DELAWARE CORPORATE LAW BULLETIN

Chancery Court Denies Pleading-Stage Dismissal Under *Corwin* due to Presence of Control Group

*Robert S. Reder**

*Robert W. Dillard***

**Professor of the Practice of Law at Vanderbilt University Law School. Professor Reder has been serving as a consulting attorney at Milbank LLP in New York City since his retirement as a partner in April 2011.*

***Vanderbilt University Law School, J.D., May 2020*

Prohibits use of cleansing doctrine when two or more stockholders form a control group

INTRODUCTION

Delaware courts continue to face questions over the scope and reach of *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015) ("*Corwin*"). Under *Corwin*, a corporate transaction "approved by a fully informed, uncoerced vote of the disinterested stockholders" is effectively cleansed, invoking business judgment review of the directors' role in the transaction and, usually, pleading-stage dismissal of stockholder challenges. Two recent Delaware Corporate Law Bulletins summarize the limits on *Corwin* cleaning imposed so far by Delaware courts and clarify that the decision is no massive eraser for all manner of corporate wrongdoing. *See* Robert S. Reder & Robert W. Dillard, *Chancery Court Declines to Apply Corwin at Pleading Stage to "Cleanse" Breach of Fiduciary Duty Claim Due to Material Non-Disclosures*, 73 VAND. L. REV. EN BANC 17 (2020) and Robert S. Reder & Amanda M. Mitchell, *Chancery Court Refuses Pleading Stage Dismissal Under Corwin When Stockholders Not Fully Informed of Long-Overdue Financial Restatement*, 73 VAND. L. REV. EN BANC 35 (2020).

One issue which has received significant attention in the Delaware courts is the applicability of *Corwin* to transactions involving controlling stockholders. As the *Corwin* court itself explained, "Delaware corporate law has long been reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party *other than a controlling stockholder* is in their best interests" (emphasis added). The element rendering *Corwin* inapplicable, however, is not the "mere presence of a controller," but rather, "coercion is assumed, and entire fairness invoked, when the controller . . . sits on both sides of the transaction, or is on only one side but 'competes with the common stockholders for consideration.' " *See In re Merge Healthcare Inc.*, No. 11388-VCG, 2017 WL 395981 (Del. Ch. Jan. 30, 2017), discussed in Robert S. Reder & Tiffany M. Burba, *Delaware Courts Confront Question Whether "Cleansing Effect" of Corwin Applies to Duty of Loyalty Claims*, 70 VAND. L. REV. EN BANC 187 (2017).

On several occasions, the Delaware Court of Chancery ("*Chancery Court*") has considered whether a large minority blockholder is a control stockholder for purposes of a *Corwin* analysis. Here are some examples:

- In *In re Rouse Props., Inc.*, No. 12194-VCS, 2018 WL 1226015 (Del. Ch. Mar. 9, 2018), the Chancery Court *granted* the defendant-directors' motion to dismiss because (i) a significant minority stockholder who was engaged in a buyout of the target company *was deemed not* to be a controlling stockholder, and because (ii) *Corwin's* requirements had been satisfied. *See*

Robert S. Reder, *Chancery Court Finds Corwin Applicable to Merger Transaction Negotiated with 33.5% Stockholder*, 72 VAND. L. REV. EN BANC 51 (2018).

- In *In re Tesla Motors, Inc. S'holder Litig.*, No. 12711-VCS, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018), the Chancery Court *denied* the defendant-directors' motion to dismiss because CEO Elon Musk, though a minority stockholder, *was deemed* to be Tesla's controlling stockholder. *Corwin* therefore was unavailable to cleanse a transaction between Tesla and a Musk affiliate. *See* Robert S. Reder, *Chancery Court Determines That 22.1% Stockholder Controls Corporation, Rendering Corwin Inapplicable*, 72 VAND. L. REV. EN BANC 61 (2018).
- In *In re Essendant, Inc. S'holder Litig.*, No. 2018-0789-JRS, 2019 WL 7290944 (Del. Ch. Dec. 30, 2019), the Chancery Court determined that an 11.6% stockholder, just the target company's third largest, controlled neither the target company nor its decision to agree to a buyout offer from that stockholder. *See* Robert S. Reder & Anna Choi, *Chancery Court Dismisses Revlon Claims Without Considering Directors' Potential Corwin Defense*, 74 VAND. L. REV. EN BANC 1 (2021).

A somewhat different issue arose in *Garfield v. BlackRock Mortg. Ventures, LLC*, No. 2018-0917-KSJM, 2019 WL 7168004 (Del. Ch. Dec. 20, 2019) ("*Garfield*"). In *Garfield*, Vice Chancellor Kathaleen S. McCormick determined that it was "at least reasonably conceivable" that two large stockholders, who together controlled approximately 41% of a corporation, "constituted a control group that stood to benefit" from a "capital structure reorganization" of the corporation. Accordingly, the Vice Chancellor rejected the defendants' attempted reliance on *Corwin* to support their pleading-stage motion to dismiss.

I. FACTUAL BACKGROUND

Robert Garfield ("*Plaintiff*") was an owner of publicly traded Class A common stock ("*Class A Stock*") of PennyMac, Inc. ("*PennyMac, Inc.*"). Garfield brought suit in Chancery Court challenging the fairness of a PennyMac, Inc. reorganization that he claimed benefitted the owners of PennyMac, Inc.'s privately held Class B common stock ("*Class B Stock*") to the detriment of the owners of Class A Stock. Plaintiff's action sought damages from two substantial owners of Class B Stock, BlackRock, Inc. ("*BlackRock*") and Highfields Capital Management ("*HC Partners*"), their four designees (two apiece) on the eleven-person PennyMac, Inc. board of directors ("*Board*"), and the three PennyMac, Inc. officers who sat on the Board. The defendants moved for pleading-stage dismissal, arguing that *Corwin* cleansed any potential breaches of fiduciary duty. To support his claim that *Corwin* did not shield defendants from an entire fairness review, Plaintiff argued that BlackRock and HC Partners together constituted a control group with respect to the challenged transaction.

A. Pre-Reorganization PennyMac

BlackRock and HC Partners "perceived a market opportunity" during the 2008 financial crisis to acquire mortgage loans from banks "seeking to reduce their mortgage exposures." As self-proclaimed "strategic partners," BlackRock and HC Partners formed Private National Mortgage Acceptance Company, LLC ("*PennyMac, LLC*") to carry out this venture. In 2013, BlackRock, HC Partners, and former PennyMac, Inc. CEO Stanford L. Kurland ("*Kurland*") decided to take "the PennyMac structure public" *via* an "Up-C" transaction that left "a new publicly traded corporation, PennyMac, Inc., [sitting] above PennyMac, LLC." In connection with the transaction, PennyMac, Inc. offered Class A Stock to the public and "issued Class B common stock to existing PennyMac, LLC Unitholders." Immediately thereafter, holders of Class A Stock "owned 15% of the voting rights and 100% of the economic rights [of] PennyMac, Inc." while holders of Class B Stock owned "85% of the voting rights." The disclosure documents relating to the transaction described BlackRock and HC Partners as "strategic partners."

The PennyMac, LLC unitholders ("*Unitholders*") supported the transaction "to take advantage of the tax-friendly Up-C structure." Two agreements provided access to these tax advantages. The "Exchange Agreement" "provided potential tax benefits to PennyMac, Inc." by enabling Unitholders to exchange their units "for Class A common stock in PennyMac, Inc. on a one-for-one basis" going forward. The second agreement, the "Tax Receivable Agreement," provided Unitholders with "85% of any such tax benefit enjoyed by PennyMac, Inc."

To the dismay of BlackRock, HC Partners, and the other owners of Class B Stock, who "owned significantly more LLC Units than Class A common stock," "these benefits did not materialize" due to changes in both the tax laws and PennyMac, Inc.'s business. As a result, "management did not expect to earn taxable income for at least a decade," rendering BlackRock and HC Partner's tax benefits obsolete. To make matters worse, any exchange of PennyMac, LLC units for Class A Stock "would be treated as a taxable event taxed as ordinary income rather than capital gains."

B. Reorganization Proposal

On February 28, 2018, Kurland "introduced the idea of a capital structure reorganization" of PennyMac, Inc. ("*Reorganization*") "designed to allow . . . Unitholders to exchange their LLC Units for PennyMac, Inc. Class A common stock in a tax-free exchange *and* receive long-term capital gains treatment on future sales of the newly acquired Class A common stock." The Reorganization required approval by PennyMac, Inc. stockholders "voting as a single class," but with BlackRock controlling 20.1% of the votes, HC Partners controlling 26%, and Kurland controlling 10.7%, approval was assured. The Board ultimately elected not to require "majority-of-the-minority" stockholder approval. Moreover, seven (BlackRock's two appointees, HC Partners' two appointees, and three PennyMac, Inc. officers, including Kurland) of the eleven Board members owned more Class B Stock than Class A Stock.

On April 24, "PennyMac, Inc. management made a presentation to Black[R]ock and HC Partners . . . quantif[ying] the size of the tax savings . . . to be approximately $3.21 per Unit." A second conversation took place a week later. Notably, management had not yet made this presentation to the Board. On May 30, management "made a formal presentation to the Board," at which Kurland revealed that "BlackRock and HC Partners were 'inclined to support the proposal.' " At this meeting, the Board's legal counsel, Goodwin Proctor LLP ("*Goodwin*"), explained that "the benefits of the Reorganization . . . included 'more favorable tax treatment for [LLC] unit holders.' "

The following day, the Board established a special committee ("*Special Committee*") comprised of the four Board members owning more Class A Stock than LLC Units. The Board gave the Special Committee power only to make "a recommendation to the Board of Directors," but no ability to give "final approval" or implement "such action or transaction." The Special Committee retained Goodwin rather than hiring an independent law firm.

After the Special Committee recommended the Reorganization "by written consent" on July 24, the Board gave its approval. At some point thereafter, BlackRock and HC Partners negotiated a consent right over any termination of the Reorganization before its effective date. On September 18, the Board distributed proxy materials to solicit PennyMac, Inc. stockholder approval of the Reorganization ("*Proxy*"). The Proxy disclosed that the Reorganization would " 'be approved if a sufficient number of votes of Class B common stockholders . . . are cast in favor of the Reorganization Proposal,' " regardless of how the holders of Class A Stock voted. Five weeks later, stockholders approved the Reorganization, which closed on November 1.

C. Potential Proxy Deficiencies

In addition to challenging the fairness of the Reorganization, Plaintiff's Chancery Court complaint alleged that "the stockholder vote was uninformed" and raised "two categories of disclosure deficiencies concerning (1) projections of PennyMac's future profitability and (2) the quantification of tax benefits for LLC Unitholders." Regarding the first issue, Plaintiff pointed to a number of projections provided to BlackRock, HC Partners, and the Board but not disclosed to stockholders in the Proxy. As for the second issue, Plaintiff complained that the Proxy did not disclose the favorable $3.21 per unit gain that Unitholders were expected to garner "by receiving long-term capital gains treatment on their exchange of LLC Units via the Reorganization."

II. VICE CHANCELLOR MCCORMICK'S ANALYSIS

Vice Chancellor McCormick's analysis focused on (1) the applicability of *Corwin* to a transaction benefiting a controller, (2) whether "BlackRock and HC Partners, if treated as a group, exercised control sufficient to give rise to fiduciary obligations under Delaware law," and (3) whether Plaintiff's allegations "support a reasonably conceivable inference that BlackRock and HC Partners indeed formed a group."

A. Applicability of Corwin

At the outset, Vice Chancellor McCormick explained that "[a] stockholder vote cannot restore the business judgment rule under *Corwin* when there is 'a controlling stockholder that extract[s] personal benefits' from the transaction." Otherwise, " 'the controller's presence is said to exert "inherent coercion" ' " on 'both . . . the board of directors and disinterested voting stockholders.' "

The only cleansing mechanism available in that scenario is the six-part test laid out in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*M&F*"), whereby if a controlling stockholder-led buyout is approved by *both* an independent board committee *and* a majority vote of public stockholders, the judicial standard of review shifts from entire fairness to business judgment. The Reorganization was not designed to achieve *M&F* protection.

B. Impact of Control Group Finding

Collectively, BlackRock and HC Partners controlled 46.1% of PennyMac, Inc.'s voting power and negotiated for the "unilateral right . . . to block the Reorganization." Thus, Kurland needed the support of "only these stockholders to secure approval of the Reorganization." Additionally, BlackRock and HC Partners "each had the right to appoint two representatives to the Board for a total of four out of eleven." Taken together, these factors indicated to the Vice Chancellor that there was "a reasonable inference that BlackRock and HC Partners *could* exercise at least transaction-specific control in connection with the Reorganization *if they worked together*" (emphasis added).

C. BlackRock and HC Partners Deemed a Control Group

Vice Chancellor McCormick's decision, therefore, "turn[ed] on whether, at the pleading stage, BlackRock and HC Partners may be treated as a group." To make this determination, the Vice Chancellor utilized the "legally significant connection" test set out in *Sheldon v. Pinto Tech. Ventures, L.P.*, 220 A.3d 245 (Del. 2019) ("*Sheldon*"):

> To demonstrate that a group of stockholders exercises "control" collectively, the [plaintiff] must establish that they are " 'connected in some legally significant way'—such as 'by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal.' " To show a "legally significant" connection, the [plaintiff] must allege . . . more than a "mere concurrence of self-interest among certain stockholders." Rather, "there must be some indication of an actual agreement," although it need not be formal or written.

Sheldon, in turn, "favorably discussed" *In re Hansen Med., Inc. S'holders Litig.*, No. 12316-VCMR, 2018 WL 3025525 (Del. Ch. June 18, 2018), for the proposition that to plead "more than a mere concurrence of self-interest," a plaintiff must "identif[y] an array of plus factors that allowed the Court to infer 'some indication of an actual agreement.' These factors included both historical ties and transaction-specific ties" (quoting *Garfield*).

According to the Vice Chancellor, Plaintiff followed "the *Sheldon* standard." In addition to alleging that "the interests of BlackRock and HC Partners were aligned in optimizing the [Reorganization's] exchange ratio to favor LLC Unitholders," Plaintiff identified several "plus factors" representing "historical and transaction-specific ties between BlackRock and HC Partners":

- *Historical ties*: (1) "ten-year history of co-investment in PennyMac with no gaps"; (2) BlackRock and HC Partners acted together as PennyMac's "founding sponsors"; and (3) references in various organizational and disclosure documents to

BlackRock and HC Partners interchangeably as "Sponsor Members," "strategic investors," and "strategic partners."

- *Transaction-specific ties*: (1) "management met jointly with BlackRock and HC Partners to negotiate the Reorganization, granting them preferential review and exclusive weigh-in" before management ever presented their analysis to the Board; (2) "management's presentations depicted BlackRock and HC Partners as belonging to a collective unit"; (3) neither BlackRock nor HC Partners ever met with management without the other present; (4) management never met with any other non-management Unitholders; and (5) "BlackRock and HC Partners ultimately secured a late-in-the-game revision in the form of an exclusive right . . . requiring 'the consent of both BlackRock and [HC Partners] . . . to terminate the Reorganization prior to the effective date.' "

All this gave "rise to a reasonably conceivable inference that the alleged group had more than a 'mere concurrence of self-interest' and an 'actual agreement' to work together in connection with the Reorganization." Defendants argued in response that their different tax status—"HC Partners is taxed at the individual rate" while "BlackRock is taxed at the corporate rate"—precluded their interests being "aligned." The Vice Chancellor did not find this argument persuasive in light of the many other ties cited by Plaintiff. Rejecting the defendants' one other argument, the Vice Chancellor clarified that the lack of any " 'formal or written' agreement pertaining to the transaction is not fatal to the Plaintiff's theory."

In light of the foregoing, Vice Chancellor McCormick concluded that "the sum-total of the facts alleged and inferences therefrom make it at least reasonably conceivable that BlackRock and HC Partners formed a control group that exercised effective control over PennyMac in connection with the Reorganization." As such, "*Corwin* does not apply at the pleadings stage . . . ." Further, because the "facts at least call into question whether the Special Committee was fully empowered to negotiate at arm's length" and because "process can infect price," the Vice Chancellor concluded that Plaintiff's complaint "states a claim when evaluated under the entire fairness standard."

CONCLUSION

Garfield further limits the reach of *Corwin*: even if all the elements are met, the presence of a "control group" realizing benefits from a transaction not shared with other stockholders negates the availability of *Corwin*. In light of the end goal shared by BlackRock and

HC Partners, together with their "historical and transaction-specific ties," Vice Chancellor McCormick found, at least for purposes of pleading-stage dismissal, that BlackRock and HC Partners had in fact formed a control group with the power to exercise at least transaction-specific control in connection with the Reorganization. As a result, *Corwin* was not available to shield the PennyMac defendants from a trial on the merits in which they would have to carry the heavy burden of proving that the Reorganization was entirely fair.