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Delaware Court Ruling on Dual-Class Recapitalization Involving Controlling Stockholders

Posted by David J. Berger, Wilson Sonsini Goodrich & Rosati, on Monday, January 8, 2018

Editor's note: David J. Berger is a partner at Wilson Sonsini Goodrich & Rosati. This post is based on a WSGR publication by Mr. Berger, Amy Simmerman, Katherine Henderson, andBrad Sorrels, and is part of the Delaware law series; links to other posts in the series are available here. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here), and The Geography of MFW-Land, by Itai Fiegenbaum.

On December 11, 2017, the Delaware Court of Chancery issued a decision that will be important for companies looking to implement measures to extend or make changes to dual-class voting structures and for companies with controlling stockholders. The decision addressed stockholder fiduciary duty challenges to a recapitalization undertaken by NRG Yield, Inc. (the "Company"), which, prior to the recapitalization, had a dual-class stock structure and a controlling stockholder. The court held that the transaction was conflicted because it was specifically designed to benefit the controlling stockholder. Despite this conflict, the court dismissed the litigation because of the process employed by the Company in adopting the recapitalization.

The recapitalization at issue was similar to other recent high-profile recapitalization efforts. Generally speaking, the Company issued one share of low-vote stock, having 1/100th of a vote, for every share held by both the controlling stockholder and the public stockholders. The Company's stated purpose for the recapitalization was undisputed: to stop the erosion of the controlling stockholder's voting power, which had fallen from 65 percent at the time of the Company's IPO to 55 percent, because of the Company's use of stock as currency in acquisitions. The decision in this litigation, issued by Chancellor Andre Bouchard and captioned *IRA Trust FBO Bobbie Ahmed v. Crane*,[1] offers important guidance for similarly situated companies.

As an initial matter, the court held that, even though the recapitalization involved a pro rata dividend of stock to all stockholders, the difficult "entire fairness" standard of judicial review applied because the transaction expressly provided a unique benefit to the controller by extending the time the controller held majority voting control of the Company. The entire fairness standard requires a judge to examine the fairness of a board's process and the terms of a transaction. The standard is much more exacting and fact-intensive than the business judgment rule, pursuant to which a court will often defer to the judgment of the directors, and other lesser standards of review. Because entire fairness requires a judge to wade into the underlying facts of the transaction, it can preclude dismissal of litigation at an early stage and has sometimes

[1] C.A. No. 12742-CB.

resulted in large damages awards after trial. The application of the standard in this new decision is groundbreaking: one older case from the Delaware Supreme Court held that the business judgment rule could apply to a recapitalization of this kind because all stockholders were treated the same, although some uncertainty about that rule had set in over time. The court directly distinguished that precedent, stating that the precedent, unlike potentially the case before the court, did not involve factual showings by a plaintiff that the recapitalization was done for the specific purpose of benefiting the controller.

Despite finding that the entire fairness standard applied to the transaction, the court still granted the defendants' motion to dismiss the case. In particular, the court held that the Company had properly followed the *"MFW"* framework, named after the 2014 Delaware Supreme Court decision in *Kahn v. M&F Worldwide Corp.*,[2] which provides a roadmap for avoiding the entire fairness standard of review in, at least, certain types of controlling stockholder transactions. Specifically, the Company's board of directors—unlike some companies that have pursued similar types of recapitalizations—conditioned the recapitalization from the outset of negotiations on approval by a fully empowered independent committee of the board of directors and by a fully informed, uncoerced majority of the minority vote. Because the Company had followed *MFW*, the court applied the business judgment rule to the recapitalization. The court also rejected the typical panoply of disclosure allegations that plaintiffs bring in these types of claims in an effort to discredit approval by minority stockholders, which must be fully informed under *MFW*.

In addition to these two key holdings, the court provided guidance on several related issues:

- First, the court expressed further support for the position espoused in the 2016 Court of Chancery decision in *In re EZCORP Inc. Consulting Agreement Derivative Litigation*,[3] that the *MFW* framework should be used wherever a company engages in a transaction with a controller in which the controller receives a special or potentially improper benefit—if the company wants to avoid the entire fairness standard of review. *EZCORP*, for example, involved consulting agreements entered into with an affiliate of a controlling stockholder. These cases are important for companies with controlling stockholders or a control group in assessing litigation risk and potential process considerations.
- Second, the court suggested that if further factual development in a litigation of this kind showed that the directors did not act for the purpose of benefiting the controller, then perhaps companies and directors could potentially succeed in ending such litigation at the summary judgment stage, after discovery but before trial.
- Third, the court noted that even if the *MFW* framework had not been properly followed, the Company's independent directors would have been able to obtain dismissal from the litigation because the plaintiff did not meaningfully allege that they lacked independence or failed to discharge their duties of care and loyalty. This aspect of the case follows the Delaware Supreme Court's 2015 decision in *In re Cornerstone Therapeutics Inc. Stockholder Litigation*,[4] and is a meaningful protection for independent directors.

This case is a significant decision for multiple contexts: recapitalizations involving a controlling stockholder or control group, and other various types of transactions in which a controller stands

[2] 88 A.3d 635.
[3] C.A. No. 9962-VCL.
[4] 115 A.3d 1173.

on both sides or receives a special, potentially improper benefit. In particular, the case suggests certain rules and concepts that companies and boards of directors of companies with a controlling stockholder or control group will want to have in mind when navigating potential fiduciary challenges in the future. More broadly, for companies contemplating adjustments to their capital structure, there are many considerations they should take into account, including, as applicable, stock exchange rules and reactions from the investor community—and, as this case illustrates, Delaware governance principles and stockholder litigation risks.