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PERSPECTIVE

When minority stockholders control

By Marc Boiron

In *Calesa Associates, L.P. v. American Capital, Ltd.*, the Delaware Court of Chancery provides insight into circumstances under which a minority stockholder becomes a controlling stockholder through its control of a corporation's board of directors. In addition, the court sheds light on the validity of a written consent of stockholders that was executed without the stockholders' receipt of all of the exhibits to the consent.

In 2007, American Capital and several of its affiliates collectively acquired 26 percent of Halt Medical, Inc.'s stock and had the right to designate for election two of five members of Halt's board of directors. A series of transactions ensued, in which American exercised certain contractual blocking rights, acquired an additional board seat and the right to elect an independent director, and obtained a supermajority vote requirement for the approval of a Chapter 11 proceeding.

In late 2013, Halt owed American $50 million. Because American demanded repayment of the entire amount by Dec. 31, 2013 and Halt's board failed to negotiate the sale of Halt, Halt and American agreed to a transaction whereby Halt would form a subsidiary that would be merged into it. In the merger, Halt would amend its certificate of incorporation, all issued and outstanding shares of Halt's common stock would remain outstanding, all shares of preferred stock would be cancelled, and the stockholders would waive their appraisal rights. Further, pursuant to a note and exchange agreement and other transaction documents, American would loan Halt up to $73 million, Halt would receive a first priority security interest in all of Halt's assets, all outstanding warrants to purchase shares of commons or preferred stock would be cancelled, and a management incentive plan would be adopted, which would pay certain of Halt's employees 12 percent of the proceeds of any subsequent sale of Halt. If Halt was not sold within one year of the transaction, certain subordinated debt would be converted to equity and certain shares of preferred stock would be cancelled.

The transaction documents, which were 297 pages long, were sent to Halt's stockholders one day before they were instructed to return signed copies of them and the stockholder consent approving the transaction. Several of the transaction documents were drafts, incomplete or missing attachments. Nonetheless, the stockholders executed the consent.

After the transaction, American owned 66 percent of Halt's capital stock and had the right to designate for election four of seven members of Halt's board.

The plaintiffs alleged, among other things, that American, as Halt's controlling stockholder, breached fiduciary duties owed to other minority stockholders, and the directors violated Section 228 of the General Corporation Law of the State of Delaware in connection with obtaining the stockholder consent.

The court considered whether American was a controlling stockholder triggering the entire fairness standard of review. As a minority stockholder, American must have exercised actual control over Halt to be a controlling stockholder. The court found that two of four directors that American designated for election to Halt's board were either an officer or a director of American. Halt's information statement disclosed that the third director had interests that were in addition to or different from those of Halt's stockholders and that American had invested $66 million in a company for which he served as the chief executive officer. The last director, who was Halt's chief executive officer, was found to be beholden to American because he would have lost his employment if Halt had not completed the transaction and American could decide whether he would continue to receive his salary and incentives.

Although American's contractual rights that gave it bargaining power over Halt did not constitute control, the court found it reasonably conceivable that a majority of Halt's board was under the influence of or shared a special interest with American, which triggered the entire fairness standards of review.

With respect to the plaintiffs' allegations that the directors violated

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The court's analysis in Calesa is helpful for determining whether a minority stockholder controls the board of directors and for refining common practices involved in obtaining written consents of stockholders.

Section 228 of the DGCL, the court held that the plaintiffs stated a claim under Section 228. As the court concluded in *Carsanaro v. Bloodhound Technologies Inc.*, "when a consent specifically refers to exhibits and incorporates their terms, the plain language of Section 228(a) requires that a stockholder have the exhibits to execute a valid consent." Therefore, the attachment of several exhibits in draft form to the written consent of stockholders and the missing attachments to that consent were sufficient to state a claim for violation of Section 228.

The court's analysis in *Calesa* is helpful for determining whether a minority stockholder controls the board of directors and for refining common practices involved in obtaining written consents of stockholders. First, a minority stockholder's ownership of a specified percentage of a company's stock, even if combined with contractual blocking rights, will not necessarily cause the stockholders to become a controlling stockholder. Although increased bargaining power as a result of contractual rights does not itself cause a stockholder to become a controlling stockholder, the effect of that bargaining power vis-a-vis particular directors may cause the stockholder to have influence over those directors, which in turn may cause the stockholder to become a controlling stockholder.

Second, the practice of venture capital- and private equity-backed companies of designating directors, even a majority of the directors, does not automatically cause the venture capital or private equity firms to become controlling stockholders. A stockholder that designates a director to the board does not necessarily dominate that director. However, if the director is also a director or officer of the venture capital or private equity firm, or if the director will lose his or her employment unless a transaction is consummated, then the director-designee likely is not independent. Where director-designees who constitute a majority of the board fall into one of those categories, the stockholder designating those directors likely will become a controlling stockholder.

Lastly, stockholders must be given the exhibits to a stockholder consent in final form for that consent to be valid. Practitioners engage in two common practices that are likely to result in the execution of invalid consents under *Calesa*: Sending to the client-corporation the stockholder consent in a separate email from the exhibits to the consent and sending to the client-corporation the stockholder consent that is in final form with exhibits that are not yet in final form. Undoubtedly, the client forwards the email containing the stockholder consent to the stockholders but fails to forward the exhibits. In addition, where the client receives the written consent in final form but the exhibits in draft form, there is a high likelihood that the client will forward the consent to be signed by stockholders and the stockholders will sign the consent before receiving the exhibits, if ever, in final form. Better practice is to recognize when documents have been sent to the client piecemeal or not yet in final form and send a later email with final versions for execution of the consent and the exhibits thereto in one email. The exhibits do not need to be in the same document as the written consent but should be in the same email to avoid common mistakes that result in the execution of invalid consents.

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