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**PROGRAM MATERIALS**

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## **The Pros and Cons of Control: Corporate Governance Risks and Litigation Trends**

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# The Pros & Cons of Control

## Corporate Governance Risks and Litigation Trends

September 27, 2021

Holland & Knight

# Overview

- Consequences of Control
- How to End Up in Control
  - Acquire Majority Ownership
  - Dual Class Stock Structures
  - Super-voting Founder Shares
  - Court Finds “Actual Control”
- Litigation Trends

# Consequences of Control

- Why does it matter?
- For stockholders:
  - Under Delaware law, stockholders do not generally owe fiduciary duties to others
  - This changes if one is a controller
  - One can be a controlling stockholder if:
    - one controls a majority of the company's voting power, or
    - stockholder exercises “a combination of potent voting power and management control without actually owning a majority of stock”

*Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304, 307 (Del. 2015)

# Consequences of Control

- In certain types of cases, courts can also find a “controlling stockholder group”

Delaware case law has recognized that a number of shareholders, each of whom individually cannot exert control over the corporation (either through majority ownership or significant voting power coupled with formidable managerial power), can collectively form a control group *where those shareholders are connected in some legally significant way* — e.g., by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal. In that case, the control group is accorded controlling shareholder status, and, therefore, its members owe fiduciary duties to their fellow shareholders.

*Dubroff v. Wren Holdings, LLC*, 2009 WL 1478697, at \*13 (Del. Ch. May 22, 2009)

# Consequences of Control

If one is a controlling stockholder or part of a “controlling stockholder group,” then one owes fiduciary duties much like a director does:

- Duty of loyalty – requires that the controlling stockholder act in the best interests of the company and its stockholders as a whole, not in the controlling stockholder’s self-interest
- Duty of care – requires that one makes informed, rational business decisions
- Duty of disclosure – requires that one disclose material facts

# Consequences of Control

- For significant transactions involving controllers, a higher level of judicial scrutiny may apply
  - “Entire fairness” requires “fair price and fair dealing”
  - As a practical matter, complaints challenging transactions that are subject to entire fairness review are rarely dismissed at the early stages of litigation
  - Defendants have the burden of demonstrating the transaction was entirely fair
    - Burden can be shifted back to plaintiff if the transaction is subject to the approval of an effective special committee of independent directors, or approval of the noncontrolling stockholders in a fully informed, uncoerced vote (*Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 642 (Del. 2014))
  - If a transaction is subject to the *Kahn v. M&F Worldwide* conditions *before* any “substantive economic negotiations have begun,” then the business judgment rule will apply (*Flood v. Synutra Int’l, Inc.*, 195 A.3d 754, 762 (Del. 2018))

# Consequences of Control

- Ability to “cleanse” a breach of fiduciary duty
  - *Corwin v. KKR Financial Holdings*, 125 A.3d 304 (Del. 2015)
    - The Delaware Supreme Court has held that a transaction subject to enhanced scrutiny under *Revlon* will instead be reviewed under the business judgment rule *if it has been approved by a majority of fully informed and uncoerced stockholders*.
  - Specifically, “[i]n the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors.”  
(*Larkin v. Shah*, 2016 WL 4485447, at \*10 (Del. Ch. Aug. 25, 2016))



# Dual (or More)-Class Stock Structures

- Company offers two or more types/classes of stock
  - Different voting rights
  - Different dividend payouts
  - Offered to different groups of individuals
    - General public
    - Founders/employees

# Dual (or More)-Class Stock Structures

- Not a new idea
  - International Silver Company's common stock initially (1898) had no voting rights and later (1902) only received one vote for every two shares
  - 1925 Dodge Brothers, Inc. listed on NYSE but only sold nonvoting common shares to public while investment banking firm held voting shares

# Dual (or More)-Class Stock Structures

- Resulted in NYSE announcing it would consider voting/non-voting structure when approving listings
- 1940 NYSE announced rule against listing nonvoting stock
- Certain exceptions to retain family control (and for NYSE to retain listing...)
  - 1956 Ford Motor Company
  - 1969 New York Times
  - 1971 Washington Post

# Dual (or More)-Class Stock Structures

- 1980s: NYSE forced to further relax restrictions when companies threatened to list on Nasdaq or American Stock Exchange that lacked such restrictions
  - Many companies were adopting dual class structures as takeover defenses

# Dual (or More)-Class Stock Structures

- SEC Attempted Ban: July 1988 SEC adopts Rule 19c-4:
  - Prohibited national security exchanges and national securities associations from listing stock of a corporation that takes any corporate action “with the effect of nullifying, restricting or disparately reducing the per share voting rights of [existing common stockholders].”

Voting Rights Listing Standards; Disenfranchisement Rule, 53 Fed.Reg. 26,376, 26,394 (1988) ("Final Rule"), codified at 17 CFR Sec. 240.19c-4 (1990)

- Invalidated in Court: *The Business Roundtable v. Securities and Exchange Commission*, 905 F.2d 406 (D.C. Cir. 1990)
  - \* Because the rule directly controls the substantive allocation of powers among classes of shareholders, we find it in excess of the Commission's authority under Sec. 19 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78s (1988)

# Dual (or More)-Class Stock Structures

- Tech Companies in particular embraced dual-class stock structures in IPOs
  - Alphabet
    - Class A: 1 vote per share
    - Class B: 10 votes per share
    - Class C: no vote
  - Facebook
    - Class A: 1 vote per share
    - Class B: 10 votes per share

# Dual (or More)-Class Stock Structures

## Snap's IPO

“To our knowledge, no other company has completed an initial public offering of non-voting stock on a U.S. stock exchange” (ahem...)

- Class A – on NYSE but no voting rights
  - Class B – executives/early investors (1 vote per share)
  - Class C – held by two co-founders with 10 votes per share
- 
- As a consequence, co-founders hold 85.5% of the company's total voting power

# Dual (or More)-Class Stock Structures

## PROS

- Allows founders to pursue vision and not react to short term stock market fluctuations
- Without structure, founders may not take companies public at all

## CONS

- Founding stockholders unlikely to lose jobs even if mismanaging the company
- May seem “fundamentally unfair” to (investing) public



# Dual (or More)-Class Stock Structures

- Potential solutions
  - SEC regulation unlikely due to *The Business Roundtable* decision (see slide 12 above)
  - Council of Institutional Investors encourages the introduction of time-based sunset provisions, which would automatically convert the dual class to one class within a specified time frame (3 to 7 years)

# Deemed in Control

- *In re Pattern Energy Group, Inc. Stockholders Litigation* (Del. Ch. May 6, 2021)
  - Class action challenging \$6.1 billion go-private, all-cash sale of Pattern Energy to Canada Pension Plan Investment Board
  - Transaction approved by 52% of the Pattern Energy stockholders
  - Riverstone Pattern Energy Holdings LP is a private equity fund that formed Pattern Energy and controlled its upstream supplier of energy projects (“Developer 2”)

# Deemed in Control

- Despite the fact that neither Riverstone nor Developer 2 were stockholders at the time of the transaction, the Court refused to dismiss them as part of an alleged “control group” that also included the officers

“Considering evolving market realities and corporate structures affording effective control, 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.”

# Deemed in Control

- Plaintiff's control theory focused on alleged controllers' "soft sources" of power
  - Long history between Riverstone and the officers
  - Riverstone controlled Developer 2, an essential part of Pattern Energy's upstream supply chain, supporting the inference of Riverstone having "leverage over" the outcome of the sales process
  - Riverstone/Developer 2 had a consent right over Pattern Energy's stake in Developer 2

# Deemed in Control

- *In re Tesla Motors, Inc. Stockholder Litigation*, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018)
  - At the motion to dismiss stage, Delaware Court of Chancery declined to grant defendants' motion to dismiss because it was "reasonably conceivable" that Elon Musk was a controlling stockholder and therefore Tesla's acquisition of SolarCity Corporation was subject to entire fairness review
  - Factors the Court considered:
    - Musk owned 22.1% of Tesla (largest stockholder)
    - Chairman of board, CEO and Chief Product Architect
    - Also founder of SolarCity (its largest stockholder as well)
    - No special committee formed and instead Musk led the board's discussions and engaged the board's advisors
    - Statements made in public filings
    - Statements made by Musk

# Controlling Stockholders & Liquidity Needs

- One recurrent fact pattern involves whether VC/PE firms as stockholders, or their appointed directors, had divergent interests in a transaction – namely, whether they had a “liquidity-driven” conflict – that needed to be disclosed in order for a stockholder vote to be fully informed under *Corwin*

# Controlling Stockholders & Liquidity Needs

*Firefighters' Pension System of City of Kansas City, Missouri Trust v. Presidio*, 251 A.3d 212, 256 (Del. Ch. 2021):

Delaware courts have been reluctant to find that a liquidity-based conflict rises to the level of a disabling conflict of interest when a large blockholder receives pro rata consideration. To reach such a conclusion requires the court to make the extraordinary inference that rational economic actors have chosen to short-change themselves in favor of liquidity. Accordingly, in most cases, a fiduciary's financial interest in a transaction as a stockholder (such as receiving liquidity value for her shares) does not establish a disabling conflict of interest when the transaction treats all stockholders equally.

# Controlling Stockholders & Liquidity Needs

- However, the theory has been successfully pled:
- *In re Rural Metro Corporation Stockholders Litig.*, 88 A.3d 54, 65 (Del. Ch. 2014)
  - hedge fund and its designee found to have favored an M&A event after new CEO instituted a growth plan based on \$50 million in acquisitions a year, which conflicted with hedge fund's investment strategy of favoring companies with predictable cash flows, and hedge fund had told its investors that it avoided companies whose valuations relied on exceptional growth
- *In re PLX Technology*, 2018 WL 5018535 at \*1-2 (Del. Ch. Oct. 16, 2018)
  - activist hedge fund stalked its target, ran a dissident slate of directors, manipulated the target's sale process, and held its target shares for little more than one year to realize a quick profit
- *In re Mindbody, Inc.*, 2020 WL 5870084 at \*3, \*16, \*24 (Del. Ch. Oct. 2, 2020)
  - CEO, who publicly stated that he had a need for liquidity and sought to fund significant outside interests, found to have a liquidity-based conflict when, *inter alia*, he played a critical role in the M&A negotiations and rejected a potential suitor because he did not want to work for that company



# Controlling Stockholders & Liquidity Needs

- *Kihm v. Mott*, C.A. No. 2020-0938-MTZ (Del. Ch. Aug. 31, 2021)
  - challenged the cash sale of Tesaro to GlaxoSmithKline, plc for \$5.1 billion.
  - Long-time VC sponsor, New Enterprise Associates (“NEA”), was alleged to have favored a near-term sale so it could exit its position and raise a new fund
  - Numerous allegations regarding NEA’s motivations, fundraising history and the VC fundraising cycle
  - NEA was *not* alleged to be a controlling stockholder
  - NEA’s board designees *not* alleged to have had any specific role in the allegedly flawed sales process

# Controlling Stockholders & Liquidity Needs

- Board had no obligation to disclose the business model of a minority stockholder, even if that model conflicted with the pursuit of value
- Key issue then became whether the chairman of the board, who had originally been appointed by NEA, was conflicted
  - Plaintiff alleged that NEA's liquidity interests, filtered through the chairman, were material to stockholders' understanding and questioned the acquisition process

# Controlling Stockholders & Liquidity Needs

- Court found that it was disclosed that:
  - chairman was a general partner at NEA
  - chairman was therefore a dual fiduciary to NEA and Tesaro
  - NEA held a substantial number of shares and planned to vote for the transaction
  - Complaint did not allege that NEA was involved with the sales process
  - Complaint did not allege that chairman played a substantial role in the negotiations
- “In this case, absent any allegation of bad acts, or even any act at all, further detail about the depths of [chairman’s] allegedly bad intentions is immaterial.”

# Presenters' Biographies



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**Roger A. Lane** is a securities litigation attorney in Holland & Knight's Boston office. Mr. Lane has significant experience representing clients involved in complex commercial litigation, with a particular emphasis on corporate law disputes, stockholder and federal securities litigation, and related risk management issues.

Mr. Lane represents venture capital and private equity firms as well as their partners; early-stage and mature corporations along with their directors, officers and independent board committees; investment advisers; investment banks; and underwriters. He handles litigation related to the federal securities laws, debt and equity financings, mergers and acquisitions (M&A), executive compensation and other matters of corporate management and governance. Mr. Lane also has experience managing internal corporate investigations and advising clients on how to mitigate litigation risk before entering major corporate and commercial transactions.

After law school and before entering private practice, Mr. Lane served as a judicial clerk for the Honorable John R. Gibson of the U.S. Court of Appeals for the Eighth Circuit.

# Presenters' Biographies

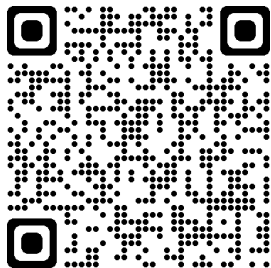


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**Courtney Worcester** is a trial attorney in Holland & Knight's Boston office. Ms. Worcester focuses her practice on complex commercial litigation involving corporations, limited liability companies (LLCs), venture capital and private equity firms, and financial institutions and their directors and officers.

Ms. Worcester regularly counsels boards, individual directors and officers on a wide variety of corporate governance matters, including books and records demands, removal or election of directors, board committee investigations and reports. In addition, she represents clients in federal securities and shareholder litigation matters, including federal securities and consumer class actions, stockholder derivative litigations, as well as in disputes between co-founders. Ms. Worcester is also experienced in diverse commercial litigation matters, ranging from contractual disputes to the protection of trade secrets, unfair competition and other business torts.

In addition to her legal practice, Ms. Worcester is a member of the recruiting committee for Holland & Knight's Boston office