The Morton's Sale Process and PE Exit Motives

Chancellor Strine's recent decision in the In re Morton's Restaurant Group, Inc. Shareholders Litigation *reflects the importance of a court's determination on whether to apply the entire fairness standard of review and the corresponding need to thoroughly vet plaintiffs' claims regarding a large stockholder's supposed conflicts and "controller" status.*

By Christopher G. Green, Peter L. Welsh, and Martin J. Crisp

As practitioners in the M&A space know all too well, the key battle in litigations concerning transactions in which the target corporation has significant stockholders often concerns the question of whether the transaction is subject to entire fairness review. In order to obtain that heightened review, stockholder plaintiffs often will characterize large blockholders as controlling stockholders with interests that supposedly diverge from the target's other stockholders, even in transactions in which all stockholders receive pro rata consideration. In his recent opinion in *In re Morton's Restaurant Group, Inc. Shareholders Litigation*, Chancellor Strine took on that issue directly in dismissing the stockholder plaintiffs' post-closing damages claims, which focused on the supposed control exerted over Morton's by its 28 percent private equity stockholder and that stockholder's supposed conflict.[1] In dismissing those claims, Chancellor Strine rejected the plaintiffs' allegations that the 28 percent stockholder was a conflicted controller, holding that they had failed to plead facts supporting a rational inference that a 28 percent holder with two board seats and no other indicia of control which received equal consideration with all other public stockholders was either conflicted or a controller.[2] The *Morton's* opinion is helpful both in its close scrutiny of overreaching invocations of the entire fairness standard and its focus on the practical reality of the large stockholder's lack of control or conflicts.

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The Morton's Transaction

In the underlying transaction, Morton's agreed to sell itself to a subsidiary of Landry's, Inc. (Landry's) for $117 million. That transaction followed a nine-month strategic review process in which the Morton's board contacted over 100 potential bidders and entered into an exclusivity agreement with another bidder before ultimately agreeing to be acquired at a 33 percent premium to Morton's undisturbed market price.[3] The strategic review process that culminated in the transaction was suggested by a large Morton's stockholder, Castle Harlan, Inc. (Castle Harlan), which had been Morton's private equity sponsor and retained

Christopher G. Green and Peter L. Welsh are partners, and Martin J. Crisp is an associate, at Ropes & Gray LLP. The views expressed in this article do not necessarily represent the views of Ropes & Gray LLP or its clients, and are not intended to, and do not, constitute legal advice.

a 28 percent stake in the company following a 2006 IPO.[4] Ultimately, 92 percent of Morton's stockholders approved the transaction, and it closed in 2012.[5] Unsurprisingly, stockholder plaintiffs filed suit shortly after the transaction was publicly announced and obtained substantial discovery before abandoning their attempt to enjoin the transaction.[6] The plaintiffs twice amended their complaint to reflect information gleaned during discovery, and the defendants moved to dismiss the plaintiffs' claims.

When Is a Large Stockholder a Conflicted Controller?

In *Morton's*, the stockholder plaintiffs followed the usual playbook, arguing that Castle Harlan, a 28 percent private equity stockholder that controlled two of ten seats on Morton's board, was a controlling stockholder whose interests in the transaction diverged from those of Morton's other stockholders because Castle Harlan had a unique liquidity need that caused it to push for a sale of Morton's at an inadequate price.[7] Chancellor Strine rejected both contentions, holding that the plaintiffs' allegations failed to create a rational inference that Castle Harlan was a controlling stockholder or had a conflict of interest with the other Morton's stockholders.[8]

In discrediting the plaintiffs' allegations, Chancellor Strine conducted a lengthy assessment on whether Castle Harlan was a controlling stockholder. In so doing, he ruled that a minority stockholder does not possess "control" unless it "exercised actual domination and control ... over [the] directors."[9] He went on to conclude that, as a practical matter, a stockholder does not possess such "domination and control" unless its power is "so potent that independent directors ... cannot freely exercise their judgment, fearing retribution" from the powerful minority stockholder.[10] This standard focuses not only on a stockholder's percentage of ownership, but also on qualitative indicia of practical control.

In assessing Castle Harlan's control (or lack thereof), Chancellor Strine focused on the fact that Castle Harlan controlled less than 30 percent of the company's voting power.[11] However, the Court did not simply conduct a numerical assessment and went on to analyze other potential ways in which Castle Harlan was alleged to have exerted control over Morton's. For example, he concluded that Castle Harlan's two seats on Morton's 10-seat board did not confer control, particularly when the plaintiffs failed to plead any facts about Castle Harlan's supposed influence over the super-majority of unaffiliated directors.[12] Nor did the Court conclude that Castle Harlan exercised control over Morton's simply because it had previously owned the entire company before Morton's was publicly traded.[13] In rejecting those allegations, Chancellor Strine continued the Court of Chancery's emphasis on the practical realities of a large stockholder's relationship with the target when assessing control.[14]

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The Court also scrutinized the plaintiffs' claims that Castle Harlan had an improper conflict of interest in supporting a sale of Morton's at an unfairly low price in order to satisfy an alleged liquidity need, which was supposedly created by the winding down of the Castle Harlan fund invested in Morton's and Castle Harlan fundraising for a new fund.[15] In evaluating those allegations, Chancellor Strine applied the Court of Chancery's presumption that large stockholders have strong incentives to maximize the value of their shares in a change of control transaction and concluded that "[w]hen a large stockholder supports an arm's-length transaction resulting from a thorough market check

that spreads the transactional consideration ratably across all stockholders, Delaware law does not regard that as a conflict transaction."[16] The Court also concluded that the "narrow circumstances" where a controlling stockholder's desire for immediate liquidity sparks a "fire sale" that harms all stockholders was not present here, as Morton's conducted a nine-month public sales process in which the Board approached over 100 potential bidders.[17] Chancellor Strine went on to specifically address the plaintiffs' theory that Castle Harlan forced a sale at a sub-optimal price in order to create liquidity for a newly formed investment fund, concluding that "[t]hat situation, which many firms in the industry face on a regular basis, and therefore is hardly unique, is not some unusual crisis, requiring a fire sale."[18]

Other Issues

Sell-Side Financial Advisors Providing Buy-Side Financing

Although the *Morton's* opinion principally addresses issues concerning a large stockholder's control and associated conflicts, it also provides helpful guidance on two other issues that frequently arise in stockholder M&A litigation.

There is no "bright-line" prohibiting sell-side financial advisors from providing buy-side financing.

First, Chancellor Strine discussed the plaintiffs' claim that the Morton's Board breached its duty of loyalty by permitting Jeffries—Morton's original financial advisor in connection with the transaction—to provide financing to Landry's.[19] In dismissing that claim, Chancellor Strine walked through the Board's careful deliberation of that issue, including Jeffries' report to the Board that Landry's was having difficulty securing financing for its premium bid and that Landry's had approached Jeffries about providing buy-side financing, as well as the Board's ultimate conclusion that it would permit Jeffries to provide buy-side financing only if (1) Jeffries recused itself from further negotiations, (2) reduced its fee by $600,000, and (3) would still opine on the fairness of the transaction once its terms were finalized.[20] The Board then used the $600,000 reduction in Jeffries' fee to hire another financial advisor, KeyBanc, which also opined on the fairness of the transaction. Ultimately, Chancellor Strine concluded that the Board's decision to permit Jeffries to provide buy-side financing "rather than risk losing a bid at a high premium" did not create an inference of bad faith. Although made in a duty of loyalty analysis, this conclusion echoes Chancellor Strine's statement in the *Toys "R" Us* opinion that there is no "bright-line" prohibiting sell-side financial advisors from providing buy-side financing, and that various "scenarios might exist when roles on both sides for the investment banker would be wholly consistent with the best interests of the primary client company."[21]

Aiding and Abetting Liability

The *Morton's* opinion also dismissed the plaintiffs' aiding and abetting claims against Castle Harlan and Morton's financial advisors, holding that such claims could not be properly stated absent a viable underlying breach of fiduciary duty claim.[22] Because Morton's corporate charter includes a Section 102(b)(7) provision insulating its directors from damages resulting from any breach of the duty of care, that dismissal raises the question of whether a duty of care claim barred by a Section 102(b)(7) provision can be used as a predicate claim for aiding and abetting liability against a third party. Vice Chancellor Laster held otherwise in his *Del Monte Foods* opinion, in which he found that the plaintiffs had established a likelihood of success on an aiding and abetting claim against Del Monte's financial advisor Barclays despite a Section 102(b)(7) clause that exculpated the Del Monte board from liability for any breach of the duty

of care.[23] While Chancellor Strine's dismissal of aiding and abetting claims in this case was consigned to a footnote and a relatively brief statement that the aiding and abetting claims failed because plaintiffs "failed to state a conceivable claim for breach of fiduciary duty against any defendant,"[24] it does suggest a potential tension between *Del Monte* and *Morton's* as to whether a 102(b)(7) clause can preclude aiding and abetting liability claims against third parties.

Key Takeaways

In apparent recognition of the heavy burden imposed on defendants by the entire fairness standard, and the corresponding impact of which standard governs a particular transaction, the *Morton's* opinion conducts a thorough assessment of the practical realities underlying the plaintiffs' claims. That rigorous analysis, which Chancellor Strine conducted despite stating that the dismissal standard is "plaintiff-friendly,"[25] is welcome precedent to those practitioners who believe that not every transaction where the target has a large stockholder is subject to entire fairness review, particularly where the stockholder receives pro rata consideration for its shares and there is no evidence that it exerted improper control over the target or the sales process.

> ***Chancellor Strine also demonstrated support for the private equity model generally.***

Also, in dismissing the plaintiffs' *Revlon* claims, Chancellor Strine showed annoyance with the improper invocation of the *Revlon* doctrine to challenge transactions "where the key problem in *Revlon*—board resistance to the highest bidder based on a bias against that bidder—is entirely absent."[26] This misuse of *Revlon* and the ubiquity of litigation challenging public company transaction results in many cases in which stockholders sue quickly to seek preeminence in the lead plaintiff hierarchy, and then seek to conform the actual facts of a particular transaction to their boilerplate *Revlon* claims.[27] Translating Chancellor Strine's concern into enhanced judicial skepticism of *Revlon* claims in M&A strike suits would be a welcome development.

Perhaps more surprisingly, Chancellor Strine also demonstrated support for the private equity model generally, at least as compared to the public markets. At one point, citing several market studies and academic papers, he notes that private equity firms have a significantly longer holding period than the average holding period for a public stock.[28] And, in a footnote that could be found in a fund PPM, he wrote:

> Because of regulatory hurdles and incentives, most ordinary American investors have no vehicle to entrust a responsible portion of their 401(k) savings to private equity, despite the fact that the industry's comparatively more patient model of investing arguably better aligns with retirement investors' goals than actively traded mutual funds that chase a better than market return through actively trading in noninfluential blocks of equity (in defiance of accepted corporate finance theory).[29]

Notes

1. *In re Morton's Restaurant Group, Inc. S'holders Litig.*, C.A. No. 7122-CS, 2013 Del. Ch. LEXIS 188, at *9-*10 (Del. Ch. July 23, 2013).
2. *Id.* at *11-*14.
3. *Id.* at *9-*10.
4. *Id.*
5. *Id.* at *18 FN34.
6. *Id.* at *2.
7. *Id.* at *12-*13.
8. *Id.* at *14.
9. *Id.* at *23 (quoting *In re Sea-Land Corp. S'holder Litig.*, C.A. No. 8453, 1988 Del. Ch. LEXIS 65, at *8 (Del. Ch. May 13, 1988)).
10. *Id.*
11. *Id.* at *26.
12. *Id.*

13. *Id.* at *22.

14. *See, e.g.*, *Kalisman v. Friedman*, C.A. No. 8447-VCL, tr. at 14-15 (Del. Ch. May 14, 2013) (concluding that contractual rights can confer control even in the absence of stockholder status, and that indicia as varied as the identity and prominence of the investor can help determine the "degree of influence that a controller has over a company"); *In re Novell, Inc. S'holder Litig.*, C.A. No. 6032-VCN, 2013 Del. Ch. LEXIS 1, at *45 (Del. Ch. Jan. 3, 2013) (analyzing whether a minority stockholder's threat to sell its shares or initiate a proxy contest constitutes control); *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 551-552 (Del. Ch. 2003) (assessing control by focusing on blockholder's status as the target company's founder, CEO, and Chairman, as well as the blockholder's practical influence over the company's operations due to his family members occupying key senior management positions).

15. *Morton's*, 2013 Del. Ch. LEXIS 188, at *28.

16. *Id.* at *14-*15.

17. *Id.* at *35.

18. *Id.* at *33.

19. *Id.* at *49.

20. *Id.* at *49-*50.

21. *In re Toys "R" Us, Inc., S'holder Litig.*, 877 A.2d 975, 1006 FN46 (Del. Ch. 2005).

22. *Morton's*, 2013 Del. Ch. LEXIS 188, at *61 FN113.

23. *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 818 (Del. Ch. 2011) ("[T]he one-two punch of exculpation under Section 102(b)(7) and full protection under Section 141(e) makes the chances of a judgment for money damages [against the Del Monte directors] vanishingly small. The same cannot be said the self-interested aiders and abetters.").

24. *Morton's*, 2013 Del. Ch. LEXIS 188, at *61 FN113.

25. *Id.* at *61.

26. *Id.*

27. Robert M. Daines & Olga Koumrian, *Shareholder Litigation Involving Mergers & Acquisitions*, Cornerstone Research Review of 2012 M&A Litigation, p. 1 (Feb. 2013) (93 percent of all public company acquisitions valued over $100 million result in stockholder litigation).

28. *Morton's*, 2013 Del. Ch. LEXIS 188, at *39.

29. *Id.* at *44-*45 FN79.

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