This article was originally published in *PLI Current: The Journal of PLI Press*, Vol. 2, No. 4 (Autumn 2018), www.pli.edu/PLICurrent.

PLI Current
The Journal of PLI Press

Vol. 2, No. 4, Autumn 2018

Controlling-Stockholder Conflicts and How to Handle Them

Amy L. Simmerman, Katharine A. Martin*
Wilson Sonsini Goodrich & Rosati

Overview

Controlling-stockholder conflicts in both the public and private company contexts continue to be an intense area of focus in the Delaware courts. Just this past July, the Delaware Court of Chancery issued a 126-page post-trial opinion awarding over $20 million in damages against a controlling stockholder and board members for breaches of the fiduciary duty of loyalty.[1] This type of litigation commonly arises in the M&A context, but has also extended into various other

* The views expressed in this article are those of the authors and are not necessarily those of the firm or its clients. In addition, the firm has represented certain of the parties discussed in this article. The descriptions of the holdings and factual issues from cases are based solely on characterizations set forth in the relevant case.

types of matters, including consulting arrangements, recapitalizations, dividends, stock redemptions, and private company financings. The trend has resulted in an enormous number of decisions in Delaware addressing several important issues such as:

- When does a controlling stockholder exist?
- When does a controlling stockholder take on fiduciary duties and what types of situations constitute controlling-stockholder conflicts?
- What does this all mean for directors and officers?
- What can significant stockholders—as well as directors and officers, who often do become embroiled in these litigations—do to ameliorate or sanitize the conflict?
- What are the foot faults to keep in mind when attempting to address a conflict?

This article provides an overview of these issues, with a focus on the areas of the case law that are usually the most significant for in-house counsel and outside counsel who provide corporate advice.

The steady focus on controlling-stockholder conflicts in fiduciary duty litigation leads to some important business points to consider. One such point for companies is whether it is worthwhile to have a controlling stockholder. This is a conversation we regularly have, for example, when companies are considering an IPO and a post-IPO governance structure that would give a founder or a group of visionaries control over the company. Of course, many companies continue to adopt dual- or multi-class structures or other similar approaches after determining that the tradeoffs are worthwhile. At the same time, this past May, the founder of Zynga voluntarily relinquished control and triggered the elimination of the company's dual-class structure. Aside from these existential issues, companies also have to consider when is it worthwhile to undertake a transaction that is likely to involve a controlling-stockholder conflict and attract litigation. Similarly, although the case law, as discussed below, provides important tools that might sanitize such a conflict, companies also have to navigate whether those tools are practicable and achievable.

When Does a Controlling Stockholder Exist?

Control can exist in a number of circumstances. The most obvious circumstance is when one stockholder possesses a majority of stockholder voting power.[2] But that is just the beginning of the analysis. A stockholder can possess control at less than a majority stake if, as a factual matter, that stockholder exerts control over the company's decision-making and the boardroom.[3] Thus, in recent decisions, the Delaware courts—albeit often at the early motion-to-dismiss stage—have been willing to consider arguments that control may exist in the following situations:

- Where a company had a 17.3% stockholder who was the chairman and CEO and the company's public filings had disclosed that the stockholder may have "significant influence" over stockholder approvals, that the company heavily relied on the stockholder, and that the stockholder could impede a transaction.[4]
- Elon Musk's position in Tesla, given the plaintiffs' allegations about his influence over board affairs and the company despite only having an approximately 22% stake in the company's common stock.[5]
- Where a private equity fund held a roughly 26% stake in a private company but the facts suggested that a majority of the board was affiliated with the fund or otherwise had a meaningful (and potentially conflicted) relationship to the fund.[6]
- Where a minority stockholder—a fund invested in a private company—possessed veto rights and, in the court's view, used those rights to threaten members of the board and management into pursuing a financing transaction with the fund, as opposed to with competing bidders, and otherwise exerted control over certain corporate affairs, such as overseeing the hiring and firing of the CEO.[7]

In addition, the Delaware case law recognizes the concept of a control group, in which two or more stockholders can together be said to possess control. The key question under the case law is whether the stockholders are connected in an adequately "legally significant" way to justify grouping them together—for example, through certain types of voting agreements or a long and meaningful pattern of working in concert in certain ways. In one case, the Delaware Court of Chancery found that a group of venture funds was a control group where, among other things, the individual firms, for a long period of time, acted together both

inside and outside the boardroom to arrive at decisions about the company, while excluding independent directors from those discussions.[8] But in another more recent case, the court rejected a claim that founders and venture capital funds operated as a control group, concluding that there were not meaningful connections among them.[9]

When Does a Controlling Stockholder Take on Fiduciary Duties, and What Types of Situations Constitute Controlling-Stockholder Conflicts?

Although the baseline rule in Delaware is that stockholders do not owe fiduciary duties to each other, *controlling* stockholders *can* take on fiduciary duties to other stockholders. This is one key basis for why controlling stockholders can become the target of fiduciary duty claims. That said, controlling stockholders do not always have fiduciary duties in every single action they take. For example, the Delaware courts have generally held that controlling stockholders can vote and make the decision whether to exercise consent rights in their own self-interest.[10] A recent Delaware decision stated the essence of this issue succinctly and as follows:

> . . . a stockholder who—via majority stock ownership or through control of the board—operates the decision-making machinery of the corporation, is a classic fiduciary; in controlling the company he controls the property of others—he controls the property of the non-controlling stockholders. Conversely, an individual who owns a contractual right, and who exploits that right—even in a way that forces a reaction by a corporation—is simply exercising his own property rights, not that of others, and is no fiduciary.[11]

Another closely related issue is just what it means for an actionable controlling-stockholder *conflict* to arise. The Delaware courts have explained that controlling-stockholder conflicts generally can be distilled into two broad categories: (1) where the company engages in a transaction with the controlling stockholder or the controlling stockholder otherwise stands on both sides of a transaction, and (2) where the controlling stockholder otherwise "competes" or negotiates for, or receives, special benefits, to the detriment of the minority stockholders.[12] Very importantly, when a controlling-stockholder conflict arises and litigation ensues, a court will, as a baseline matter, apply the difficult and onerous entire-fairness standard of judicial review. That standard is essentially the opposite of the deferential business judgment standard of review. It examines

all components of the transaction, both as to the surrounding process and as to price and terms, to determine if the transaction was fair—and if a breach of the duty of loyalty occurred. Importantly, entire-fairness claims involve the allegation that the duty of loyalty has been breached, and the plaintiff is usually seeking money damages from the controlling stockholder—and potentially from officers and directors, as discussed further below.

The recent Delaware case law sheds bright light on which types of transactions may or may not constitute a conflict. A frequent area of litigation for controlling-stockholder conflicts is the M&A context. This can include a controller squeezing out the minority in a merger,[13] or a sale to a third party in which the controller is alleged to receive special benefits compared to the minority[14]—with the 2017 *Martha Stewart* case, among others, exploring just what it means to receive special benefits.[15] This can also include an alleged controlling stockholder causing the company to engage in a combination with another company in which the stockholder is said to have a special interest or controlling stake, such as the recent *Tesla* case involving Tesla's acquisition of SolarCity.[16] In addition to the M&A context, the Delaware courts have concluded that the following types of transactions can constitute a conflict:

- a board's decision to redeem the preferred stock of a controlling stockholder, following the stockholder's invocation of a charter-based redemption right;[17]
- private company financing rounds with a controlling stockholder;[18] and
- consulting and services agreements between a company and the controlling stockholder's affiliates.[19]

The case law has also addressed recapitalizations undertaken by companies with dual-class structures. In a landmark decision in December 2017, the Delaware Court of Chancery concluded that a recapitalization in which a corporation issued a new class of non-voting stock to all stockholders on a pro rata basis triggered the entire-fairness standard of review because the recapitalization was allegedly aimed at shoring up the controlling stockholder's eroding control.[20] At the same time, the court, in a separate litigation, cited the classic *Sinclair Oil* decision and rejected the claim that a pro rata *cash* dividend to all stockholders triggered the entire-fairness standard based on an allegation that the dividend provided unique benefits to the controlling stockholder.[21]

What Does This All Mean for Officers and Directors?

Controlling-stockholder conflict claims also often target directors and officers—alleging that they, too, breached their duty of loyalty and should be personally liable for damages. In 2015, the Delaware Supreme Court issued a helpful decision holding that even where a controlling-stockholder conflict exists and the entire-fairness standard of review applies, independent directors who appear to have discharged their fiduciary duties can be dismissed from the litigation at the motion-to-dismiss stage.[22] At the same time, plaintiffs frequently look for ways to allege that directors have a close relationship with large stockholders to try to keep directors in the litigation.[23] In some cases, the courts have awarded very large monetary damages against certain directors and officers, alongside the controlling stockholder, where the court viewed directors and officers as acting inappropriately to advance the controlling stockholder's interests instead of the minority's interests.[24]

Sanitizing a Controller-Stockholder Conflict: The *MFW* Framework

Given the stakes for all parties involved, the remaining obvious question is what companies and large stockholders should do when engaging in a transaction that may involve a controlling-stockholder conflict. A critical principle here is that the Delaware courts have, over the last several years, developed a specific framework that companies and controlling stockholders can follow to sanitize a controlling-stockholder conflict. This is the so-called *MFW* framework, named after the landmark 2014 Delaware Supreme Court case that established this approach.[25] If the *MFW* framework is correctly followed, the transaction in question can be "returned" to the protections of the business judgment rule, with the consequence that resulting litigation can end at the motion-to-dismiss stage. Several companies have achieved exactly that result in stockholder litigation.[26]

The *MFW* framework requires a company and the large stockholder to follow several specific rules. The controller must condition the procession of the transaction up front, before negotiations begin, on the approval of the transaction by *both* an independent committee of the company's board of directors and the company's unaffiliated stockholders. Both conditions must be non-waivable. The committee must be composed of independent directors, must be fully empowered to say "no" to the transaction, and must be authorized to hire separate committee

advisors if the committee wishes. The committee must ultimately meet its duty of care in negotiating a fair price, and approval by the minority stockholders must be "uncoerced" and fully informed. The rationale behind these requirements—all of which must be followed—is that they simulate true arm's-length bargaining and counteract the controller's influence.

If the *MFW* framework is correctly followed, a controlling-stockholder transaction may be returned to the protections of the business judgment rule.

Over the last several years, the Delaware case law has explored various components of the *MFW* framework and just what it means to comply (or fail to comply) with the components. A common issue that arises in litigation is whether the parties adequately declare the *MFW* conditions "up front" before negotiations begin—for example, if preliminary discussions occur before the conditions are declared.[27] In a July 2018 decision involving a situation in which the parties had engaged in several sets of discussions—including as to diligence and possible pricing—before declaring the *MFW* conditions, the Delaware Court of Chancery concluded that the parties nonetheless implemented the *MFW* conditions early enough.[28] The court distinguished between exploratory "discussions" and ultimate "negotiations" and noted, among other things, that the committee was engaged, having met sixteen times, and had overseen meaningful negotiations.

In addition to the timing issue for properly declaring the *MFW* conditions, the Delaware case law interpreting the *MFW* framework has focused on whether committee members truly are independent, whether disclosures to stockholders are adequate, and whether stockholders are given a clean "up or down" vote on a transaction without being coerced to agree to other matters in the vote.[29] The Delaware courts have also clarified that minority stockholder approval can be expressed and obtained by way of minority stockholders tendering into a tender offer,[30] and that the *MFW* framework is available to private companies.[31] Finally,

at least for the time being, the Delaware courts are requiring that companies use *MFW* to return any type of controlling-stockholder conflict to the business judgment rule, even if the underlying type of transaction does not otherwise require stockholder approval under Delaware law.[32]

Of course, for many companies, the *MFW* framework may be impracticable or impractical. Companies may not have independent directors or may, as a practical matter, severely doubt their ability to obtain disinterested stockholder approval of certain transactions. We have seen some companies weigh the complexity of

Even companies that don't choose *MFW* should keep in mind process lessons learned from the case law.

the *MFW* framework—particularly, the need to obtain stockholder approval and to condition the procession of the transaction up front on such approval—and determine not to use *MFW*, especially if the transaction in question is small or less likely to attract litigation.

Even where companies choose not to use *MFW*, they should keep in mind various process lessons from the case law that could still prove beneficial from a variety of standpoints. Taking these lessons to heart may at least help directors, officers, and large stockholders fare better should an entire-fairness litigation arise—in addressing the fairness of the transaction, in showing that they satisfied their fiduciary duties, and in avoiding personal liability. Recent entire-fairness litigations in Delaware illustrate that judges may pay careful attention to the following types of facts:

- whether directors understood their fiduciary duties and the types of conflicts at issue;
- whether directors engaged legal and financial advisors—including independent advisors where appropriate;
- if a company cannot afford a financial advisor for a transaction, whether a company explained that reality contemporaneously in the record;

- whether directors carefully handled and considered valuation issues;
- whether directors considered alternatives and all reasonably available information—and explained why certain courses of action were not pursued;
- whether directors were engaged and conducted real negotiations;
- whether directors made appropriate disclosures to stockholders;
- whether the company used either an independent committee or obtained disinterested stockholder approval, even if the company could not do both.

Takeaways

In our view, the considerable amount of litigation involving controlling-stockholder conflicts will likely only continue. That trend is consistent with the ongoing focus in the Delaware courts on all types of conflicts of interest—including concerning conflicted boards of directors and the divergence of interests between directors and funds who hold preferred stock and a company's common stockholders. The above points will continue to be important for companies as they navigate these issues.

Amy L. Simmerman is a partner at Wilson Sonsini Goodrich & Rosati. She leads the firm's corporate governance practice and is based in the firm's Wilmington, Delaware office. Her practice focuses on providing advice on all aspects of Delaware corporate law, including fiduciary duties, M&A, stockholder activism, corporate governance, corporate formation, stock issuances, preferred stock investments, and various statutory matters. **Katharine (Katie) A. Martin** is also a partner at Wilson Sonsini Goodrich & Rosati. She is chair of the firm's board of directors and is based in the firm's Palo Alto, California office. She practices corporate and securities law and has extensive experience in representing public companies. Her practice includes all aspects of company representation, including corporate governance, SEC compliance, 1934 Act issues, public offerings, private placements, and M&A. A version of this article has been published in the course handbook for PLI's 50th Annual Institute on Securities Regulation, at which Ms Martin was a speaker.

NOTES

1. Basho Techs. Holdco B, LLC v. Georgetown Basho Inv'rs LLC, 2018 WL 3326693 (Del. Ch. July 6, 2018).
2. Carr v. New Enter. Assocs., Inc., 2018 WL 1472336 (Del. Ch. Mar. 26, 2018).
3. *In re* KKR Fin. Holdings LLC S'holder Litig., 101 A.3d 980 (Del. Ch. 2014), *aff'd sub nom*. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 364 (Del. 2015).
4. *In re* Zhongpin, Inc. S'holders Litig., 2014 WL 6735457 (Del. Ch. Nov. 26, 2014).
5. *In re* Tesla Motors, Inc. S'holder Litig., 2018 WL 1560293 (Del. Ch. Mar. 28, 2018).
6. Calesa Assocs., L.P. v. Am. Capital, Ltd., 2016 WL 770251 (Del. Ch. Feb. 29, 2016).
7. *Basho*, 2018 WL 3326693.
8. *In re* Nine Sys. Corp. S'holders Litig., 2014 WL 4383127 (Del. Ch. Sept. 4, 2014), *aff'd sub nom*. Fuchs v. Wren Holdings, LLC, 129 A.3d 882 (Del. 2015).
9. van der Fluit v. Yates, 2017 WL 5953514 (Del. Ch. Nov. 30, 2017).
10. Ford v. VMware, Inc., 2017 WL 1684089 (Del. Ch. May 2, 2017).
11. Thermopylae Cap. Partners, L.P. v. Simbol, Inc., 2016 WL 368170, at *14 (Del. Ch. Jan. 29, 2016).
12. *In re* Crimson Expl. Inc. S'holder Litig., 2014 WL 5449419 (Del. Ch. Oct. 24, 2014).
13. *In re* Books-A-Million, Inc. S'holders Litig., 2016 WL 5874974 (Del. Ch. Oct. 10, 2016), *aff'd*, 164 A.3d 56 (Del. 2017); Swomley v. Schlecht, 2015 WL 1186126 (Del. Ch. Mar. 12, 2015), *aff'd*, 128 A.3d 992 (Del. 2015); *In re* MFW S'holders Litig., 67 A.3d 496 (Del. Ch. 2013), *aff'd sub nom*. Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014).
14. Frank v. Elgamal, 2014 WL 957550 (Del. Ch. Mar. 10, 2014); SEPTA v. Volgenau, 2013 WL 400919 (Del. Ch. Aug. 5, 2013), *aff'd*, 91 A.3d 563 (Del. 2014); *In re* John Q. Hammons Hotels, Inc. S'holders Litig., 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).
15. *In re* Martha Stewart Living Omnimedia, Inc. S'holder Litig., 2017 WL 3568089 (Del. Ch. Aug. 18, 2017).
16. *Tesla*, 2018 WL 1560293.
17. Frederick Hsu Living Tr. v. ODN Holding Corp., 2017 WL 1437308 (Del. Ch. Apr. 14, 2017).
18. *Basho*, 2018 WL 3326693; *New Enter. Assocs.*, 2018 WL 1472336; *Calesa*, 2016 WL 770251; *In re* Nine Sys. Corp., 2014 WL 4383127; Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618 (Del. Ch. 2013).
19. *In re* EZCORP Inc. Consulting Agreement Deriv. Litig., 2016 WL 301245 (Del. Ch. Jan. 25, 2016).
20. IRA Tr. FBO Bobbie Ahmed v. Crane, 2017 WL 7053964 (Del. Ch. Dec. 11, 2017).
21. GAMCO Asset Mgmt., Inc. v. iHeartMedia Inc., 2016 WL 6892802 (Del. Ch. Nov. 23, 2016), *aff'd*, 172 A.3d 884 (Del. 2017).
22. *In re* Cornerstone Therapeutics Inc. S'holder Litig., 115 A.3d 1173 (Del. 2015).
23. *Tesla*, 2018 WL 1560293; *In re* Oracle Corp. Deriv. Litig., 2018 WL 1381331 (Del. Ch. Mar. 19, 2018).

24. *Basho*, 2018 WL 3326693; *In re* Dole Food Co. S'holder Litig., 2015 WL 5052214 (Del. Ch. Aug. 27, 2015).
25. *M&F Worldwide Corp.*, 88 A.3d 635.
26. Olenik v. Lodzinski, 2018 WL 3493092 (Del. Ch. July 20, 2018); *In re* Synutra Int'l, Inc. S'holder Litig., 2018 WL 705702 (Del. Ch. Feb. 2, 2018); *Crane*, 2017 WL 7053964; *Martha Stewart*, 2017 WL 3568089; *Books-A-Million, Inc.* 2016 WL 5874974.
27. *Synutra*, 2018 WL 705702; *Martha Stewart*, 2017 WL 3568089; *In re* Sauer-Danfoss, Inc. S'holders Litig., 65 A.3d 1116 (Del. Ch. 2011).
28. *Olenik*, 2018 WL 3493092.
29. Sciabacucchi v. Liberty Broadband Corp., 2017 WL 2352152 (Del. Ch. May 31, 2017).
30. *In re* Volcano Corp. S'holder Litig., 143 A.3d 727 (Del. Ch. 2016), aff'd, 156 A.3d 697 (Del. 2017).
31. *Swomley*, 2015 WL 1186126.
32. *EZCORP*, 2016 WL 301245; *Crane*, 2017 WL 7053964.