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CLIENT ALERT

Delaware Chancery Court Holds Minority Shareholder Liable as Controlling Shareholder For Abusing Contractual Consent Rights

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AUTHORS

Tariq Mundiya | Martin L. Seidel | Mary Eaton | Sameer Advani

On July 6, 2018, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery ordered Chester Davenport and his investment fund Georgetown Basho Investors, LLC (“Georgetown”), to pay $20.3 million in damages, after finding that defendants breached their fiduciary duties in connection with the collapse of Basho Technologies, Inc (“Basho”). The Court found that Georgetown, a minority stockholder of Basho, used contractual consent rights granted to it as a preferred shareholder together with “hardball” negotiating tactics to force Basho to the brink of insolvency and leave it with no choice but to accept “oppressive” financing terms from Georgetown.

The decision is notable because the consent rights at issue—which required Basho to obtain Georgetown’s consent to any new financing or extraordinary transaction—are commonplace in many venture capital and private company financings. While investors remain free to leverage such rights to their own advantage, the Court found that the “hardball” tactics used by the defendants here, including freezing management out of negotiations with alternative financing sources, sabotaging alternative transactions and using Georgetown’s compliance with its own funding obligations to impose onerous terms on Basho, resulted in a process that was “decidedly unfair” to Basho and benefited the defendants at the expense of the company and its other investors.

Background

In 2011, Georgetown began investing in Basho, a venture stage technology company. Davenport then joined Basho's Board of Directors. Over the next three years, Georgetown participated in two additional preferred stock offerings and provided a $7.5 million loan facility to Basho. Georgetown and the other investors received preferred stock in each round, which gave the investors contractual consent rights over certain corporate transactions, including subsequent financings, or a sale of Basho or its assets. These consent rights are fairly typical in private company financings and require the consent of a majority of the stock in each class of preferred stock for each transaction. In the second-to-last round of financing, Georgetown provided half of the financing and received consent rights that gave it the effective ability to block all future financings. According to the Court, Georgetown then effectively made itself Basho's "sole lifeline" for money. Georgetown then sought to use this power to force a sale of Basho, in which Georgetown's preferred stock would give it "the largest share of proceeds."

Basho, which was not yet profitable, remained dependent upon outside financing to develop its technology and become profitable. Georgetown used its consent rights to block any proposed financing and force Basho to issue Georgetown additional preferred stock (the "Series G Financing") that would give it outright control of Basho's Board and the right to receive up to three times its investment in the Series G Financing before other investors received anything in a sale of the company. The Court found that Georgetown took active steps to sabotage three alternative financing proposals that even the investment bank handpicked by Georgetown indicated were less oppressive than Georgetown's offer. Davenport and Georgetown replaced or isolated management when they objected to its proposed financing or advocated for alternative financing, took control of the negotiations with potential investors and "r[a]n out the clock while claiming…to cooperate" with the company and its potential new investors. In the end, Georgetown's tactics succeeded in driving away each potential new investor, while leaving Basho, which was out of money, dependent on a bridge loan and new financing from Georgetown. When Basho's Board of Directors nevertheless rejected Georgetown's proposal, Georgetown refused to make contractually promised disbursements under its bridge loan, leaving the company out of money and unable to meet its payroll obligations. Having thus triggered a liquidity crisis, Georgetown gave the Board less than a day to accept the previously rejected Series G Financing. Ultimately, the Board agreed to Georgetown's terms, but three directors resigned in protest and another demanded that his written objections to the transaction be attached to the minutes. Once it had outright control, Georgetown appointed a majority of the Board and created an Executive Committee comprised of Georgetown loyalists to run the company. The Executive Committee then pushed through several self-dealing transactions. In the end, Georgetown could not raise any additional financing for Basho, and the company was liquidated in 2017.

The Litigation

The plaintiffs—former Basho shareholders—alleged that Davenport and Georgetown breached their fiduciary duties both in connection with the onerous Series G Financing and through their self-interested operation of Basho following the Series G Financing. The Court found after trial that Davenport owed a fiduciary duty in his capacity as a director of Basho. With respect to Georgetown, the Court held that it controlled Basho both in connection with the Series G Financing and the subsequent transactions. The Court explained that a "defendant without majority voting power can be found to owe fiduciary duties if the plaintiff proves that the defendant in fact '*exercises control* over the business and affairs of the corporation'" (emphasis in original). The Court identified two kinds of control by a non-majority blockholder: (1) pervasive control over the business and affairs of the company generally, and (2) transaction-specific control. The Court noted that the defendant must exercise "actual"––not merely potential—control with regard to the particular transaction. According to the Court, various factors can contribute to a finding of actual control over a particular decision, such as:

- relationships with particular directors that compromise their disinterestedness or independence;
- relationships with key managers or advisors who play a critical role in presenting options, providing information, and making recommendations;
- the exercise of contractual rights to channel the corporation into a particular outcome by blocking or restricting other paths; and
- the existence of commercial relationships that provide the defendant with leverage over the corporation, such as status as a key customer or supplier.

Additionally, broader *indicia* of effective control also play a role in evaluating whether a defendant exercised actual control over a decision. Examples include ownership of a significant equity stake (albeit less than a majority); the right to designate directors (albeit less than a majority); decisional rules in governing documents that enhance the power of a minority stockholder or board-level position; and the ability to exercise outsized influence in the board room, such as through high-status roles like CEO, chairperson, or founder. The Court cautioned, however, that a finding of control requires a fact-specific analysis of multiple factors. For instance, a court can consider specific conduct by the defendant, such as whether the defendant insisted on a particular course of action over objections from other fiduciaries, and whether the defendant used "aggressive, threatening, disruptive, or punitive behavior" to force the decision.

Notably, the Court emphasized that blocking rights standing alone are highly unlikely to support either a finding or a reasonable inference of control. The Court also highlighted that, more generally, exercising contractual rights—even to force an outcome that is beneficial to the shareholder—is not a breach of fiduciary duty.

Here, the Court found that Georgetown owed a fiduciary duty because it exercised actual control over Basho for purposes of the decision to consummate the Series G Financing. In finding control, the Court considered the following transaction-specific factors:

- Georgetown's use of its contractual rights to channel the Company into a position where it had no options other than to accept Georgetown's terms.
- Davenport and his confidante Robert Reisley's efforts, taken on Georgetown's behalf, to spread misinformation about Georgetown's intentions and the status of negotiations.
- Davenport's interference with members of management, such as subverting or firing anyone who did not support Georgetown's interests, and using the monthly draw process to control management after Georgetown became Basho's primary source of capital.
- Davenport's selection of Basho's bankers, who were also Davenport's bankers, in connection with the fundraising process.
- Georgetown's insistence on the Series G Financing, supported by Davenport and Reisley's combative behavior, such as threatening to personally sue former director Greg Collins unless Basho signed Georgetown's deal within five days.

Because the Series G Financing involved self-dealing by a controlling shareholder, the Court applied the entire fairness standard to the plaintiffs' challenge. Applying this heightened standard, Vice Chancellor Laster examined the process leading up to the formal proposal and found that the transaction was unfair in the way it was initiated. In particular, the Court cited to the fact that before making the Series G proposal, Georgetown interfered with Basho's ability to seek funding from third parties by discouraging competing investors from submitting term sheets and insisting on vetting every investor before allowing the investor to speak with management. In addition to the process, Vice Chancellor Laster found that the eventual terms offered to Basho were unfair, characterizing the deal as "punitive."

Moreover, in rejecting the defendants' argument that the Series G Financing was fairly priced because no other party submitted an actionable investment proposal, the Court stated that the "absence of competing offers says more about Georgetown's actual control over the Company and the defendants' acts of unfair dealing than it does the fairness of the Series G Financing's price." The Court concluded that the Series G Financing was an unfair, "oppressive" transaction that Georgetown and Davenport forced Basho to accept, and which resulted in Georgetown's control of a majority of the

Company's voting power and a majority of its Board seats, despite providing only $2.5 million in new money. With respect to the period following the Series G Financing, the Court determined that the defendants continued to control Basho in a self-interested manner and, at trial, made no effort to prove that the post-Series G transactions were entirely fair. In holding the defendants liable for $20.3 million, Vice Chancellor Laster concluded that "the Series G Financing started the Company on a greased slide to failure, and the defendants' actions after the Series G Financing contributed to the Company's completion of that journey."

Conclusion

The 126-page *Georgetown* decision is significant because it demonstrates that non-majority stockholders who use contractual rights to force a company into transactions uniquely beneficial to the blockholder can, under certain circumstances, face sharp liability for breach of fiduciary duties. As Vice Chancellor Laster explained, however, the decision does not signal a "heightened risk for venture capital firms who exercise their consent rights over equity financings." Instead, the decision reflects a fact-specific analysis of a controlling shareholder's "egregious" conduct that ran a company into the ground.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

Tariq Mundiya	**Martin L. Seidel**	**Mary Eaton**	**Sameer Advani**
212 728 8565	212 728 8385	212 728 8626	212 728 8587
tmundiya@willkie.com	mseidel@willkie.com	meaton@willkie.com	sadvani@willkie.com

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