'Entire Fairness' Takeaways From Tesla-SolarCity Ruling

By **Gail Weinstein, Philip Richter and Steven Epstein** (July 24, 2023)



Gail Weinstein



Philip Richter



Steven Epstein

On June 6, the Delaware Supreme Court unanimously affirmed the Court of Chancery's post-trial dismissal of claims by Tesla stockholders against Elon Musk in connection with Tesla's $2.6 billion acquisition of SolarCity Inc.

The plaintiffs in In re: Tesla Motors Inc. Stockholder Litigation, who sought damages of more than $13 billion, claimed that Musk, who was an executive and major stockholder in both companies, had caused Tesla to overpay for SolarCity — which allegedly benefited Musk personally given that SolarCity, according to the plaintiffs, was insolvent.

The Tesla board did not utilize a special committee to consider and negotiate the transaction. The transaction was approved by the Tesla stockholders unaffiliated with Musk, however. The Supreme Court upheld the lower court's holding that, although the deal process was not perfect, Musk established that the price paid for SolarCity was entirely fair to Tesla's stockholders.

In an opinion written by Justice Karen L. Valihura, the Supreme Court held that the Court of Chancery had erred in a portion of its entire fairness analysis, but that the error was not sufficient to require reversal given that there was substantial other evidence of the fairness of the transaction to Tesla and its stockholders.

Key Points

The entire fairness standard can be satisfied even if the deal process did not include an independent special committee of directors.

The Delaware Supreme Court stated that, although use of a special committee is considered best practice when a transaction involves a potential conflicted controller, its use is not a requirement for a finding, under the entire fairness standard of review, that the deal process was fair.

Price may be the predominant consideration in an entire fairness determination.

The Supreme Court reiterated that even a flawed process can result in a fair price. The Supreme Court stated that it was appropriate to defer to the Court of Chancery's determination that the price was fair to Tesla — i.e., was not an overpayment — particularly because the appellants' only argument at trial as to unfairness of the price to Tesla was based on their theory that SolarCity had been insolvent and therefore worth nothing at the time of the deal, and that theory had been resoundingly rejected by the Court of Chancery based on expert testimony that the lower court found convincing.

The Court of Chancery erred by relying on certain market-based data — but the error was not significant enough to warrant reversal.

The Supreme Court criticized the lower court for relying on the unaffected market price — that is, the price just before announcement of the deal — to determine fairness of the deal price, when certain nonpublic information about SolarCity relating to its liquidity problems became known to the Tesla board during the five-month period between the announcement and the closing of the deal.

Also, the Supreme Court criticized the lower court for not having explained, at least in a general sense, the weight it gave to the unaffected market stock price. The Supreme Court concluded, however, that these errors were not significant enough to warrant reversal, given substantial other evidence of fairness of the price, as well as the collapse of the plaintiffs' primary theory that SolarCity was insolvent at the time the price was agreed.

In so holding, the Supreme Court rejected the argument a group of law professors made in amici briefs that characterized the lower court's analysis as reliance on "market evidence run amok," which, if affirmed, would disincentivize any board considering a conflicted transaction from utilizing the procedural protections under the court's 2014 decision in Kahn v. M&F Worldwide Corp.

Discussion

Flaws in the deal process — including not utilizing a special committee — did not preclude a finding of entire fairness.

The Supreme Court emphasized that, although Musk had more contact with the board than a conflicted fiduciary should have had, and although other directors also had conflicts that were not fully neutralized, "'the Tesla Board meaningfully vetted the Acquisition' and Musk 'did not impede the Tesla Board's pursuit of a fair price.'"

Critically, the board was led by a strong director who was indisputably independent of Musk; the board was advised by experienced, independent legal and financial advisers; and the transaction was overwhelmingly approved, in a fully informed vote, by a majority of the stockholders unaffiliated with Musk.

The Supreme Court ruled that the lower court did not err in viewing these indicia of fairness of the deal process as outweighing the flaws in the process.

Use of a special committee is best practice in potential conflicted controller transactions.

The Supreme Court noted that the price Tesla paid for not utilizing a special committee was having the transaction subjected to entire fairness review, which it characterized as "an expensive, risky, and 'heavy lift' in the litigation arena."

The Supreme Court pointed out that — notwithstanding that Musk may not have been a controller, and that even if he was a controller that the board may not have been influenced by him, and that the process apparently worked to accomplish a fair transaction for the stockholders — the litigation challenging the transaction spanned half a decade. In addition, the directors other than Musk had agreed to a $60 million insurance-funded settlement before trial, pursuant to which they were removed as defendants in the case.

In another recent case, In re: Oracle Corporation Derivative Litigation, the Court of Chancery held that a challenged transaction involving a potential conflicted controller —

Larry Ellison, who, the court found, had the ability to control the transaction at issue but did not attempt to do so — was reviewable under the deferential business judgment rule rather than the stringent entire fairness standard.

The case was dismissed at the pleading stage on that basis. The court emphasized in Oracle that Ellison had absented himself from the process and that the unaffiliated stockholders had approved the transaction — both of which the court also found were the case in Tesla.

The difference from Tesla, however, was that, in Oracle, an independent special committee was utilized and had functioned effectively to consider and negotiate the transaction.

We note that it is only with MFW-type procedural protections in place — that is, requiring that the transaction be approved by an independent special committee and by the unaffiliated stockholders — that a challenge to a potential conflicted controller transaction might be dismissed at the early pleading stage of litigation.

There was substantial evidence of fairness of the deal process.

The Supreme Court stressed that it was deferring to the Court of Chancery's "numerous unchallenged credibility and factual findings" that underpinned the lower court's determination that process flaws did not predominate or cause the process to be unfair or to infect the price.

The Court of Chancery had emphasized that:

- The Tesla board did not appear to have been dominated by Musk — as the board had rejected certain of Musk's proposals with respect to the transaction, without pushback from Musk; Musk did not engage in "threats, fits or fights"; and the director leading the negotiations for Tesla, and Tesla's financial adviser, Evercore, both were unquestionably independent of Musk.

- The evidence at trial substantiated that (1) the Tesla board's consideration of the acquisition was not for the purpose of bailing out SolarCity, but was based on Musk's long-held strategic rationale for the combination, and (2) the acquisition in fact had greatly benefited Tesla.

- Evercore's 10-member team engaged in extensive due diligence and spent thousands of hours reviewing SolarCity's financial condition, performing analyses, and negotiating with SolarCity's financial adviser.

- The Tesla board lowered its offer price after completing due diligence and discovering that the extent of SolarCity's liquidity challenges was more severe than the board had known.

The Court of Chancery erred in relying on the unaffected stock price of the

SolarCity shares to determine fairness of the price.

The appellants challenged what they characterized as the lower court's rote and almost exclusive reliance on market-based data to establish fair price. They contended that the Court of Chancery based its ruling that the price was fair to Tesla stockholders almost entirely on the fact that the unaffected price of SolarCity's stock on the date the acquisition was announced — $21.19 per share, on June 21, 2016 — was higher than the implied deal price — $20.35 per share, based on the merger exchange ratio agreed on Nov. 21, 2016.

Those prices led the Court of Chancery to conclude that no premium was paid and in fact that the deal price reflected a discount of 84 cents per share.

The appellants argued, first, that the June 21 stock price was unreliable due to material, nonpublic information relating to SolarCity's liquidity problems, which was unknown until later in the summer and in the fall of 2016 and thus was not factored into the June 21 market price; and, second, that the Court of Chancery's approach, if confirmed, would reduce the entire fairness analysis to the single question of whether a purchase price is sufficiently near the unaffected stock price.

The amici brief submitted by a group of law professors supported the appellants on this issue, arguing that if the court allows a conflicted party to "rely on little more than the pre-announcement transaction price to demonstrate the fairness in question, the party has little to gain from submitting to the procedural protections in MFW."

The Court of Chancery criticized the board for not explaining why the June 21 market stock price was reliable given the information that became known after that date; and for not explaining the weight it gave to the June 21 stock price. The Supreme Court acknowledged that "specific weighting of valuation methodologies takes on more significance in the appraisal context where the court is required to derive a single numerical estimate of fair value" rather than, in the case of an entire fairness analysis, a range of values where the price is deemed to be fair.

The Supreme Court stated that, although the lower court's opinion reflected that it had not relied almost exclusively on the unaffected stock price, and in fact had relied on many factors, to determine the valuation of SolarCity, it would have greatly aided the reviewing court and the litigants if the lower court had provided a more fulsome discussion of how it weighed the valuation evidence.

The Supreme Court stressed that, in any event, although the Court of Chancery erred in this portion of its analysis, there was an array of valuation and fair price evidence presented that supported the court's finding that the price Tesla paid was fair to its stockholders.

SolarCity was not insolvent.

The Supreme Court deferred to the Court of Chancery's critical finding that, during the deal process, despite SolarCity's being "cash-strapped to a dangerous degree, [the company] was solvent, valuable and never in danger of bankruptcy." The Court of Chancery had rejected the plaintiffs' expert testimony that SolarCity was insolvent based on the company's liquidity problems and the fact that its assets would be worthless in a liquidation context.

The Court of Chancery found that the relevant analysis was, as Musk's expert argued, what the value was to Tesla of the assets that were purchased and would be continuing as

opposed to being liquidated.

The Court of Chancery also credited as evidence that SolarCity was not insolvent: Evercore's analysis and fairness opinion; the financial analysis by SolarCity's auditors at the time of the closing; Tesla's having booked in its financial statements an $89 million gain on the acquisition; and other financial testimony on SolarCity's cash flows and retained value.

Practice Points

Litigation Strategy

Reliance on only one financial theory or valuation methodology may present significant risk as a litigation strategy. In Tesla, the Supreme Court indicated that the appellants' credibility, and their substantive case, were undermined by their having placed their valuation case entirely in one expert's hands; that expert, in turn, having relied exclusively on a single valuation theory; and that theory having been focused on just one financial factor.

Valuation Analysis and Presentation

The Supreme Court indicated that an entire fairness analysis is best presented by setting forth separately and expressly the deal process conclusions and the deal price conclusions, followed by a unitary determination of entire fairness in a separate section.

Most importantly, the Supreme Court reaffirmed that a record demonstrating that the negotiations were conducted at arm's length, in good faith, with the advice of independent financial and legal advisers, led by an indisputably independent director, is evidence of a fair process that led to a fair price.

Value of a Special Committee

In conflicted controller transactions, use of a special committee, combined with approval of a transaction by the stockholders unaffiliated with the controller, makes dismissal possible at the early pleading stage of litigation.

We note that the court did not address in Tesla, nor in Oracle, whether, in a case involving a conflicted controller, the effective functioning of an independent special committee would cleanse a challenged transaction that did not require a stockholder vote and for which the approval of the unaffiliated stockholders was not obtained.

Gail Weinstein is senior counsel, and Philip Richter and Steven Epstein are partners, at Fried Frank Harris Shriver & Jacobson LLP.

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