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Update | Delaware Corporate Law

April 2024

Early 2024 Delaware Corporate and M&A Law Update

Delaware courts have issued a barrage of important guidance in early 2024, and the Corporation Law Section of the Delaware State Bar Association has reacted by proposing related amendments to the Delaware General Corporation Law. In particular, the Delaware Supreme Court and Court of Chancery have issued decisions, regarding controlling stockholders, compliance with foundational statutory provisions, and private ordering, that relate to core corporate, governance, and M&A issues. We discuss those decisions and the proposed DGCL amendments in this GT Update and expect that the market will continue grappling with their implications for some time.

CORPORATE

Contractual Governance Arrangements with Significant Stockholders and Activists. A flurry of disputes arising under stockholder agreements has involved whether certain terms comply with DGCL requirements that key governance provisions should be set forth in the charter. In a recent case, the Court of Chancery laid out a framework that divides such provisions into "governance arrangements," which implicate DGCL provisions and related equitable principles, and "commercial arrangements," which are not subject to those concerns, though both arrangements may arise in a single contract. Contractual terms may constitute a governance arrangement based on factors such as relevance to the DGCL, parties' corporate positions, presence of economic substance, available remedies, and contemplated duration and termination. Such contractual governance arrangements may be assessed in the aggregate or based on specific provisions and would likely be invalid if they "have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters" or "tend to limit in a substantial way the freedom of director decisions on matters of management policy." In this recent case, provisions of a public company's stockholder agreement requiring stockholder pre-approval for board planning and obligating the company to recommend the stockholder's designees, maintain board size, and fill vacancies and populate committees with the stockholder's designees were facially invalid, while other provisions not meaningfully infringing on the board's managerial authority, such as designation rights and company nomination and efforts obligations, were not facially invalid. The decision addressed validity under Section 141(a) of the DGCL, but its analysis rested on cases involving both Section 141(a) and fiduciary duties. That opinion suggests that its principles may apply broadly, including to contracts related to D&O compensation and M&A and bylaws, while emphasizing that governance provisions placed in the charter or containing fiduciary-outs and stockholder-level arrangements will be on firmer ground. Indeed, subsequent decisions have applied these principles of equitable and statutory law, suggesting that activist settlements may have impermissibly burdened public company boards' discretion regarding

board size, formation and powers of board committees, and board recommendations of activist nominees. The decision also took under advisement whether the addition of a "fiduciary out" would be sufficient to permit the agreement regarding director recommendations. The Court of Chancery explained that fiduciary outs may apply differently to third-party contractual rights (e.g., M&A termination rights) than to more "strongly internal" matters (e.g., director recommendations). The court separately stated that a settlement agreement with an activist, which may have saved the incumbent directors' positions by adding designees of the activist, supported a conceivable *Unocal* claim. In another case, the court is considering how incorporation of stockholder agreements by reference in the charter may coincide with and facilitate resolution of these issues. These principles are likely to continue factoring into a range of contexts including activist settlements.[1] ***See Related Topics and Outlook section regarding proposed DGCL amendments and revisions to the NVCA model documents***

Controlling Stockholder Fiduciary Duties when Selling and Voting. Controlling stockholders—unlike non-controlling stockholders—owe fiduciary duties in certain contexts, but Delaware case law leaves open questions about the exact contours of those contexts and duties. In a decision that a controller had breached its fiduciary duties in connection with a squeeze out transaction found to be unfair, the Court of Chancery provided extensive guidance regarding controller duties. After the board of directors began pursuing a plan to liquidate one of the company's businesses, the controller adopted bylaws impeding approval of the liquidation and then pushed through a squeeze out transaction. The court explained: (1) when a controller declines to sell and/or votes to maintain the status quo, fiduciary duties are not implicated; (2) selling to a corporate looter and voting to alter the status quo, which was found to have occurred via bylaw amendments in this case, implicate the controller's fiduciary duties; (3) the judicial standard of review applicable to a claim that a controller breached its fiduciary duties when voting to affect corporate control, as applied to claims regarding the bylaws in this case, is enhanced scrutiny; and (4) the standard of review applicable to claims in the context of a transaction where the controller received a unique benefit, such as the squeeze out in this case, is entire fairness.[2]

Enforceability of Forfeiture-for-Competition Provisions. Restrictive covenants and related provisions have been the subject of recent litigation in Delaware, and continue to attract significant attention nationally, including in light of a recent ban on employment-based noncompetes imposed by the Federal Trade Commission. The Delaware Supreme Court upheld a forfeiture-for-competition provision in a limited partnership agreement, noting that it was not subject to judicial review for reasonableness. The court explained that a forfeiture-for-competition provision was not a liquidated damages provision and, unlike a noncompete that prohibits competitive activity, operates to present the former employee with a choice. Although Delaware courts have stated that they will not revise non-competition provisions to bring them within a permissible scope, another recent decision noted that noncompetes may be subject to blue penciling by the court if a to-be-restricted party with leverage negotiates for an overbroad provision. Noncompete enforceability continues to be a live and evolving issue in Delaware and nationally.[3]

Board Process and Approvals Related to Executive Compensation for a Controlling Stockholder. Delaware courts apply the entire fairness standard of review with respect to claims challenging a transaction in which a controlling stockholder receives a unique benefit not shared proportionately with other stockholders, such as compensation of the controller for his or her services as an executive. As with fiduciary duty claims related to other conflicted controller transactions, approval by an independent director committee and/or unaffiliated stockholders can shift the burden of proof or even entitle defendants to business judgment deference. The court's recent analyses

of whether a stockholder is a controller and the entire fairness of the transaction—i.e., fair process and fair price—have involved a close examination of the record regarding levers of influence that the stockholder may pull generally or specific to the transaction. Such sources of influence may include the other directors' resistance, how the directors' actions advance the interests of the corporation and its unaffiliated stockholders, and the rationale for compensation of such an employee, who may already be incentivized by a substantial equity stake.

Stockholder Class Votes for Charter Amendments. Section 242(b)(2) entitles the holders of a class of stock to a separate vote on a charter amendment that would adversely affect the rights, powers, and preferences of the class. Although certain rights and powers of stockholders may arise outside of the DGCL and the certificate of incorporation, the Supreme Court has confirmed that the DGCL class voting rights are only applicable to charter amendments adversely affecting the rights, powers, and preferences of the class which are contemplated by Section 151. In a recent decision, the Supreme Court determined that a class vote was not required for a charter amendment adding an exculpation of officers' personal liability in accordance with Section 102(b)(7).[4]

Affiliated Stockholder Rights to Access Information via Designated Directors. Directors designated by a stockholder generally have a right to share information with the designating stockholder, and the stockholder may even have rights to access corporate information as a result of that designation. In one case, a director, who was also affiliated with stockholders owning less than 2% of a public company, was found to have impermissibly shared confidential information with the affiliate stockholders who in turn impermissibly used that information in a complaint alleging breach of fiduciary duty against other directors. The court explained the case law as establishing the rule that a director may share privileged or confidential company information with a stockholder if (1) the director is designated to the board by the stockholder pursuant to contract or the stockholder's voting power; or (2) if the director also serves in a controlling or fiduciary capacity with the stockholder.[5]

Expeditious Judicial Validation of Defective Corporate Acts. Section 205 provides the Court of Chancery with broad jurisdiction to validate potentially invalid corporate actions, and that jurisdiction has been exercised in large part when corporate ratification under Section 204 is unavailable. The process for judicial validation requires a petition setting forth the act to be validated, the nature of the underlying defects, and related information and reasons for the petition. The Court of Chancery has demonstrated impressive responsiveness to such petitions often involving technical issues of corporate law. A recent order was granted, on the eve of a public company stockholder meeting to approve a charter amendment increasing authorized shares, approximately eight weeks after the petition was filed for validation of public company stock issuances and other corporate acts.[6]

MERGERS & ACQUISITIONS

Requirements for Board and Stockholder Approval of a Merger Agreement. Section 251(b) requires that the board approve the merger agreement before it is signed and approved by stockholders. A recent decision stated that the version of the agreement approved by the board in that deal, which omitted deal consideration and pre-closing dividend provisions, a frequently referenced side letter, and the amended survivor charter that were part of the execution version, was not sufficiently finalized because it was not essentially complete. The court noted that reasonable minds could differ on whether finalized disclosure schedules are required to be part of the version approved by the board. The court separately stated that the stockholder meeting notice may not have contained a copy of the required version of the merger agreement and may not have referenced the summary in the proxy statement, as contemplated by Section

251(c). The court also noted that the DGCL provides remedial paths for statutory defects, such as ratification and validation under Sections 204 and 205.[7] ***See Related Topics and Outlook section regarding proposed DGCL amendments***

Conceivable Benefits to a Controlling Stockholder in Delaware-to-Nevada Conversion. A fiduciary duty claim related to a change in corporate domicile providing a non-ratable benefit to a controlling stockholder is subject to the entire fairness judicial standard of review. In the pleading stages of a case where a Delaware corporation sought to convert to a Nevada corporation, the Court of Chancery recently found it reasonably conceivable that the conversion could provide the controller with additional protection from liability for breach of fiduciary duty, while the other stockholders could receive litigation rights not substantially equivalent to those under Delaware law. The court denied an injunction, thereby potentially allowing the conversion to proceed, but noting that damages could remedy any harm for which the defendants might ultimately be liable. A panel of the Delaware Supreme Court has accepted an interlocutory appeal of this decision.[8]

Aiding and Abetting Potential SPAC Director Fiduciary Duty Breaches by De-SPAC Target Directors. Delaware case law has addressed fiduciary duty claims related to de-SPAC transactions. In a recent decision, the court allowed a claim to proceed against target company founder-directors on the theory that they aided and abetted alleged fiduciary duty breaches by the SPAC board. Specifically, the SPAC directors were alleged to have breached their disclosure obligations in connection with the de-SPAC proxy statement, which may have failed to adequately describe the company's projections, supplier agreements, and pre-merger discounted stock sales to the target founders. Typically, the most difficult element of an aiding and abetting claim is the required showing of "knowing participation," which was found in this case based on the founders' knowledge of the underlying facts, the target's obligation under the merger agreement to review the proxy statement, and the founders' involvement "from start to finish" in the negotiation, execution, and promotion of the transaction. In another case alleging target directors' breaches of disclosure obligations in connection with a de-SPAC transaction, however, the court dismissed aiding and abetting claims against target officers who had made presentations to investors but had not been "part of a long, involved process" related to potentially misleading disclosures underlying the claims against the target directors.[9]

Requirements for MFW Committees. The *MFW* procedure adopted by the Delaware Supreme Court just over a decade ago to establish a path for conflicted controller transactions to receive business judgment deference has been closely examined in Delaware case law. In a recent case where *MFW* was satisfied, the court considered whether the independent director committee, which was empowered only to consider a transaction with the controlling stockholder (i.e., not a third-party alternative), was sufficiently empowered. Although the court noted policy reasons for providing a committee with full power of the board when dealing with a controller, the court determined that *MFW* permits the committee's power to be so cabined. In another decision affirming the entire fairness standard of review as to all fiduciary duty claims related to a conflicted controlling stockholder transaction, the Delaware Supreme Court explained that all directors (not a bare majority) on a *MFW* committee must be independent. These decisions will require thoughtful planning around the formation of a committee when implementing the *MFW* procedure.[10]

Fiduciary Duty Claims related to SPAC Winding Down Distribution. A SPAC received a busted de-SPAC termination fee and then engaged in the winding down process pursuant to its charter. In the winding down, the publicly held Class A shares were redeemed for the stated redemption price, while the proceeds of the termination fee were to be withheld and later distributed to the holders of Class B shares (i.e., the sponsor, its owners, and other insiders).

Class A holders brought litigation claiming that this constituted a breach of fiduciary duty, and the claims were settled for $12 million, with $2 million in attorneys' fees. When approving the settlement, the court noted that the claims for breach of fiduciary duty were strong, though the parties had identified no clear precedent for a SPAC's failure to distribute assets other than those held in trust.[11]

ABC Petition Dismissed for Failure to Follow Statutory Requirements. Delaware's assignment for the benefit of creditors (ABC) statute prescribes steps for effecting an ABC. Although ABC proceedings have often been conducted *ex parte*, the Court of Chancery has sought to increase transparency by requiring certain information in connection with a petition. A recent ABC petition was dismissed in its entirety when the petitioner sought to appoint appraisers and fix a bond before the statutorily required court order. The court also noted that one appraisal was unsigned and contained a draft heading, which the assignee could not explain.[12]

Sale of Parent Entity Not an Indirect Sale of Subsidiary Stock. Provisions related to stock transfers and changes in control of a company may be drafted to apply to 'upstream' dispositions that only indirectly affect that company. In a recent case, a stock purchase agreement provided for payment to sellers in the event of a "Change of Control Event," which was defined to include "indirectly . . . the sale of 50% or more of the equity ownership or voting power of the then-outstanding capital stock of [subsidiary]." A post-closing sale of the parent that indirectly owned the subsidiary stock did not constitute such a Change of Control Event, because the subsidiary's stock was not sold (even though control over that stock was disposed) and drafting history showed that the parties had rejected an interpretation of Change of Control Event that would have included a sale of the parent.[13]

RELATED TOPICS AND OUTLOOK

Proposed DGCL Amendments Responsive to Delaware Cases. Following several important decisions over the past year by the Court of Chancery, the Corporation Law Section of the Delaware State Bar Association, which is responsible for drafting statutory updates, has proposed amendments to the DGCL, which are intended to ensure statutory validity for certain governance arrangements, approval of merger agreements and charter amendments, and claims for lost-premium damages after busted deals. The proposed legislative synopsis explains that the amendments are intended to shift disputes from statutory validity to compliance with equitable principles and fiduciary duties. The proposed amendments remain subject to adoption by the Executive Committee of the DSBA, the Delaware General Assembly, and the Delaware governor. We expect developments around these proposed amendments of significant interest to the market and practitioners, which we will continue to monitor.

Further Revisions to NVCA Model Documents. Company Efforts to Ensure Stockholder Rights. The National Venture Capital Association (NVCA) model investment and governance documents (Certificate of Incorporation, Voting Agreement, Investors' Rights Agreement, ROFR and Co-Sale Agreement, and Stock Purchase Agreement) were amended in January 2024 and again in April, just months after extensive revisions were made in Q3 2023. For instance, the NVCA model voting agreement previously included a company covenant to ensure the effectiveness of stockholders' rights under the agreement. That covenant has been amended and limited to more specific ministerial matters, in light of concerns about an interpretation of that covenant as a restriction on the company's ability to terminate the employment of stockholders. The model investors' rights agreement has also been updated to include a fiduciary out with respect to certain company covenants implicated by the *Moelis* decision discussed above.[14]

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[1] *West Palm Beach Firefighters' Pension Fund v. Moelis & Company*, C.A. No. 2023-0309-JTL (Del. Ch. Feb. 23, 2024); *Miller v. Bartolo*, C.A. No. 2024-0176-JTL (Del. Ch. Mar. 8, 2024) (TRANSCRIPT) (finding potential issues based on the timing of settlement and cooperation agreement in advance of the nomination window and the activist's use of derivatives); *Seavitt v. N-able, Inc.*, C.A. No. 2023-0326-JTL (Del. Ch. Mar. 6, 2024) (LETTER) (questioning use of facts ascertainable and incorporation of documents by reference); *Taylor v. L3Harris Technologies, Inc.*, C.A. No. 2024-0205-JTL (Del. Ch. Mar. 13, 2024) (TRANSCRIPT) (finding colorable claim that an activist settlement agreement provision requiring the

board's recommendation of the activist's nominee may have been invalid; declining to determine whether there was "an implicit fiduciary out built into the agreement because of the requirement that the new directors meet the company's governance policies and other items that are collected under the defined term 'Director Criteria' in the cooperation agreement"). The court in *Miller* explained, with respect to the board's obligations to recommend directors:

> And here, after the modification by the fiduciary out, I'm not saying that it's invalid. I'm saying that I'm not sure. What Elliott and the company did to modify this provision was to allow the directors to withdraw their recommendation of a specific individual if the directors determined, after consultation with counsel, that their fiduciary duties required it. That is a common formulation that's used in M&A agreements, so that starts out with a lot going for it. As you-all know from *Moelis*, but also from my earlier *Primedia* decision, following the work of distinguished practitioners like Frank Balotti and some of the folks over at Morris Nichols, I distinguish between a termination right and a recommendation right. The termination right is what, to me, more obviously implicates third-party contractual interests. The recommendation right is something that, to me, is strongly internal and connected to the board's duties to its stockholders. It's not clear to me that the same limitations can apply to a recommendation right that we all would readily concede, or at least acknowledge, can apply to a termination right. I basically want to think about this one more, and I want your help thinking about it more. I think that there continues to be a colorable challenge to the recommendation obligation as made subject to the fiduciary out. Again, no one should interpret this as meaning that it's going to be held invalid. There is a question in my mind about the use of that format in this context involving an election scenario where the board's recommendation is so important.

[2] *In re Sears Hometown and Outlet Stores, Inc. Stockholder Litig.*, Consol. C.A. No. 2019-0798-JTL (Del. Ch. Jan. 24, 2024).

[3] *Cantor Fitzgerald, L.P. v. Ainslie*, No. 162, 2023 (Del. Jan. 29, 2024); *Labrinth, Inc. v. Urich*, C.A. No. 2023-0327-MTZ (Del. Ch. Jan. 25, 2024). On April 23, 2024, the FTC voted to ban noncompete clauses, including forfeiture for competition clauses. Such a rule would supersede all contrary state laws. However, the ban permits existing agreements with senior executives to remain in place and will not go into effect immediately. The U.S. Chamber of Commerce, Business Roundtable, and multiple business groups have sued to block the ban on the basis that the FTC exceeded its authority in promulgating the ban. *See* Gregory S. Bombard, Justin K. Victor, Emily W. Collins, Jacob R. Dean, *GT Alert: FTC Votes to Ban Noncompete Clauses Nationwide* (Apr. 24, 2024).

[4] Nos. 120 & 121, 2023 (Consol.) (Del. Jan. 17, 2024, rev. Jan. 25, 2024). In a subsequent LinkedIn post, Vice Chancellor J. Travis Laster, who issued this decision that was affirmed by the Supreme Court, noted potential implications for this decision, such as how it might interact with Delaware law around provisions for management of the corporation and forum selection.

[5] *Icahn Partners LP v. deSouza*, C.A. No. 2023-1045-PAF (Del. Ch. Jan. 16, 2024), interlocutory appeal refused 107, 2024 (Del. Apr. 11, 2024).

[6] *In re Lightpath Technologies, Inc.*, C.A. No. 2023-1202-KSJM (Del. Ch. Jan. 30, 2024) (validation petition and motion to expedite filed Dec. 1, 2023). That pace rivals the timeline for a corporate ratification involving a certificate of validation under Section 204.

[7] C.A. No. 2022-1001-KSJM (Del. Ch. Feb. 29, 2024). The Delaware Court of Chancery has previously validated potentially defective mergers under Section 205. *See, e.g., In re Belden Inc.*, C.A. No. 9842-CB (Del. Ch. July 8, 2014) (ORDER); *In re Beadles Lumber Co.*, C.A. No. 10247-VCL (Del. Ch. Oct. 24, 2014) (ORDER).

[8] *Palkon v. Maffei*, C.A. No. 2023-0449-JTL (Del. Ch. Feb. 20, 2024), interlocutory appeal accepted 125,2024 (Del. Apr. 16, 2024) (ORDER). This case also reflects the importance of the recent amendment to Section 266, which allows a Delaware corporation to convert to another entity and/or jurisdiction with approval by holders of only a majority of the outstanding stock. Before that amendment, such a change of domicile by means of conversion would have required unanimous stockholder approval, so changes of domicile were generally effected by means of a merger requiring only majority approval.

[9] *Electric Last Mile Consolidated Solutions, Inc. Stockholder Litig.*, C.A. No. 2022-0630-KSJM (Del. Ch. Jan. 22, 2024) (ORDER); *In re Nikola Corp. Derivative Litig.*, C.A. No. 2022-0023-KSJM (Del. Ch. Apr. 9, 2024) (TRANSCRIPT).

[10] *In re StoneMor Inc. Stockholders Litig.*, Consol. C.A. No. 2023-0095-JTL (Del. Ch. Jan. 9, 2024) (TRANSCRIPT); *In re Match Group, Inc. Derivative Litig.*, No. 368, 2022 (Del. Apr. 4, 2024).

[11] *In re FAST Acquisition Corp. Stockholders Litig.*, Consol. C.A. No. 2022-0702-PAF (Del. Ch. Jan. 22, 2024) (TRANSCRIPT).

[12] *In re: Windmil Therapeutics, Inc., Assignor, To: WMT (an ABC) LLC, Assignee*, C.A. No. 2023-1294-PAF (Del. Ch. Mar. 13, 2024).

[13] *Johnson Revocable Living Trust v. Davies US, LLC*, C.A. N22C-03-148 EMD CCLD (Del. Super. Mar. 7, 2024).

[14] *See* NVCA Model Voting Agreement Section 4.1; NVCA Model Investors' Rights Agreement Section 5.20.