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Delaware Court Denies Dismissal of Claims Based on Controller and Financial Advisor Conflicts

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On May 31, 2024, the Delaware Court of Chancery issued an important decision addressing several key areas of Delaware law related to merger litigation. The opinion indicates that the court will continue to closely scrutinize potential conflicts of interest in M&A transactions involving controlling stockholders and financial advisors, particularly as to disclosures concerning their fees and relationships.

Background

In *Firefighters' Pension System of the City of Kansas City, Missouri Trust v. Foundation Building Materials, Inc.*, Vice Chancellor Travis Laster granted in part and denied in part six separate motions to dismiss arising from the sale of Foundation Building Materials (the Company) to a subsidiary of American Securities LLC (American).

Though the Company was publicly traded, the court found that private equity firm Lone Star possessed "hard control" of the Company at both the stockholder and board level. Prior to its IPO, the Company executed a tax receivable agreement (TRA) that contained an early termination provision. When the 2017 tax cuts sharply reduced the expected value of the payments under the TRA, the plaintiff alleged that Lone Star began exploring a sale of the Company to capture the more valuable early termination payment (ETP).

A special committee was established after price negotiations had begun, and the court credited allegations that it met infrequently and deferred to the Lone Star representatives who negotiated the sale.

Court's Analysis

The court issued a split decision, dismissing certain breach of fiduciary duty claims, aiding and abetting claims, and statutory claims but sustaining others in all three categories.

Breach of fiduciary duty: sale process claims. The plaintiff alleged various breaches of fiduciary duty by Lone Star entities (as controller), the Lone Star director designees, the CEO and the special committee, for (i) pursuing a sale rather than continuing to operate the Company, (ii) diverting merger consideration to Lone Star through the early termination payment and (iii) following an unreasonable sale process.

The court sustained the first claim, finding that the transaction was presumptively subject to entire fairness because the ETP was a conflict of interest when making certain decisions and provided a nonratable benefit to Lone Star.

The court dismissed the remaining two claims because the ETP was a contractual right (and thus any consideration associated with that right was not "diverted" away from minority stockholders), and the process used to sell the company was reasonable "given Lone Star's substantial economic alignment with the stockholders as a whole."

Breach of fiduciary duty: disclosure claims. The court sustained disclosure claims related to (i) the role of the TRA in the Company's decision to pursue a sale and (ii) the board and special committee's financial advisors' fee arrangements and their respective ties to Lone Star. The court held that the descriptions of the TRA failed to provide "meaningful information about the calculation of the Early Termination provision or why the payment was made."

On the latter claim, the court held the proxy omitted material information, namely that the financial advisors' fees were described in the aggregate and did not explain that a portion of the fees included the consideration Lone Star would receive under the TRA. The court also held that relationships between Lone Star and certain financial and legal advisors needed to be disclosed.

Aiding and abetting claims against financial advisors. The court sustained aiding and abetting claims against both the board and the special committee's financial advisors because their contingent fee arrangements — which were tied to both the merger consideration and the amount of the ETP — incentivized them to pursue transactions that paid an ETP, and the facts alleged made it reasonably conceivable that they favored Lone Star's interests.

The court dismissed aiding and abetting claims against the buyer because it had negotiated at arm's length.

Appraisal notice claims. The plaintiffs alleged a range of defects in the timing and contents of the appraisal notice. Applying the bright-line rules in the statute, the court dismissed the claim that the content was statutorily deficient but held it reasonably conceivable that the Information Statement issued with the merger did not give all stockholders the required 20 days to decide whether to demand appraisal.