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Surgery Partners, Inc. Fails To Excise Conflicts Infecting Three Interdependent Transactions

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In *Klein v. H.I.G. Capital, L.L.C.*, et. al, C.A. No. 2017-0862-AGB, the Delaware Chancery Court issued a Memorandum Opinion granting in part and denying in part a motion to dismiss under Court of Chancery Rule 23.1 for failing to make a demand and under Court of Chancery Rule 12(b)(6) for failing to state a claim of relief. Melvyn Klein ("Plaintiff"), a stockholder of Surgery Partners, Inc. ("SP"), brought direct and derivative claims against one of SP's directors Michael Doyle ("Doyle"), SP's controlling stockholder H.I.G. Capital, L.L.C. ("HIG"), and Bain Capital Private Equity, LP ("Bain") (collectively, "Defendants"), alleging breaches of fiduciary duty against Defendants stemming from three interdependent transactions that were allegedly conflicted and unfair. The Court found that demand was futile because the Plaintiff sufficiently alleged that the board was interested, and found that Plaintiff stated claims for breach of fiduciary and aiding and abetting breach of fiduciary duty by HIG and Bain, respectively, because Defendants failed to show that the conflicted transactions were entirely fair.

The board of directors of SP (the "Board") approved, and SP entered into, three transactions on May 9, 2017 (the "Transactions"). The Transactions consist of: (1) SP acquiring National Surgical Healthcare for $760 million; (2) HIG selling its shares of SP to Bain at a price of $19 per share; and (3) SP issuing to Bain 310,000 shares of a new class of stock of SP at a price of $1,000 per share. These transactions were interrelated and dependent on each other; if one fell through, the others would fail as well. The Board approved the Transactions without a special committee and with no publicly disclosed abstentions. No public stockholders voted on the transactions as HIG approved each by written consent as majority stockholder. Bain and SP used the same law firm and accounting firm to represent them during negotiations. Once the Transactions were finalized, Bain was SP's controlling stockholder.

Plaintiff filed a complaint alleging eight claims. Of those claims, four were pled directly and four were pled derivatively. Each direct claim had a corresponding derivative claim. Counts I and V asserted claims for breach of fiduciary duty against the Board of LP (all of whom were dropped from the complaint except for Doyle) for entering into the Transactions without ensuring that the share issuance to Bain was entirely fair. Counts II and VI were claims for breach of fiduciary duty against Bain and HIG for entering into a conflicted transaction in the share issuance to Bain. Counts III and VII alleged claims of breach of fiduciary duty against HIG, in the alternative, as the sole controlling stockholder for entering into the conflicted transaction. Lastly, Counts IV and VIII asserted that Bain aided and abetted breaches of fiduciary duty by HIG and Doyle.

In deciding Defendants' motion to dismiss, the Court first turned to whether Counts I-IV were properly brought as direct claims. The Court observed that the claims brought by Plaintiff constitute "a classic form of an 'overpayment' claim," which must normally be pled derivatively. Plaintiff, however, argued that his claim resembles the claim brought in Gentile v. Rosette, where the Delaware Supreme Court recognized a situation where a corporate overpayment claim implicated both direct and derivative injury. The Court, in rejecting Plaintiff's argument, cited several subsequent Delaware cases that limited the holding in Gentile to its facts and applied it only where the challenged transaction resulted in an improper transfer of both economic value and voting power from the minority stockholders to the controlling stockholder. The Court also observed that not only was Bain not yet the controlling stockholder before the share issuance, but that even if it was, its increase in voting power would not have been so great as to have triggered the Gentile rule. Furthermore, the Court pointed to the structure of the share issuance for the proposition that common stockholders' shares will only be diluted if and when Bain converts its preferred shares into common stock. Ultimately, the Court found that Plaintiff's claims could not be brought directly, and therefore dismissed Counts I-IV.

The Court next turned to the question of whether Plaintiff was excused from making demand on the Board on the basis of demand futility. In assessing Plaintiff's futility allegation, the Court applied the test articulated in Aronson v. Lewis, under which a Plaintiff must "provide particularized factual allegations that raise a reasonable doubt that (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." Of the Board's seven members, Plaintiff conceded that two were disinterested, while Defendants conceded that three were interested. The Court, therefore, was tasked with determining whether either of the two remaining directors, Doyle and Brent Turner, were conflicted. The Court found that the complaint raised a reasonable doubt as to whether Doyle could make decisions regarding the Transactions independently by alleging that SP engaged him in a consulting agreement that paid him more per month than he made as SP's CEO. On that basis, the Court found that Plaintiff had properly alleged that making demand on the board was futile.

Once the Court determined that demand was excused, it addressed the merits of Plaintiff's remaining claims (V-VIII). First, the Court turned to Count VI, which argued in the alternative that Bain and HIG had breached fiduciary duties by acting as a "control group." The Court dispatched Plaintiff's argument quickly by pointing out that there was never any allegation that Bain owned any stock, let alone a controlling percentage of stock, prior to the Transactions. Ultimately, the Court dismissed Count VI for failing to state a claim.

The Court then examined Count VII, in which Plaintiff alleged that HIG breached its fiduciary duty by issuing the new shares to Bain. The Court determined that entire fairness was the proper standard of review, observing that that standard is triggered when a controlling stockholder effectuates a conflicted transaction. The Court determined that HIG was conflicted in entering into the issuance of new shares to Bain because that transaction was a condition precedent to HIG's sale of its own shares to Bain. Entire fairness is an onerous standard for a defendant to overcome, requiring the controlling stockholder to "show, conclusively, that the challenged transaction was entirely fair based solely on the allegations of the complaint and the documents integral to it." Because Defendants failed to show entire fairness, the Court denied Defendants' motion to dismiss Count VII.

Count VIII alleged that Bain aided and abetted HIG's breach of fiduciary duty. The Court found that Plaintiff's allegations that Bain was aware of its shared legal representation with HIG, as well as the interrelated nature of the three transactions, and the lack of a stockholder vote, inferred Bain's "knowing participation" in HIG's breach. The Court, therefore, denied Defendants' motion to dismiss as to Count VIII.

Lastly, due to the inclusion of an exculpatory provision in SP's certificate of incorporation, the Court dismissed Plaintiff's Count V for failing to allege that Doyle acted in bad faith or had personal interest in the transactions.

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