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Controlling Stockholder or Member Status Under Delaware Law – A Table of Key Decisions

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Whether a stockholder of a corporation or member of a limited liability company (LLC) is a controlling stockholder or member often has a significant impact on breach of fiduciary duty actions, including those arising out of merger and acquisition (M&A) transactions. Indeed, when a stockholder or member is a controller, there are two primary consequences.

First, the stockholder or member owes fiduciary duties and is a possible target of a fiduciary duty claim. Second, unless certain procedural safeguards are put in place, if the controlling stockholder or member is conflicted, a court will closely scrutinize the challenged M&A transaction under the entire fairness standard of review, instead of deferring to the directors' or managers' decision-making under the business judgment rule.[1]

Where entire fairness review is triggered, it is exceedingly difficult to secure dismissal of a fiduciary duty action at the pleading stage, which means that the action will likely proceed to discovery. Because discovery in such actions is costly, time-consuming, and distracting to management, it is advisable for stockholders or members to avoid controller-status where possible and practical.

Thus, we have reviewed dozens of Delaware decisions analyzing whether a stockholder or member is a controller, summarized in the accompanying Table the key factors involved in the opinions, outlined some of the primary takeaways from the caselaw collectively, and provided high-level guidelines for avoiding controller status based upon our review of the caselaw.

The Table and guidance is intended to serve as a guide for corporate stockholders and LLC members, including private equity (PE) and venture capital (VC) firms, seeking to minimize the risk of being deemed a controlling stockholder or member that owes fiduciary duties under Delaware law. It may be used together with our previously released Flowchart of Delaware Standards of Review, which is designed to serve as a high-level tool to assess which standard of review might apply to a given M&A transaction.

Overview

As depicted in the Flowchart, a plaintiff can rebut the business judgment rule and trigger entire fairness review by showing that: (i) a controlling stockholder stands on both sides of a transaction, receives consideration different than that received from other stockholders, or receives a unique benefit from the transaction; or (ii) at least half of the directors who approved the transaction were not disinterested or independent.[2]

Thus, the first step in assessing the proper standard review is often analyzing whether there is a conflicted controlling stockholder or member. Delaware law is clear that stockholders and members in manager-managed LLCs do not owe fiduciary duties, unless they are deemed to be controllers.[3] A stockholder or member, such as a PE or VC firm, will be deemed to be a controller (and therefore owe fiduciary duties) only when it owns more than 50 percent of the company's stock or membership interests, or if the member or stockholder owns less than 50 percent of the company's stock or membership interests, but nevertheless exercises "actual control" over the company in general or the specific transaction at issue.[4]

The "actual control" test requires the court to undertake an analysis of whether, "despite owning a minority of shares, the alleged controller wields 'such formidable voting and managerial power that, as a practical matter, it is no differently situated than if it had majority voting control."[5] "Making this showing is no easy task, as the minority blockholder's power must be so potent that it triggers . . . concern that independent directors' free exercise of judgment has been compromised."[6]

Determining whether a less-than-majority stockholder or member exercises actual control over the company is a fact-specific inquiry involving the analysis of multiple factors, including:

- Ownership or control over a significant portion of the corporation's equity.
- The right or ability to designate directors.
- The existence of provisions in governance documents that enhance the power of the stockholder or member, such as negative voting power.
- The degree of control the stockholder or member has over particular directors.
- The degree of control the stockholder or member has over key managers or advisers that play a critical role in presenting information and making recommendations.
- The ability to exercise contractual rights to channel the company into a particular outcome by blocking or restricting other paths.
- Other commercial relationships with the company that provide the stockholder or member with leverage over the corporation, such as lending relationships.
- The ability to influence decisions through high-status roles, such as CEO, chairman, or founder, or coercive action, such as threats of retribution.[7]

Given the myriad of factors involved in determining whether a stockholder or member is a controlling one, there are no bright line rules and the analysis is often fact specific.[8] That said, there are a number of takeaways that can be gleaned from the decisions to help guide a less-than-majority stockholder or member seeking to avoid controller status.

Key Takeaways Regarding Controller Status

<u>First</u>, limiting the stockholder's or member's ownership stake to below 35% may help ward off a finding of control. It is recognized in Delaware case law that the "level of stock ownership is not the predominant factor" in a

controller analysis,[9] and that Delaware courts do not mechanically apply a "linear, sliding-scale approach whereby a larger share percentage makes it substantially more likely that the court will find the stockholder [or member] [to be] a controll[er]."[10] That is evidenced by the fact that stockholders or members owning as little as 15%, 17%, 22%, 26%, and 28%[11] equity stakes have been deemed controllers, and stockholders or members owning as high as 49%, 47%, 46%, and 44%[12] have been held *not* to be controllers. Indeed, as the Court of Chancery recently held, a person or entity may be deemed to be a controller *even if that person or entity does not own any stock at all.*[13]

That said, it is undeniable that size matters in the controller context. For one, recent caselaw in particular has recognized the significant influence that large voting blocks, particularly those 35% and greater, have on the outcome of stockholder votes.[14] Moreover, anecdotal data from the cases summarized in the Table show that stockholders or members owning 35% or more of a company's voting equity were deemed to be controllers at more than double the rate as stockholders or members with ownership stakes below that threshold. Six of eighteen (~33%) of the cases in which the stockholder(s) or member(s) owned less than 35% were deemed to be controllers. Two of six (~33%) of the cases in which the stockholder(s) or member(s) owned between 25% and 35% were deemed to be controllers. In stark contrast, thirteen of nineteen (~68%) of the cases in which the stockholder or member owned 35% or more were deemed to be controllers.

Second, independence of the board, special committee, and key officers and advisers is often paramount in determining whether a stockholder or member is a controller. There is authority for the proposition that the mere fact that at least half of the directors lack independence from a stockholder or member does not necessarily deem the stockholder or member to be a controller.[15] It should come as no surprise, however, that stockholders or members were deemed controllers in *all* of the cases in the Table in which there were well-pled allegations or proof that at least half of the board or special committee charged with considering or approving the challenged transaction lacked independence from the stockholders or members, either because of their close ties to the alleged controller or because of the alleged controller's outsized influence in the boardroom.[16] That is so even where their ownership interest was relatively small.[17]

Third, although the mere exercise of contractual rights, such as blocking rights, will not render a stockholder or member a controller, if such rights are used to channel the company into a particular outcome that is unfair to the company, then the stockholder or member may be deemed to be a controller and be required to demonstrate the fairness of its actions. Indeed, although Delaware case law is clear that "a significant shareholder [or member], who exercises a duly-obtained contractual right that somehow limits or restricts the actions that a [company] otherwise would take, does not become, without more, a controll[er],"[18] there "may be circumstances where the holding [or exercise] of contractual rights, coupled with a significant equity position and other factors, will support the finding" of controller-status."[19] As summarized in the Table, stockholders or members were deemed controllers in all of the cases we reviewed in which there were well pled allegations or proof that those stockholders or members weaponized certain contractual rights to secure benefits for themselves at the expense of other stockholders/members.[20] Again, that is so even where their equity interest was relatively small.[21]

<u>Fourth</u>, in contrast to weaponizing contractual *rights*, agreeing to certain contractual *limitations* may guard against a finding of control. For instance, the Court of Chancery has held that a stockholder was not a controlling one, in part because a stockholders agreement prohibited the stockholder from accumulating more than 35% of the stockholder vote, designating more than four of ten directors, and soliciting proxies or consents, and the

corporation's charter required the transaction in question to be approved by independent directors and unaffiliated stockholders.[22]

<u>Fifth</u>, while perhaps the least influential factor, statements in public disclosures often impact the Court's analysis as to whether the stockholder or member in question is a controller, particularly at the pleading stage.[23]

Ways to Minimize Risk of Controller-Status

Based upon the above, a stockholder or member seeking to minimize the likelihood of being deemed a controller and owing fiduciary duties should consider the following:

- 1. Limit Ownership Stake. While not dispositive and perhaps obvious, maintaining a lower ownership stake will decrease the likelihood of being deemed a controller. As explained above, recent Delaware decisions have seemingly given greater weight to the influence that large voting blocks have on the outcome of stockholder votes than earlier decisions, which focused more heavily on board control. Moreover, although anecdotal in nature, Delaware courts have held that stockholders and members owning less than 35% of a company's equity to be controllers at less than half the rate than stockholders or members that owning equity at or above that threshold, which supports the notion that block size matters.
- 2. Ensure Board and Committee Independence. Large stockholders or members should ensure that a majority of the board of directors/managers or special committee members are undeniably independent. That means that more than half of the board or committee should have no material financial or personal ties to the stockholder or member. It also means that substantial stockholders or members should give the members of the board or committee tasked with considering a transaction the freedom to exercise their business judgment free from interference, threats, and/or coercion from the stockholder or member.
- 3. Foster Officer and Adviser Independence. Relatedly, the officers and advisers tasked with presenting information and making recommendations to the board with respect to a proposed transaction should also be independent. Thus, the officers and advisers tasked with those roles should not have material financial or personal ties to the significant stockholder or member. Moreover, stockholders, members, and their board designees should avoid interfering or appearing to interfere with or circumvent such officers' and advisers' information sharing and decision-making processes. Independent and disinterested officers and advisers should be given the latitude to reach their own conclusions and make their own recommendations.
- 4. Avoid Weaponizing Contractual Rights. Significant stockholders or members should feel free to exercise their bargained-for contractual rights, such as blocking or veto rights. That said, stockholders or members should avoid weaponizing those rights. That is, they should not utilize such rights to channel the company into a particular outcome that benefits that stockholder or member to the detriment of the company and the other stockholders or members, such as by forcing the company to accept the stockholder's or member's proposed transaction, even though that transaction has more onerous terms than other available alternatives.
- 5. Consider Agreeing to Contractual Limitations on Control. Although not necessary, a stockholder or member can reduce the risk of being deemed a controller by agreeing to certain contractual limitations on its ability to control the company, such as agreements not to accumulate more than a certain percentage of the company's equity, designate, nominate, or elect more than a minority of a company's directors, or solicit proxies or consents. The stockholder or member could also agree to contractual requirements that require approval of certain transactions by directors and stockholders unaffiliated with the large stockholder or member.
- 6. Consider the Necessity of Public Statements Regarding Control. As noted above, when analyzing whether a stockholder or member is a controller, Delaware courts often cite public statements made by the stockholder, member, or the company regarding the stockholder's or member's ability to influence company decisions. While federal securities laws and other disclosure obligations must be considered, those requirements should be weighed against the possibility of such disclosures being used against the company's stockholders or members and directors or managers in breach of fiduciary duty actions. Even if some disclosure is required, the specific substance of such disclosures should be carefully crafted. For instance, disclosures that conclude that a stockholder or member is a controlling one may be neither required nor advisable; the facts underlying such conclusion may suffice.

- [1] See Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014).
- [2] Sciabacucchi v. Liberty Broadband Corp., 2017 WL 2352152, at *16 (Del. Ch. May 31, 2017).
- [3] Voigt v. Metcalf, 2020 WL 614999, at *10 (Del. Ch. Feb. 10, 2020).
- [4] Kahn v. Lynch Commc'n Sys., Inc. 638 A.2d 1110, 1113 (Del. 1994).
- [5] Reith v. Lichtenstein, 2019 WL 2714065, at *7 (Del. Ch. June 28, 2019).
- [6] Larkin v. Shah, 2016 WL 4485447, at *13 (Del. Ch. Aug. 25, 2016).
- [7] Basho Techs. Holdco B, LLC v. Georgetown Basho Invs., LLC, 2018 WL 3326693, at *28 (Del. Ch. July 6, 2018), aff'd sub nom. Davenport v. Basho Techs. Holdco B, LLC, 221 A.3d 100 (Del. 2019).
- [8] In re GGP, Inc. S'holder Litig., 2021 WL 2102326, at *12 (Del. Ch. May 25, 2021) (pleading actual control is "an intensely factual' inquiry that is often 'difficult [] to resolve on the pleadings,' [but] a plaintiff cannot simply allege that a minority blockholder is a controller, tout its substantial holdings and commensurate influence, leave it at that and then hope to survive a motion to dismiss. More is needed.").
- [9] *In re GGP, Inc. S'holder Litig.*, 2021 WL 2102326, at *21 (Del. Ch. May 25, 2021) ("Far from dispositive, this court's evaluation of a blockholder's voting power based on hypothetical voter turnout has, since its genesis, been merely one of a mix of factors to be considered in the controlling stockholder analysis."); *FrontFour Capital Gp. LLC v. Taube*, 2019 WL 1313408, at *21 (Del. Ch. Mar. 11, 2019).
- [10] In re Crimson Expl. Inc. Stockholder Litig., 2014 WL 5449419, at *10 (Del. Ch. Oct. 24, 2014).
- [11] FrontFour Cap. Grp. LLC v. Taube, 2019 WL 1313408 (Del. Ch. Mar. 11, 2019) (15%); Williamson v. Cox Commc'ns, Inc., 2006 WL 1586375 (Del. Ch. June 5, 2006) (17%); In re Tesla Motors, Inc. S'holder Litig., 2018 WL 1560293 (Del. Ch. Mar. 28, 2018) (22%); In re Zhongpin Inc. Stockholders Litig., 2014 WL 6735457 (Del. Ch. Nov. 26, 2014) (26%); Skye Min. Invs., LLC v. DXS Cap. (U.S.) Ltd., 2020 WL 881544 (Del. Ch. Feb. 24, 2020) (28%).
- [12] Citron v. Steego Corp., 1988 WL 94738 (Del. Ch. Sept. 9, 1988) (49%); Odyssey Partners, L.P. v. Fleming Companies, Inc., 735 A.2d 386, 392 (Del. Ch. 1999) (47%); In re W. Nat. Corp. S'holders Litig., 2000 WL 710192 (Del. Ch. May 22, 2000) (46%); Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971) (46%); Superior Vision Servs., Inc. v. ReliaStar Life Ins. Co., 2006 WL 2521426 (Del. Ch. Aug. 25, 2006) (44%).
- [13] In re Pattern Energy Grp. Inc. S'holders Litig., 2021 WL 1812674, at *40 (Del. Ch. May 6, 2021) ("With this foundation, and considering evolving market realities and corporate structures affording effective control, Delaware law may countenance extending controller status and fiduciary duties to a nonstockholder that holds and exercises soft power that displaces the will of the board with respect to a particular decision or transaction.").
- [14] Compare In re Cysive, Inc. S'holders Litig., 836 A.2d 531, 551 (Del. Ch. 2003) (deeming "about 40% of the

voting equity" significant); Neil Ross v. Lineage Cell Therapeutics, Inc., C.A. No. 2019-0822-AGB (Del. Ch. Oct. 5, 2020) (TRANSCRIPT) (noting that "[a] 38.9 percent block of shares takes on particular significance" where "voter turnout" was low); Voigt v. Metcalf, 2020 WL 614999, at *19 (Del. Ch. Feb. 10, 2020) (noting that "if the holder of a 35% block favors a particular outcome at a meeting, then the blockholder will win as long as holders of 1-in-7 shares vote the same way. The opponents must garner over 90% of the unaffiliated shares to win. . . . Based on the math alone, large blocks at levels of 35% . . . carry significant influence.") (emphasis added); Reith v. Lichtenstein, 2019 WL 2714065, at *8 (Del. Ch. June 28, 2019) (stating that a "35.62% stake in the Company is not enough [to establish control] on its own, but it is "a large enough block of stock to be the dominant force in any contested election."); with In re GGP, Inc. S'holder Litig., 2021 WL 2102326, at *20 (Del. Ch. May 25, 2021) ("[A]n ownership stake approximating Brookfield's 35.3% is 'not impressive on its own.'"; "While judges certainly should be, and are, mindful of the practical reality of an alleged controller's voting power, a 35.3% equity stake does not transmogrify a minority blockholder into a controlling stockholder (with the accompanying fiduciary duties to match). No amount of mental or mathematical gymnastics can establish controllership by metaphysically stretching one-third into more than one-half."); In re Rouse Props., Inc., 2018 WL 1226015, at *18 (Del. Ch. Mar. 9. 2018) ("Brookfield's 33.5% ownership stake in Rouse is not impressive on its own."); In re PNB Hldg. Co. S'holders Litig., 2006 WL 2403999, at *10 (Del. Ch. Aug. 18, 2006) (describing a 33.5% ownership group as "an overall level of ownership that is relatively low" and would require "additional facts supplementing [the stockholder's] clout"); Zlotnick v. Newell Companies, 1984 WL 8242, at *2 (Del. Ch. July 30, 1984) (33% ownership "means little" in the controller analysis); cf. Basho, 2018 WL 3326693, at *27, n. 319, 322.

[15] See In re Rouse Properties, Inc., 2018 WL 1226015, at *15 (Del. Ch. Mar. 9, 2018) ("[I]t does not necessarily follow that an interested party also controls directors, simply because they lack independence. Lack of independence focuses on the director, and whether she has a conflict in the exercise of her duty on behalf of her corporation. Consideration of controller status focuses on the alleged controller, and whether it effectively controls the board of directors so that it also controls disposition of the interests of the unaffiliated stockholders."); Sciabacucchi v. Liberty Broadband Corp., 2017 WL 2352152, at *17-19 (Del. Ch. May 31, 2017) ("[T]he Plaintiff appears to be conflating a pleading that a majority of the Board lacked independence from an interested party, with a pleading of actual control by that interested party.").

[16] FrontFour Cap. Grp. LLC v. Taube, 2019 WL 1313408 (Del. Ch. Mar. 11, 2019); In re Tesla Motors, Inc. S'holder Litig., 2018 WL 1560293 (Del. Ch. Mar. 28, 2018); Voigt v. Metcalf, 2020 WL 614999 (Del. Ch. Feb. 10, 2020); Reith v. Lichtenstein, 2019 WL 2714065 (Del. Ch. June 28, 2019); In re Loral Space & Commc'ns Inc., 2008 WL 4293781 (Del. Ch. Sept. 19, 2008); In re Tri-Star Pictures, Inc., Litig., 634 A.2d 319 (Del. 1993); Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110 (Del. 1994); Harbor Fin. Partners v. Sugarman, 1997 WL 162175 (Del. Ch. Apr. 3, 1997); Zimmerman v. Braddock, 2005 WL 2266566 (Del. Ch. Sept. 8, 2005), rev'd on other grounds, 906 A.2d 776 (Del. 2006); Arkansas Tchr. Ret. Sys. v. Alon USA Energy, Inc., 2019 WL 2714331 (Del. Ch. June 28, 2019).

[17] FrontFour Cap. Grp. LLC v. Taube, 2019 WL 1313408 (Del. Ch. Mar. 11, 2019) (15%); In re Tesla Motors, Inc. S'holder Litig., 2018 WL 1560293 (Del. Ch. Mar. 28, 2018) (22.1%).

[18] Superior Vision Servs., Inc. v. ReliaStar Life Ins. Co., 2006 WL 2521426, at *5 (Del. Ch. Aug. 25, 2006).

[19] Id.

[20] Skye Min. Invs., LLC v. DXS Cap. (U.S.) Ltd., 2020 WL 881544 (Del. Ch. Feb. 24, 2020); Basho Techs. Holdco B, LLC v. Georgetown Basho Invs., LLC, 2018 WL 3326693 (Del. Ch. July 6, 2018); Hamilton Partners, L.P. v. Highland Cap. Mgmt., L.P., 2014 WL 1813340 (Del. Ch. May 7, 2014); O'Reilly v. Transworld Healthcare, Inc., 745 A.2d 902 (Del. Ch. 1999); Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1113 (Del. 1994); see also In re Pattern Energy Grp. Inc. S'holders Litig., 2021 WL 1812674, at *45 (Del. Ch. May 6, 2021).

[21] See Skye Min. Invs., LLC v. DXS Cap. (U.S.) Ltd., 2020 WL 881544 (Del. Ch. Feb. 24, 2020) (weaponization of blocking rights deemed 28.07% member to be controller at motion to dismiss stage).

[22] Sciabacucchi v. Liberty Broadband Corp., 2017 WL 2352152, at *117-19 (Del. Ch. May 31, 2017); cf. Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd, 177 A.3d 1, 20 (Del. 2017); Di Nardo v. Renzi, 1987 WL 10014, at *3 (concluding that a majority stockholder can lack the ability to exercise control where it has contractual limitations on its ability to vote shares).

[23] See e.g., In re Tesla Motors, Inc. S'holder Litig., 2018 WL 1560293 (Del. Ch. Mar. 28, 2018); In re Zhongpin Inc.Stockholders Litig., 2014 WL 6735457 (Del. Ch. Nov. 26, 2014), rev'd sub nom. on other grounds, In re Cornerstone Therapeutics Inc, S'holder Litig., 115 A.3d 1173 (Del. 2015); In re Primedia Inc. Derivative Litig., 910 A.2d 248, 258 (Del. Ch. 2006).

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