

Court applies entire fairness standard to commercial arrangement with controlling stockholder

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Introduction

In a recent opinion⁽¹⁾ Vice Chancellor Laster of the Delaware Court of Chancery held that the entire fairness standard of review governs any transaction between a controlling stockholder and the controlled corporation in which the controller receives a non-*pro rata* benefit, unless the controller complies with the cleansing steps outlined in the Delaware Supreme Court's 2014 opinion in *Kahn v M&F Worldwide Corp.* Citing various Delaware cases for the proposition that the entire fairness standard of review is not limited to squeeze-out transactions, the court held that the transactions at issue – advisory services agreements between EZCorp and entities affiliated with its controlling stockholder – must be evaluated using the entire fairness standard, even though the agreements had been approved by an independent committee of EZCorp directors. Applying that heightened standard, the court rejected the controlling stockholder's motion to dismiss derivative claims filed by an EZCorp minority stockholder challenging the agreements.

Decision

EZCorp is a Delaware corporation that provides pawn services and other short-term consumer loans. As a result of EZCorp's dual-class structure, Phillip Ean Cohen, through his ownership of 5.5% of the company's outstanding stock, controlled 100% of EZCorp's voting power. EZCorp had a long history of entering into advisory services agreements with entities affiliated with Cohen. Under those agreements, Cohen's affiliates agreed to provide EZCorp with business development and strategic planning services. The affiliated entities were small firms with limited resources, and EZCorp was their only publicly traded client in the United States. The annual fees EZCorp paid to Cohen's affiliated entities steadily increased from \$1.2 million in 2004 to \$7.2 million in 2012 (constituting roughly 21% of EZCorp's 2012 net income). The company's audit committee approved the renewal of the advisory service agreement in 2013, but then terminated the agreement in 2014. The court attributed the termination to the committee's concerns about the fairness of the arrangement. Cohen responded quickly, using his voting power to remove the audit committee members from the board.

The plaintiff, an EZCorp minority stockholder, filed a derivative action challenging the advisory services agreements. The plaintiff contended that the agreements were not legitimate contracts for services, but rather a way for Cohen to extract cash from EZCorp. In evaluating the plaintiff's claims against Cohen and his controlled entities, the court held that the entire fairness review governs any transaction between a controller and the controlled corporation in which the controller receives a non-ratable benefit. In so holding, the court rejected Cohen's argument that the entire fairness standard applied only to squeeze-out mergers – relying on a series of prior cases that reached a similar conclusion and rejecting three prior decisions of the Delaware Court of Chancery that had held to the contrary. The court then evaluated the advisory services agreements to see whether they had been approved in accordance with the process set out by the Delaware Supreme Court in *MFV*,

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which provides that transactions with controllers will be subject to the business judgement standard of review if they are approved by both an independent fully empowered special committee and a majority of the unaffiliated stockholders. The court found that entry into the agreements had not been conditioned *ab initio* on compliance with the *MFW* requirements, and accordingly the agreements were not eligible for review under the business judgement standard of review. However, the court did explain that the fact that the transactions were approved by the audit committee might be sufficient to shift the burden of proof under the entire fairness standard back to the plaintiff.

In holding that entire fairness applies to all transactions between a controlled company and its controller where the controller receives a non-ratable benefit, Laster reasoned that it would be inappropriate to limit heightened scrutiny to squeeze-out merger transactions where other procedural protections (including appraisal rights) already exist. The court dismissed the argument that applying the entire fairness review to all such transactions would precipitate a drastic increase in litigation, noting that in its view entire fairness was already the standard of review, and that no flood of litigation had ensued.

Comment

EZCorp is the first decision since *MFW* to hold that a controlling stockholder may avail itself of the *MFW* protections to avoid the entire fairness review outside the minority squeeze-out transaction context. However, to do so the controlling stockholder would have to voluntarily submit a transaction that is not otherwise subject to stockholder approval to a majority of the minority vote. This is unlikely to be a widely attractive option and a more practical approach in many situations will continue to be to rely on the burden-shifting benefit under the entire fairness standard of approval by a special committee of independent directors.

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Endnotes

(1) *In re EZCorp Inc Consulting Agreement Derivative Litigation*, CA No 9962-VCL, 2016 Del Ch LEXIS 14 (Del Ch January 25 2016).

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