Under Control: Recent Delaware Decisions on Controller Transactions, Standards of Review and Disclosure Obligations

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The first half of 2024 has been a watershed moment for the development of controller law in the Delaware courts. Among the highlights, the Delaware Supreme Court reexamined and confirmed that transactions involving a conflicted controller will invoke entire fairness review, and that the *MFW* framework is the only method in that context to secure business judgment review.[1] The Court of Chancery also broke new ground in controller law, articulating duties for controllers that exercise stockholder-level voting rights and applying entire fairness review to a controlled company's attempt to reincorporate from Delaware to Nevada. The Court of Chancery also issued a ruling that voided, post-trial, what may be the largest-ever executive compensation package, based on the court's determination that the CEO/controller fell short of complying with *MFW* under an entire fairness analysis.

In light of these recent cases, controlled companies, boards of directors and their financial advisors should pay close attention to these rulings and continue to monitor additional developments. Below, we examine each of the recent decisions.

Match Group: Delaware Supreme Court Confirms That *MFW* Must Be Satisfied To Secure Business Judgment Review in Controller Transactions

In re Match Group, Inc. Derivative Litigation[2] concerned a challenge to a "multi-step reverse spinoff" of online dating website Match.com by the company's then-controlling stockholder. At the trial level, the primary question for the Court of Chancery was whether the reverse spin-off complied with *MFW*. In its ruling, the court concluded that "the process as pled satisfied *MFW*" and dismissed the stockholder case under the business judgment rule. The plaintiffs appealed, claiming that the court erred when dismissing the case. In response, the defendants raised a new argument — that *MFW* was not always required to secure business judgment review, particularly when the challenge was to a controlling stockholder transaction that did not involve a freeze-out merger. This argument prompted the Delaware Supreme Court to take the rare step of requesting supplemental briefing "in the interests of justice to provide certainty to boards and their advisors who look to Delaware law to manage their business affairs."

In an *en banc* opinion, the Delaware Supreme Court analyzed the development of *MFW* and how it has been utilized. Importantly, the court emphasized that it is "important to recognize that 'an interest conflict is not in itself a crime or a tort or necessarily injurious to others.' In other words, 'having a "conflict of interest" is not something one is guilty of.' Indeed, a corporation and its stockholders may benefit from a controlling stockholder's influence." The court then went on to reaffirm *MFW* as the only method to reduce entire fairness review to business judgment, concluding that, even outside the freeze-out context, "in a suit claim-ing that a controlling stockholder stood on both sides of a transaction with the

[1] In addition, the Delaware Supreme Court, in two separate decisions, emphasized a need for more robust "conflict" disclosures, with a particular emphasis on those involving special committees and financial advisors. See our article "Recent Updates in Delaware Financial Advisor Conflict and Disclosure Law" from this edition of *Insights: The Delaware Edition for information on these two opinions.*

[2] -- A.3d --, 2024 WL 1449815 (Del. Apr. 4, 2024).

controlled corporation and received a non-ratable benefit ... [i]f the controlling stockholder wants to secure the benefits of business judgment review, it must follow all *MFW*'s requirements." The other significant issue addressed in *Match Group* concerned the special committee prong of *MFW*. Specifically, the court held that all members of a special committee in a conflicted controller transaction — not just a majority of the committee, as some courts have held — must be independent in order for the committee to pass muster under *MFW*.

Further Developments in Controller Jurisprudence

Sears: Controllers may owe duties and be subject to enhanced scrutiny when exercising stockholder-level rights.

In *In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation*,[3] the Court of Chancery addressed the standard of fiduciary conduct for controllers exercising stockholder-level voting rights.

As the court explained, in *Sears*, an independent committee of Sears' board endorsed a plan to liquidate a segment of the company's business. The company's controller believed that this liquidation plan would destroy value and tried to convince the committee not to have it implemented. When the committee refused to back down, the controller took action by written consent to (i) adopt a bylaw amendment that prevented the board from implementing the liquidation plan without two separate board approvals (from 90% of the board), 30 business days apart, and (ii) remove two (of three) committee members who he believed were the most insistent on pursuing the liquidation plan (the Controller Intervention). Thereafter, the sole remaining special committee member did not believe the status quo was viable for the company and negotiated an end-stage transaction with the controller that eliminated the minority stockholders' interest in the company (the Transaction). Minority stockholders then sued the controller, contending that he breached his fiduciary duties by using his stockholder voting power to effectively block the liquidation plan (through the Controller Intervention) and later forcing the company to enter into the Transaction.

The Court of Chancery analyzed both Delaware Supreme Court and its own precedent to discern when a controller owes fiduciary duties, what duties the controller owes and how a court should review the exercise of controller power for compliance with those duties. In considering the Controller Intervention-related issues, the court focused on the duties owed by a controller when exercising stockholder-level rights (rather than the controller wielding its power over the board and causing the corporation to act). According to the court, "[a] controller can say 'no' to a sale, thereby maintaining the status quo, without engaging in a fiduciary act. An affirmative sale, however, implicates the controller's fiduciary duties, albeit to a limited degree" (such as not selling the company to a "looter"). Moreover, a "controller does not owe any enforceable duties when declining to vote or when voting against a change to the status quo … [b]ut if the majority stockholder seeks to change the status quo, then the majority controller cannot harm the corporation knowingly or through grossly negligent action." More specifically, when voting to change the status quo, the court said "a controlling stockholder owes a fiduciary duty of loyalty which requires that the controller not intentionally harm the corporation or its minority stockholders, plus a fiduciary duty of care that requires that the controller not harm the corporation or its minority stockholders through grossly negligent action."

[3] 309 A.3d 474 (Del. Ch. 2024).

The court then examined which standard of review should apply when a controller exercises voting power, concluding that enhanced scrutiny should apply to the Controller Intervention in light of the fact that the controller "t[ook] action to impair the rights of the directors or a stockholder minority." The court reasoned that "enhanced scrutiny applies when directors amend bylaws or otherwise intervene in elections or voting contests touching on corporate control. Enhanced scrutiny also should apply when a controller does something comparable." In order to prevail, a controller must show that they acted in good faith for a legitimate objective, had a reasonable basis for believing the action was necessary and selected a reasonable means for achieving their legitimate objective.

Referencing these concepts and taking the controller's trial testimony into account, the court found that the controller did not intend to harm the company and was acting in good faith to protect the company from the threat of value destruction. The court further found that the controller identified a threat after a reasonable investigation and that the Controller Intervention was a reasonable means to neutralize the special committee's unilateral implementation of the liquidation plan. Thus, the court held, when the controller exercised his stockholder-level voting power to carry out the Controller Intervention, he did not breach his fiduciary duties. "If nothing else had happened, and if the Company had merely continued operating as it had before the Controller Intervention, then judgment would be entered for the defendants … [h]owever, after the Controller Intervention, the Company did not simply continue operating as it had before. The status quo was not sustainable, and the Transaction resulted." Accordingly, the court found that the Transaction yielded both an unfair price and process, and entered judgment for the plaintiffs.

TripAdvisor: Reincorporating from Delaware to Nevada may confer a non-ratable benefit to a controller.

In *Palkon v. Maffei*,[4] stockholders challenged the conversion of two controlled Delaware corporations to Nevada corporations, seeking an injunction to prevent the conversions from closing. The Court of Chancery held that it was reasonably conceivable that the conversion of a Delaware corporation into a Nevada corporation conferred a non-ratable benefit on the controller because Nevada stockholders have less "litigation rights ... than what Delaware provides." While the court left open the possibility that the defendants could later prove that Delaware and Nevada offer equivalent rights, at the pleading stage it was reasonable to infer "that Nevada law provides greater protection to fiduciaries and confers a material benefit on the defendants." Finding that the controller had benefitted from the conversion to the detriment of the other stockholders, the court applied entire fairness review and denied in part the motion to dismiss, highlighting that this result "fulfills important public policies" and ensures that "litigation rights cannot become second-class rights."

The court granted the motion to dismiss as to injunctive relief, declaring that an injunction preventing the conversion was "off the table." While the court made clear that this opinion "does not mean that corporations cannot leave Delaware," it also indicated that in order to avoid litigation risk, the conversion of a controlled corporation would need to be conditioned on the protections of *MFW*.[5]

[4] 311 A.3d 255 (Del. Ch. 2024), *cert. denied*, 2024 WL 1211688 (Del. Ch. Mar. 21, 2024).

[5] As of the date of publication of this article, this case is pending appeal to the Delaware Supreme Court.

Controller Stripped of Facially Earned Compensation Package After Failing MFW

The Court of Chancery, in *Tornetta v. Musk*,[6] ordered rescission of Tesla CEO Elon Musk's $55.8 billion compensation plan after concluding that the defendants failed to prove at trial that the compensation package (the Grant) was entirely fair. Though Mr. Musk, who maintains 21.9% of Tesla's voting power, lacked mathematical voting control, the court found that he "exercised transaction-specific control over the Grant." The court also declined to shift the burden of proving entire fairness to the plaintiff because there was "no well-functioning committee of independent directors" and the stockholder vote was tainted by a "materially deficient" proxy statement. With respect to the latter, the proxy failed to disclose, among other things, the Compensation Committee's potential conflicts with Mr. Musk. Specifically, the court found that rather than disclose certain committee members' personal and other business relationships with Mr. Musk, the proxy repeatedly described the Compensation Committee as "independent." The court noted that the proxy could have disclosed "the relevant relationships while stating that the Board did not view them as serious impediments to independence thereby allowing stockholders to make their own assessment."

The court also held that the defendants fell short on both the fair dealing and fair price analyses. With respect to fair dealing, the court observed that the committee engaged in a "'cooperative and collaborative' process antithetical to arm's-length bargaining." Regarding fair price, the defendants argued that the Grant was "all upside" for the stockholders, and urged the court to evaluate the price by comparing what Tesla "gave" against what Tesla "got." Instead, the court held the "principal defect" with fair price was the failure to explain — "why did Tesla have to 'give' anything in these circumstances? Musk owned 21.9% of Tesla at the time of the Grant. If the goals were retention, engagement, and alignment then Musk's pre-existing equity stake provided a powerful incentive for Musk to stay and grow Tesla's market capitalization." However, based on public statements, the court found that Mr. Musk had no intention of leaving the company, regardless of his compensation package. Ultimately, the court rescinded the Grant in its entirety as a remedy.[7]

[6] 310 A.3d 430 (Del. Ch. 2024).

[7] On June 13, 2024, Tesla announced that stockholders had again approved Elon Musk's rescinded pay package. No appeal has yet been taken in this matter.

Key Points

Delaware controller law has been impacted by significant case law developments issued in a relatively short time period. Though the Delaware Supreme Court has ruled on certain issues, the Court of Chancery decisions are either on appeal or may potentially be appealed. Nevertheless, in light of these recent rulings:

- Controlled companies should be mindful of further case law developments in this area.
- When considering using *MFW*, boards should consider whether *all* directors slated for committee membership are truly independent.
- Traditional proxy statement disclosures concerning conflicts may need to be revisited.
- Enhanced scrutiny may apply where a conflicted controller takes stockholder-level action that impacts or influences the board.
- Controlled Delaware companies contemplating reincorporation in other states should consider the outcome in *TripAdvisor*, including the potential risk of additional litigation and remedies as part of any such process.

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