CORPORATE LITIGATION

Delaware Judicial Review of Commercial Arrangements among Affiliates

Litigation over commercial and operational arrangements among affiliates are becoming more prevalent, as several recent Delaware cases illustrate. In such cases, there is a focus on when the transaction was timed, how it was initiated, structured and negotiated, disclosed to directors and how the approval of the directors and shareholders were obtained.

By Nathan Emeritz and Ryan Greecher

Recent cases in the Delaware Court of Chancery and the Delaware Supreme Court involving commercial arrangements among affiliates provide guidance on the governance of portfolio and affiliated companies.[1]Because Delaware litigation more often focuses on transformational transactions and statutory compliance, these opinions may be useful to transaction planners considering synergistic and operational arrangements among affiliated entities. This collection of opinions also allows for a comparison between the judicial review of change-of-control transactions, which fall under the umbrella of mergers and acquisitions, and that of commercial arrangements, which may be intended to organize ownership and financing of a diversified business.[2]

AGNC Investment: REIT Management Services Agreement

In *AGNC Investment*, Vice Chancellor Montgomery-Reeves addressed claims regarding allegedly inappropriate allocation of expenses for management services provided by an affiliate of a private equity firm to two REITs, AGNC Investment Corp. and American Capital Mortgage Investment Corporation (MTGE).[3] During relevant periods, the founder of the private equity firm was the CEO of both REITs and the management company, and a majority of the boards of both REITs comprised the same directors.[4]

In the *AGNC Investment* litigation, an AGNC Investment stockholder alleged that AGNC Investment had "acted collectively for MTGE and the Company, even though the two entities had diverging interests," by paying a disproportionate share of the management fees owed by both portfolio companies and acquiring the management company that continued to provide services to MTGE.[5] Although AGNC Investment could terminate the management after its initial term, AGNC Investment then would be obligated to pay a termination fee in the amount of three times the average annual fee.

The vice chancellor found that the directors' decisions whether to renew the management agreement and whether to internalize the management functions by acquiring the management company were "the company's biggest business decision (in terms of expenditures) every year."[6] This was a particularly important decision for the AGNC Investment directors because AGNC Investment was allegedly subsidizing MTGE's management costs by paying over $100 million while MTGE was paying less than $20 million.[7]

According to meeting minutes, a joint committee constituted by directors from both the AGNC Investment and MTGE boards met annually to consider the renewals for approximately 10 to 15 minutes without further deliberation, relied on

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materials from the management company and did not hire outside advisors.[8] Another committee of AGNC Investment and MTGE directors also convened to consider the possibility, structure and pricing of the internalization, which was repeatedly recommended by the private equity firm.[9] Minutes of that committee reported that the private equity firm had been "upset" when the committee sought to initiate its own process to consider the internalization and had withheld information from the independent directors.[10] The vice chancellor found that the joint committee had hired outside advisors but had accepted recommendations and presentation materials from, and delegated primary negotiations to, a representative of the private equity parent.[11]

The vice chancellor found that the process had been dominated by the private equity firm and that a majority of the directors were not independent of the private equity firm.[12] Vice Chancellor Montgomery-Reeves denied the directors' motion to dismiss, holding that reasonable doubt existed whether the directors had been adequately informed.[13]

RCS Capital: Wholesaling Agreement and Staffing Arrangement

There have been two decisions in the *RCS Capital* litigation regarding allegedly inappropriate allocation of fees paid under a wholesaling agreement and alleged overstaffing decisions. Each of these arrangements was allegedly structured by a group that maintained voting control over the relevant entities, such that benefits would inure to one affiliate in which the control group held a 100 percent economic stake, while the costs would be borne by an affiliated public company in which the control group held only a 25 percent economic stake and majority voting power.[14] The plaintiff stockholder further alleged that the wholesaling agreement was off-market and unprofitable[15] and that the staffing arrangement was irrational in light of the employer-company's performance.[16] In addressing claims for breach of fiduciary duty and aiding and abetting breach of fiduciary duty against directors, officers and entities who allegedly exercised control over the relevant affiliated companies, Vice Chancellor Glasscock characterized the incentives created by this ownership structure as "perverse."[17]

Vice Chancellor Glasscock held that, because representatives of the control group sat on both sides of the wholesaling agreement, and because the wholesaling agreement had only been approved by the control group representatives on behalf of each constituent party, that arrangement was subject to entire fairness review.[18] The vice chancellor held that "in turn precludes dismissal of the core claim on a Rule 12(b)(6) motion."[19] The defendants asserted as a defense that, as a broker dealer, the company was prohibited by FINRA rules from receiving the relevant fees, but the vice chancellor credited the plaintiff's argument that the control group could have pursued alternative legal structures such as payment of fees to a subsidiary of the public company.[20] The vice chancellor also rejected the defense that the arrangements had been adequately disclosed when the company went public, which would have thereby extinguished such claims.[21]

However, with respect to the alleged arrangement to allocate the costs of staffing to one affiliate during less profitable times while using those employees to generate revenue that more directly benefited the control group, Vice Chancellor Glasscock found that the control group was not directly on both sides of the decisions.[22] The vice chancellor stated that entire fairness would apply only if the arrangement "directly implicated" the controller's interests or if the control group had received a material non-ratable benefit.[23] Materiality in this context was determined

> if it is so significant, "in the context of the [fiduciary]'s economic circumstances, as to have made it improbable that [she] could perform her fiduciary duties to the . . . shareholders without being influenced by her overriding personal interest."[24]

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The vice chancellor held that the plaintiff had failed to show either that the control group was directly across from itself in these arrangements, or that the benefit was material, and therefore the staffing arrangement was subject to business judgment deference.[25]

The plaintiff stockholder also brought claims for aiding and abetting breach of fiduciary duty. These claims were pleaded in the alternative against the same individual defendants who were the subject of the fiduciary duty claims, in the event that those individuals were found not to owe fiduciary duties to the company. The defendants asserted that the plaintiff had failed to meet the "knowing participation" prong of the aiding and abetting standard.[26] Vice Chancellor Glasscock denied the motion to dismiss the aiding and abetting claim with respect to the wholesaling agreement, holding that the claim regarding the wholesaling agreement "rests on allegations about a self-dealing scheme hatched by the Control Defendants themselves" which could constitute "knowing participation" for aiding and abetting a breach of fiduciary duty.[27]

New Senior Investment: REIT Management Agreement

In *New Senior Investment*, Vice Chancellor Slights addressed claims for breach of fiduciary duty and aiding and abetting breach of fiduciary duty against directors, officers and a private equity firm that was a 7.2 percent stockholder of New Senior Investment. The litigation revolved around several transactions including a REIT management agreement at allegedly above-market rates between New Senior Investment and an affiliate controlled by the same private equity firm that invested in New Senior Investment.[28] The management agreement was described in New Senior Investment public filings as making the company "completely reliant on [the private equity firm's affiliate]" and subject to risks of termination and inability to find a replacement manager.[29] The public disclosures further provided that the management agreement was "not negotiated at arm's length, and its terms, including fee payable, may not be as favorable to [New Senior] as if it had been negotiated with an unaffiliated party."[30]

Noting,

> [a]llegations revealing unfair dealing should focus on "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained,"[31]

the vice chancellor found that a majority of the directors were not independent of the private equity founder, that a representative of the private equity firm had negotiated the management agreement for New Senior Investment by no-bid process, that there was no fairness opinion with respect to the management agreement and that the board had not seen the relevant incentive compensation structure.[32] Entire fairness was, therefore, determined to be the standard of review.[33]

Solely by abstaining from voting on the transactions, directors would not necessarily be absolved from liability.

Vice Chancellor Slights noted, "[t]he applicability of the entire fairness standard 'normally will preclude a dismissal of a complaint on a Rule 12(b)(6) motion to dismiss,'" but nevertheless proceeded to find that facts had been pleaded to show that the challenged transactions were not entirely fair.[34] Vice Chancellor Slights held that the New Senior Investment CEO had led the process without consulting or receiving advice from a transaction committee formed to negotiate on behalf of the company, while noting that she would not be exculpated for any breaches of the duty of care

committed in her capacity as an officer.[35] The vice chancellor also held that, solely by abstaining from voting on the transactions, directors would not necessarily be absolved from liability—especially because those directors had been involved in negotiations.[36] Finally, the vice chancellor denied the motion to dismiss the aiding and abetting claim against the private equity firm, because of the relationships among the directors and because the potential self-dealing actions and knowledge of those fiduciaries could be imputed to the private equity firm.[37]

New Residential Investment: REIT Management Arrangement

In the most recent of these decisions, the Delaware Supreme Court affirmed Vice Chancellor Montgomery-Reeves's decision in *New Residential Investment*.[38] The *New Residential Investment* litigation involved the same private equity firm as in *New Senior Investment* and its management of a different public REIT. In *New Residential Investment*, the private equity firm provided all officers and employees to the REIT, a minority of the company's directors and management services under a management agreement.[39] After unsuccessfully merging with a third party, New Residential Investment acquired substantially all of that party's assets.[40] A New Residential Investment stockholder alleged that the private equity firm had caused New Residential Investment to overpay for those assets to facilitate an increase in the value of the firm's stock options and management fees.[41]

In granting the motion to dismiss claims that the New Residential Investment directors had breached their fiduciary duties, Vice Chancellor Montgomery-Reeves held that, although the private equity representatives on the New Residential Investment board were conflicted dual fiduciaries, the plaintiff-stockholder had not pleaded facts demonstrating that the benefits of the challenged transactions were material to the private equity firm.[42] The vice chancellor stated:

> Allegations that some of the effects of the challenged transactions benefited [the firm] alone are not enough. Plaintiff must allege that the benefits were material to [the firm] to excuse demand under the first prong of *Aronson*. Without allegations of the materiality of the fees and options, Plaintiff has not cast a reasonable doubt on [the firm's designated directors'] independence in the challenged transactions. . . . Plaintiff should allege the amount by which New Residential allegedly overpaid, and Plaintiff's allegations should deal with the overpayment incentives so the Court can analyze the effects of the challenged transactions in the aggregate.[43]

The Delaware Supreme Court affirmed the vice chancellor's decision that "it was the duty of the plaintiffs to plead that [the private equity firm] received a side benefit that was material to it."[44] The Court noted, however, that a showing of materiality was required because the seller was "not controlled in any way" by the firm or New Residential Investment and "did not involve classic self-dealing."[45]

Takeaways

The cases discussed above provide insight into the types of commercial issues that are being litigated in the Court of Chancery with greater frequency and the judicial perspective on those issues. Although the facts of each case were complex and warrant close study, practitioners may note the following high-level takeaways.

Litigation over Commercial and Operational Arrangements among Affiliates

In light of the decrease in deal litigation in Delaware courts,[46] disputes over commercial agreements may become more prevalent. As the cases above demonstrate, the entire context—often involving a broad web of affiliated entities and individuals

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with personal and professional relationships—may become relevant and subject to plaintiff-friendly pleading standards of review. As Vice Chancellor Slights stated in *New Senior Investment*, there is a focus on

> when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[47]

Deal planners should keep these guideposts in mind while advising on the structure of commercial arrangements among affiliates.

Recent Delaware opinions involving mergers and acquisitions between potential sister affiliates (which all involved a potential controlling stockholder) also outline theories of conflicts that plaintiffs may attempt to extrapolate to the commercial arrangement context and deal planners may consider when advising on commercial transactions among affiliates.[48] Although some of these cases involved potential controlling stockholders, the efficacy of processes in mitigating a controller's power (as well as the methods of documenting them) can be examined for use as appropriate in the context of affiliates' commercial arrangements. This is particularly the case at flashpoints such as initiation, structuring, negotiation, approval and disclosure of the transactions.

Standard of Review Applicable to Commercial Agreements

These cases also suggest that, in the context of litigation over such complex commercial and operational arrangements, Delaware courts are at this point unlikely to prescribe a unique standard of review that would differ from the transactional or M&A context.[49] That is, Delaware courts initially will defer to directors' business judgment, unless the plaintiff can plead facts demonstrating that would be inappropriate in the context of the challenged transaction. In his 2016 *EZCorp* opinion, Vice Chancellor Laster examined case law on interested-party commercial arrangements and, although he found the weight of authority in favor of applying entire fairness to commercial agreements between a controller and its affiliates, he acknowledged that there were differences of opinion on this point. Thus, notwithstanding guidance in these cases regarding the applicable standard of review, there may be some questions remaining with respect to the Delaware judicial review of commercial arrangements.

After finding that certain defendants sat on both sides of negotiations over commercial agreements, the vice chancellors in *RCS Creditor* and *New Senior Investment* held that entire fairness was the applicable standard of review. Those vice chancellors also held that application of the entire fairness standard of review precluded a motion to dismiss under Chancery Court Rule 12(b)(6). Vice Chancellor Glasscock made clear, however, that entire fairness may apply to some but not all transactions in a seemingly interconnected commercial arrangement—the standard of review for each agreement will depend on whether a party sits directly across from itself or the benefits from the arrangement are shown to be material. This focus on pleadings showing materiality, control and self-dealing was reinforced by the Delaware Supreme Court in *New Residential Investment*. These technical points could become critical in litigation and may be vetted from the outset of the transaction.

Potential Exposure of Controllers and Dual Fiduciaries

These cases also serve as reminders of the potential for liability of controllers and dual fiduciaries when dealing with affiliates. As in more than one of the above cases, the parent entity may have a risk of aiding and abetting liability when affiliated directors and officers are found to have breached their fiduciary duties, even if the parent is not found to be a controlling stockholder imbued with fiduciary duties of its own directly flowing to the corporation. Subject to the facts of a transaction resembling one of the above cases, the theories of such an aiding and abetting claim could be premised on alleged

knowledge and actions of representatives of the parent entity that could be imputed to the parent, or alleged failures by the parent to share information with independent directors.

Individuals, such as directors and officers of more than one affiliated company, who are found to be dual fiduciaries, also must navigate practical issues when complying with their fiduciary duties. Candor and confidentiality regarding key information can present difficult issues when attempting to act in the best interests of multiple parties with divergent interests. As an initial matter, corporate fiduciaries may be well advised to check whether their companies' charters have exculpatory provisions and the extent of indemnification and D&O insurance coverage.[50]

Notes

1. *H&N Mgmt. Gp. v. Couch et al.*, C.A. No. 12847-VCMR (Del. Ch. Aug. 1, 2017) (*AGNC Investment*); *RCS Creditor Trust v. Schorsch*, C.A. No. 2017-0178-SG (Del. Ch. Nov. 30, 2017), mot. for rearg. denied (Apr. 5, 2018) (*RCS Capital*); *Cuming v. Edens*, C.A. No. 13007-VCS (Del. Ch. Feb. 20, 2018) (*New Senior Investment*); *Chester Cty. Empls. Ret. Fund v. New Residential Investment Corp.*, No. 457, 2017 (Del. May 10, 2018), aff'g, C.A. No. 11058-VCMR (Del. Ch. Oct. 7, 2016) (*New Residential Investment*).
2. Note that the parties in these cases raised issues in addition to the commercial arrangements, but this article focuses solely on the analysis of the commercial arrangements.
3. *AGNC Investment*, at 2.
4. *Id.* at 9.
5. *Id.* at 4.
6. *Id.* at 11.
7. *Id.*
8. *Id.* at 10-11.
9. *Id.* at 11.
10. *Id.*
11. *Id.* at 19.
12. *Id.*
13. *Id.* at 20.
14. *RCS Capital*, at 8-9 (2017).
15. *Id.* at 36.
16. *Id.* at 44.
17. *Id.* at 18.
18. *Id.* at 30-31.
19. *Id.* at 31.
20. *Id.* at 33-34.
21. *Id.* at 35.
22. *RCS Capital*, at 7 (2018); *RCS Capital*, at 41 (2017).
23. *RCS Capital*, at 8 (2018); *RCS Capital*, at 29 (2017).
24. *RCS Capital*, at 8 (2018) quoting *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 617 (Del. Ch. 1999).
25. *RCS Capital*, at 9-11 (2018); *RCS Capital*, at 42-44 (2017).
26. *RCS Capital*, at 16 (2018).
27. *Id.* at 17.
28. *New Senior Investment*, at 24-25.
29. *Id.* at 12-13.
30. *Id.*
31. *Id.* at 64 quoting *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).
32. *New Senior Investment*, at 61-65.
33. *Id.* at 61.
34. *Id.* at 62-63.
35. *Id.* at 66.
36. *Id.* at 66 n.251.
37. *Id.* at 69-74.
38. The *New Residential Investment* litigation involved two other decisions which were not on appeal to the Delaware Supreme Court. *See* C.A. No. 11058-VCMR (Del. Ch. Dec. 1, 2016 and Oct. 6, 2017).
39. New Residential Investment, at 3 (Del. Ch. 2016).
40. *Id.* at 10-11.
41. *Id.* at 12.
42. *Id.* at 27 (the claims were dismissed with leave to replead, which the plaintiff did).
43. *Id.* at 30.
44. *New Residential Investment*, at 2 (Del. 2018).
45. *Id.* In the October 6, 2017 *New Residential Investment* opinion, Vice Chancellor Montgomery-Reeves held that the New Residential Investment stockholder's attempt to show such control or self-dealing was insufficient and the amended complaint was dismissed.
46. Ravi Sinha, *Shareholder Litigation Involving Acquisitions of Public Companies: Review of 2015 and 1H 2016 M&A Litigation* (Cornerstone Research, 2016); Nathan Emeritz and Jeffery Wolters, *Delaware Litigation 2017: Assessing Trends at Year-End*, (Law360, Dec. 20, 2017).

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47. *New Senior Investment*, at 64 quoting *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).
48. *See, e.g., In re Tesla Motors, Inc. S'holder Litig.*, Consol. C.A. No. 12711-VCS (Del. Ch. Mar. 28, 2018); *In re Oracle Corp. Deriv. Litig.*, C.A. No. 2017-0337-SG (Del. Ch. Mar. 19, 2018); *In re Rouse Properties Inc. Fiduciary Litig.*, Consol. C.A. No. 12194-VCS (Del. Ch. Mar. 9, 2018).
49. *Cf. In re EZCorp Consulting Agreement Deriv. Litig.*, C.A. 9962-VCL (Del. Ch. Jan. 25, 2016) (*EZCorp*) (holding that, unless certain prophylactic steps are taken, "the entire fairness framework governs any transaction between a controller and the controlled corporation in which the controller receives a non-ratable benefit. This is because 'Delaware is more suspicious when the fiduciary who is interested is a controlling stockholder.'").
50. The Delaware Supreme Court has refused to hear interlocutory appeal from Judge Carpenter's decision that Delaware public policy does not prohibit insurance of bad faith conduct. *Arch Ins. Co. v. Murdock*, C.A. No. N16C-01-104 EMD CCLD (Del. Super. Mar. 1, 2018) interlocutory appeal denied by *Navigators Ins. Co. v. Murdock*, No. 144, 2018 (Del. Apr. 6, 2018).