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Katherine L. Henderson and Lori W. Will, Controlling Stockholder Transactions: The Ins, the Outs, and Developing Trends

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INTRODUCTION

Under Delaware law, the business judgment presumption generally protects rational business decisions made by independent boards of directors. Where this default principle applies, courts will not second guess those decisions unless stockholder plaintiffs can show that the decision was not made by disinterested, independent directors. The business judgment presumption, however, is generally unavailable where a controlling stockholder conflict exists. If a conflicted transaction is challenged by a stockholder, the more stringent entire fairness standard of review may be applied. Unlike the business judgment rule, the exacting entire fairness test places the burden on defendant directors or controlling stockholders to demonstrate that both the process and terms with respect to a transaction were fair.

Because the application of entire fairness can have significant implications for defendants in deal litigation, it is important to carefully and thoroughly explore whether a controlling stockholder conflict is present as early as practicable in a potential transaction process. There are three primary types of issues that should be considered.

First, the threshold determination is whether a controlling stockholder is present. Typically, a majority stockholder will be considered a controller and a minority stockholder will not. But where a minority stockholder has outsized influence, or can be considered part of a "control group," courts may find otherwise.

Second, if there is a controlling stockholder, whether a conflict with the controller is created by a transaction must be assessed. A controlling stockholder standing on both sides of a deal is typically a clear case of conflict, warranting entire fairness review. However, a conflict can exist even if the controller is not strictly standing on both sides of a transaction. Delaware courts have found conflicts to exist, and thus applied entire fairness review, in two general types of situations: (1) where the controller receives disparate deal consideration or a continuing stake in the surviving entity; and (2) where all stockholders receive the same deal consideration but the controller gets some additional, non-ratable benefit.

Finally, if a transaction would otherwise be subject to entire fairness review under these circumstances, it is possible to structure the transaction so that it reverts to the business judgment rule standard. In particular, the 2014 Delaware Supreme Court's decision in *Kahn v. M&F Worldwide Corp* ("*MFW*") allows the protections of the business judgment rule to extend to controlling stockholder transactions where certain procedural protections are present at the outset of substantive negotiations.[1] Since *MFW*, Delaware courts have clarified that a range of conflicted controller transactions—from squeeze-out mergers to pro rata recapitalizations where the controller receives a unique benefit—may receive business judgment review if these protections are timely in place. Thus, any companies with a controlling stockholder should consider complying with *MFW* if they are facing a potentially conflicted transaction.

WHO IS A CONTROLLING STOCKHOLDER?

Where a stockholder controls a majority of the voting power, the stockholder almost always will be deemed a controller—absent circumstances (such as contractual or other voting restrictions) that limit the stockholder's power with regard to the board of directors. Conversely, a minority stockholder is not a controller in most cases,[2] unless the stockholder exercises control over the board or business affairs of the corporation.[3]

Where a stockholder appears to have "outsized influence," even if not a majority holder, Delaware courts will evaluate whether the stockholder in fact controlled the board "such that the directors … could not freely exercise their judgment" with respect to a transaction.[4] Domination or influence over the corporation can come in many forms beyond equity ownership, such as contract rights or status (for example, as a founder). The most critical part of the inquiry is whether the person—or a control group of affiliates—has "actual control" over the board (rather than just managerial control). Courts will consider a variety of factors in making this determination, such as whether the stockholder has the power to appoint and remove directors, to unilaterally cause the board to act or refrain from acting, or generally dominates a majority of the directors.

In one recent case arising from Tesla's acquisition of SolarCity, the Court of Chancery found a plaintiff had pleaded that founder, Chairman,

1. 88 A.3d 635 (Del. 2014).
2. For example, in the recent *Rouse* case, the Court of Chancery found, at the pleading stage, that it was not reasonably conceivable that a 33.5% stockholder was a controller with respect to a going-private transaction that it had proposed. *In re Rouse Props., Inc. Fiduciary Litig.*, 2018 WL 1226015 (Del. Ch. Mar. 9, 2018). In that case, there was a special committee process in place and the stockholder recused itself from the board's consideration of the stockholder's self-interested transaction.
3. *Kahn v. Lynch Commc'ns Sys.*, 638 A.2d 1110, 1113–14 (Del. 1994). Notably, in *Kahn*, the controller was a 43% stockholder that threatened to vote down other issues if the board refused to approve the merger the controller desired.
4. *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 993 (Del. Ch. 2014).

and CEO Elon Musk could be considered a controlling stockholder of Tesla, despite having just 22% ownership of the company. This was so, according to the court, because Musk exercised a significant amount of influence over Tesla.[5] In finding, at the motion to dismiss stage, that Musk controlled the company, the court explained that Musk's status as the "face of Tesla" was not itself dispositive. The court considered Musk's alleged prior behavior in "oust[ing] . . . senior management when displeased" and his "singularly important role in sustaining Tesla in hard times and providing the vision for the company's success," which supported a control determination.[6] The court also weighed circumstantial evidence presented by the plaintiffs' pleadings that Musk dominated the board when voting to approve the transaction, and examined board-level conflicts and ties to Musk.[7]

In another case concerning Oracle's acquisition of NetSuite, the Court of Chancery drew a pleading stage inference that Oracle's co-founder Larry Ellison (with a 27% stake) functionally controlled the corporation, despite not going so far as to call him a controlling stockholder.[8] Like

5. *In re Tesla Motors, Inc. Stockholder Litig.*, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018).
6. *Id.* at *15–16.
7. *See Tesla*, 2018 WL 1560293 at *16–17.
8. *In re Oracle Derivative Litig.*, 2018 WL 1381331 (Del. Ch. Mar. 19, 2018). Before the 2018 *Tesla* and *Oracle* decisions, there were just three cases in the past 15 years where Delaware courts found that a minority stockholder might be a controller—*In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531 (Del. Ch. 2003) (35% stockholder); *In re Zhongpin Inc. S'holders Litig.*, 2014 WL 6735457 (Del. Ch. Nov. 26, 2014), *rev'd on other grounds sub nom. In re Cornerstone Therapeutics Inc., Stockholder Litig.*, 115 A.3d 1173 (Del. 2015) (17% stockholder); and *Calesa Assocs., L.P. v. Am. Capital, Ltd.*, 2016 WL 770251, at *10–11 (Del. Ch. Feb. 29, 2016) (26% stockholder). In each of these cases, the court emphasized the stockholder's unusual and extraordinary level of influence—through the stockholder's other critical roles at the company (such as founder, CEO and/or Chairman), the stockholder's importance to the company, and the stockholder's history of dominating board decisions. *E.g.*, *Calesa*, 2016 WL 770251, at *10–11 (finding at pleadings stage that stockholder and affiliates which collectively owned 26% stake to be controller in context of a squeeze out transaction where stockholder allegedly exercised substantial control over the board). In another recent case challenging a preferred stock financing round and the subsequent winding up of a private company, the Court of Chancery determined that an investor that owned less than a majority stake nonetheless possessed control, given the investor's ongoing dominance over the company and its use of veto rights to exert influence over the board's decision-making. *Basho Techs. Holdco B, LLC v. Georgetown Basho Investors, LLC*, 2018 WL 3326693 (Del. Ch. July 6, 2018).

Musk, Ellison was alleged to have a "firm grip" on the company's daily operations and close ties to a majority of the directors. Notably, although the court found that each independent director's "entanglement" to Ellison was itself insufficient to support an inference that the director lacked independence, the "substantial" connections "taken together" created a reasonable doubt that a majority of the board could impartially consider a demand.[9] The court also considered that Ellison had a history of removing directors and officers who disagreed with him, and received "massive overcompensation" despite stockholders' rejection of multiple say-on-pay votes.

Effective procedural protections, such as a fully-functioning independent committee of directors, can play a role in whether a minority stockholder is considered a controller for purposes of a transaction. In *Tesla*, Musk was found to be a controlling stockholder where there was no special committee and he did not separate himself from the Board's deliberations of an allegedly conflicted deal. The court in *Oracle* reached the same effective conclusion about Ellison despite the presence of a special committee and Ellison's recusal from the board's consideration of the deal, where the court observed Ellison stealthfully controlled the committee process. In the *Dell* appraisal action, by contrast, 15% stockholder Michael Dell, who arguably had "outsized influence" similar to Musk and Ellison, was found not to be a controller where he took extensive steps to separate himself from the deal process.[10] The court in *Tesla* noted that, unlike Musk, Dell did not participate in board-level discussions about the deal, participated in due diligence with other potential counterparties, and expressed a willingness to sell his shares in a superior transaction.[11]

Although a controlling stockholder is typically a single person or entity, Delaware courts have also recognized that a "control group" may collectively be given controlling stockholder status. The Court of Chancery has explained that proving a control group is "a fact-intensive inquiry" that is "rarely a successful endeavor" for plaintiffs because it requires evidence of "more than parallel interests."[12] A control group may be found

9. *Oracle*, 2018 WL 1381331 at *17.
10. *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, 177 A.3d 1 (Del. 2017).
11. *Tesla*, 2018 WL 1560293 at *15–16.
12. *In re Nine Sys. Corp. S'holders Litig.*, 2014 WL 4383127 (Del. Ch. Sept. 4, 2014) (finding three stockholders, with a collective 54% stake, constituted a control group with regard to a recapitalization based on circumstantial evidence of coordination that was not disclosed to the board, particularly regarding a 90-day option to invest in the recapitalization).

where minority stockholders, who alone lack managerial power over the corporation, "are connected in some legally significant way—e.g., by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal."[13] In *PNB Holding*, the court emphasized that a lack of any voting agreement or other arrangement limiting the stockholders' abilities to act in his or her own self-interest cuts against a finding that they comprise a control group.[14]

WHEN IS A CONTROLLING STOCKHOLDER CONFLICTED?

"Entire fairness is not triggered solely because a company has a controlling stockholder. The controller must also engage in a conflicted transaction."[15] A controller largely has the right to act in its own self-interest when it is acting in its capacity as a stockholder.[16] But, because controlling stockholders owe fiduciary duties to the corporation and minority stockholders, they cannot "*exercis[e] corporate power* (either formally as directors or officers or informally through control over officers and directors) so as to advantage themselves while disadvantaging the corporation."[17]

In *Crimson Exploration Inc. Stockholder Litigation*,[18] the Court of Chancery articulated two scenarios where entire fairness applies to "conflicted transactions" with controlling stockholders: (1) transactions where the controlling stockholder stood on both sides of the transaction; and (2) transactions where the controlling stockholder competed with minority stockholders for consideration. The first scenario articulated in *Crimson Exploration* occurs where a controller engages in self-dealing by standing on both sides of a deal and dictating its terms. This became settled law in Delaware after the Delaware Supreme Court decided *Kahn v.*

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13. *Dubroff v. Wren Holdings, LLC*, 2009 WL 1478697, at *3 (Del. Ch. Mar 22, 2009) (citing *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *10 (Del. Ch. Aug. 18, 2006)).
14. *PNB Holding*, 2006 WL 2403999, at *10.
15. *Crimson Exploration Inc. Stockholder Litig.*, 2014 WL 5449419, at *12 (Del. Ch. Oct. 24, 2014).
16. *See In re CompuCom Sys., Inc. Stockholders Litig.*, 2005 WL 2481325, at *6 (Del. Ch. Sept. 29, 2005) ("Generally speaking, a controlling shareholder has the right to sell his control share without regard to the interests of any minority shareholder, so long as the transaction is undertaken in good faith.").
17. *Thorpe v. CERBCO, Inc.*, 1995 WL 478954, at *8 (Del. Ch. Aug. 9, 1995) (emphasis in original), *aff'd in part, rev'd in part*, 676 A.2d 436 (Del. 1996).
18. 2014 WL 5449419, at *12.

Lynch Communications Systems, Inc. in 1994.[19] Generally speaking, "the controlling or dominating shareholder proponent of the transaction bears the burden of proving its entire fairness."[20] This is the case even when no coercion by the controller is intended, because the controlling stockholder has an inherent ability to influence the deal such that "no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation."[21]

The second scenario described in *Crimson Exploration* involving "competition" with minority stockholders is more fact-dependent. As a general matter, Delaware courts have recognized that disparate treatment of different groups of stockholders may be appropriate in some circumstances, and that strong policy concerns cut against an outright prohibition. Although the differential treatment of two classes of stock alone may not trigger entire fairness, if the controller directs the apportionment of merger consideration in such a way that the controller is treated differently from other stockholders, the controller may bear the burden of showing the entire fairness of that apportionment.[22]

The court in *Crimson Exploration* identified three ways in which a controlling stockholder could be found to have competed with minority stockholders for consideration. First, where the controller received "disparate deal consideration" approved by the board of directors. Second, where the controller received a continuing stake in the surviving entity, or rolled over their stock, and the minority is cashed out. These two situations often arise where a corporation has different classes of stock, with the higher-vote class of shares (including the controller) receiving more or different consideration from the single-vote class. The third

19. 638 A.2d 1110 (Del. 1994). The principles of *Kahn* had been articulated since the 1980s. *See Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985) ("'[T]he requirement of fairness is unflinching . . . where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.'") (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983)); *see also Weinberger*, 457 A.2d at 710 ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

20. *Kahn*, 638 A.2d at 1117.

21. *Kahn*, 638 A.2d at 1116 (quoting *Citron v. E.I. du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990)).

22. *See Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594–95 (Del. Ch. 1986).

situation occurs where the controller received a unique benefit despite pro rata treatment in terms of deal consideration.[23]

Disparate Consideration

The Court of Chancery has described a classic "disparate consideration" case triggering entire fairness as one where "the controller takes more monetary consideration from the third-party transaction than is given to the minority."[24] In *In re Tele-Communications, Inc. Shareholders Litigation*, for example, the company's CEO and Chairman owned a majority of high-vote Series B shares and controlled 47% of the overall vote, and insisted that Series B shares receive a 10% premium over Series A shares.[25] A majority of the board also owned large amounts of Series B shares. As a result of the deal, Series B stockholders were ultimately given $376 million in additional consideration than what was received by Series A holders. The court applied entire fairness, and observed that the special committee formed to negotiate the deal—which included a director who had more Series B than Series A shares— should have obtained a "relative fairness opinion" as to whether the deal was fair to Series A holders in light of the preferential treatment given to Series B holders.

Continuing Stakes

The Court of Chancery has described a typical "continuing stake" case as one where "the controller receives more consideration from the third-party transaction than the other stockholders in a form other than money—typically by retaining a continuing equity stake in the surviving entity while the minority common stockholders are cashed out."[26] For example, in *In re John Q. Hammons Hotels, Inc. Shareholder Litigation*, the controlling stockholder, John Q. Hammons (who controlled 76% of the company's vote through ownership of all high-vote Class B shares and a small percentage of single-vote Class A shares) separately bargained for a continuing preferred interest in

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23. *Crimson*, 2014 WL 5449419, at *14.
24. *GAMCO Asset Mgmt. Inc. v. iHeartMedia Inc.*, 2016 WL 6892802 (Del. Ch. Nov. 23, *revised*, Nov. 29, 2016), *aff'd*, 172 A.3d 884 (Del. 2017); *see also In re Delphi Fin. Grp. S'holder Litig.*, 2012 WL 729232, at *3 (Del. Ch. Mar. 6, 2012) (controlling stockholder negotiated a substantial premium for his shares).
25. 2003 WL 21543427 (Del. Ch. July 7, 2003).
26. *GAMCO*, 2016 WL 6892802, at *16.

the surviving entity. Specifically, the controller received a $300 million line of credit, and ownership of one of the company's marquee hotel properties in exchange for his Class B shares, while Class A stockholders received only cash consideration at a substantial premium.[27] Similarly, in the *LNR Property* case, the controlling stockholder negotiated a cash-out merger, including an arrangement where the controller (with senior management) rolled part of the deal proceeds into a 25% stake in the surviving company.[28] The court found that this arrangement created a conflict such that the controller might have been disincentivized from seeking the best price for the target, and applied entire fairness.[29]

Unique Benefits

A third situation—where a controller obtains a unique benefit not shared with the minority—is perhaps the most nuanced. In a "unique benefit" case, "the controller receives some sort of special benefit not shared with the other stockholders," such that the controller "extracts something uniquely valuable to the controller."[30] As a general matter,

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27. 2009 WL 3165613 (Del. Ch. Oct. 2, 2009); *see also In re LNR Prop. Corp. S'holders Litig.*, 896 A.2d 169 (Del. Ch. 2005) (applying entire fairness to cash-out merger where controller received right to purchase 20.4% interest in acquiring company after the merger). Foreshadowing *MFW*, which is discussed below, the court in *Hammons* applied business judgment review because the transaction was conditioned on procedural protections—namely, the transaction was "(1) recommended by a disinterested and independent special committee *and* (2) approved by stockholders in a non-waivable vote of the majority of all minority stockholders." *Hammons*, 2009 WL 3165613, at *12. Without such procedural protections, however, Delaware courts generally apply entire fairness to transactions like *Hammons* where a controller (or control group) competes with the minority for differential consideration. *E.g.*, *Frank v. Elgamal*, 2012 WL 1096090 (Del. Ch. Mar. 30, 2012).
28. *LNR Prop.*, 896 A.2d 169.
29. *Id.* at 178.
30. *GAMCO*, 2016 WL 6892802, at *16 (citing *Crimson*, 2014 WL 5449419, at *13). Outside of the M&A context, transactions involving controllers that receive a non-ratable benefit (that is, a benefit not shared with other stockholders) have also been subjected to entire fairness review. For example, in *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, the Court of Chancery applied entire fairness to claims about advisory services agreements between the company and its controlling stockholder, holding that the agreements were used to extract a non-ratable cash benefit. 2016 WL 301245 (Del. Ch. Jan. 25, 2016). Vice Chancellor Laster listed several ways controlling stockholders can extract a non-ratable benefit from a company, such as: "cash flow tunneling," where the controller "removes a portion of the current year's cash flow, but does not affect the remaining stock of long-term

pro rata treatment of all stockholders (such as a dividend paid equally) does not invoke entire fairness. In the seminal case of *Sinclair Oil*, the Delaware Supreme Court held that the business judgment rule applied to transactions involving a company and its controlling stockholder where the parent did not gain a benefit to the "exclusion of and detriment to" its minority stockholders.[31] The court in *In re Synthes, Inc. Shareholder Litigation* explained that this principle flows from the alignment of all stockholders' interests where they receive the same consideration, given controller's "natural incentive to obtain the best price for their shares."[32] The court explained:

> As a general matter, therefore, if one wishes to protect minority stockholders, there is a good deal of utility to making sure that when controlling stockholders afford the minority pro rata treatment, they know that they have docked within the safe harbor created by the business judgment rule.[33]

Delaware courts have developed an exception to this rule however, where a controller's desire for liquidity can invoke entire fairness review despite pro rata treatment. Starting with *McMullin v. Beran*,[34] the Delaware Supreme Court found that entire fairness applied even though the controller and minority stockholders received the same per-share cash consideration in a third-party merger. The court focused on the fact that the controlling stockholder (rather than the board) directed the sales process, and the controller's desire for liquidity.

Similarly, in *N.J. Carpenters Pension Fund v. Infogroup, Inc.*,[35] the court declined to dismiss fiduciary duty claims against a controller who orchestrated the sale of the company to a third party. Although

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productive assets"; "asset tunneling," where the controller transfers "major long-term (tangible and intangible) assets" to or from the company, often not at market value; and "equity tunneling," in which the controller "increases [its] share of the firm's value, at the expense of minority shareholders, but does not directly change the firm's productive assets or cash flows." Because the court has been consistent in applying entire fairness review in cases involving "equity tunneling" (such as going private transactions), heightened scrutiny should apply to other types of potential value extraction to discourage controllers selecting a method based on different standards of review.

31. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).
32. 50 A.3d 1022, 1035 (Del. Ch. 2012). In *Synthes*, the minority stockholders alleged that the controller had obtained a unique benefit in the form of liquidity by rejecting a disparate-consideration offer that would have only cashed out the minority stockholders in favor of a cash-stock mix for all stockholders.
33. *Id.*
34. 765 A.2d 910 (Del. 2000).
35. 2011 WL 4825888 (Del. Ch. Sept. 30, 2011).

all stockholders received the same cash consideration, the plaintiff alleged the controller—whose only liquid assets were his stock—was motivated by a need for cash to address personal debts and business interests, and had threatened fellow directors with lawsuits if they did not approve the deal. In *In re Answers Corp. Shareholders Litigation*,[36] the court allowed fiduciary duty claims to go forward where a minority stockholder alleged that a venture capital firm (which owned 30 percent of the company) forced a quick sale to meet its own liquidity needs, even though Answers had strong projections and was about to announce a "blowout" quarter.

In *Synthes*, the current Chief Justice of the Delaware Supreme Court, then Chancellor, seemed to restrict the use of this liquidity argument as a basis for invoking entire fairness. In *Synthes*, the court found that the entire fairness standard did not apply to a corporate sale because all stockholders received the same consideration for their shares—despite an allegation that the sale was for the purpose of providing liquidity to the controlling stockholder. The court described the types of extreme facts that could give rise to a finding otherwise as "very narrow," and involving "a crisis, fire sale where the controller, in order to satisfy an exigent need (such as a marginal call or default in a larger investment) agreed to a sale of the corporation without any effort to make logical buyers aware of the chance to sell, give them a chance to do due diligence, and to raise the financing necessary to make a bid that would reflect the genuine fair market value of the corporation."[37]

The use of these liquidity arguments since *Synthes* has been limited. The Court of Chancery in *Larkin v. Shah* more recently explained that Delaware courts have "evaluated liquidity theories of this sort with marked skepticism" because they require "an extraordinary inference: that rational economic actors have chosen to short-change themselves."[38] As such, "absent the presence of additional circumstantial indicators of conflict," the Court of Chancery is "reluctant to find a liquidity-based conflict" meriting entire fairness review.[39] Consistent with this

36. 2012 WL 1253072 (Del. Ch. Apr. 11, 2012).
37. *Synthes*, 50 A.3d at 1036.
38. 2016 WL 4485447, at *16 (Del. Ch. Aug. 25, 2016).
39. *Id.*; *In re Merge Healthcare Inc.*, 2017 WL 395981, at *8 (Del. Ch. Jan. 30, 2017) ("It is true that exigent circumstances that require a controller to dump stock, for liquidity purposes, at less than full value, create divergent interests between the controller and the other stockholders. A simple interest in selling stock on the part of

trend, in *GAMCO Asset Management Inc. v. iHeartMedia Inc.*, the court rejected an argument that entire fairness should apply where a controller, allegedly for the purpose of satisfying the controller's liquidity needs, pushed for asset sales to third parties at allegedly "suboptimal prices" that resulted in pro rata dividends. Once again, the Court of Chancery emphasized that only "very narrow circumstances" supported by well-pled facts will cause the court find that pro rata dividends or "an arms-length transaction with a third party yielded the kind of unique benefit to a controller that would justify entire fairness review."[40]

A current example of a non-ratable benefit leading to entire fairness review is the *IRA Trust FBO Bobbie Ahmed v. Crane* ("*NRG*") decision, where the Court of Chancery applied entire fairness even though the challenged reclassification was implemented through pro rata dividends.[41] The court distinguished *Sinclair Oil* because the controller had received a unique benefit to the exclusion of the minority: "the means to perpetuate its control position by financing future acquisitions with the low-vote Class C stock authorized in the Reclassification."[42] The court also rejected an argument that the extension of control was not a unique benefit because stockholders could not reasonably expect the controller would voluntarily dilute its position through stock issuances. The court found instead that the plaintiff had sufficiently pleaded the controller was "on the cusp of losing [] control" when the reclassification was consummated, delivering a non-ratable benefit to it.[43] Thus, it remains that controllers must still be wary in transactions where they receive a non-ratable benefit even if the consideration is otherwise applied pro rata to all stockholders.

Similarly, the Court of Chancery's 2018 decision in *Carr v. New Enterprise Associates, Inc.* reaffirmed the basic principle that a controlling stockholder cannot engage in behavior that prioritizes its own self-interests over other stockholders when acting in a fiduciary

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the controller, by contrast, is insufficient to demonstrate divergent interests. In order for such a situation to constitute a disabling conflict, a controller must not only seek liquidity but the circumstances under which she does so must be akin to a 'crisis' or a 'fire sale' to 'satisfy an exigent need.'"); *see also In re Cyan, Inc. Stockholders Litig.*, 2017 WL 1956955, at *10 (Del. Ch. May 11, 2017).

40. *GAMCO*, 2016 WL 6892802 at *17.
41. 2017 WL 6335912 (Del. Ch. Dec. 11, 2017, *revised,* Jan. 26, 2018).
42. *Id.* at *8.
43. *Id.* at *9.

capacity.[44] In that case, the court found it was reasonably conceivable that the controlling venture firm and its board representatives had breached the duty of loyalty by orchestrating and approving the sale of a warrant, with an option to purchase the company at a favorable price, to a third party buyer. Because the warrant sale was conditioned on the buyer acquiring (and investing in) another portfolio company of the controller, the plaintiff argued that the controller had interests on both sides of the deal and received disparate consideration. The court applied entire fairness, explaining that the controller's engaging in "a form of portfolio optimization" by "prioritiz[ing] its fund's overall rate of return over maximizing value for [the company]'s shareholders" was "precisely the kind of behavior that controllers may not engage in under Delaware law."[45]

WHEN DOES THE BURDEN SHIFT, OR STANDARD RETURN TO BUSINESS JUDGMENT?

If a transaction is determined to be a conflicted controlling stockholder transaction, such that entire fairness applies, Delaware cases have provided that the controlling stockholder may receive the benefit of a burden shift where either a special committee or majority of the minority voting condition is utilized.[46] In other words, the burden of proof to show that the transaction was unfair will shift to the plaintiff if the controller can demonstrate the transaction was approved by either a "well functioning committee of independent directors"[47] or an "informed majority of the minority" stockholder vote.[48] While such a burden shift may appear to be favorable for the controller, the Court of Chancery has explained that "[t]he practical effect of the *Lynch* doctrine's burden shift is slight" because it does not "remove the case from entire fairness review" meaning that the case will not be dismissed at the pleadings stage.[49] The court has also observed that, regarding a special committee, the burden shifting analysis requires "questions of whether the special committee was

44. 2018 WL 1472336 (Del. Ch. Mar. 26, 2018).
45. *Id.* at *23.
46. *Kahn*, 638 A.2d at 1117.
47. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) (citing *Kahn*, 638 A.2d at 1117).
48. *See Kahn*, 638 A.2d at 1117.
49. *Cysive*, 836 A.2d at 548–49 (noting inefficiencies in trying to obtain pretrial burden-shift ruling).

substantively effective in its negotiations with the controlling stockholder," guaranteeing that "the burden shift will rarely be determinable on the basis of the pre-trial record alone."[50] Thus, controllers have historically had little incentive to utilize these protective measures until the Delaware Supreme Court's game changing decision in *MFW*.

In *MFW,* the court announced a new doctrine such that if a conflicted controller transaction is conditioned from the outset on both the approval of an independent, fully-empowered special committee and an uncoerced, informed vote of a majority of the minority stockholders), the standard of review can be "returned" to business judgment.[51] In *MFW*, a 43% stockholder (which the parties conceded was a controlling stake) made an offer to take the company private at a time that the stock price dipped. The court recognized the general principle that "[w]here a transaction involving self-dealing by a controlling stockholder is challenged, the applicable standard of review is 'entire fairness,' with the defendants having the burden of persuasion."[52] But, the Delaware Supreme Court affirmed the Court of Chancery's holding that the business judgment review nonetheless applied because merger discussions were conditioned up front on both the negotiation and approval of an empowered independent committee and an uncoerced, fully informed, majority-of-the-minority stockholder vote.

The court in *MFW* explained that: "[W]here the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm's-length mergers, which are reviewed under the business judgment standard."[53] The detailed requirements that must be met for business judgment review to apply to a controlling stockholder transaction are listed in the opinion:

> (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special

50. *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 52 A.3d 761, 792 (Del. Ch. 2011); *see also ACP Master, Ltd. v. Sprint Corp.*, 2017 WL 3421142, at *17 (Del. Ch. July 21, 2017) (holding that because the record did not permit pretrial determination that defendants were entitled to burden shifting, the burden of proving entire fairness remained with controlling stockholder throughout trial).
51. 88 A.3d at 644.
52. *Id.* at 642.
53. *Id.* at 644.

Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.[54]

This inquiry focuses on many factors in the context of the transaction, including whether the board of directors fully empowered the committee, whether the committee was well informed by independent advisors, and whether it actually did the work to complete its task appropriately without being "undermined" or manipulated by the controller, management, or other interested parties.

Two recent cases explored at which point these conditions must be implemented for business judgment review to apply. In one case, the Delaware Supreme Court explained that the conditions must be declared before "substantive economic negotiations" begin.[55] In another decision, currently on appeal, the Court of Chancery drew a distinction between preliminary discussions versus substantive negotiations, concluding that exploratory meetings and conversations before the parties agreed to use the *MFW* framework were not fatal, especially because the independent board committee became active and engaged in price negotiations.[56]

Delaware courts have also clarified that *MFW* may provide a means to business judgment review for any type of conflicted controller transactions—from squeeze-out mergers to unique benefit cases. In *EZCORP*, for example, the *MFW* framework was applied to an advisory agreement with a controller. And in *In re Martha Stewart Living Omnimedia, Inc. Stockholder Litigation*,[57] it was applied to a third-party merger where the controller stood on one side of the deal but received a non-ratable benefit—"side deals" in the form of employment and intellectual property agreements. In *Martha* Stewart, the court explained that, in such circumstances, business judgment review may apply if both procedural protections are implemented before the controller begins to negotiate for the unique benefit.[58] The *NRG* decision also made clear that

54. *Id.* at 645.
55. *Flood v. Synutra Int'l, Inc.*, 195 A.3d 754, 763 (Del. 2018).
56. *Olenik v. Lodzinski*, 2018 WL 3493092 (Del. Ch. July 20, 2018) (currently under appeal).
57. 2017 WL 3568089 (Del. Ch. Aug. 18, 2017).
58. *Id.* at *19 (finding the *ab initio* requirement will be satisfied in a third-party transaction if the dual procedural protections are in place at "the point where the controlling stockholder actually sits down with an acquiror to negotiate for additional consideration"). Notably, the court also determined that the side payments to the controller in that case were not an "*improper* diversion" of consideration in light of the "immeasurable value" of the controller's "time, energy and talent to keep" her name brand "alive and thriving." *Id.* at *11 (emphasis in original). The court

MFW could bring a transaction back to business judgment where a controller receives a unique benefit not shared by all stockholders.[59]

Given the onerous nature of the entire fairness standard of review and its essentially guaranteeing that a case must proceed through trial, *MFW* has changed the lens through which we view litigation of controlling stockholder transactions.

CONCLUSION

Whether a controlling stockholder is present, and whether that controller is conflicted, are critical issues that should be considered early on in every deal process. The application of entire fairness, should the deal be challenged, makes it very difficult to resolve lawsuits about conflicted transactions before trial, making them very costly and burdensome for defendants. Avoiding entire fairness review should therefore be the focus of any party where controlling stockholder conflicts are potentially present. Procedural protections are an important part of the analysis, as they can factor into whether a minority stockholder will be treated as a controller in the first place, whether the burden of entire fairness shifts, and—if *MFW* is followed from the outset—whether the standard of review can return to business judgment.

Delaware courts will undoubtedly continue to develop the case law surrounding who can be deemed a controller, when a controller is conflicted, and the standard of review for conflicted controller transactions—including when and whether the business judgment rule applies. If current trends continue, we expect to see additional cases where minority stockholders with "outsized influence" on the company and board are deemed controllers, and where additional types of transactions are swept into the *MFW* framework. How proper procedural protections factor into the courts' analyses of those issues will be an issue to closely watch.

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concluded that it could not "reasonably conceive of a circumstance where Plaintiffs could prevail upon the Court as fact-finder that Stewart's side deals with [the buyer], which to reasonable degrees tracked the structure, value and obligations of the side deals she had in place before the Merger, reflect her improper attempt to divert to herself consideration that [the buyer] would have paid to the stockholders." *Id.* *13.

59. 2017 WL 6335912.

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