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In re Zhongpin: Chancery Court Looks to Underlying Reality of Influence and Determines 17% Stockholder May Have Controller Status in Context of His Going-Private Bid

In *In re Zhongpin Inc. Stockholders Litigation* (Nov. 26, 2014), the Delaware Chancery Court found that the plaintiffs had pled sufficient facts to raise an inference that Xianfu Zhu, who was the company's founder, Chairman and CEO, was a controlling stockholder, even though he owned only 17% of the company's stock and had not controlled the directors' decision relating to his going-private bid. Vice Chancellor Noble's decision appears to have been based on a conclusion that the unusual degree to which Zhu was indispensable to the company as a practical matter precluded the special committee from functioning effectively because—without Zhu's cooperation (which he would not provide)—the committee had no leverage to negotiate a higher price with Zhu and no ability to attract a competing bidder.

Importantly,

- Zhu's power over the company had been far more than would be expected of a minority stockholder and CEO, as (by virtue of a combination of factors not fully articulated by the court) his remaining CEO was so critical to the company that it appeared to create an effective veto power over a sale of the company;
- the company itself had acknowledged in its 10-K that Zhu was the company's "controlling stockholder"; that his loss would have a material adverse effect on the company; and that it might not be possible to sell the company to anyone but him; and
- events had unfolded to prove those statements true—as the only competing bidder that emerged in the pre-signing market check conditioned its bid on Zhu's remaining as CEO, and not one of the eighty potential bidders contacted during the 60-day post-signing go-shop period expressed an interest in bidding (or even signed a nondisclosure agreement), even though the merger agreement provided that no termination fee would be payable.

The court applied an entire fairness standard of review (as Zhu stood on both sides of the transaction and the MFW prerequisites for business judgment review had not been met), and, at the pleading stage, did not dismiss the plaintiffs' complaint as the allegations suggested unfairness of the process and price.

<u>Key Points</u>

- There is a high threshold to find that a minority holder whose ownership is not close to 50% is a controller.

- The court will look to the underlying reality of a stockholder's influence, from whatever sources, to determine controller status.
- Controller status may be inferred when a stockholder-bidder's "grip" over a company appears to prevent a special committee from being able to function effectively to conduct a market check or negotiate a higher price from the stockholder.
- The court did not address the issue of whether a minority stockholder-bidder who is also the CEO may have any additional duty to the company, by virtue of his management position, to facilitate, or at least not to effectively block, possible competing bids for the company .
- Entire fairness review (which applies if a controlling stockholder stands on both sides of the transaction and the *MFW* prerequisites for application of business judgment review have not been met) almost invariably will preclude dismissal on a motion to dismiss at the pleading stage. Although the nature and extent of pleadings as to unfairness of the process or price that might be sufficient to preclude review under the business judgment rule is still developing through the courts' post-*MFW* jurisprudence, it appears that, if business judgment governs, motions to dismiss usually will result in dismissal at the pleading stage unless the complaint raises plausible issues with respect to the duty of loyalty.

Background

- Zhu offered $13.50 per share in cash for all the Zhongpin shares he did not own. The proposal was not initially conditioned on majority-of-the-minority stockholder approval (although he later agreed to that condition). Zhu maintained that he was only interested in being a buyer, not a seller, and that he would not participate with any other bidder or commit to remain as CEO to facilitate any other bid. A facially independent special committee, with its own bankers and legal counsel, asked Zhu repeatedly to increase his price, but Zhu refused. The committee conducted a pre-signing market check, during which one competing bid emerged, with an offer price of $15—but the offer was conditioned on Zhu's continuing as CEO (which he was not willing to do). Zhu agreed to a 60-day post-signing go-shop period, with the company having the unusually broad right to terminate the merger agreement for any reason during the period and not pay a termination fee, but not one of the over eighty strategic and financial firms contacted made a competing bid (or even entered into a non-disclosure agreement).

Discussion

- **There is a high threshold to find that a minority holder whose ownership is not close to 50% is a controller.**

The court confirmed that less-than-50% stockholders are presumptively not controllers. A minority stockholder is a controlling stockholder only if he "exercises such formidable voting and managerial power that [he], as a practical matter, [is] no differently situated than if [he] had majority voting control," the court said. Notably, in two recent cases (Synthes and Crimson Exploration), the court found that a 35% stockholder was not a controller; and, in another, where the court found that a 35% stockholder was a controller (In re Morton's), the court characterized the decision as "one of its most aggressive finding[s] that a minority blockholder was a controlling stockholder" and emphasized that the stockholder there (who also was the company's founder, CEO and Chairman) had more power than a typical CEO.

Moreover, in past decisions, the court typically has required that, in order for it to determine that a stockholder is a controller, the stockholder must have actually controlled the directors' decision with respect to the transaction under review—a very high standard, as it is difficult to prove in any case why directors acted as they did. In Zhongpin, there was no suggestion that Zhu had taken any action to try to "force" the special committee to approve his take-private offer. The court nonetheless inferred controller status for Zhu, apparently because the circumstances resulted in the functional equivalent— "Zhu's dominance over Zhongpin left the Company with no practical alternatives other than to accept his Proposal."

- **The court will look to the underlying reality of a stockholder's influence, from whatever sources, to determine controller status.**

The percentage of stock owned is only one factor in the case-specific evaluation of controller status. The court will look to whether a stockholder can "control a company, as a practical matter." Among the important indicia of control, according to the court, are the ability to elect directors and to adopt or reject fundamental transactions. The factors that supported an inference of controller status for Zhu, despite his owning only 17% of the stock, were as follows:

    - <u>Chair, CEO and founder</u>. Zhu was not only the single largest shareholder of the company, but also the founder, Chairman, and CEO.

    - <u>Control over day-to-day operations</u>. According to the court, Zhu appeared not only to have had "active control over Zhongpin's day-to-day operations" but to have "exercised significantly more power than would be expected of a CEO and 17% stockholder."

    - <u>Company's 10-K disclosure about Zhu's influence and control</u>. The company's 10-K disclosure described Zhu as a controlling stockholder—including statements that he "[is] the company's] controlling shareholder…[who is] able to exercise significant influence over [the] company," including with respect to the election of directors, selection of management, and payment of dividends, among other matters; that he "has significant influence over [the company's] management and affairs and could exercise this influence against [the other stockholders'] best interests"; that the company "substantially relies on [him] … to manage its operations"; and that "loss of [Zhu] … would have a material adverse effect on [the company's] business and operations."

    - <u>Effective veto power over sale of the company</u>. The 10-K also stated that Zhu's ownership stake could impede or deter a potential acquiror's submission of a competing bid for the company, "delaying or preventing a change of control". Events proved this statement true, as the only competing bidder who emerged conditioned his proposal on Zhu's committing that he would continue as CEO, and not one of the more than eighty parties contacted during the go-shop period emerged as a competing bidder (or even entered into a confidentiality agreement). Zhu's being indispensable to the company as CEO (for reasons not fully specified by the court) had the practical effect of precluding competing bids—unless Zhu would cooperate to facilitate them, which he refused to do.

- **Controller status may be inferred when a stockholder-bidder's "grip" over a company appears to prevent a special committee from being able to function effectively to conduct a market check or negotiate a higher price from the stockholder.**

The court viewed Zhu as having so much power over the company that he rendered the special committee's authority illusory. The key appears to have been Zhu's having had effective veto power over a sale of the company. This power precluded both an effective market check and meaningful negotiation over price. The court has determined in other cases that private equity firms that held substantial non-majority ownership of portfolio companies; that nominated and had long, close relationships with the directors; and that directly and indirectly influenced the management (including having managerial control through management agreements), without more were not controllers if they did not control the board's decisions that were under review. In those cases, the court typically emphasized that the directors still had the authority and the practical ability to ignore the wishes of the private equity firm and make decisions that they thought would be in the best interests of the company. By contrast, in Zhongpin, even though the stockholder did not hold as substantial an ownership stake; did not nominate the directors; and there were not even allegations of close relationships with the directors or any attempt by Zhu to control the committee's process or decision, the court's view appeared to be that the committee as a practical matter could make no decision other than to accept Zhu's purchase of the company at whatever price he commanded. The committee could not attract a competing bid, presumably because it was critical for the company that Zhu remain as CEO. Because there was no possibility of a competing bid, the committee had no leverage to cause Zhu to increase his price.

- **The court did not address the issue of whether a minority stockholder-bidder who is also the CEO may have any additional duty to the company, by virtue of his management position, to facilitate, or at least not to effectively block, possible competing bids for the company.**

A stockholder-bidder has no obligation to cooperate with the company or other bidders to facilitate the making or success of competing bids. However, a question that the plaintiffs did not raise (and the court did not address) is whether Zhu, as the CEO of the company, may have had some additional duty to the company and its stockholders, by virtue of his management position, that would have obligated him to cooperate to some extent.

- **Entire fairness review (which applies if a controlling stockholder stands on both sides of the transaction and the MFW prerequisites for application of business judgment review have not been met) almost invariably will preclude dismissal on a motion to dismiss at the pleading stage. Although the nature and extent of pleadings as to unfairness of the process or price that might be sufficient to preclude review under the business judgment rule is still developing through the courts' post-MFW jurisprudence, it appears that, if business judgment governs, motions to dismiss usually will result in dismissal at the pleading stage unless the complaint raises plausible issues with respect to the duty of loyalty.**

As now well established, the entire fairness standard of review applies if a controlling stockholder stands on both sides of a transaction—unless the *MFW* prerequisites for a shift to business judgment review have been satisfied. (*MFW* had not been decided before Zhu made his bid; thus, the roadmap to business judgment review had not been available to him). As the majority-of-the-minority stockholder vote condition to Zhu's bid had not been present from the outset (but, rather, was agreed by Zhu at "the tail end of the process" in exchange for the special committee's acceptance of his price), at least one *MFW* requirement had not been satisfied, so business judgment would not apply. The court did not address the issue of whether its view that the special committee was precluded, as a practical matter, from functioning effectively would have defeated satisfaction of the other major *MFW* requirement—approval by an independent, fully functioning and effective special committee.

The court noted that application of entire fairness "normally will preclude dismissal of a complaint on a motion to dismiss," as the pleadings must only include allegations that suggest that the process or price may have been unfair.

Here, in addition to the basic issue of unfairness of the process (based on the special committee having had no real power because of Zhu's practical control and unwillingness to work with third parties), the following allegations suggested unfairness of the price:

- Initial banker's refusal to provide a fairness opinion (and subsequent resignation). The board approved the merger agreement after the special committee's banker, Barclays, stated that it could not provide a fairness opinion even for a deal price ($13.75—which Zhu had said he was considering but then rejected) that was higher than Zhu's $13.50 offer price, and shortly thereafter Barclays resigned. Post-signing, new bankers, Cowen and Duff & Phelps, provided a fairness opinion for the $13.50 deal price, after Zhu rejected their requests for a price increase and no competing bids emerged during the go-shop process.

- Evidence that the price significantly undervalued the company. The plaintiffs alleged that the deal price failed to account for the company's "undeniable growth" and offered evidence that the price significantly undervalued the company—including that it was below even the low end of valuation ranges for the company's stock; represented a 42% discount to the three-year high for the stock; and, according to data published by Bloomberg, compared unfavorably to comparable transactions.

- Only competing bid was at a higher price. The only competing bid had a proposed purchase price of $15 per share (although it was conditioned on Zhu's remaining as CEO).

- Stockholder approval was by a slim margin. The unaffiliated stockholders approved the merger by only a slim margin (51.3%).

Practice tips

- **For companies**.

  - Characterization of non-majority stockholders as controllers. A company should carefully review the nature and scope of any disclosure it makes that a non-majority stockholder is a controlling stockholder.

  - Exculpatory provision does not mandate dismissal when entire fairness standard applies. An exculpatory provision is beneficial and obviously should be included in a company's charter. Although an exculpatory provision should result in dismissal of plaintiffs' claims against independent directors at the pleading stage under a business judgment review unless there are allegations of a breach of the duty of loyalty, that is not the case when entire fairness applies. Under the precedent set in the Chancery Court's decision in Cornerstone, the court will not dismiss a complaint until there has been a determination, after development of the factual record, as to whether the transaction was entirely fair; and only then will it consider whether directors do or do not have liability. Thus, in the context of a motion to dismiss, disinterested directors will face the same pleading standard as interested fiduciaries in cases subject to entire fairness. All that is necessary for plaintiffs to avoid dismissal at the pleading stage when entire fairness applies is a reasonable inference that there is a controlling stockholder on both sides of the transaction and allegations that suggest the absence of fairness of the price or process.

- **For special committees**.
  - Banker's refusal to provide a fairness opinion. If, prior to the signing of a merger agreement, a banker cannot provide a fairness opinion for the proposed purchase price, the special committee may decide to refuse to approve the transaction or could try to use the banker's refusal as leverage to try to negotiate a higher price or better terms from the bidder. After a banker states that it cannot provide a fairness opinion for a proposed purchase price, a new banker should consider all applicable information, including developments that have occurred since the former banker's refusal (such as attempts, if any, to try to negotiate price increases and the emergence, or not, of competing bidders).
  - Favorable "shopping" provisions. Favorable shopping provisions (such as the go-shop in *Zhongpin* that permitted the company to terminate the merger agreement for any reason during the 60-day post-signing go-shop, without paying a termination fee) can be critical in establishing a fair process, but only if they can be effectively implemented. All the shopping in the world may be meaningless if, as the court inferred in *Zhongpin*, a dominant individual apparently critical to the company's fortune is unwilling to be part of the process except as a buyer.
  - Revision of management projections. Courts are typically skeptical of revisions of management projections during a sale process (particularly in controller transactions), and they should be avoided when possible. When they are necessary, the special committee should explore the revisions with management and the bankers and be prepared to explain the revisions and why they were necessary. In *Zhongpin*, management revised its projections downward during the sale process to reflect preliminary quarter results. The court noted (without comment) that the committee discussed with management the process that was undertaken and the assumptions made in creating the new projections, the rationale for the revisions, and management's expectations regarding the business (including the reasons for the poor results).
- **For controlling stockholders.**
  - Increase in bid price. A controlling stockholder's legal position will generally be advantaged, as a practical matter, by its reserving room in its initial offer price so that it can be increased during negotiations with the special committee.
  - Cooperation. While a controlling stockholder is not legally required to facilitate the company's seeking competing bids, his legal position will be advantaged to the extent he can cooperate with the company's process, assist in its effort to identify and negotiate competing bids, and, if necessary, be willing to participate with bidders. Of course, the legal advantage will have to be balanced with the stockholder's business objectives

relating to his decision to sell or not to sell his stock, and whether and with whom to partner in a change of control transaction. One issue to be considered (although not raised in Zhongpin) is whether a controller who is also CEO has any additional duty to the company in this respect by virtue of his or her management positions.

  - Upfront majority-of-the-minority condition. To obtain business judgment review of a proposed merger with the company, a controlling stockholder must condition its bid on approval by an independent special committee and a majority-of-the-minority stockholder vote condition *from the outset* of the process.

- **For bankers.**

  - Fairness opinion support. When opining on fairness of a price, in addition to reviewing relevant financial information and conducting appropriate financial analyses, bankers should consider other factors that could be relevant to fairness of the price. These could include, depending on the facts and circumstances: the nature and extent of pre- and post-signing market checks conducted by the company; whether there were factors that limited or precluded effective shopping of the company; any disclosures by the company that the bidder is a controller or may have an effect on change of control situations; and whether material revisions were made to management projections during the process. These factors may have been important in *Zhongpin*, in the context of no competing bids having emerged, there being evidence that the deal price may have undervalued the company, and a previous banker had resigned after refusing to provide a fairness opinion.

Conclusion

What could the parties here have done differently?

The special committee appears to have done everything it could under the circumstances to accomplish a deal, including repeated attempts to obtain a price increase from the bidder, a pre-signing market check, and a robust post-signing go-shop. The only other alternative the committee may have had was to refuse to participate in the process given the controller's unusually dominant position. The initial banker resigned when it did not believe it could deliver a fairness opinion for the proposed deal price. In response to a threat by the bidder that he might withdraw the proposal, the special committee negotiated an unusually favorable post-signing go-shop, and then approved the proposal and sought a post-signing fairness opinion. The new bankers provided a fairness opinion taking into account that no competing bidders had emerged during the go-shop and that the bidder had continued to refuse to increase his bid or to participate with other bidders.

It was the bidder who possibly could have created a more favorable legal environment for review of the transaction and reduced his risk of liability. Because of Zhu's direct interest in the transaction reviewed by the board, he clearly was subject to a duty of loyalty and, under the circumstances, was obligated to have offered a "fair price" and to have participated in a "fair process". An openness to negotiate and a greater willingness to cooperate likely would have advantaged his legal position.

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