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CLIENT MEMORANDUM

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Delaware Court of Chancery Holds That Controller Lacked Liquidity-Based Conflict

In a recent post-trial opinion in *Manti Holdings, LLC* v. *The Carlyle Group Inc.*, the Delaware Court of Chancery, after initially declining to dismiss the case, held that the business judgment rule applied to the third-party sale of a controlled company because the private equity controller did not have a liquidity-based conflict and its interests were aligned with the minority in the sale. In what may be his last opinion before retiring, Vice Chancellor Glasscock confirmed the high bar that plaintiffs must overcome to prove a private equity controller's liquidity-based conflict triggering entire fairness review of a transaction.

Background

In 2017, Authentix Acquisition Company, Inc. was sold to Blue Water Energy LLP following a year-long process. At the time of the sale, affiliates of the Carlyle Group Inc. ("Carlyle") controlled Authentix, owning through a fund 70% of Authentix's preferred stock and 52% of its common stock. The fund's partnership agreement provided for a fund life of 10 years (expiring in 2017), but there was no obligation to exit any particular investment at that time, and the fund was extended after the sale of Authentix. Plaintiffs, minority stockholders of Authentix, brought claims on the argument that Carlyle had sought a fire sale of Authentix in a process that was unfair to the minority and from which Carlyle extracted a unique benefit, namely liquidity and a timely exit for its fund. In an earlier opinion, the court denied the defendants' motion to dismiss the complaint, finding that Carlyle was sufficiently alleged to be a controller of Authentix. Then drawing plaintiff-friendly inferences at the pleadings stage, the court held that the complaint adequately pled that Carlyle had acted to achieve a non-ratable benefit that was denied to the minority, and therefore entire fairness presumptively applied.

Analysis

After trial, the court held that while Carlyle was a controller, its interests were aligned with the minority and it did not have conflicts of interest that triggered entire fairness review. Therefore, the business judgment rule applied. Specifically, the court held as follows:

- Carlyle did not have a liquidity conflict. First, the court held that Carlyle did not have a liquidity conflict resulting from the fund's expiration or any investor pressure for returns. Although the facts demonstrated that Carlyle wished to exit its Authentix investment in 2017, it did not *need* to exit the investment, nor was it driven by time pressure that would cause it to accept less than fair value for its investment. Even though the fund's initial term was set to expire in 2017, it could continue to hold investments after expiration, the term could be extended, Authentix was not the fund's only remaining asset and there was no pressure from fund investors to engage in a quick sale of Authentix. The court wrote, "[t]o prove a liquidity-driven conflict of a controller, it is not enough to show a general interest in investors that a fund adhere to a timeline; a plaintiff must show sufficient evidence 'of a cash need' that explains why 'rational economic actors have chosen to short-change themselves.'" The court also noted that the "comprehensive marketing and sales process" of Authentix, which lasted a year and consisted of contacting 127 potential buyers, was evidence that Carlyle did not have liquidity pressure in this regard.

Second, Carlyle did not seek liquidity to avoid disgorgement under a clawback mechanism operative under the fund documents, which would have required Carlyle to return excess carried interest if the fund failed to achieve certain returns. Instead, the court found that the clawback created an incentive structure that motivated Carlyle to sell investments that may be likely to decline in value (like Authentix), and that it would be best for all stockholders, regardless of the clawback, to sell before any further decline in value.

- Carlyle's receipt of consideration for its preferred stock was not a non-ratable benefit triggering entire fairness. Plaintiffs alleged that Carlyle, through its ownership of 70% of Authentix's preferred stock, received a non-ratable benefit in the sale due to the preferred stock's liquidation preference, which ensured that the preferred stockholders received the first $70 million in consideration. Rejecting this argument, the court noted that Carlyle, which also held 52% of the company's common stock, had the most to gain from a high sale value, as Carlyle would be paid approximately half of every dollar in consideration over the $70 million liquidation preference. Therefore, its interests were aligned with the minority in extracting as high of a price as possible for Authentix.

Takeaways

Manti reaffirms that liquidity-based conflicts of controllers can be difficult to prove under Delaware law. Plaintiffs must show strong evidence as to why a controller would choose to short change itself in a sale, and allegations based on "'[s]weeping characterizations' of the '[private equity] industry writ large'" are unlikely to overcome this burden. Notwithstanding this high bar, as in *Manti*, liquidity-based controller conflict claims stemming from facts that likely would not support a post-trial finding of liability may nonetheless survive a motion to dismiss due to the plaintiff-friendly standards applied at that stage. Controllers and their representatives should be mindful of not developing a record suggesting that liquidity needs are more dire than they actually are to minimize risk of a plaintiff's success.

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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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