# DELAWARE CORPORATE LAW BULLETIN

# Chancery Court Again Rejects Motion by Large Minority Blockholder to Dismiss Fiduciary Breach Claims Under *Corwin*

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*Extends presumption of controlling stockholder "inherent coercion" to summary judgment stage even absent evidence of actual coercion*

## INTRODUCTION

In 2016, Elon Musk ("*Musk*"), the largest stockholder and CEO of publicly traded Tesla, Inc. ("*Tesla*"), engineered a merger between Tesla and another corporation in which he owned a large block of shares, publicly traded SolarCity Corporation ("*SolarCity*"). Not surprisingly, the transaction was challenged by unhappy Tesla stockholders in the Delaware Court of Chancery ("*Chancery Court*"), who alleged that the transaction was the product of a breach of fiduciary duties by Musk and the other Tesla directors. This litigation in turn has produced two significant decisions by Vice Chancellor Joseph R. Slights III concerning Musk's potential status as Tesla's "controlling stockholder" and the implications of that status on the defense asserted by Musk and his fellow Tesla directors under *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015) ("*Corwin*"). *See In re Tesla Motors, Inc. S'holder Litig.*, No. 12711-VCS, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018) ("*Tesla I*"); *In re Tesla Motors, Inc. S'holder Litig.*, No. 12711-VCS, 2020 WL 553902 (Del. Ch. Feb. 4, 2020) ("*Tesla II*").

Simply stated, under *Corwin*, cleansing of potential breaches of fiduciary duty upon a fully informed, uncoerced vote of disinterested stockholders is *not* available if the transaction involves a controlling stockholder. Of course, nothing is quite that simple. As an aside, the suits challenging the Tesla/SolarCity transaction are not the only ongoing Chancery Court proceedings involving Musk and Tesla. For a discussion of a Tesla stockholder challenge to a substantial compensation award granted to Musk, see Robert S. Reder & Alexandra N. Bakalar, *Chancery Court Indicates Willingness to Extend M&F to Compensation Award to Controlling Stockholder*, 73 VAND. L. REV. EN BANC 61 (2020).

## I. LEGAL BACKGROUND

### *A. Judicial Standard of Review in Controlling Stockholder Transactions*

Under Delaware law, most corporate transactions (i.e., those not involving a conflict of interest) are reviewed under the deferential *business judgment rule* standard, effectively insulating unconflicted directors from liability for any decision made with due care and in good

faith. On the other hand, the heightened *entire fairness* standard of judicial review is typically applied to transactions involving a fiduciary with a conflict of interest. As the Delaware Supreme Court famously wrote in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), "[t]here is no 'safe harbor' for . . . divided loyalties in Delaware. . . . The requirement of fairness is unflinching in its demand that 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." Echoing this fundamental principle of Delaware law in *Tesla II*, Vice Chancellor Slights noted that "[o]ne of the fundamental purposes of the entire fairness standard of review is to provide a framework for this Court to review transactions involving conflicted controllers" because "as an '800-pound gorilla' in the board room and at the ballot box, the controller has retributive capacities that lead our courts to question whether independent directors or voting shareholders can freely exercise their judgment in approving transactions sponsored by the controller."

### *B. Controlling Stockholder Analysis*

Consistent with other aspects of Delaware law, there is no bright-line rule for establishing whether a person or entity controls a corporation. In *Tesla II*, Vice Chancellor Slights wrote that "a minority blockholder can, as a matter of law, be a controlling stockholder through 'a combination of potent voting power and management control such that the stockholder could be deemed to have effective control of the board without actually owning a majority of stock.' " Further, "[t]he requisite degree of control can be shown to exist generally or 'with regard to the particular transaction that is being challenged.' "

In the absence of a majority stockholder, the "focus of the [controller] inquiry [is] on the *de facto* power of a significant (but less than majority) shareholder, which, *when coupled with other factors*, gives that shareholder the ability to dominate the corporate decision-making process." As discussed in *In re Cysive, Inc., S'holders Litig.*, 836 A.2d 531 (Del. Ch. 2003) ("*Cysive*"), one of these "'other factors' is 'managerial supremacy' " (quoting *Tesla II*). In *Cysive*, the Chancery Court "gave great weight to the minority blockholder's role as a company's 'hands-on' CEO and 'inspirational force' who was 'involved in all aspects of the company's business' " (quoting *Tesla II*). Accordingly, "the '*ability*' to control, rather than the actual *exercise* of control, is the determinative factor in our controlling stockholder jurisprudence."

*C. Impact of "Inherent Coercion" on Corwin Defense*

The concept that a transaction involving a controlling stockholder can be "inherently coercive" first arose in 1990 in *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490 (Del. Ch. 1990) ("*Citron*"). The Chancery Court recognized in *Citron* that any transaction involving a controlling stockholder is "inherently coercive" (quoting *Tesla II*). Four years later, the Delaware Supreme Court endorsed *Citron*'s doctrine of inherent coercion in its landmark decision in *Kahn v. Lynch Commc'n Sys., Inc.,* 638 A.2d 1110 (Del. 1994) ("*Lynch*"), which emphasized that "[t]he controlling stockholder relationship has the *potential to influence*, however subtly, the vote of [ratifying] minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party" (emphasis added). Three years later in *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997) ("*Tremont*"), the Delaware Supreme Court expanded on this principle by holding that the mere existence of a controlling stockholder is inherently coercive, thereby mandating review of controlling stockholder transactions under entire fairness due to the "risk . . . that those who pass upon the propriety of the transaction might perceive that disapproval may result in retaliation by the controlling shareholder."

The nullifying effect of inherent coercion in the *Corwin* context was addressed by Vice Chancellor Slights in *In re Rouse Props., Inc., Fiduciary Litig.,* 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.' " Thus, "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.' " The Vice Chancellor reiterated this position in *Tesla II*, opining "[t]hat conflicted controller transactions are inherently coercive . . . is a fixture of our law endorsed by our highest court and re-emphasized in numerous decisions of this Court." 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 51 (2018).

### *D. Tesla I and Tesla II*

*Rouse* featured a 33.5% minority blockholder who Vice Chancellor Slights determined, based on several factors, was *not* a "controlling stockholder." As a result, the Vice Chancellor *granted* the defendants' motion to dismiss on the strength of their *Corwin* defense. Less than three weeks after deciding *Rouse*, the Vice Chancellor confronted similar issues in *Tesla I*. This time, however, the Vice Chancellor *denied* the defendants' motion to dismiss, determining that the plaintiffs had "pled sufficient facts to allow a reasonable inference that Musk [a 22.1% stockholder] was Tesla's controlling stockholder, thereby triggering entire fairness review" of the SolarCity transaction (quoting *Tesla II*). This ruling negated, at least at the pleading stage, the potential cleansing effect of the Tesla stockholder vote approving the transaction for purposes of *Corwin*. For a discussion of *Tesla I*, see Robert S. Reder, *Chancery Court Determines That 22.1% Stockholder Controls Corporation, Rendering Corwin Inapplicable*, 72 VAND. L. REV. EN BANC 61 (2018).

The litigation continued and, after discovery, both sides brought motions for summary judgment. In an argument Vice Chancellor Slights labelled "provocative," Musk and the other defendants "urge[d] the Court to enter complete summary judgment in their favor" because "after conducting extensive discovery, Plaintiffs have failed to unearth any evidence that would undermine Defendants' stockholder ratification defense" (quoting *Tesla II*). In *Tesla II*, the Vice Chancellor rejected this attempted limitation of the inherent coercion doctrine: "While I commend Defendants for their ingenuity, I decline to accept their position that the notion of 'inherent coercion,' as relates to controlling stockholders, evaporates when the case moves beyond the pleading stage."

## II. FACTUAL BACKGROUND

### *A. Tesla Acquires SolarCity*

Tesla "designs, develops, manufactures and sells electric vehicles and energy storage products" (quoting *Tesla I* here and throughout this section). Tesla's seven-person board of directors ("*Tesla Board*") includes Musk—Tesla's CEO, Chief Product Architect, and "largest stockholder" who owned 22.1% of the outstanding common stock. Tesla's public filings with the Securities and Exchange Commission ("*SEC*") admit that Tesla "is 'highly dependent on the services of Elon Musk,' and acknowledges 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, founded in 2006 by Musk and two cousins, "principally operated as a solar energy system installer." Musk also served on SolarCity's board of directors and was its "largest stockholder, holding approximately 21.9% of the common stock." Musk once remarked 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.' "

In June 2016, SolarCity, suffering from a severe liquidity crisis, appeared in imminent danger of defaulting on its revolving credit facility. In the three-year period before June 2016, SolarCity increased its debt by a factor of thirteen while its stock price declined by 64%. Additionally, it faced litigation over intellectual property rights that were critical to its future business. To shore up SolarCity, Musk proposed and aggressively campaigned for a merger between Tesla and SolarCity at several Tesla Board meetings. To support his plan, Musk touted "the possible benefits . . . [of] acquiring a solar energy company in the context of [Tesla's] strategic plan." Tellingly, the Tesla Board did not consider acquiring other solar energy companies despite one prominent investment banker's characterization of SolarCity as "the 'worst positioned' company in the solar energy sector."

On June 21, Tesla announced an offer to purchase SolarCity in a stock-for-stock merger valued at $26.50 to $28.50 per SolarCity share. This range represented a 21% to 30% premium to SolarCity's trading price. While the companies negotiated, Musk actively promoted the transaction at investor conferences and on social media. On August 1, the companies announced the signing of a merger agreement with a final exchange ratio of $25.37 per SolarCity share. Although not required to do so, the Tesla Board submitted the merger to the Tesla stockholders for their approval. Holders of 58% of Tesla shares, excluding shares owned by Musk and certain other Tesla stockholders who also owned SolarCity stock, voted to approve the transaction. The transaction nearly doubled Tesla's debt the instant it closed.

### *B. Litigation Ensues*

Following public announcement of the transaction, several Tesla stockholders filed lawsuits that were ultimately consolidated in Chancery Court. The plaintiffs alleged: (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" (quoting *Tesla I* here and below).

Musk and the other defendants moved to dismiss, citing the cleansing impact of the Tesla stockholder vote under *Corwin*. Plaintiffs countered that the defendants were not entitled to assert a *Corwin* defense "because the Acquisition involved a conflicted controlling stockholder (Musk)." Defendants in turn responded 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." As noted above, Vice Chancellor Slights denied the defendants' motion to dismiss in *Tesla I*, determining that *Corwin* was inapplicable at this stage of the litigation because the plaintiffs "pled sufficient facts to allow a reasonable inference that Musk was Tesla's controlling stockholder" (quoting *Tesla II* here and for the remainder of the piece).

Following discovery, both sides petitioned the Vice Chancellor for summary judgment. The defendants sought summary judgment because "after conducting extensive discovery, Plaintiffs have failed to unearth any evidence . . . that Musk, as the alleged conflicted controller, actually coerced Tesla's stockholders into approving" the SolarCity transaction and because the "uncoerced and fully informed" Tesla stockholder vote approving the transaction "trigger[ed] business judgment review" under *Corwin*, entitling defendants to summary judgment absent any allegation of corporate waste. For their part, the plaintiffs sought "partial summary judgment on two grounds: (1) that a majority of the Tesla Board was conflicted with regard to the Merger; and (2) that the stockholder vote approving the Merger was not fully informed." If plaintiffs were to prevail on these issues, the "[d]efendants w[ould] be required to prove entire fairness at trial regardless of

how the Court decides Plaintiffs' claim that Musk was Tesla's controlling shareholder."

## III. VICE CHANCELLOR SLIGHTS'S ANALYSIS

Vice Chancellor Slights's analysis of the competing motions for summary judgment focused on

> (1) the rationale for holding that a minority blockholder can, in some instances, be regarded as a controlling stockholder; (2) the origins of, and rationale for, the notion of "inherent coercion" in our controlling stockholder jurisprudence; and (3) the reasons we subject transactions involving conflicted controllers to our law's most rigorous standard of review, entire fairness.

His analysis led the Vice Chancellor to deny summary judgment to either side (other than two narrow disclosure issues described below), effectively requiring the litigants either to reach a settlement or proceed to trial.

### *A. Impact of the Inherent Coercion Presumption*

The inherent coercion presumption that accompanies controlling stockholder status in Delaware led Vice Chancellor Slights to deny pleading stage dismissal to Musk and his codefendants in *Tesla I*. In *Tesla II*, Musk and the others sought to convince the Vice Chancellor that the "Plaintiffs can no longer ask the Court to presume that Musk's status as a conflicted controller coerced any Tesla stockholder into approving" the Solar City transaction. From their point of view, "in the absence of evidence that Musk actually coerced Tesla's disinterested stockholders into approving" the transaction, their *Corwin* defense was "case dispositive," entitling them to summary judgment.

Although he recognized this issue was not "settled" under Delaware law, the Vice Chancellor at the same time found "no support" for the defendants' position "in our Supreme Court's existing precedent." Therefore, in a critical extension of the inherent coercion doctrine, the Vice Chancellor ruled that the presumption of "inherent coercion" does not "evaporate[ ] when the case moves beyond the pleading stage," but rather extends to summary judgment even when the plaintiff fails to unearth evidence of actual coercion during discovery.

On this basis, because there remained "genuine disputes of material fact as to whether Musk is Tesla's controlling stockholder," coupled with the presumption of "inherent coercion" nullifying the cleansing effect of the Tesla stockholder vote at this stage, the Vice Chancellor declared that summary judgment "predicated upon the

defense of stockholder ratification must be denied." The Vice Chancellor also rejected the plaintiffs' cross-motion, finding it "desirable to inquire more thoroughly into the facts before deciding whether a majority of the Tesla Board was conflicted or whether the stockholder vote . . . was fully informed." In other words, settle or go to trial.

### *B. Was the Stockholder Vote Fully Informed?*

The plaintiffs disputed the adequacy of five separate items disclosed by the Tesla Board in the proxy materials provided to Tesla stockholders when soliciting their votes to approve the SolarCity transaction. After reviewing the competing arguments, Vice Chancellor Slights concluded that the defendants "have exposed certain disclosure claims that are not viable" and "[i]n the interest of focusing presentations at trial," he granted summary judgment to the defendants on the second and fifth disclosure issues outlined below while reserving the remaining three for disposition at trial:

1. Extent of SolarCity's Financial Woes
    - "Plaintiffs have provided evidence that: SolarCity was at serious risk of breaching the liquidity covenants in its revolver in 2016; SolarCity had limited options for outside financing; and SolarCity's advisors questioned whether the company had 'sufficient cash to meet its obligations as they come due.' "
    - This evidence created "a triable issue of fact as to SolarCity's ability to function as a going concern but for" the transaction with Tesla.
2. Financial Advisor's Discounted Cash Flow Valuation
    - The plaintiffs complained that Tesla's financial advisor, in disclosing "how it performed its discounted cash flow ('DCF') valuation of SolarCity," failed to "disclose that it relied on an assumption that the Solar Investment Tax Credit ('Solar ITC'), which was set to expire without Congressional action, would continue in perpetuity."
    - "The methods [the financial advisor] used to create its valuations were adequately disclosed . . . [and] fail[ure] to disclose [the financial advisor's] tax assumptions . . . is immaterial as a matter of law."
3. Elon Musk's Recusal
    - "Tesla's proxy statement represented that Musk was recused 'from any vote by the Tesla Board on matters relating to a potential acquisition of SolarCity . . . .' "

- "Discovery has uncovered evidence that raises a genuine issue regarding whether these statements were accurate. . . . If Musk is a controller, then his involvement in the process beyond what was disclosed in the proxy would likely have been something a reasonable stockholder would have considered important when deciding whether to vote" for the SolarCity transaction. On the other hand, if "Musk was not a conflicted controller . . . , then the discrepancy between the disclosures and actual events is far less likely to be material."

4. Status of SolarCity's Solar Roof Project
    - "Plaintiffs argue that statements made by Defendants about the efficacy of SolarCity's 'solar roof' product were materially misleading . . . [including] a comment made by Musk before the vote that the 'first solar roof deployments will start next summer.' "
    - "Defendants respond that Plaintiffs are misinterpreting appropriately qualified, forward-looking statements about a product in development."
    - "There seem to be unsettled issues of material fact here" such that "[f]urther inquiry is desirable."
5. Impact of SolarCity Transaction on Tesla's Financial Position
    - "The statements Plaintiffs identify as misleading shareholders about the dilutive effect of the Merger are appropriately qualified."
    - "Likewise, the claim that Tesla expected the Merger to add $500 million to Tesla's balance sheet 'over the next 3 years' is not misleading. . . . The financial projections here were 'accurately described and appropriately qualified; that is sufficient.' "

## CONCLUSION

Vice Chancellor Slights's extension of the inherent coercion doctrine to the summary judgment phase in *Tesla II* demonstrates the risks faced by dealmakers who hope to rely on a *Corwin* defense when a potential controlling stockholder is in the mix. In *Tesla I*, the Vice Chancellor refused to dismiss the claims for fiduciary breach brought against Musk and his codefendants because plaintiffs "pled sufficient facts to allow a reasonable inference that Musk was Tesla's controlling stockholder." In *Tesla II*, the result was much the same, as the inherent coercion doctrine continued to operate even though discovery had

yielded no allegations of actual coercion by Musk. These rulings afford plaintiffs significant leverage in settlement discussions by placing a heavy burden on defendants at trial to either rebut the presumption of coercion by a controlling stockholder or satisfy the entire fairness standard of review.

*Tesla II* also highlights the potential benefits of employing the so-called *M&F Framework* sanctioned by the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014). The *M&F Framework* grants business judgment review to a transaction involving a controlling stockholder who, from the earliest days of the transaction, conditions closing on approval by *both* a special committee of independent directors *and* an informed vote of public stockholders. When the *M&F Framework* is successfully followed, stockholder challenges to transactions are typically dismissed at the pleading stage. This provides a level of certainty from the outset of a transaction not afforded by reliance on *Corwin*. For a discussion of a recent application of the *M&F Framework*, see Robert S. Reder, *Delaware Supreme Court Explores Application of MFW's "Ab Initio" Requirement in Controlling Stockholder-Related Litigation*, 72 VAND. L. REV. EN BANC 237 (2019).