Notes on Conflicted Controller Transactions October 26, 2023

Caroline Bradley[*]

Corwin and Kahn

Corwin holds that the business judgment rule applies to a transaction decision made by the Board which is approved by a majority of disinterested, fully informed and uncoerced stockholders, so long as there is no conflicted controlling stockholder. Kahn provides that a transaction involving a controlling stockholder will be subject to the business judgment rule if it is both (i) negotiated by a well-functioning special committee of independent directors and (ii) conditioned on the approval of a majority of the minority shareholders. This is another example of the focus on process we have noticed before. The involvement of a controlling stockholder has implications for how much process is necessary to ensure that the business judgment rule applies.

Defining Control

This analysis hinges on the idea of control, which is, as we have noted before, a fluid concept. In Sinclair Oil a 97% stockholder was a dominant stockholder; in Brookfield Asset Management the shareholder had control with shares carrying 51% of the voting rights, but there are other cases where a significantly smaller percentage interest is treated as raising issues of control.

In 2018 the Delaware Chancery Court denied a motion to dismiss a shareholder derivative suit alleging that Tesla's Board breached fiduciary duties in approving an acquisition of Solarcity. Musk was at that time CEO, Board Chair and a 22.1% shareholder in Tesla. He was aslo Chair of the Board of Solarcity and a 21.9% shareholder. Defendants argued that Muck was not a controlling shareholder and the transaction should therefore be reviewed under the BJR, following Corwin. Vice Chancellor Slights found that plaintiffs had adequately alleged that Musk was a controlling shareholder, and that Corwin did not, therefore apply:

"That Musk is the "face of Tesla" cannot meaningfully be disputed.This fact alone, however, is not dispositive of the controller question. Indeed, just recently, in Dell, our Supreme Court relied on this Court's post-trial fact findings to conclude that a management buyout of Dell, Inc. led by Dell's founder and CEO, Michael Dell, was not a controlling stockholder transaction. In reaching that conclusion, however, this Court emphasized that after Mr. Dell announced his intent to pursue the MBO: (1) he immediately advised Dell's board he "did not want to proceed further without approval of the Board, and that he would not engage a financial advisor without first informing the Board"; (2) the board formed an independent committee to negotiate with Mr. Dell and Mr. Dell did not participate in any of the board level discussions regarding a sale of the company; (3) the committee actively explored alternatives to Mr. Dell's MBO proposal and Mr. Dell committed to work with any competing bidders; (4) Mr. Dell agreed to "to join up with whoever" in the event a superior proposal emerged; (5) when the negotiations reached an impasse over price, Mr. Dell agreed to roll over his shares at a lower price than the deal price to resolve the stalemate; and (6) importantly, Mr. Dell entered into a voting agreement that required him and his affiliates to vote their shares "in the same proportion as the number of [s]hares voted by the

[*] Professor of Law, University of Miami School of Law, PO Box 248087, Coral Gables, FL, 33124, cbradley@law.miami.edu. © Caroline Bradley 2023. All rights reserved.

[u]naffiliated [s]tockholders . . . that are voted in favor of the adoption" of either (i) the MBO merger agreement or (ii) a superior proposal. These facts, and perhaps others, allowed the trial court to determine that, at least with respect to the transaction at issue, Mr. Dell did not "dominate the corporate decision-making process."They also provided a basis for the court to resist the instinctive appeal of the "face of the company" argument when engaging in the controlling stockholder analysis.
According to the well-pled facts in the Complaint, there were practically no steps taken to separate Musk from the Board's consideration of the Acquisition. He brought the proposal to the Board not once, not twice, but three times. He then led the Board's discussions regarding the Acquisition throughout its laser focus on SolarCity and was responsible for engaging the Board's advisors. According to the Complaint, the Board never considered forming a committee of disinterested, independent directors to consider the bona fides of the Acquisition. It took that role
upon itself, notwithstanding the obvious conflicts of its members... Under these circumstances, it is appropriate to consider whether Musk brought with him into the boardroom the kind of influence that would support a reasonable inference that he dominated the Board's decision-making with regard to the Acquisition.
When Musk rather insistently brought the proposed acquisition to the Board for consideration, the Board was well aware of Musk's singularly important role in sustaining Tesla in hard times and providing the vision for the Company's success.
"As Tesla has acknowledged, '[i]n addition to serving as the CEO since October 2008, Mr. Musk has contributed significantly and actively to us since our earliest days in April 2004 by recruiting executives and engineers, contributing to the Tesla Roadster's engineering and design, raising capital for us and bringing investors to us, and raising public awareness of the Company.'" When Tesla was on the ropes, Musk infused his own capital into the Company to keep it afloat. His "Master Plans," parts one and "deux," apparently the products of his mind alone, provide the architecture by which the Company has been and will be operated, right down to the acquisition of a solar energy company. Thus, setting aside Musk's and the Company's public acknowledgments of Musk's substantial influence..., and the obvious conflicts at the Board level... , the pled facts reveal many of the markers that have been important to our courts when
determining whether a minority blockholder is a controlling stockholder."[1]

At trial, the Chancery Court applied entire fairness review but found that the Acquisition was entirely fair to Tesla, and the Delaware Supreme Court upheld the decision finding it was supported by the record and there was no reversible error in applying the test. With respect to Kahn v MFW, the Court wrote:

"our decisions — which we continue to adhere to — have established a "best practices" pathway that, if followed, allow for conflicted transactions, such as the Acquisition, to avoid entire fairness review. Tesla's and Musk's determination not to form a special committee invited much risk (not to mention incursion of costs and diversion of personnel to litigation matters). Although the Vice Chancellor aptly observed that perhaps the Tesla Board subjected itself to "unnecessary peril," we also recognize that there may be reasons why a board decides not to employ such devices, including transaction execution risk. Also, a board may wish to maintain some flexibility in the process, as the Tesla Board did here, by having the ability to access the technical expertise and strategic vision and perspectives of the controller. Although we continue to encourage the use of special negotiation committees as a "best practice,"

[1] In Re Tesla Motors, Inc. Stockholder Litigation (Del. Ch. 2018) (footnotes omitted).

nothing in Delaware law requires a board to form a special committee in a conflicted transaction. Here, the price of not utilizing a special committee was being subjected to entire fairness review — an expensive, risky, and "heavy lift" in the litigation arena.
...After hearing extensive testimony and reviewing voluminous evidence, the trial court "searched during [its] deliberations for persuasive evidence that [Musk] exploited the coercion inherent in his status as a controller" to influence the Tesla Board. The court concluded that "any control [Musk] may have attempted to wield in connection with the Acquisition was effectively neutralized by a board focused on the bona fides of the Acquisition, with an indisputably independent director leading the way." It amplified that holding, adding that "even assuming [Musk] had the ability to exercise control over the Tesla Board, the credible evidence produced at trial shows that he simply did not do so with respect to the Acquisition." Thus, Appellants' theory that both MFW mechanisms were needed to neutralize Musk was tested in the trial arena, and the court rejected it. The record supports the trial court's conclusion, which, we note, is heavily dependent upon unchallenged fact and numerous credibility determinations.

Notice that the facts of this case, involving a challenge to an acquisition by Tesla, rather than to a going private transaction, illustrates what some have described as MFW creep.[2] On the other hand, Ann Lipton has argued that the problem may not be subjecting too many transactions to increased procedural requirements or scrutiny, but that perhaps non-controller transactions should be scrutinized more carefully:

“Though, doctrinally, the divergent treatment between controller deals and noncontroller ones may be traceable to controllers' degree of entrenchment (and thus their enhanced capacity for retaliation), that explanation may fail to justify the dramatic differences in how courts approach the two types of cases. The reality is, at least when it comes to major transactions like buyouts and restructurings, the advantages that all insiders enjoy with respect to control over process, information, and timing may be far more important than the risks posed specifically by a spiteful controller....It is one thing to assume that shareholders can ratify an ordinary-course interested
transaction, such as payment of a director's compensation,' and quite another to assume that they can ratify far more complex decisions, like mergers, where no amount of disclosure can level the playing field between insiders and public shareholders,' which is exactly the argument that has been made by numerous scholars criticizing Corwin. If Delaware courts were to restore heightened scrutiny to transformative transactions, at least when they present risks of self dealing, the controlling shareholder label would fade in significance.”[3]

Displacing the BJR

Where Board members want to rely on stockholder approval it is important to note that the stockholder vote must be by disinterested, fully informed, and uncoerced stockholders. Material misstatements and/or omissions in disclosures to the stockholders will remove the

---

[2] Patrick O'Neal, 'Unnecessary Peril': MFW Creep, the MFW Tax, and the Future of Entire Fairness Review in Conflicted Controller Transactions (May 15, 2023). Available at SSRN: https://ssrn.com/abstract=4522546 or http://dx.doi.org/10.2139/ssrn.4522546 .

[3] Ann M. Lipton, *The Three Faces of Control*, 77 BUS. LAW. 801, 827-828 (2022).

protective effect of the stockholder vote. Where negotiation of the transaction by a special committee is required (where there is a controlling stockholder) the directors who are members of the committee must be independent (and this is another area of uncertainty, like the definition of control).