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## **Delaware Court of Chancery Finds 22% Stockholder to be Controller Due to Unique Facts**

Recently in *In re Tesla Motors, Inc. Stockholder Litigation*, the Delaware Court of Chancery (in an opinion by Vice Chancellor Sights) declined to grant defendants' motion to dismiss because the court found it reasonably conceivable that Elon Musk, a 22.1% stockholder of Tesla Motors, Inc., was a controlling stockholder and therefore Tesla's 2016 acquisition of SolarCity Corporation (of which Musk was the largest stockholder and founder) would be subject to a stringent entire fairness review. In this regard, it is rare for Delaware courts to find that a stockholder with such "relatively low" ownership levels is a controller. They have done so only, as was the case here, where there is other evidence that the stockholder exercised "actual domination and control over . . . [the] directors" and wielded more power than may be evidenced by the stockholder's minority holdings. The court's conclusion that Musk was a controller meant that stockholder approval of the acquisition did not ratify the transaction and invoke business judgment review because *Corwin v. KKR Financial Holdings LLC* does not apply to controller transactions.

### **Background**

Elon Musk, a 22.1% stockholder of Tesla, was the company's largest stockholder and also its chairman of the board, CEO and Chief Product Architect. Musk also co-founded SolarCity Corporation and was its largest stockholder and the chairman of its board. In 2016, Tesla acquired SolarCity in a stock-for-stock transaction. Musk had proposed the transaction to the Tesla board on several occasions and the well-pled facts suggested that such an acquisition was in Musk's long-term plan for Tesla. The Tesla board did not form a special committee to consider the potential acquisition, despite "obvious conflicts" of the directors, including their personal and business relationships with Musk and ownership of SolarCity stock. The court also noted that Tesla's debt load would nearly double after the acquisition due to the fact that SolarCity was in the midst of a liquidity crisis. Yet despite all of these and other issues, Tesla stockholders approved the acquisition in a vote that excluded certain interested Tesla stockholders who were also directors or executive officers of SolarCity. Plaintiffs, Tesla stockholders, brought suit challenging the transaction, and the defendants moved to dismiss.

### **Takeaways**

The most notable aspect of the court's opinion denying the defendants' motion to dismiss is that even a stockholder with a "relatively low" ownership stake representing a "small block" may be found to be a

controlling stockholder, but only if there are other factors that reflect additional, outsized control of the corporation.

Under Delaware law, a stockholder can be considered a controlling stockholder when the stockholder: (i) owns more than 50% of the corporation's voting power or (ii) owns less than 50% of the voting power, but "exercises control over the business affairs of the corporation." With regard to the latter, the stockholder must "exercise[] actual domination and control over . . . [the] directors" that is "so potent that independent directors . . . [could not] freely exercise their judgment." While there is no absolute percentage of voting power required for a Delaware court to find (or eliminate) control status, the court has observed, in at least one case, that to find a stockholder with a 33.7% ownership stake a controller would be "aggressive" (see *In re Crimson Exploration Inc.*). With no bright line, however, the court has allowed a theory of controller liability to proceed where the ownership level was significantly below such threshold based on other indicia of control (see *In re Zhongpin Inc. Stockholders Litigation*, where the court concluded that plaintiffs had raised reasonable inferences that a 17.3% minority stockholder, who served as CEO and chairman of the board, was a controller where the company publicly disclosed that he was a controller and had significant influence over the company). Thus, Delaware courts have found controller status for stockholders with "relatively low" holdings, albeit in only a limited number of cases where the unique facts demonstrate particularly high levels of corporate control and influence by the minority stockholder. In *Tesla*, the court agreed with the plaintiffs that the well-pled facts presented such unique circumstances, which facts combined to make it reasonably conceivable that Musk controlled Tesla, including that:

- Musk held what could be the equivalent of majority voting control because he had the ability to rally other stockholders to bridge the gap between his 22.1% ownership stake and majority control. This alone would not be enough to make him a controller, but the plaintiffs also pled that Musk demonstrated a willingness to use such power to oust senior management when he was displeased, having replaced the former CEO and appointing himself to the position.
- Musk exercised control over Tesla's board as the company's visionary, CEO and chairman of the board. When considering the transaction, the board was well aware of Musk's "singularly important role in sustaining Tesla in hard times and providing the vision for the Company's success." There were no steps taken to separate him from the board's consideration of the SolarCity acquisition, such as through the formation of a special committee, and he even led the board's discussions regarding the acquisition and engaged the board's advisors.
- Musk had strong personal and business connections with the other directors, making a majority of them interested in the transaction. According to plaintiffs, the fact that Tesla paid approximately \$2.6 billion in its own stock to acquire SolarCity, a severely distressed company on the brink of bankruptcy, suggested that no fiduciary acting in good faith could have approved those terms, and further revealed that the board was dominated by Musk when voting to approve the acquisition.

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- Musk and Tesla repeatedly acknowledged Musk’s influence over the company in public filings, noting that he “contributed significantly and actively” to the company by recruiting talent, contributed to product engineering and design, raised capital and public awareness of the company, and “spen[t] significant time with Tesla and [was] highly active in [Tesla’s] management.” The company also publicly stated that a loss of Musk’s services would disrupt and have a negative impact on its business, and that the concentration of ownership among the company’s executive officers and directors may prevent new investors from influencing significant corporate decisions. For his part, Musk publicly stated that Tesla, SolarCity and SpaceX (another company founded by Musk) form a “pyramid” on top of which he sits, and has referred to Tesla as “his company.”

Based on the foregoing, although decisions finding minority shareholders to be controllers continue to be relatively rare, companies entering transactions with significant, influential stockholders may not be able to rely on a stockholder vote (even where informed and involving only disinterested stockholders) to attain dismissal of transaction-related litigation and to insulate the action from entire fairness review, especially where any facts support outsized control over the management and direction of the company by the stockholder. Boards in such situations may need to consider the protections mandated by Delaware courts in controlling stockholder transactions to invoke business judgment protection (*e.g.*, conditioning the transaction *ab initio* upon both (i) the approval of an independent, adequately empowered special committee that fulfills its duty of care and (ii) the uncoerced, informed vote of a majority of the minority stockholders).

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