INSIDE FUNDING ROUNDS IN VENTURE-BACKED COMPANIES: THE PERILS OF "EFFECTIVE CONTROL"

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ABSTRACT

Funding rounds led by existing investors in venture capital-backed firms occur for a variety of different reasons, and under a wide array of circumstances. While such investors frequently possess a minority equity position, they nonetheless may be deemed to exercise control over the enterprise, either broadly or in connection with the round they lead. The determination of control can be exceedingly nuanced, and for that reason is not always foremost on the minds of investors and advisors as the round is brought to fruition. Whether the investor leading the round is a controller, however, has potentially profound implications for litigation risk, and measures that may be taken pre-closing to mitigate that risk. This article examines the effective control determination under Delaware law and corresponding procedural enhancements that have been tested in the case law.

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TABLE OF CONTENTS

I. INSIDE FUNDING ROUNDS: A FACT OF LIFE

While pulling in a new investor to lead a financing round may offer certain advantages (value and concept validation, broader investor base, expansion of contact network, and so on[1]), inside funding rounds (*i.e.*, rounds led by an existing investor) in venture-backed companies occur relatively frequently, and under a variety of circumstances. An inside round can broadcast a good, bad, or neutral signal to the outside world.[2] It can signal that all is well, and that a venture capital ("VC") investor with an inside view (a particularly well-informed one if the investor is represented on the board) is confident in the trajectory of the enterprise. On the other end of the spectrum, it can signal that the company is facing challenges that undermine its ability to attract outside investors to lead a round.[3] And it can signal many things in between—perhaps, by way of example, that the CEO is busy rolling out an ambitious business plan, and can ill-afford the inevitable distractions associated with raising an outside round.[4]

A. *Categories of Inside Funding*

Broadly viewed, there are three "species" of inside funding:

1. Interim Funding

This involves a cash injection by way of, for example, re-opening a prior round or secured bridge funding. The purpose of such funding is to meet short-term cash needs sufficient to carry the enterprise to an anticipated milestone (be it the next round, a major announcement that changes the company's fundamentals, or an IPO).

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[1] *See e.g.*, Brian J. Broughman & Jesse M. Fried, *Do VCs Use Inside Rounds to Dilute Founders? Some Evidence from Silicon Valley*, 18 J. CORP. FIN. 1104, 1104 (2012).

[2] The "outside world" can include other potential investors, existing or prospective customers or joint venture partners, and potential strategic acquirers, among others.

[3] *See* Ethan Stone, *Is an "inside round" a bad thing? Does it hurt a startup's chances of future funding?* FOUNDER SPACE, https://www.foundersspace.com/fund-raising/is-an-inside-round-a-bad-thing-does-it-hurt-a-startups-chances-of-future-funding/.

[4] Outside perceptions also are influenced, of course, by whether the round is an "up," "flat," or "down" round—that is, whether the valuation implied by the round is more than, the same as, or less than the valuation implied by the prior round. *But see generally* Broughman & Fried, *supra* note 1, at 1116. (Broughman concluding that, within the data set examined, inside VC rounds generally were not used to dilute founders, and instead occurred at relatively high valuations).

2. "Double-down"

This can happen when, for example, the company's prospects are promising. In a double-down, an existing VC investor seeks to increase its ownership position without letting others come to the table or a founder increases her investment to avoid bringing in other outside investors.[5]

3. Recapitalization

This refers to a full-fledged funding round—the next series of preferred.[6]

The transactional paradigm examined in this article involves an existing VC investor purchasing an increased stake in a closely-held Delaware corporation by leading an equity round.[7] As shown below, whether that inside VC investor is, or may deemed to be, exercising control over the enterprise can affect litigation risk *vis-à-vi*s the fiduciary calculus, and thus the advisability of procedural safeguards, considerably.

B. The Question of Control

Founders (who by virtue of a substantial investment of intellectual capital and effort may have a strong emotional tie to the enterprise), angel, and smaller seed investors (who may not be following the fortunes of the enterprise closely or who otherwise may have elevated expectations) can react negatively to being diluted, to learning that an exit is more distant than hoped, or to funding terms perceived to be unfair or heavy-handed. Disappointment in the early investor ranks, if sufficiently acute, can pave the way for a costly foray into the court system. Whether or not the VC investor leading an inside round may be deemed a controlling stockholder, or "controller," bears directly on the question of whether fiduciary duties are owed, what process enhancements may be called for and, ultimately,

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[5] Rob Day, *Are Insider-Led VC Rounds a Good or Bad Sign for a Startup? Here's What to Look For*, GREENTECHMEDIA (Sept. 2, 2014), https://www.greentechmedia.com/articles/read/inside-the-inside-rounds#gs.8yprqXFM.

[6] *Id.*

[7] Where dilutive to existing stakeholders, such rounds sometimes are referred to in VC circles as "burnout" or "cramdown" financings. Joseph W. Bartlett & Kevin R. Garlitz, *Fiduciary Duties in Burnout/Cramdown Financings*, 20 U. IOWA J. CORP. L. 593, 594 (1995).

what level of judicial scrutiny will be applied if the transaction is challenged in litigation.[8]

What is a "controlling" stockholder? "A stockholder is controlling, and owes fiduciary duties to the other stockholders, 'if it owns a majority interest in or *exercises control* over the business affairs of the corporation.'"[9] So, generally speaking, there are two types of stockholder control:

1. "Hard" or "Majority" Control

"Hard" or "majority" control is a stark, mathematical reality. An investor with a majority (*i.e.*, over 50%) voting position at the stockholder level, a majority of the voting board seats, or both generally is deemed to exercise control over the enterprise.[10]

2. "Effective" or "*De Facto*" Control

"Effective" or "*de facto*" control exercised by an investor not having majority control, by contrast, is a matter of circumstance. This type of control is nuanced and can be somewhat elusive. *In fact, a VC investor with a minority stock position may not fully be aware that it could be deemed a controller.* For this reason, this type of control is exceedingly important and the focus of this article.

II. EFFECTIVE CONTROL

A. Broad Contours of Effective Control

There is no "magic formula" by which to determine whether a non-majority investor is exercising effective control; rather, it is a highly fact

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[8] *See* Basho Tech. Holdco B, LLC v. Georgetown Basho Inv., LLC, 2018 WL 3326693, at *26, *51 (Del. Ch. July 6, 2018) (holding that a VC investor was a controlling stockholder that breached its fiduciary duties). (Appeal pending).

[9] Calesa Assocs., L.P. v. Am. Capital, Ltd., 2016 WL 770251, at *10 (Del. Ch. Feb. 29, 2016) (quoting Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1113 (Del. 1994)); *see also In re* EZCORP, Inc. Consulting Agreement Deriv. Litig., 2016 WL 301245, at *9 (Del. Ch. Jan. 25, 2016) ("Delaware corporate decisions consistently have looked to who wields control in substance and have imposed the risk of fiduciary liability on that person.").

[10] *But see infra* note 16 (discussing Delaware statutory law on business combinations between corporations and interested stockholders).

specific inquiry.[11] Whether a minority stockholder "'is so powerful as to have obtained the status of 'controlling stockholder' is intensely factual [and]'[12] . . . courts have considered 'many factors . . . in analyzing whether a shareholder is controlling.'"[13]

Effective control can exist generally (*i.e.*, pervasively, over the enterprise at large) or with regard to a particular transaction (frequently, the one being challenged in litigation).[14] Effective control may be manifest over time, in connection with serial transactions or acts.[15] The "cases do not reveal any sort of linear, sliding-scale approach whereby a larger share percentage makes it substantially more likely that the court will find the stockholder was a controlling stockholder."[16] Likewise,

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[11] Calesa Assocs, L.P. v. American Capital, Ltd., C.A. No. 10557–VCG, 2016 WL 770251, at *11 (Del. Ch. Feb. 29, 2016) (*citing In re* Crimson Expl. Inc. S'holders Litig., C.A. No. 6541–VCP, 2014 WL 5449419, (Del. Ch. Oct. 24, 2014); *accord In re* Primedia Inc. Deriv. Litig., 910 A.2d 248, 257 (Del. Ch. 2006); *see also* Basho Techs. Holdco B, LLC v. Georgetown Basho Inv'rs, *LLC*, 2018 WL 3326693, C.A. No. 11802–VCL, at *25–28 (Del. Ch. July 6, 2018).

[12] *In re* Tesla Motors, Inc. S'holders Litig., Consol. C.A. No. 127110-VCS, 2018 WL 1560203, at *13 (Del. Ch. Mar. 28, 2018) (*quoting In re* Cysive Inc. S'holders Litig., 836 A.2d 531, 550-51 (Del. Ch. 2003)).

[13] *Tesla*, 2018 WL 1560293, at *14 (quoting Williamson v. Cox Commc'ns, Inc., 2006 WL 1586375, at *4 (Del. Ch. June 5, 2006), *reprinted in* 32 Del. J. Corp. L. 307).

[14] Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618, 659 (Del. Ch. 2013) (quoting *Williamson*, 2006 WL 1586375, at *6); *see also* FrontFour Capital Group LLC v. Taube, No. CV 2019-0100-KSJM, 2019 WL 1313408, at *22 (Del. Ch. Mar. 22, 2019) (Delaware recognizes *de facto* control where stockholder actually dominates and controlls majority of the board generally or actually dominated and controlled the corporation, its board or board committee with respect to challenged transaction); PRINCIPLES OF CORPORATE GOVERNANCE § 1.10(a)(2) (AM. LAW INST. 1994) (controlling stockholder has power to vote more than 50% of the voting equity or "otherwise exercises a controlling influence over the management or policies of the corporation *or the transaction or conduct in question*") (emphasis added).

[15] *See Carsanaro*, 65 A.3d at 659 ("The complaint does not describe a single transaction in which the interests of the directors and their funds happened to align, but rather actions taken in concert, over time, to direct the company's capital raising activities in a self-interested way.").

[16] *Crimson Expl.*, 2014 WL 5449419, at *10–12 (analyzing cases involving effective control exercised by stockholders with stock positions ranging from slightly over 35% to 49%). The Delaware General Corporation Law ("DGCL") creates a presumption of control at or above the 20% ownership level in connection with business combinations between the corporation and an interested stockholder. *See* 8 *Del. C.* § 203(c)(4) ("A person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership, unincorporated association or other entity shall be presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary."); *see also id.* § 203(c)(5) (defining "interested stockholder" and providing that the acquisition of a 15% ownership interest triggers certain restrictions).

control may be found to exist based on factors other than stock ownership.[17]

Under limited circumstances, multiple investors may be deemed to be acting as a "control group," with each owing the duties of a controller.[18] For investors to be aggregated as a control group, the nexus between them must be more than merely a "concurrence of self-interest."[19] Instead, the investors "must be 'connected in some legally significant way'—such as 'by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal.'"[20]

B. *Indications of Effective Control*

What factors may contribute to a determination that a minority VC investor is exercising effective control? Indications of effective control may be grouped (imprecisely) into three general categories, each of which may and often does integrate with the others:
(1) *structural*, so as to give rise to an *inference* of control;
(2) *actual* control asserted *pervasively* over the enterprise or its board; and
(3) *actual* control exercised over a *specific transaction* (through control of the board directly or the board's deliberative process).

1. Structural Control

As discussed below, the concept of "structural control" is for the most part relevant only in the context of assessing the adequacy of a shareholder complaint under the forgiving standard of a Rule 12(b)(6)[21] challenge (where all reasonable inferences are drawn in favor of the plaintiff[22]). Structural control does not necessarily involve a specific

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[17] *See In re* Zhongpin Inc. S'holders Litig., 2014 WL 6735457, at *8 (Del. Ch. Nov. 26, 2014) ("Actual control over business affairs may stem from sources extraneous to stock ownership."), *overruled on other grounds by In re* Cornerstone Therapeutics Inc., S'holder Litig., 115 A.3d 1173 (Del. 2015).

[18] *Crimson Expl.*, 2014 WL 5449419, at *15.

[19] *Id.*

[20] *Id.* (quoting Dubroff v. Wren Hldgs., LLC, 2009 WL 1478697, at *3 (Del. Ch. May 22, 2009)).

[21] Ct. Ch. R. 12(b)(6) (providing for motion to dismiss based on failure to state a claim upon which relief can be granted).

[22] Malpiede v. Townson, 780 A.2d 1075, 1083 (Del. 2001) (noting that the court is required to accept "reasonable inferences that logically flow" from the non-conclusory facts pleaded).

demonstration that control is being wielded in any particular way, pervasively or in connection with a particular transaction. Rather, structural control is inferred from an array of largely tangible factors, which may include a substantial minority stock position, substantial (but not majority) representation on the board, blocking rights,[23] unique access to or influence over key members of management, and things of that nature. In the context of litigation, a combination of these or other factors may give rise to a "presumption" of control—that is, an inference of control even in the absence of allegations demonstrating specific instances of actual control—at least at the pleading stage.[24] Effective control was "assumed," for example, where the Yucaipa Companies, LLC, though "not owning a mathematical majority of the Company's [Morgans'] common stock, . . . held a combination of securities and contract rights that, together with Yucaipa's board representation and close relationships with management, gave Yucaipa effective control over Morgans."[25] The court observed:

> Yucaipa's control over Morgans stems from a combination of holdings at multiple levels of Morgans's capital structure, a web of contractual rights, board representation, and close relationships with management and certain directors. Yucaipa owns 51% of the Company's senior subordinated notes (the "Notes"), a position with a face value of $88 million. The Notes come due in October 2014. Beginning in July 2014, Yucaipa

[23] *See* Bo Yaghmaie, *Consider Control and Voting Rights When Making Venture Capital Deals*, ENTREPRENEUR (June 19, 2014), https://www.entrepreneur.com/article/234654 ("These protective provisions effectively give an investor a veto right to protect the investment by not allowing a majority of the board or stockholders to unilaterally undertake actions that would diminish a venture investor's equity value or return by: [among other things,] . . . [r]aising senior or *pari passu* capital, which would negatively impact the value of the investors liquidation preference or, in a low valuation scenario, create the potential for significant ownership dilution."); *see generally* Joseph W. Bartlett & Kevin R. Garlitz, *Fiduciary Duties in Burnout/Cramdown Financings*, 20 J. CORP. L. 593, 594 (1995) (discussing VC blocking rights and their use as a lever of control over portfolio companies).

[24] As noted, that structural control based on a combination of factors may be assumed inferentially for purposes of assessing the adequacy of a complaint through the forgiving lens of a Rule 12(b)(6) challenge *does not* likewise mean that effective control based solely on structural factors (absent a showing that such control actually was wielded over the enterprise pervasively or in connection with a specific transaction) is "assumed" for purposes of an ultimate determination of control based on the merits. Ct. Ch. R. 12(b)(6); *Malpiede*, 780 A.2d at 1083. This distinction is important, and discussed further below.

[25] OTK Assocs., LLC v. Friedman, 85 A.3d 696, 702 (Del. Ch. 2014) (disposing of motions to dismiss, among other motions directed to the pleadings).

> can convert the Notes into shares of common stock. Yucaipa also owns 100% of the Company's Series A preferred stock (the "Series A Preferred"), whose terms give Yucaipa blocking rights over various transactions, including the ability to veto a sale of all or substantially all of the Company's assets and other transactions where a vote of the Series A Preferred is required by law or the Company's certificate of incorporation. On top of this, Yucaipa owns warrants to purchase 12.5 million shares of the Company's common stock. Pursuant to a securities purchase agreement, Yucaipa has contractual blocking rights that give it the power to veto (i) a sale of substantially all of the Company's assets to a third party, (ii) the acquisition of the Company by a third party, (iii) any acquisition by the Company of a third party that involves an equity investment of $100 million or greater, and (iv) any change in the number of directors to more than nine or less than seven. Yucaipa also has the right to appoint one person to the Board, which Yucaipa has used to make Burkle [the investor who controlled Yucaipa] a director. This right gives Yucaipa access to board-level information about the Company.[26]

While *OTK*, *Transworld Healthcare*, and to an extent *Williamson*, as well as other decisions cited below, suggest that control based on a combination of structural factors may be presumed for purposes of assessing the adequacy of control allegations through the forgiving lens of

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[26] *Id.* at 704. *See also* O'Reilly v. Transworld Healthcare, Inc., 745 A.2d 902, 912 (Del. Ch. 1999) (holding that alleging facts from which a shareholder's exercise of corporate control can be inferred is sufficient to survive Rule 12(b)(6) motion to dismiss). "Defendants argue that the Complaint fails to plead adequately that Transworld was HMI's controlling stockholder because the Complaint does not expressly allege that Transworld controlled HMI's corporate conduct. O'Reilly responds by arguing that a plaintiff can plead sufficiently that a stockholder has actual control of corporate conduct by alleging facts from which a stockholder's exercise of corporate control can be inferred, which O'Reilly maintains she has done. While the preferred complaint might be one that expressly alleges corporate control, I agree with O'Reilly." *Id. But see* Thermopylae Capital Partners, L.P. v. Simbol, Inc., No. CV 10619-VCG, 2016 WL 368170, at *13 (Del. Ch. Jan. 29, 2016) ("To survive a motion to dismiss, these facts must 'demonstrat[e] actual control with regard to the particular transaction that is being challenged.'") (quoting In re KKR Fin. Holdings LLC S'holder Litig., 101 A.3d 980, 991 (Del. Ch. 2014)).

a Rule 12(b)(6) challenge,[27] the question that presents itself is: can effective control likewise be *inferred* based merely on the presence of certain structural factors (*i.e.*, absent a demonstration of the actual exercise of control) in disposing of fiduciary duty claims on the merits? The weight of authority suggests almost uniformly that the answer to this question is "No."

The Court of Chancery's post-trial decision in *Kaplan v. Centex Corp.*[28] disposed of shareholder derivative claims brought on behalf of Lomas & Nettleton Financial Corporation ("L&N"), which provided various types of financing for real estate development projects.[29] The claims arose from joint venture development projects involving two other entities, Centex Corporation ("Centex") and Heftler Corporation ("Heftler").[30] Fiduciary duty claims asserted against Centex and Heftler (and affiliated individuals) in connection with transactions among the three entities, alleged in part that Centex and Heftler (which together with affiliated individuals owned approximately 20% of L&N's outstanding stock and had an unspecified number of L&N board representatives) effectively controlled L&N.[31] In rejecting this contention, the court wrote:

> A plaintiff who alleges domination of a board of directors and/or control of its affairs must prove it. . . . Stock ownership alone, at least when it amounts to less than a majority, is not sufficient proof of domination or control. . . . "Control" and "domination" are here used in the ordinary meaning of the words and they may be exercised directly or through nominees. *But, at a minimum, the words imply (in actual exercise) a direction of corporate conduct in such a way as to comport with the wishes or*

[27] *But see* Gilbert v. El Paso Co., 490 A.2d 1050, 1056 (Del. Ch. Nov. 27, 1984) (holding that alleging potential for control not sufficient to withstand dismissal); *In re* Sea-Land Corp. S'holders Litig., 1987 WL 11283, at *4–5 (Del. Ch. May 22, 1987) (holding allegation that 40% stock position gave investor power to frustrate a competing bid was insufficient to withstand motion to dismiss where there was no allegation that stockholder actually leveraged that power to do so); *Williamson*, 2006 WL 1586375, at *4 (holding that to survive motions to dismiss, plaintiff must allege domination and control through *actual* control of corporate conduct; simply alleging *potential* ability to exercise control is insufficient).

[28] Kaplan v. Centex Corp., 284 A.3d 119 (Del. Ch. 1971).

[29] *Id.* at 123.

[30] *Id.* at 120.

[31] *Id.* at 121.

> *interests of the corporation (or persons) doing the controlling.*[32]

Subsequent decisions rendered in an array of transactional and procedural (including, somewhat inconsistently, Rule 12(b)(6) motions to dismiss) contexts carry forward and amplify the "actual exercise" requirement.[33]

In at least one post-trial decision (not involving an inside round), however, circumstances appear to have compelled the court to determine that an investor was exercising effective control based on the *potential* for control rather than on evidence demonstrating the actual exercise of control. In *In re Cysive, Inc. Shareholders Litigation*, Chief Justice Strine (then Vice Chancellor) wrote, "the analysis of whether a controlling stockholder exists must take into account whether the stockholder, *as a practical matter*, possesses a combination of stock voting power and managerial authority *that enables him to control the corporation, if he so wishes.*"[34]

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[32] *Id.* at 122–23 (emphasis added) (citations omitted).

[33] *See, e.g.*, *Gilbert*, 490 A.2d at 1055 (rejecting contention that the "potential for control" is sufficient to withstand dismissal, and holding that for "controlling stock ownership to exist in the absence of a numerical majority there must be domination by a minority shareholder through actual exercise of direction over corporate conduct"); *Sea-Land Corp.*, 1987 WL 11283, at *4–5 (granting motion to dismiss and finding that 39.4% stock position and unexercised authority to nominate three directors was "not sufficient to carry the day" in the absence of exercise of "actual domination and control in directing the corporation's business affairs" and that the allegation that stockholder's 40% interest equipped it with potential to frustrate a competing bid insufficient to demonstrate control where there was no allegation that the stockholder "actually took any steps to exert leverage to pressure Sea-Land to accede to a transaction that disadvantaged Sea-Land's other stockholders"); *Transworld Healthcare*, 745 A.2d at 912–13 (holding that to establish control, a plaintiff must plead domination by a minority shareholder through actual control of corporate conduct, but this can be achieved by alleging facts from which a stockholder's exercise of corporate control can be inferred); *Williamson*, 2006 WL 1586375, at *4 (citations omitted) ("To survive defendants' motions to dismiss, plaintiff must allege domination and control by [minority investors] through *actual* control of corporate conduct. Simply alleging that they had the *potential* ability to exercise control is not sufficient."); *Crimson Expl.*, 2014 WL 5449419, at *12 ("These cases show that a large blockholder will not be considered a controlling stockholder unless they actually control the board's decisions about the challenged transaction."); *see also Crimson Expl.*, 2014 WL 5449419, at *12–14, FrontFour Capital Group LLC v. Taube, No. CV 2019-0100-KSJM, 2019 WL 1313408, at *21 n.244 (Del. Ch. Mar. 22, 2019) (providing detailed overviews of prior effective control cases).

[34] *In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 553 (Del. Ch. 2003) (emphasis added).

Cysive involved a shareholder challenge to a management buy-out ("MBO").[35] The MBO's chief proponent was Cysive's founder, CEO, and board Chair (Nelson A. Carbonell) who, with "his close managerial-subordinate and family member-subordinates" and options, controlled approximately 40% of the company's voting equity.[36] In determining that Carbonell was a "controlling stockholder" and thus that the MBO was subject to entire fairness review under *Kahn v. Lynch Communication Systems, Inc.*,[37] the court observed that Carbonell held "a large enough block of stock [especially when taking into account subordinate management and family members] to be the dominant force in any contested Cysive election" and that "[g]iven this voting power, the *threat* of 'inherent coercion' that Carbonell present[ed] to the independent directors and public stockholders . . . cannot be rationally distinguished from that found to exist in *Lynch*, or cases of its kind."[38] The court held that this conclusion is "reinforced when one takes into account the fact that Carbonell is Chairman and CEO of Cysive[] and . . . . is, by admission, involved in all aspects of the company's business, was the company's creator, and has been its inspirational force."[39] Referring to Carbonell's "day-to-day managerial supremacy," the court continued, "[h]is practical control is also evidenced by the presence of two of his close family members in executive positions at the company, and the fact that his sister also worked at the company in the past."[40]

While the court did, in fact, note ways in which Carbonell historically had exerted actual control over the enterprise, the control determination appears to have hinged on the structural factors arming Carbonell with the "potent retributive capacity" contemplated by *Lynch*.[41]

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[35] To facilitate the MBO, an acquisition vehicle was formed, Snowbird Holdings, Inc., and the MBO was affected through a merger transaction. *Id.* at 542, 545.

[36] *Id.* at 535.

[37] Kahn v. Lynch Comm. Sys., Inc., 638 A.2d 1110 (Del. 1994).

[38] *In re Cysive*, 836 A.2d at 551–52.

[39] *Id.* at 552.

[40] *Id.*

[41] Then-Vice Chancellor Strine's articulation (*i.e.*, that the mere presence of potent retributive capacity, rather than the actual exercise of that power, can be sufficient to hold a stockholder to a fiduciary standard as a controller) arguably parallels *Lynch*, at least to the extent that *Lynch* recognizes the inherent, and thus presumptive, influence that can be exerted by a controlling stockholder in a transaction between it and the company such as to trigger entire fairness review as a matter of law. *See Lynch*, 638 A.2d at 1116 ("The controlling stockholder relationship has the potential to influence, however subtly, the vote of [ratifying] minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party.").

The examples of actual control, according to the court, merely "reinforced" that conclusion. Lending further support to this reading, with respect to the challenged transaction, the court affirmatively determined that the deliberative process, including especially the special committee process, was rigorous, effective, and free from interference by Carbonell.[42] In other words, the Vice Chancellor acknowledged the *absence* of any actual control exercised in connection with the board process giving rise to the transaction itself.[43]

By way of distillation, with respect to effective control inferred solely from structural factors, the following can be said based on the current status of Delaware decisional law:

First, in the context of litigation and specifically a Rule 12(b)(6) challenge, an inference of effective control may rest on a combination of structural factors, among them:

- a significant (but not majority) position within the capital structure of the enterprise;
- material contract rights, such as blocking rights;
- board representation;
- material managerial roles or influence within the enterprise; and
- close relationships with or material leverage over key members of management or other directors.

If and to the extent control is presumed and a complaint withstands a motion to dismiss, the case can proceed to discovery (this assumes that discovery had been stayed by agreement of the parties or by court order pending resolution of the motion).[44] Even well-tailored discovery presents

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[42] *In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 553 (Del. Ch. 2003).

[43] *In re* Morton's Rest. Grp., Inc. S'holders Litig., 74 A.3d 656, 665 (Del. Ch. 2013). ("[I]n *In re Cysive*, this court made, perhaps, its most aggressive finding that a minority block holder was a controlling stockholder and again, it bears repeating that examples of prior instances of the actual exercise of control were cited, though evidently not relied on, in the *Cysive* opinion.").

[44] *See id.*; *see also* Fed. R. Civ. P. 12(b)(6).

the potential for expense and intrusion, often distracting key members of management from their critical functions within the firm. Additionally, discovery opens the door to the additional risk that evidence suggesting the exercise of *actual* control may be uncovered.[45]

Second, the weight of authority suggests that an ultimate determination of effective control (*i.e.*, a determination on the merits) requires evidence demonstrating the *actual* exercise of control, pervasively or in connection with the challenged transaction. In this regard, *Cysive* appears to be an outlier, at least to the extent that it may be read to support the position that structural factors demonstrating the threat of inherent coercion alone may be sufficient to support a determination of control on the merits.[46]

2. Pervasive Control

This can and often does dovetail with the structural factors listed above or the transaction-specific control described below. Simply put, effective control can be shown by evidence that the VC investor in fact has been exercising control over material aspects of the enterprise such that, "'as a practical matter,'" the VC investor is "'no differently situated than if [it] had majority voting control.'"[47]

Indications of control over the enterprise generally (or "pervasive" control) have included combinations of a wide array of factors; including the appointment of close family members or other individuals aligned with the controller to executive positions within the enterprise, participating in or influencing significant hiring decisions generally,[48] material influence of business or strategic decisions,[49] historical involvement in or influence

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[45] "Subject to certain formal and substantive requirements, shareholders of Delaware corporations may pursue the inspection of books and records on a pre-litigation basis." DEL CODE ANN. tit. 8, § 220 (1953).

[46] *In re Cysive*, 836 A.2d at 553.

[47] *See* Basho Tech. Holdco B, LLC v. Georgetown Basho Inv., LLC, 2018 WL 3326693, at *25. *See cf. In re* PNB Hldg. Co. S'holders Litig., 2006 WL 2403999, at *9 (Del. Ch. 2006). *But see* Thermopylae Capital P'rs. L.P. v. Simbol, Inc., 2016 WL 368170, at *13 (Del. Ch. Jan. 29, 2016) ("To survive a motion to dismiss, these facts must 'demonstrat[e] actual control with regard to the particular transaction that is being challenged.'"); *see also In re* KKR Fin. Hldgs. LLC S'holder Litig., 101 A.3d 980, 991 (Del. Ch. 2014).

[48] *See In re* Tesla Motors, Inc. S'holders Litig., 2018 WL 1560293, at *16 (Del. Ch. 2018).

[49] *See id.* at *18.

over fund-raising activities,[50] material influence over the company's external messaging,[51] influencing the selection of advisors or other vendors of the company,[52] providing key services or guidance to the company,[53] or exercising contractual rights such as to influence (or dictate) key decisions. Many of these levers of control can be utilized with reference to a specific transaction as well as persuasively. There is neither a single marker nor a finite list of considerations determinative of pervasive control; rather, the determination encompasses a combination of factors and the broader circumstances confronting the enterprise.[54]

3. Transaction-Specific Control

Effective control may be found to have been exerted by an investor that generally does not exercise actual control over the corporation's business and affairs, but which controlled the board (directly or through the deliberative process) in connection with a specific transaction.[55] "For this purpose, a showing of 'pervasive control over the corporation's actions is not required.'"[56] Control over the transaction actually must be exercised; the mere *potential* ability to exercise control is not sufficient.[57] Like the other indications of control, the inquiry into transaction-specific control is without rigid boundaries, as "[i]t is impossible to identify or foresee all of the possible sources of influence that could contribute to a finding of actual control over a particular decision."[58]

Among the possible sources of influence are:

> (i) relationships with particular directors that compromise their disinterestedness or independence, (ii) relationships with key managers or advisors who play a critical role in presenting options, providing information, and making

[50] *See id.* at *16.
[51] *Id.*
[52] *See id.* at *16, 18.
[53] *See id.* at *18–19.
[54] *See In re Zhongpin Inc. S'holders Litig.*, 2014 WL 6735457, at *7 (Del. Ch. Nov. 26, 2014).
[55] *See, e.g.*, *In re* W. Nat'l Corp. S'holders Litig., 2000 WL 710192, at *20 (Del. Ch. May 22, 2000) (citing Kahn v. Lynch, 638 A.2d at 1114–15).
[56] *Basho*, 2018 WL 3326693, at *26 (quoting Superior Vision Servs., Inc. v. Reliastar Life Ins. Co., 2006 WL 2521426, at *4 (Del. Ch. Aug. 25, 2006)).
[57] *Id.* (quoting *Williamson*, 2006 WL 1586375, at *4).
[58] *Id.*

> recommendations, (iii) the exercise of contractual rights to channel the corporation into a particular outcome by blocking or restricting other paths, and (iv) the existence of commercial relationships that provide the defendant with leverage over the corporation, such as status as a key customer or supplier.
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> * * *
>
> Examples of broader indicia include [v] ownership of a significant equity stake (albeit less than a majority), [vi] the right to designate directors (albeit less than a majority), [vii] decisional rules in governing documents that enhance the power of a minority stockholder or board-level positon [*sic*], and [viii] the ability to exercise outsized influence in the board room, such as through high-status roles like CEO, Chairman, or founder.[59]

Effective control adequately was alleged in *Calesa Assocs., L.P. v. Am. Capital, Ltd.*, specifically with respect to challenged transactions involving (among other things) an inside equity round.[60] There, the investor ("ACAS") owned a 26% interest in Halt Medical, Inc., but was in a position to (and did) "on its own and through [the Director Defendants] on the Halt Board . . . repeatedly manipulate[] Halt by promising, then withholding, funding [under a promissory note], and [by] acquiring [a third party] note secured by Halt's intellectual property in order to force the Halt board to make decisions under duress that were to the detriment of" Halt's other stockholders.[61] Through the exercise of its blocking rights and maneuvering with respect to its obligations under a substantial promissory note, ACAS brought Halt to the threshold of financial collapse so that it could impose oppressive financing terms on Halt while precluding the consideration of alternatives or the exploration of more favorable terms.[62]

In determining that it could be inferred from the allegations that ACAS had exercised control over the board in connection with the

[59] *Basho*, 2018 WL 3326693, at *26, 27.

[60] *See* Calesa Assocs., L.P. v. Am. Capital, Ltd., 2016 WL 770251 at 10* (Del. Ch. Feb. 29, 2016).

[61] *Id.* at *10.

[62] *Id.* at *10–12.

transaction, the court accepted the plaintiffs' suggestion that one director, Halt's CEO (who otherwise was unaffiliated with ACAS), was controlled by virtue of having been left with a choice between watching the company fail or acceding to the unfavorable terms demanded by ACAS:

> I turn next to the allegations surrounding Cohen, the Halt CEO. The Plaintiffs suggest that Cohen was subject to a classic Morton's Fork[[63]]: approve the transaction despite what the Plaintiffs allege is the detriment to the unaffiliated stockholders, or see the Company—the source of his income—driven into ruin. Thus, in the Plaintiffs' view, Cohen was unable to exercise his independent business judgment on behalf of the Company. Specifically, the Plaintiffs allege that Cohen became beholden to ACAS when ACAS "became empowered to decide whether Mr. Cohen would continue to receive material benefits in the form of salary and incentives," and that Cohen, "[w]hile recognizing that ACAS's conduct was detrimental, . . . supported ACAS through his votes as a director because he knew that his job as Halt's Chief Executive Officer and his income depended upon ACAS's support." I find that these factual allegations are sufficient to demonstrate that Cohen was not independent from ACAS. Given that Cohen faced a decision between supporting the Transaction, on terms highly favorable to ACAS, and rejecting the Transaction, which was tantamount (on the facts alleged) to voting for the collapse of the Company and losing his employment, it is reasonably conceivable that Cohen was "beholden" to ACAS.[64]

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[63] The term "Morton's Fork" refers to a "dilemma, especially one in which both choices are equally undesirable." Its origins are rooted in "the collecting of taxes by John Morton, Archbishop of Canterbury in the late 15th century, who held that a man who was living modestly must be saving money and could therefore afford taxes, whereas if he was living extravagantly then he was obviously rich and could still afford them." *See http://www.oxforddictionaries.com/us/definition/american_english/fortion's-fork* (last visited June 10, 2016); *see also https://en.wikipedia.org/wiki/Morton%27s_fork* (last visited February 2, 2019).

[64] *See Calesa*, 2016 WL 770251 at *12.

Demonstrating the breadth of factors that may be considered in determining transaction-specific control, the court in *N.J. Carpenters Pension Fund v. infoGROUP, Inc.* determined that a board lacked independence (*i.e.*, was controlled) in connection with a merger transaction based on allegations that the company's founder (Vinod Gupta), former CEO, and director owning approximately 37% of the company's stock pressured the board to sell the company under sub-optimal circumstances due to a personal liquidity concern.[65] The court summarized the operative allegations of the complaint as follows:

> The Complaint alleges that a seemingly disinterested (aside from Gupta) and independent Board came under the control of Gupta, a fellow Board member and the Company's founder and largest shareholder. *Gupta's alleged power over the Board arose not from financial dependence, business relationships, or interlocking board memberships, but from a pattern of threats aimed at other Board members and unpredictable, seemingly irrational actions that made managing the Company difficult and holding the position of director undesirable.* Having achieved the necessary level of domination, Gupta forced the Merger on the Company at an inopportune time and utilize[ed] a flawed and inadequate sales process. This sale was allegedly orchestrated so that Gupta could obtain desperately needed liquidity; he is not alleged to have obtained any other additional financial benefit different from the merger price paid to other shareholders.[66]

[65] *See* N.J. Carpenters Pension Fund v. infoGROUP, Inc., 2011 WL 4825888 at *4, *11 (Del. Ch. Oct. 6, 2011).

[66] *Id.* at *2. The court further noted:

> Gupta's campaign for a sale employed some rather indelicate methods of persuasion. As alleged in the Complaint, Gupta repeatedly threatened other Board members with lawsuits if they did not take actions to sell the company. Gupta also told the Board that he had uncovered evidence of financial fraud at the Company, and that he had "a strong feeling that some of the directors will be sued again, even personally for not acting in the shareholders [sic] best interest [sic]." Throughout 2009, Gupta also denigrated and called for the firing of the Company's management, including then-CEO and Board member Fairfield. This conduct allegedly drove down the morale and performance of management.

The court concluded that the allegations of the complaint supported the pleading-stage inference that the investor dominated the other directors, who "succumbed to [his] control after being cowed by his threats and hostile, erratic behavior."[67]

More recently, Vice Chancellor Laster found, based on an extensive trial record, that Georgetown Basho Investors, LLC (together with its principal, Chester Davenport, "Georgetown") exercised effective control over Basho Technologies, Inc. ("Basho," an early entrant in the big data enterprise software industry) in connection with an inside funding round.[68] Effective control was determined based on a broad combination of general indicia of control (including, explicitly, "Georgetown's status as a significant stockholder and its ability to designate two Board seats"[69]) coupled with "transaction-specific considerations."[70]

Georgetown first invested in Basho through a D round in 2011, at which time it exercised its right to designate a board member.[71] Georgetown desired a quick sale exit, but fundamentally misunderstood the status of the big data storage market and its receptivity to the exit sought.[72] Eventually disabused of the notion of an immediate sale, Georgetown decided to seek hard control, enhancing its position for a future sale and permitting it to influence (as it turned out, dictate) the company's direction in the meantime. Georgetown increased its stake and

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Id. at *4 (alteration in original) (citation omitted).

[67] *Id.* at *7. *infoGROUP* differs from other control cases in that the focus in *infoGROUP* was board independence, and not whether the stockholder could be deemed an effective controller so as to trigger an entire fairness review under *Lynch*. Nonetheless, *infoGROUP* has been cited in subsequent decisions in connection with effective control determinations. *See, e.g.*, *Basho*, 2018 WL 3326693, at *26 n.313.

[68] Basho Tech. Holdco B, LLC v. Georgetown Basho Inv., LLC, 2018 WL 3326693, at *25 (Del. Ch. July 6, 2018). The evidence in *Basho* was noteworthy, consisting largely of remarkably unguarded e-mail communications among the defendants themselves. In this respect, *Basho* represents what rightly may be characterized as an extreme example of the exercise of control by an inside investor and corresponding fiduciary breaches facilitating an inside funding round.

[69] *Basho*, 2018 WL 3326693, at *28.

[70] *Id.* at *28. The court emphasized that although the "decision discusses the transaction-specific considerations individually, the finding of actual control rests on the totality of the facts and circumstances, considered in the aggregate." *Id.* at *28.

[71] *Id.* at *3.

[72] *Basho*, 2018 WL 3326693, at *5.

board representation through subsequent funding rounds, exercising blocking rights to deter or otherwise influence outside investors, ultimately making a play for hard control (that is, majority voting control and numerical control of the Basho board) through the onerous terms it imposed on the company in a Series G preferred round (the "G Round," which was the primary, though not exclusive, transaction challenged in the litigation).[73]

The transaction-specific considerations supporting the court's determination that Georgetown was exercising effective control at the time of the G Round included the following:

- *Contractual rights utilized to deter outside investors, create cash-dependence on Georgetown, and ultimately maneuver the company into a position of acute cash distress.* Georgetown used its blocking rights to turn away outside investors. In this regard, the court noted the particular circumstances under which the blocking rights were exercised:

> For a profitable company that can finance its own business plan out of working capital, or for a company that has access to multiple sources of financing, including debt, the ability to block equity raises might not contribute significantly to a finding of control. Basho, however, was a cash-burning, asset-light company that could not borrow and that required regular rounds of equity financing to build out its business. For a company like Basho, the parties that control its access to cash "sit on the company's lifeline, with the ability to turn it on or off." *When cash is like oxygen, self-interested steps to choke off the air supply provide a strong indicator of control.*[74]

The court then noted specific instances in which Georgetown used its blocking rights to deter outside investments that would have been beneficial to Basho, foremost among them a proposed Series G investment by a reputable investor syndicate, Southeast Venture Partners, on terms

[73] *Id.* at *11

[74] *Id.* at *29 (quoting Joseph W. Bartlett & Kevin R. Garlitz, *Fiduciary Duties in Burnout/Cramdown Financings*, 20 U. Iowa J. Corp. L. 593, 601 (1995)) (emphasis added) (citation omitted).

materially superior to those ultimately offered by Georgetown.[75] In addition to Georgetown's blocking rights, the court focused on a bridge loan extended by Georgetown to Basho prior to the G round (the "Georgetown Loan"). The terms of the Georgetown Loan (which was necessary to fill the void left by the investment opportunities Georgetown had blocked) were memorialized in a senior secured convertible note purchase agreement, which, among other things, provided for 60-day funding periods.[76] Georgetown manipulated its funding obligations under the agreement, delaying payments such as to cause severe cash distress and in some instances threatening to withhold funding altogether to leverage its negotiating position on the Series G terms. These manipulations coupled with Georgetown's exercise of blocking rights were used to force the company to accept the onerous Series G funding terms: "With Georgetown and Davenport having cut off all exits, the Board was forced to accept [the Series G terms]."[77]

- *Disseminating misinformation, making threats, and engaging in combative behavior.* The court found that Georgetown actively encouraged Basho's investment banker to give Basho's CEO the impression that he was leading efforts to find investors without Georgetown's involvement, while simultaneously directing that the investment banker communicate directly with Georgetown and not undertake any activity without Georgetown's prior approval.[78] Georgetown engaged in erratic and sometimes combative behavior in

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[75] *Id.* at *29. The court's consideration of Georgetown's blocking rights in the control determination focused not on the rights themselves, but rather on how and under what particular circumstances they were exercised. The court emphasized that its opinion does not stand for the blanket proposition that blocking rights and their lawful exercise generally may be equated with control:

> Lest sensitive readers fear that this decision signals heightened risk for venture capital firms who exercise their consent rights over equity financings, *I reiterate that a finding of control requires a fact-specific analysis of multiple factors. If Georgetown only had exercised its consent right, that fact alone would not have supported a finding of control.* The plaintiffs proved that Georgetown and Davenport did far more.

Id. at *29 n.327 (emphasis added).

[76] *Basho*, 2018 WL 3326693, at *7.

[77] *Id.* at *31 (citation omitted).

[78] *Id.* at *31.

its interactions with Southeast Venture (which had submitted a term sheet superior to Georgetown's) and directed that it not speak directly with Basho management, while misrepresenting the nature and substance of those interactions to Basho management and its unaffiliated directors. The cumulative effect of Georgetown's dishonest and aggressive conduct was to channel Basho "into a position where it had no alternatives other than to accept the Series G Financing."[79]

- *Georgetown's interference with management.* The court found that Georgetown exerted control over management through Davenport's presence on the board, Davenport's hostile interactions with management, and through its status as Basho's primary source of operating capital under the Georgetown Loan. With respect to the former, the court noted that if a member of management did not support Georgetown's position, Davenport would subvert them, threaten legal action, or get rid of them. This dynamic precipitated the resignations of two Basho CEOs.[80] Respecting the latter, the court found that Georgetown used its funding obligations under the Georgetown Loan to "bring management to heel" by inserting itself into Basho's financial operations, requiring as a pre-condition to loan disbursements that Basho's CEO provide a monthly budget and financial statements.[81] In some instances, Georgetown dictated which bills would be paid and which were not to be paid, though it had no right to do so under the loan documents.[82] Thus, the court considered Georgetown's manipulation of its funding obligation to be extreme,[83] and concluded that "Georgetown and Davenport engaged in these practices to dominate management."[84]

[79] *Id.* at *32.
[80] *Basho*, 2018 WL 3326693, at *32.
[81] *Id.*
[82] *Id.*
[83] *Id.* at *8 ("Rather than complying with Georgetown's contractual obligations, Davenport told Basho's CFO, Marisa Linardos, that Georgetown would evaluate Basho's funding needs on a monthly basis and provide funds at its discretion. This diktat resulted in Linardos meeting with Reisley [who was affiliated with and appointed by Georgetown to the Basho board] to justify the uses of the funds that comprised each draw request. If Reisely [sic] disagreed, Georgetown would not fund. Georgetown's micromanagement of Basho's operations caused Basho to miss its third and fourth quarter forecasts.") (citations omitted).
[84] *Id.* at *32.

- *Influence over investment banker.* The court determined that Georgetown "supplanted [Basho's] management team during the lead-up to the Series G Financing" by requiring, in connection with the Georgetown Loan, that Basho retain an investment banker selected by and friendly to Georgetown (Cowen and Company, LLC, with which Georgetown had been working privately) to pursue a sale or financing.[85] After Cowen was retained, Georgetown instructed that Georgetown needed to drive the process and to refrain from communicating with management.[86] While the court found no culpability on the part of Cowen, it cited the relationship with Cowen to underscore how Georgetown controlled Basho *vis-à-vis* the sale and fundraising processes.[87]

- *Forcing the G Round terms on Basho*. The measures taken by Georgetown to force the Basho board (which, coupled with the circumstances described above, was deprived of any practical alternative) to approve the "onerous" Series G Funding terms were extreme.[88] The court summarized its extensive factual findings[89] demonstrating how Georgetown pressured the Basho board as follows:

> Finally, Georgetown insisted on the Series G Financing, refused to negotiate or answer questions, and threatened Basho's directors and officers with dire consequences if they did not accept it. In November 2013, Georgetown proposed the onerous terms of the Series G Financing and demanded an answer within 72 hours. [Basho's CEO] asked for more time, but Georgetown refused. When a committee of the Board initially rejected Georgetown's Series G term sheet as too onerous, Davenport threatened to stop funding the Loan Agreement by claiming that Basho had suffered a material adverse change. He also told [the CEO] that Georgetown's deal would only get worse if the Company did not accept it. These threats caused the Board to change its position and authorize the

[85] *Id.* at *33–34.
[86] *Basho*, 2018 WL 3326693, at *33.
[87] *See id.* at *34.
[88] *See id.* at *11.
[89] *See id.* at *2–22.

> negotiation of definitive documents for a transaction with Georgetown.
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> Rather than simply going along, [Basho's CEO] continued pursuing an investment from Southeast. When the Company secured a superior term sheet from Southeast, Davenport told [the CEO] that Basho needed to sign Georgetown's deal within five days or he would sue [the CEO] personally. Davenport also threatened to sue [the Basho Board Chair Earl] Galleher personally. Later than [sic] month, Davenport told [Basho Director Tony] Thornley that Basho "will be insolvent" and "this could end badly" unless Basho accepted Georgetown's terms. During a call, he "[y]elled at [Thornley] for two minutes and would not let him say anything." He also told Thornley that he was "upset with him and do not feel he can be trusted." After this call, Thornley supported Georgetown.
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> In January 2014, Galleher asked Georgetown to make a fair proposa1. Davenport refused to budge from the Series G term sheet. Within two weeks, [Basho's CEO] had resigned, and Galleher feared that the Company could not make its next payroll. At this point, Reisley sent a revised Series G proposal that gave Georgetown full control of the Company at the stockholder and Board-levels in return for only $2.5 million in new money. He demanded an answer by January 18, 2014 at 6:00 pm—19 hours and 20 minutes later. Galleher replied with a list of questions that he believed Georgetown should answer. Georgetown ignored the questions and insisted that the Company take its deal. With no other options or alternatives, the Company accepted it. Thornley voted in favor because he felt that the Company had no other options. Galleher voted in favor, but only after expressing a lengthy list of objections. Within three months, six senior officers and directors had resigned from the Board, including [the CEO], Brewer, and Thornley.[90]

[90] *Basho*, 2018 WL 3326693, at *34 (citations omitted).

Based on these transaction-specific findings and the broader structural contours of Georgetown's stake and influence in the company, the court concluded:

> Taken as a whole, the plaintiffs proved by a preponderance of the evidence that Georgetown exercised actual control over the Company in connection with the Series G Financing. Georgetown's actual control did not arise from any single factor, but rather from a confluence of multiple sources of influence. These factors included its contractual rights, which enabled Georgetown to block other financing alternatives, limit the Company's access to capital, and force it into a position of maximum financial distress. They also included the coordinated actions of its representatives, Davenport and Reisley, who spread misinformation, made threats, and engaged in combative behavior. Georgetown also used Cowen to serve its goals. By creating a situation in which the Company had no other alternatives and no more money, Georgetown forced the Company to accept its deal. Because Georgetown exercised actual control over the Company for purposes of the Series G Financing, Georgetown became a fiduciary for purposes of evaluating that transaction.[91]

Accordingly, to summarize, a VC investor with a minority stock position leading a round may be deemed to be exercising transaction-specific control over the enterprise or its board based on a broad constellation of considerations, which may include:

[91] *Id.* at *35. While the Basho decision involved a finding of control broadly exercised over management, the board at large, and through other factors limiting the options available to the corporation in connection with the challenged funding round, effective control likewise can exist where transaction-specific control is exerted narrowly, such as over a majority of the members of a special committee negotiating and recommending the challenged transaction. *See* FrontFour Capital Group LLC v. Taube, No. CV 2019-0100-KSJM, 2019 WL 1313408, at *22 (Del. Ch. Mar. 22, 2019) (finding of effective control based on determination that at least half of the ostensibly independent and disinterested special committee members in fact were not independent from the alleged controlling stockholders when negotiating the challenged transactions).

- Whether the investor inserted itself in, directed, or strongly influenced fundraising efforts (through the retention of an investment banker "friendly" to the investor, substantial direct interactions with potential investors, and so on). At worst, such control may be wielded such as to constrict or eliminate funding options otherwise available to the board[92];

- Whether the investor created circumstances that deprived the board of an ability to negotiate or conduct a market check, such as through the imposition of unrealistic deadlines or conditions[93];

- Whether the investor utilized otherwise-legitimate contractual rights (such as blocking rights or bridge loans) to create cash dependency, financial distress, or otherwise to pressurize or undermine the board's deliberative process[94];

- Whether the investor utilized a bridge loan to stand between the company and the disbursement of needed capital, such as (for example) to permit it to control operations or exert influence over management's efforts to execute on a board-approved business plan[95];

- Whether the investor through some other means exerted outsized influence over the CEO or CFO through a special relationship or other form of pressure[96];

- Whether the investor deployed strong-arm tactics, such as ultimatums, threats or generally abusive behavior directed at management or board members[97]; and

- Whether the investor otherwise maneuvered the board into a "Morton's Fork" dilemma, such that the board had no practical choice but to accede to the will of the VC investor (*e.g.*, either agree to sub-optimal funding terms or lose the company and expose the board to personal liability for payroll obligations, *etc.*).[98]

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[92] *See id.* at *26–28.
[93] *See id.*
[94] *See Basho*, 2018 WL 3326693, at *26–28.
[95] *See id.*
[96] *See id.*
[97] *See id.*
[98] *See id.*

III. INSIDE FUNDING ROUNDS: A FACT OF LIFE

A. Legal Considerations

Why is any of this important, and worthy of consideration in the context of a VC-led inside funding round? To the extent it is not yet apparent from the analysis above, the answer is straightforward: *litigation risk.*[99] A minority VC investor *qua* shareholder owes no fiduciary duties to the enterprise or its other investors;[100] a minority VC investor deemed to be a controller does.[101]

1. Negotiating a Round With a Company to which Fiduciary Duties are Owed

a. The Duty of Loyalty, Generally

Regardless of how beneficial (more often than not, critical) funding may be to the company,[102] negotiating the terms of a funding round, as with virtually any transaction, is an intrinsically adversarial process.[103] As noted, under Delaware law a controlling stockholder owes the fiduciary duty of loyalty to the company and its minority stockholders.[104] Accordingly, a controlling VC investor unavoidably wears two hats as it negotiates the terms of an inside round *against* the company, thereby stepping into a potentially sensitive dual allegiance scenario.

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[99] *See, e.g.*, *Basho*, 2018 WL 3326693, at *43.

[100] *See id*. at *25. Of course, as noted below, the VC investor's board appointees, if any, owe fiduciary duties to the corporation and its shareholders as an undifferentiated whole, as any other director does.

[101] Quadrant Structured Prods. Co., Ltd. v. Vertin, 102 A.3d 155, 183–84 (Del. Ch. 2014) ("Delaware law imposes fiduciary duties on those who effectively control a corporation.") (citations omitted).

[102] Broughman & Fried, *supra* note 1, at 1105 (Unquestionably, venture capital plays "a critical role in the financing of startup firms.") (citation omitted); *see also* Thomas Hellman & Manju Puri, *The Interaction Between Product Market and Financing Strategy: The Role of Venture Capital*, 13 Rev. Fin. Stud. 959–84 (2000).

[103] *See In re* CBS Corp. Litig., 2018 WL 3414163, at *4–8 (Del. Ch. July 13, 2018) (holding that communications between special committee and counsel were privileged as to directors appointed by controller, which controller had proposed a business combination with another entity it controlled and thus was in a position of adversity to company relative to proposed transaction).

[104] *Calesa*, 2016 WL 770251, at *10 (Del. Ch. Feb. 29, 2016).

"[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[105] As blockholder fiduciaries with dual allegiances, directors appointed by a VC investor (whether controlling or not) likewise owe fiduciary duties to the company and its stakeholders, the latter as an aggregated whole.[106]

b. Fiduciary Restraint

While a third party (including a non-controlling minority investor) generally is free to negotiate aggressively, constrained only by the confines of legality[107] and what, as a practical matter, it can get away with, the presence of fiduciary obligations counsels a degree of restraint. This is not to say that a fiduciary may not negotiate with an enterprise to which it owes the duty of loyalty, but the fiduciary nexus adds an ever-present[108] overlay that may come to bear on how such negotiations are conducted, procedurally and to an extent substantively.

Though not involving an inside funding round, *Auriga Capital Corp. v. Gatz Properties, LLC* is instructive.[109] In *Auriga*, the court determined that an LLC manager (with voting power sufficient to block competing transactions) breached his fiduciary duties by, among other things: "turning away a responsible bidder which could have paid a price

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[105] *Carsanaro*, 65 A.3d at 637 (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).

[106] *See generally* J. Travis Laster & John Mark Zerberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 BUS. LAW. 33 (2014).

[107] *See, e.g.*, DEL CODE ANN. tit. 8, § 203.

[108] *See Carsanaro*, 65 A.3d at 637–638. While Delaware law supports and in fact protects the valid exercise of legitimate contract rights held by stockholders, it does not support the view, on the other hand, that the fiduciary hat may be "taken off" to negotiate them or, for that matter, in any other context involving the affairs of the enterprise to which duties are owed. In other words, the fiduciary status does not come with a "kill" switch.

[109] Auriga Capital Corp. v. Gatz Properties, LLC, 40 A.3d 839 (Del. Ch.), *aff'd sub nom.* 59 A.3d 1206 (Del. 2012). While the *Auriga* trial decision drew criticism from the Delaware Supreme Court, members of the Court of Chancery nonetheless have acknowledged the persuasive value of then-Chancellor Strine's analysis. *See, e.g.*, Feeley v. NHAOCG, LLC, 62 A.3d 649, 659–63 (Del. Ch. 2012) ("Although the Delaware Supreme Court determined that the Chancellor should not have reached the question of default fiduciary duties, his explanation of the rationale for imposing default fiduciary duties remains persuasive, at least to me. In citing the Chancellor's discussion I do not treat it as precedential, but rather afford his views the same weight as a law review article, a form of authority the Delaware Supreme Court often cites.") (citations omitted).

beneficial to the LLC and its investors"; "using the leverage obtained by his own loyalty breaches to play 'hardball' with the Minority Members by making unfair offers on the basis of misleading disclosures"; and "buying the LLC at an auction conducted on terms that were well-designed to deter any third-party buyer, and to deliver the LLC to [the manager] at a distress sale price."[110] The manager argued that "he and his family were entitled to vote their economic interest against selling [the LLC] to a third-party buyer and to choke off the LLC's pursuit of any other strategic options."[111] The court rejected this defense:

> The manager's defense that his voting power gave him a license to exploit the minority fundamentally misunderstands Delaware law. The manager was free not to vote his membership interest for a sale. *But he was not free to create a situation of distress by failing to cause the LLC to explore its market alternatives and then to buy the LLC for a nominal price.* The purpose of the duty of loyalty is in large measure to prevent the exploitation by a fiduciary of his self-interest to the disadvantage of the minority.[112]

The principle articulated in *Auriga* has been applied to inside funding rounds: "A fiduciary may not play 'hardball' with those to whom he owes fiduciary duties, and our law provides recourse against *disloyal fiduciaries or controllers who use their power to coerce the minority into economic submission*."[113]

c. The Exercise of Valid Contract Rights

While fiduciary obligations do not require that a controller surrender legitimate contractual rights that provide it value not shared with other stockholders, the *Auriga* decision makes clear that the exercise of

[110] *Id.* at 859.
[111] *Id.* at 848.
[112] *Id.* at 844 (emphasis added); *see also Auriga*, 40 A.3d at 843 ("The manager's course of conduct here breaches both his contractual [*i.e.*, under the operating agreement] and fiduciary duties. Using his control over the LLC, the manager took steps to deliver the LLC to himself and his family on unfair terms.").
[113] *Basho*, 2018 WL 3326693, at *43 (quoting *Auriga*, 40 A.3d at 870) (emphasis added); *see also Auriga*, 40 A.3d at 849 (citing Delaware Supreme Court precedent regarding the co-existence of fiduciary duties with the revised DGCL: "inequitable action does not become legally permissible simply because it is legally possible") (citation omitted).

otherwise valid contractual rights by a controller (in *Auriga*, a manager with voting power sufficient to block an outside buyer) does not occur in a vacuum and may implicate fiduciary considerations. Again, the principle that "inequitable action does not become legally permissible simply because it is legally possible" seems particularly germane to the exercise of contractual rights, including blocking rights, by a controller.

Blocking rights are powerful medicine. Time and again, commentators have described the potent financial control often wielded by non-majority VC investors in the context of early stage companies:

> Sometimes the control issue is not as clear. The founder might control, for example, 40% of the board, the VCs 40%, with ostensibly independent directors occupying the other 20% of the seats. In such a case, the VCs are, at least arguably, in de facto control either because of their stock position, their board seats, *or, more importantly, because they control the spigot: They sit on the company's lifeline, with the ability to turn it on or off.*[114]

Specifically, with respect to blocking rights, Broughman and Fried write:

> VCs typically negotiate rights to block any subsequent financing round they oppose. They can thus block any financing round other than their own, starving the firm of capital and forcing it to accept an undervalued inside round that gives the VCs a larger equity share of the company at the entrepreneur's expense.[115]

Simply put, the invocation of blocking rights under certain circumstances, and coupled with other considerations, may buttress a

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[114] Joseph W. Bartlett & Kevin R. Garlitz, *Fiduciary Duties in Burnout/Cramdown Financings*, 20 J. CORP. L. 593, 601 (1995) (emphasis added); *see also Carsanaro*, 65 A.3d at 665 n.20 (citing Bartlett & Garlitz with approval).

[115] Broughman & Fried *supra* note 1, at 1107. *See also id.* (noting that commentators recognize the power wielded by VC investors over portfolio firms, and that "such power creates the potential for self-dealing in inside rounds.")

finding of transaction-specific effective control.[116] Is this a faint condemnation of legitimately-negotiated approval rights? No, it is not.[117]

Additionally, where control exists, contractual blocking rights must be invoked (*if* they are invoked) with reference to fiduciary obligations (*i.e.*, just because it is legally possible does not mean it is equitably permissible). It is interesting to speculate how the *Basho* case would have come out (assuming litigation was filed at all) if Georgetown would have (a) permitted the disinterested members of the Basho board and senior management to negotiate (free from the interference of a conflicted fiduciary) optimal terms with Southeast Venture, (b) elected to invoke its blocking rights, but (c) thereafter modified its proposal to match the terms offered by Southeast Venture.

In addition to blocking rights, courts and commentators likewise have recognized the leverage exerted by VC investors which extend secured bridge loans to the company:

> Lending relationships can be particularly potent sources of influence, to the point where courts have recognized a claim for lender liability when a lender exercises influence over a company that goes "beyond the domain of the usual money lender" and, while doing so, acts negligently or in bad faith.[118]

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[116] *See Basho*, 2018 WL 3326693, at *26, *29–31; *see also* Superior Vision Servs., Inc. v. Reliastar Life Ins. Co., 2006 WL 2521426, at *5 (Del. Ch. Aug. 25, 2006) ("There may be circumstances where the holding of contractual rights, coupled with a significant equity position and other factors, will support the finding that a particular shareholder is, indeed, a 'controlling shareholder,' especially if those contractual rights are used to induce or to coerce the board of directors to approve (or refrain from approving) certain actions.").

[117] *See id.* at *29 n.327 ("Lest sensitive readers fear that this decision signals heightened risk for venture capital firms who exercise their consent rights over equity financings, I reiterate that a finding of control requires a fact-specific analysis of multiple factors. If Georgetown only had exercised its consent right, that fact alone would not have supported a finding of control.")); *see also* Thermopylae Capital P'rs., L.P. v. Simbol, Inc., 2016 WL 368170, at *13 (Del. Ch. Jan. 29, 2016) ("Under Delaware law, however, contractual rights held by a non-majority stockholder do not equate to control, even where the contractual rights allegedly are exercised by the minority stockholder to further its own goals.").

[118] *Id.* at *26 (quoting NVent, LLC v. Hortonworks, Inc., 2017 WL 449585, at *9 (Del. Super. Feb. 1, 2017)) (citations omitted); *see also* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1243–45 (2006) (discussing private debt as a "lever of corporate control").

In *Basho*, the pressure created by Georgetown's funding manipulations (which came by way of a bad faith reinterpretation of the Georgetown Loan agreement's funding period) was so acute, it overtook Basho's operating budget and caused Basho to fall short of expected performance objectives. Ultimately, a material adverse change clause in the loan documents was used to pressurize special committee deliberations, resulting (as intended) in the committee reversing its initial decision to reject Georgetown's term sheet.[119] This illustrates (albeit through an extreme example) the substantial leverage potentially available to VC investors that lend to the company, the magnitude of which, of course, may be amplified by the circumstances confronting the company at any given time.

2. Heightened Judicial Scrutiny if Round is Challenged in Litigation

a. Entire Fairness, Generally

Contract rights and the teachings of *Auriga* aside, the presence of fiduciary duties, *vis-à-vis* effective control, has material consequences that come into play if the funding transaction is challenged in litigation. "To determine whether a corporate fiduciary has breached its duties, a court examines the fiduciary's conduct through the lens of a standard of review."[120] Where "a challenged transaction would confer a unique benefit on a party exercising *de facto* control, then entire fairness is the standard of review."[121]

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[119] *Basho*, 2018 WL 3326693 at *7–8, *11, *30–31.

[120] *Id.* at *35.

[121] OTK Assocs., LLC v. Friedman, 85 A.3d 696, 724 (Del. Ch. 2014) (citing Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) ("Regardless of where the burden lies, when a controlling shareholder stands on both sides of the transaction the conduct of the parties will be viewed under the more exacting standard of entire fairness."); *Lynch*, 638 A.2d at 1115 ("A controlling or dominating shareholder standing on both sides of a transaction . . . bears the burden of proving its entire fairness.")). It is well-settled that controller transactions involving minority freeze-outs are subject to entire fairness review. The Delaware Court of Chancery likewise has concluded that the weight of authority as well as compelling policy considerations favor the application of entire fairness to *all* controlling stockholder transactions involving the transfer of a non-ratable benefit to the controller. *See In re* EZCORP Inc. Consulting Agreement Deriv. Litig., 2016 WL 301245, at *11–24 (Del. Ch. Jan. 25, 2016) (providing a comprehensive analysis of decisional law, commentary, and policy considerations implicated by non-freeze-out controlling stockholder transactions). *See also Basho*, 2018 WL 3326693, at *35 ("When a transaction involving self-dealing by a controlling shareholder is challenged, the applicable standard of judicial review is entire fairness, with the defendants having the burden of persuasion.") (quoting Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1239 (Del. 2012))

This is so because a "controlling stockholder occupies a uniquely advantageous position for extracting differential benefits from the corporation at the expense of minority stockholders."[122] "'For that reason, when a controlling stockholder is on the other side of the deal from the corporation, our law has required that the transaction be reviewed for substantive fairness even if the transaction was negotiated by independent directors or approved by the minority stockholders.'"[123]

b. Fair Dealing and Fair Price

Entire fairness review involves two interrelated lines of judicial inquiry: whether the course of dealing leading up to the transaction was fair ("fair process" or "fair dealing") and whether the terms of the transaction are fair ("fair price" or "substantive fairness").[124] Each is examined with reference to the other, as a unified inquiry, to determine whether the challenged transaction was "entirely fair."

The fair dealing inquiry examines factors such as "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[125]

> The various dimensions of fair dealing can interact and elide such that a particular instance of unfair dealing affects multiple phases of the process. This is often the case when a controller engages in an act of unfair dealing that it

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(citations omitted) (quoting Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1239 (Del. 2012)) (citations omitted).

[122] *In re* EZCORP, 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016) (citing Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 678 (2005)). *See also id.* at *21 (The entire fairness review "reflects the reality that '[m]anagers and controlling shareholders (insiders) can extract (tunnel) wealth from firms using a variety of methods.'") (quoting Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1, 2 (2011)) (citation omitted) (quoting Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1, 2 (2011)) (citation omitted).

[123] *Id.* at 12 (citation omitted); *see also In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 177 (Del. Ch. 2005) ("[T]he business judgment rule does not protect the board's decision to approve a merger (even where a majority of the directors are independent and disinterested) where a controlling shareholder has a conflicting self-interest.") (citation omitted).

[124] *Basho*, 2018 WL 3326693, at *36.

[125] *Id.*

> subsequently fails to disclose. In those situations, the act both provides evidence of unfairness in its own right and gives rise to an additional instance of unfairness in the form of a disclosure violation.[126]

The substantive fairness inquiry relates to the economic fairness of the transaction with reference to a broad array of factors dictated largely by the nature of the transaction under scrutiny. Not surprisingly, the inquiry rarely dictates a precise numerical end point or terms; rather, it involves a range of fairness in which the disputed deal contours either fit or do not fit. That range of fairness, critically, often is influenced (sometimes strongly) by the process employed or not employed by the board in considering, negotiating, and ultimately approving the challenged transaction. The Court of Chancery has observed:

> Consistent with the unitary nature of the entire fairness test, the fair process and fair price aspects interact. The range of fairness has most salience when the controller has established a process that simulates arm's-length bargaining, supported by appropriate procedural protections.[409] *A strong record of fair dealing can influence the fair price inquiry and lead to a conclusion that the price was fair.* But the range of fairness is not a safe-harbor that permits controllers to extract barely fair transactions. *Factors such as coercion, the misuse of confidential information, secret conflicts, or fraud could lead a court to hold that a transaction that fell within the range of fairness was nevertheless unfair compared to what faithful fiduciaries could have achieved.* Under those circumstances, the appropriate remedy can be a "fairer" price or an award of rescissory damages. *Just as a fair process can support the price, an unfair process can taint the price.*[127]

3. Process Enhancements

In view of the interplay between process and price in the entire fairness inquiry, as well as the material impact certain procedural devices can have on the level of judicial scrutiny and the burden of proof allocation

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[126] *Id.*
[127] *Id.* at *37 (emphasis added) (citations omitted).

(discussed below), process in inside funding rounds involving a potential controller is more than merely window dressing.

a. Business Judgment Deference where Both Special Committee Process and Majority-of-the-Minority Stockholder Vote Employed

With respect to the latter (that is, procedural devices affecting the level of scrutiny and burden of proof), a controlling stockholder transaction may be removed from the ambit of entire fairness scrutiny altogether if (and only if) it is conditioned at the outset on *both* (1) the affirmative recommendation of a duly empowered, independent special committee and (2) the non-waivable, affirmative vote of a majority of the shares owned by stockholders not affiliated with the controller. Where both of these devices are faithfully deployed, the transaction will be entitled to business judgment protection if challenged in litigation.[128] This is so because the use of *both* of these prophylactic measures, in combination, essentially insulates the deliberative process from the intrinsic control risk described in *Lynch* and progeny,[129] replicating an arms-length transaction.

The Special Committee Process. The Court of Chancery is not a form-over-substance tribunal,[130] and the author is aware of no circumstance under which the court has wilted from peering behind the facade of process where there is *prima facie* cause to do so. So, for the sanitizing effects of a special committee process to be realized, the process must be demonstrably effective.[131] The special committee must be

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[128] Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014). The business judgment standard is exceedingly deferential. Where it applies, claims against the deal proponents must be dismissed unless no rational person could have believed that the transaction was favorable to the minority stockholders. *Id.* at 654. *See also* Walt Disney Co. Deriv. Litig. v. Eisner, 906 A.2d 27, 74 (Del. 2006) ("[W]here business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.'" (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (further citation omitted)).

[129] "[E]ntire fairness is . . . applied in the controller merger context as a substitute for the dual statutory protections of disinterested board and stockholder approval, because both protections are potentially undermined by the influence of the controller." *M & F Worldwide*, 88 A.3d at 644.

[130] *In re* Carlisle Etcetera LLC, 114 A.3d 592, 601–07 (Del. Ch. 2015).

[131] *See M & F Worldwide*, 88 A.3d at 646 ("[D]eciding whether an independent committee was effective in negotiating a price is a process so fact-intensive and inextricably

independent,[132] it must be empowered to freely select its own advisors and to say "no" definitively,[133] and the committee must meet its duty of care[134] in negotiating a fair price.[135]

At the end of the day, a special "committee must function in a manner [that] indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power at an 'arms-length.'"[136] Where the committee process was not truly independent such as to be insulated from the influence of a controller, it will not be deemed effective:

> [F]acts are alleged that would establish that [the] special committee was not given the opportunity to select from among the range of alternatives that an independent, disinterested board would have had available to it; it was, in effect, 'hemmed in' by the management group's actions. Under these circumstances, where, according to the allegations contained in the amended complaint, the management group could (and did) veto any action of the special committee that was not agreeable to the conflicted interests of the management directors it would be formalistically perverse to afford the special committee's action the effect of burden shifting of which that device is capable.[137]

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intertwined with the merits of an entire fairness review (fair dealing and fair price) that a pretrial determination of burden shifting is often impossible.").

[132] "To show that a director is not independent, a plaintiff must demonstrate that the director is 'beholden' to the controlling party 'or so under [the controller's] influence that [the director's] discretion would be sterilized.'" *Id.* at 648–49 (alteration in original) (quoting Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)) (further citation and footnote omitted). "Bare allegations that directors are friendly with, travel in the same social circles as, or have past business relationships with the proponent of a transaction or the person they are investigating are not enough to rebut the presumption of independence." *Id.* at 649 (citing Beam *ex rel.* Martha Stewart Living Omnimedia v. Stewart, 845 A.2d 1040, 1051–52 (Del. 2004)).

[133] *See, e.g.*, *Theriault*, 51 A.3d at 1244–46 (noting that a special committee that could only "evaluate" an offer had a "narrow mandate"); Brinckerhoff v. Tex. E. Prods. Pipeline Co., 986 A.2d 370, 381 (Del. Ch. 2010) (observing that a special committee should have the mandate to "review, evaluate, negotiate, and to recommend, or reject, a proposed merger").

[134] *See generally M & F Worldwide*, 88 A.3d at 651–53 (describing actions deemed to discharge the special committee's duty of due care).

[135] *Id.* at 645.

[136] Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997).

[137] Freedman v. Rest. Assocs. Indus., Inc., 1990 WL 135923, at *7 (Del. Ch. Sept. 21, 1990).

The Majority-of-the-Minority Stockholder Vote. Similarly, a majority-of-the minority stockholder vote will not be deemed effective if the transaction was not conditioned on such approval from the outset,[138] if the stockholders were not adequately informed[139] or if approval was coerced.[140]

b. Burden Shifting through use of Either Special Committee Process and Majority-of-the-Minority Stockholder Vote

Use of either a special committee process or a majority-of-the-minority vote (but not both), while insufficient to remove the transaction from entire fairness scrutiny, can transfer the entire fairness burden of proof to the plaintiffs challenging the transaction.[141] While burden shifting may seem academic and perhaps mechanical in the context of legal commentary, its ramifications are felt with full force in the context of high-stakes litigation, particularly with respect to pleading, dispositive motion practice, and the presentation of proofs at trial. Burden allocation is, in that corner of the universe, a "big deal."

c. Other Process Enhancements

Where the dual protections of a majority-of-the-minority vote and a special committee process are not or cannot be used to insulate a round led by an effective controller from entire fairness scrutiny, other procedural protections[142] may be deployed to enhance fair dealing optics.

[138] *Zhongpin*, 2014 WL 6735457, at *10 ("In this case, Zhu's Proposal did not include a majority-of-the-minority provision at the outset. The provision was included in the final Merger Agreement only after the parties had negotiated and agreed to a $13.50 per share price. This transactional structure, where the majority-of-the-minority provision came in at the tail end of the sales process, does not satisfy *M & F Worldwide*'s strict guidance. Therefore, entire fairness is the appropriate standard of review.") (footnote omitted).

[139] *See generally M & F Worldwide*, 88 A.3d at 653–54 (discussing adequacy of proxy disclosures regarding the background of the special committee's work, of the valuation ranges calculated by the special committee's financial advisor, and of the analyses supporting the financial advisor's fairness opinion).

[140] *See id.* at 644.

[141] *See id.* at 642.

[142] That is, process enhancements other than (but ideally in combination with) a special committee process or a majority-of-the-minority shareholder approval requirement.

Recusal. Where, as often is the case, the VC investor leading an inside round has appointed members to the board, recusal from board deliberations regarding the round (assuming a special committee process is not used to achieve the same result) may be a prudent course of action. While not dispositive, recusal can assist in demonstrating the absence of undue influence at the board level.[143] Similarly, if senior executive officers were hired at the insistence of the controller or otherwise have a connection with the controller sufficient to call to question their independence, consideration may be given to transferring some of the deal-related responsibilities typically in their charge to other, clearly-unaffiliated officers.

Fairness opinion. For all inside rounds, but especially down rounds, the board may consider retaining an independent investment banker or other financial advisor to provide consultation, value the firm, and render an opinion on the fairness of the funding terms to existing stockholders. Inputs and direct interaction with the financial advisor should come by way of management members and directors unaffiliated with the controller.[144]

Market check. The type of round examined in this article implies either that the VC investor has signaled that it will exercise blocking rights, that efforts to secure an outside lead investor have proven unsuccessful, or that due to any number of circumstances, the board has determined not to seek (or that it cannot seek) an outside investor. If the first scenario—that is, an inside round is under consideration due to blocking rights—consideration (or solicitation, if permitted) of potential outside investors

[143] Among other things, commentators have recognized the value of "soft data" that can be channeled through board designees to VC investors, which in turn can be used to fortify the VC investor's negotiating position. *See, e.g.*, Broughman & Fried, *supra* note 1, at 1105 (describing how an "informational lock-in" may advantage inside VC investors relative to potential outside investors in subsequent rounds). *See also M & F Worldwide*, 88 A.3d at 641–42 (noting that directors affiliated with the controller recused themselves from the board meeting concerning the transaction prior to formation of special committee).

[144] *See M & F Worldwide*, 88 A.3d at 651–53 (describing painstaking analysis and valuation process undertaken by special committee and its financial advisor).

nonetheless may be advisable.[145] Additionally, securing outside interest enhances the leverage of those negotiating against the controller.[146]

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In the most extreme instance, where the funding transaction is in essence a *fait accompli* in which the VC investor controls the board such as to undercut the board's ability to bring business judgment to bear in a genuine deliberative process, the specter of an effective control determination looms large. Given the variety of indicia and circumstances that may come to bear on a control determination, however, *caution may be the more prudent course even when the contours of an inside round seem less than extraordinary.* Consider process enhancements where, and to the extent, possible.

B. Practical Considerations

Beyond the parameters of academic discourse, business people, investors, and their respective advisors are called upon to deal with reality. Often, that reality is not pretty. Early stage enterprises find themselves out of cash, out of time, confronting markets not maturing as anticipated, or sometimes simply on the wrong side of happenstance. The following is but a sampling of the practical considerations that may come to bear when weighing the cost and delay of process enhancements against the incremental advantages offered.

- Entire fairness cases are more attractive to enterprising plaintiffs' counsel, meaning that the chances of litigation being brought in connection with a given round, while dependent on a wide variety of variables, may be assumed to increase where there arguably is a controller and both a special committee process and a majority-of-the-minority vote have not been utilized.

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145 *See id.* (describing special committee's efforts to analyze other potential buyers notwithstanding practical reality that controller announced that it would not sell and thus could block any outside transaction).

146 *See* OTK Assocs., LLC v. Friedman, 85 A.3d 696, 705 (Del. Ch. 2014) ("The Special Committee . . . [understood] the Company needed an alternative to the Yucaipa [controller] transaction for the Special Committee to have any leverage in the negotiations with Burkle [the conflicted director].").

- Entire fairness cases, given the fact-intensive issues typically implicated, can be difficult to dispose of on a motion to dismiss.

- To the extent not disposed of in a pleading-based motion, entire fairness cases can proceed to costly discovery, which in turn can be highly disruptive to the company's management team and board. The cost of defense is elevated where, as is typically the case, certain officers, directors or director contingents retain their own counsel, and are entitled to fee and cost advancement contractually or under the corporation's governing documents.

- Claims alleging breaches of the duty of loyalty on the part of the VC investor's board appointees are not protected from personal liability for money damages under exculpatory charter provisions authorized by 8 *Del. C.* § 102(b)(7) and may face considerable exposure. Likewise, disloyal conduct often is subject to exclusion under director and officer insurance policies, prompting the carrier to deny coverage and the provision of defense costs.

Given these and other practical considerations, a careful analysis of (1) whether a VC investor leading an inside round may be deemed a controller and, hand in hand with that, (2) what procedural enhancements may be called for, are determinations that should be made early in the deal process, rather than as an afterthought.

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