Who is in control? Considerations for significant equityholders in the current business environment

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Equity investors and sponsors are actively reviewing the financial needs and business operations of their portfolio companies. As a result of the economic upheaval and government-mandated social restrictions imposed by the blistering spread of COVID-19 around the world, there are a number of challenging decisions that will need to be made with significant speed and limited information.

Accordingly, it is important to consider the responsibilities and duties that attach to equity investors and sponsors who are deemed “controlling equityholders” under applicable law.

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In Delaware, courts have long held that controlling equityholders, which can include minority equityholders in certain cases, owe fiduciary duties to the company and their fellow equityholders.

These duties mean that a controlling equityholder, absent certain specified waivers, is required to act in the best interests of the company and all equityholders when engaging in transactions and arrangements with the company, rather than its own self-interest.

As equity investors and sponsors look for business solutions and investment opportunities presented by the COVID-19 pandemic, equity investors and sponsors with significant influence or control over the business and affairs of a company should take special care as they engage in transactions and arrangements with company and evaluate whether they may be subject to the duties of controlling equityholders.

Equityholders who determine that they may be considered controlling equityholders should become familiar with the responsibilities of being a controlling equityholder and carefully consider the appropriate process to govern their interactions and transactions with the company.

This evaluation takes on increasing importance as we anticipate that Delaware courts will continue the pattern that developed following the 2008 financial crisis of reviewing transactions between a company and significant equityholders as inherently suspicious and often without deference to the board’s business judgment unless specific procedures were followed.

Although the discussion that follows is primarily focused on private companies, controlling equityholders of public companies have the same responsibilities and fiduciary duties as those of private entities, and their interactions with the companies they control are subject to the same level of scrutiny by courts.

WHO IS A ‘CONTROLLING EQUITYHOLDER’?

A controlling equityholder is an equityholder who either (a) owns or controls a majority of the voting power of a company (which can take the form of designating a majority of a company’s directors or managers) or (b) is a minority equityholder with the practical ability to exercise control over the business and affairs of the company in general or in the context of a particular transaction (e.g., an emergency financing or M&A transaction).

Determining whether a minority equityholder has the practical ability to exercise control is highly fact-specific. Courts often analyze multiple factors when determining whether an equityholder can effectively exercise control of a company.

Typically, these factors include:

• An equityholder’s ownership percentage of voting securities. Notably, courts have determined that an equityholder who owns 20 percent or more of a company’s voting securities is the largest single equityholder can be (when combined with other factors) a controlling equityholder.

• The right of an equityholder to designate or nominate one or more directors to the board and board committees (even though less than a majority of the board or committee members).

• Significant personal or business relationships between an equityholder and particular directors (e.g., directors serving on multiple boards affiliated with an equityholder or a history of being an investor in or partner or employee of an equityholder
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In addition, to the considerations listed above, groups of equityholders that act in concert and are connected in some legally significant way (e.g., by contract, common ownership, stockholders’ agreement or voting agreement) can be deemed controlling equityholders. Courts have emphasized that groups of equityholders need to engage in coordinated action to be considered a control group, similar to the requirements to be considered a “group” under Section 13(d) of the Securities Exchange Act of 1934.

Please note that an agreement giving holders the ability to designate directors, for example, does not by itself make a group of investors controlling equityholders.

In sum, there is no set formula that will lead a court to find that a minority equityholder can exercise “control.” Courts strive above all to use a variety of factors to discern how a company makes decisions and what role a significant equityholder plays in the process.

RESPONSIBILITIES OF BEING A CONTROLLING EQUITYHOLDER

Being a controlling equityholder brings with it significant responsibilities that should be considered by boards and controlling equityholders when making decisions relating to (a) transactions between the company and a controlling equityholder or (b) rights granted by the company to a controlling equityholder.

Controlling equityholders owe a duty of loyalty to the company and non-controlling equityholders. Accordingly, the controlling equityholder (among other things) is required to refrain from using its power or influence over corporate action to obtain favorable treatment and further its self-interest at the expense of the company or other equityholders.

The controlling equityholder must also disclose any material conflicts of interest between itself and the company that may affect minority equityholders.

Additionally, interested or conflict transactions involving a controlling equityholder face an increased risk that the transaction will be reviewed by a court, particularly transactions governed by Delaware law, under the heightened “entire fairness” standard instead of the “business judgment” standard.

The “business judgment” standard is much more deferential to those parties owing fiduciary duties to companies and typically shields parties from second-guessing by courts.
• Keep robust minutes of deliberations, including factors considered and information relied upon (e.g., presentations from management and advisors with consideration given to advantages of written vs. oral presentations).

• Have directors appointed by the controlling equityholder recuse themselves from decisions involving the controlling equityholder.

• To the extent practical and feasible, notify other equityholders of transactions and arrangements with controlling equityholders ahead of time.

• Engage legal and financial advisors (preferably those that do not have strong relationships with the controlling equityholder) to evaluate the potential transaction or arrangement. This will help confirm that board’s business judgments made in compliance with the company’s legal obligations were otherwise informed, in good faith, and in the best interest of the company. If advisors are engaged, disclose any relationships with them that could indicate a bias (including if you or your affiliates or portfolio companies use the advisor in other contexts).

• Consider offering minority equityholders the chance to participate in transactions on a pro-rata basis, even if not contractually required, either contemporaneously with the transaction with the controlling equityholder or shortly thereafter.

• Adhere to provisions in governance documents regarding board and equityholder meetings and decisions.

WAIVERS OF FIDUCIARY DUTIES

Many businesses that have issued equity to controlling equityholders are limited liability companies or partnerships. Unlike corporations, many jurisdictions, including Delaware, permit the waiver of fiduciary duties that would otherwise be owed by directors, managers and equityholders to the entity. However, these duties must be expressly waived in the limited liability company agreement or limited partnership agreement. We note that many fiduciary duty waivers in operating or partnership agreements often omit or limit a waiver of fiduciary duties of the members and limited partners.

Therefore, waivers of duties should be analyzed carefully to ensure they are sufficiently broad to include the applicable duties and cover the applicable equityholders.

It is important to remember that all contracts, including limited liability company agreements and limited partnership agreements, impose a duty on the contracting parties to deal with each other honestly, fairly, and in good faith, and to not take intentional actions that will injure the right of the other parties to receive the benefits of the contract to which they are entitled.

This implied duty of good faith and fair dealing does not impose fiduciary-level duties when none exist contractually, but it also cannot be waived by a company or its equityholders.

Boards and controlling equityholders should consider the applicability of the implied duty of good faith and fair dealing even in the presence of otherwise robust waivers of duties.

However, Delaware courts have emphasized that parties may not use this implied duty to (a) override terms or transactions that are explicitly agreed to by the parties or (b) fill in gaps not specifically addressed by the contract that could have been negotiated among the parties at the time they entered into the applicable contract.

SUMMARY AND KEY TAKEAWAYS

While the existing legal principles and guidance offer a roadmap for the way courts have reviewed controlling equityholder transactions, we note the economic conditions resulting from the disruption of the COVID-19 pandemic present new challenges.

Courts will take into account the unprecedented social and economic realities facing equity investors, sponsors and their portfolio companies and investments when reviewing transactions involving controlling equityholders, particularly emergency financings and other transactions to fortify a company’s balance sheet.

Nonetheless, to the extent feasible, controlling equityholders should be circumspect when engaging in these transactions and frequently consult with advisors so that transactions accomplish the goal of “keeping the lights on” while minimizing the risk of being challenged for improperly benefiting the controlling equityholder at the expense of the company and other equityholders.

Key Takeaways

• There could be significant legal exposure for controlling equityholders that breach fiduciary duties to the company and the non-controlling equityholders.

• An equityholder need not own or control a majority of a company’s equity or its voting rights to be a controlling equityholder. The analysis of whether a minority equityholder is considered a controlling equityholder is complex and fact-specific.

• Review equity and debt documents for negative covenants and limitations on transactions with control parties and/or affiliates.

• Careful attention should be given in reviewing provisions waiving fiduciary duties to ensure the waiver is sufficiently
broad to the extent the board or the controlling equityholder are relying on the waiver.

• Ensure the board is fully informed about conflict transactions, the context in which they arose and any conflicts or potential conflicts of interest between the equityholder and directors, management and advisors.

• While a controlling equityholder can never shirk duties it owes to the company and non-controlling equityholders, courts recognize that (a) certain protections and procedures may not be applicable or practicable when a company is in distress or facing unprecedented conditions like those brought about by the current pandemic and (b) controlling equityholders, by virtue of their familiarity with a company and alignment of interests, may be in the best position to quickly execute transactions to keep a company in business.

NOTES
2 Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997).

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