DELAWARE CORPORATE LAW BULLETIN

Chancery Court Determines That 22.1% Stockholder Controls Corporation, Rendering C*orwin* Inapplicable

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Determines on a "close call" that minority blockholder exhibited sufficient indicia of control to create "inherent coercion"

INTRODUCTION

Under the Delaware Supreme Court's landmark 2015 decision in *Corwin v. KKR Fin. Holdings, LLC,* 125 A.3d 304 (Del. 2015) ("*Corwin*"), the business judgment standard of review applies where a corporate acquisition is approved by a majority vote of disinterested

stockholders. *Corwin* stands for the proposition that if defendant directors can establish that the stockholder vote approving the acquisition was both (1) uncoerced and (2) fully informed, then, absent a sufficient pleading of waste, a post-closing damages action will be dismissed at the pleading stage.

The concept of coercion in the *Corwin* context was addressed by Vice Chancellor Joseph R. Slights of the Delaware Court of Chancery ("*Chancery Court*") in *In re Rouse Properties, Inc. Fiduciary Litigation,* C.A. No. 12194-VCS, 2018 WL 1226015 (Del. Ch. Mar. 9, 2018) (*"Rouse"*). According to *Rouse*, "a stockholder vote will have no cleansing effect if the vote 'may reasonably be seen as driven by matters [other than] the merits of the transaction.' " Further, "[t]he coercion analysis focuses on whether the stockholders were able to exercise their right to vote 'free of undue pressure created by the fiduciary that distracts them from the merits of the decision under consideration.' " (For a discussion of *Rouse*, see Robert S. Reder, *Chancery Court Finds Corwin Applicable to Merger Transaction Negotiated with 33.5% Stockholder*, 72 VAND. L. REV. EN BANC 50 (2018).)

In *Rouse*, Vice Chancellor Slights identified three ways in which a stockholder vote may be found to have been coerced:

1. *Inherent coercion* is present "in transactions involving conflicted controlling stockholders," but only if the controlling stockholder has extracted personal benefits such as a controlling stockholder buyout of the company or a third-party buyout in which the controlling stockholder receives favorable treatment in relation to other stockholders.
2. *Structural coercion* is present when a board of directors "structures the vote in a manner that requires stockholders to base their decision on factors extraneous to the economic merits of the transaction at issue."
3. *Situational coercion* is present when a board of directors, "by its conduct, creates a situation where 'stockholders are being asked to [vote] in ignorance or mistaken belief as to the value of the[ir] shares.'"

As an aside, for a discussion of relevant Chancery Court decisions cited by the *Rouse* Court, see Robert S. Reder & Tiffany M. Burba, *Delaware Courts Confront Question Whether "Cleansing Effect" of* Corwin *Applies to Duty of Loyalty Claims*, 70 VAND. L. REV. EN BANC 35 (2017); Robert S. Reder, *Delaware Court Refuses to Invoke* Corwin *to "Cleanse" Alleged Director Misconduct Despite Stockholder Vote Approving Merger*, 70 VAND. L. REV. EN BANC 47 (2017); and Robert S. Reder & Tiffany M. Burba, *Delaware Courts Diverge on Whether "Cleansing Effect" of*

Corwin *Applies to Duty of Loyalty Claims*, 70 VAND. L. REV. EN BANC 1 (2017).

With respect to *inherent coercion*, Vice Chancellor Slights explained that "our law recognizes that 'controller transactions are inherently coercive,' and that a transaction with a controller 'cannot, therefore, be ratified by a vote of the unaffiliated majority.' " *Rouse* arose in the context of the acquisition of a company by a "minority blockholder" owning less than 50 percent of the company's stock. The Vice Chancellor determined that a 33.5 percent stockholder *did not control* the target company for purposes of his *Corwin* analysis. The following factors were cited by the Vice Chancellor in support of his conclusion:

- The blockholder's 33.5 percent ownership stake "is not impressive on its own," nor did the blockholder have any practical or contractual ability to elect or remove directors.
- Public disclosures that the blockholder " 'may exert influence over us that may be adverse to our best interests and those of our other stockholders' is a far cry from the outright admission that a minority blockholder was the corporation's 'controlling stockholder' that the [Chancery C]ourt deemed persuasive evidence of control" in an earlier decision.
- In contrast to an earlier decision in which a "40% blockholder [who] was the Chairman and CEO of the company . . . was, 'by admission, involved in all aspects of the company's business, [and] was the company's creator, and . . . inspirational force,' [and] . . . could, in his roles as CEO and 40% blockholder, wield 'his voting power . . . to elect a new slate [of directors] more to his liking . . . ,' " was determined to be a controlling stockholder, the *Rouse* plaintiffs "failed to plead facts that allowed a reasonable inference that [the blockholder] exercised 'influence over even the ordinary managerial operations of the company,' much less actual control over a majority of the company's board."

Less than three weeks after deciding in *Rouse* that a 33.5 percent minority blockholder *was not* a controlling stockholder, Vice Chancellor Slights ruled in *Tesla Motors, Inc. Stockholder Litigation*, C.A. No. 12711-VCS, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018) ("*Tesla*"), on the basis of a very different record, that a 22.1 percent minority blockholder *was* in a control position. Among other things, these decisions demonstrate there is no bright line for determining whether a minority blockholder controls a corporation. To the contrary, the underlying facts, evaluated in light of available Chancery Court precedent, are of paramount importance.

I. FACTUAL BACKGROUND

Tesla, Inc. ("*Tesla*") "designs, develops, manufactures and sells electric vehicles and energy storage products." Tesla's seven-person board of directors (the "*Tesla Board*") includes Elon Musk, who is Tesla's "largest stockholder" (owning 22.1 percent of the outstanding common stock), Chairman, CEO, and Chief Product Architect. Tesla's public filings with the Securities and Exchange Commission ("*SEC*") admit Tesla "is 'highly dependent on the services of Elon Musk' and acknowledge[ ] that if it were to lose Musk's services, the loss would . . . 'negatively impact [its] business, prospects and operating results as well as cause [its] stock price to decline.' " Moreover, the Tesla Board is populated with Musk's "close friends," business associates, and co-investors. In fact, Tesla's "SEC filings acknowledge that the 'concentration of ownership among [Tesla's] existing executive officers, directors and their affiliates may prevent new investors from influencing significant corporate decisions.' "

SolarCity Corporation ("*SolarCity*"), founded by Musk and his two cousins, "principally operated as a solar energy system installer." Musk also served on SolarCity's board of directors (the "*SolarCity Board*") and was its "largest stockholder, holding approximately 21.9 percent of the common stock." Musk apparently commented that "Tesla, SolarCity and SpaceX form a 'pyramid' on top of which he sits, and that it is 'important that there not be some sort of house of cards that crumbles if one element of the pyramid . . . falters.' "

By June 2016, SolarCity faced both a "liquidity crisis" and a looming default under its revolving credit agreement, in each case stemming from a "thirteen-fold" increase in its debt over the previous three years. SolarCity also had experienced a 64 percent decline in its stock price and faced litigation over important intellectual property rights. Concerned with a potential collapse of the "house of cards," Musk doggedly promoted a merger between Tesla and SolarCity at a series of Tesla Board meetings, pointing to "the possible benefits . . . [of] acquiring a solar energy company in the context of [Tesla's] strategic plan." The Tesla Board considered no other potential solar energy targets despite one prominent investment banker's characterization of SolarCity as "the 'worst positioned' company in the solar energy sector. "

Once Musk convinced the Tesla Board to pursue his idea, on June 21, 2016, Tesla announced an offer to purchase SolarCity in a stock-for-stock merger valued at $26.50 to $28.50 per SolarCity share, representing a 21 to 30 percent premium to SolarCity's trading price. As negotiations between the two companies proceeded, Musk actively

promoted the deal at investor conferences and in social media. The two companies announced their agreement to merge on August 1. The final negotiated price "valued SolarCity at . . . $25.37 per share," slightly below the range set forth in Tesla's initial offer. Although not required to do so, the Tesla Board submitted the merger to Tesla stockholders for approval. Excluding shares owned by Musk and certain other SolarCity stockholders, the transaction was approved by a 58 percent majority of the Tesla shares entitled to vote. (As noted by Vice Chancellor Slights, not quite the " 'overwhelming' majority" announced by Tesla.) When the merger "closed on November 21, 2016 . . . with the stroke of a pen, Tesla's debt load nearly doubled."

After public announcement of the transaction, several lawsuits, subsequently consolidated, were filed by Tesla stockholders in the Chancery Court. The consolidated action ultimately included several counts, including (1) with respect to Musk, "breach of fiduciary duty . . . as Tesla's controlling stockholder for using 'his control over the corporate machinery to, among other things, orchestrate [Tesla] Board approval of the Acquisition' "; and (2) with respect to the Tesla Board, "breach of the fiduciary duties of loyalty and care by approving and executing the Acquisition, which 'unduly benefit[ted] controlling stockholder Elon Musk' " and "breach of the duty of disclosure for failure to make accurate and non-misleading disclosures to Tesla's stockholders in connection with the Acquisition and any stockholder vote."

Defendants moved to dismiss, citing the "cleansing" impact of the Tesla stockholder vote under *Corwin*. Plaintiffs countered that defendants were not entitled to assert a *Corwin* defense "because the Acquisition involved a conflicted controlling stockholder (Musk)." Defendants in turn contested this argument on the basis that "[p]laintiffs have failed to plead facts that would support a reasonable inference that Musk, as a minority blockholder, exercised either control over Tesla generally or control over Tesla's Board during its consideration and approval of the Acquisition."

II. VICE CHANCELLOR SLIGHTS'S ANALYSIS

Because defendants' "showcase defense rests on *Corwin*," Vice Chancellor Slights focused his analysis on whether Musk was Tesla's "controlling stockholder," thereby rendering *Corwin* inapplicable. Because the Vice Chancellor concluded that plaintiffs' "[c]omplaint pleads facts that allow reasonable inferences that Musk was a controlling stockholder . . . I *begin and end* my analysis of the motion to dismiss here" (emphasis added). It is also worth noting, however, that

the Vice Chancellor did not find the availability of the *Corwin* defense negatively impacted by either the facts that the stockholder vote was (i) at the acquiring company rather than (as more typical) the target company, or (ii) undertaken on a voluntary basis rather than required by statute or corporate charter.

A. Controlling Stockholder Analysis

Vice Chancellor Slights explained that a stockholder will be deemed "controlling" if the stockholder either "(1) owns more than 50% of the voting power of a corporation or (2) owns less than 50% of the voting power of the corporation but '*exercises control* over the business affairs of the corporation.' " Because Musk is a *minority* blockholder, "the inquiry is whether Musk 'exercised actual domination and control over . . . [the] directors,' " giving him power "so potent that independent directors . . . [could not] freely exercise their judgment."

In this connection, the Vice Chancellor explained that plaintiffs' burden "is to 'show it is ***reasonably conceivable*** that [Musk] controlled [Tesla].' " The Vice Chancellor offered two alternatives for plaintiffs to successfully plead that a minority blockholder "exercises control": the blockholder either "actually dominated and controlled the corporation, its board or the deciding committee with respect to the challenged transaction or . . . actually dominated and controlled the majority of the board generally."

B. Is Musk a Controlling Stockholder?

Applying the standards summarized above, Vice Chancellor Slights concluded, on "a close call," that plaintiffs' complaint "pleads sufficient facts to support a reasonable inference that Musk exercised his influence as a controlling stockholder with respect to" Tesla's purchase of SolarCity. Rather than relying on any one of the indicia of control outlined below, the Vice Chancellor viewed "the combination of [plaintiffs'] well-pled facts" as driving his conclusion to reject defendants' motion to dismiss. Nevertheless, he cautioned, "[t]he facts developed in discovery may well demonstrate otherwise" as to Musk's status as a controlling stockholder.

1. Musk's Control of the Vote:

- While Musk's 22.1 percent stock ownership in Tesla is " 'relatively low' reflecting a 'small block,' " "[a]ctual control over business affairs may stem from sources extraneous to stock ownership." Further, "there is no 'linear, sliding scale approach whereby a

larger share percentage makes it substantially more likely that the court will find the stockholder was a controlling stockholder."

- Allegations that "Musk has demonstrated a willingness to facilitate the ouster of senior management when displeased," based on Musk's apparent ouster of Tesla's founder and CEO at some point after his initial investment in Tesla.
- Tesla's bylaws contained "several supermajority voting requirements," giving Musk a near veto over various key corporate matters.

2. *Musk's Control of the Tesla Board*:
   - Not only was Musk "the 'face of Tesla,' " but "there were practically no steps taken to separate Musk from the Board's consideration of the Acquisition." In this connection, the Vice Chancellor contrasted the safeguards agreed to by Michael Dell in connection with his buyout of Dell, Inc., including formation of a special committee of independent directors, active consideration by the committee of alternative transactions, creation of a level playing field for all bidders, and Mr. Dell's agreement to participate with the eventual winning bidder, even if not his personal favorite. (For two discussions of the appraisal action arising from the Dell buyout, see Robert S. Reder & Loren D. Goodman, Dell *Appraisal Proceeding: Delaware Court of Chancery Finds Price Payable in Management Buyout Understates "Fair Value" by 28%*, 70 VAND. L. REV. EN BANC 11 (2017); and Robert S. Reder & Stanley Onyeador, *Delaware Chancery Disqualifies Lead Petitioner in* Dell *Appraisal Who Inadvertently Voted "FOR" Management Buyout*, 69 VAND. L. REV. EN BANC 279 (2016)).
   - Musk persistently urged the Tesla Board to pursue the purchase of SolarCity, he retained the Tesla Board's advisors, and the Tesla Board "never considered forming a committee of disinterested, independent directors to consider the *bona fides* of the Acquisition."
   - Further, the directors were "well aware of Musk's singularly important role in sustaining Tesla in hard times and providing the vision for the Company's success," including the purchase of SolarCity.

3. *Tesla Board-Level Conflicts*:
   - The Vice Chancellor noted that while "[t]he question of whether a board is comprised of independent or disinterested directors is

relevant to the controlling stockholder inquiry," "[e]ven an independent, disinterested director can be dominated in his decision-making by a controlling stockholder."

- Further, "[a] director is even less likely to offer principled resistance when the matter under consideration will benefit him or a controller to whom he is beholden."
- The Vice Chancellor noted the Tesla Board's failure to establish an independent committee to consider the merits of the purchase of SolarCity, even though "it is reasonably conceivable that a majority of the . . . Board members . . . were interested in the Acquisition or not independent of Musk."
- In this connection, the Vice Chancellor pointed to a number of relationships between Musk and various Tesla directors, including lengthy service on the Tesla Board, "Musk gifting to [one director] the first Tesla Model S and the second Tesla Model X ever made," and overlapping investments in a variety of entities.

4. *Public Acknowledgment of Musk's Control*:
   - Tesla's public filings emphasize its reliance on Musk and the disruption that would occur in his absence. Further, Musk publicly refers to Tesla as "his company."
   - While neither Tesla nor Musk have conceded his status as a controlling stockholder, his "substantially outsized influence . . . do[es] bear on the controlling stockholder inquiry."

CONCLUSION

That Vice Chancellor Slights, on the basis of the contrasting records before him, reached different conclusions on controlling stockholder status in *Tesla* and *Rouse* demonstrates the fact-reliant nature of this inquiry. And the size of a majority blockholder's stake is certainly no predictor of the outcome of a controlling stockholder analysis. As the *Tesla* defendants learned, deal planners take a risk in assuming a *Corwin* defense will be available when majority stockholders are asked to approve a transaction where a minority blockholder sits on both sides.

Of course, there is an *ex ante* approach available to deal planners when the presence of a minority blockholder clouds the applicability of the *ex post Corwin* defense: the six-factor process, now commonly referred to as the "*M&F Framework,*" laid out by the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.* 88 A.3d 635 (Del. 2014) ("*Kahn*"). Under *Kahn*, when a control stockholder, from the earliest

days of a transaction, conditions a proposed buyout on approval by *both* a special committee of independent directors *and* an informed vote of a majority of public stockholders, the transaction will be reviewed under the deferential business judgment rule. On that basis, pleading stage-dismissal of a stockholder challenge to the transaction will typically result. (For a discussion of a recent application of the *M&F Framework* by the Chancery Court, see Robert S. Reder, *Delaware Court Grants Pleading-Stage Dismissal of Litigation Challenging Control Stockholder-Led Buyout*, 70 VAND. L. REV. EN BANC 217 (2017)).