Chancery Court Dismisses Claims Over Buyout of Externally Managed Company

Rules that entire fairness standard of review does not apply to merger between an externally-managed specialty finance company and an affiliate of the manager.

In April 2014, KKR & Co. LLP ("KKR") acquired KKR Financial Holdings LLC ("KFN") in a share-for-share transaction (in the transaction, common units representing limited partnership interests of KKR were exchanged for the common shares of KFN). The terms of the transaction implied a value for KFN of $2.6 billion, and represented a 35% premium above the price at which KFN's common shares traded immediately before the announcement of the transaction. The transaction was approved by a transaction committee of independent directors of KFN, by the holders of a majority of KFN's outstanding shares and by the holders of a majority of KFN's outstanding shares not held by KKR or its affiliates. The agreement governing the transaction contained deal protection provisions that included no-shop provisions, a fiduciary out subject to a four-day matching provision and a break fee of $26.25 million (approximately 1% of the implied transaction value at the time of announcement).

Before the completion of that transaction, KFN was a publicly traded real estate investment company that was externally managed by an affiliate of KKR. Pursuant to the external management arrangement, KFN had no employees and all of its officers were members or employees of KKR's affiliates. The management agreement could be terminated with or without cause, but termination without cause required payment of a substantial termination fee (equal to four times the average base management fees and incentive fees paid during the two years preceding termination). It appears that in this case the termination fee would have been in excess of $250 million. Any interloper seeking to outbid KKR for KFN presumably would have had to bear the cost of this termination fee, in addition to the $26.25 million break fee provided for in the transaction agreement.

Stockholders of KFN challenged the adequacy of the consideration they received in the acquisition in proceedings before the Delaware Chancery Court. The defendants moved to dismiss. The court recently issued its decision on that motion to dismiss in *In re KKR Financial Holdings LLC Shareholder Litigation*.

The critical threshold issue that the court had to address in considering the motion to dismiss was the applicable standard of review. The court explained that this was a share-for-share transaction in which control of KFN before the transaction and of the combined company after the acquisition was held by public shareholders, and accordingly the enhanced judicial scrutiny imposed under the *Revlon* line of cases to sale-of-control transactions was inapplicable. Instead, because the transaction had been approved by KFN's directors, of which a majority were disinterested and independent, and by a fully-informed vote of KFN's stockholders, the actions of KFN's directors in approving the acquisition transaction would be subject only to the deferential business judgment standard of review, unless the plaintiffs could establish that the exacting "entire fairness" standard applied.

The Delaware courts apply the entire fairness standard of review to transactions between a corporation and its controlling stockholder. When that standard applies, the controlling stockholder and the directors that approved the transaction bear the burden of establishing that the transaction in question was entirely fair, taking into account both price and process. The plaintiffs challenging the KFN transaction acknowledged that KKR and its affiliates owned only approximately 1% of KFN's shares and accordingly did not exercise voting control over KFN. The plaintiffs alleged, though, that KKR nonetheless controlled KFN

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because of the management agreement that bound KFN and the close ties between KFN's board members and various KKR affiliates. Accordingly, according to the plaintiffs, the entire fairness standard should apply.

The Chancery Court rejected the plaintiffs' position, found that the business judgment standard of review (and not entire fairness) applied, and granted the defendants' motions to dismiss. Specifically, the court found that "[a]lthough [Plaintiffs'] allegations 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 – such that the directors of KFN could not freely exercise their judgment in determining whether or not to approve and recommend to the stockholders a merger with KKR." The court emphasized among other things that KFN's management agreement provided that the manager was required to operate at the direction of KFN's board of directors and that the directors in turn were elected by the stockholders. Notably, the court stated that "[p]laintiffs' real grievance, as I see it, is that KFN was structured from its inception in a way that limited its value-maximizing options." The court went on to note that the management agreement and KFN's resulting dependence on KKR and its affiliates had been prominently disclosed to KFN's stockholders from the time of the initial public offering of KFN's predecessor entity.

Take-aways

- The *KFN* decision is a useful precedent for anyone considering a business combination transaction between an externally-managed vehicle and an affiliate of the manager, because it shows it is possible to efficiently dispose of stockholder challenges to that type of transaction – at least where (as was the case here) the combination is between two publicly-traded entities, neither of which has a controlling stockholder. In particular, the court seemed untroubled by the fact that the management termination fee remained in effect, even though its cost was approximately 10% of the transaction value.
- The *KFN* decision does not address the treatment of a cash buyout (as opposed to a share-for-share buyout) of an externally-managed vehicle by an affiliate of the manager. It is conceivable that if the transaction challenged in *KFN* had been an all-cash transaction, and therefore subject to *Revlon,* the court might have taken a different view of the potential effect that the management termination fee could have in deterring any competing takeover proposal. On the other hand, the court's emphasis in the *KFN* decision on the fact that KFN had been "structured from its inception in a way that limited its value-maximizing options" might support the conclusion that stockholders of externally-managed entities cannot be heard to complain about the limits on value maximization imposed by the terms of a fully disclosed management agreement, even in the context of a cash sale of the entity.
- Since the *KFN* decision left open the question of how to deal with a management termination fee in an all-cash transaction, the terms of last year's Annaly / CreXus transaction continue to provide an interesting reference point. Annaly Capital Management took CreXus Investment Corp. private in an all-cash transaction. CreXus was externally managed by an Annaly subsidiary. Annaly agreed to modify its subsidiary's management agreement with CreXus to make it easier to terminate, and also agreed that the break fee and expense reimbursement that CreXus would have to pay if it terminated its merger agreement with Annaly in order to sell itself to a third party (a maximum of $30 million) would be credited against the management termination fee (estimated to be over $37 million) if the management termination fee became payable within 12 months.
- The holding in *KFN* likely would have been different if the plaintiffs could have pled facts supporting an inference that the manager and its affiliates dominated the board of KFN. Sponsors of externally-managed vehicles should note the importance of respecting the independence of the managed vehicle's directors and of ensuring that they do in fact effectively oversee the activities of the manager.

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