ALERT MEMORANDUM

Delaware Chancery Court Finds Private Equity Sponsor's Tax Receivable Agreement Potentially Led to Conflicted Sale Process

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In a May 31, 2024 opinion, the Delaware Court of Chancery denied a motion to dismiss a complaint challenging the sale of a public company with a controlling private equity sponsor to an unrelated, arms-length buyer, finding that the sale was potentially tainted by conflicts of interest.[1] In particular, the court found that it was reasonably conceivable that the private equity sponsor's receipt of an early termination payment under a tax receivable agreement put into place upon the target company's initial public offering was a material non-ratable benefit, which may have led the sponsor to push for a sale (which would trigger the early termination payment), even if remaining a standalone company would have been better for the minority stockholders. The opinion also touches on important issues relating to financial advisors' advice in connection with such a sale. While tax receivable agreements ("TRAs") are common in sponsor-backed and "Up-C" IPOs, this case highlights a rarely considered issue involving these agreements, and the need for careful navigation of related potential conflicts of interest in a sale process where a private equity sponsor, and TRA beneficiary, continues to control the public company.

[1] *Firefighters' Pension System v. Foundation Building Materials, Inc., Lone Star Fund IX (U.S.), et. al.*, C.A. No. 2022-0466-JTL, order at 1-5 (Del. Ch. May 31, 2024), *available at* https://www.courtalert.com/chancerypdf/601_202405311205CANo20220466JTL.pdf.

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Background and Decision

Lone Star,[2] a private equity fund, acquired Foundation Building Materials, Inc. (the "Company") in a going-private transaction in 2015.[3] Less than eighteen months later, Lone Star took the Company public again.[4] After the IPO, Lone Star owned shares constituting 65.4% of the Company's outstanding voting power, retaining control at the stockholder level and of the Company's board of directors (the "Board").[5]

In connection with the IPO, Lone Star and the Company entered into a TRA, pursuant to which Lone Star was entitled to a payment equal to 90% of any benefit the Company received from using a tax asset generated while the Company was privately held.[6] The TRA was publicly filed in connection with the IPO. Under the TRA, Lone Star also held the right to terminate the TRA upon a change of control, and if Lone Star exercised its termination right, Lone Star was entitled to receive an "Early Termination Payment" which would be calculated as the present value of all payments required to be made by the Company under the TRA applying sponsor-favorable valuation assumptions, including that the Company would generate sufficient taxable income to use all of the tax assets during the term of the TRA.[7] The Early Termination Payment was calculated using a discount rate of the lesser of (i) 6.5% per annum, compounded annually, and (ii) LIBOR plus 100 basis points.[8] At the time the transaction was entered into in late 2020, following the COVID-19 pandemic, prevailing interest rates were lower than today, meaning the discounted present value of the Early Termination Payment would be relatively large.[9]

On January 1, 2018, the Tax Cuts and Jobs Act of 2017 (the "Tax Act") took effect, reducing the U.S. federal corporate income tax rate, thereby reducing the payments Lone Star could expect under the TRA, as the Company's tax assets became less valuable.[10] The court noted that the Company had initially disclosed an estimate of total TRA payments of between \$190 and \$220 million.[11] Following the passage of the Tax Act, however, the Company reported a \$68 million reduction in anticipated payments under the TRA, meaning Lone Star stood to receive approximately one-third less in aggregate value if the Company remained a standalone public company for the duration of the TRA.[12] Therefore, the court observed, selling the Company and triggering an Early Termination Payment became more attractive to Lone Star as compared to selling its position in an ongoing public company over time.[13]

In early 2018, the chairman of the Board, and a Lone Star senior managing director, set the Board off on a sale process.[14] At the outset, a Lone Star director observed that the Early Termination Payment could generate a conflict of interest for Lone Star's representatives on the Board.[15] The Board retained Royal Bank of Canada ("RBC"), an investment bank which had done substantial business with Lone Star, as financial advisor to the Company.[16] RBC's engagement letter called for RBC to receive a success fee calculated as a percentage of the consideration received in any deal, including the value of any Early Termination Payment.[17]

Well after the sale process was underway, the Board created a special committee specifically to address the potential conflict created by the Early Termination Payment, even though no bidder had addressed this

[2] The term "Lone Star" refers both to Lone Star Fund IX (U.S.), L.P. ("Fund IX") and LSF9 Cypress Parent 2 LLC ("Cypress"). Fund IX is the Lone Star fund that acquired and controlled the Company. Cypress is the specific entity that Fund IX used for the investment.
[3] *Id*. at 5.
[4] *Id.* at 6.
[5] *Id.*
[6] *Id*.
[7] *Id*. at 6-7.
[8] *Id*. at 6-7.
[9] *Id.* at 8.
[10] *Id*.
[11] *Id*. at 9.
[12] *Id*. at 8-9.
[13] *Id*. at 1.
[14] *Id*. at 10-11.
[15] *Id*. at 10.
[16] *Id*. at 11-12.
[17] *Id*.

topic at the time.[18] The special committee engaged Evercore as its financial advisor.[19] Like RBC, Evercore's transaction fee was calculated based on both the per-share consideration and any Early Termination Payment.[20] The Board charged the committee with determining whether a sale was advisable and gave the committee the power to disapprove the sale.[21] Despite such powers and its charge, the complaint alleged that the committee was passive, its members repeatedly going months without convening, including during busy periods when the fund's representatives were negotiating the terms of a sale, and did not disapprove the transaction.[22]

After a lengthy sales process that spanned two years and involved multiple bidders, the Board eventually negotiated a transaction with American Securities LLC in 2020, in which the Early Termination Payment would be payable by the Company at the closing of the transaction, in accordance with the preexisting terms of the TRA. The special committee recommended the merger to the Board, and the Board approved the merger. After the merger closed, Lone Star received an Early Termination Payment of $74.8 million, plus a payment of $8.6 million for tax benefits used through January 29, 2021.[23]

After stockholders of the Company sued Lone Star, its directors, and their financial advisors, the defendants moved to dismiss on a number of grounds, some of which the court agreed with and some of which it did not. This article focuses on (i) the court's conclusion that entire fairness review applied to the decision whether to sell the Company, (ii) the claims for breach of fiduciary duty by the special committee and (iii) the aiding and abetting claims against the financial advisors.

The Sale Process Claims

Typically, the sale of a company (even one with a controlling stockholder) to an unrelated third party is subject to deferential business judgment, not entire fairness, review. But the Delaware courts have held that entire fairness review will apply if the controlling stockholder received a material non-ratable benefit in connection with the transaction and such conflict is not cleansed through compliance with the "MFW framework," which requires the conflicted transaction to be conditioned "*ab initio*" on the approval of both an independent special committee and an informed vote of a majority of the minority stockholders.[24] In this case, there was no attempt at compliance with MFW, and thus the key question was whether Lone Star, which controlled the Company, received a material non-ratable benefit in connection with the sale.

On the alleged facts of this case, the court found it was reasonably conceivable that the change in value of the TRA following the passage of the Tax Act, and better outcome, for Lone Star, of receiving the Early Termination Payment, was a material non-ratable benefit – and the driving force behind Lone Star's allegedly flawed decision to sell the Company. The court acknowledged that in choosing between two change of control transactions, both of which would trigger the Early Termination Payment, Lone Star faced no conflict (and, on the contrary, was fully aligned with the minority stockholders in wanting as high a price as possible). But in choosing between a change of control transaction (which would trigger the Early Termination Payment) and remaining an independent, publicly traded company (which would not), the court found a potential conflict.[25] Importantly, according to the court, the allegations in the complaint supported an inference that, for the minority holders,

[18] *Id*. at 13-14.
[19] *Id*. at 25.
[20] *Id*.
[21] *Id*.
[22] *Id*. at 1.
[23] *Id*. at 36.

[24] *In re Match Grp., Inc. Derivative Litig.*, No. 368, 2022, 2024 WL 1449815, at *11-13 (Del. Apr. 4, 2024).
[25] *Firefighters' Pension Sys.* at 56. While this analysis is technically correct, it is interesting that the court made this distinction, in that in most situations, a public company board should evaluate any change of control deal against a standalone alternative.

remaining an independent, public company was the better alternative than a sale.[26] Consequently, since Lone Star would receive the Early Termination Payment (and presumably mitigate the negative impact of the Tax Act on ongoing TRA payments), the court found there to be a reasonably conceivable inference that the non-ratable benefit received by Lone Star was the motivating factor behind the Board's decision to sell, and would be subject to entire fairness review.[27]

Interestingly, we note that the court dismissed plaintiff's claim that the Early Termination Payment diverted consideration that otherwise would go to the minority stockholders, largely because the TRA was a preexisting, disclosed commercial contract with the Company to which the minority stockholders had no entitlement.[28] In other words, the court held that plaintiffs may not challenge the propriety of the payment itself, but may challenge the decision to sell the Company to the extent they can show it was motivated by such payment.

The court also held that the complaint sufficiently pleaded that the special committee defendants breached their fiduciary duties by deferring to the Lone Star defendants and approving a sale, rather than saying "no" to the merger.[29] The plaintiffs alleged that, among other things, the special committee (i) acted only when prompted by Lone Star and repeatedly went into hiding for months while the sale process was unfolding, (ii) more than once, "acted as a retroactive rubber stamp" by purporting to discuss or approve issues that the full Board had already discussed and (iii) hired Evercore using the same compensation structure that the special committee had flagged as a conflict for RBC (*i.e.*, basing its fee in part on the amount of any Early Termination Payment, which would only be received by Lone Star).[30] The court held that these allegations supported an inference that the special committee defendants consciously disregarded their responsibilities and acted to facilitate the transaction that Lone Star wanted, in breach of their duty of loyalty.[31]

The Aiding and Abetting Claims

The complaint alleged RBC was conflicted because it had acted as Lone Star's financial advisor, including with respect to the Company, over several years, and that RBC had collected over $70 million in fees from Lone Star and its affiliates. It is also alleged that RBC's fee arrangement expressly aligned its interests with Lone Star's because its fee, which was originally calculated on the basis of deal consideration, was modified to include in the calculation any consideration Lone Star received under the TRA.[32] The court noted that without that change, RBC's interests would have been aligned with the public stockholders.[33] Instead, in the final months of the sales process, RBC allegedly worked closely with the Lone Star-affiliated directors to secure proposals that included a maximum Early Termination Payment.[34] The court provided a similar analysis for the claim against Evercore, and declined to dismiss such claim largely because of Evercore's compensation arrangement.[35] Plaintiffs alleged that Evercore, when it pitched its services to the special committee in October 2018, specifically warned the special committee that Lone Star's interests may not be fully aligned with the Company's public shareholders because of the prospect for an Early Termination Payment, but when engaged two years later, demanded that its fee include a percentage of the Early Termination Payment.[36] Importantly, the court noted that the financial analysis presented by Evercore factored in the Early Termination Payment at the high

[26] *Id*.
[27] *Id.* at 54-56.
[28] *Id.* at 57-58.
[29] *Id*. at 76.
[30] *Id*. at 103. The court also noted that the chair of the special committee "revealed the real power structure" by asking Lone Star if he could share information with the committee's advisors. *Id.* at 104. As practitioners should be aware, these types of procedural lapses are reviewed in hindsight and, while perhaps natural or seemingly harmless in context at the time, can shed a different light on the facts in a complaint.
[31] *Id*. at 104.
[32] *Id*.
[33] *Id*.
[34] *Id*. at 114.
[35] *Id*. at 115-20.
[36] *Id*. at 116.

end of the valuation range (thereby making the transaction look better), but not at the low end, and had the Early Termination Payment been excluded from both ranges, every valuation metric would have exceeded the deal price.[37]

Key Takeaways

— ***TRA Termination Payments May Be Scrutinized.*** The court concluded in this case that the Early Termination Payment under the TRA was a material non-ratable benefit to the controlling stockholder and thus, in the absence of MFW compliance, triggered entire fairness review. In part for this reason, parties have addressed TRA early termination payments in various transactions from time to time in different ways, including waiving them in certain circumstances. This case illustrates their potential materiality to a conflicts analysis generally, but it is far from clear that all early termination payments under a TRA will be considered *material* non-ratable benefits, thus triggering entire fairness review. In this case, the court highlighted changes in tax law, interest rates and Company profitability expectations that all led to a material discrepancy between the value of the TRA to the controlling private equity sponsor in a sale versus standalone scenario. In addition, we note that the allegations here were that continuing as a standalone public company was financially superior to the minority stockholders, which put a focus on the Early Termination Payment. In other cases, the facts may be very different (*e.g.*, there may be no material discrepancy in the value of the TRA in a sale versus standalone scenario, and no reasonably conceivable allegation that remaining standalone is a superior alternative to a sale). But this case demonstrates that careful attention should be paid to at least the *potential* conflicts that may arise from the existing of a TRA.

— ***Special Committees Can Be a Double-Edged Sword.*** In this case, the Board formed a special committee to address the potential TRA conflict up front, but given time lags and inattention to the process, the plaintiffs had sufficient facts to allege a pattern of action the court found to be a "rubber stamp" for the Board.[38] Where special committees are properly used, they can be an effective tool to properly run a process and mitigate potential legal risks that may be present. But where a special committee is ineffective or employed clumsily, a special committee's presence and actions can shine a spotlight on the conflict at issue, while also exacerbating the adverse factual record as to the controller or fiduciary with the conflict. Although the facts here are unique, we note that there have been a number of transactions involving a controlling stockholder with a TRA and early termination payment rights where a special committee was not employed (which, to our knowledge, did not attract lawsuits like this one).

— ***Fund Liability and Legal Separateness.*** In a separate portion of the court's opinion, the court found that the Lone Star fund, and not just its special purpose vehicle actually holding the shares of the Company, was a proper defendant as a controlling stockholder. The court noted that fiduciary claims are inherently equitable in nature, and notwithstanding defendants' arguments that a veil-piercing analysis applies to shield the fund from potential liability, the court will look to "substance over form" and impose fiduciary liability where control is exercised.[39] The court stated that if the plaintiff had been able to identify another party that controlled the fund, that party would have been a proper defendant as well.[40] Fund sponsors should be aware of this holding for purposes of potential fiduciary claim liability. While standard contractual non-recourse language in private equity acquisition agreements can shield upper-tier entities from contractual liability (assuming no facts permitting veil-piercing are present), these provisions may not suffice to shield the fund – or potentially management company or

[37] *Id.* at 119-20.
[38] *Id.* at 103.
[39] *Id.* at 73-74.
[40] *Id.* at 75.

general partner entities – from fiduciary liability to the extent they exercise control over a company.

— ***Financial Advisory Assignments with a TRA Can Be Tricky***. The court focused on both advisors' fee arrangements, which allegedly improperly aligned the banks' incentives with Lone Star's, and also their analysis in finding the potential for aiding and abetting liability. The financial analysis treated the TRA payments here differently in different circumstances, which allegedly shaded the analysis. Financial advisors should take a consistent approach to treating TRA payments in the financial analysis, or provide a justification for why they should be viewed differently in one case versus another. And as in any other conflicted transaction, it is important that the fee arrangements are structured to avoid the appearance of misaligned incentives.

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