

Lessons in Control and Conflict Analysis

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In *In re Crimson Exploration Stockholder Litigation*, (October 24, 2014), the Delaware Court of Chancery provides valuable guidance for directors, advisers and block shareholders involved in merger transactions. Vice Chancellor Donald F. Parsons Jr.'s analysis identifies key factors used by Delaware courts in determining whether non-majority shareholders are controlling, conflicted and subject to entire-fairness analysis. The opinion is also particularly useful for practitioners because it contains detailed pleading critiques and comparisons of prior, non-majority shareholder control and conflict holdings.

The case concerns a challenge made by plaintiff shareholders to Crimson's stock-for-stock merger with Contango Oil & Gas Co. The plaintiffs alleged that Crimson's largest shareholder—which held a third of Crimson's shares and was a Crimson creditor—controlled Crimson's board and caused the company to be sold at an improperly low price. The plaintiffs pointed to side agreements involving lien repayment and future stock placement benefits as demonstrating the alleged conflict and self-interest.

Parsons issued a comprehensive and detailed dismissal with prejudice of the plaintiffs' complaint, finding that their allegations were inadequate across the board, did not trigger entire-fairness review, and were insuf-

ficient under the business judgment rule. The court provides a summary of past cases that practitioners would do well to bear in mind when tackling future transactions. The question of whether the alleged controller or other defendants had interests that diverged from securing the highest value for all shareholders formed a recurring touchstone in the court's analysis.

Percentage Ownership versus Fact-Based Analysis

The court emphasized that the presence of a controlling shareholder is not enough to trigger entire-fairness analysis. Rather, control must be accompanied by a conflicted transaction. Establishing control when a shareholder owns a majority of a company's shares is relatively straightforward. But establishing the presence, or otherwise, of a controlling minority shareholder requires a more in-depth, context-heavy analysis. In determining whether the Crimson minority shareholder exercised control, the court examined minority block shareholder analysis used in 10 previous control cases. These cases involved minority ownership ranging from 27.7 percent to 49 percent. But control findings did not track the percentages, and the court dispensed with the notion that quantity formed the measure of control. The court concluded that there is no presumptive "linear, slid-



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ing-scale approach whereby a larger share percentage makes it substantially more likely that the court will find the [minority] stockholder was a controlling stockholder." Unable to provide guidance based on percentage ownership alone, the court focused on the "importance and fact-intensive nature of the actual control factors."

Parsons used the batch of prior cases to identify factors erring on the side of finding actual, rather than inferential, minority shareholder control. Such factors included: allegations of the ability to designate nearly half the number of board members; literal domination of the boardroom and/or merger discussions; the issuance of takeover threats; the direct pressuring of board members; the existence of a legally significant agreement between alleged members of a control group; de facto command over stock owned by others (for example, in family ownership situations); and managerial dominance by the minority shareholder (for

example, a minority block shareholder who also happened to be CEO and founder of the target company).

By contrast, factors weighing against a control finding included: limited board designation powers; contractual limitations on the block shareholder's ability to increase the number of board members; and contractual limitations on share acquisition. The court also dismissed the plaintiffs' argument that shared self-interest between shareholders warranted adding up share blocks to reach the 50 percent-plus majority control threshold. Parsons explained that evidence of an actual bargain in the form of a legally recognizable contract, shared ownership or a similar form of agreement between the shareholder blocks would need to be demonstrated before the court would undertake a control-group combination analysis.

The court's dissection of the plaintiffs' control claims provides a useful lesson in how to attack inference-based pleadings. That said, it is notable that even though the court found aligned interests to be legally insufficient to demonstrate a control group, the court still hesitated to conclude that the plaintiffs could not make a reasonably conceivable showing that the minority shareholder controlled Crimson. But even with the benefit of a strained control inference, the Crimson plaintiffs still could not pass the conflict test to get to entire-fairness analysis.

The Necessity of Conflict

Notably, minority shareholder control alone is not enough to trigger an entire-fairness review. The

controlling shareholder must also be engaged in a conflicted transaction. The court identified two main categories of conflict: First, where the alleged controlling shareholder stands on both sides of a transaction; and second, where the shareholder receives different compensation or benefits versus the other shareholders. In the latter category, the court identified three types of compensation conflicts: (1) the receipt of disparate compensation; (2) the receipt of a continuing stake in the company while other shareholders are cashed out; and (3) the receipt of a "unique benefit" denied to other shareholders.

Here, the court found the plaintiffs' allegations wanting: at the time the merger agreement was signed, the alleged controller was due the same consideration as all other shareholders; second, even though two side agreements existed between the acquiring company and the alleged controller, both agreements were made after the merger agreement, were arranged without the involvement of the target's board, and were not initiated by the controller; and third, the court found that the benefits conferred by the side agreements were not significant enough to cause the alleged controller to diverge from the highest share value touchstone.

Business Judgment Rule

Even if the minority shareholder had been a controller, the court found that it was not conflicted and the interests of the majority of the board members aligned with common stockholders. In reviewing the plaintiffs'

bad-faith claims—which included an attack on a deal fairness opinion—the court noted that disagreements with financial adviser methodology, or a preference for the work of a different adviser, do not support a bad-faith claim. The court also found that there was nothing to suggest that the adviser, target and alleged controller had objectives that diverged from the common goal of securing the highest value for shareholders.

In sum, the court was unwilling to apply entire fairness to this suit involving minority shareholder control. Nevertheless, merger participants and their counsel should be on the lookout for control and conflict factors in guiding decision-making. Minority shareholders with multiple control markers should consider taking extra steps to ensure that transaction processes are sufficiently fair so that they do not prompt reviewing courts to abandon their business judgment deference.

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