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When Minority Stockholders Take Control: Recent Delaware Cases Shine a Light on Fiduciary Obligations of Controlling Stockholders

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It is well understood that when a stockholder owns a majority of a company's voting stock, that stockholder is considered to be a "controlling stockholder" under Delaware law, triggering certain fiduciary duties owed to the company's other stockholders. These fiduciary duties inhibit, among other things, the ability of the controlling stockholder to perform any actions that can be interpreted as unduly "squeezing out" other company stockholders or benefiting the controlling stockholder at their expense. Claims like these are routinely litigated in the Delaware Chancery Court, often involving loans and commercial arrangements outside of the change of control context.

Recent Delaware Chancery Court cases have once again reinforced that it is a mistake to assume that just because a stockholder does not own 51% of the company's equity that they are free from the constraints that apply to controlling stockholders. For instance, fiduciary duties prohibit these stockholders from engaging in behavior that would disproportionately benefit themselves at the expense of the company's other stockholders. Moreover, these duties also constrain the ability of the company to enter into otherwise arm's-length negotiations with affiliates of the controlling stockholder unless the company has sufficient procedural safeguards in place.

Recent Delaware Cases

The following recent Delaware Chancery Court cases, decided during the first half of 2016, provide key insight into when minority stockholders can be deemed controlling stockholders and the level of judicial review that applies to agreements with affiliates of the controlling stockholders:

- *Calesa Associates, L.P, et. al v. American Capital*: In *Calesa*, the stockholders of Halt Medical (Halt) brought fiduciary duty claims against American Capital alleging that American Capital purposefully engaged in a series of recapitalization transactions that disproportionately benefitted American Capital at the plaintiffs' expense. In connection with its initial investment in Halt, American Capital received the right to appoint two of five directors, as well as blocking rights for subsequent equity transactions. With these blocking rights, American Capital blocked a third-party loan in Halt. Thereafter, Halt's board subsequently approved a $20 million loan from American Capital at a 22% interest rate, which also allocated American Capital an additional seat on Halt's board. Unable to pay the note upon maturity, American Capital demanded that Halt enter into a merger transaction as a means

of debt repayment. This transaction, which among other things had the effect of recapitalizing and increasing American Capital's equity interest in Halt from 26% to 66%, was approved by Halt's board (including three of seven members affiliated with Halt at the time) and was put to a vote by Halt's stockholders with only a one-day period to review and evaluate the underlying 297-page transaction proposal. Notably, the Court held that the plaintiffs had sufficiently alleged that American Capital and its affiliates, despite only owning 26% of Halt's shares at the time that the transaction was approved, could be deemed to be controlling stockholders owing fiduciary duties to the other Halt stockholders. The Court reaffirmed that "control" is a fact-specific inquiry that focuses on the stockholder's influence over the company's board rather than mere ownership percentage. The Court assessed whether a majority of the board was "affiliated with or beholden to" American Capital, and whether any party was given significant benefits to reasonably infer that such party was beholden to American Capital. Although American Capital was technically a minority stockholder, the Court found that it was nevertheless a controlling stockholder because it exercised significant control over Halt's board; of the seven director positions, three of the directors could be deemed to be affiliated with American Capital and sufficient facts were pled to also suggest that the CEO of Halt and his assistant were also beholden to American Capital because they had been given substantial raises and could be terminated at any time. Thus, the Court decided that American Capital was indeed a controlling stockholder that thereby owed fiduciary duties directly to Halt's other stockholders.

- *In re EZCorp Inc. Consulting Agreement Derivative Litigation*: *EZCorp* involves a stockholder derivative suit for breach of fiduciary duty, which challenged the fairness of three consultant agreements between EZCorp and Madison Park, an entity owned by EZCorp's controlling stockholder, Phillip Cohen. Due to EZCorp's dual-class structure, although Cohen owned only about 5.5% of EZCorp's total equity, MS Pawn L.P., an entity ultimately controlled by Cohen, owned 100% of EZCorp's total common stock. This meant that Cohen had full control over EZCorp's board, and could remove board members at will. The suit alleged that EZCorp's audit committee rubber stamped the consulting agreements at Cohen's request, and that these agreements were a means by which Cohen could improperly extract a non-ratable cash return from EZCorp. The plaintiffs particularly noted that Cohen had previously replaced two EZCorp directors that had terminated a similar consultant agreement with Madison Park with directors that were allegedly loyal to him. The Court found that the plaintiff had pled sufficient facts to infer a direct claim against Cohen, and the Court ruled that the entire fairness standard, not the more deferential business judgment rule, applied even though it was a non-merger business transaction and even though the consulting agreements had been approved by a board-established process for considering related-party transactions. Specifically, the Court noted that by not having sufficient procedural safeguards in place, including the approval of the consulting agreements by independent directors or the vote of informed, unaffiliated stockholders, the consulting agreements were tantamount to self-dealing whereby "the applicable standard of judicial review is entire fairness, with the defendants having the burden of persuasion."

What are Minority Stockholders to do?

Stockholders who have less than a majority equity interest in a company should keep in mind that courts do not simply rely on ownership as the sole test for whether a stockholder constitutes a "controlling stockholder" and owes fiduciary duties. A minority stockholder should be wary of performing any actions that could be viewed as disproportionately benefitting themselves at the

expense of the company's other stockholders if (i) the minority stockholder exercises control over the company's board and (ii) the company's executive officers are terminable at will. As *Calesa* illustrates, even a stockholder who merely owned 26% interest in a company was found to be a controlling stockholder that thereby triggered the entire fairness standard in scrutinizing that stockholder's actions and its effect on the other company stockholders. The risks and scrutiny of such actions are further heightened by the presence of complex and intertwining relationships between the shareholder, management and the company, or in instances where such individuals are sitting on multiple sides of a transaction.

EZCorp demonstrates that controlling stockholders, and potentially controlling stockholders as in *Calesa*, should be wary of engaging in related-party transactions because the Delaware courts will apply the entire fairness standard to those transactions even when made in the ordinary course of business (i.e., in a non-merger context), a surprising result to those who assume that this stricter standard only applies in the higher profile change of control context. Thus, any controlling stockholder, or any potentially controlling stockholder, should either (i) avoid related-party transactions entirely or (ii) ensure that sufficient procedural safeguards are in place. These procedural safeguards could include, for example, having the transactions approved by independent directors or submitting the transactions for approval by the informed, unaffiliated other stockholders of the company. Only then can a controlling stockholder, or a potentially controlling stockholder, be sure that the transaction does not violate any fiduciary duties and will survive judicial scrutiny.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings New York lawyers:

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