

Delaware Reaffirms that Corporate Control Lies in the Boardroom

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Editor's Note: [Edward D. Herlihy](#) is a partner and co-chairman of the Executive Committee at Wachtell, Lipton, Rosen & Katz. The following post is based on a Wachtell Lipton memorandum authored by Mr. Herlihy, [William Savitt](#), [David E. Shapiro](#), and [Ryan A. McLeod](#). This post is part of the [Delaware law series](#), which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available [here](#).

In an important ruling [October 14, 2014], the Delaware Court of Chancery dismissed a merger challenge on the pleadings and reaffirmed the primacy of director authority, the significance of the vote of disinterested stockholders, and the vibrancy of the business judgment rule. [In re KKR Fin. Holdings LLC S'holder Litig., C.A. No. 9210-CB \(Del. Ch. Oct. 14, 2014\)](#).

The case concerned KKR's \$2.6 billion acquisition of KKR Financial Holdings LLC ("KFN"). KFN was a specialty finance company, originally formed by KKR in 2004, that relied on a KKR affiliate for its officers, employees, and operations under the terms of a management agreement. Although KKR thus influenced the day-to-day management of KFN, KKR held less than 1% of KFN's voting power, had no right to appoint directors, and had no veto authority over board action. When KKR proposed a merger in October 2013, KFN formed a special committee of directors that retained advisors, negotiated against KKR, obtained improvements to KKR's proposed terms, and ultimately recommended in favor of the 35% premium transaction.

Fifteen duplicative shareholder lawsuits challenging the transaction were then filed in three different courts in both California and Delaware. The California actions were stayed, and the Delaware actions were consolidated, where lead plaintiffs argued that the merger was subject to exacting "entire fairness review" because KKR should be deemed a "controller" by virtue of the power it held over KFN under the management agreement.

The Court of Chancery's carefully reasoned opinion disagreed. The Court held that while the allegations of the complaint "demonstrate that KKR, through its affiliate, managed the day-to-day operations of KFN, they do not support a reasonable inference that KKR *controlled the KFN*

board—which is the operative question under Delaware law.” The Court thus refused to conclude that “pre-existing contractual obligations” that “constrain the business or strategic options available to the corporation” gave KKR control, because it was the board, and not KKR, that had the ultimate say over the decision to merge. The Court also rejected plaintiffs’ contention that “past business relationships” between certain directors and KKR undermined the independence of those directors, thus repudiating plaintiffs’ “transitive theory” of conflict that sought to impute one director’s association with KKR to his fellow directors. Finally, the Chancellor clarified that “the legal effect of a fully-informed stockholder vote” approving a “transaction with a non-controlling stockholder is that the business judgment rule applies and insulates the transaction from all attacks other than on the grounds of waste, even if a majority of the board approving the transaction was not disinterested or independent.”

The *KFN* opinion strongly reconfirms that courts will respect the well-informed decisions of independent directors and demonstrates that courts remain ready to dismiss post-closing deal litigation in an appropriate case.