2 Del. Decisions Call Out Conflicted Controlling Stockholders

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Two recent Delaware Chancery Court decisions — Tornetta v. Musk et al. and In re BGC Partners Inc. Derivative Litigation — highlight the Delaware courts' "reflexive skepticism," in the words of Vice Chancellor Joseph Slights, with respect to transactions involving conflicted controllers.

The court emphasized in these cases the potential for coercive influence by controlling stockholders over directors (who the controller typically can remove or not reappoint) and unaffiliated stockholders (who the controller can harm through retributive acts such as a squeeze-out merger or cutting dividends).

Retiring Delaware Chief Justice Leo Strine characterized controllers as "800-pound gorillas" in a previous case, quoted in Tornetta. As the chief justice had explained, there is "an obvious fear that even putatively independent directors may owe or feel a more-than-wholesome allegiance to the interests of the controller, rather than to the corporation and its public stockholders."

In Tornetta and BGC, the court reaffirmed that this concern is not necessarily eliminated, even where the controller has no intention to be coercive, the transaction is negotiated by outside, putatively independent directors, and/or the transaction is stockholder-approved.

Tornetta v. Elon Musk

In Tornetta, decided Sept. 20, Vice Chancellor Slights denied the defendants' motion to dismiss at the pleading stage of litigation. Shareholders challenged Tesla Inc.'s 10-year, incentive-based compensation plan for CEO Elon Musk, even though the plan had been approved by Tesla's board (comprised of seven outside directors and two inside directors) and by a majority of the minority stockholders. As Tesla's largest stockholder, Musk was deemed to be a controller.

The court held that unless a board's decision on executive compensation for a controlling stockholder CEO complies with the protections outlined in the seminal decision in In re: MFW Shareholders Litigation (i.e., approval by both a special committee of independent directors and the disinterested shares), the entire-fairness standard of review (which is the strictest standard) applies to the court's evaluation of a stockholder challenge to the compensation.

The court so decided, notwithstanding that until now, 1) business judgment review has applied to compensation decisions made by independent directors, and 2) MFW compliance has been required for business judgment review of conflicted controller transactions only in the context of transactions that are considered transformational for the corporation.

The Tesla board had not followed the MFW road map, as a special committee of independent directors was not established. The court found that the plaintiff had alleged facts that supported — "albeit just barely" — a reasonable inference that the plan that provided Musk with stock options worth up to $55.8 billion might not be entirely fair to Tesla.

Key Points

The court held that the so-called "entire fairness" review applies to a board's executive compensation decision for a controller, unless the MFW prerequisites were satisfied.

Even though a board's executive compensation decisions typically are accorded great judicial deference — and especially so when they have been approved by the stockholders — entire fairness applies to transactions with conflicted controllers where the process was not structured to nullify the potential for coercive influence by the controller, the court held.

In the court's view, the Tesla board's and stockholders' approvals could be free of the inherent coercion resulting from the presence of a controller only if the additional safeguards provided by the MFW framework — in this case, an independent special committee of the board — had been in place.

The decision expands MFW applicability beyond transformational transactions.

The decision extends MFW to a board's executive compensation decisions ("about as work-a-day as board decisions get," Vice Chancellor Slights conceded).

The court acknowledged that neither the Delaware Chancery Court nor the Delaware Supreme Court had provided any indication that their MFW holdings were to apply — and in fact MFW has not previously been applied — outside the context of transformational transactions. With the dual MFW protections in place, however, the court wrote:

[The] minority stockholders can cast their votes knowing the controller has agreed at the outset to negotiate his compensation award with an independent, fully functioning committee of the board, to condition consummation of the award on that committee's endorsement, and to allow the unaffiliated stockholders to have the final say.

Under such circumstances, the minority stockholders "have far less reason to fear that the controller will retaliate if the committee or minority stockholder votes do not go his way." The vice chancellor reasoned that a controlling stockholder's

coercive influence is no less present and no less consequential, in instances where the board is negotiating the controlling stockholder's compensation than it is when the board is negotiating with the controller to effect a 'transformational' transaction … [and] stockholder ratification, without more, does not counterpoise the risk of coercion in either context.

The plaintiff met the low bar for nondismissal, but defendants could still prevail.

While the court found that the plaintiff met the low bar for nondismissal at the pleading stage, the defendants' arguments could well ultimately prevail. In explaining its holding for the plaintiff, the court (1) cited the allegations in the complaint that the compensation awarded was "well in excess of that paid to Musk's peers," and (2) emphasized the low bar to meet the "reasonably conceivable" standard applicable at the pleading stage.

At the same time, however, the vice chancellor observed that the defendants' arguments ultimately "may well carry the day" in the context of a summary judgment motion or trial. The defendants' primary arguments were that:

- The award is entirely performance-based and aligns Musk's incentives with the interests of other stockholders, especially given his several other business interests that might distract him from his work at Tesla;

- It is possible Musk will never obtain the full value of the award, given its contingency certain "extraordinary" milestones; and

- If the performance milestones are met, Tesla would be one of the world's most valuable companies and all stockholders then will have reaped the benefits of Musk's incentivized focus.

In re BGC Partners Derivative Litigation

In BGC, decided on Sept. 30, Chancellor Andre Bouchard found at the pleading stage of litigation that there was reasonable doubt whether a majority of the directors who approved a conflicted controller transaction were independent of the controller.

Public company BGC Partners paid $875 million to acquire Berkeley Point Financial LLC, a private company. BGC and Berkeley both were affiliates of Cantor Fitzgerald LP, and were controlled by Howard Lutnick, who was the CEO and chairman of BGC and also controlled Cantor and many of its affiliated companies.

The transaction was approved by a special committee of outside directors of BGC, but was not subject to approval by BGC's stockholders. After the closing, two BGC stockholders brought suit, alleging that Lutnick, standing on both sides of the transaction, had BGC overpay for Berkeley because his economic interest in Berkeley (60%) far exceeded his economic interest in BGC (13.8%).

They also alleged the outside directors of BGC acted in bad faith in allowing the overvalued sale to happen. The defendants moved to dismiss. They asserted that the plaintiffs, who had not made a demand on the board to bring the derivative claims on behalf of BGC, had failed to establish that demand would have been futile.

In addition, the director defendants argued that the claims against them should be dismissed under a test set out in In re Cornerstone Therapeutics Inc. Shareholder Litigation, given the protection for independent directors set forth in the exculpatory provision in BGC's charter.

However, the court found that because there was reasonable doubt as to the directors' independence from the controller, (1) demand was excused, and (2) the claims were not dismissible under Cornerstone.

Key Points

The court emphasized the threat of implicit coercion represented by a conflicted controller.

The court considered the issue of demand futility in the context of a controlled company. Demand futility refers to the requirement that, before making claims against directors or a controller, a plaintiff stockholder must first make a demand on the board for it to bring a derivative suit on behalf of the stockholders, unless the plaintiff can establish that the demand would have been futile, because the directors, based on their own personal

interests or other factors, could not have been expected to make the decision impartially.

The court reaffirmed that the presence of a conflicted controller will not automatically establish demand futility, but emphasized that:

[Our] law is not blind to the practicalities of serving as a director of a corporation with a controlling stockholder … [and the] threat of implicit coercion because of the controller's ability to not support the director's re-nomination or re-election [or to cause the director's removal].

The court may apply a more stringent standard.

The court signaled that it may apply a more stringent standard than in the past for evaluating whether putatively independent directors can be presumed to be capable of acting independently from a controller in the context of evaluating demand futility.

The court highlighted that in the past few years when considering the issue of demand futility, the Delaware Supreme Court, under a de novo standard of review, several times has overturned the Delaware Chancery Court's findings of director independence from a controller or other interested party. These Supreme Court decisions, the court wrote, "reinforce the importance of considering a plaintiff's factual allegations holistically and affording [the] plaintiff all reasonable inferences."

BGC underscores that the evaluation must be based on "the constellation of facts," considered in totality, relating to the director's business and personal relationships with the controller or other interested party.

In determining that each of the BGC directors may not have been independent of Lutnick, the court focused primarily on the facts that the directors (1) were "go-to" candidates for Cantor affiliate boards, and (2) had overlapping social connections. Significantly, the court did not view these as coincidences, but as indicating that in reality the directors appeared to owe their general status or positions of importance to the controller.

How did the court weigh the board's process?

It is unclear to what extent the process the directors engaged in to evaluate the challenged transaction influenced the court's determination as to nonindependence. In the lengthy factual background section of the opinion, the court recited the special committee's process. The court did not characterize or comment on the process in any way.

However, the facts as alleged indicated that the process was severely flawed. Indeed — although the court did not articulate this — arguably, any director independent from the controller would not have engaged in such a process.

Practice Points Arising From Tornetta and BGC

A company and its controller should be prepared for the potential that a transaction of any type pursuant to which the controller obtains a nonratable benefit as compared to the other stockholders may be reviewed by the court under the entire-fairness standard, unless the transaction was structured to be MFW compliant.

With respect to compensation decisions for a controller, one possible question is whether there may be a continuum of decisions such that, even without MFW compliance, they

would not all necessarily be subject to entire fairness.

We observe that the compensation decision in Tornetta was, if not transformational, certainly highly significant given the extreme importance of Musk to the company and the extreme amount awarded to him. Query whether more mundane compensation awards for controllers (or other garden-variety transactions with controllers) necessarily would be subjected to the entire-fairness standard under Tornetta — and, if entire fairness were applied, whether the court might be more inclined to find that the award (or other transaction) was entirely fair.

A controller should consider the benefits of including independent directors on the board. Tornetta and BGC highlight the potential benefits of having some number of independent directors on a board so that MFW compliance is an option. We note that, as there is judicial skepticism as to one-person special committees, it may be advisable to appoint more than one clearly independent director.

Tornetta does not necessarily lead one to conclude that MFW compliance typically should be pursued in connection with a board's decision on compensation for a controller. Indeed, Tornetta suggests that if the process is reasonable and there are good reasons for the compensation award made, then, even if it is in excess of the compensation received by the controller's peers, the court is likely to find the award entirely fair — although it may not be likely that it would dismiss the case at the early pleading stage.

At the same time, we note that MFW compliance should be less risky in the context of a compensation decision for a controller than a going-private transaction with a controller. In the compensation decision context, it is unlikely that there would be interference by a third party attempting to block the minority stockholder vote for holdup value (i.e., to obtain better terms for the proposed transaction or to permit the third party to accomplish its own proposed transaction instead).

In Tornetta, out of respect for Vice Chancellor Slight's prior ruling in another case at the pleading stage to the effect that Musk likely is a controller of Tesla, Musk did not contest the plaintiff's allegation that he is a controller for purposes of the motion to dismiss. We would observe that in almost every case where, based on the facts and circumstances, one can argue that he or she is not a controller, those arguments should be made, even if only to preserve the issue in the event there is an appeal.

A controller and the board should be aware of the kind of relationships that the court may view as establishing a reasonable doubt as to a director's ability to be independent of the controller. BGC reflects that directors appointed to numerous boards by the controller, and directors with whom the controller has an extensive business and/or personal relationship, may well be considered to be not independent of the controller.

The determination is relevant both for purposes of a court deciding whether demand on the board to bring a derivative action is futile and therefore excused, and deciding whether a director may, under Cornerstone, be dismissed from a case based on the exculpatory provision that appears in the charter of most companies.

The board should proactively seek the information required to make a judgment in advance about possible nonindependence or interestedness of directors with respect to proposed transactions. The evaluation of independence and interestedness of directors is, of course, critical if the controller seeks to structure the transaction to be MFW compliant in order to obtain review under the business judgment standard.

The board process is likely to influence the court on the issue of independence of the directors. As BGC apparently reflects, a board process may well influence the court's view of the directors' independence from the controller if the process was so flawed that arguably no director who was actually independent would have engaged in it.

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