Delaware Decision Suggests Pro Rata Recap That Enables Prolonging of Existing Control Structure May Be Subject to Entire Fairness Absent Independent Director and Minority Stockholder Approval—NRG Yield

In *NRG Yield v. Crane* (Dec. 12, 2017), the Court of Chancery dismissed fiduciary duty claims against directors who approved a corporate recapitalization that was proposed by a controller and would perpetuate its control. The reclassification provided for the issuance of non-voting equity that could be used by the corporation as currency to make future acquisitions without diluting the controller's voting control.

Chancellor Bouchard concluded that the recapitalization was a "conflicted controller transaction" to which "entire fairness" presumptively applied because the controller obtained a "unique benefit" from the transaction not shared with the other stockholders—namely, the ability to maintain its control (by avoiding the dilution that would result from use of the existing equity to fund future transactions). However, the court held that *MFW* (which provides a pathway to business judgment review of conflicted controller transactions) could apply to a recapitalization, and, finding that the *MFW* prerequisites were satisfied (*i.e.*, the transaction was subject from the outset to approval by an independent committee of directors and a majority of the minority stockholders), dismissed the case.

Key Points

- **The decision signals that *MFW*'s reach may extend to—and thus provides a pathway to business judgment review—any type of conflicted controller transaction.** The court stated that, although the Delaware Supreme Court was silent in its *MFW* opinion as to other potential applications of the *MFW* framework beyond the context of the merger in that case between a company and its controller, "the Supreme Court decision never indicated that the rationale for the court's holding only applied to mergers and [there is] no principled reason why that rationale would not apply equally to other conflicted controller transactions." We note that *MFW*'s reach now has been extended beyond the parent-subsidiary merger involved in that case to: (i) in *NRG Yield*, a recapitalization where the company's controller received a "unique benefit" not shared with the other stockholders; (ii) in *EZCORP* (2014), advisory agreements that a company entered into with an affiliate of its controller; and (iii) in *Martha*

Stewart Omnimedia (2017), a third party merger where the target company's controller received "side deals" not shared with the other stockholders.

- **The Supreme Court found that the recapitalization, although a pro rata distribution that facially treated all stockholders equally, was a "conflicted controller transaction" which would be subject to entire fairness review if *MFW* did not apply.** The court viewed the recapitalization as providing the controller with the "unique benefit" of the ability to maintain its control. The decision thus suggests that a recapitalization—at least when the transaction is proposed by the controller and would perpetuate its control—may be subject to entire fairness unless it is, from the outset, subject to approval by an independent committee of directors and a majority of the minority stockholders. We note, however, that in a footnote in the opinion, the court stated that, even if entire fairness were to apply to a conflicted controller transaction, dismissal nonetheless would be available at the pleading stage, under *Cornerstone*, if the company's charter includes a standard exculpation provision and the plaintiff's allegations do not meet the high bar for pleading bad faith or breach of the duty of loyalty.

Background

NRG Yield, Inc. ("Yield") is a so-called "yieldco"—that is, a company whose business model is the acquisition of income-producing portfolio assets from which dividends can be distributed to the public stockholders. NRG Energy, Inc. ("NRG") manages the company and locates the opportunities for its acquisitions. Following Yield's initial public offering in 2013, NRG had 65% voting control over Yield through its ownership of all of Yield's Class B shares (which carried one vote per share); and the public stockholders had an aggregate 45% voting interest through their ownership of Yield's Class A shares (which also carried one vote per share). The prospectus for the Class A shares stated that: NRG was a controlling stockholder; Yield was highly dependent on NRG; NRG had the right to appoint all of Yield's directors and to cause the company to take actions even if its interests conflicted with those of the Class A stockholders; and NRG intended to maintain its controlling interest in Yield.

Due to the unexpectedly rapid pace of acquisitions by the company, and its use of Class A shares to fund the acquisitions, NRG's voting interest in Yield had been reduced to 55% by 2015. Concerned about the possibility of future additional dilution, NRG proposed that Yield effect a recapitalization in which Class A shareholders would receive one non-voting share for each Class A share—and the nonvoting shares could be used by Yield to fund future acquisitions, without diluting NRG's voting interest. The proposal was conditioned from the beginning on receipt of the approval of independent directors and a majority of the outstanding shares of Yield not affiliated with NRG. The Yield board's standing Conflicts Committee (comprised of three directors, whose independence was not challenged) negotiated changes in the proposal and recommended the recapitalization as revised. The necessary stockholder approvals were then obtained and the recapitalization was effected. The stockholder plaintiff claimed that the board had breached its fiduciary duties in approving the recapitalization and that NRG had breached its duties as a controller by causing Yield to undertake the recapitalization.

Discussion

The recapitalization was a "conflicted controller transaction" that invoked entire fairness review. As the court reviewed, there are two types of conflicted controller transactions in the M&A context (both of which are presumptively subject to entire fairness review): (i) transactions in which a company is acquired by its controller and (ii) transactions in which a company is sold to a third party and the controller "competes" with the other stockholders for consideration (such as where the controller (a) receives greater consideration per share, (b) takes a different form of consideration, or (c) gets a "unique benefit" by extracting "something uniquely valuable" to the controller even if the controller nominally receives the same consideration as the other stockholders). Further, outside the M&A context, transactions involving controllers that receive a "non-ratable" benefit (*i.e.*, a benefit not shared with the other stockholders) have been held to be subject to entire fairness review. In *NRG Yield*, the court viewed the recapitalization as providing the unique benefit to the controller of the prolonging of its control.

The court rejected the concept that a pro rata distribution cannot represent a non-ratable benefit. As a general matter, a pro rata distribution to all stockholders does not invoke entire fairness. However, the decision indicates that a pro rata distribution may invoke entire fairness when, as in this case, the controller proposes the distribution, the distribution has the effect of prolonging the controller's control, and the board is controlled or dominated. The court distinguished two earlier cases in which it was held that business judgment review applied to pro rata distributions by controlled companies:

- In *Sinclair Oil v. Levien* (1971), a parent corporation caused its subsidiary to pay large cash dividends on a pro rata basis to the shareholders. The Delaware Supreme Court held that the pro rata dividends did not provide any benefit to the parent to the exclusion of the minority stockholders. In *NRG Yield,* the court distinguished *Sinclair* on the basis that the Yield recapitalization *did* provide a benefit to the controller to the exclusion of the minority—that is, the means to perpetuate its control position.
- In *Williams v. Geier* (1996), a controlled corporation was recapitalized to provide for "tenure voting" for all shares, whereby each outstanding share would have ten votes but, on sale or transfer of the share, the share would revert to having just one vote until it was held by its owner for three years. The plaintiff argued that entire fairness should apply because the recapitalization favored the controller by entrenching its control. The Delaware Supreme Court ruled that business judgment review applied because, based on the fully developed record in the case, the plaintiff's allegations were only conclusory and had "no factual support." The Supreme Court wrote that, on the record presented, there was "no non-pro rata or disproportionate benefit which accrued to the [controller] on the face of the Reclassification, although the dynamics of how the [Reclassification] would work in practice had the effect of strengthening the [controller]'s control…." Moreover, the Supreme Court noted, the board was independent and disinterested and there was no evidence that it was dominated or controlled by the controller. In *NRG Yield,* the Court of Chancery distinguished *Williams* by noting that *Williams* was decided on the basis of a fully developed record after discovery was almost complete. In *NRG Yield*, by contrast, the court stated, at the pleading stage (without evidence of board motivation), the facts alleged indicated that the controller proposed the recapitalization for the purpose of perpetuating its control; and, further, the controller's control over the board was "self-evident."

We note that it may be difficult to determine whether a reclassification that has the effect of perpetuating control will be deemed to fall under the rubric of *Williams* (in which case business judgment review would apply with or without the application of *MFW*) or of *NRG Yield* (in which case entire fairness would apply unless *MFW* applied).

The court confirmed that a fairness opinion is not necessarily required for *MFW* to apply (even in the context of a merger). The plaintiff in *NRG Yield* argued that *MFW* should not apply outside of a "controller merger scenario" because there are "protections" that may be present in the context of a merger that are not present in other contexts such as a recapitalization—such as the provision of a fairness opinion. The plaintiff also contended that the Conflict Committee's failure to demand a fairness opinion was a breach of its duty of care in negotiating a fair price. The court rejected these arguments. The court stated that fairness opinions generally are not essential, as a matter of law, to support an informed business judgment with respect to any type of transaction (including mergers); the framework established in *MFW* does not specify or require the provision of a fairness opinion; and the breach of duty of care assertion was "wholly conclusory" and the facts alleged did not support a reasonably conceivable inference that the committee had been grossly negligent in failing to obtain a fairness opinion here. The court added: "It also is far from clear what a fairness opinion would look like for this type of transaction." In that regard, we note that fairness opinions are generally issued with respect to exchanges of value. In a transaction such as the Yield recapitalization, there is no exchange of value with the recipients of the pro rata distribution; and, moreover, it is uncertain how the value to the controller, and the value to the company, of the perpetuation of the controller's control would be valued.

Practice Point:

- **When a controller plans a proposed transaction, it should consider the likely standard of judicial review that would be applicable to a challenge and determine whether it would be beneficial to structure the transaction to achieve a lower standard of review.** The "entire fairness" standard is presumptively applicable to a transaction between a controller and the controlled company—and requires that the defendant directors prove that the transaction was fair to the other stockholders with regard to both price and process. If such a transaction is approved by an independent committee *or* by the minority stockholders, then entire fairness applies but the burden shifts to the plaintiffs to prove that the transaction was *not* entirely fair. If such a transaction, from the outset, is conditioned on approval by *both* an independent committee of directors *and* the minority stockholders, and those approvals are obtained, then, under *MFW*, the deferential business judgment rule standard of review would apply. Where stockholder approval is not required to effect the transaction, the controller should consider and balance the likelihood of (and cost, time and uncertainty involved with) obtaining minority stockholder approval as compared to the likelihood of meeting the entire fairness test when structuring the transaction.

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