Protection in Post-Closing Review of Merger

October 5, 2015

In an October 2, 2015 decision, *Corwin, et al. v. KKR Financial Holdings LLC, et al.*, the Delaware Supreme Court clarified that once a merger closes, as long as it has been approved by a fully informed vote of the disinterested stockholders, the standard for reviewing the board's conduct will be the business judgment rule unless the transaction is subject to the entire fairness standard (as can be the case in a transaction with a controlling stockholder). The Court stated that business judgment rule protection would also apply in this scenario even if the *Revlon* enhanced scrutiny standard applied to the merger.

Background

KKR & Co. L.P. engaged in a stock-for-stock merger with KKR Financial Holdings LLC, a specialty finance company whose primary function was to provide financing for KKR & Co.'s leveraged buyouts. The merger was approved by a majority of Financial Holdings' stockholders other than KKR & Co. and its affiliates. Soon thereafter, several of Financial Holdings' stockholders commenced an action challenging the merger, claiming that KKR & Co. was a controlling stockholder of Financial Holdings and that the KKR & Co. directors breached their fiduciary duties in approving the transaction. The Chancery Court reviewed the merger under the business judgment rule and dismissed the action.

Takeaways

The Delaware Supreme Court upheld the Chancery Court's decision, affirming the power of a disinterested stockholder majority and the reluctance of Delaware courts to second-guess the stockholder majority's determination of what is in their best interest.

1. In a Post-Closing Damages Case, a Merger Approved by a Fully Informed, Uncoerced Vote – Even If *Revlon* Applies – Is Reviewed under the Business Judgment Rule. The stockholder plaintiffs asserted that the *Revlon* standard should apply to their post-closing damages claims, and the Financial Holdings board breached its *Revlon* duties in approving

the merger. The Court disagreed, finding that it did not even need to reach the issue of whether or not *Revlon* applied to the merger because approval by the fully informed, uncoerced majority of stockholders was “outcome determinative” and resulted in review under the business judgment rule. The Court’s decision confirms that a transaction supported by a majority of a company’s disinterested and well-informed stockholders should not be disturbed or challenged in court after the fact unless a plaintiff can overcome the business judgment rule in its initial complaint. This decision should significantly limit the scope of post-closing damages claims.

2. The Applicability of the Business Judgment Rule to a Post-Closing Claim for Damages Would Not Affect the Applicability of the *Unocal* and *Revlon* Enhanced Scrutiny Standards to Cases before a Merger Closes. The Court noted that *Unocal* and *Revlon* provide stockholders and the courts with the “tool of injunctive relief to address important M&A decisions in real time, before closing,” but an uncoerced vote of a majority of disinterested stockholders would subject a post-merger damage claim to business judgment rule review. Thus, at the preliminary injunction stage, before an insulating stockholder vote can take place, a transaction is not safe from the enhanced scrutiny of *Revlon* and *Unocal*. Nevertheless, defendants at this stage may argue that the merger should be allowed to proceed in order to give the disinterested stockholders the opportunity to vote for or against the transaction. Indeed, this has already been a popular argument, and the Court’s opinion only strengthens it, underscoring the importance that courts place on an informed stockholders’ decision.
3. The Stockholder Vote Must Be Truly Informed and Uncoerced for the Business Judgment Rule to Be the Applicable Standard for Post-Closing Review of the Merger. In this case, the stockholders were truly fully informed and uncoerced, and the Court emphasized the importance of meeting these conditions in actuality. For instance, if “troubling facts regarding director behavior” were not disclosed, the Court said that that would be material and the business judgment rule would not be invoked. Just this August, the Chancery Court proved its commitment to a thorough review of whether a stockholder vote meets this requirement when it found that director action had effectively impaired a seemingly uncoerced vote in [In re Dole Food Co.](#)
4. Business Judgment Rule Review May Apply to Other Types of Transactions Approved by Disinterested Stockholders. The Court concluded by emphasizing the importance of the policy behind the business judgment rule: that judges are not fit to second-guess the decision of boards and that boards should be free to make decisions that they believe are best for the company without fear of being challenged based on hindsight. The decision also emphasizes that courts should not second-guess the fully informed voting choice of the real parties in interest (i.e., the disinterested stockholders). As such, there is equally

compelling logic that where an uncoerced and well-informed stockholder base tenders its shares into an offer, courts should not second-guess the stockholders' rational economic choices absent indicia that a transaction was tainted by disloyalty or bad faith.

5. Control Does Not Require Majority Ownership of a Corporation But It Does Require "Effective" Control. KKR held less than 1% of Financial Holdings' shares, and it did not have any rights to appoint directors or veto board actions. Nevertheless, plaintiffs contended that KKR & Co. was a controlling stockholder of Financial Holdings because of its management structure; Financial Holdings was run by an affiliate of KKR & Co., and this arrangement could not be terminated without payment of a fee. The Delaware Supreme Court agreed with the Chancery Court that while this management arrangement presented "unusual existential circumstances" it was not nearly enough to render KKR & Co. a controlling stockholder of Financial Holdings. The Court emphasized that fully independent directors were in control at all times and that Financial Holdings was managed by all of its stockholders – not simply by its 1% stockholder. The Court reaffirmed that while a controlling stockholder may own less than 50% of the company's shares, it would need to have a "combination of potent voting power and management self-control" in that situation, enough so that the stockholder would have "effective" control over the board. Because the Court found that KKR & Co. was not a controlling stockholder, entire fairness review was not invoked. This opinion aligns with last year's *In re Crimson*, wherein the Chancery Court found that a stockholder needed to have control over the specific transaction or decision at issue in order to be deemed controlling.

For a full copy of the opinion, click [here](#).

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