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M&A Update

No Control, No Conflict, No Problem

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On October 24th, the Delaware Chancery Court dismissed a lawsuit challenging the merger of Crimson Exploration and Contango Oil & Gas. Minority Crimson stockholders alleged that Oaktree Capital Management, Crimson's largest stockholder with a 33.7% stake, controlled Crimson and caused it to be sold below market value for "self-serving reasons." The Court disagreed, finding that even if Oaktree was a controlling stockholder—which was likely not the case—the merger should be reviewed under the deferential business judgment rule, and not the more stringent entire fairness standard, because Oaktree was not conflicted in the transaction. The Court concluded that the Crimson directors had not breached their fiduciary duties, and the case was dismissed.

Takeaways

Vice Chancellor Parsons' opinion in *In re Crimson Exploration* provides guidance for when a stockholder holding less than 50% of a company's stock will be considered a "controlling stockholder" and when entire fairness review will apply to a transaction involving a company with a controlling stockholder.

1. A Stockholder Holding Less than a Majority will be Deemed a Controlling Stockholder only if it Exercises Control Over the Transaction. The Court referred to a line of cases where less than 50% stockholders were found to be controllers because they actually exercised control over the conduct of the company. In this case, the Court clarified that a less than 50% stockholder will only be deemed to be a "controlling stockholder" in respect of a specific transaction if the stockholder actually dominated the board's decision over the challenged transaction. Therefore, even though three of the seven Crimson directors were employed by Oaktree, and despite plaintiffs' arguments that Oaktree designated senior management of Crimson and that the Crimson CEO was beholden to Oaktree, the Court was hesitant to deem Oaktree a "controlling stockholder" with respect to the transaction because the complaint did not provide specific allegations of Oaktree's dominance over the transaction and the lead negotiators for the transaction were not employed by Oaktree.
2. "There Must be Some Indication of an Actual Agreement" for a Control Group to Exist. The Court explained that a stockholder or a "control group" owning more than 50% of a

company's shares would be considered a controlling stockholder. Here, plaintiffs' allegation that Oaktree was part of a control group simply because its interests aligned with those of other stockholders was not sufficient. The members of a control group must be "connected in some legally significant way" by "contract, common ownership, agreement, or other arrangement," although such agreement need not be a formal written one.

3. A Controlling Stockholder will be Deemed Conflicted if it is Either on Both Sides of the Transaction or Competes with Minority Stockholders for Consideration. Entire fairness review applies in "transactions where the controller stands on both sides," or "transactions where the controller competes with the common stockholders for consideration," such as when the controller receives more consideration for its shares, a stake in the continuing company, or some other "unique benefit" not received by other stockholders. In this case, Oaktree was not standing on both sides of the transaction, and did not receive more consideration for its shares or a stake in the surviving entity. Plaintiffs' only argument was that Oaktree received a unique benefit in the form of a prepayment of Crimson debt held by Oaktree with a 1% penalty and a Registration Rights Agreement ("RRA"), which would facilitate liquidity of Oaktree's shares following the transaction. The Court rejected the argument that Oaktree's RAA represented a "unique benefit," citing previous cases holding that for liquidity to be a driving motivation, there would need to be circumstances involving "a crisis, fire sale," which did not exist in this instance. Furthermore, the Court noted that at the time the merger agreement was executed, no agreement existed with respect to prepayment of the debt and the 1% penalty and the RRA provided a negligible economic benefit to Oaktree compared to receiving a higher price for its shares. Therefore, no conflict of interest existed that would warrant application of the entire fairness standard of review.

4. If a Stockholder is Not Conflicted, Neither are its Representatives on the Board. The Court also rejected the claim that the business judgment rule should not apply because a majority of the Crimson directors were interested in the merger themselves or were not independent from Oaktree. Even though several Board members were appointed by Oaktree, Oaktree was not conflicted, and thus, absent their own personal conflicts, neither were the directors it appointed. Plaintiffs claimed that three other directors were not disinterested; one because of his continued employment with the surviving company and two others because of their continued service on the board of directors of the combined company. The Court noted that only the allegations of disinterestedness due to a director's continued employment "have significant traction."

5. A Low Premium Does Not Automatically Represent an Unfair Deal. Plaintiffs further argued that even if the transaction was only reviewed under the business judgment rule, the directors breached their duties of loyalty and care. The court disagreed, finding that

outside of the *Revlon* context where a sale or break-up of the company is inevitable, selling the stock for a low premium does not always signify a breach of the duty of loyalty.

6. Criticism of Methodology Does Not Signify an Inadequate Fairness Opinion. Plaintiffs also alleged that the duty of loyalty was breached because Crimson's financial advisor gave an inadequate fairness opinion. The Court quickly dismissed plaintiffs' quibbles with the opinion, including the allegedly "unreasonably high discount rates," as mere disagreements with methodology and not evidence of bad faith. The Court similarly rejected claims that the financial advisor was beholden to Oaktree because it had worked with Oaktree in the past. Absent sufficient allegations that Oaktree had a goal different than that of other Crimson shareholders, the connection between the advisor and Oaktree was meaningless.

For a copy of the full opinion, click here.

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