Delaware Law Update Roundtable, March 23, 2022
hosted by
John L. Weinberg Center for Corporate Governance at the University of Delaware

Recent Delaware Perspectives on Special Committees and Controllers

Overview

- Special Committees in Transactional Context
  - Recent instances where “bad faith” was successfully pled against special committees
  - *Empire Resorts* and *Pattern Energy*

- Special Committees and Controllers
  - *Pattern Energy’s* (and other recent cases’) discussion of controlling stockholder status
  - Delaware’s potentially evolving views and consequences

Overview

- *"Delaware law has long encouraged boards to form special committees when confronted with a conflicted transaction to neutralize the influence any conflicted board members might have on the decision-making process." In re CBS Corp. S'holder Class Action & Derivative Litig.*, 2021 WL 268779, at *39 (Del. Ch. Jan 27, 2021) (quoting *Kahn v. Lynch Comm'cn Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994))

- *"[I]n the context of a transaction with a controlling stockholder, the special committee must have real bargaining power that it can exercise with the majority stockholder on an arm's-length basis." Id.*

Overview

Frequently cited "key attributes" of a well-functioning Special Committee in a conflict context:

- Independent and disinterested members
- Properly empowered, with appropriately broad mandate under the circumstances
- Independent financial and legal advisors
- Fully informed (as reflected in minutes) *E.g.*:
  - Thorough review of options or proposals
  - Regular or frequent meetings (consistent with circumstances)
  - Analysis of conflicts (*e.g.*, management, advisors) and how they might impact process, and implementation of appropriate responses
- Formed before start of substantive economic negotiations

Bad Faith under Delaware Law

3 categories of "bad faith" discussed in the Special Committee / sale context:

(1) subjective bad faith, in conduct motivated by an intent to do harm;

(2) intentional dereliction of duty or conscious disregard of duty;

- *"Empire Resorts"*: *MH Haberkorn 2006 Tr. v. Empire Resorts, Inc.*, C.A. No. 2020-0619-KSJM (Del. Ch. July 23, 2021) (TRANSCRIPT)

(3) permitting interests -- other than obtaining the best value reasonably available for a company's stockholders -- to influence director decisions during the sales process, given that directors made decisions falling outside the range of reasonableness.

- *"Pattern Energy"*: *In re Pattern Energy Grp. Inc. S'holders Litig.*, 2021 WL 1812674 (Del. Ch. May 6, 2021)

Empire Resorts – Special Committee "Bad Faith"

Overview

- Minority stockholders of gaming business, Empire, were cashed out in a merger transaction with the controlling stockholder of Empire
- Class action plaintiff stockholders alleged that the merger was the product of breaches of fiduciary duty
- Typically, a conflicted transaction with a controller results in application of the "entire fairness" standard of judicial review
- Empire asserted that deferential business judgment rule applied under *MFW** (and not entire fairness) because Empire:
  - formed Special Committee, and
  - obtained approval of majority-of-the-minority stockholders
- Court applied entire fairness, finding neither prong of *MFW* to be satisfied
- Court found complaint supported inference of bad faith by Special Committee; denied motion to dismiss

* *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

Empire Resorts – Special Committee "Bad Faith"

Background*

- June 21, Board formed 3-person Special Committee to evaluate acquisition by related party (controller)
  - Per earlier letter agreement, controller could not take Empire private before February 2020 unless disinterested director approval and majority-of-the-minority stockholder vote
- Board retained *company's* financial advisor and long-time legal advisor to advise Special Committee
- July 25, controller went public with acquisition offer, saying Empire no longer viable as stand-alone and threatening to cease providing equity financing while company remained public
- July 25, Special Committee met for first time, prompted by controller's letter
  - Both CEO and Chairman of Empire (designated to board by controller) were present for strategy discussion
  - Someone at July 25 Special Committee meeting leaked information
  - Nevertheless, Special Committee did not restrict outsiders from attending future meetings
- August 5, controller proposes $9.74, which reflected less than 2% premium to then-current trading price
- Special Committee: (i) requested undefined increase in consideration because it thought price not yet compelling, (ii) sought continued financing from controller, and (iii) sought right to solicit alternative proposals

* As alleged in complaint

Empire Resorts – Special Committee "Bad Faith"

Background, *cont'd*

- August 9, Empire announced it may need to enter into Chapter 11, and stock price fell to $8.18; Special Committee authorized sending draft agreement to controller with the objective of negotiating price
- August 12, controller refused to raise offer price, declaring it best and final offer; Special Committee learned controller would not agree to support any other alternative transactions even if superior terms
- August 14, Party A expressed interest in potentially investing in Empire to help it through liquidity issue
- Controller, aware of Party A, indicated to Special Committee that agreement needed to be signed by April 18 (Sunday); controller could not guarantee it would be willing to continue negotiations past the 18th
- Controller agreed to 10-day go-shop following signing and financial advisor told Special Committee that 10 days would be adequate to negotiate with third party. But controller refused to sell its stake in company, indicating that, realistically, no superior offer could be achieved
- Projections from management were allegedly compromised, as they eliminated certain business scenarios or "cases" and included reductions in EBITDA; allegedly no explanation in proxy but documents obtained in a books and records proceeding under DGCL 220 allegedly indicated financial advisor was working with management to make negative changes to drive down projections without Special Committee's involvement
- Financial advisor wanted more time to evaluate management projections but management pressed it to send the financial model to controller
- August 18, board approved transaction with controller. November 2019, majority-of-the-minority vote to approve (~52% of minority approved)

Empire Resorts – Special Committee "Bad Faith"

Conduct at Issue

- **Special Committee allegedly failed to manage conflicts of interest during the merger process**
  - Special Committee allegedly allowed conflicted management to participate in meetings, despite known "leaks" to controller
  - Special Committee allegedly allowed conflicted management to work with its financial advisor to "taint" Empire's valuation
    - Special Committee allegedly never asked about Empire's value, taking into account certain alternative or upside business plans
- **Special Committee allegedly permitted itself to be "rushed"**
  - Special Committee allegedly accepted controller proposal "after only 10 days of negotiations" with controller
  - Special Committee allegedly acknowledged offer price reflected low premium and that price was not compelling

Empire Resorts – Special Committee "Bad Faith"

- No finding of well-pled allegations that the Special Committee members lacked independence or were interested

- Instead, Chancellor McCormick determined:

  The complaint's "allegations support a conclusion that the special committee acted consciously with disregard for its duties and allowed management to taint the process so that the proposal was not adequate consideration for Empire's minority shares."

  "Plaintiffs have pled a claim that the special committee defendants acted in bad faith and, therefore, breached their duty of loyalty."

In re Pattern Energy – Special Committee "Bad Faith"

Overview

- Pattern Energy was formed by Riverstone, a private equity fund ("Investor")
- Pattern Energy formed Special Committee to explore strategic transactions, including potentially with Investor
- Ultimately, Pattern Energy engaged in a merger with a third party which was allegedly preferred by Investor
- Court applied *Revlon's* "enhanced scrutiny" standard of review but noted "entire fairness" may be implicated:
    - "*Revlon enhanced scrutiny applies to 'final stage' transactions, including a 'cash sale, a break up, or a transaction like a change of control that fundamentally alters ownership rights*.'" (Op. *31)
    - Court indicated "entire fairness" might apply in the future if Investor and others are shown to constitute a "control group"

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- As pled, the Special Committee *seemingly* oversaw a robust sales process:

  "The sales process of Pattern Energy Group … was run by an undisputedly disinterested and independent special committee that recognized and nominally managed conflicts, proceeded with advice from an unconflicted banker and counsel, and conducted a lengthy process attracting tens of suitors that the special committee pressed for value." (Op. *1)

- Yet, the Court found well-pled allegations of bad faith, denying a motion to dismiss breach of fiduciary duty claims

In re Pattern Energy – Special Committee "Bad Faith"

Conduct at Issue

- Court found **no** well-pled allegations that directors were interested or lacked independence (Op. *32)
  - Accordingly, unless finding of bad faith, exculpation under Section 102(b)(7) typically would apply
- Court also found **no** well-pled allegations of "conscious disregard or the absence of any rationally conceivable basis for the Directors Defendants' actions" (Op. *50)
- Court found that Special Committee appeared to take "**a great number of reasonable actions to fulfill their duties**":
  - Hired independent legal and financial advisors
  - Met regularly with advisors
  - Disclosed conflicts in the proxy (related to second banker and management)
  - Required pre-authorization for management to contact bidders
  - Sale process lasted more than a year
  - Active discussions with roughly a dozen bidders
    - Executed confidentiality agreements with serious bidders
    - Exchanged draft agreements with more than one bidder
    - Resisted requests for exclusivity
    - Obtained go-shop and interfaced with numerous bidders during that period

In re Pattern Energy – Special Committee "Bad Faith"

Conduct at Issue, *cont'd*

"Bad Faith" Properly Pled

- Court found well-pled allegations that Special Committee prioritized Investor's interest over maximizing value
    - Special Committee's minutes acknowledged that committee's duty was to maximize value and that another bidder's proposal was "superior from a value perspective" to others that the company had received and will receive (Op. *56)
    - Special Committee rejected bidder that intended to cash out the Investor, while the preferred bidder would permit the Investor to own an equity interest (Op. *55)
    - Special Committee's work was tainted by conflicted management and conflicted second financial advisor (Op. *53-54)
- Defendants argued Special Committee favored buyer's all cash offer based in part on the complexities of the other bidder's stock-for-stock deal, *"[b]ut in the Revlon context, it is dispositive that Buyer's offer took Merger consideration away from the Company's public stockholders*." (Op. *57)

In re Pattern Energy – Special Committee "Bad Faith"

Vice Chancellor Zurn determined:

- *"At this procedural stage and in view of the Court's obligation to view end-game transactions with inherent skepticism, 'the predicate question of what the board's true motivation was comes into play, and the court must take a nuanced and realistic look at the possibility that personal interests short of pure self-dealing have influenced the board.'"* (Op. *50)

- It was *"reasonably conceivable that the Director Defendants placed the interests of [others, including Investor] above the interest of Company stockholders and their obligation to maximize stockholder value, and therefore acted in bad faith."* (Op. *51)

Pattern Energy's Discussion of "Controller" Status

- *Pattern Energy c*ourt applied *Revlon's* "**enhanced scrutiny**" standard at the pleading stage
  - Complaint did not plead facts sufficient to indicate that Special Committee was interested and lacked independence such that the committee could not exercise objective judgment in evaluating the merits of a transaction (Op. *32)

- However, *Pattern Energy c*ourt indicated that "**entire fairness**" might apply later in the case, ***if*** the Investor and others are determined to be a "**control group**"

  - "[T]his cash out Merger may warrant entire fairness under a controller theory; time and discovery will tell."

"Controller" under Delaware Law

- Delaware courts will deem a stockholder a "controlling stockholder" when the stockholder:
  - owns more than 50% of the voting power of a corporation or
  - owns less than 50% of the voting power of the corporation but exercises control over the business affairs of the corporation
    - control in general, or control specifically for purposes of transaction
- Thus, "[w]hile every stockholder with majority voting control is a controller, not every controller is a majority stockholder."
- The matter is "highly contextualized and is difficult to resolve based solely on the complaint."

Voigt v. Metcalf, 2020 WL 614999 (Del. Ch. Feb. 10, 2020)

In re Tesla Motors, Inc. S'holders Litig., 2020 WL 553902 (Del. Ch. Feb. 4, 2020)

Consequences of Controller Status

1. **Imposition of fiduciary duties on controlling stockholder**
2. **Change standard of review to rigorous "entire fairness" standard**
   - When a transaction allegedly involving self-dealing by a controlling stockholder is challenged, the applicable standard of judicial review is entire fairness, with defendants having the burden of persuasion
   - *Corwin** protections unavailable (*i.e.*, fully informed stockholder vote/approval does not trigger deferential business judgment rule)
3. **Formation of effective Special Committee in controller context may impact burden or standard of review**
   - Shift burden of entire fairness *from* defendants *to* plaintiff, or
   - Special Committee and majority-of-the-minority vote can, under *MFW*, give rise to business judgment rule
4. **Complaints more likely to survive motion to dismiss**
   - Courts view controller questions as "difficult to resolve based solely on the complaint"
   - At pleading stage, plaintiff (receiving benefit of doubt) must allege only facts sufficient to support a reasonable inference that a party controlled a company
   - Where controller status is adequately pled, for breach of fiduciary duty claim *against controller*, plaintiff need only plead facts from which it is reasonably conceivable that a challenged transaction was not entirely fair; breach of fiduciary duty claim *against directors* also likely survives unless exculpation under DGCL 102(b)(7) (*i.e.*, no indication director acted disloyally or in bad faith)

Corwin v. KKR Fin. Holding LLC, 125 A.3d 304 (Del. 2015)

Recent "Controller" Discussion

Courts Assessing "Soft Power" When Stock Ownership is Less than 50%:

- *Pattern Energy*: *"It is impossible to identify or foresee all of the possible sources of influence that could contribute to a finding of actual control."* (Op. *37)

- *Voigt v. Metcalf*: *"Rarely (if ever) will any one source of influence or indication of control, standing alone, be sufficient to make the necessary showing. A reasonable inference of control at the pleading stage[] typically results when a confluence of multiple sources combines in a fact-specific manner to produce a particular result."* (Op. *43)

- Pleading-stage indicia of control (considered in combination) have included:
  - Outsized influence in board room
  - Nature of relationships between controller and majority of board members
    - Ability to designate directors
    - A right to proportionate representation on the board, including representation in key committees
    - Close and long relationship with directors (not designated by controller); "sense of owing-ness"
  - Nature of relationships with key managers or advisors
  - Exercise of contractual rights to channel the corporation into a particular outcome
  - Commercial relationships that provide a party with leverage over the corporation (*e.g.*, key customer, supplier)

Voigt v. Metcalf, 2020 WL 614999 (Del. Ch. Feb. 10, 2020) (well-pled allegations that 34.8% stockholder was a controller)

Recent "Controller" Discussion

Pattern Energy *indicates* even ***non***stockholders might be controllers

- *"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."* (Op. *40)

- *"It is an* ***open question*** *under Delaware law whether [the Investor and affiliated business]'s* ***soft power alone****, anchored in* ***historical and commercial ties and the contractual Consent Right****, can support including [the Investor and affiliated business] in a control group and imposing fiduciary duties."* (Op. *38)

Recent "Controller" Discussion

Pattern Energy court identified three sources of "soft power" in assessing alleged "control group"

- "Controller Defendants": two entity defendants (including Investor) owned no stock in Pattern Energy; others, including officer defendants of Pattern, owned around 10% (Op. *44)
    1. Investor had **"long history" with officer defendants**, who had significant roles at Pattern Energy; supporting inference that Investor, via officers, had ability to exercise "outsized influence" in the board room
    2. Investor controlled another entity that was "essential part" of Pattern Energy's "**upstream supply chain**"; supporting inference of more Investor "leverage over" outcome of sale process
    3. Investor had contractual "**consent right**," which was a "direct source of control over [Pattern's] fate"; supporting ability to channel the corporation into a particular outcome (although third parties understood the consent right was "readily circumvented," the Special Committee nevertheless worried Investor would sue to block a transaction with third party)
- Court determined Controller Defendants were "connected in a 'legally significant' way" (*See Sheldon v. Pinto Tech. Ventures,* L.P., 220 A.3d 245, 253 (Del. 2019))
- But Court **declined to make a definitive determination** that the Control Defendants "operated as a control group owing fiduciary duties"
    - "Control Defendants' duties and resultant standard of review can only be known after the record is developed through discovery."

Recent "Controller" Discussion

Other recent cases regarding "controller" status

- ***Blue v. Fireman***, 2022 WL 593899 (Del. Ch. Feb. 28, 2022), Vice Chancellor Zurn
  - Vice Chancellor Zurn also decided *Pattern Energy*
  - Indicated that stock ownership is not necessary for being deemed controller
  - Background:
    - Plaintiffs argued that Fireman Capital was a controller because its Class B Proxy (secured via its creditor-debtor relationship with company) allowed it to exercise 83% of the company's outstanding voting power
    - Defendants argued, among other things, that Fireman Capital cannot be a controller because it is a *non*stockholder
  - Court:
    - ***"[W]hether Fireman Capital owns any or all of the stock it can vote is of no moment. It is true that stock ownership is the traditional vehicle through which outsiders gain voting power. But holding stock is not a prerequisite to exercising voting control that carries weight of fiduciary duties."***

Recent "Controller" Discussion

Other recent cases regarding "controller" status

- ***In re Tesla Motors, Inc. S'holder Litig.***, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018)
  - Court found well-pled allegations that Elon Musk (22.1% stockholder) was a controller of Tesla
  - Musk, alleged visionary CEO, also purportedly had:
    - the ability to rally other stockholders to follow his initiatives, including removal of board members
    - a history of dominating the Tesla board
    - a dominating role in directing Tesla policy and strategy
    - acknowledged his own control in public filings

- ***FrontFour Cap. Grp. LLC v. Taube***, 2019 WL 1313408 (Del. Ch. Mar. 11, 2019)
  - Court found well-pled allegations that Taube brothers (with less than 15% beneficial stake) were controllers; consequently, "entire fairness applies because the Taube brothers [were] controllers"
    - 15% stake was subject to "echo voting": obligation to vote shares in proportion to those of public stockholders
  - Court determined Taube brothers were controllers "because those tasked with standing independent from the Taube brothers willfully deferred to their authority."

Observations and Questions

Evolving and Flexible Standard?

- historically, meaningful stock ownership and voting power were important
- more recently, courts seemingly have increasingly focused on “soft powers”
- perhaps, no stock ownership, at all, is required to be a controlling stockholder

Professor Ann Lipton of Tulane Law School:

> *“Some courts … have apparently found flexibility in the definition of control itself, allowing claims that smack of self-dealing to proceed by designating minority shareholders as potential controllers. The result is a confusing body of caselaw that leaves the definition of control shifting and uncertain.”*

Observations and Questions

What's at stake?

- **Imposition of Fiduciary Duties**

- **Winning a Motion To Dismiss *versus* Discovery/Potential Trial**:
  - Labelling a party "controller" not only imposes fiduciary duties on the party but can cause interested transactions to be reviewed under entire fairness
  - Discovery and trial on fairness often ensues
  - In contrast, an "interested transaction" -- not involving a controller -- can still receive deferential business judgment review if approved by (i) a majority of independent and disinterested directors, or (ii) approval by disinterested stockholders. (Compare: an interested transaction involving a controller must satisfy both prongs (the *MFW* requirements) to achieve business judgment review.)

Hamermesh, Jacobs and Strine:

> *"Our concern … is that the amorphous concept of 'soft power' not arising out of stock ownership could be applied to trigger the entire fairness standard and preclude dismissal, where the premise of control involves circumstances that reflect garden variety commercial dealings …."*

Observations and Questions

Can I lessen risk of a "controller" finding at the pleading stage?

- Recent judicial focus on "soft powers" potentially leads to some uncertainty
- Should I limit stockholdings to below 35%? (*See Voigt v. Metcalf*)
- Should I avoid or minimize relationships with directors and management?
- Can I agree to contractual limitations that help to disable any perceived control over board or business?
- Should I adopt *MFW* mechanisms (Special Committee approval and majority-of-the-minority stockholder vote) in order to achieve business judgment rule? Do I risk conceding "controller" status at the pleading stage if I use *MFW* mechanisms?

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