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Significant Recent Decisions Relevant To Private Company M&A

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This report contains a summary of significant court cases issued since January 1, 2023 that are of relevance for private company M&A. The topics addressed include governance arrangements in contemplation of M&A, issues that arise in connection with drafting or approving merger agreements, acquiror and controlling stockholder issues, and the latest developments in connection with unification of the *Blasius* and *Unocal* standard of review. As indicated below, amendments to the Delaware General Corporation Law ("DGCL") are pending in response to certain of these decisions.

New Enterprise Associates 14, L.P. v. Rich, 295 A.3d 520 (Del. Ch. May 2, 2023)[1]

Rejecting the argument in a motion to dismiss that a covenant not to sue for breach of fiduciary duties in a stockholder agreement that applied to drag-along transactions was facially invalid, the Delaware Court of Chancery held that such covenants can be legitimate forms of "fiduciary tailoring" and provided fact-specific test for determining their validity.

Background

The decision (the "*NEA*" decision) involved a motion to dismiss in a case brought by venture funds (the "Funds") challenging the drag-along sale of Fugue, Inc. (the "Company"), a company in which they were early stage investors. After a sale process in 2020 and early 2021 failed, the Company raised new capital from an investor group led by defendant George Rich ("Rich"), and a few existing investors. The Funds did not participate. The financing transaction involved a recapitalization of the Company in which existing preferred was converted to common, and investors in the financing purchased Series A-1 Preferred Stock. It was a condition to closing that all new investors, and certain existing investors, including the Funds, execute a voting agreement that contained a drag-along provision and a covenant not to sue Rich or his affiliates and associates in connection with a drag-along sale, including for breach of fiduciary duty (the "Covenant").

In July 2021, the Company's board (by then consisting of just Rich, a designee of his, and the CEO) authorized the issuance and sale of additional shares of Series A-1 Preferred Stock to Rich and some of the other investors through an extension of the earlier financing. The board also authorized equity awards to management and large equity grants to the directors.

The Company's CEO was first contacted about a potential acquisition in June 2021. This outreach resulted in a merger agreement being signed and the deal closing in February 2022. In February 2022, the Company reached out to existing investors with a form merger agreement, notifying them of their obligation to support the transaction under the drag-along provision by signing a joinder agreement and a voting form. The Funds refused to sign unless Rich and the CEO affirmed that they had not communicated with the potential acquiror about a sale of the Company prior to the recapitalization. In May 2022, when the affirmation was not forthcoming, the Funds filed the lawsuit challenging the drag-along sale and alleging breach of fiduciary duty by the directors of the Company and Rich, as a controlling stockholder, in approving the drag-along sale. The Funds claimed that the drag-along sale was an

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[1] https://courts.delaware.gov/Opinions/Download.aspx?id=347110

interested party transaction subject to entire fairness because it conferred a unique benefit on Rich, as controlling stockholder, and the directors, as a result of extinguishing derivative claims related to their self-dealing in the July 2021 Series A-1 Preferred extension and equity grants. The key issue in the motion to dismiss was whether the Covenant barred the Funds' claims.

Court's Decision

The *NEA* court noted the competing considerations of Delaware law's pro-contractarian nature, and public policy considerations in preserving fiduciary accountability in the absence of express statutory authority to limit it.

The court considered the Funds' argument that the Covenant was facially invalid because Delaware law does not permit parties to waive the duty of loyalty in Delaware corporations, as evidenced by exclusion of loyalty claims from DGCL Section 102(b)(7). The court distinguished *Totta v. CCSB Financial Corp*.,[2] a recent decision that seemed to support the Funds' argument, on the basis that it dealt with a charter provision and not a stockholder agreement. The court also distinguished *Delman v. GigAcquisitions3, LLC*[3] because the defendants in that case attempted to justify the purported waiver of the duty of loyalty on public disclosure and assumption of the risk. The *NEA* court held that while the Funds' argument for facial validity was reasonable, it ignored the importance of private ordering through stockholder agreements.

The *NEA* court undertook a detailed analysis of arguments against facial invalidity. The court held that such a covenant would not be facially invalid under trust or agency law. Looking to Delaware statutory law, the court held that Section 102(b)(7) indicated that the Covenant should be valid insofar as it dealt with waivers of direct claims for breach of the duty of care, or for claims based on gross negligence, or recklessness. The court also held that other DGCL provisions evidence support for fiduciary tailoring, and undermined the argument for facial invalidity of the Covenant, such as Section 122(17), which permits corporate opportunity waivers, Section 102(a)(3), which permits limits on corporate purpose, Section 141(a), which permits charter provisions that narrow the powers and duties of the board, and Section 145, which authorizes limitations on fiduciary accountability. The court held that several common law doctrines also indicate that the Covenant was not facially invalid, such as the principle that "contractual obligations preempt overlapping fiduciary claims,"[4] the doctrine of advance ratification,[5] and the doctrine of laches.[6]

The *NEA* court looked to *Manti Holdings, LLC v. Authentix Acquisition Co*.[7] for guidance on how the Delaware Supreme Court had treated the similar public policy issue in the context of advance waivers of appraisal rights, also in connection with a drag-along sale. The *Manti* court held that the appraisal waivers were not facially invalid because appraisal rights were not "sufficiently important in regulating the balance of power between corporate constituencies" to justify prohibiting "sophisticated and informed stockholders" from agreeing to advance waivers of them. The *Manti* court also held that the advance waivers were not invalid under an as applied challenge given that they were logically related to the drag-along provisions, and due to factors such as the waivers not having been unilaterally imposed on stockholders, the stockholders were sophisticated institutions, there was no imbalance of information, and the stockholders understood the implications of the waiver and gave knowing waivers.

In light of *Manti* and the above considerations, the *NEA* court set forth a two-part test for determining the validity of fiduciary waivers, the first step concerning facial validity and the second step concerning an "as applied" test. Under the first step, "the provision must be narrowly tailored to address a specific transaction that otherwise would constitute a breach of fiduciary duty." Under the second step, a court should consider whether the waiver is "reasonable" based on factors such as the following: "(i) the presence of the provision in a bargained-for contract,

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[2] 2022 WL 1751741 (Del. Ch. May 3, 2022)
[3] 288 A.3d 692 (Del. Ch. 2023)
[4] See *Nemec v. Shrader*, 991 A.2d 1120, 1129 (Del. 2010)
[5] See, e.g,,. *In re Invs. Bancorp, Inc. S'holder Litig*., 177 A.3d 1208, 1222 (Del. 2017)
[6] See, e.g., *Lebanon Cnty. Empls.' Ret. Fund V. Collis*, 287 A.3d 1160, 1194 – 95 (Del. Ch. 2022)
[7] 261 A.3d 1199 (Del. 2021).

(ii) the clarity and specificity of the provision, (iii) the stockholder's level of knowledge about the provision and the surrounding circumstances, (iv) the stockholder's ability to foresee the consequences of the provision, (v) the stockholder's ability to reject the provision, (vi) the stockholders' level of sophistication, and (vii) the involvement of counsel." The court also invoked an overriding requirement for validity that a fiduciary waiver could not foreclose claims for intentional or bad faith breaches of fiduciary duty.

In the case at hand, the court held that under the first step, the Covenant was not facially invalid. The court also upheld the Covenant under the second step, noting that several of the factors were present, including: "(i) a written contract formed through actual consent, (ii) a clear provision, (iii) knowledgeable stockholders who understood the provision's implications, (iv) the Funds' ability to reject the provision, and (v) the presence of bargained-for consideration." However, the court denied the motion to dismiss given that the allegations in the complaint supported claims for bad faith breach of fiduciary duty.

Takeaways

The issue addressed in the case is an important one for M&A practitioners. Drag-along provisions are intended to provide certainty that a sale transaction can be accomplished under circumstances where not all stockholders might otherwise support it, such as a sale following a recap transaction. To minimize the risk of a stockholder challenge at the time of exercise, drag-along provisions are typically drafted with contractual waivers of the right to challenge them. But if fiduciary duty challenges by disgruntled stockholders cannot be validly waived in advance, that significantly undermines the utility of the drag-along mechanism. Several recent cases, included the *Totta* and *GigAcquisitions3* decisions discussed by the *NEA* court, supported the view that drag-along provisions contained this inherent flaw.

At first blush, the *NEA* decision can be seen as significantly ameliorating this flaw. The *NEA* court upheld the validity of the Covenant on both facial validity and as-applied grounds. But on closer look, the decision has important qualifications. First, it relies heavily on the waiver being in a contract as opposed to a charter or bylaws, and on the Funds being sophisticated investors, who were fully informed and uncoerced in agreeing to the waiver. Some of those elements may be absent, for example, in a challenge by a founder or employee holding common stock. Second, the decision also made clear that bad faith or intentional breaches of fiduciary duty cannot be waived in advance. This may serve as a roadmap for plaintiffs seeking to survive a motion dismiss. The decision can therefore perhaps best be viewed as providing important guidance in the drag-along context, but not fundamentally altering the legal landscape.

Colon v. Bumble, 305 A.3d 352 (Del. Ch. Sept. 12, 2023)[8]

In granting a motion for summary judgment, the Delaware Court of Chancery held that "identity-based voting," where shares are entitled to a number of votes based on the identity of the holder of the shares, is valid under Delaware law.

Background

The decision involved a challenge to provisions in a company's certificate of incorporation that provided that each share of Class A common stock was entitled to one vote per share, unless it was held by a "Principal Stockholder" in which case it was entitled to 10 votes. There were just two Principal Stockholders: the company's founder and its financial sponsor, Blackstone, Inc. The arrangement was put in place as part of an "Up-C" structure, with Class

[8] https://courts.delaware.gov/Opinions/Download.aspx?id=352960

A common stock being publicly traded. The lawsuit was brought on behalf of the holders of Class A common stock, and challenged the identity-based voting provisions as being in conflict with Sections 151 and 212 of DGCL.

Court's Decision

The court held that under DGCL Section 102 (addressing what provisions are required to be set forth in a corporation's charter) and Section 151 (addressing what attributes a class of stock can have), special voting rights must appear in a corporation's charter. The court held that neither of those sections, nor DGCL Section 212 (addressing the voting rights of stockholders) required that the charter designate voting power in terms of a specific number of votes per share. The court held that the identity-based voting provisions were consistent with precedent. In *Providence & Worcester Co. v. Baker,*[9] the Delaware Supreme Court upheld an arrangement where the number of votes to which a share was entitled varied based on the number of shares the stockholder owned. In *Williams v. Geier,*[10] the Delaware Court of Chancery dismissed a challenge to a voting system based on the share holding period. In *Sagusa v. Magellan Petroleum Corp*,[11] the Delaware Court of Chancery dismissed a challenge to voting rights based on one vote per stockholder, regardless of the number of shares held.

The court rejected plaintiff's argument, based on language from *Providence*, that the voting provisions violated DGCL section 212(a), based in part on an amendment to Section 151(a) after *Providence* was decided that expressly permits voting rights to be based on "facts ascertainable" outside the charter, and in part on reasoning flaws in the *Providence* language plaintiff relied on. The court also rejected another argument of plaintiff to the effect that Section 151(a) required that any formula in the charter for determining voting rights had to create the same outcome for each share in the same class, and that failure to do so created *de facto* subclasses of shares. The court held that this was contrary to the precedent referred to above. Moreover, if plaintiffs were correct, the same result would apply in connection with other special attributes of stock, which would render invalid provisions that tie liquidation preference to the date on which shares are issued (i.e., shares of the same class issued on different dates have different accrued dividends, and therefore different liquidation preferences), and poison pill provisions in charters that treat an acquiring person differently following a trigger event. The court also rejected a less stringent version of plaintiff's argument that premised validity on giving each stockholder "an equal opportunity to gain the superior right," which identity-based voting provisions do not do. The court held that while plaintiff's goal of giving all stockholders "equality of opportunity" reflected "noble sentiments," that goal was inconsistent with the plain language of the DGCL. Having rejected plaintiff's legal challenge to the voting provisions, the court noted that the plaintiff had not also challenged the provisions in equity. Accordingly, the court granted defendants' motion for summary judgment.

Takeaways

The structure upheld in *Bumble* was implemented to address tax structuring issues presented by trying to combine a dual class voting structure with an Up-C structure. But it could be used to simplify dual class voting structures going forward. Typically, dual class voting structures involve two classes of stock: one high vote and one low vote. The high vote stock is typically held by founders and/or sponsors, and the low vote is held by public stockholders. The *Bumble* decision makes clear that you can simplify the structure by just having one class of stock, and providing that if the stock is held by a founder or sponsor, it is entitled to a higher vote per share.

More generally, *Bumble* also provides a useful reminder that Delaware does not have a general rule that prohibits disparate treatment of stockholders holding the same class of stock. Delaware provides greater flexibility than some other states in structuring M&A transactions and governance arrangements, subject to compliance with standards in equity.

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[9] 378 A.2d 212 (Del. 1977)
[10] 1987 WL 11285 (Del. Ch. May 20, 1987)
[11] 1993 WL 512487 (Del. Ch. Dec. 1, 1993), *aff'd*, 650 A.2d 1306 (Del. 1994)

West Palm Beach Firefighters’ Pension Fund v. Moelis & Co., 2024 WL 747180 (Del. Ch. Feb. 23, 2024)[12]

In ruling on cross motions for summary judgment, the Delaware Court of Chancery held that provisions of a stockholder agreement that dealt with governance matters violated Section 141(a) of the Delaware General Corporation Law and were therefore invalid and unenforceable.

Background

This decision relates to a cross-motion for summary judgment in an action by a stockholder of the investment bank Moelis & Company (the “Company”) against the Company challenging provisions of a stockholder agreement entered into by the Company, its founder, Ken Moelis (“Moelis”), and three affiliates of Moelis. Plaintiff alleged that the following provisions (the “Challenged Provisions”) infringed on the authority of the board of directors under Section 141(a) (“Section 141(a)”) of the DGCL and were therefore invalid and unenforceable:

- A requirement that the Company’s board obtain the prior written consent of Moelis (the “Pre-Approval Requirements”) prior to taking any of eighteen types of action, such as the incurrence of certain debt, the issuance of preferred stock, the adoption of a rights plan, the removal or appointment of a Section 16 officer, a charter or bylaw amendment, and the adoption and material amendments of the Company’s annual budget and business plan.
- Certain requirements intended to ensure that Moelis could designate a majority of the members of the Company’s board (the “Board Composition Provisions”), including the following:
  - An obligation to limit the size of the board to eleven (the “Size Requirement”);
  - The right of Moelis to name a number of designees representing a majority of the board seats (the “Designation Right”);
  - An obligation of the board to nominate the Moelis designees for election (the “Nomination Requirement”);
  - An obligation of the board to recommend that stockholders vote in favor of the Moelis designees (the “Recommendation Requirement”);
  - An obligation of the Company to use reasonable efforts to enable the Moelis designees to be elected and continue to serve (the “Efforts Requirement”);
  - An obligation of the board to fill a vacancy created by a Moelis designee leaving the board with a new Moelis designee (the “Vacancy Requirement”); and
- On obligation of the board to give Moelis’ designees proportionate representation on any board committee (the “Committee Composition Provision”).

The stockholder agreement terminates by its terms if Moelis’ indirect ownership of high vote Class B Common Stock drops below a specified number of shares.

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[12] https://courts.delaware.gov/Opinions/Download.aspx?id=360460

Court's Decision

Plaintiff alleged that the Challenged Provisions violate Section 141(a), which provides: "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." Plaintiff's allegations involved a "facial challenge" to the Challenged Provisions, and thus Plaintiff was required to show that the provisions could not lawfully operate under Section 141(a) under any circumstances.[13]

The Legal Test

The court held that precedent differentiated between external commercial agreements and contracts or provisions governing a corporation's internal affairs. The court derived the following two-part test for challenges under Section 141(a):

(1) Does the challenged provision form part of an internal governance arrangement? If not, then Section 141(a) is not implicated, and the inquiry ends.
(2) If so, the court applies the test from the seminal case *Abercrombie v. Davies*.[14]

With regard to the first prong, the court held that while there is not a bright line between commercial arrangements and internal governance arrangements, the latter tend to have one or more of the following characteristics:

- they are often grounded in a section of the DGCL, such as Sections 218(c) and (d) for stockholder agreements, Sections 151 and 157 for rights plans, and Section 251 for merger agreements;
- the agreements are often with intra-corporate actors, such as officers, directors or stockholders;
- the challenged provisions dictate how intra-corporate actors authorize the exercise of corporate powers, such as requiring voting in a certain way;
- the provisions do not clearly evidence an underlying commercial exchange;
- the arrangements have a governance purpose and not a commercial purpose;
- the presumptive remedy is equitable relief and not monetary damages; and
- the arrangement is less likely to be terminable or of fixed duration.

With regard to the second prong, the court held that the *Abercrombie* test involved an analysis of whether the provision, directly or indirectly, "[has] the effect of removing from [the] directors in a very substantial way their duty to use their own best judgment on management matters" or "tends to limit in a substantial way the freedom of director decisions on matters of management policy."[15] Based on its review of precedent, the court categorized restrictions as falling into the following four categories:

	DIRECT	INDIRECT
Board-level	Purports to bind the board or individual directors, as in "the board shall" or "the board shall not"	Imposes a sufficiently onerous consequence on the board or individual directors for taking or not taking the specified action

[13] In contrast, for an "as applied" challenge, a plaintiff would only need to demonstrate invalidity under the particular facts of the case.
[14] *Abercrombie v. Davies*, 123 A.2d 893, 899 (Del. Ch. 1956), rev'd on other grounds, 130 A.2d 338 (Del. 1957).
[15] Quoting *Abercrombie*, 123 A.2d at 889.

Corporate-level	Purports to bind the company, as in "the company shall" or "the company shall not," where the issue requires a board decision	Imposes a sufficiently onerous consequence on the company for taking or not taking an action that requires a board decision

Examples of board-level restrictions can be found in the *Abercrombie* decision, where six stockholders, who had the right to designate an aggregate of eight directors, entered into an "agents agreement" designed to ensure the eight directors voted as a block, by obligating all eight directors to vote in favor of any action supported by seven of the directors. If seven directors could not agree, an arbitrator would resolve the matter. All six stockholders agreed to remove any director who did not vote in accordance with the arrangement. One of the parties to the agents agreement, Ralph Davies, was both a stockholder and a director. The *Moelis* court held that the agents agreement operated as a direct board-level restriction for him, and an indirect board-level restriction for the other directors, both of which violated Section 141(a). Impermissible board level restrictions can also be found in agreements with third parties, such as a "dead hand" feature of a rights agreement, which conditions redemption of the rights on approval by continuing directors (*i.e*., incumbent directors and directors whose appointment has been approved by incumbent directors).[16]

Examples of corporate-level restrictions include situations where the board has delegated authority to a third party and bound the board to accept the result, such as: (i) granting management complete control and responsibility to manage the corporation's sole asset, subject only to the ability of the board to approve the annual budget, such approval not to be unreasonably withheld;[17] (ii) delegating to management the responsibility to determine whether to sell the corporation's assets and on what terms as long as the value exceeds a floor amount;[18] and (iii) inclusion of a "no-talk" provision in a merger agreement where the fiduciary out requires an opinion of counsel.[19]

According to the court, restrictions that fall in the first quadrant (involving direct board-level restrictions) are consistently invalidated by courts. Restrictions that fall in the third quadrant (involving corporate-level restrictions) can also be invalidated. Restrictions that fall in the other two quadrants (indirect board-level or corporate-level restrictions) can be invalid if the consequences of the restrictions are so extreme that a board would not want to risk triggering them.

In the context of stockholder agreements, the court held that stockholders are expressly authorized under DGCL Section 218(c) to enter into agreements governing how they vote their shares. But where stockholder agreements also address governance issues, they can raise issues under Section 141(a). According to the court, the DGCL, charter and bylaws establish the rights of stockholders and are hierarchically superior to stockholder agreements. There is no conflict where the stockholder agreement addresses how those rights are exercised, but if the stockholder agreement purports to alter those rights, then the DGCL, charter and bylaws prevail.

Analysis of the Moelis Stockholder Agreement

Analyzing the Moelis stockholder agreement under the first part of its two-part test and considering the six bulleted factors above, the court held that the challenged provisions in the stockholder agreement clearly formed part of an internal governance arrangement. They were implemented as part of a pre-IPO reorganization to preserve Moelis' control over the Company after it became publicly traded.

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[16] See, e.g., *Carmody v. Toll Bro*s., Inc., 723 A.2d 1180 (Del. Ch. 1998).
[17] *In re Bally's Grand Deriv. Litig*, 1997 WL 305803, at *5
[18] *Clarke Mem'l Co.. v. Monaghan Land Co*., 257. A.2d 234, 240-4 (Del. Ch. 1969)
[19] *ACE Ltd. v. Cap. Re Corp.*, 747 A.2d 95, 106 (Del. Ch. 1999)

Under the second part of its two-part test, the court held that the Pre-Approval Requirements, considered as a whole, facially violated Section 141(a). The court held that the provisions fell within the first quadrant of the box set forth above, given that they prohibited the board from authorizing, approving or ratifying specified actions. The court rejected the Company's argument that the Pre-Approval Requirements just established consent rights that did not constrain what action the board took, holding that the provisions contained an express prohibition on board action without Moelis consent. Moreover, even if they were consent rights and not pre-approval rights, the court held that they would still be invalid under Section 141(a). Either as a consent or a pre-approval right, both would serve as a contractual block that a counterparty could decide to enforce at any time and both are equally constraining.

The court also rejected the Company's argument that the provisions did not violate Section 141(a) because they had never been triggered. The court held that the lack of any triggering action over the ten years that the stockholder agreement had been effective showed instead how potent a deterrent the Pre-Approval Requirements were. According to the court, they effectively turned the Company board into an advisory board that reported to Moelis.

The court rejected the Company's argument that a facial challenge fails because the Pre-Approval Requirements operate legitimately when Moelis does not invoke them. The court held that the proper analysis was whether the provisions could operate validly when Moelis invokes them, which the court held they could not.

With respect to the Board Composition Provisions, the court held that the Recommendation Requirement, the Vacancy Requirement and the Size Requirement failed the *Abercrombie* test and were facially invalid, but the Designation Right, the Nomination Requirement and the Efforts Requirement were not facially invalid.

The court held that the Recommendation Requirement mandated that the board recommend Moelis' designees, regardless of the directors' independent judgment, and thus removed "in a very substantial way [the directors'] duty to use their own best judgment on a management matter." The court held that the Vacancy Requirement conflicted with the Company's charter and bylaw provisions that provided that only the board could fill a vacancy. According to the court, the "power to fill a vacancy includes the power to select the person to fill it," and the obligation to appoint a Moelis designee to a vacancy created by another Moelis designee's departure meant that the board would be unable to use the judgment required to fill its obligation to fill vacancies under the charter and bylaws. Regarding the Size Requirement, according to the court and in accordance with DGCL Section 141(b), the Company's charter fixed an upper and lower size limit to the board, and authorized the board to fix the actual size within those limits. The Company's bylaws contained provisions consistent with this approach. The court held that the Size Requirement was facially invalid because it capped the board size at eleven unless Moelis consented. The cap would conflict with the charter and bylaws if they were amended to provide for an upper limit that exceeded eleven.

The court found the Designation Right, the Nomination Right, and the Efforts Requirement could operate legitimately and so were not facially invalid. The Designation Right permitted Moelis to propose a specified number of designees, but did not force the board to appoint them.

The court held that the Nomination Right obligated the Company to include the Moelis nominees in its slate, but stockholders had the right to nominate board candidates under Delaware law and a company agreement to nominate candidates a stockholder proposes did not on its face violate Section 141(a). Finally, the court held that the Efforts Requirement only obligated the Company to take ministerial steps to ensure the Moelis nominees could be considered for election, and so also was not facially invalid under Section 141(a).

The court noted that in accordance with DGCL Section 141(c)(2), the Company's bylaws gave the board authority to determine the composition of board committees. The court held that the Committee Composition Provision was facially invalid because it negated the directors' duty to use their own best judgment with respect to the composition of committees.

Takeaways

The decision has caused consternation in the legal community because this type of stockholder agreement is not uncommon. The court rejected the policy argument against facial invalidity that it would unsettle market practice of using these types of provision in settlements with stockholder activists, or as a corporate planning tool for dealing with stock ownership decreases by controlling stockholders.[20]

The court offered up two solutions. The first is to place these types of provisions in charters instead of agreements. The court noted that this could be done with minimal disruption using a certificate of designations to create a "golden share". The second solution was to invite the legislature to change the DGCL. Such a change seems to be underway. At the end of March of this year, the Council of the Corporation Law Section of the Delaware State Bar Association released proposed amendments to the DGCL, which includes a proposed amendment to Section 122 to authorize the type of agreement at issue in this decision. If enacted, the amendments would be expected to become effective in August of this year.

Crispo v. Musk, 304 A.3d 567 (Del. Ch. Oct. 31, 2023)[21]

In denying a petition for mootness fee, the Delaware Court of Chancery held that a stockholder did not have third-party beneficiary status to sue for loss of merger premium, but the court offered in dicta potential solutions to make lost merger premium a workable remedy in busted deals.

Background

Following Elon Musk's attempt to terminate his merger agreement with Twitter, a Twitter stockholder sued Musk and entities he controlled for breach of fiduciary duty, and breach of the merger agreement. After most of the claims had been dismissed and Musk had completed his acquisition of Twitter, the plaintiff filed a motion for a $3 million mootness fee based on its purported role in getting the deal to close. The key issue was whether the plaintiff had standing to sue for breach of the merger agreement. On one hand, the merger contained a provision that expressly disclaimed third-party beneficiary rights, subject to narrow exceptions. On the other hand, the merger agreement contained a provision that in the event of a buyer breach, the buyer would be liable for the benefits lost by the Twitter stockholders, including for lost stockholder premium. The court had to resolve whether the plaintiff had third-party beneficiary rights to sue under this "Lost-Premium Provision."

Court's Decision

The court noted that Delaware courts were reluctant to extend third-party beneficiary rights to stockholders for a number of reasons. Giving stockholders the concurrent right to enforce company contracts undermines Delaware's board centric model. It could also lead to a proliferation of lawsuits, creating inefficiencies and increasing the cost of doing business. In the context of merger agreements, while stockholders are economic beneficiaries, providing them with third-party beneficiary status risks undermining the board's fiduciary role.

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[20] Evidencing little sympathy for concerns about disrupting market practice, the court wrote: "What happens when the seemingly irresistible force of market practice meets the traditionally immovable object of statutory law? A court must uphold the law, so the statute prevails."
[21] https://courts.delaware.gov/Opinions/Download.aspx?id=354960

Analyzing the language disclaiming third-party beneficiary rights in the merger agreement (Section 9.7), the court held that its three carve-outs, including one intended to protect stockholders from claims if the merger did not close, created a negative implication that stockholders were not entitled to third-party beneficiary rights in other contexts. The court also looked to the termination section (Section 8.2), which provided that full range of contract damages were preserved in the event of willful breach, and which contained the Lost-Premium Provision. The court noted that the more specific language in Section 8.2 could be interpreted to modify the more general language in Section 9.7 "by granting stockholders third-party beneficiary status for the limited purpose of pursuing lost-premium damages."

The court noted that language like the Lost-Premium Provision was a response to the Second Circuit's *Con Ed* decision,[22] which held that the stockholders in that case lacked standing to bring a lawsuit against the acquiror for breach of the merger agreement. The court noted deal practitioners' concern that the inability for stockholders to sue for lost premium in effect allowed the acquiror to walk away from a merger agreement with little consequences, turning the agreement into an option deal. The court noted three potential solutions discussed by deal practitioners. First, stockholders could be expressly provided with third-party beneficiary rights. This risked a proliferation of lawsuits and undermining the target board's control over the deal process. A second approach was to designate the target company the agent of the stockholders for recovering damages. The court noted that this approach was of questionable enforceability, because a party cannot unilaterally appoint itself as agent for someone else. The court noted in a footnote that perhaps the agent relationship could be embedded in the target's charter. A third approach was to define lost premium as part of the target company's damages. The court noted that under principles of contract law, a party is not entitled to recover in excess of expectancy damages. A target company has no right to receive lost merger premium, which is an economic right of stockholders. Accordingly, lost premium could be interpreted as an unenforceable penalty. Similarly, a lost merger premium provision would only be enforceable if the merger agreement provided third-party beneficiary rights to stockholders.

The court held that a reasonable interpretation of the Twitter merger agreement was that the Lost-Premium Provision was unenforceable because the merger agreement did not provide stockholders with third-party beneficiary rights. But the court noted that such an interpretation would violate a rule of contract construction that "a court should give effect to all contract provisions." The court held that an alternative interpretation that addressed this problem was that third-party beneficiary status would only vest after the merger agreement had terminated, when the remedy of specific performance was no longer available. The court held that the plaintiff lacked standing to enforce the merger agreement under either interpretation, and accordingly denied the plaintiff's motion for a mootness fee.

Takeaways

This decision provides helpful guidance to practitioners on the drafting of *Con Ed* provisions. Many practitioners currently simply specify that lost premium is a form of damages available to the target. The decision makes clear that is very likely to be viewed by a court as an unenforceable penalty under existing law. The court indicated that making the target company the agent of the stockholders also would not work if the agency relationship were merely set forth in the merger agreement. But the court suggested the agency approach may work if the agency relationship were set forth in the charter. It will be interested to see whether practitioners start pursuing that approach. The court also indicated that giving stockholders limited third-party beneficiary rights that only apply after a merger agreement has terminated would also be workable. If practitioners want to pursue that approach, they should explicitly provide for it in the merger agreement and not rely on the type of language in the Twitter merger agreement that was subject to multiple interpretations.

The court's guidance may, however, soon be moot. At the end of March 2024, the Council of the Corporation Law Section of the Delaware State Bar Association released proposed amendments to Section 261 of the Delaware General Corporation Law that would specifically permit parties to a merger agreement to include lost premiums (or

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[22] *Consolidated Edison, Inc. v. Northeast Utilities*, 426 F.3d 524 (2d Cir. 2005)

other penalties or consequences available at law or in equity) as a remedy for a breach that occurs prior to the effective time, or for other failure to complete the merger. Target companies would not be obligated to distribute this lost premium (or other amount) to their stockholders.

HControl Holdings *LLC v. Antin Infrastructure Partners S.A.S,* 2023 WL 3698535 (Del. Ch. May 29, 2023)[23]

In keeping with Delaware's pro-contractarian approach, the Delaware Court of Chancery held that Buyers were entitled to terminate a merger agreement due to immaterial breach of the capitalization representation, given that the representation was required to be true and correct in all respects at closing.

Background

The decision involved a post-trial memorandum in an action for specific performance to force buyers to close a merger agreement relating to the acquisition of a group of broadband companies (each company is referred to as a "group company" and the group companies are collectively referred to generically as the "Company" or "Company Group"). After the merger agreement was entered into, a former employee, Marquez, made claims that he was entitled to 5% of the equity of HControl Corporation ("HCC"), which was one of the group companies. Marquez had been hired by HCC in 2004 for software development. His software development agreement with HCC provided that, in consideration for his services, HCC "shall pay to the Consultant . . . 5% ownership of [HCC] to be distributed upon a liquidation event". His ownership was not reflected in the capitalization information that was provided to Buyers and that formed that basis of the capitalization representation and warranty (the "cap rep") in the merger agreement. Accordingly, his claim to 5% ownership of HCC potentially created a breach of the cap rep, which was subject to a flat bring-down at closing.

Marquez engaged in a plan to disrupt the deal in order to gain leverage in negotiations with the group companies. When negotiations with Marquez proved futile and discussions with buyers were breaking down, the target company parties to the merger agreement ("sellers") entered into a restructuring of the group company that was subject to the 5% claim, which involved selling that company's assets to another group company and commencing dissolution proceedings in order to cure the breach of the cap rep. Buyers ultimately terminated the merger agreement, based on breach of the representations and warranties and the interim operating covenants. Sellers sued for specific performance, alleging wrongful termination and failure to use best efforts to close. Buyers filed counterclaims for breach of the cap rep, interim operating covenants and no shop provisions of the merger agreement.

Court's Decisions

The court considered whether Marquez's claim constituted either "Equity Securities" or phantom equity, both of which were covered by the cap rep. As an initial matter, the court rejected Sellers' claims that the dissolution of HHC rendered the issue moot by turning Marquez's claim into simply a cash claim for dissolution proceeds. The court held that under Florida law, filing articles of dissolution simply initiates the dissolution process but doesn't change securities into cash claims. The court then considered whether Marquez's interest was in the nature of a contingent value right ("CVR"), as maintained by Sellers, or an equity interest, as maintained by Buyers. The court held that both views were reasonable, but that Sellers' argument that the interest was in the nature of a CVR was the better argument, based on several factors. The court noted that the software development agreement Marquez

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[23] https://courts.delaware.gov/Opinions/Download.aspx?id=348170

entered into contained the words “shall pay”, which suggested a cash payment and not the grant or issuance of equity. The court also credited testimony of the Company founder as to the intent at the time the software development agreement was drafted, and to testimony of Sellers’ expert witness that the contract right did not have the typical features of an equity right. The court held that the CVR right was a type of phantom equity. The court held that the cap rep that there was no phantom equity was accordingly false. The court noted that there was no “de minimis” qualifier to the bring down, and thus the bring down was not satisfied because the cap rep was not “true and correct in all respects.”

The court rejected Buyers’ other claims. Given the failure of the cap rep to be true and correct in all respects, the court entered judgment in favor of Buyers.

Takeaways

The decision is consistent with Delaware’s pro-contractarian approach to contract interpretation, which can yield harsh results. The court noted that the financial value of Marquez’ interest in HCC was “minor relative to the deal value” – it appears to have represented just 1 – 2% of the $225 million deal value. The court explained that there was already a dollar one uncapped indemnity obligation for claims brought by third parties relating to capitalization matters, and Sellers could have provided even more protection to Buyers through a special escrow. But the court noted that Buyers had no obligation to accept such an arrangement, and in fact didn’t choose to terminate because of economic risk, but because of a purported fear of reputational damage due to Marquez’s erratic behavior. According to the court: “it is not for this court to question the business wisdom of Buyers’ decision to terminate.”

For sellers, the decision highlights the merits of requiring a de minimis bring down of a capitalization representation, and the risk of a flat bring down giving the buyer an option to walk, regardless of how immaterial the inaccuracy of the representation or the basis for the buyer’s decision to walk. More generally, the decision is another reminder to deal practitioners that Delaware courts will hold them to the language they have negotiated, even if it produces a harsh result.

Sjunde AP-Fonden v. Activision Blizzard, Inc., 2024 WL 863290 (Del. Ch. Feb. 29, 2024)

In denying a motion to dismiss, the Delaware Court of Chancery held that a plaintiff adequately alleged that a merger agreement was invalid as a result of the board having approved a draft of the merger agreement that did not include the disclosure letter, omitted the charter of the surviving corporation, omitted the amount of the deal consideration, and delegated to a committee responsibility for negotiating terms relating to pre-closing dividends.

Background

This decision concerns a motion to dismiss in a lawsuit by a stockholder of Activision Blizzard, Inc. (“Activision”) challenging the validity of Microsoft’s acquisition of Activision, and alleging unlawful conversion of its shares, due to alleged failure to comply with Sections 141 and 251 of the DGCL. The Activision board met to approve the merger agreement on January 17, 2022. In advance of the meeting the board received a draft of the merger agreement which omitted the following:

- The Activision disclosure letter, which was still being drafted[24]
- The charter of the surviving corporation
- The amount of deal consideration
- A provision dealing with pre-closing dividends
- The name of Activision as the target

The board approved the merger agreement at the meeting, and created an ad hoc committee of directors to address the dividend issue. The committee reached an agreement with the acquiror to limit Activision to one pre-closing regular cash dividend in the amount of $0.47 per share of Activision common stock. The board did not review the merger agreement again before it was signed the next day.

Activision filed a proxy statement on March 21, 2022, attaching the merger agreement as Annex A, without the disclosure letter or the charter of the surviving corporation. On November 3, 2022, plaintiff filed its lawsuit against the Activision board, Microsoft, Microsoft's board and the merger subsidiary, challenging various aspects of the merger. In its decision on a motion to dismiss after the merger had closed, the court considered plaintiff's challenges to the merger under DGCL Sections 251(b), 251(c), 251(d) and 141.

Court's Decision

Section 251(b): form of merger agreement approved by the Activision board

DGCL Section 251(b) requires the board of each merging party to adopt a resolution "approving an agreement of merger," and specifies various items that the merger agreement must contain. Plaintiff argued that Section 251(b) requires a board to approve an execution version of the merger agreement. The court noted that this was supported by the plain language of Section 251(b). The court noted defendants' argument that such a position was contrary to market practice of having boards approve a near final version of the merger agreement, and would "disserve Delaware's long-standing public policy of encouraging merger," but noted that market practice was nonetheless subject to the constraints of law. Declining to rule on whether an execution version of the merger agreement was required, the court held that at a minimum an "essentially complete version" of the merger agreement was required. The court held that, for purposes of the motion to dismiss, it was reasonably conceivable that the board failed to satisfy this requirement given the omission from the merger agreement approved by the board of the items listed in the first four bullets above.

Section 251(c): notice to Activision stockholders

Plaintiff alleged that the notice to stockholders that accompanied the proxy statement failed to comply with DGCL section 251(c), which requires that the notice contain either a copy of the merger agreement required under Section 251(b), or a brief summary of it The notice referenced the merger agreement that was attached as Annex A to the proxy statement. The court held that this did not constitute a copy of the agreement required under Section 251(b) because Annex A did not include the charter of the surviving corporation. The court also held that the notice did not provide a summary of the merger agreement because it did not reference a summary and any summary was contained in the proxy statement and not the notice. Accordingly, the court denied defendants' motion to dismiss plaintiff's claim under Section 251(c).

Section 141 – negotiation of pre-closing dividends

[24] The court also referenced omission of "disclosure schedules," which it seemed to view as less important than the disclosure letter. These two terms are often used interchangeably by deal practitioners, and the court did not explain the distinction it was drawing between the two.

Plaintiff alleged that delegating authority to a board committee to negotiate provisions dealing with pre-closing dividends violated DGCL Section 141. The court noted that Section 141(c)(2) provides that no committee of the board "shall have the power or authority . . . approving or adopting, or recommending to the stockholders, any action or matter . . . expressly required by this chapter to be submitted to stockholders for approval . . ." The court held that Section 251(b) requires the board to approve the terms of a merger agreement, and Section 141(c)(2) therefore does not allow a board to delegate to a committee power to approve a merger agreement or its terms. The court held that for purposes of the motion to dismiss it was reasonably conceivable that the board delegated negotiation of the dividend provision in the merger agreement to the committee and that the committee alone, and not the board, approved the dividend provision. The court held that plaintiff had therefore adequately alleged a violation of Section 141(c).

The court granted defendants' motion to dismiss plaintiff's claim under Section 251(d), relating to an alleged failure to obtain a required stockholder vote for an amendment to the merger agreement, on the basis of plaintiff's failure to correctly plead its claim. The court held that plaintiff had adequately alleged unlawful conversion of plaintiff's shares in the merger, based on plaintiff's allegations that the merger was invalid under Section 251.

Takeaways

This decision introduces a significant new degree of formality, and a lot of uncertainty, into the merger approval process. By not specifying whether the execution version agreement has to be approved by the board or merely an "essentially complete version," practitioners should assume the former. Practitioners should also assume that the disclosure letter and each other schedule have to be provided to the board, as does the charter of the surviving corporation. That is significantly more than is customarily provided to board members, and it seems very unlikely that they will review these additional materials. It also creates more timing pressures. It will no longer be possible to have the board approve the merger agreement at an hour that is convenient for board members, with the understanding that disclosure schedules have the benefit of additional time. Now, boards will need to either wait until everything has been finalized, or undertake a second step, either as a meeting or by written consent, to approve the agreement when everything has been finalized.

The decision also introduces a formalistic approach to the notice to stockholders. The decision indicates that if the notice complies with the alternative in Section 251(c) of providing a copy of the merger agreement, it will need to include the surviving corporations' charter and, possibly, also the disclosure letter. Companies that have a large stockholder base will typically not want to make the disclosure letter available to stockholders. The notice can refer to the summary of the merger agreement in the information circular instead of the full agreement.[25] The violation of Section 141 would be fairly easy to avoid by having any committee used in the merger negotiation process make a recommendation to the full board, and have the full board make the final decision instead of the committee, consistent with the approach customarily taken for transaction committees and special committees.

This new formality in the merger approval process is likely to be short lived. At the end of March 2024, the Council of the Corporation Law Section of the Delaware State Bar Association released proposed amendments to the DGCL that address the *Activision* decision. A new Section 147 would permit merger agreements to be approved in "substantially final form" and also includes a ratification process. Proposed amendments to Section 232 would provide that documents enclosed with or annexed to a notice to stockholders are deemed to be part of the notice. A proposed new Section 268 provides that charter provisions of the surviving corporation do not need to be included for the agreement to be in final form, and documents like disclosure letters and disclosure schedules are not deemed to be part of the merger agreement.

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[25] It is arguable that *Activision* requires that the summary has to actually be in the notice as opposed to being incorporated by reference. The latter seems permissible given that the court did not object to incorporating the merger agreement by reference – the objection to the merger agreement was that it did not comply with the requirements of Section 251(b), not that it was incorporated by reference.

Coster v. UIP Companies, Inc., 300 A.3d 656 (Del. June 28, 2023)[26]

In affirming a Delaware Court of Chancery decision, the Delaware Supreme Court set out a new integrated Blasius/Unocal test applicable to challenges to board action that interferes with a corporate election or stockholder voting rights in contests for control.

Background

This is the second decision by the Delaware Supreme Court in a dispute stemming from a deadlock between Marion Coster and Steven Schwat, both 50% stockholders of UIP Companies, Inc. (the "Company"). Schwat was the Chairman of the 3-person board of directors. One of the other directors was Peter Bonnell, a friend of Schwat and a long term Company employee. Coster was in discussions for a buyout of her interest in the Company, having inherited her interest from her late husband. In June 2018, when discussions over valuation broke down and the two stockholders deadlocked over board composition, Coster filed an action in the Delaware Court of Chancery to appoint a custodian. In July 2018, the Company hired a valuation firm to prepare a valuation of the Company. On the basis of the valuation report, the Company's board of directors approved the sale of a one-third interest in the Company to Bonnell, thereby breaking the deadlock between Coster and Schwat. Coster filed a second action in the Delaware Chancery Court, challenging the stock sale as an improper interference with her voting rights.

After consolidating the two actions and applying an entire fairness standard of review, the Chancery Court found that the stock sale was entirely fair. On appeal by Coster, the Delaware Supreme Court held that the entire fairness analysis did not end the judicial inquiry, even though it was the most exacting standard of judicial review. The Supreme Court held that the Chancery Court should have considered whether the board approved the stock sale for inequitable purposes, resulting in a breach of its fiduciary duties, under *Schnell v. Chris-Craft Indus., Inc*.[27] In addition, even if the board acted in good faith and not for inequitable purposes, if the board acted for "the primary purpose of interfering with Coster's statutory or voting rights," under *Blasius Indus., Inc. v. Atlas Corp.*[28] the board would still be in breach of its fiduciary duties unless it could show that it had a "compelling justification" for the stock sale. The Supreme Court remanded to the Chancery Court to review its factual findings under the *Schnell* and *Blasius* tests.

On remand, the Chancery Court grappled with the lack of clarity in the Supreme Court's instructions to apply the *Schnell/Blasius* tests. The Chancery Court noted the uncertainty as to whether they were in fact two tests or whether *Blasius* superseded *Schnell* in the voting context, and if two tests how they should be applied together. The Chancery Court noted the general lack of judicial guidance on the meaning of "inequitable purpose" under *Schnell* and the judicial policy of applying the *Schnell* test sparingly given its outcome-determinative nature, the unworkability of having two different enhanced scrutiny tests under *Blasius* and *Unocal,*[29] and then Vice-Chancellor Strine's invitation in *Mercier v. Inter-Tel, Inc.*[30] to merge the standards. The Chancery Court interpreted *Schnell*, applied in the context of challenges to disenfranchising action, to mean that "the directors have no good faith basis" for approving such action. The Chancery Court found that the Company's board had several reasons for approving the stock sale, including a desire "to advance the best interests of UIP . . . the UIP board sought to reward and retain an essential employee, to implement a succession plan . . . and to moot the

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[26] https://courts.delaware.gov/Opinions/Download.aspx?id=349150

[27] 285 A.2d 437 (Del. 1971).
[28] 564 A.2d 651 (Del. Ch. 1988).
[29] *Unocal Corp. v. Mesa Petroleum Co*., 493 A.2d 946 (Del. 1985)
[30] 929 A.2d 786, 809 (Del. Ch. 2007).

Custodian Action to avoid risk of default under key contracts." Accordingly, the Chancery Court held that there were good faith bases for the board's actions here, and thus the Company's board did not act for inequitable purposes.

Turning to *Blasius*, the Chancery Court assumed that the "primary purpose" prong of *Blasius* was triggered by issuing stock to avoid a 50/50 stockholder voting deadlock, and held that, to satisfy the "compelling justification" standard, the defendant directors "must show that their actions were reasonable in relation to their legitimate objective, and did not preclude the stockholders from exercising their right to vote or coerce them into voting a particular way."[31] The Chancery Court held that the defendants satisfied their burden by showing that had Coster been successful in appointing a custodian it could have caused significant damage to the Company through triggering broad termination rights under key contracts, and because a custodian would be antithetical to the relationship nature of the Company's business. The Chancery Court also noted that the stock award was appropriately tailored in that it rewarded Bonnell for his service, but did not constrain him on how he could vote his stock. Accordingly, the Chancery Court entered judgment in favor of the defendant directors. Coster appealed, arguing that the Chancery Court (i) misinterpreted the *Schnell* test, and (ii) erred in finding a compelling justification under *Blasius*.

Court's Decision

The Supreme Court reviewed the history of the *Schnell* and *Blasius* line of cases, and the judicial efforts to combine *Blasius* with *Unocal*, with the shift from a "reasonable" standard to a "compelling" standard requiring "that the directors establish a closer fit between means and ends" and requiring the court to scrutinize board action "with a gimlet eye."[32] The Supreme Court held that "[e]xperience has shown that *Schnell* and *Blasius* review, as a matter of precedent and practice, have been and can be folded into *Unocal* review to accomplish the same ends – enhanced judicial scrutiny of board action that interferes with a corporate election or a stockholder's voting rights in contests for control." The Supreme Court held that in that context, the following test should be applied, independent of other standards of review, with the board bearing the burden of proof:

> "First, the court should review whether the board faced a threat "to an important corporate interest or to the achievement of a significant corporate benefit."[33] The threat must be real and not pretextual, and the board's motivations must be proper and not selfish or disloyal. As Chancellor Allen stated long ago, the threat cannot be justified on the grounds that the board knows what is in the best interests of the stockholders..
>
> Second, the court should review whether the board's response to the threat was reasonable in relation to the threat posed and was not preclusive or coercive to the stockholder franchise. To guard against unwarranted interference with corporate elections or stockholder votes in contests for corporate control, a board that is properly motivated and has identified a legitimate threat must tailor its response to only what is necessary to counter the threat. The board's response to the threat cannot deprive the stockholders of a vote or coerce the stockholders to vote a particular way."

The Supreme Court affirmed the Chancery Court's decision, based on application of the above test to the Chancery Court's findings. The Supreme Court noted that with respect to the first part of the test, the Chancery Court found that the Company faced an "existential crisis" as a result of the custodian appointment, and the "board was properly motivated in responding to the threat." The Supreme Court noted that with respect to the second part of the test, the Chancery Court held that the stock sale "was appropriately tailored to achieve the goal of mooting the Custodian Action" and also helped the Company advance its succession planning and retention of Bonnell. The Supreme Court held that the board's action was not preclusive or coercive because, as noted by the

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[31] Quoting *Stroud v. Grace*, 606 A.2d 75, 91 (Del. 1992).
[32] Quoting *Pell v. Kill*, 135 A.3d 764, 787 (Del. Ch. 2016).
[33] Quoting *Phillips v. Insituform of North America, Inc.*, 1987 WL 16285, at *7 (Del. Ch. 1987)

Chancery Court, Bonnell was free to vote with either Coster or Schwat. The Supreme Court dismissed Coster's various arguments regarding factual findings on the basis that the findings were not "clearly wrong".

Takeaways

The *Blasius* decision has been the subject of longstanding criticism for being outcome determinative and inconsistent with *Unocal*. Since the *MM Companies v. Liquid Audio, Inc*.[34] decision in 2003 and *Mercier* in 2007, Blasius seemed destined to be merged into *Unocal*. The first Supreme Court decision in *Coster v. UIP Companies* seemed to break with that trend and reinvigorate *Blasius*. The second Supreme Court decision, however, dispelled any doubts and expressly merged *Blasius* into *Unocal* to set forth a new test that applies with respect to challenges to board action that interferes with a corporate election or a stockholder's voting rights in contests for control. The new test provides a more workable framework for evaluating board action than the outcome oriented "compelling justification" test under *Blasius*. However, the decision left open the question of what remains of *Blasius* outside the "situationally specific" context described above in which the new test applies. That question was addressed by the Chancery Court in *In re AMC Entertainment Hldgs. Inc*., discussed below.

In re AMC Entertainment Holdings, Inc. S'holder Litig., 2023 WL 5165606 (Del. Ch. Aug. 11, 2023)

In approving a settlement proposal in a stockholder lawsuit alleging breach of fiduciary duties in connection with board action taken to ensure passage of charter amendments at a stockholder meeting, the Delaware Court of Chancery held that the Blasius test applies outside the context of director elections and contests for corporate control.

Background

AMC Entertainment Goldings, Inc. ("AMC") suffered significant financial distress during the pandemic. By the middle of 2021, it had stayed afloat through massive offerings of common stock to retail investors. In March 2021, it filed a preliminary proxy statement for its annual stockholders meeting that included a proposal for a charter amendment to increase its authorized shares to permit additional equity financings. After experiencing stockholder resistance, it dropped the proposal, and also dropped another proposal for a smaller share increase. One of the challenges to obtaining stockholder approval was the high level of retail ownership, given that retail investors traditionally have a poor record of attending and voting at stockholder meetings compared to institutional investors.

AMC decided to switch tactics through the use of AMC Preferred Equity Units ("APEs"), created from its blank check preferred. Each APE represented 1/100th of a share of Series A Convertible Participating Preferred Stock, which would convert into common stock when the requisite charter amendments were obtained. APE intended to seek stockholder approval to amend the charter to increase the authorized shares to permit conversion of the preferred stock, and to effect a 1-for-10 reverse split (the "Proposals"). Each APE had the same voting rights as a

[34] 813 A.2d 1118 (Del. 2003).

share of common stock, but a key difference was that AMC's transfer agent was required to vote uninstructed APEs in the same proportion as instructed APEs (the "mirrored voting feature"). Given that a charter amendment was not a routine proposal under NYSE rules and so uninstructed shares of common stock could not be voted, this meant the APEs would contribute disproportionately to the voting tally for a charter amendment. AMC issued one APE as a dividend to each outstanding share of Class A common stock, and also sold $110 million of APEs to Antara Capital LP ("Antara"), with Antara agreeing to vote its APEs in favor of the Proposals.

Two class action lawsuits were filed by holders of common stock, including allegations of breach of fiduciary duty by the AMC board, in part through using the APEs to thwart the voting rights of the holders of common stock. In connection with the proposed settlement of that litigation, the court considered the merits of the fiduciary duty claim.[35]

Court's Decision

The dispute turned on the applicable standard of review for the breach of fiduciary duty claims. Plaintiffs alleged that enhanced scrutiny was the applicable standard of review under *Blasius*. The defendants argued that business judgment was the applicable standard of review because *Blasius* only applies with respect to director elections or contests for corporate control, neither of which was involved here.

Vice Chancellor Zurn in *AMC* noted that in *Blasius*, Chancellor Allen was concerned with the conflict created between boards and stockholders when a board takes action "for the primary purpose of impeding the exercise of stockholder voting power," and Chancellor Allen held that such board action would only be upheld if the board had a "compelling justification."[36] Vice Chancellor Zurn noted that in the aftermath of *Blasius*, director interference with stockholder voting frequently arose in the situational context of director elections or a change of control. Given that these situations implicated *Unocal*, this led to a judicial effort to harmonize *Blasius* with *Unocal*, with *Coster IV* (summarized elsewhere in this advisory)[37] being the most recent in that line of cases.

Vice Chancellor Zurn held that the decision in *State of Wisconsin Investment Board v. Peerless Systems Corporation*[38] supported the conclusion that *Blasius* enhanced scrutiny applies outside of that context. That case involved the adjournment of a stockholder meeting to permit management to solicit more votes in favor of a proposal to add shares to an option plan, which was the only proposal out of three that did not have sufficient votes to pass at that company's annual meeting. With the meeting adjourned, management proceeded to solicit votes from stockholders most likely to support the proposal without informing all stockholders of the adjournment or solicitation. On summary judgment, the *Peerless* court held that *Blasius* applied because the primary purpose of the adjournment to ensure passage of the option plan proposal. With respect to language in the *Peerless* decision suggesting that *Blasius* "does not apply in all cases where a board of directors has interfered with a shareholder vote,"[39] Vice Chancellor Zurn noted that the cases the *Peerless* court relied on did not trigger *Blasius* because of an absence of evidence that the "primary purpose was to impede the vote," and not because of the type of vote or board action.

- [35] Many of the background facts are contain in a July 2023 opinion in which the court rejected the settlement based on the scope of the release. See https://cases.justia.com/delaware/court-of-chancery/2023-c-a-no-2023-0215-mtz-6.pdf?ts=1689971507**.** The court approved a modified settlement about three weeks later. See https://courts.delaware.gov/Opinions/Download.aspx?id=351520

[36] Quoting *Blasius*, 564 A.2d at 661.
[37] Vice Chancellor Zurn refers to the recent Supreme Court decision in *Coster* as "*Coster IV*", given the two preceding Chancery Court decisions and the prior Supreme Court decision in that case.
[38] 2000 WL 1805376 (Del. Ch. 2000)
[39] Quoting *Peerless*, at *8-9.

Vice Chancellor Zurn noted the judicial concern about using the stringent *Blasius* test outside the context of corporate control, noting that "ministerial board functions affecting the franchise, such as "scheduling the meeting and record dates, deciding on a location for the meeting, choosing inspectors of elections, or retaining proxy solicitors," are shielded from *Blasius* enhanced scrutiny in order to ensure an orderly voting process."[40] Vice Chancellor Zurn noted that the judicial concern arose from application of the "compelling justification" standard, which, in the change of control context "has been defined to mean reasonableness with a 'closer fit between means and ends' or viewed with a 'gimlet eye.'"[41] Vice Chancellor Zurn held: "[o]utside the director election or corporate control setting, I read the weight of authority to call for a reasonableness analysis and to permit the "fit" between the means and ends to be looser than in the corporate control setting." In other words, outside of this situational context, "where a plaintiff establishes directors acted with the primary purpose of impeding the exercise of stockholder voting power . . . in the absence of another basis to apply enhanced scrutiny, the directors must demonstrate their actions were reasonable in relation to their legitimate objective." Vice Chancellor Zurn then applied this test to the facts at hand and held that the plaintiffs were likely to be able to show that the primary purpose of the defendants' actions was to impede the stockholders' vote. She also held that while the defendants may have been able to show that their actions were reasonable in relation to a legitimate objective of protecting the company from a desperate need for cash that could lead to bankruptcy, plaintiffs' claims nonetheless had merit.

Takeaways

The decision answers in the affirmative the question left open in *Coster IV*: whether *Blasius* applies outside the context of director elections or contests for corporate control. In some respects it is an odd fit, given that *Coster IV* modified the *Blasius* test into a sort of heightened *Unocal* test (which some practitioners refer to as "Unocal +"), but *Unocal* has no application in the situation to which the *AMC* decision applies. But putting its *Unocal* origins aside, the *AMC* test seems to be a workable test for practitioners. It should be factually determinable whether the "primary purpose" element is met, and whether the board action is "reasonable" in relation to a "legitimate objective". The decision makes clear that ministerial board actions, and actions that only incidentally impact the stockholder vote (and are not undertaken for the primary purposes of impacting it) will not run afoul of the new test. In addition, the decision suggests that outside the director election and change of control contexts, it would be easier for directors to satisfy the "reasonableness" standard than within that situational context. For M&A practitioners, the decision is likely to have most relevance in situations such as restructurings, carve-outs, and buy-side deals, in each case where there is a stockholder vote.

In re Mindbody, inc. S'holder Litig., 2023 WL 2518149 (Del. Ch. Mar. 15, 2023)[42]

A private equity buyer that worked with a target company's CEO behind the scenes and in violation of board-approved auction procedures, and received resulting informational and timing advantages over other bidders, was held liable for aiding and abetting fiduciary duty breaches of the CEO.

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[40] Quoting *In re MONY Grp., Inc. S'holder Litig.*, 853 A.2d 661, 675 (Del. Ch. 2004).
[41] Citing *Coster IV*.
[42] https://courts.delaware.gov/Opinions/Download.aspx?id=345390

Background

This post-trial decision involved consolidated actions against Richard Stollmeyer, the founder and CEO of Mindbody, Inc., for breach of fiduciary duty, and Vista Equity Partners Management, LLC ("Vista"), for aiding and abetting, in connection with Vista's acquisition of Mindbody in 2019. Claims against various other parties were settled or dismissed. Stollmeyer was frustrated that he could not generate sufficient liquidity from his shares without eliciting a negative reaction from the market. The clock was also ticking on his Class B high-vote stock, which was scheduled to convert to common stock in three years' time. Stollmeyer commenced the sale process largely without the knowledge or involvement of the Mindbody board. In August 2018, Stollmeyer was introduced by a Qatalyst Partners banker to a representative of Vista. At an in-person meeting in September, Stollmeyer informed Vista that he planned to step down from the company, and he was looking "for a good home" for it. In early October 2018, Stollmeyer attended Vista's "CXO Summit", an annual event for CEOs of public companies that Vista had acquired. At the summit, Stollmeyer was very impressed by presentations that showed the wealth that these CEOs could generate under the Vista umbrella, and he communicated his "love" for Vista to another Mindbody executive over text messages. According to the court, after that point, Stollmeyer appeared focused on selling Mindbody to Vista. Mindbody's largest stockholder, Institutional Venture Partners XIII, L.P. (IVP), which had a representative, Eric Liaw, on Mindbody's board, was also interested in an exit. IVP also held Class B high-vote stock in Mindbody with the same sunset provision as Stollmeyer's, and IVP was likely to lose its board seat when its Class B stock converted to common stock.

On October 15, Vista delivered Stollmeyer an oral expression of interest for the acquisition of Mindbody. Stollmeyer did not notify the Mindbody board of it until October 23rd, while omitting key elements of his discussions with Vista and key pieces of information that he had shared with certain Mindbody management team members. The board was unaware of the extent of Stollmeyer's communications with Vista and so didn't form a transactions committee until October 30th. Liaw served as de facto chair of the committee and steered the committee to hiring Qatalyst as financial advisor. The committee established guidelines to deal with communications, conflicts and disclosure matters, but Stollmeyer ignored them by giving Vista advance notice of the sale process. Qatalyst also impermissibly communicated to Vista the deal price that Stollmeyer was targeting.

To kick off the formal sale process, Qatalyst planned to reach out to strategic acquirors on November 19th and to financial sponsors on November 30th. Vista learnt of the sale process from Stollmeyer on November 10th, and was therefore in a position to do a lot of work behind the scenes so it would have a big timing advantage over other financial sponsors. Qatalyst further advantaged Vista by not contacting other financials sponsors until December 3rd and 4th. Thirteen potential acquirors were contacted, and seven signed an NDA and gained data room access after it opened on December 15th. On December 18th, Vista submitted an offer to acquire Mindbody for $35 a share. By December 20th, only one other bidder, another financial sponsor that was much further behind Vista, remained in the mix. On December 20th, the board authorized Qatalyst to deliver a counteroffer at $40 per share. Vista responded the same day with a "best and final" offer of $36.50 per share. Qatalyst reached out to the other bidder, who conveyed that they needed an additional two weeks to complete their process, and that they would be unwilling to pay $40 per share. On December 21st, the board approved the $36.50 offer price. The parties signed a merger agreement on December 23rd. The merger agreement authorized a 30 day go shop period, although Stollmeyer went on vacation half way through that period and instructed management to decline go-shop presentations unless they were urgent. The merger closed on February 14, 2019.

Stockholder lawsuits were filed prior to and after closing. After the merger closing and some of the litigation had been dismissed or settled, the court was left to adjudicate claims against Stollmeyer and Vista.

Court's Decision

Claims against Stollmeyer

The claims against Stollmeyer were for breach of fiduciary duties through favoring Vista in the sale process (the "sale process claims") and through failure to disclose material information in the merger proxy statement (the "disclosure claims"). The court held that there were multiple legal frameworks for analyzing "fraud on the board" claims, where a conflicted fiduciary misleads a board in a sale process, such as was alleged here. One framework involves application of the entire fairness standard of review. But the court instead adopted Stollmeyer's proposed approach and evaluated the sale process claims under the *Revlon* intermediate standard of review,[43] and whether any fiduciary duty breach was cleansed by the stockholder vote under *Corwin*.[44] The court considered the disclosure claims as an independent basis for liability.

The court made short shrift of the *Revlon* analysis. The court held that when directors favor one bidder over others "not in a reasoned effort to maximize advantage for the stockholders, but to tilt the process toward the bidder more likely to continue current management, they commit a breach of fiduciary duty."[45] The court held that Stollmeyer had a disabling conflict of interest because of his desire for a quick sale to generate liquidity for himself, and his expectation of employment with Vista. The court held that Stollmeyer biased the process on multiple occasions by providing Vista with an informational and timing advantage relative to other bidders, among other things.[46] As expected in a case involving fraud on the board, the court held that the board failed to manage the conflicts effectively, and thus Stollmeyer could not rely on board action to show the reasonableness of the sale process.

With regard to the disclosure claims, the court held that Stollmeyer, having read the proxy disclosures before they were filed and signed the proxy materials in his capacity as CEO, "knowingly withheld information from the stockholders by painting his interactions with Vista in a sterile light." For example, describing a meeting with a Vista representative as a typical one that Stollmeyer had with investors was inaccurate given the omission of Stollmeyer's statement to Vista that he was eager to sell the company and was only expecting to stay another two or three years. Similarly, positioning the CXO Summit as a typical industry gathering was inaccurate because it failed to disclose that at the event Stollmeyer repeated his desire to sell the company, even though he had no board authorization to do so. The proxy disclosure also omitted numerous events, such as various communications Stollmeyer had with Vista representatives, and Qatalyst's tip to Vista as to the price per share that Stollmeyer was looking for. The court found that, taken together, the disclosure omissions "altered the total mix of information" available to Mindbody's stockholders (the applicable standard for materiality)[47], thereby

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[43] This is enhanced scrutiny that applies in connection with the sale of control under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173 (Del. 1986),
[44] Where a *Revlon* transaction is "approved by a fully informed, uncoerced majority of the disinterested stockholder," an irrebuttable business judgment standard of review applies *under Corwin v. KKR Fin. Hldgs. LLC*, 125 A.3d 304, 305–06 (Del. 2015).
[45] Quoting *In re Topps Co. S'holders Litig*., 926 A.2d 58, 64 (Del. Ch. 2007).
[46] In support of its finding of a *Revlon* breach, the court also cited Stollmeyer's attempt to drive down Mindbody's stock price through providing unusually low guidance, as discussed further in a footnote below.
[47] *Rosenblatt v. Getty Oil Co*., 493 A.2d 929, 944 (Del. 1985) (using the materiality standard set forth in *TSC Indus., Inc. v. Northway, Inc*., 426 U.S. 438, 449 (1976))

showing a breach of Stollmeyer's fiduciary duties and also foreclosing the possibility of *Corwin* cleansing of fiduciary duty breaches described above for the sale process claims.[48]

Claims against Vista

The court held that plaintiffs proved that Vista aided and abetted the disclosure claims.[49] The court held that the elements for the aiding and abetting claim were: "(1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, . . . (3) knowing participation in that breach by the defendants, and (4) damages proximately caused by the breach."[50] The court held that the first element was undisputed and the second element was established, as described above. The court held that "knowing participation" involved both knowledge and participation. Knowledge involves "actual or constructive knowledge that the conduct was legally improper",[51] and involves a showing of scienter. The court held that Vista knew a lot - including about Vista's interactions with Stollmeyer, his communications to Vista personnel of his desire to sell the company, advance notice Vista received about the sale process and information about the targeted sale price - that should have been, but was not, included in the proxy statement. The court held that the fact that Vista personnel scrubbed some of that information from a deck prepared for Vista's own investment committee showed that Vista knew the significance of it. The court held that "knowing participation" required a showing of "substantial assistance" in the breach. The court noted that Vista was contractually obligated under the merger agreement to notify the company of omissions in the proxy statement that would result in materially misleading disclosure. The court held that Vista had multiple opportunities to review the proxy materials and that Vista personnel signed off on the materially misleading disclosure in both the preliminary provide statement and the definitive proxy statement. The court held that Vista's obligation to correct materially misleading disclosure and failure to do so supported liability for aiding and abetting.[52]

Damages

The court held that damages for the sale process breaches were the amount that Vista would have paid in the absence of the breaches. The court held that this was $1.00 more per share than the sale price, based in part on evidence at trial relating to an internal bet between Vista team members regarding the ultimate sale price. The court held that Stollmeyer was liable for these damages. For the disclosure claims, given that plaintiffs had not proved reliance and causation, they were only entitled to nominal damages, for which the court held that $1.00 was an appropriate amount in light of precedent. The court held that Stollmeyer and Vista were jointly and severally liable for this amount. Plaintiffs could elect to recover on either the sale process fiduciary breach claims or the disclosure claims, but not both. Based on the capitalization representation in the merger agreement, the $1.00 per share award appears to have totaled around $45 million, on top of which plaintiffs were entitled to interest, calculated at a rate of 5% over the federal discount rate.

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[48] The court also discussed management's lowering of Q4 guidance in an apparent attempt to make a sale of the company appear more attractive, and its failure to update guidance prior to the stockholder vote on the merger when it was clear that the company had outperformed the lowered guidance. Given that the court had already found a disclosure violation, it declined to rule on whether the failure to preannounce Q4 numbers constituted another disclosure violation.
[49]The court denied plaintiffs' aiding and abetting claims for sales process breaches on the grounds that they were not timely made.
[50] Citing *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001).
[51] Citing *Firefighters' Pension Sys. of City of Kansas City, Missouri Trust v. Presidio, Inc*., 251 A.3d 212, 275 (Del. Ch. 2021) (quoting *RBC Cap. Mkts., LLC v. Jervis*, 129 A.3d 816, 862 (Del. 2015))
RBC, 129 A.3d at 862)
[52] The court declined to rule on whether Vista aided and abetted Stollmeyer's breach of fiduciary given plaintiffs' failure to timely asset the claims.

Takeaways

Given the court's depiction of Stollmeyer's behavior as paradigmatic "fraud on the board," it is not surprising that he was found liable for breaching his fiduciary duties. The decision's lessons relate more to aiding and abetting exposure of acquirors. The decision should not be taken as a prohibition on acquirors from developing relationships with management of potential acquisition candidates with the goal of getting ahead of other potential acquirors. That is an important skill and a potential differentiator between successful acquirors and their less successful peers. The decision also does not signal a prohibition on companies from favoring one bidder over the other. The court made clear that such favoring is permissible when it constitutes "a reasoned effort to maximize advantage for the stockholders." A key lesson of *Mindbody* is rather that when a target company ultimately runs a sales process, bidders who work with management behind the scenes to obtain informational and timing advantages over other bidders, in violation of a sales process established by a board or board committee, run the risk of incurring joint and several liability, as aiders and abettors, for the fiduciary duty breaches of management.

Mindbody also has lessons specific to aiding and abetting disclosure claims. Acquirors are typically fairly deferential to target companies with respect to the background section of the merger in a proxy statement or other information document delivered to the target's stockholders. A lesson from *Mindbody* is that acquirors should be more proactive in reviewing that section for material misstatements and omissions. As a related point, acquirors may wish to ensure that the merger agreement does not allocate responsibility to them for reviewing any other sections of the merger, so as to minimize the risk of aiding and abetting liability being predicated on misstatements and omissions in those other sections.

Acquirors should also be cognizant of their written records and internal discussions of essential deal terms. They should assume that any and all written records are discoverable in litigation, whether sent via text or email or on personal devices. As indicated above, the damage determination in *Mindbody* was linked in large part to the Vista deal team's own predictions as to the ultimate deal price.

In re Columbia Pipeline Group, Merger Litig., 299 A.3d, 393 (Del. Ch. June 30, 2023)[53]

Buyer that exploited target company's CEO and his fiduciary duty breaches and made an exploding offer, with a threat to publicly disclose termination of deal discussions if the offer was not accepted, held liable for aiding and abetting the fiduciary duty breaches.

Background

This post-trial decision arose from the 2016 sale of Columbia Pipeline Group, Inc. ("Columbia") to TC Energy Corp. ("TransCanada") for $25.50 per share in cash. Robert Skaggs, Jr served as Columbia's Chief Executive Officer and Chairman of the Board of Directors, and Stephen Smith served as Columbia's Chief Financial Officer. Skaggs and Smith both had plans to retire in 2016, and wanted a sale of Columbia in order to receive significant

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[53] https://courts.delaware.gov/Opinions/Download.aspx?id=349400

change of control benefits that were put in place when they joined Columbia in connection with its 2015 spin-off from NiSource Inc.

Skaggs started receiving acquisition overtures within a few days after the spin-off. The Columbia board commenced a formal sales process in November 2015. The court depicted a process that was "haphazard" and oriented towards achieving the personal goals of Skaggs and Smith. Bidders were required to execute a nondisclosure agreement that contained a standstill with a "don't-ask-don't-waive provision" ("DADW"), which prevented the bidders from asking the Columbia board for a waiver from the agreement's standstill provisions. One of the bidders, TransCanada, repeatedly violated the DADW provisions by channeling discussions through Smith, with whom TransCanada's internal deal lead, Francois Poirier, and external banker, Eric Fornell of Wells Fargo Securities, LLC, had a longstanding professional relationship. The court depicted Smith as a savvy CFO but a novice M&A negotiator who Poirier, a former investment banker, could manipulate with ease.

One such incident happened at the end of November, after the Columbia board had put the sale process on hold. In violation of the standstill, Poirier called Smith for color on why the sale process was being halted. Without board authorization, Smith divulged to Poirier that the process was likely to pick back up within a few months, and suggested a likely a deal could be concluded in the March to June 2016 time frame. The court noted that this information heavily advantaged TransCanada over other bidders. Skaggs and Smith had further conversations with the TransCanada deal team during December and January, in breach of the standstill. During the middle of December, Poirier indicated to Smith (also in violation of the standstill) that TransCanada was interest in paying up to $28 per share. In early January, Smith sent updated projections and other materials to Poirier, without board authorization, in preparation for an in-person meeting with Poirier. In advance of the meeting, Smith received talking points from the Columbia bankers intended to elicit from Poirier how serious TransCanada's interest was, and to get TransCanada to put forward a preemptive bid. Instead of going through the talking points, Smith simply handed them over to Poirier – an act that the court noted a seasoned deal professional typically would not do, and which signaled that Smith "trusted Poirier and was open to a deal." The court noted that during the meeting, Smith shared other confidential information about the Columbia board's perspective on a sale transaction and that TransCanada was unlikely to face competition from any other bidders. Towards the end of January, after receipt of additional due diligence information, TransCanada's CEO provided an oral expression of interest to Skaggs for a deal at $25 - $28 per share, also in breach of the standstill.

After receiving the oral expression of interest, Skaggs obtained board authorization to enter into exclusive negotiations with TransCanada. Emboldened by its perception of Columbia management's interest in a sale, in early March TransCanada offered $24 per share, which it immediately increased to $25.25 after eliciting a very negative reaction from Skaggs and Smith. After the Columbia board rejected this offer, Skaggs and Smith countered with $26 per share, to which TransCanada agreed, based on 90% cash and 10% equity consideration, and subject to various conditions. Shortly after, the deal leaked in the Wall Street Journal. Smith informed Poirier that the Columbia board was "freaking out" over the deal leak and had instructed management to get a deal done. Seizing the opportunity, Poirier reneged on the agreement in principle of $26 per share, lowered TransCanada's bid to $25.50 per share in cash, demanded an answer within three days, and threatened to publicly announce that the negotiations were dead unless Columbia accepted the reduced offer. The court noted that Poirier's threat of public disclosure violated the standstill.

Skaggs and Smith considered countering at a higher price per share, but they eventually recommended that the Board accept the TransCanada offer at $25.50 per share, not wanting to lose a benefits-triggering deal. The court noted board minutes falsely characterized the price as a "best and final" offer from TransCanada. After receiving fairness opinions, the board approved the merger agreement, which the parties executed the following day, March 17, 2016. The merger closed on July 1, 2016.

Various stockholder lawsuits were filed. A consolidated action involving two of these lawsuits alleged breach of fiduciary duty by Skaggs and Smith in connection with the sale process and for false and misleading statements in the merger proxy statement, and aiding and abetting by TransCanada. Smith and Skaggs settled for $79 million, and the aiding and abetting claims against TransCanada proceeded to trial.

Court's Decision

The court held that a claim for aiding and abetting a breach of fiduciary duty has four elements: (i) the existence of a fiduciary relationship giving rise to a duty to the plaintiff, (ii) a breach of that duty by the fiduciary, (iii) knowing participation in the breach by the defendant, and (iv) damages proximately caused by the breach.[54] According to the court, the most critical element is the defendant's knowing participation in the breach, which entails two dimensions: knowledge and culpable participation.

The Sale Process Claims

The court held that Skaggs and Smith were clearly fiduciaries, given their status as corporate officers. The court held that they breached their fiduciary duties by pursuing a deal in order to be able to retire in 2016 with their change of control benefits, and by employing a deal process that fell outside the range of reasonableness.[55] The court held that the Columbia board members breached their duty of care through not sufficiently monitoring Skaggs and Smith.[56]

The court held that "knowing participation" involves knowledge and culpable participation. For knowledge, the accessory actor must have had "actual or constructive knowledge that their conduct was legally improper," which means the actor acted "knowingly, intentionally, or with reckless indifference."[57] The court held that TransCanada knew, or at least had constructive knowledge, that Skaggs and Smith were engaging in a breach of the duty of loyalty, unchecked by the Columbia board, through knowledge of their financial motivations to get a deal done, and signals the two sent, such as the following:

- messaging that social issues would not be a deal obstacle, given that they would be retiring;
- overlooking multiple standstill breaches;
- Smith's solicitous behavior during the early January meeting;
- daily calls that Smith had with Poirier after that meeting;
- Smith's unusual behavior during February 2016 that caused some members of the TransCanada team to believe a deal could go forward below the $25 - $28 price range;
- Smith's reassurance after the deal leak that messages to interested parties who reached out following the leak would be phrased in a way that was helpful to the deal with TransCanada;

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[54] *Malpiede v. Townson,* 780 A.2d 1075, 1097 (Del. 2001).

[55] The court's disdain for the deal process is evidenced by the following passage: "Maybe there could be a time when obtaining the best transaction reasonably available requires telling the buyer you are eager to sell, reassuring the buyer that there is unlikely to be any competition, never mentioning a standstill, eagerly providing due diligence, appearing receptive to a price below the range you had asked for, revealing to the buyer that your side is "freaking out" and wants to get a deal done, extending exclusivity after a public leak about the deal talks and an inbound inquiry from a second bidder, and then not countering a last-minute price drop. This is not that case."

[56] The court held that board members (other than Skaggs) were not personally liable given (i) exculpation under the Columbia charter, (ii) protection under Section 141(e) of the Delaware General Corporation Law in connection with good faith reliance on information provided by officers, employees and outside experts, and (iii) the heightened "gross negligence" standard of liability applicable to duty of care claims against outside directors.

[57] *RBC Cap. Mkts.,* 129 A.3d 816, 862 (Del. 2015).

- Smith's statements after the leak that the Columbia board was "freaking out" and instructed management to get a deal done.

According to the court, culpable participation can involve conduct that causes a breach of fiduciary duty, or assistance in the breach through an agreement with the fiduciary. Culpable participation requires volitional conduct and not simply inaction, unless the inaction involves the conscious refusal to perform a duty. The court held that aiding and abetting claims against a buyer are difficult to prevail on because of the buyer's right to engage in arms' length negotiations. But a buyer cannot create or exploit a fiduciary breach. According to the court, aiding and abetting claims against third-party buyers have typically involved a buyer "who obtained privileged access to a disloyal sell-side actor, then used the resulting relationship to ignore guardrails or violate boundaries that the sell-side board established."

The court held that TransCanada "exploited – with gusto – the breaches of fiduciary duty by Skaggs, Smith, and the Board." The court held that TransCanada "definitively crossed the line into exploitation" when Poirier reneged on a $26 deal price and conveyed an exploding offer at $25.50 per share, coupled with a threat to publicly announce the termination of discussions, in violation of its standstill obligations, if the offer wasn't accepted. The court held that TransCanada was only able to employ this negotiating tactic because of knowledge gained from exploiting Skaggs and Smith. The court differentiated this behavior from aggressive bargaining, given the "persistent and opportunistic violations of a process boundary." According to the court, it was the combination of the "persistent and opportunistic breaches over an extended period" and the "exploitative" $25.50 offer that gave rise to aiding and abetting liability. TransCanada could have avoided aiding and abetting liability by simply complying with its contractual obligations, particularly the standstill, and complying with the auction process rules set by the Columbia board. According to the court, assurances from the Columbia deal team that TransCanada need not worry about the standstill were misplaced – TransCanada should have insisted on a written invitation from the Columbia board prior to engaging in conduct that breached the plain standstill language.

The court held that an aider and abettor is jointly and severally liable for damages of a fiduciary. Here, the appropriate measure of damages was the additional amount that TransCanada would have paid but for the fiduciary duty breaches, which the court found was $1.00, based on the $26 per share part cash/part stock offer price and an increase in TransCanada's stock price between signing and closing.

The Disclosure Claims

The court held that Skaggs, Smith and the Columbia board breached their fiduciary duties by failing to include information about management's contacts with TransCanada described above in the merger proxy statement. Three disclosure omissions (relating to Smith telling Poirier that TransCanada did not face competition, Columbia's ignoring standstill breaches, and the desire of Skaggs and Smith to retire in 2016) were held to be material omissions in a prior appraisal action brought in connection with the deal. The court held that there were multiple additional material omissions in the proxy statement.

The court held that "an acquirer knowingly participates in a disclosure violation when the acquirer has the opportunity to review a proxy statement, has an obligation to identify material misstatements or omissions in the proxy statement, and fails to identify those misstatements or omissions."[58] The court held that TransCanada knowingly participated in disclosure violations, given its actual or constructive knowledge of material

[58] Citing *In re Mindbody, Inc., S'holder Litig.*, 2023 WL 2518149, at *43-44 (Del. Ch. Mar. 15, 2023).

misstatements and omissions, its obligation under the merger agreement to disclose it to Columbia and its failure to do so.

In considering damages, the court held that plaintiffs had not introduced evidence of reliance, but precedent supported a presumption where corporate fiduciaries "[1] distribute a disclosure document, [2] to diffuse stockholders, [3] in connection with a request for stockholder action, and [4] the disclosure document contains a material misstatement or omission." The court held this rule should apply in future litigation, but not this case given it was not raised by plaintiffs. Here, only the equitable remedy of nominal damages would be available, which the court held should be $0.50 per share, representing 1.96% of the deal price. The court held that this overlapped, but was not cumulative with, the $1.00 per share for the sale process claims.

Takeaways

Columbia Pipeline involved aiding and abetting claims for both deal process fiduciary duty breaches and disclosure breaches, and thus builds on the lessons from *Mindshare*, which only involved the latter. The *Columbia Pipeline* court acknowledged that aiding and abetting based on deal process breaches are difficult for plaintiffs to win,[59] and the decision should not be viewed as presaging a significant shift in the landscape. The decision nonetheless provides buyers with important guidance on how to stay out of trouble. According to the *Columbia Pipeline* court, the key criteria for liability is "knowing participation" in a fiduciary duty breach. The breaches at issue involved fiduciary duty breaches of management by in effect running a shadow sale process outside of the deal process guidelines set by the board.

Columbia Pipeline does not signal that buyers must undertake thorough diligence on whether the target management is breaching its fiduciary duties. But in a situation where a buyer attempts to gain a process edge through communications directly with target's management, such as happened in *Columbia Pipeline*, a buyer could protect itself by asking management to confirm that key decisions are authorized by the target board. The court also focused on buyer's violations of the DADW standstill provisions. TransCanada took comfort in assurances of Columbia's management and outside counsel that buyer's actions would not be viewed as a breach, even though management had no authority to waive a breach. The court made clear that in such a situation the buyer should insist on a board invitation to make a proposal, and not assurances from opposing counsel. The court in *Columbia Pipeline* also stated that what pushed TransCanada over the liability line was its exploding offer, coupled with a threat to publicly announce termination of discussion if the offer was not accepted. It was the combination of the sale process violations with the exploding offer and threat that triggered aiding and abetting liability. The implication is that either on its own would not have triggered aiding and abetting liability.

The *Columbia Pipeline* analysis of the disclosure violations was similar to that in *Mindshare*, discussed above. In addition, Vice Chancellor Laster set forth a new rule that would, in many situations, presume reliance on material misstatements in the stockholder disclosure document. This is likely to lead to increased damages for disclosure violations, given that nominal damages will no longer be the sole remedy. That could make disclosure claims more attractive to bring, and could lead to increased exposure to buyers for aiding and abetting liability for disclosure claims.

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[59] In its discussion, the court extrapolated from several cases where aiding and abetting was not the basis for relief.

Palkon v. Maffei, 2024 WL 678204 (Del. Ch. Feb. 20, 2024)[60]

In denying a motion to dismiss, the Delaware Court of Chancery held that reincorporation from Delaware to Nevada, which was allegedly undertaken to decrease litigation risk for the benefit of the controlling stockholder and other fiduciaries and was approved by the board without any procedural protections, was a self-interested transaction that was subject to the entire fairness standard of review.

Background

This decision concerns a motion to dismiss in a stockholder lawsuit against the controlling stockholder and board of directors of TripAdvisor, Inc. seeking to enjoin a reincorporation of TripAdvisor into Nevada based on allegations that the reincorporation was an unfair self-interested transaction. Gregory B. Maffei controlled TripAdvisor through a dual class voting structure. (Maffei exercised control through a holding company, the board members of which were also defendants in the litigation.) Plaintiffs argued that Nevada law was less protective of stockholder litigation rights, and more protective of corporate fiduciaries, than Delaware law, and that by pursuing the reincorporation, Maffei and the directors were obtaining benefits not shared by the minority stockholders in breach of their fiduciary duties.

Court's Decision

The court noted that the plaintiffs did not challenge the transaction as a violation of the Delaware General Corporation Law, but instead alleged that the defendants breached their fiduciary duties when approving the reincorporation. The court's ruling on a fiduciary duty breach turned on the applicable standard of review.

Rejecting defendants' argument for business judgment, the court held that entire fairness applies to transactions between a corporation and its controlling stockholder where the controlling stockholder receives a non-ratable benefit. The court held that "a controller or other fiduciary receives a non-ratable benefit when a transaction materially reduces or eliminates the fiduciary's risk of liability." The court held that this principle had been consistently applied with respect to merger transactions, and in one case with respect to a merger reincorporation. The court rejected defendants' argument that a material benefit from a reduction in liability exposure can only exist for an "existing potential liability" and not a "future potential liability" as a distinction that would make Delaware law "piteously naïve," and completely at odds with how insurance markets work.

The court held that at the pleading stage it was reasonable to infer that the reincorporation would confer a material benefit on the defendants owing fiduciary duties. Protection against litigation risk was a focus of the board and a topic discussed in board materials. It was also described in the proxy materials as a reason that the board recommended that stockholders approve the reincorporation. The court also held that it was reasonable at the pleadings stage to infer that Nevada law was more protective of fiduciaries than Delaware law, and thus entire fairness applied.

The entire fairness test involves both substantive and procedural fairness. Rejecting defendants' argument that entire fairness does not make sense outside of transactions where minority stockholders are receiving cash for their shares, the court held that substantive fairness involves an inquiry into whether minority stockholders receive at least "the substantial equivalent in value" of what they held prior to the transaction. The court held that this test was not satisfied, at the pleadings stage, because of plaintiffs' allegations that minority stockholders would have inferior litigation rights under Nevada law. The court held that plaintiffs had also sufficiently alleged procedural unfairness, given the complete absence of any showing that defendants tried to replicate arms' length bargaining. In denying the motion to dismiss, the court held that injunctive relief was not the appropriate remedy, and that monetary damages could be determined at a later stage of the proceedings, even after completion of the reincorporation.

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[60] https://courts.delaware.gov/Opinions/Download.aspx?id=360330

Takeaways

The decision notes that shortly prior to issuance of the decision, TripAdvisor announced that it was entering into discussions with its parent entity, controlled by Maffei, regarding a going private transaction. As a precursor to a going private transaction, it is easy to see how the reduction in litigation exposure could have bestowed a material benefit to the fiduciary defendants. The decision provides a warning shot to corporate controllers that reincorporation under similar circumstances, or for other self-serving reasons, will be evaluated under an entire fairness standard of review. For controlled corporations that nonetheless want to go down the reincorporation path, boards should consider the court's invitation to implement the twin protections of *Kahn v. M&F Worldwide Corp*., 88 A.3d 635 (Del. 2014) ("*MFW*") in order to obtain the benefit of the far more lenient business judgment standard of review.

Even if the *MFW* dual protections can be successfully implemented, the decision ought not be seen as providing a road map for controllers contemplating a going private transaction through first reincorporating into a more controller-friendly jurisdiction. The decision notes that the court asked the litigants whether the going-private transaction had implications for the motion to dismiss, and both agreed that it didn't. But one issue that could be implicated is whether failure to reference a potential going private transaction in the proxy statement for the reincorporation constitutes a material omission. An obligation to reference it would likely make the reincorporation unworkable in many cases.

The court made clear that its decision should not be taken to mean that corporations cannot leave Delaware without litigation risk. The court made clear that the decision only applied in the context of controlled corporations. In the absence of a controlling stockholder, stockholder approval could immunize the transaction under a business judgment standard of review (see *Corwin v. KKR Fin. Hldgs, LLC*, 125 A.3d 304 (Del. 2015)).

In re Sears Hometown and* Outlet *Stores, Inc. S'holder Litig., 309 A.3d 474 (Del. Ch. Jan. 24, 2024)[61]

In a post-trial decision, the Delaware Court of Chancery considered the fiduciary duty constraints on controlling stockholders when exercising stockholder powers, and set forth a test for evaluating fiduciary duty challenges to such controller action.

Background

This post-trial decision involved an action against a controlling stockholder for breach of fiduciary duty in connection with blocking a liquidation plan of the controlled company and forcing the company into a sale to the controller. Sears Hometown and Outlet Stores, Inc. (the "Company") operated through two segments, a struggling one that sold home products, equipment and tools mainly through dealer arrangements ("Hometown"), and a more successful one that sold similar but lower quality or discontinued products. Eddie Lampert controlled an entity that held a majority of the outstanding shares of the Company's common stock. He was a passive long term investor, never having acted by written consent or replaced any members of the board. At a time when the Company's stock was trading at under $2 per share, a committee of three independent directors pursed a plan to liquidate the Hometown business, believing that it would yield a value per share for the Company as a whole of up to $9.58.

[61] https://courts.delaware.gov/Opinions/Download.aspx?id=358990

Lampert strongly opposed the plan, believing that the committee had significantly undervalued risks and potential liabilities, including potential breach of contract claims by the dealers.

When Lampert was unable to dissuade the committee from its course of action, he took stockholder action (the "Controller Intervention") to impede it. He adopted a bylaw amendment that required the liquidation plan to be approved by at least 90% of the members of the board in two votes that were at least 30 days apart. He also removed two members of the board who were on the committee and who he believed to be most supportive of the liquidation plan, and replaced the two members with two designees recommended by one of his financial backers. Believing it to be the best alternative for the company, the single remaining committee member then proceeded to negotiate a sale to Lampert.

Several stockholder actions were filed after the sale to Lampert was announced. After claims against directors were dismissed or settled, the claims against Lampert and affiliated entities proceeded to trial.

Court's Decision

The parties agreed that as a controlling stockholder, Lampert owed fiduciary duties to the Company and its minority stockholders, but they disagreed on the extent of those fiduciary duties. Plaintiffs argued that unless a controlling stockholder is entitled to vote on a matter under the Delaware General Corporation Law, use by the controller of voting power to block board action constitutes a breach of fiduciary duty. Rejecting this view, the court held that a controller can take action as a stockholder, subject to Professor Berle's two-part test that it must comply with both statutory law and fiduciary duties. The court held that there are two situations in which controller action implicates fiduciary duties. The first is where a controller uses "its influence over the board and management to wield corporate power indirectly and cause the corporation to act. Having effectively moved into the boardroom, the controller becomes subject to the same fiduciary standards that apply to directors." (citations omitted). The court held that that such a situation was not present here. The second situation is where a controller only uses its powers as a stockholder, as was the case here. The court held that Delaware law was inconsistent in such a situation, where some cases hold that fiduciary duties do not apply in this context and others hold that the duty of loyalty can arise.

The court then considered precedent in the context of the right of controllers to sell their stock and their rights to vote. With respect to the sale of stock, the court held that fiduciary duties do not arise in the context of refusing to sell. The court held that limited fiduciaries duties arise where the controller decides to sell, such as the duty to refrain from knowingly selling to looters or being grossly negligent in doing so. The court held that case law was similar with respect to voting, articulating the rule as follows: "[a] controller can refuse to vote in favor of, or affirmatively vote against, a transaction that would alter the status quo, even if a board of directors might conclude that the transaction was in the best interests of all stockholders. But when exercising voting power affirmatively to change the status quo, a controlling stockholder owes a fiduciary duty of loyalty which requires that the controller not intentionally harm the corporation or its minority stockholders, plus a fiduciary duty of care that requires that the controller not harm the corporation or its minority stockholders through grossly negligent action."

The court held that while case law has not discussed a standard of review with respect to controller sales or voting, Delaware courts now typically apply a standard of review when considering challenges to fiduciary duties. The court held that since enhanced scrutiny applies when directors interfere with elections or voting contests implicating corporate control, it makes sense for enhanced scrutiny to apply in similar situations involving controllers. Accordingly, the court held that Lampert was required to show that: (1) "he acted in good faith for a legitimate objective and had a reasonable basis for believing that action was necessary," and (2) "he selected a reasonable means for achieving his legitimate objective."

The court held that both prongs of the test were satisfied. With respect to the first prong, the court held that Lampert had extensive experience investing in retail stores, including bankruptcy situations, and that he testified credibly regarding his concerns about the path the transaction committee was pursing, including his belief that the committee significantly overestimated proceedings to be received from a liquidation and underestimated potential liabilities. With respect to the second prong, the court held that Lampert took the action he did as a last resort, after having unsuccessfully tried to negotiate with the committee, having met in person with the board and the committee, and after being faced with an impending deadline. The court held that the bylaw amendment did not technically prohibit the board from pursuing the liquidation, but instead only delayed it, albeit to give Lampert time to take additional preventative action. Lampert only removed two directors from the board, and he did not fill the resulting vacancies with directors he controlled. The court held that taken as a whole, the Controller Intervention fell within a range of reasonableness. Accordingly, the court held that Lampert did not breach his fiduciary duties of loyalty or care when he engaged in the Controller Interventions.

The court then analyzed whether Lampert breached his fiduciary duties in connection with his acquisition of the Company. Applying an entire fairness standard of review, the court held that Lampert breached his fiduciary duties, and awarded damages in the amount of $1.78 per share.

Takeaways

Most controller decisions in the M&A context have involved either going private transactions, such as was present in Lampert's acquisition of the Company, controllers otherwise receiving non pro-rata benefits in a sale, or controllers exercising corporate power. For the first time, *In re Sears Hometown and Outlet Stores* lays out a framework with respect to the fiduciary duties owed by controllers outside of these contexts. The decision provides important guidance to investment funds and strategics that make controlling investments regarding the fiduciary constraints on action they take using their stockholder powers.