

Select Legal Topics for Controlled Companies

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Fiduciary Duties

- **Board owes fiduciary duties to the corporation and stockholders (applies to all board decisions)**

Duty of care

- Obligation to act on an informed basis after due consideration and appropriate deliberation
- Entitled to rely on management and advisors, so long as no reason to believe reliance is unreasonable

Duty of loyalty

- Obligation to act in the best interests of the company and stockholders, as opposed to directors' personal interests

- **If duties are satisfied, the decisions of a board are generally protected by the “business judgment rule”**
- **“Business judgment rule,” however, may not be available in certain “conflict transactions” where there is a reason to believe that the directors may not be acting in the best interest of the company and the stockholders**

Legal Framework for Conflict Transactions

- If a “conflict” transaction is challenged in court, the interested fiduciary (e.g., the controlling stockholder or conflicted management) ordinarily bears the burden of demonstrating that the transaction was “entirely fair” to the corporation and its stockholders
- **Two parts to entire fairness:**
 - “Fair dealing” (procedurally fair)
 - “Fair price” (fair consideration)
- **Delaware courts are willing to apply a more deferential standard of review if the parties employ certain “sanitizing” mechanisms, including approval of the transaction by:**
 - Disinterested directors;
 - Disinterested stockholders; or
 - Both disinterested directors and disinterested stockholders
- **“Sanitizing” mechanism could lead the court to apply one of the following deferential standard of review:**
 - Plaintiff has burden of proving that the transaction was not “entirely fair”
 - Business judgment rule
- **Need to weigh benefit of “sanitizing” mechanism in terms of better standard of review versus additional risk of the mechanism to consummation of the deal**

Who Is a “Controller”?

- A shareholder owes a fiduciary duty to other shareholders “only if it owns a majority interest in or exercises control over the business affairs of the corporation”
- Shareholders with majority voting power are deemed to be “controllers”
- But ownership of a majority of stock of a company is not required for a person to be deemed “control” for purposes of entire fairness analysis.
- “Control” can be evidenced in a variety of ways:
 - Relationships with management
 - Influence over other directors
 - Affiliations to other stockholders
 - Threats of retaliation or vetos

What is a “Conflict” Transaction?

- A “conflict” transaction is one where the interests of the “controller” may be different than the interests of the corporation and its other stockholders
- **Classic examples:**
 - Controlling stockholder acquires remaining equity of the controlled company
 - Sale of assets between controller and the controlled company
 - Transaction involving the company in which controlling stockholder receives greater consideration than non-controlling stockholder on a per share basis
- **Plaintiffs are alleging additional situations are “conflict” transactions:**
 - Transactions where the controlling stockholder nominally receives the same amount of cash or stock as other stockholders, but where controlling stockholder received a “unique” or “non-ratable” benefit in terms of tax treatment
 - Compensation awards to a controller or controller affiliate

What Constitutes a “Disinterested” Director?

- **Difference between “independent” director for NYSE and Nasdaq listing purposes and for purposes of qualifying for a sanitizing mechanisms under Delaware law**
- **Consider all personal and financial relationships (not just direct financial interests) between a director and the controller, although not all relationships are necessarily disabling**
- **Difference between “independent” director for a sanitizing mechanism vs demand futility vs Special Litigation Committees**
- **A demand is futile if:**
 - (i) the director received a material personal benefit from the alleged misconduct;
 - (ii) the director would face a substantial likelihood of liability on the claims that are subject of the demand; or
 - (iii) the director lacks independence from another person who received a material personal benefit from the alleged misconduct or would face a substantial likelihood of liability on the claims that are the subject of the demand
- **A director may be considered independent for purposes of his or her service on a special committee or to vote on a conflict transaction, but fail independence for purposes of demand futility or for service on a Special Litigation Committee**

Practice Points: Independent Directors / Special Committees

- **Board composition**

- Rule of three
- Composition prior to consideration of a conflict transaction

- **Power granted to a special committee**

- Ability to say “no”; ability to consider alternative transactions; ability to select its own advisors

- **Interactions with the special committee**

- Consider interactions with independent directors before formation of the special committee
- Once committee is formed, ensure special committee has adequate information
- Avoid problematic one-off conversations between the controller and committee members
- Create record that reflects careful and informed consideration of material issues

- **Legal standard of review**

- In order to invoke *MFW* standard of review, controller must agree “at the outset” to conditions (i.e., approval by both disinterested directors and non-waivable condition of “majority of the minority” stockholder approval)

Practice Points: Compensation Matters

- **Best practices for compensation decisions:**
 - Fairly compensate management for service to the company
 - Properly incentivize management to achieve performance goals
- **Process is critical:**
 - Well-supported record of considerations by compensation committee
 - Role of independent compensation consultant
 - Fulfillment of compensation committee responsibilities in accordance with its charter and other governing documentation
- **Increased scrutiny on:**
 - Family members
 - Extraordinarily large or specially-timed grants

Practice Points: Other Issues

- **Privilege Issues**

- Legal advice being provided to the company or to the controller or both?

- **Disclosure / Schedule 13D**

- When does a controller have a “plan” or “proposal” with respect to an extraordinary corporate transaction?
- Structuring the offer process in light of disclosure obligations

- **Succession Planning**

- Clear delineation of new leadership
- Agreed expectations and ground rules (particularly between the departing leader and the new leader)
- Communication of leadership structure to internal and external constituents