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## Delaware Court of Chancery holds that a 17.3% Stockholder/CEO may be a Controlling Stockholder

In *In re Zhongpin Inc. S'holders Litig.*, the Delaware Court of Chancery denied motions to dismiss breach of fiduciary duty claims against an alleged controlling stockholder and members of the company's board of directors, holding that the plaintiffs had raised reasonable inferences that (i) although the stockholder held only 17.3% of the company's outstanding common stock, as CEO and Chairman of the Board, he possessed "both latent and active control" over the company, and (ii) the sales process was not entirely fair.

### BACKGROUND

In 2012, Zhongpin Inc.'s CEO and Chairman of the Board, who held 17.3% of the outstanding common stock of Zhongpin, offered to purchase the remaining common stock for \$13.50 per share; however, he told the board of directors that he was interested only in acquiring the shares of Zhongpin that he did not own and that he would not sell his stake to a third-party. In response, the board formed a special committee which then retained its own financial advisor and conducted a market check. A third-party submitted a non-binding proposal at \$15.00 per share, but conditioned the offer on the CEO's participation in the transaction as a rollover stockholder and his agreement to remain chairman and CEO, to which the CEO would not agree. Soon thereafter, the special committee's financial advisor informed the special committee that it could not render an opinion on the fairness of the CEO's offer and terminated its engagement. The special committee, however, still approved the transaction with the CEO at a price of \$13.50 per share, and entered into a merger agreement conditioned on, among other items, a majority-of-the-minority vote and a 60-day go-shop. Two new financial advisors were engaged after signing to oversee the go-shop, but no superior offer emerged (even after the go-shop was extended for another three weeks).

After the execution of the merger agreement, Zhongpin filed a Form 10-K which stated, among other things, that (i) the CEO had "significant influence over [Zhongpin's] management and affairs and could exercise this influence against [other stockholder's] best interests"; (ii) "the concentration of ownership may delay or prevent a change of control or otherwise discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of [Zhongpin] which could decrease the market price of [its] shares," and (iii) referred to the CEO as Zhongpin's "controlling shareholder."

### ANALYSIS

The plaintiffs alleged that the CEO was a controlling stockholder and owed fiduciary duties to Zhongpin and that the CEO and the board breached their fiduciary duties. In denying the defendants' motions to dismiss, the court held that:

- *The complaint supported inferences that the CEO possessed control of Zhongpin because of his ability to influence Zhongpin's management and affairs* – Although the CEO held only 17.3% of Zhongpin's shares, the company's disclosures in the Form 10-K implied that the CEO possessed latent control of

Zhongpin because “he could exercise significant influence over shareholder approvals for the election of directors, mergers and acquisitions, and amendments to Zhongpin’s bylaws” and he may have the ability to impede a potential acquirer’s submission of a competing bid. Further, the 10-K indicated that the CEO had active control over Zhongpin’s day-to-day operations because it stated that the company heavily relied on the CEO for the management of the business and that his departure would have a material adverse effect on Zhongpin.

- *Entire fairness was the applicable standard of review because the CEO’s offer did not include a majority-of-the-minority approval condition at the outset* – In *Kahn v. M&F Worldwide Corp.*, the Delaware Supreme Court held that the business judgment standard of review will apply in controlling stockholder transactions, but only when the merger is conditioned from the outset on both the approval of an independent adequately-empowered special committee and an uncoerced, informed majority-of-the-minority vote.
- *By alleging that third-parties were unlikely to bid for Zhongpin without the CEO’s support and that the special committee approved the merger agreement without receiving a fairness opinion from a financial advisor, the plaintiffs adequately pleaded that the merger was the result of unfair dealing* – The plaintiffs’ allegations that \$13.50 per share represented a 42% discount to recent highs and was below even low end valuations was sufficient to support a reasonable inference of unfair price.

As this litigation progresses additional facts may rebut the plaintiffs’ allegations, but as the court noted, “determining whether a stockholder exerts control is a case-specific exercise” and “[w]hether or not a particular CEO and sizeable stockholder holds more practical power than is typical should not be decided [by the court] at the motion to dismiss stage if a plaintiff pleads facts sufficient to raise the inference of control.”

However, even at the motion to dismiss stage, this decision is noteworthy because the court indicated that a 17.3% stockholder could be considered a controlling stockholder. As the Court of Chancery recently noted in *In re Crimson Exploration Inc. S’holder Litig.*, the courts have been reluctant to apply the label of controlling stockholder to—and thereby impose new or additional fiduciary duties on—large, but minority, blockholders. This decision is of further interest because the court focused on the latent control of the stockholder. Recent Court of Chancery decisions, *In re KKR Financial Holdings LLC S’holder Litig.*, *In re Crimson Exploration Inc. S’holder Litig.*, and *In re Sanchez Energy Derivative Litig.*, have emphasized that a stockholder must exercise actual control over the board of directors to be a controlling stockholder.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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