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**Richards, Layton & Finger**

# Recent Developments in Delaware Law

*Front cover:* Delaware Legislative Hall, the state capital building in Dover, houses the chambers and offices of the Delaware General Assembly. The General Assembly has a distinguished history: established in 1704, it announced Delaware's independence from Great Britain several weeks before the enactment of the Declaration of Independence in 1776; in 1787, Delaware became the first state to ratify the U.S. Constitution, earning it the distinction of "The First State." Delaware's capital was moved from New Castle to Dover in 1777, where Legislative Hall was built in 1933.

## UNIQUELY SKILLED AT HELPING SOPHISTICATED CLIENTS NAVIGATE THE INTRICACIES OF DELAWARE CORPORATE LAW

This publication, which highlights recent corporate and alternative entity cases and statutory developments in Delaware, continues our long tradition of providing insight into the development of Delaware law. Our corporate and alternative entities teams, the largest and most recognized in the state, play a crucial role in Delaware. For decades we have contributed to the development of key statutes, litigated influential decisions, and provided counsel on sophisticated transactions—making us uniquely skilled at helping sophisticated clients navigate the intricacies of Delaware corporate law.

Richards Layton has been intimately involved with many of the cases highlighted in this publication, and we have handled, as Delaware counsel, the most M&A transactions valued at or above $100 million for more than 20 years running, as reported in *The Deal* and *Corporate Control Alert.* We welcome the opportunity to discuss the practical implications of the recent developments in Delaware law with you, and we look forward to helping you whenever a need may arise.

—Richards, Layton & Finger

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Since the Delaware Supreme Court decision in *Corwin v. KKR Financial Holdings LLC,* 125 A.3d 304 (Del. 2015), the Delaware courts have grappled with the effect of the so-called *Corwin* defense (i.e., that fully informed, uncoerced approval of a transaction by the disinterested stockholders will restore business judgment review) in a variety of different circumstances. In three recent decisions, the Delaware Court of Chancery has imposed limitations on the applicability of the *Corwin* defense. First, in *In re Massey Energy Company Derivative and Class Action Litigation,* 160 A.3d 484 (Del. Ch. 2017), the Court held that the *Corwin* defense was inapplicable to fiduciary claims for pre-merger conduct that was not specifically ratified by a stockholder vote in connection with a merger. Then, in *Sciabacucchi v. Liberty Broadband Corporation,* 2017 WL 2352152 (Del. Ch. May 31, 2017), the Court, ruling on a motion to dismiss, found that the requirements of *Corwin* had not been met because the stockholder vote on the transaction at issue was "structurally coercive." And finally, in *Lavin v. West Corporation,* 2017 WL 6728702 (Del. Ch. Dec. 29, 2017), the Court held that the *Corwin* defense cannot be used to prevent an otherwise properly supported demand for inspection of books and records pursuant to Section 220 of the General Corporation Law of the State of Delaware (the "DGCL").

In *Massey,* Massey Energy Company was acquired by Alpha Natural Resources, Inc. in a 2011 transaction that was approved by a majority of Massey's stockholders. At the time of the merger, the Massey board of directors was subject to derivative litigation alleging *Caremark* claims related to alleged failures of oversight by the board in connection with a deadly mine explosion in 2010. After the merger closed, the defendants asserted that the claims in the pre-merger *Caremark* litigation should be dismissed under *Corwin*, arguing that stockholder approval of the merger in effect ratified the pre-merger conduct of the Massey board of directors. The Court held that the *Corwin* defense was inapplicable to the pre-merger conduct, reasoning that *Corwin* was "never intended to serve as a massive eraser, exonerating corporate fiduciaries for any and all of their actions or inactions preceding their decision to undertake a transaction for which stockholder approval is obtained." The Court stated that, in order for a transaction to receive a "cleansing" effect under *Corwin*, there must be a "far more proximate relationship" between the transaction for which stockholder approval is sought and the nature of the claims to be cleansed as a result of the stockholder vote.

In *Liberty,* Charter Communications, Inc. sought stockholder approval of the acquisition by Charter of two media communications companies. The stockholders were also asked to approve the issuance of equity to Charter's largest stockholder, Liberty Broadband Corporation, ostensibly to raise capital to partially finance the acquisition, and a voting proxy agreement pursuant to which Liberty obtained the right to vote additional shares in the post-transaction company. In the proxy statement related to the deal, Charter expressly conditioned the consummation of the acquisition on obtaining stockholder approval of the Liberty share issuance and the voting proxy agreement. After a majority of the disinterested stockholders approved the acquisition, the Liberty share issuance, and the voting proxy agreement, the plaintiffs brought fiduciary duty claims against the Charter board of directors and Liberty with respect to the Liberty share issuance and the voting proxy agreement for allegedly structuring the transaction in a manner that benefited Liberty to the detriment of Charter's other stockholders. The defendants argued that, under *Corwin*, the business judgment rule applied to the entire series of transactions and under that standard the complaint must be dismissed.

In analyzing the *Corwin* defense, the Court of Chancery focused on whether the stockholder vote had been coerced. Although the Court determined that Liberty ultimately did not constitute a controlling stockholder under the circumstances, the Court noted that if a controlling stockholder had stood on both sides of the transaction, the inherent coercion posed by the controller would render stockholder approval insufficient to cleanse the transaction under *Corwin*. Nevertheless, the Court concluded that the manner in which Charter had proposed the related transactions to the stockholders for approval was structurally coercive. The Court found that, for purposes of a motion to dismiss, the plaintiffs had adequately pled that the Liberty share issuance and the voting proxy agreement were unfair and that the Charter stockholders were required to approve them in order to obtain the benefits of the acquisition. Because the Charter stockholders were unable to evaluate the economic merits of the Liberty share issuance and the voting proxy agreement on their own, the Court determined that the stockholder vote on those items was coercive and the prerequisites of the *Corwin* defense had not been met.

**_Corwin_ was "never intended to serve as a massive eraser, exonerating corporate fiduciaries for any and all of their actions or inactions preceding their decision to undertake a transaction for which stockholder approval is obtained."**

In *Lavin,* the plaintiff submitted a demand to inspect West Corporation's books and records for "potential wrongdoing and mismanagement" following stockholder approval of a merger of West with an affiliate of Apollo Global Management. West rejected the plaintiff's demand on the basis that the plaintiff had not alleged a proper purpose. West argued that, under *Corwin*, stockholder approval had effectively "cleansed" the underlying transaction and, accordingly, the only possible proper purpose for a demand under the business judgment rule would be investigation of a waste claim, which had not been included as a purpose of the plaintiff's demand.

The Court found *Corwin* inapplicable in a Section 220 proceeding on both procedural and public policy grounds. Procedurally, the Court reasoned that the applicability of a merit-based defense such as *Corwin* depends on nuanced factual and legal questions (such as whether the stockholder vote was fully informed and uncoerced) that are inappropriate for determination by the Court in a summary Section 220 proceeding. From a public policy perspective, the Court noted that Delaware courts frequently encourage plaintiffs to use Section 220 to fully investigate the merits of their claims prior to filing a complaint. The Court held that applying *Corwin* in this context would limit the most valuable of the plaintiff's "tools at hand" to investigate potential claims and would ultimately deprive the Court of information that could assist it in making an informed decision as to whether a viable breach of fiduciary duty claim exists in the underlying proceeding. ◆

## ***Oklahoma Firefighters Pension & Retire. Sys., et al. v. Corbat, et al.:*** Court of Chancery Highlights Difficulty of Successfully Alleging *Caremark* Claims

In *Oklahoma Firefighters Pension & Retire. Sys., et al. v. Corbat, et al.*, 2017 WL 5484125 (Del. Ch. Dec. 18, 2017), the Delaware Court of Chancery dismissed a claim against current and former directors of Citigroup, Inc. for failing to exercise appropriate oversight with regard to the corporation's operations, which allegedly resulted in violations of law by employees and large fines and penalties being assessed against Citigroup. In the detailed opinion, the Court explained the challenges that plaintiffs face in alleging lack of oversight claims against directors when an exculpation clause applies, including the need to allege facts suggesting not merely inattention, but actual *scienter*.

The plaintiffs alleged that Citigroup's directors had failed to develop, implement, and enforce effective internal controls throughout the corporation and its subsidiaries, resulting in four distinct corporate traumas: (i) violations of anti-money-laundering rules that resulted in a $140 million fine; (ii) falling victim to a $400 million fraud at its Mexican subsidiary, which led to a $2.5 million fine; (iii) wrongful manipulation of benchmark foreign exchange rates, resulting in $2.2 billion in fines; and (iv) deceptive credit card practices, resulting in $35 million in fines and $700 million in restitution payments.

**"A board's efforts can be ineffective, its actions obtuse, its results harmful to the corporate weal, without implicating bad faith."**

At the outset, the Court noted that lack of oversight claims, commonly known as *Caremark* claims named for the seminal opinion *In re Caremark International Inc. Derivative Litigation,* 698 A.2d 959 (Del. Ch. 1996), are among the most difficult claims to establish under Delaware corporate law. Directors may be liable for violation of their oversight duties if they utterly fail to establish a system of controls to monitor the corporation's conduct or, having established a system of controls, nonetheless fail to act in response to "red flags" putting the directors on notice of wrongdoing in the corporation. There was no question that Citigroup had implemented various controls to monitor the corporation. Accordingly, the plaintiffs' *Caremark* claim focused on the directors' alleged failure to act in the face of facts suggesting violations of applicable law. However, because Citigroup's certificate of incorporation contained an exculpation clause protecting directors from liability for violations of the duty of care, the plaintiffs were required to allege that the directors' failure to act constituted bad faith or knowing failure to act in the corporation's best interest.

With regard to the anti-money-laundering violations, the plaintiffs alleged that Citigroup had received a number of regulatory warnings and orders that should have placed the directors on notice of the corporation's weak anti-money-laundering controls. Nonetheless, the plaintiffs asserted that the directors "sat like stones growing moss" and took no steps to strengthen Citigroup's controls. The Court found that if the complaint actually supported this rhetoric, it would state a *Caremark* claim. However, in reviewing the documents on which the complaint was based, the Court found that those documents revealed that the directors did take actions to address the various red flags identified by the plaintiffs. The fact that those actions were ineffective in actually preventing employees from violating the law was insufficient to state a claim for breach of the duty of loyalty. As the Court noted, "a board's efforts can be ineffective, its actions obtuse, its results harmful to the corporate weal, without implicating bad faith."

Turning next to the $400 million fraud at Citigroup's Mexican subsidiary, the Court noted that *Caremark* claims typically seek to hold directors liable for harms arising from wrongdoing by the corporation's employees. Yet the plaintiffs' theory appeared to be that Citigroup's weak controls caused the corporation to fall victim to illegal conduct by a third party. The Court characterized this as a failure to monitor or properly limit "business risk." The Court noted that Delaware has never "definitively accepted" such a theory of liability. Thus, the Court suggested that the plaintiffs' claim was limited to the $2.5 million fine that resulted from the fraud, not the damages Citigroup suffered from the fraud itself. Regardless of the scope of the claim, however, the Court concluded that the red flags that the plaintiffs identified were insufficiently related to the fraud that ultimately occurred to put the directors on notice of a need to take action. Moreover, the Court again noted that the documents on which the complaint relied revealed that the directors did take action in response to the red flags. The fact that those actions proved insufficient to prevent the fraud is not a basis for oversight liability.

With regard to the manipulation of benchmark foreign exchange rates by Citigroup traders, the plaintiffs identified several risk management reports and prior incidents of employee misconduct that they alleged should have put the directors on notice of the

likelihood of a scheme to manipulate exchange rates. Again dismissing this claim, the Court found that Citigroup took action in response to the red flags and, more significantly, the plaintiffs failed to plead that those red flags were actually known by the board. The Court explained that if the red flags are not waved in front of the directors, they cannot establish a lack of oversight liability.

Similarly, with regard to deceptive credit card practices, the Court found that the directors did not simply brush aside red flags suggesting potential wrongdoing, but were informed that the corporation was taking active measures to improve controls and train employees appropriately. That these measures were ineffective in preventing violations of law was insufficient to raise a reasonable inference of bad faith.

Finally, the Court addressed the plaintiffs' argument that the Court must consider the allegations "holistically, not in isolation," as suggestive of a board that had failed to comply with its oversight obligations. While the Court acknowledged that a series of actions or inactions may be helpful in determining whether a board acted with *scienter,* the Court found that *Caremark* liability requires a separate examination of each corporate trauma, whether the directors had knowledge of specific red flags that should have put them on notice of the likelihood of that trauma, and their actual responses to those red flags. The plaintiffs had failed to satisfy this standard.

Notably, the decision was appealed to the Delaware Supreme Court, but remanded back to the Court of Chancery for consideration of the plaintiffs' Rule 60(b) motion, which asserted that the trial court should consider a new $70 million fine levied against Citigroup less than two weeks after the opinion was issued.◆

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## ***In re Saba Software, Inc. Stockholder Litigation:*** Court of Chancery Declines to Find Stockholder Ratification under *Corwin*

In *In re Saba Software, Inc. Stockholder Litigation,* 2017 WL 1201108 (Del. Ch. Mar. 31, 2017), the Court of Chancery refused for the first time to apply the cleansing effect available under *Corwin v. KKR Fin. Holdings LLC,* 125 A.3d 304 (Del. 2015), to a stockholder vote approving a merger, finding that the plaintiff pled sufficient facts alleging that the stockholder vote was neither fully informed nor uncoerced.

The Court's determination was based on a unique set of facts. As uncovered by the Securities and Exchange Commission (the "SEC"), Saba Software, Inc. had engaged in financial fraud between 2008 and 2012, overstating its pre-tax earnings during that period by $70 million. Saba repeatedly and publicly provided assurances that it would restate and correct its financials, but never did. On April 9, 2013, because of Saba's failure to correct its financial statements, NASDAQ suspended trading of Saba's stock. On June 12, 2013, NASDAQ delisted Saba, and Saba's common stock began trading over the counter. The SEC filed a complaint against Saba in early September 2014. On September 24, 2014, Saba announced that it had reached a settlement with the SEC regarding the allegations of financial fraud. The settlement required, among other things, that Saba restate its financials by February 15, 2015, or the SEC would deregister Saba's common stock.

Saba had been exploring strategic alternatives for several years before these events. At a board meeting on November 19, 2014, the board formed an ad hoc committee comprised of three members to direct a sales process. In early December 2014, the ad hoc committee was advised that the restatement of Saba's financials was unlikely to be completed on time. At that point, Saba was progressing towards a transaction with a private equity firm from which it had received its only indication of interest.

On December 15, 2014, Saba announced that it would not be able to complete the required restatement of its financials by the February 15, 2015 deadline and that it was evaluating strategic alternatives. This news caused Saba's stock price to fall from its post-settlement high of $14.08 to $8.75 per share. Nonetheless, a group of analysts set a price target for Saba stock of $17 per share and gave it a "Buy" rating, and the board doubled down on its efforts to consummate a sale of the company.

In early 2015, Saba received several communications from companies interested in purchasing Saba, including Vector Capital Management, L.P., one of Saba's former lenders. On January 20, 2015, Saba announced its intention to enter into a definitive acquisition agreement prior to the restatement deadline if the board determined that a sale was in the best interests of the company. Vector resubmitted its indication of interest to acquire Saba at $9.00 per share on February 2, 2015. The same day, the closing price for Saba's stock was $9.45. The ad hoc committee met the next day to consider Vector's offer.

Despite the fact that several potential bidders had signed non-disclosure agreements and Saba continued to receive new indications of interest, on February 9, 2015, Saba's board approved, and the next day announced, a merger with an affiliate of Vector for $9.00 per share. One day before agreeing to the merger, the board had awarded itself equity awards that would convert into cash upon a change in control. The SEC deregistered Saba's stock nine days after the announcement of the merger. The plaintiff, a former Saba stockholder, then brought suit against the individual members of Saba's board alleging breach of fiduciary duty. On March 26, 2015, Saba's stockholders voted to approve the merger.

**The Court found that the plaintiff had pled facts suggesting that the stockholder vote was neither fully informed nor uncoerced, and that these alleged facts undermined the cleansing effect of the stockholder vote under *Corwin*.**

The Court found that the plaintiff had pled facts suggesting that the stockholder vote was neither fully informed nor uncoerced, and that these alleged facts undermined the cleansing effect of the stockholder vote under *Corwin*. The Court held that the plaintiff had pled two reasonably conceivable material omissions from Saba's proxy statement. First, the Court concluded that Saba's stockholders could not have made a fully informed decision without an explanation for Saba's repeated failure to restate its financials. This omission was material because, according to the Court, Saba's failure to restate its financials "spurred the sales process" and "materially affect[ed] the standalone value of Saba going forward." Without knowing why Saba had repeatedly failed to restate its financials or whether there was any likelihood of Saba restating its financials and becoming reregistered with the SEC, stockholders could not make an informed decision whether to support the merger. Second, the Court agreed that the proxy statement failed to disclose adequately the range of post-deregistration options potentially available to Saba. Although Delaware law does not normally require disclosure of alternatives to a given transaction, the Court determined that the dynamic of the registration, which "dramatically affected the environment in which the Board conducted the sales process," required the board to disclose Saba's other prospects.

The Court also held that the *Corwin* cleansing effect did not apply because the pleadings supported a reasonable inference that the stockholder vote was coerced. The Court found the board's failure to act to restate its financials in the face of a known duty to act led to "situational coercion" and "may have wrongfully induced the Saba stockholders to vote in favor of the Merger for reasons other than the economic merits of the transaction," because Saba's stockholders found themselves in the precarious position of choosing between holding onto "recently-deregistered illiquid stock or accepting the Merger price of $9 per share, consideration that was depressed by the Company's nearly contemporaneous failure once again to complete the restatement of its financials." The Court determined that Saba's stockholders were left with "no practical alternative but to vote in favor of the Merger."

Because the stockholder vote did not cleanse the merger under *Corwin* and because the challenged transaction involved a change in control, the Court

determined that the *Revlon* enhanced scrutiny standard would apply.

Saba's directors further argued that the claims should be dismissed because (i) the plaintiff lacked standing to bring what the defendants argued were derivative claims once the merger was consummated, and (ii) the directors were exculpated from any monetary liability by the Section 102(b)(7) provision in Saba's certificate of incorporation.

The Court concluded that the plaintiff's claims were direct because the complaint challenged the directors' actions during the merger process. The Court also determined that the facts pled concerning Saba's repeated failure to restate its financials and the rushed, forced stockholder vote that followed justified a pleading-stage inference of bad faith, and the late-stage equity awards to the directors prior to the transaction supported an inference that the board members had breached their duty of loyalty, stating non-exculpated claims. ◆

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## ***In re EZCORP Inc. Consulting Agreement Derivative Litigation:*** Court of Chancery Applies Entire Fairness Scrutiny to Contract between Controlling Stockholder and Corporation Despite Approval by Independent Committee

In *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, 2016 WL 301245 (Del. Ch. Jan. 25, 2016), the Court of Chancery denied a motion to dismiss derivative claims challenging a series of payments between a corporation and its controlling stockholder, even though those payments had been approved by the audit committee of the corporation's board. After review of extensive case law, the Court concluded that the weight of authority called for application of the entire fairness standard at the pleading stage, with the possibility that an evidentiary showing of independent committee approval could support a shift in the burden of proof later in the case. The Court determined that controlling stockholder transactions could be subject to dismissal at the pleading stage under the business judgment rule only where the transaction is approved by both an independent committee of the board and a majority of the minority stockholders.

Headquartered in Austin, Texas, EZCORP Inc. provided instant cash solutions through a variety of products and services, including pawn loans, other short-term consumer loans, and purchases of customer merchandise. The plaintiff stockholder brought suit challenging the fairness of three advisory service agreements between EZCORP and defendant Madison Park, LLC, an affiliate of EZCORP's controlling stockholder, Phillip Cohen. Cohen was the sole stockholder of the general partner of the limited partnership that held all of the company's voting common stock. Thus, Cohen held 100% of EZCORP's voting power, but only 5.5% of its equity.

**The Court determined that controlling stockholder transactions could be subject to dismissal at the pleading stage under the business judgment rule only where the transaction is approved by both an independent committee of the board and a majority of the minority stockholders.**

In May 2014, the audit committee terminated the renewal of one of the service agreements, allegedly due in part to the committee's concern about the fairness of the relationship between EZCORP and Madison Park. In early July, the stockholder-plaintiff made a demand under Section 220 of the DGCL to inspect EZCORP's books and records relating to the service agreements. Nine days after the books and records demand arrived, Cohen responded to the termination by removing three directors (including two members of the audit committee that had terminated the agreements and EZCORP's CEO) from the board; another director resigned the same day.

The Court considered at length the appropriate standard of review for transactions in which a corporation's controlling stockholder receives a non-ratable benefit. The Court noted that in an ordinary case involving self-dealing between a corporation and its controlling stockholder, the standard of review is entire fairness and the burden of proof rests on the defendants. However, in the context of a cash-out merger, the Delaware Supreme Court has held that application of the business judgment rule is appropriate if, but only if, the transaction is conditioned *ab initio* on both the affirmative recommendation of a sufficiently authorized, independent, and disinterested committee of the board and the affirmative vote of a majority of the minority stockholders. *See Kahn v. M & F Worldwide,* 88 A.3d 635 (Del. 2014). If the controlling holder agrees to use only one of these protections, however, "then the most that the controller can achieve is a shift in the burden of proof such that the plaintiff challenging the transaction must prove unfairness."

The Court then considered a controversy posed in the case law: whether challenges to controlling-stockholder transactions other than cash-out mergers may be dismissed under the business judgment rule where the transaction is conditioned on *either* approval by an independent and disinterested board committee *or* approval by a majority of the minority stockholders, but not both. After an extensive review of cases taking both sides of that issue, the Court concluded that the weight of the authority called for a broader application of the entire fairness framework.

The Court also considered the tension between that conclusion and the demand futility analysis articulated in *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984), a case in which the Delaware Supreme Court had reversed (on discretionary interlocutory review) the Court of Chancery's denial of a motion to dismiss a derivative suit challenging a transaction with a 47% stockholder that had been approved by a majority disinterested and independent board, but not by the corporation's stockholders. The Supreme Court in *Aronson* held that unless a stockholder plaintiff pleads particularized facts calling into question the board's ability to exercise properly its independent and disinterested business judgment in responding to a demand to institute suit, a board's refusal to sue is subject to business judgment review. After extended discussion of post-*Aronson* case law, the Court determined that *Aronson* applies only to the demand-excusal context and does not provide an independent basis for changing the substantive standard of review of controlling stockholder transactions.

After finding that the operative standard of review was entire fairness with possible burden shifting based on the audit committee's approval of the service agreements, the Court held that the complaint supported a reasonable inference that the agreements were not entirely fair. Among the factors that the Court found to raise such inference were: (i) Cohen's voting control despite having only a 5.5% equity stake; (ii) the long history of advisory service agreements between EZCORP and Cohen's affiliates; (iii) the amount and timing of the payments; (iv) the minimal resources of Madison Park; (v) the duplication between the services Madison Park provided and the capabilities of EZCORP management; (vi) the lack of similar service agreements at any of EZCORP's peer companies; (vii) the decision by two members of the audit committee to cancel the renewal of one agreement; and (viii) Cohen's retaliation against those board members.

The Court added that at the motion to dismiss stage, the involvement of the audit committee in the transactions does not defeat the fiduciary duty claim because a determination of whether an independent committee is "well-functioning" requires a "fact intensive inquiry."

The Court next turned to its analysis under Court of Chancery Rule 23.1. The Court found that reasonable doubt existed as to the ability of a majority of the directors to exercise independent and disinterested business judgment over a demand, and thus that demand was excused. Notably, the Court found demand excused as to a retired board member whom Cohen brought out of retirement and reappointed after removing three directors in July 2014. While the Court acknowledged the general rule that a director's nomination or election by an interested party is, by itself, insufficient to raise a reasonable doubt about his independence, "it is not necessarily irrelevant." The Court found that this director's alleged "eagerness to be of use," combined with his participation as an audit committee member in approving some of the challenged agreements, could support the reasonable inference that "Cohen wanted to bring back a cooperative member of the placid antebellum regime." ◆

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## *Corwin v. KKR Financial Holdings LLC:* Delaware Supreme Court Affirms Application of Business Judgment Review to Transaction Approved by Fully Informed, Uncoerced Majority of Disinterested Stockholders

In *Corwin v. KKR Financial Holdings LLC,* 125 A.3d 304 (Del. 2015), the Delaware Supreme Court affirmed a ruling by the Court of Chancery granting the defendants' motions to dismiss a suit challenging the acquisition of KKR Financial Holdings LLC ("KFN") by KKR & Co. L.P. ("KKR"). The Court held that the business judgment rule is the appropriate standard in post-closing damages suits involving mergers that are not subject to the entire fairness standard and that have been approved by a fully informed, uncoerced majority of the disinterested stockholders, even where such approval is statutorily required.

In December 2013, KKR and KFN executed a stock-for-stock merger agreement, which was subject to approval by a majority of KFN shares held by persons other than KKR and its affiliates. The merger, which was priced at a premium of 35% to market, was approved in April 2013 by an independent board majority and by a majority of disinterested stockholders.

Following the merger, nine lawsuits challenging the merger were brought in the Court of Chancery and consolidated. The plaintiffs alleged that (i) the members of the KFN board breached their fiduciary duties by agreeing to the merger, and (ii) KKR breached its fiduciary duty as a controlling stockholder by causing KFN to enter into the merger agreement.

**Business judgment rule is the appropriate standard in post-closing damages suits involving mergers that are not subject to the entire fairness standard and that have been approved by a fully informed, uncoerced majority of the disinterested stockholders.**

The plaintiffs' control claims focused on the facts that a KKR affiliate managed the company's day-to-day operations and that KFN's primary business was financing KKR's leveraged buyout activities.

The Court of Chancery dismissed the complaint, finding that KKR, which owned only 1% of KFN's stock, was not a controlling stockholder. Additionally, the Court of Chancery held that the business judgment rule would apply to the merger because the merger was approved by a majority of the shares held by the disinterested, fully informed stockholders of KFN.

The Supreme Court, sitting *en banc,* unanimously affirmed the judgment of the Court of Chancery. With respect to the control issue, the Court found that the plaintiffs had not alleged sufficient facts to support the argument that KKR had effective control of the board and could therefore prevent KFN's board from exercising its own independent judgment in determining whether to approve the merger. To support this finding, the Court noted that KKR "owned less than 1% of the stock, had no right to appoint any directors, and had no contractual right to veto any board decision." Accordingly, the Court rejected the plaintiffs' control claims.

The Court further held that the business judgment standard of review would apply to the merger "because it was approved by a majority of the shares held by disinterested stockholders of KFN in a vote that was fully informed." The Court also declined to review the Court of Chancery's holding on the non-applicability of *Revlon,* finding that even if *Revlon* applied to the merger, the voluntary approval by an informed majority of disinterested stockholders was sufficient to support application of the business judgment rule. The Court stated that *Revlon* and *Unocal* were not designed to address post-closing claims for money damages, but rather to provide stockholders and the Court of Chancery the ability to address merger and acquisition decisions before closing.

In so holding, the Court agreed with the Court of Chancery's interpretation of *Gantler v. Stephens,* 965 A.2d 696 (Del. 2009). In *Gantler,* the Supreme Court stated that ratification is limited to circumstances where a fully informed stockholder vote approves director action that does not legally require stockholder approval in order to become effective. Using this interpretation, the plaintiffs argued that the merger should be subject to heightened scrutiny regardless of the statutorily required stockholder vote approving the merger. The Court rejected this argument, finding that *Gantler* was a narrow decision that focused on the meaning of the term "ratification," and was not meant to overturn Delaware's "long-standing body of case law" regarding the effect of fully informed stockholder approval.

The Supreme Court noted, however, that its holding applies only to fully informed and uncoerced votes of disinterested stockholders. Thus, the business judgment rule is not invoked if material facts regarding the merger are not disclosed to the voting stockholders. ◆

# Disclosures

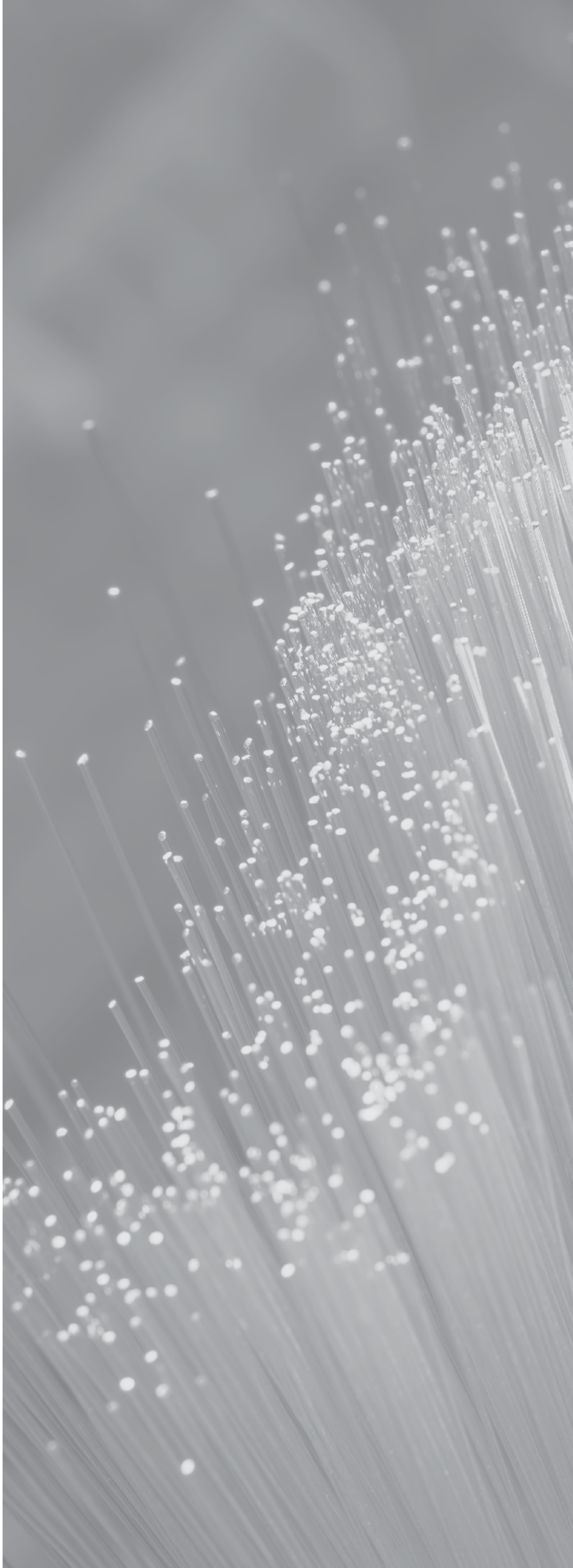
## ***Vento v. Curry:*** Preliminary Injunction to Remedy Buried Disclosure of Fees to Be Paid to Affiliate of Financial Advisor for Providing Transaction Financing

In *Vento v. Curry,* 2017 WL 1076725 (Del. Ch. Mar. 22, 2017), the Court of Chancery preliminarily enjoined a special meeting of stockholders of Consolidated Communications Holdings, Inc. to vote on a proposed issuance of the company's common stock in connection with a proposed merger. Finding information concerning the compensation to be received by Consolidated's financial advisor and its affiliates in connection with providing a portion of the financing for the merger to be both material and quantifiable, the Court determined that Consolidated had failed to disclose this information "in a clear and transparent manner" to its stockholders.

On December 3, 2016, Consolidated entered into a merger agreement with FairPoint Communications, Inc., under which Consolidated would acquire FairPoint in a stock-for-stock merger. The merger was expected to close in mid-2017. Morgan Stanley & Co. LLC served as the lead financial advisor for Consolidated, and an affiliate of Morgan Stanley committed to provide part of the debt financing for the merger. NASDAQ listing rules obliged Consolidated to secure a vote of its stockholders approving the issuance of the shares to be used as merger consideration. In a Form S-4 Registration Statement filed on January 26 and amended on February 24, 2017 (the "Amended Registration Statement"), Consolidated announced a special meeting of the company's stockholders to be held on March 28, 2017, to vote on the proposed share issuance.

**The Court found it unreasonable to require stockholders to embark on a "scavenger hunt to try to obtain a complete and accurate picture of a financial advisor's financial interests in a transaction."**

On March 3, 2017, a stockholder plaintiff filed an action alleging that Consolidated's directors breached their fiduciary duties by failing to disclose in the Amended Registration Statement details concerning the amount of compensation Morgan Stanley expects to earn in connection with providing a portion of the debt financing for the merger. Specifically, the



Amended Registration Statement disclosed the fees paid to Morgan Stanley by both Consolidated and FairPoint in connection with current and prior advisory and financing services, but stated only that the Morgan Stanley affiliate would receive "additional fees" from Consolidated for providing a portion of the debt financing for the merger. On March 14, 2017, the plaintiff filed a motion for a preliminary injunction to suspend the stockholder vote until Consolidated further amended the Amended Registration Statement to disclose this information.

The defendants did not dispute that the fees to be earned by the Morgan Stanley affiliate in connection with the merger financing were both material and quantifiable. They noted instead that the Amended Registration Statement identified (as a pro forma balance sheet adjustment) the total amount of the fees to be paid for the financing commitment, and a separate Form 8-K, filed several weeks earlier, had attached the commitment letter showing that the Morgan Stanley affiliate would provide approximately 40% of the committed financing. On that basis, the defendants argued that the Amended Registration Statement enabled a stockholder to estimate that the Morgan Stanley affiliate would receive approximately 40% of the fee amount.

The Court rejected the defendants' argument. Relying on the "buried facts" doctrine, the Court found it unreasonable to require stockholders to embark on a "scavenger hunt to try to obtain a complete and accurate picture of a financial advisor's financial interests in a transaction," which, the Court reiterated, is information critical to the stockholders' assessment of how much weight to afford a financial advisor's analysis of a proposed transaction. The Court therefore determined that "there is simply no excuse for Consolidated's failure to disclose that information in a clear and transparent manner." The Court thus found that it was probable that the plaintiff would succeed on the merits of his disclosure claim and that the remaining elements of the preliminary injunction test were met.

The Court enjoined the meeting until five days after Consolidated supplemented its disclosures to provide a "clear and direct explanation of the amount of financing-related fees" Morgan Stanley and its affiliates would receive in connection with the merger, if approved. ♦

# Merger Agreement Construction

### *Chicago Bridge & Iron Company N.V. v. Westinghouse Electric Company LLC:* Delaware Supreme Court Reverses Trial Court Decision Construing Post-Purchase Adjustment Provision

In *Chicago Bridge & Iron Company N.V. v. Westinghouse Electric Company LLC,* 166 A.3d 912 (Del. 2017), the Delaware Supreme Court reversed the Delaware Court of Chancery's grant of judgment on the pleadings. The Court of Chancery had held that a dispute over a post-closing purchase price adjustment under the terms of a purchase agreement was to be submitted to and resolved by an independent auditor. On appeal, the Supreme Court reversed and held that the buyer could not use the purchase price adjustment dispute resolution mechanism to remedy the buyer's assertions that the seller's historical financial statements did not comply with generally accepted accounting principles ("GAAP"). The Supreme Court further held that the Court of Chancery should, among other things, enjoin the buyer from submitting (or continuing to pursue already submitted) claims before the auditor that were not based on changes in facts and circumstances between signing and closing.

In 2015, an acquisition vehicle controlled by Westinghouse Electric Company LLC (the buyer) purchased a subsidiary of Chicago Bridge & Iron Company N.V. (the seller). The purchase agreement between the parties provided for a purchase price of $0, subject to a post-closing purchase price adjustment (the "Closing Date Adjustment") and the potential for deferred future payments. The Closing Date Adjustment was to be tied to the difference between the contractually defined target net working capital amount of $1.174 billion and the net working capital amount as calculated by the parties in accordance with the terms of the agreement (the provisions governing the calculation of such amount, the "True Up").

Under the True Up, in advance of closing, the seller was required to prepare a closing payment statement containing a "good faith estimate" of the closing date purchase price. The closing payment statement was to be prepared in accordance with GAAP, applied on a consistent basis throughout the periods indicated in the purchase agreement and with the Agreed Principles (as such term was defined in the purchase agreement). The Agreed Principles similarly provided that the working capital would be determined in a manner "consistent with GAAP, consistently applied by [the subsidiary]" and, to the extent not inconsistent with the foregoing, "the past practices and accounting principles, methodologies and policies applied by [the subsidiary]." Three days before closing, the seller provided the buyer with a closing payment statement estimating net working capital as approximately $1.6 billion, exceeding the contractual target net working capital amount and suggesting that the buyer owed the seller $428 million.

After receiving the closing payment statement, the buyer chose to close the transaction. Under the terms of the purchase agreement, although the buyer could have refused to close the transaction if the seller had breached its representations and warranties (including its representation and warranty that its historical financial statements were prepared in accordance with GAAP), the purchase agreement provided that the seller would have no post-closing liability for any breach of representations and warranties and that none of the representations and warranties would survive closing (the "Liability Bar").

In connection with the True Up, following closing, the buyer was required to prepare a final closing statement containing the buyer's "good faith calculations" of the purchase price at closing. The buyer's closing statement estimated the net working capital amount at closing as negative $976,500,000, which suggested that the seller owed the buyer $2.15 billion. The difference between the closing statements stemmed from four changes that the buyer made to the seller's closing payment statement, including: (i) reducing an outstanding receivable identified on the subsidiary's balance sheet as "claim cost" by 30% based on the buyer's objection under GAAP to the seller's estimate of "100 percent collectability" of this receivable; (ii) adjusting the claim cost receivable by establishing a claim cost reserve and deducting the amount of the reserve; (iii) increasing by 30% the seller's estimate of the cost to complete the subsidiary's ongoing projects; and (iv) deducting a liability of $432 million relating to the seller's acquisition of the subsidiary that the buyer claimed was improperly omitted under GAAP.

Claiming that the buyer breached the terms of the purchase agreement and the implied covenant of good faith and fair dealing in its calculation of the Closing Date Adjustment, the seller argued that the purchase agreement's terms precluded the buyer from "making any adjustments to items that appeared on the Company's balance sheet or adding liabilities with the avowed goal of complying with GAAP." The seller further argued that the buyer's claims were actually claims for breaches of representations and warranties that had been extinguished at closing. In response, the buyer argued that it did not give up its right to raise issues of GAAP compliance when calculating the Closing Date Adjustment, and that in any event, the purchase agreement required the parties to submit their dispute to an independent auditor. Under the purchase agreement, the "determinations of the Independent Auditor were 'final, conclusive, binding, non-appealable and incontestable by the parties ... for any reason other than manifest error or fraud.'"

In rejecting the Court of Chancery's reading of the True Up as providing the buyer "a wide-ranging, uncabined right to challenge any accounting principle used by [the seller], however consistent that principle was with the ones used in the financial statements represented to be GAAP compliant," the Supreme Court stressed that the purchase agreement must be read together in its entirety. Viewed in its entirety, the Supreme Court found that the True Up "is an important, but narrow, subordinate, and cabined remedy available to address any developments affecting [the subsidiary's] working capital that occurred in the period between signing and closing." A contrary holding, the Supreme Court explained, failed to give adequate weight to the structure of the purchase agreement, including, without limitation, the Liability Bar. ◆




# Appraisal Actions and Proceedings

***Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd.; DFC Global Corp. v. Muirfield Value Partners, L.P.; ACP Master, Ltd. v. Sprint Corp; In re Appraisal of SWS Group, Inc.; In re Appraisal of PetSmart, Inc.:*** Developments in Statutory Appraisal

The Delaware courts have decided a number of statutory appraisal cases recently. Most prominently, the Delaware Supreme Court reversed two post-trial appraisal decisions of the Court of Chancery, in *DFC Global Corp. v. Muirfield Value Partners, L.P.,* 172 A.3d 346 (Del. 2017), and *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd.,* 2017 WL 6375829 (Del. Dec. 14, 2017). The Court of Chancery in *In re Appraisal of PetSmart, Inc.,* 2017 WL 2303599 (Del. Ch. May 26, 2017), determined that a transaction price generated through an arm's-length auction process was reliable evidence of fair value and declined to place any weight on the parties' competing discounted cash flow analyses. And in two recent decisions, *In re Appraisal of SWS Group, Inc.,* 2017 WL 2334852 (Del. Ch. May 30, 2017), and *ACP Master, Ltd. v. Sprint Corp.,* 2017 WL 3421142 (Del. Ch. July 21, 2017), the Court of Chancery declined to rely on transaction price, but used a discounted cash flow analysis to reach valuation conclusions below the transaction price.

In *DFC Global,* the Court of Chancery had opined that, while the transaction was arm's length and subject to a robust pre-signing market check, significant regulatory uncertainty undermined the reliability of the corporation's cash flow forecasts (and hence of a valuation based on discounting those forecast cash flows), but also undermined the reliability of the transaction price and of a multiples-based valuation as indicators of fair value. The trial court had therefore placed equal weighting on transaction price, a discounted cash flow valuation that was above the deal price, and a comparable companies valuation that was below the deal price. *See In re Appraisal of DFC Global Corp.,* 2016 WL 3753123 (Del. Ch. July 8, 2016).

On appeal, the Delaware Supreme Court reversed. Although the Supreme Court declined to establish a presumption in favor of the transaction price, it rejected the premise that the future uncertainty that rendered the cash flow forecasts unreliable also vitiated the transaction price and the multiples analysis as indicators of fair value. The Supreme Court also rejected the thesis, referenced in the trial court's opinion, that the transaction price may have been unreliable because the buyer, a private equity firm, determined the price it was willing to pay by reference to achieving an internal rate of return and reaching a deal within its financing constraints; the Supreme Court held that a buyer's focus on its internal rate of return has "no rational connection to whether the price it pays as a result of a competitive process is a fair one." The Supreme Court concluded that the trial court had not adequately explained, in light of the record and the economic literature, the basis for its decision to assign equal weight to the three measures of value, and remanded for further proceedings.

Similarly, in *Dell,* the trial court had declined to place mathematical weight on the transaction price in a management-led buyout in which a special committee had elected to conduct a limited pre-signing market check followed by a post-signing go-shop process. *See In re Appraisal of Dell Inc.,* 2016 WL 3186538 (Del. Ch. May 31, 2016). The trial court determined that the process included "sufficient pricing anomalies and dis-incentive to bid ... to create the possibility that the sale process permitted an undervaluation of several dollars per share." The trial court therefore placed exclusive weight on a discounted cash flow valuation that resulted in an appraisal value approximately 28% above the deal price. The trial court also focused on the fact that the private equity group that had participated in the buyout along with the company's founder, Michael Dell, had determined its bid based in part on a leveraged buyout model, and that, at the value returned by the Court's discounted cash flow valuation model, the internal rate of return under the LBO model would have been unacceptably low, and the corporation would not have been able to support the necessary levels of leverage.

On appeal, the Delaware Supreme Court reversed, holding that "the reasoning behind the trial court's decision to give no weight to any market-based measure of fair value runs counter to its own factual findings." The Supreme Court rejected the thesis that the corporation was obliged to show that the sale process is "the most reliable evidence of its going concern value in order for the resulting deal price to be granted any weight." Rather, the Supreme Court wrote, the fact that the corporation attracted no bidders at the price determined by the trial court "is not a sign that the asset is stronger than believed—it is a sign that it is weaker." The Supreme Court identified numerous factors suggesting that the transaction process was well designed to capture the highest available price for the company, and stated that those factors "suggest strong reliance upon the deal price and far less weight, if any, on the DCF analysis." The Supreme Court remanded, with the instruction that the trial court was at liberty to enter judgment at the deal price with no further proceedings or to follow another route, potentially including a weighing of multiple factors with an explanation "based on reasoning that is consistent with the record and with relevant, accepted financial principles."

**The Supreme Court identified numerous factors suggesting that the transaction process was well designed to capture the highest available price for the company, and stated that those factors "suggest strong reliance upon the deal price and far less weight, if any, on the DCF analysis."**

The Court of Chancery's *PetSmart* decision, released several months before the Supreme Court's decisions in *DFC Global* and *Dell,* sounded many of the same themes. In that case, the Court concluded that the petitioners had not carried "their burden of persuasion that a DCF analysis provides a reliable measure of fair value" on the facts of the case, due in large part to the speculative nature of the projections involved. Rather, the Court determined that the corporation had established that the merger "was the result of a proper transactional process comprised of a robust pre-signing auction in which adequately informed bidders were given every incentive to make their best offer in the midst of a well-functioning market." In reaching that conclusion, the Court rejected the argument, also raised in *DFC Global* and *Dell,* that a buyer's use of the leveraged buyout model to determine its offer price implied that the offer price would "rarely if ever produce fair value because the model is built to allow the funds to realize a certain rate of return that will always leave some portion of the company's going concern value unrealized." The Court finally noted that the petitioners' valuation contention, based on a discounted cash flow model that valued the company at a 55% premium to deal price, "would be tantamount to declaring that a massive market failure occurred here that caused PetSmart to leave nearly $4.5 billion on the table." Concluding that the transaction price was a reliable indicator of fair value under the circumstances of the case, the Court entered judgment at the $83 per share deal price, which judgment was not appealed by the petitioners.

Finally, in two cases decided in mid-2017, the Court of Chancery relied exclusively on discounted cash flow analyses to find appraised values below deal prices. Both cases, *SWS Group* and *Sprint,* involved purchasers with significant degrees of control over the sale process; SWS was sold to a substantial creditor that possessed a contractual right to block competing bids, and the target company in the *Sprint* case, Clearwire Corporation, was sold to its majority stockholder. Hence, neither case involved a claim that the Court should determine that the transaction price was the fair value for appraisal purposes. Both transactions included significant synergistic elements. Appeals to the Delaware Supreme Court are pending in both cases. ◆

## ***Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd.:*** Delaware Supreme Court Reverses *Dell* Appraisal Decision, Remands for Consideration of Market Data and Deal Price

In *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd.,* 2017 WL 6375829 (Del. Dec. 14, 2017), the Delaware Supreme Court reversed and remanded the Court of Chancery's appraisal valuation of Dell Inc. and remanded for reconsideration in light of market data and the transaction price following a robust sale process.

In its post-trial decision, the Court of Chancery had determined, based exclusively on its own discounted cash flow analysis, that the fair value of Dell Inc., at the time of its October 2013 going-private transaction, was $17.62 per share, or approximately 28% above the $13.75 per share transaction price. *See In re Appraisal of Dell Inc.,* 2016 WL 3186538 (Del. Ch. May 31, 2016). Dell appealed, contending that the trial court improperly declined to consider the deal price and made several errors in its discounted cash flow valuation.

**"The issue in an appraisal is not whether a negotiator has extracted the highest possible bid. Rather, the key inquiry is whether the dissenters got fair value and were not exploited."**

The Delaware Supreme Court wrote: "[W]e agree with the Company's core premise that, on this particular record, the trial court erred in not assigning any mathematical weight to the deal price. In fact, the record as distilled by the trial court suggests that the deal price deserved heavy, if not dispositive weight." The Supreme Court identified and rejected three premises on which the trial court had relied in deciding to assign no weight to the transaction price.

First, the trial court had concluded that there had been a "valuation gap" between the trading price of Dell's stock and the intrinsic value, leading the trial court to believe that the bidding during the sale process had been anchored at an artificially low value. The Supreme Court rejected this premise, emphasizing that Dell's stock was widely traded in a liquid and efficient market and that the company had been transparent about its long-term plans.

Second, the trial court had focused on the absence of strategic (as opposed to financial) bidders during the pre-signing market check. Following its ruling in *DFC Global Corp. v. Muirfield Value Partners,* 172 A.3d 346 (Del. 2017), the Supreme Court wrote that it saw "'no rational connection' between a buyer's status as a financial sponsor and the question of whether the deal price is a fair price." The Supreme Court emphasized that "Dell's sale process bore many of the same objective indicia of reliability that we found persuasive enough to diminish the resonance of any private equity carve out or similar such theory in *DFC*."

Third, the trial court had credited expert testimony to the effect that management-led buyouts tend to suffer from structural problems, such as the "winner's curse" and the perceived value of management to the company, that undercut the reliability of the deal price as evidence of fair value. The Supreme Court held that "none of these theoretical characteristics detracts from the reliability of the deal price on the facts presented here." With regard specifically to the "winner's curse," the Supreme Court wrote: "If a deal price is at a level where the next upward move by a topping bidder has a material risk of being a self-destructive curse, that suggests the price is already at a level that is fair. The issue in an appraisal is not whether a negotiator has extracted the highest possible bid. Rather, the key inquiry is whether the dissenters got fair value and were not exploited."

The Supreme Court concluded that the market-based indicators of value, including both stock price and deal price, had "substantial probative value." The Court also emphasized that Dell's sale process had "adopt[ed] many mechanisms designed to minimize conflict and ensure stockholders obtain the highest possible value," and noted that if a company's reward for adopting "best practices" in deal structuring is to be exposed to the risk of appraisal at a premium to deal price based on a discounted cash flow analysis, the incentives to adopt "best practices" will diminish.

The Supreme Court therefore reversed the Court of Chancery's valuation determination and remanded for further proceedings. ◆

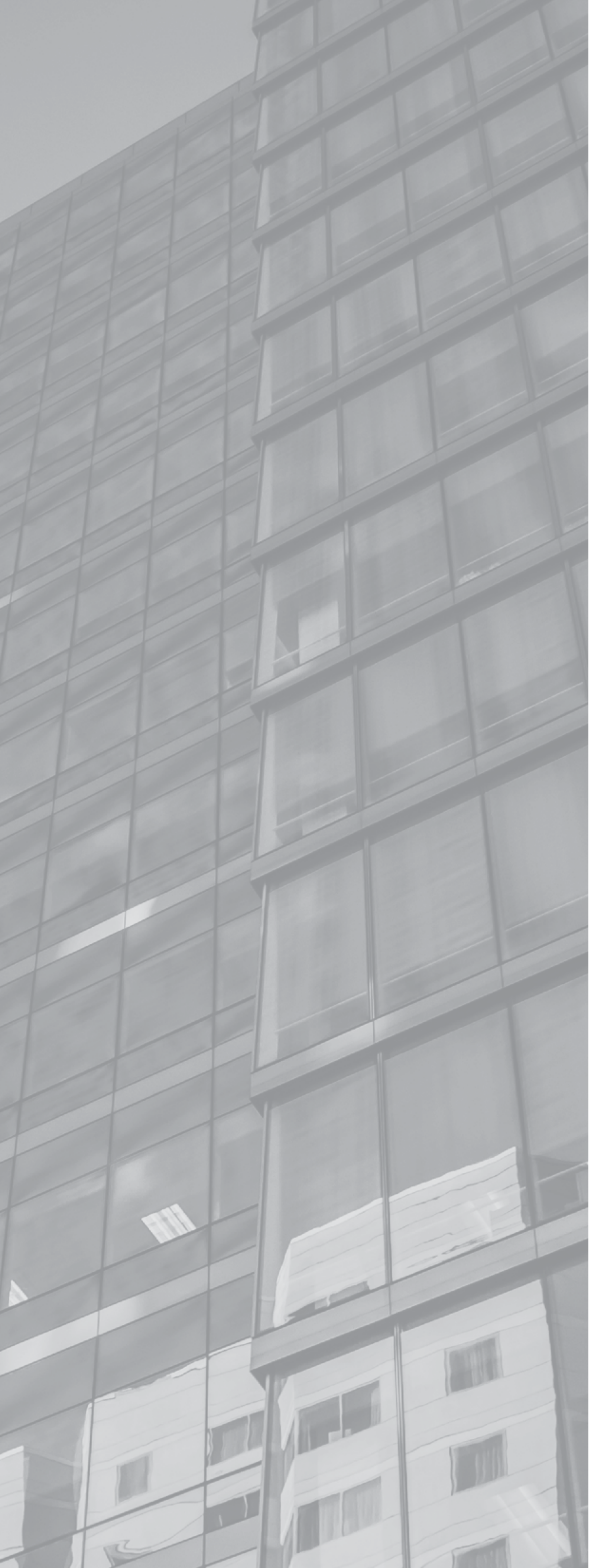
## Section 205 Actions

### ***Nguyen v. View, Inc.:*** The Court of Chancery Discusses the Contours of Ratification of Defective Corporate Acts under Section 204

In *Nguyen v. View, Inc.,* 2017 WL 2439074 (Del. Ch. June 6, 2017), the Delaware Court of Chancery held in a proceeding brought under Section 205 of the DGCL that Section 204 of the DGCL may not be used to ratify a "deliberately unauthorized corporate act" in order to "undo a stockholder vote rejecting a transaction proposed by the company's board of directors."

In *View,* the founder of View, Inc. challenged the ratification of several rounds of financings in which View had raised an aggregate of approximately $500 million. Prior to the first round of such financings (the "Series B Financing"), the founder held approximately 70% of View's outstanding common stock and was entitled to certain representation rights on View's board of directors. In connection with the Series B Financing, View's governance documents were to be amended to, among other things, eliminate such representation rights and enable the company to increase or decrease the number of authorized shares of common stock without a separate class vote of the holders of common stock.

The negotiation of the Series B Financing coincided with the deterioration of the founder's relationship with View. The founder's employment with View was terminated, and he was removed from View's board of directors. The founder challenged those actions,



and thereafter the parties negotiated and entered into a settlement agreement. At View's insistence, the settlement agreement included the founder's consent to the Series B Financing. The settlement agreement also provided that either View or the founder could rescind the agreement within seven days of its execution.

**Section 204 may not be used to ratify a deliberately unauthorized corporate act in order to undo a stockholder vote rejecting a transaction.**

Following the execution of the settlement agreement but before the seven-day revocation period had expired, View consummated the Series B Financing. Subsequently, the founder revoked the settlement agreement within the revocation period, and the parties agreed to submit their claims relating to the revocation to arbitration. While the arbitration was pending, View proceeded to consummate a series of additional financing rounds. The arbitrator then issued a decision finding that the founder had properly revoked the settlement agreement, including his consent to the Series B Financing, and that the Series B Financing was void and invalid. Due to the invalidity of the Series B Financing, the subsequent financings were also effectively invalidated.

After the arbitrator's decision, View acted under Section 204 to ratify each of the financings. In connection with the ratification, the holders of View's Series A preferred stock converted their shares into common stock, which resulted in their holding a majority in voting power of the outstanding common stock at the time of the ratification. The conversion of the Series A preferred stock also eliminated View's need to obtain the founder's consent to authorize the ratification of the financings under Section 204. Following the ratification, the founder filed suit under Section 205 of the DGCL challenging the ratification.

Addressing whether to grant View's motion to dismiss, the Court of Chancery noted that it must first determine whether the Series B Financing and the subsequent financings constituted defective corporate acts that were eligible for ratification under Section 204. In framing the issue, the Court stated that it "must consider whether an act that the majority of stockholders entitled to vote deliberately declined to authorize, but that the corporation nevertheless determined to pursue, may be deemed a 'defective corporate act' under Section 204 that is subject to later validation by ratification of the stockholders." Noting that the issue was one of first impression, the Court considered the plain language of the statute and the legislative synopsis, and wrote that Section 204 is a remedial statute that requires the action that is the subject of the ratification to be an action that was within the corporation's power at the time that the act was purportedly taken.

In considering whether View had the power to consummate the Series B Financing and the subsequent financing rounds, the Court did not limit its consideration to whether the act taken was an act within the power of corporations generally under subchapter II of the DGCL, such as the power to issue one or more classes of stock. Rather, the Court also considered whether, at the time the acts were initially taken, View had the power to take the actions under its operative governing documents in light of the composition of its stockholder base. In this regard, the Court noted that View's "operative reality" at the time of the Series B Financing and the subsequent financings was that the founder, as the holder of a majority in voting power of the outstanding common stock at such times, was required to consent to the Series B Financing and the subsequent financings. Consequently, the Court concluded that View did not have the corporate power to consummate the Series B Financing or the subsequent financings without the consent of the founder, which consent had been revoked.

In finding that the Series B Financing and the subsequent financings were not defective corporate acts subject to ratification under Section 204, the Court explained that the validity of the Series B Financing was not called into question by a "failure of authorization," but rather "the classic exercise of the stockholder franchise to say 'no' to a Board-endorsed proposal." In making such distinction, the Court stated that "[t]he plain meaning of 'failure' in [the context of Section 204] is distinct from a 'no' vote or outright rejection of the proposal by a majority of the stockholders entitled to vote." Thus, because the Series B Financing was deliberately rejected by the founder (as opposed to as a result of View's failure to comply with the DGCL or its organizational documents), the Court held that the Series B Financing was not an act that was subject to ratification under Section 204. To hold otherwise, the Court noted, would "allow a corporation to ratify an act that stockholders years earlier had expressly voted not to take and to certify that act as effective on the date the stockholders rejected it," a result that the Court noted was clearly not intended by the Delaware General Assembly in adopting Section 204. ◆

# Stock Option Plans

## *In re Investors Bancorp, Inc. S'holder Litig.:* Stockholder Ratification of Equity Incentive Plan Does Not Foreclose Fiduciary Review of Discretionary Grants under the Plan

In *In re Investors Bancorp, Inc. S'holder Litig.*, 2017 WL 6374741 (Del. Dec. 13, 2017, *revised* Dec. 19, 2017), the Delaware Supreme Court recently considered "the limits of the stockholder ratification defense" in actions challenging directors' compensation where stockholders have approved the compensation plan, and the Court provided guidance regarding when that defense may apply based on the level of discretion retained by the directors under the plan. Reversing the trial court, the Court held that "when stockholders have approved an equity incentive plan that gives the directors discretion to grant themselves awards within general parameters, [and a plaintiff properly challenges the exercise of that discretion] ... then the ratification defense is unavailable to dismiss the suit."

Investors Bancorp, Inc. is a bank holding company that operates 143 branches in New Jersey and New York. In

2014, Bancorp's compensation committee approved cash-based compensation for the non-employee directors which ranged from $97,200 to $207,055 per director. In 2015, the board approved similar cash compensation. Shortly thereafter, the board approved

> **"When stockholders have approved an equity incentive plan that gives the directors discretion to grant themselves awards within general parameters, ... then the ratification defense is unavailable to dismiss the suit."**

an equity incentive plan (the "2015 EIP"), described to stockholders as designed to incentivize future growth and performance. The 2015 EIP reserved up to 30% of equity awards for the board's non-employee directors. Bancorp's proxy noted that the "number, types and terms of awards to be made pursuant to the [2015 EIP] are subject to the discretion of the [compensation committee] ... and will not be determined until subsequent to stockholder approval." The stockholders approved the 2015 EIP.

The board later awarded the non-employee directors equity compensation worth a total of $21,594,000. According to the plaintiffs, this compensation was both backward-looking (i.e., a reward for past service rather than to incentivize future performance) and significantly higher than comparable, or even much larger non-comparable, companies' director compensation. In 2015, the CEO and CFO also received increased salaries, bonuses, and significant equity awards.

The trial court, relying on a line of cases focusing on whether the compensation plan had "meaningful, specific limits on awards to all director beneficiaries," dismissed the action. The Supreme Court reversed, noting that directors are allowed by statute to set their compensation but that such action is a "self-interested" decision. The Court noted that the ratification defense has been recognized in three instances: (i) when stockholders approve specific director awards, (ii) when the plan is self-executing and the directors retain no discretion over the awards, and (iii) when directors exercise discretion over the amount and terms of the awards after stockholder approval.

Focusing on the third instance, the Court held that "when it comes to the discretion directors exercise following stockholder approval of an equity incentive plan, ratification cannot be used to foreclose" judicial review "when a breach of fiduciary duty claim has been properly alleged." The Court explained that such discretion can be granted "precisely because [stockholders] know that authority must be exercised consistently with equitable principles." In other words, an inequitable exercise of discretion does not become permissible merely because the equity awarded is within certain parameters of discretion granted by the plan. The Court held that the complaint raised a pleading stage inference that the board's compensation was excessive and unfair, and the board must demonstrate its fairness. ◆

## ***In re Investors Bancorp, Inc. Stockholder Litigation:*** Stockholder Ratification of Equity Compensation Package

In *In re Investors Bancorp, Inc. Stockholder Litigation,* 2017 WL 1277672 (Del. Ch. Apr. 5, 2017), the Court of Chancery granted the defendants' motion to dismiss claims challenging the adoption of an equity compensation plan by the board of directors of Investors Bancorp, Inc. The Court held that because the plan contained discrete limits with respect to director equity awards, the ratifying effect of approval of the plan by a fully informed stockholder vote extended to individual awards made pursuant to the plan.

Bancorp was created in December 2013 through a "mutual-to-stock" reorganization transaction of a two-tier mutual holding company bearing the same name. Following the reorganization, the surviving company's board was comprised of 12 directors, including 10 non-employee directors, the chief executive officer, and the chief operating officer.

Seven of the ten non-employee directors served on the compensation committee of the board, which was charged with making recommendations to the board concerning director compensation. On December 15, 2014, the compensation committee met to set compensation for the upcoming year. The committee recommended the board maintain the existing compensation arrangements for non-employee directors and maintain the base salaries of the chief executive officer and chief operating officer, but increase the cash incentive component of their compensation packages.

On March 24, 2015, the board approved Bancorp's 2015 Equity Incentive Plan, which reserved approximately 31 million shares for various types of equity-based awards for the company's officers, employees, non-employee directors, and service providers. Within that ceiling, the plan limited the number of shares of each type that could be issued and the number of shares Bancorp could award to any one employee or director, as well as the maximum percentage of total shares available to be awarded that could be issued to non-employee directors in the aggregate.

The plan was submitted to stockholders at Bancorp's 2015 annual meeting. Over 96% of the shares voted at the meeting—representing nearly 80% of the total shares then outstanding—voted to approve the plan. The proxy statement for the annual meeting disclosed the purpose and limits of awards pursuant to the plan. The proxy statement also disclosed that the number, type, and terms of any specific awards to be made pursuant to the plan would remain subject to the compensation committee's discretion and would not be determined until after stockholder approval of the plan.

On June 23, 2015, based on the compensation committee's post-approval recommendations, the board approved equity incentive awards to the non-employee and employee directors that had an aggregate fair value as of the grant date of approximately $51.5 million. Bancorp announced the equity awards in a proxy statement issued on April 14, 2016. Three complaints were filed shortly thereafter and were soon consolidated.

In reviewing the plaintiffs' claims in respect of the non-employee director grants, the Court presumed that, because every member of the board who made the decision to grant the awards received a special benefit from the decision, "entire fairness [would be] the default standard of review." To overcome the entire fairness standard, the defendants needed to establish that the stockholders' approval of the plan had the effect of ratifying the awards, in which case the board's decision would be subject to the presumption of the business judgment rule.

**To overcome the entire fairness standard, defendants needed to establish that the stockholders' approval of the plan had the effect of ratifying the awards, in which case the board's decision would be subject to the business judgment rule.**

The plaintiffs raised three principal arguments in response to the affirmative defense of ratification. First, the plaintiffs claimed that the awards were not ratifiable because the plan lacked a "self-executing" feature (i.e., one that would provide for fixed amounts of awards to the non-employee directors with no board discretion to increase or enhance such awards) or "meaningful limits" on the amount of awards. Second, the plaintiffs claimed that the board could have sought stockholder approval of the specific grants, but failed to do so. Finally, the plaintiffs claimed that the stockholder ratification was ineffective because the stockholder vote was not fully informed.

The Court concluded that the plan was not so broad as to preclude ratification. The Court rejected the plaintiffs' attempt to analogize the plan to the equity incentive plan that was reviewed under entire fairness in *Calma v. Templeton,* 2015 WL 1951930 (Del. Ch.

Apr. 30, 2015), in which the Court had concluded that the stockholders' adoption of the "broad parameters" of a plan that covered multiple beneficiaries and had no specific limits on the magnitude of awards to non-employee directors was insufficient to ratify subsequent grants to the non-employee directors. Rather, the Court determined that the fact that the plan was a company-wide "omnibus stock plan," as opposed to a director-specific plan, was not dispositive. Analogizing to the Court's decision in *In re 3COM Shareholders Litigation,* 2009 WL 5173804 (Del. Ch. Dec. 18, 2009), the Court determined that the "key point is the specific focus on the limit or limits imposed on awards to various beneficiaries of the plan." The Court found that the board, in seeking stockholder approval of the plan, had not sought a "blank check" on awards to directors; instead, the stockholders were advised when approving the plan of the maximum number of shares of each type of award available, limits pertaining to non-employee and executive directors, and the magnitude of the potential awards board members could make to themselves when approving the plan.

As the grants to the non-employee directors were made within the confines of the specific limits indicated by the stockholder-approved plan, the board's decision to make the grants was reviewable only for waste, which the plaintiffs had not pled. Accordingly, the Court dismissed the plaintiffs' claims challenging the non-employee director grants.

The Court separately rejected the plaintiffs' disclosure-based claims, holding that demand on the board was not excused in respect of the specific grants of equity compensation to the executive officer defendants in the absence of facts indicating that the executive officers would not have supported the awards to non-employee directors had their own awards not been approved, and because the votes of the executive officers were not required for approval of the plan.

On appeal, the Delaware Supreme Court reversed the Court of Chancery's opinion, holding that the stockholder ratification defense was not available under the circumstances because the incentive plan at issue was discretionary, was not self-effectuating, and did not place meaningful limits on the directors' authority to grant awards, and the individual award grants were not approved by the stockholders. Thus, while stockholder approval gave the directors the legal authority to grant awards, decisions made by the directors to make grants under the incentive plan remained subject to equitable review under the entire fairness standard. ◆

# Multi-Forum Litigation

## ***California State Teachers' Retirement System v. Alvarez:*** Delaware Supreme Court Finds Dismissal of Derivative Action for Failure to Plead Demand Futility Has Preclusive Effect on Other Derivative Plaintiffs

In *California State Teachers' Retirement System v. Alvarez,* 2018 WL 547768 (Del. Jan. 25, 2018), the Delaware Supreme Court declined to adopt a proposed rule from the Court of Chancery that, as a matter of due process, a judgment in a derivative action cannot bind a corporation or other stockholders until the suit has survived a motion to dismiss for failure to plead demand futility. In doing so, the Supreme Court confirmed that, generally, the dismissal of a shareholder derivative action for failure to plead demand futility precludes other derivative actions brought in other jurisdictions as long as the plaintiff in the dismissed case adequately represented the corporation's interests.

In April 2012, *The New York Times* reported on an alleged bribery scheme and subsequent cover-up by executives of a Wal-Mart subsidiary. Derivative lawsuits asserting claims for breach of fiduciary duty against Wal-Mart's officers and directors were filed in Arkansas federal court and in the Delaware Court of Chancery. The Delaware plaintiffs made a books and records demand pursuant to Section 220 of the DGCL, while the plaintiffs in the Arkansas litigation did not make a similar demand, relying solely on publicly available information, including internal Wal-Mart corporate memos referenced in a news article.

While litigation relating to the Delaware plaintiffs' Section 220 demand was pending, Wal-Mart moved to dismiss the Arkansas action under Federal Rule of Civil Procedure 23.1, arguing that the Arkansas plaintiffs had failed to plead sufficiently that demand on Wal-Mart's board of directors would have been futile. The Arkansas court granted the motion to dismiss, and Wal-Mart moved to dismiss in Delaware on the grounds that the decision by the Arkansas court had a preclusive effect on the issue of demand futility. The Delaware Court of Chancery agreed, applying Arkansas preclusion principles and dismissing the Delaware action.

Following the Court of Chancery's original decision, the Delaware plaintiffs appealed to the Delaware Supreme Court. The Supreme Court issued an order in January 2017 in which it did not disagree with the Court of Chancery's dismissal, but expressed concern over the due process implications. The Supreme Court remanded the action to the Court of Chancery to determine whether "the subsequent stockholders' Due Process rights [had] been violated" by the dismissal of the Arkansas action on demand futility grounds. *See Cal. State Teachers' Ret. Sys. v. Alvarez,* 2017 WL 6421389 (Del. Jan. 18, 2017) (TABLE).

**A subsequent derivative plaintiff's due process rights were protected, and dismissal based on issue preclusion was appropriate where the plaintiff's "interests were aligned with and were adequately represented by the prior plaintiffs."**

On remand, the Court of Chancery recommended that the Supreme Court adopt a rule that derivative litigation does not have a preclusive effect against stockholders in another derivative action "until the [first] action has survived a Rule 23.1 motion to dismiss, or the board of directors has given the plaintiff authority to proceed by declining to oppose the suit." *See In re Wal-Mart Stores, Inc. Del. Deriv. Litig.,* 167 A.3d 513 (Del. Ch. 2017).

The Supreme Court declined to adopt the Court of Chancery's recommendation, and instead affirmed the Court of Chancery's original dismissal of the Delaware action on preclusion grounds. The Supreme Court observed that three federal Courts of Appeals had arrived at the same conclusion—a subsequent derivative plaintiff's due process rights were protected, and dismissal based on issue preclusion was appropriate where the plaintiff's "interests were aligned with and were adequately represented by the prior plaintiffs."

Applying that test, the Supreme Court found that, under the Arkansas privity test—which is satisfied "when two parties are so identified with one another that they represent the same legal right"—the Arkansas and the Delaware plaintiffs stood in privity. The Supreme Court reasoned that even where there are multiple pending derivative actions, the derivative plaintiffs "seek to control the corporation's cause of action" and therefore stand in privity to one another. The Supreme Court rejected the plaintiffs' argument that the dual-phase nature of a derivative action, as first a suit seeking authority to pursue the corporation's claim and then a suit to recover on behalf of the corporation, transformed the first step of a derivative action into an individual claim by the shareholder, which (plaintiffs argued) caused a stockholder-plaintiff who fails to reach the second phase not to be in privity with other stockholders seeking to assert the same claim.

Turning to the due process analysis, the Supreme Court applied the test outlined in Restatement (Second) of Judgments, under which a prior representation would be considered inadequate only where (i) the prior litigation was conducted in a "grossly deficient" manner, or (ii) the first-filed plaintiffs had a conflict of interest that caused them to pursue the litigation at the expense of later-filed plaintiffs. The Supreme Court found that neither prong of that test was present. First, while the Supreme Court recognized that the Arkansas plaintiffs may have made a "tactical error" by not pursuing a books and records demand prior to filing a derivative action, such a decision was considered and one upon which "[r]easonable litigants can differ" in the context of this litigation. Second, the Delaware plaintiffs made no showing that the Arkansas plaintiffs' interests were adverse to those of Wal-Mart, and therefore the Supreme Court found no conflict of interest that would render the Arkansas representation inadequate. ◆

# Dividends, Repurchases, and Redemptions

## ***The Frederick Hsu Living Trust v. ODN Holding Corp.:*** Court of Chancery Addresses the Legality and Equity of Preferred Stock Redemption

In *The Frederick Hsu Living Trust v. ODN Holding Corp.*, 2017 WL 1437308 (Del. Ch. Apr. 25, 2017), the Court of Chancery dismissed claims of unlawful redemption of preferred stock by ODN Holding Corporation, but denied a motion to dismiss claims that ODN's directors and officers improperly favored the interest of the company's controlling stockholder in connection with ODN's redemption of preferred stock to the detriment of the long-term interests of the company's stockholders.

In 2008, funds sponsored by venture capital firm Oak Hill Capital Partners invested $150 million in internet technology company Oversee.net, which formed ODN as a holding company to facilitate the investment. Oak Hill received shares of Series A Preferred Stock from ODN in return for its investment. The terms of the preferred stock included a mandatory redemption right after five years—provided that ODN had sufficient surplus, calculated in accordance with Section 160 of the DGCL, and "funds legally available" to effect the redemptions. ODN had an obligation to generate funds for redemptions through "'reasonable actions (as determined by [ODN's] Board of Directors in good faith and consistent with its fiduciary duties).'"

The plaintiff alleged that, beginning in 2011, Oak Hill caused ODN to shift from a growth-oriented strategy to a single-minded focus on amassing cash reserves that could be used for redemptions, beginning with selling two of the company's four lines of business for a third of the price it had paid for them. By the end of 2012, ODN had accumulated a $50 million reserve. Shortly before Oak Hill's redemption rights became exercisable, ODN appointed a special committee tasked with evaluating the company's options for raising capital and negotiating the terms of any redemptions. In turn, the special committee tasked three ODN officers with creating a proposal for Oak Hill. The officers, whose employment agreements granted them special payments if ODN redeemed at least $75 million of the preferred stock, advised the special committee that ODN required a cash reserve of only $10 million. They proposed that ODN use the remaining $40 million of accumulated cash and borrow an additional $35 million in order to redeem $75 million worth of the preferred stock, conditioned upon Oak Hill's agreement not to seek redemption of the rest of its preferred stock until 2017. This proposal was unacceptable to Oak Hill, and ODN and Oak Hill were unable to reach an agreement before the redemption right matured.

On February 1, 2013, Oak Hill informed the special committee that it intended to exercise its redemption right on February 13, the earliest possible date. Knowing that ODN did not have sufficient funds to redeem the preferred stock in full, Oak Hill proposed that ODN make a redemption payment of $45 million. In exchange for this payment, Oak Hill would agree to delay additional redemption payments until year-end 2013, but would have the right to cancel the forbearance agreement and demand additional redemptions on 30 days' notice. Despite the fact that Oak Hill had no ability to compel ODN to make redemptions except out of legally available funds, the accrual of which was subject to the board's business judgment, the special committee resolved to recommend that the board accept Oak Hill's terms. The special committee realized that redeeming $45 million would leave ODN with a reserve of only $5 million, but the officers had revised their assessment of the necessary cash reserve down to $2 million.

On February 13, 2013, Oak Hill demanded redemption in full. ODN reclassified Oak Hill's preferred stock as a current liability on its balance sheet in the amount of $150 million in accordance with GAAP. When the board met to consider Oak Hill's redemption demand on February 27, 2013, however, it did not treat the preferred stock as a current liability, which would have resulted in ODN having a deficit of $60 million and being unable to redeem any of the preferred stock. The board instead concluded that ODN had sufficient surplus as required by Section 160 of the DGCL to redeem $45 million of preferred stock. ODN made the $45 million payment to Oak Hill on March 18, 2013. Over the next year and a half, ODN implemented a restructuring and sold all but two segments of its business, and used the funds generated by these actions to complete a second redemption of $40 million in September 2014. The aggregate $85 million in redemption payments triggered the officers' bonuses.

**The Court rejected the claim that ODN's contractual obligation to Oak Hill superseded the directors' fiduciary duty to the stockholders, writing that "[e]ven with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach."**

On March 15, 2016, the plaintiff sued, alleging that ODN unlawfully redeemed the preferred stock and that by deliberately selling 92% of the income-generating assets of ODN to amass enough cash to effect the redemptions, various defendants breached their duty of loyalty, aided and abetted those breaches, or were unjustly enriched.

The Court rejected the claim that the redemptions violated Section 160 of the DGCL. Notwithstanding ODN's GAAP-driven reclassification of the preferred stock as a current liability, the Court determined that

the company had sufficient surplus at the time of the redemption. The Court explained that Delaware law treats preferred stock as equity rather than debt, and even a matured redemption right does not convert the holder of preferred stock into a creditor. The Court also held that the complaint failed to plead facts supporting a reasonable inference that the company would become insolvent as a result of the redemptions, noting that ODN still had $23 million in net assets following the redemptions and a reduced need for cash given its reduced operational footprint.

However, the Court denied the motion to dismiss the claims of breach of fiduciary duty, except as to one director who had resigned in 2011. The Court allowed claims to proceed against the directors (including Oak Hill's designees on the board, who had abstained from the votes to redeem Oak Hill's preferred stock), the officers, and Oak Hill itself (both as controlling stockholder and as an alleged aider and abettor).

The Court discussed at length the interplay between the directors' fiduciary obligations—which generally oblige them to strive to maximize value for the benefit of residual claimants, and do not oblige them to protect preferred stockholders' special contractual rights—with ODN's contractual obligation to "take all reasonable actions (as determined by the [ODN] Board of Directors in good faith and consistent with its fiduciary duties)" to generate sufficient legally available funds to redeem the preferred stock. The Court rejected the claim that ODN's contractual obligation to Oak Hill superseded the directors' fiduciary duty to the stockholders, writing that "[e]ven with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach." The Court observed that the plaintiff alleged that the directors acted disloyally by selling off ODN's businesses to raise cash to satisfy a future redemption obligation before any contractual obligation to redeem Oak Hill's preferred stock existed, an allegation that was strengthened by the fact that the redemption provisions contained a fiduciary out to the board's obligation to raise funds to pay for the redemption.

The Court also discussed the standard of review applicable to a transaction involving a controlling stockholder. Noting that the complaint alleged that Oak Hill exercised control over several of the challenged decisions and that the members of the special committee were subject to well-pled allegations of breach of the duty of loyalty, the Court determined that the use of a special committee, without a separate majority-of-the-minority stockholder vote, would not suffice to reduce the standard of review from entire fairness to business judgment. The Court further held that the allegations of misconduct against the special committee members were sufficient to preclude the Court from determining at the pleading stage that the use of the special committee shifted the burden of proof under the entire fairness standard from the defendants to the plaintiffs. ◆

## Controlling Stockholder Issues

### ***IRA Trust FBO Bobbie Ahmed on Behalf of Class A Stockholders of NRG Yield, Inc. v. Crane:*** Court of Chancery Suggests Dual Class Reclassification Confers Unique Benefit on Controller

In *IRA Trust FBO Bobbie Ahmed on Behalf of Class A Stockholders of NRG Yield, Inc. v. Crane,* 2017 WL 6335912 (Del. Ch. Dec. 11, 2017, *revised* Jan. 26, 2018), the Court of Chancery granted the defendants' motion to dismiss breach of fiduciary duty claims against NRG Energy, Inc. ("NRG"), the controlling stockholder of NRG Yield, Inc. ("Yield"), and the Yield directors in connection with a reclassification of Yield's shares. While the Court found that the plaintiff adequately pled that the reclassification was a conflicted transaction and the entire fairness standard would apply, it ultimately held that the transaction met the requirements for application of the business judgment rule under *Kahn v. M&F Worldwide,* 88 A.3d 635 (Del. 2014) ("MFW"), and dismissed the case.

NRG, a power company, incorporated Yield as a dividend-growth-oriented company to serve as the primary vehicle through which NRG would own, operate, and acquire energy generation and infrastructure assets. Under a Management Services Agreement, NRG provided Yield management and other services. NRG also always appointed Yield's senior management, and Yield depended on NRG as a source for income-producing assets. NRG took Yield public in 2013, after which Yield had two classes of voting stock—Class A and Class B—each of which was entitled one vote per share. Through its ownership of Yield's Class B shares, which were never offered to the public, NRG held approximately 65% of Yield's voting power at the time of the IPO. Public stockholders represented the remaining 35% through their ownership of Class A shares.

Yield's business model required the continual acquisition of new income-producing assets, which Yield often acquired through new issuances of Class A shares. Because the Class A and Class B shares had equal voting rights at the time of the IPO, the post-IPO issuances of Class A shares diluted NRG's voting control over Yield to 55% by the autumn of 2014. To stem the dilution of its voting control, NRG proposed that Yield undertake a recapitalization pursuant to which Yield would issue new Class C non-voting common stock to the holders of Class A shares on a *pro rata* basis, and gain the ability to finance future acquisitions with non-voting Class C stock. NRG conditioned the proposal on obtaining approval of a majority of the minority of Yield's public stockholders.

After negotiation between Yield's conflicts committee (composed of independent directors) and NRG, the parties agreed that Yield would create two new classes of stock, Class C and Class D, each with 1/100 vote per share, which were distributed *pro rata* to holders of then outstanding Class A and Class B shares, respectively, through a stock split (the "Reclassification"). NRG also agreed to make certain additional assets of NRG subject to a right of first offer ("ROFO") in favor of Yield. On May 5, 2015, the Reclassification was approved by a majority of the Class A and Class B stockholders, voting together, as well as a majority of the Class A stockholders unaffiliated with NRG.

The Court determined that three key questions needed to be answered to resolve the motion to dismiss: Is the Reclassification subject to entire fairness review even though it involved a *pro rata* distribution of shares? If entire fairness did apply, should the analytical framework articulated in *MFW* (a squeeze-out merger case) apply to the Reclassification? If *MFW* does apply, have defendants satisfied that framework on the face of the pleadings?

As to the first issue, the Court, agreeing with the plaintiffs, found that at the pleading stage, the complaint had adequately alleged that NRG received a "uniquely valuable or 'non-ratable'" benefit in the Reclassification not shared with Yield's other stockholders, i.e., the ability to retain its majority voting control of Yield. Thus, the Reclassification would be viewed as a conflicted controller transaction presumptively subject to entire fairness review.

As to the second issue, the Court found that the transaction's procedural protections—including the independent conflicts committee and majority-of-the-minority approval condition—warranted application of the business judgment rule under *MFW*. Citing other recent Court of Chancery decisions in which the

**NRG received a uniquely valuable benefit in the Reclassification not shared with Yield's other stockholders: the ability to retain its majority voting control of Yield.**

*MFW* protections were applied to transactions other than a squeeze-out merger (e.g., *EZCORP,* where the Court endorsed applying the *MFW* framework to any conflicted controller transaction, and *Martha Stewart,* which applied *MFW* to challenged side deals with the controlling stockholder), the Court found there was no principled basis not to apply *MFW* to the Reclassification.

Finally, the Court rejected the plaintiff's "only serious challenge" to application of the *MFW* framework—the assertion that the stockholder vote was inadequately informed. The Court concluded that the proxy disclosed all material information and that the defendants had not misled stockholders concerning, and/or were not required to disclose, (i) all possible alternatives to the Reclassification, (ii) the impact of the new ROFO assets on Yield's cash available for distribution, (iii) the fact that the conflicts committee's financial advisor did not analyze the "potential value transfer" to NRG as a result of the Reclassification, (iv) the hypothetical scenario whereby NRG's ownership could fall below 50.1% by 2015, (v) whether the issuance of Class C stock was a "sunset provision" on NRG's control, and (vi) the financial advisor's fee.

As a result, because *MFW* applied and the plaintiff had "made no effort to overcome" the business judgment rule, the Court granted the defendants' motion to dismiss. ◆

## Proxy Contests

### ***Sarissa Capital Domestic Fund LP v. Innoviva, Inc.:*** Court of Chancery Enforces Oral Contract to Settle Proxy Fight by Requiring Seating of Two Insurgent Directors

In *Sarissa Capital Domestic Fund LP v. Innoviva, Inc.*, 2017 WL 6209597 (Del. Ch. Dec. 8, 2017), the Delaware Court of Chancery, in a fact-intensive, post-trial memorandum opinion, specifically enforced an oral agreement to settle a proxy contest between Innoviva, Inc. and Sarissa Capital Domestic Fund LP. In so doing, the Court ordered Innoviva to expand the size of its board of directors and seat two of Sarissa's director nominees.

In early 2017, Sarissa launched a proxy contest with the goal of electing three directors to the board at Innoviva's annual meeting of stockholders. Innoviva's proxy solicitor advised Innoviva that the outcome of the proxy contest would likely depend on the votes of two key undecided stockholders: Vanguard Group, Inc., which was expected to side with the incumbents, and BlackRock, Inc., which was expected to vote for Sarissa's slate.

With the outcome of the election still in doubt two days before the scheduled annual meeting, James Tyree, Innoviva's then vice chairman, and Alexander Denner, Sarissa's chief investment officer, engaged in settlement discussions on behalf of their respective principals. The two camps were in basic agreement that the proxy contest could be settled if Innoviva agreed to seat two of Sarissa's proposed directors, but negotiations broke down because Sarissa was not willing to enter into a standstill agreement preventing it from acquiring more Innoviva shares or engaging in another proxy contest in the future.

The day before the annual meeting, Innoviva learned that Vanguard had voted for Sarissa's slate and, as a result, Sarissa would prevail in the proxy contest if BlackRock also voted for Sarissa's slate, as expected. Now facing likely defeat, the board determined to drop the standstill requirement if Sarissa would agree to include a conciliatory quote in a joint press release announcing the settlement. The board authorized Tyree to convey the revised settlement offer to Denner. In anticipation that the revised offer would likely be accepted, the board adopted resolutions conditionally resolving to expand the size of the board and fill the resulting newly created directorships with two of Sarissa's nominees.

After the board meeting, Tyree made the revised settlement offer to Denner, as instructed. Denner quickly accepted the proposal, given that the key sticking point from Sarissa's perspective—the standstill—had been resolved in Sarissa's favor. At the end of the call, both Tyree and Denner confirmed that they "had a deal" and that they would leave it to their respective teams to finalize the paperwork. However, neither party indicated that the settlement was contingent upon execution of a written settlement agreement or that it was subject to further approval of the board. Thereafter, counsel for the respective parties worked to finalize a written settlement agreement memorializing the terms agreed to by Tyree and Denner during the call. The parties also exchanged comments on, but did not finalize, the press release.

> **Given the extreme time pressure the parties were under in the hours leading up to the meeting, the Court concluded that a reasonable negotiator would have expected that the oral settlement agreement was binding and enforceable.**

Before the settlement agreement was executed by the parties, BlackRock unexpectedly voted in favor of Innoviva's slate. With complete victory in the election now assured, Innoviva ceased all settlement discussions with Sarissa and elected to proceed with the annual meeting the next day without executing the settlement agreement. Innoviva held the annual meeting as scheduled, and all of Innoviva's nominees were elected. That same day, Sarissa filed a verified complaint pursuant to Section 225 of the DGCL with the Court to enforce the oral settlement agreement reached the day before.

The Court held a one-day trial to determine whether the parties had entered into a valid, enforceable settlement agreement. The Court's post-trial opinion resolved three primary issues disputed by the parties: (i) whether Tyree had authority to bind Innoviva to an oral settlement agreement, (ii) whether the discussion between Tyree and Denner on the day prior to the annual meeting was sufficient to create a binding oral settlement agreement, and (iii) whether the oral settlement agreement should be specifically enforced.

The Court concluded that a single director is capable of binding a corporation to a contract provided that the director has actual or apparent authority to do so. The Court held that Tyree had actual authority because, among other things, the board had appointed him as the lead negotiator in settlement discussions with Sarissa and authorized him to convey the final settlement agreement terms. Tyree also had apparent authority because, among other things, Denner reasonably believed that Tyree was Innoviva's sole negotiator and was authorized to bind Innoviva to the settlement agreement based on their prior negotiations and his conduct during the settlement discussions. The Court also rejected an argument that, under Sections 141 and 223 of the DGCL and Innoviva's bylaws, the board had impermissibly delegated its authority with respect to the settlement (and the filling of the newly created board seats) to Tyree because the full board had in fact approved the very same settlement terms that Tyree had conveyed to Denner and taken preliminary steps at the key board meeting to implement the terms of the settlement.

The Court also found that Tyree and Denner had in fact formed a binding oral contract during the settlement discussion because the parties had reached a meeting of the minds on all of the key terms to the settlement, and there was no indication by either party that the agreement would only be effective upon the execution of a written agreement. The Court reasoned that merely expressing or manifesting intent to prepare a written memorial of an oral agreement does not prevent contract formation absent a positive agreement that it should not be binding until reduced to writing and formally executed. Given the extreme time pressure the parties were operating under in the hours leading up to the annual meeting, the Court concluded that a reasonable negotiator would have expected that the oral settlement agreement was binding and enforceable.

Finally, the Court concluded that Sarissa was entitled to specific performance of the oral settlement agreement, finding that the balance of equities favored granting specific performance because "Innoviva's opportunistic maneuvers to escape its contractual obligations offend[ed] basic notions of equity." Accordingly, the Court entered an order of specific performance requiring Innoviva to expand the size of the board and seat two of Sarissa's director nominees. ◆

# LIMITED LIABILITY COMPANIES AND PARTNERSHIPS

## ***Dieckman v. Regency GP LP:*** Delaware Supreme Court Invokes Implied Covenant of Good Faith and Fair Dealing to Reverse Court of Chancery's Dismissal of Lawsuit Challenging MLP Conflict of Interest Transaction

In the latest in a series of decisions addressing conflict of interest transactions involving Delaware limited partnerships, the Delaware Supreme Court confirmed in *Dieckman v. Regency GP LP,* 155 A.3d 358 (Del. 2017), that although Delaware courts will enforce clear, express, and unambiguous language modifying or eliminating default fiduciary duties, a conflict of interest transaction may still run afoul of implied contractual standards.

In *Dieckman,* the transaction at issue involved a merger of Regency Energy Partners LP, a publicly traded Delaware limited partnership (the "MLP"), with an affiliated entity. To reconcile this inherent conflict of interest, the general partner of the MLP attempted to satisfy two safe harbor mechanisms enumerated in the partnership agreement, either of which could be used to insulate the transaction from legal challenge—"Special Approval" by the independent conflicts committee and "Unaffiliated Unitholder Approval." The plaintiff, a common unitholder of the MLP, alleged that (i) the general partner failed to satisfy the Special Approval safe harbor because there was a conflicted member on the conflicts committee, and (ii) the general partner failed to satisfy the Unaffiliated Unitholder Approval safe harbor because the general partner made false and misleading statements in a proxy statement to secure such approval. The Court of Chancery, while not reaching the defendants' Special Approval defense, found that the Unaffiliated Unitholder Approval safe harbor had been satisfied because (i) the partnership agreement had eliminated all fiduciary duties, including the duty of disclosure, and (ii) the disclosures expressly required by the partnership agreement had been made. The Court of Chancery therefore granted the defendants' motion to dismiss.

On appeal, the Delaware Supreme Court noted that even when a partnership agreement waives fiduciary duties, investors of publicly traded partnerships still have protections afforded to them through principles of *contra proferentem* (ambiguities are construed against the drafter to give effect to the reasonable expectations of the investors) and the implied covenant of good faith and fair dealing. The Supreme Court focused on the safe harbor process in its entirety and found that the language in the partnership agreement's conflict resolution provision implicitly required the general partner to act in a manner that would not undermine the protections afforded to the unitholders in connection with the safe harbor process.

**Although contractual flexibility afforded to Delaware limited partnerships provides general partners with significant protections, general partners must still comply with implied contractual responsibilities in the partnership agreement.**

In analyzing the Unaffiliated Unitholder Approval defense, the Supreme Court noted that the general partner had issued a comprehensive proxy statement, which went far beyond the minimal disclosures required by the express terms of the partnership agreement, to induce the unitholders to approve the merger transaction. The Supreme Court held that once the general partner determined to go beyond the minimal disclosure requirements under the partnership agreement, then—pursuant to the implied covenant of good faith and fair dealing—the general partner had an obligation not to mislead investors. The Supreme Court found that the plaintiff pled facts raising sufficient doubt concerning whether the proxy statement misled investors by creating the false appearance that the conflicts committee, which had approved the transaction, was composed solely of unaffiliated and independent persons.

In analyzing the Special Approval defense, the Supreme Court found the general partner had an obligation to form a conflicts committee as set forth in the partnership agreement, which required committee members to be independent from and unaffiliated with the general partner. The plaintiff alleged the general partner created a two-member committee that included an individual who began reviewing the merger transaction while still a member of an affiliate board, which is not consistent with the independent status of the conflicts committee members as required by the partnership agreement. The Supreme Court concluded that the plaintiff had raised sufficient doubt as to whether the conflicts committee was properly constituted, which would call into question whether the general partner could utilize the safe harbor provisions under the partnership agreement to preclude judicial review of the merger transaction.

The *Dieckman* decision is a reminder that although contractual flexibility afforded to Delaware limited partnerships can be used to provide general partners with significant protections, general partners must still comply with implied contractual responsibilities in the partnership agreement. ◆

## ***In re Energy Transfer Equity L.P. Unitholder Litig.:*** Court of Chancery Rules Full Factual Record Is Needed to Determine Whether Offering of Convertible Units Constitutes an Issuance or a Distribution

In *In re Energy Transfer Equity L.P. Unitholder Litig.*, 2017 WL 782495 (Del. Ch. Feb. 28, 2017), the Delaware Court of Chancery considered whether an issuance of convertible units by Energy Transfer Equity, L.P. ("ETE"), a Delaware limited partnership, constituted an impermissible non *pro rata* distribution under the terms of the ETE partnership agreement (the "ETE Agreement"). The general partner of ETE authorized the issuance of convertible units to some, but not all, unitholders of ETE, in return for which the unitholders gave up common units of ETE. The plaintiffs were common unitholders of ETE who were not offered the opportunity to acquire any of the convertible units that were issued. The plaintiffs challenged the purported issuance on the basis that it constituted a distribution and, as such, was made in violation of the requirement in the ETE Agreement that "distributions" be provided *pro rata* to all unitholders.

In authorizing the issuance, ETE relied on Section 5.8(a) of the ETE Agreement, which permitted ETE to "issue additional Partnership Securities and options, rights, warrants and appreciation rights relating to the Partnership Securities for any Partnership purpose at any time and from time to time to such Persons for such consideration and on such terms and conditions as the General Partner shall determine, all without the approval of any Limited Partners." The ETE Agreement provided an overarching "good faith" requirement whereby the board, or the party acting, must "believe that the determination or other action is in the best interests of the Partnership."

The plaintiffs argued that the issuance was a distribution of value to favored unitholders and thus amounted to an improper distribution of ETE's assets. ETE argued that the issuance was an exchange for value, in connection with which ETE issued units. ETE further argued that an issuance of units, even if conflicted, was permitted under the ETE Agreement, so long as it was "fair and reasonable" to ETE. The plaintiffs defined a "distribution" as any transfer "to partners in their capacity as partners," and asserted that there was no requirement that the transfer occur without consideration. The plaintiffs further argued that a distribution "occurs when cash, Partnership Securities or other property of the Partnership is allocated among the Partners." Additionally, the plaintiffs argued that to the extent there was any ambiguity in the ETE Agreement, it should be construed against ETE.

ETE contended that "a 'distribution' is a disbursement of the partnership's assets to the partners by virtue of their status as equity holders." ETE asserted that a distribution is "akin to a corporate dividend" and "occurs when a partnership, without receiving anything in return, gives its assets or earnings to its partners by virtue of their status as equity holders." ETE argued that Section 7.6(f) of the ETE Agreement conflicts with the plaintiffs' definition of distribution. Such section provides that in the context of conflicted transactions, when assets are contributed "in exchange for Partnership Securities, the Conflicts Committee, in determining whether the appropriate number of Partnership Securities are being *issued,* may take into account" various factors.

The Court noted that no provision of the ETE Agreement defined issuance or distribution and that the Delaware Revised Uniform Limited Partnership Act also does not define the term "distribution." The Court therefore looked to the contextual use of the term "distribution" in the ETE Agreement and to everyday usage to supply a meaning. It noted that *Black's Law Dictionary* defines partnership distribution as "[a] partnership's payment of cash or property to a partner out of earnings or as an advance against future earnings, or a payment of the partners' capital in partial or complete liquidation of the partner's interest." The Court held that usage of the term "distribution" within the ETE Agreement appeared consistent with this dictionary definition. However, the Court ultimately declined to find as a matter of law on the record before it what "distribution" means in the context of the issuance of convertible units in return for common units. The Court held that the record was incomplete, or in dispute, on issues helpful to the analysis, including whether the issuance was a true exchange for value or simply a way to benefit favored unitholders. ♦

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## ***Brinckerhoff v. Enbridge Energy Co.:*** Delaware Supreme Court Holds Specific Requirements for Conflict of Interest Transactions Control over General Good Faith Standard in Related-Party Transaction

In *Brinckerhoff v. Enbridge Energy Co.,* 159 A.3d 242 (Del. 2017, *revised* Mar. 28, 2017), the Delaware Supreme Court reversed in part a decision of the Delaware Court of Chancery granting a motion to

dismiss the complaint and remanded the case for further proceedings. In 2009, Enbridge Energy Partners, L.P. ("EEP"), a master limited partnership, owned 100% of a proposed pipeline construction project. EEP subsequently entered into a joint venture agreement with its parent entity, Enbridge, Inc., pursuant to which EEP sold a two-thirds interest in the project to Enbridge for $800 million. In 2015, EEP repurchased the same exact interest in the project back from Enbridge for $1 billion. In connection with the repurchase, EEP's general partner ("EEP GP") also amended EEP's partnership agreement (the "EEP LPA") to effect a "special tax allocation" whereby the public investors in EEP were allocated items of gross income that would otherwise have been allocated to EEP GP, allowing EEP GP to avoid a large taxable gain on the transaction.

The plaintiff, a limited partner of EEP, filed suit challenging the repurchase transaction in the Court of Chancery, alleging, *inter alia,* breach of contract claims under the EEP LPA against EEP GP. The plaintiff claimed that (i) the terms of the repurchase were not "fair and reasonable" to EEP, as required by Section 6.6(e) of the EEP LPA, and (ii) the amendment to the EEP LPA implementing the special tax allocation violated prohibitions in the EEP LPA on effecting amendments that materially adversely affected EEP's limited partners or enlarged their obligations without their consent. The Court of Chancery, interpreting the EEP LPA to contain an overarching "good faith" standard applicable to EEP GP's actions under the EEP LPA, regardless of whether EEP GP had breached any specific provision of the agreement, held that the plaintiff had failed to adequately allege that EEP GP acted in bad faith in approving the transaction and dismissed the complaint.

On appeal, the Delaware Supreme Court held that the Court of Chancery had erred in determining that the general provision of the EEP LPA imposing a "good faith" standard of conduct on EEP GP modified the specific "fair and reasonable" standard applicable to affiliated transactions such as the transaction at issue here. The Court found that the plaintiff had stated a claim that EEP GP had breached its affirmative obligation to satisfy the "fair and reasonable" standard in connection with the repurchase transaction. This conclusion was based in large part on (i) the language in the EEP LPA providing that whether a transaction meets the "fair and reasonable" standard is to be considered in the context of "all similar or related transactions," (ii) the allegations that EEP paid $200 million more to repurchase the same exact assets it had sold a few years earlier at a lower price, (iii) the fact that this higher price for the same assets was paid despite declining earnings for the underlying assets and the declining state of oil prices in the interim, and (iv) the negative effects of the special tax allocations on the public investors.

**Because EEP paid more for the same assets only several years after the initial transaction, and in an environment with declining earnings and slumping oil prices, the Court determined that the plaintiff had carried his burden to plead bad faith.**

The Court found for the defendants, however, in holding that the special tax allocation did not breach the EEP LPA. In reaching this conclusion, the Court considered whether the special tax allocation, which increased the public investors' tax liability, could be considered to have "enlarged the obligations" of the affected limited partners. Noting that the article of the EEP LPA entitled "Tax Matters" did not use the term "obligations," the Court reviewed the ways in which the term was used in other provisions of the agreement and determined that the amendment restriction applied only to obligations of EEP's limited partners *to the partnership* under the EEP LPA and did not extend to obligations of the limited partners to others, including the amount of their tax liability to the government.

The Court next turned to potential remedies available to the plaintiff given that the EEP LPA exculpated EEP GP from monetary damages to EEP and its limited partners if it acted in good faith. In addressing this issue of good faith and bad faith, the Court noted that in one of its earlier opinions in the dispute, the Court had characterized the pleading standard for asserting bad faith to be similar to waste—namely, that the action or decision was so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith. Here, however, the Supreme Court walked back from the standard it had adopted in its earlier decision and instead used a more commonly used definition of bad faith. In applying this "new" standard, the Supreme Court determined that, to survive a motion to dismiss, the plaintiff had to allege facts to support the inference that the transaction was not fair and reasonable to the partnership. This conclusion, the Court held, was more faithful to the contractual language. The EEP LPA provided that a transaction would be deemed fair and reasonable if no less favorable to EEP than an arm's-length transaction. Because EEP paid approximately $200 million more for the same assets only several years after the initial transaction, and in an environment with declining earnings and slumping oil prices, the Court determined that the plaintiff had carried his burden to plead bad faith.

Finally, the Court addressed the question of whether, notwithstanding the foregoing, EEP GP was nonetheless entitled to a conclusive presumption of good faith by virtue of its reliance on the fairness opinion of EEP's financial advisor, as such presumption was set forth in a provision of the EEP LPA. The Court answered this question in the negative, holding that, since EEP's financial advisor had not been involved in valuing the interests being repurchased throughout the course of negotiations with respect to the transaction and instead had "appeared on the scene" to render its fairness opinion after the financial terms of the transaction had been determined, EEP GP had not "relied" upon the financial advisor in the manner contemplated by the provision in the EEP LPA setting forth the presumption of good faith. For all these reasons, the Supreme Court reversed and remanded to the Court of Chancery for further proceedings. ◆

## ***Morris v. Spectra Energy Partners (DE) GP, LP:*** Court of Chancery Denies Motion to Dismiss Despite Conflicts Committee Approval of Transaction

In *Morris v. Spectra Energy Partners (DE) GP, LP,* 2017 WL 2774559 (Del. Ch. June 27, 2017), a unitholder of a publicly traded limited partnership brought a derivative action for, *inter alia,* breach of contract against the general partner for allegedly engaging in a self-dealing transaction whereby the general partner received $1.5 billion of the partnership's assets in exchange for consideration ultimately valued between $950 million and $1.15 billion.

The plaintiff was a unitholder in Spectra Energy Partners, LP, a Delaware limited partnership ("Spectra"). Both Spectra and Spectra's general partner were ultimately controlled by Spectra Energy Corp. ("SE Corp"). SE Corp publicly announced it was entering into a 50/50 joint venture with a third party, in which SE Corp would contribute certain assets that were to be valued at $1.5 billion in order to match the $1.5 billion cash contribution being made by the third party. SE Corp, however, did not initially own the assets that it intended to contribute to the joint venture. Rather, these assets were owned by Spectra. Therefore, SE Corp first had to acquire the assets from Spectra.

SE Corp proposed to acquire the assets from Spectra in exchange for consideration consisting of unit redemptions, incentive distribution right give-backs, and reduced general partner distributions. Pursuant to the partnership agreement of Spectra, the general partner established a conflicts committee consisting of two independent directors. The conflicts committee retained a financial advisor. Negotiations ensued between the conflicts committee and SE Corp. The financial advisor—despite knowing that SE Corp planned to immediately contribute the assets to be acquired to the joint venture with an implied value of $1.5 billion and despite having initially valued the assets at $1.46 billion—ultimately provided a favorable opinion based on a value range for these assets between $950 million and $1.15 billion. Although the conflicts committee was able to gain some relatively minor increase in consideration, the conflicts committee eventually approved the sale of the assets to SE Corp for consideration valued at less than $1 billion.

The plaintiff challenged this transaction alleging, *inter alia,* that it was on patently unfair and unreasonable terms, given that Spectra had sold the assets for a half-billion dollars less than the implied and announced market value of such assets. The defendants sought to dismiss the complaint, relying on certain provisions of the Spectra partnership agreement. The Court noted that the partnership agreement had replaced common law fiduciary duties with the contractual standard requiring the Spectra general partner and the conflicts committee to act in good faith when taking actions with respect to Spectra. Although the partnership agreement also provided for a presumption that the general partner and the conflicts committee acted in good faith, this presumption was rebuttable. The partnership agreement also provided that the Spectra general partner may consult with experts and advisors selected by it, and any act taken by it in reliance upon an opinion of such expert or advisor is conclusively presumed to be done in good faith. The defendants argued that (i) the alleged $500 million valuation gap was illusory and not supported by the mechanics of the transaction, and (ii) even if a valuation gap did exist, the provisions of the partnership agreement required dismissal of the plaintiff's claims.

After analyzing the provisions of the partnership agreement, the Court concluded that the conclusive presumption of good faith based on reliance on an opinion of an advisor was a general provision that could not be read to supersede the more specific requirement requiring that the Spectra general partner and the conflicts committee act in good faith in the context of conflict of interest transactions. The Court also noted that given the relationship between the parties and their relative bargaining power, ambiguities in the partnership agreement should be resolved in favor of public unitholders, which further supported the Court's conclusion. The Court next concluded that the plaintiff had alleged enough at the pleading stage to overcome the rebuttable presumption of good faith with respect to actions taken by the conflicts committee. Namely, the Court stated that the $500 million shortfall in value between the consideration received by Spectra for the assets and the publicly stated value of the assets, and the fact that the conflicts committee was aware of this valuation disparity, gave rise to an inference of subjective bad faith. As a result, the Court held that the complaint pled facts upon which it could be determined that the general partner breached the partnership agreement by acting in subjective bad faith, and therefore denied the motion to dismiss as to this claim. ◆

## ***Obeid v. Hogan:*** Court of Chancery Addresses Authority to Delegate under Section 18-407 of the Delaware Limited Liability Company Act

In *Obeid v. Hogan,* 2016 WL 3356851 (Del. Ch. June 10, 2016), the Delaware Court of Chancery held that the board of directors of a board-managed Delaware limited liability company and the managers of a manager-managed Delaware limited liability company did not have the authority under the respective limited liability company agreements to delegate to a non-manager the power to act as a special litigation committee. Based primarily on the language of the limited liability company agreements, the Court found that, on the factual record before it, the "core governance function" of controlling litigation on behalf of the companies could be discharged only by the board (or a committee) of the board-managed company and by the managers (or a subset of managers) of the manager-managed company, notwithstanding the provisions of Section 18-407 of the Delaware Limited Liability Company Act (the "Act") providing members and managers broad authority to delegate managerial powers.

The dispute in *Obeid* arose out of a series of internal disputes involving the members and managers of Gemini Equity Partners, LLC, the board-managed company (the "Corporate LLC"), and Gemini Real Estate Advisors, LLC, the manager-managed company (the "Manager LLC"). The Corporate LLC and the Manager LLC had the same three members, William T. Obeid, Christopher S. La Mack, and Dante A. Massaro, each of whom initially served on the board of the Corporate LLC and as a manager of the Manager LLC. In 2014, La Mack and Massaro took action to remove Obeid from the board of the Corporate LLC and as operating manager (but not as a manager) of the Manager LLC. Shortly thereafter, Obeid filed claims against La Mack and Massaro, both directly and derivatively in the name of the companies, in the U.S. District Court for the Southern District of New York (the "NY Action"), alleging, among other things, usurpation of corporate opportunities and other breaches of fiduciary duty. In connection with the derivative claims, Obeid did not make a demand that the managers of the companies institute an action in the name of the companies, as he contended that, due to alleged conflicts of interest, demand would be futile. The Court found that the NY Action had proceeded beyond the stage at which La Mack and Massaro could contest Obeid's authority to assert such derivative claims.

**Corporate LLC's limited liability company agreement, by mirroring a corporate structure, imported the relevant principles of the DGCL restricting the delegation of the board's core governance functions to third parties.**

In August 2015, La Mack and Massaro, each acting as member-manager of the two companies, executed an engagement letter with Michael R. Hogan, a retired federal judge, with the apparent intent of delegating to him the powers of a special litigation committee for purposes of asserting control over the derivative litigation. Judge Hogan was not a member of either company, he was not appointed as a manager of either company, and there were no formal resolutions of either company establishing a special litigation committee or appointing Judge Hogan to that role. After Obeid learned of Judge Hogan's engagement, he filed suit in the Court of Chancery, seeking a declaration that Judge Hogan could not act as a special litigation committee for either company. Obeid also sought an injunction preventing Judge Hogan from taking any action on behalf of either company, including exerting influence or control over the derivative claims.

In addressing whether Judge Hogan had been duly vested with the authority of a special litigation committee, the Court reviewed the provisions of the limited liability company agreement of each of the Corporate LLC and the Manager LLC. The Court found that the Corporate LLC's limited liability company agreement was designed to recreate the governance structure of a Delaware corporation. Specifically, it provided that the business and affairs of the Corporate LLC would be managed by or under the direction of its board, using the same basic language found in Section 141(a) of the DGCL. Likewise, the Corporate LLC's limited liability company agreement, using language drawn primarily from Section 141(c) of the DGCL, provided that the board could delegate its powers to committees consisting solely of board members. The Court found that the presence of these provisions, among other features of the agreement embracing the governance structure of a Delaware corporation, counseled in favor of applying corporate-law analogies to guide the determination as to whether the Corporate LLC's board could validly delegate its powers to a non-director.

The Court noted that in *Zapata v. Maldonado,* 430 A.2d 779 (Del. 1981), the Delaware Supreme Court held that a committee of a board of directors retained the power to dismiss derivative litigation, subject to an inquiry into the independence and good faith of the directors and the determination that the recommendation falls within a range of reasonable outcomes. According to the *Obeid* Court, central to the *Zapata* Court's holding was the observation that, under Section 141(c) of the DGCL, a committee could exercise the power of the board of directors with respect to the litigation asset. The *Obeid* Court found that delegating such power to an officer or non-director would constitute an improper abdication of the board's authority.

In an effort to overcome the argument that the authority to control derivative litigation could only be delegated to a committee of directors, the Corporate LLC pointed to Section 18-407 of the Act, which provides, in relevant part, that "unless otherwise provided in the limited liability company agreement, a member or manager of a limited liability company has the power and authority to delegate to 1 or more other persons the member's or manager's ... rights and powers to manage and control the business and affairs of the limited liability company." The Court rejected the Corporate LLC's argument, observing that the "general default provision" regarding delegation did not overcome the specific provisions of the Act vesting the power to bring derivative suits in "managers or members" and finding, in any event, that by embracing a governance structure modelled after Sections 141(a) and 141(c) of the DGCL, the Corporate LLC's limited liability company agreement "provided otherwise" for purposes of Section 18-407 of the Act—that is, the Corporate LLC's limited liability company agreement, by mirroring a corporate structure, imported the relevant principles of the DGCL restricting the delegation of the board's core governance functions to third parties.

While noting that similar reasoning may likewise apply to the Manager LLC, as its limited liability company agreement also evidenced the governance features of a Delaware corporation (albeit to a lesser degree), the Court did not need to reach that issue, as it found a separate basis on which the Manager LLC's limited liability company agreement "provided otherwise" for purposes of Section 18-407 of the Act. The Court found that specific provisions of the Manager LLC's limited liability company agreement evidenced a distinction between matters relating to the ordinary course of business of the LLC and more significant matters vested solely in the managers. Because such provisions demonstrated the apparent intent of the drafters of Manager LLC's limited liability company agreement to limit the delegation of core functions to managers, the Court found that the power to control litigation could not be delegated to non-manager Judge Hogan.

The Court's opinion in *Obeid* confirms that Delaware courts may review the provisions of limited liability company agreements to determine the governance structure the parties intended and, absent other factors, may view that as evidence of an intent to have aspects of the entity law of similarly managed entities apply to the limited liability company. In drafting limited liability company agreements, transaction planners and their counsel should give careful consideration to the provisions authorizing or restricting the delegation of authority to various parties and whether the governance structure may impact the ability to delegate certain authority to third parties. ◆

# Recent Developments in Delaware Law

## 2017 Amendments to the Delaware General Corporation Law

Legislation amending the DGCL has been approved by the Delaware General Assembly and was signed by then Delaware Governor Jack Markell on July 21, 2017. The amendments amended the DGCL to, among other things, (i) provide statutory authority for the use of "blockchain" or "distributed ledger" technology for the administration of corporate records, (ii) dispense with the requirement that stockholder consents be individually dated, thereby eliminating a common "foot fault" for the validity of stockholder consents, (iii) update and harmonize the various provisions of the DGCL dealing with the authorization and accomplishment of mergers and consolidations involving different types and forms of entities, and (iv) make other clarifying technical changes.

All of the amendments (other than the amendments relating to stockholder action by written consent) became effective on August 1, 2017. The amendments relating to stockholder action by written consent are effective only for actions taken by consent having a record date, for purposes of determining the stockholders entitled to consent, on or after August 1, 2017.

### The "Blockchain" Amendments

Several sections of the DGCL were revised to accommodate the use of "blockchain" or "distributed ledger" technology for the maintenance of corporate records. In general, blockchain or distributed ledger technology allows for the creation of a ledger of transactions shared among a network of participants, rather than relying on a central source. It has been suggested that distributed ledger technology, which has a wide range of applications, is particularly well suited to the maintenance of a stock ledger, as it has the potential to facilitate the timely and accurate settlement of stock issuances and transfers.

The core blockchain amendments, involving Sections 219 and 224 of the DGCL, address the fact that a distributed ledger does not involve a central database. Section 219, which requires the corporation to prepare and make a list of its stockholders and specifies the evidentiary effect of the stock ledger, was revised to add a definition of the term "stock ledger." As amended, Section 219(c) defines "stock ledger" as "one or more records *administered by or on behalf of* the corporation in which the names of all of the corporation's stockholders of record, the address and number of shares registered in the name of each such stockholder, and all issuances and transfers of stock of the corporation are recorded in accordance with [Section 224 of the DGCL]."

Section 224, which previously provided that records "maintained" by the corporation may be kept on, by means of, or in the form of any information storage device or method, subject to specified requirements, was also updated to accommodate distributed ledger technology. As amended, Section 224 provides that any records *"administered by or on behalf of the corporation"* may be kept on, by means of, or in the form of, any information storage device or method, "or one or more electronic networks or databases (including one or more distributed electronic networks or databases)." Section 224 preserves the requirement that records so kept must be convertible into clearly legible paper form within a reasonable time. The amendments further provide, with respect to the stock ledger, that the records so maintained must be able to be used to prepare the list of stockholders specified in Section 219 as well as in Section 220 (which deals with stockholder demands to inspect the corporation's stock ledger, list of stockholders, and other books and records). In addition, such records must record the information specified in Section 156 (dealing with the amount of consideration for partly paid shares), Section 159 (relating to the transfer of shares for collateral security, and not absolutely), Section 217(a) (relating to the voting of shares subject to a pledge), and Section 218 (dealing with voting trusts). Finally, such records must record transfers of stock as governed by Article 8 of the Delaware Uniform Commercial Code.

In conjunction with the core blockchain amendments, Sections 151, 202, and 364 of the DGCL have been amended to clarify that the written notices required by those sections may be given by "electronic transmission." (The provision of notice by electronic transmission is governed by existing Section 232, subsection (c) of which defines "electronic transmission" as "any form of communication, not directly involving the physical transmission of paper, that creates a record that may be retained, retrieved and reviewed by a recipient thereof, and that may be directly reproduced in paper form by such a recipient through an automated process.") Section 151(f), which previously provided for delivery of written notice to holders of uncertificated stock of the information otherwise required to be set forth on a stock certificate under that section as well as Sections 156, 202(a), and 218(a), was updated to clarify that such notice may be given in writing *or by electronic transmission*. Corresponding changes were made to Section 202(a), which deals with notice of restrictions on transfer and ownership of securities, as well as Section 364, which deals with notices given by public benefit corporations.

While the 2017 amendments accommodate the use of distributed ledger technology, not all existing corporations that desire to adopt the technology will be able to administer their stock ledgers through such technology immediately and entirely. Corporations that have certificated stock, for example, will not be able to adopt the technology to administer their stock ledgers as long as their shares remain represented by certificates, as the transfer of certificated stock, under Article 8 of the Delaware Uniform Commercial Code, involves procedures inconsistent with the use of distributed ledger technology for such purposes. Moreover, although Section 158 of the DGCL allows the board of directors to provide by resolution that some or all of any or all classes or series of stock shall be uncertificated shares, it provides that "[a]ny such resolution shall not apply to shares represented by a certificate until such certificate is surrendered to the corporation." No amendments to Section 158 were made in connection with the 2017 blockchain amendments. Accordingly, corporations with certificated stock that desire to make use of distributed ledger technology to administer their stock ledgers must first take measures to provide that their stock is and shall be uncertificated.

## Stockholder Consents

Section 228 of the DGCL, which deals with stockholder action by consent in lieu of a meeting, was amended to dispense with the requirement that each consent bear the date of signature of the stockholder executing the consent. The amendment addresses the concerns stemming from *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129 (Del. Ch. 2003), where the Court of Chancery denied the defendants' motion to dismiss the plaintiff's challenges to the validity of stockholder consents, which challenges were based on the fact that the consents had a "preprinted" date but were not individually dated by the stockholders providing them. The *Wexford* Court explained that Section 228(c)'s instruction that every written consent *shall* bear the date of signature of each stockholder is a statutory mandate, thus requiring each consent to be individually dated to be valid. Issues arising out of the *Wexford* Court's opinion have called into question the validity of corporate actions taken in reliance on consents that were not signed and *dated* by stockholders representing a sufficient number of votes to take the action.

Section 228(c), as amended, continues to provide a 60-day period for the delivery of consents representing a sufficient number of votes to take the action; however, the amendments modified the provisions dealing with the commencement of such period. Section 228(c) previously provided that no written consent shall be effective to take corporate action unless, "within 60 days of the earliest dated consent delivered in the manner required by [Section 228]," written consents signed by a sufficient number of holders are delivered to the corporation. As amended, Section 228(c) provides that the 60-day period commences on the first date a consent is delivered to the corporation.

Consistent with the foregoing, the 2017 amendments eliminated from Section 228(c) the prior language providing that, where a stockholder has provided that its consent is to become effective at a later time (including a time determined upon the occurrence of an event), "such later effective time will serve as the date of signature." The 2017 amendments did not change the requirement that, where instructions are given or provision is made for a later effective time, the later effective time must occur within 60 days after the instruction is given or provision is made. The amendments also made technical conforming changes to Section 228(d)(1) to eliminate references to the "deemed" dates for electronic consents.

## Merger Amendments

The 2017 amendments revised the provisions of the DGCL dealing with the authorization and accomplishment of mergers and consolidations. Despite their length, the merger amendments were primarily technical and clarifying in nature. Most of the amendments were intended to provide consistency among the various sections of the DGCL governing mergers and consolidations, not to effect substantive changes.

First, Section 254 (dealing with mergers or consolidations of domestic corporations and joint stock or other associations), Section 263 (dealing with mergers or consolidations of domestic corporations and partnerships), and Section 264 (dealing with mergers or consolidations of domestic corporations and limited liability companies) were amended to expressly permit mergers and consolidations of Delaware corporations with joint stock or other associations, partnerships, and limited liability companies, respectively, formed or organized under the laws of a non-U.S. jurisdiction.

Second, the sections of the DGCL governing mergers or consolidations, as applicable, with non-Delaware entities (i.e., Sections 252, 253, 254, 256, 258, 263, 264, and 267) were amended to provide that such mergers or consolidations are permitted under Delaware law so long as the laws of the non-Delaware jurisdictions *do not prohibit* such mergers or consolidations. Previously, certain of those sections required that the laws of the other jurisdictions "permit" such mergers or consolidations, while others required that the other jurisdictions' laws not "forbid" them. The 2017 amendments help to ensure maximum flexibility with respect to mergers and consolidations with non-Delaware entities and provide for consistency among the applicable sections of the DGCL.

Third, minor technical amendments were made to Section 251 (dealing with mergers or consolidations of domestic corporations). Section 251 previously provided that any two or more corporations "existing under the laws of [the State of Delaware]" may merge or consolidate. The 2017 amendments eliminated the term "existing under the laws of this State," using instead the phrase "corporations of this State"; no substantive change was intended by the amendment. In addition, Section 251(b)(6), which deals with the treatment of fractional interests in a merger or consolidation, was amended to clarify and confirm the treatment of such interests, whether of the surviving corporation or of any other corporation or entity the shares, rights, or other securities of which are to be received in the merger or consolidation; similar changes dealing with fractional interests were made to the other applicable sections of the DGCL. Section 251(c) was also revised to make clear the distinction between the "surviving corporation" of a merger and the "resulting corporation" of a consolidation; similar amendments clarifying the distinction were made to the other applicable sections of the DGCL.

Fourth, Section 252 (dealing with mergers or consolidations of domestic and foreign corporations), Section 253 (dealing with short-form mergers involving corporations), Section 258 (dealing with mergers or consolidations of domestic and foreign stock and nonstock corporations), and Section 267 (dealing with short-form mergers involving a non-corporate parent entity) were amended to employ the use of the term "foreign corporation" as it is defined in Section 371(a) of the DGCL. (Section 371(a) defines a "foreign corporation" as a "corporation organized under the laws of any jurisdiction other than [the State of Delaware].") The amendments were generally designed to ensure that all such sections deal consistently with mergers or consolidations, as applicable, with a corporation organized under the laws of any jurisdiction other than the State of Delaware.

Fifth, Section 255 (dealing with mergers or consolidations of domestic nonstock corporations), Section 256 (dealing with mergers or consolidations of domestic and foreign nonstock corporations), and Section 257 (dealing with mergers or consolidations of domestic stock and nonstock corporations) were amended to clarify and confirm the manner in which memberships and membership interests in a nonstock corporation may be treated in a merger. In addition, pre-existing language in Section 257 dealing with the treatment of such interests was eliminated, as it was redundant of the new language. (The key amendments to Section 257 apply by reference, in the case of Delaware corporations, to Section 258, which deals with mergers or consolidations of domestic and foreign stock and nonstock corporations.)

Lastly, the 2017 amendments updated the applicable sections of the DGCL dealing with mergers and consolidations to adopt a consistent convention for the use of the terms "organized" and "formed" as they relate to constituent entities. Under the amendments, the term "organized" is used with respect to corporations and refers to the method by which a corporation is formed, incorporated, created, or otherwise comes into being under the laws governing its internal affairs, while the term "formed" is used with respect to entities other than corporations and includes the method by which any such entity is formed, created, or otherwise comes into being under the laws of the jurisdiction governing its internal affairs. (Both terms are used with respect to joint stock associations, as such associations may have attributes of being both "organized" and "formed," depending on the laws of the jurisdiction governing them.)

### Effective Time of Section 203 "Opt-Out"

Section 203 of the DGCL, which deals with restrictions on business combinations between a corporation and an "interested stockholder," was amended to clarify when an amendment to the certificate of incorporation or bylaws "opting out" of those restrictions becomes effective. Previously, Section 203(b)(3) provided that the restrictions shall not apply if "the corporation, by action of its stockholders, adopts an amendment to its certificate of incorporation or bylaws expressly electing not to be governed by [Section 203]." It then provided that any amendment so adopted would be "effective immediately" with respect to corporations that (i) have never had a class of voting stock listed on a national securities exchange or held of record by more than 2,000 holders, and (ii) have not elected through their certificate of incorporation (or any amendment thereto) to be governed by Section 203, and that, in all other cases, the amendment "shall not be effective until 12 months after the *adoption* of such amendment, and shall not apply to any business combination between such corporation and any person who became an interested stockholder of such corporation on or prior to such adoption."

The amendments to Section 203(b)(3) clarified that an amendment to the corporation's certificate of incorporation opting out of the restrictions on business combinations becomes effective at the date and time such amendment becomes effective under Section 103 of the DGCL (in the case of a corporation that has never had a class of voting stock listed on a national securities exchange or held of record by more than 2,000 stockholders and that has not elected through its original certificate of incorporation or any amendment thereto to be governed by Section 203) or 12 months after the effective date and time of such amendment (in the case of all other corporations), rather than the time at which the amendment is *adopted* by a vote of stockholders. In the latter scenario, the amendment electing not to be governed by Section 203 will not apply to any business combination between the corporation and any person who became an interested stockholder of the corporation before, in the case of an amendment to the certificate of incorporation, the date and time at which the certificate filed in accordance with Section 103 becomes effective or, in the case of an amendment to the bylaws, the date of the adoption of such amendment.

### Annual Reports

Section 374 of the DGCL was amended to streamline the annual reporting requirements for corporations formed in another jurisdiction and qualifying to do business in the State of Delaware. In addition, Section 502 of Title 8 of the Delaware Code was amended to clarify the information required to be disclosed in annual reports filed by Delaware corporations with the Secretary of State of the State of Delaware. ◆

## 2017 Amendments to Delaware's LLC and Partnership Acts

Legislation amending the Delaware Limited Liability Act (LLC Act), the Delaware Revised Uniform Limited Partnership Act (LP Act), and the Delaware Revised Uniform Partnership Act (GP Act) (collectively, the LLC and Partnership Acts) was approved by the Delaware General Assembly and signed into law by the Governor of Delaware. The following is a brief summary of some of the more significant amendments that became effective on August 1, 2017, and affect Delaware limited liability companies (Delaware LLCs), Delaware limited partnerships (Delaware LPs), and Delaware general partnerships (Delaware GPs).

### Broad Authority to Delegate Rights, Powers, and Duties

The LLC and Partnership Acts each contain a similar general default provision addressing the ability of members, managers, and partners to delegate managerial authority. In *Obeid v. Hogan,* 2016 WL 3356851 (Del. Ch. June 10, 2016), the Delaware Court of Chancery analyzed and discussed the general default provision addressing the delegation of managerial authority contained in Section 18-407 of the LLC Act. In light of this decision, the LLC and Partnership Acts were amended to confirm and clarify the broad power and authority of a member or manager of a Delaware LLC, a general partner of a Delaware LP, and a partner of a Delaware GP to delegate any or all of such member's, manager's, general partner's, or partner's rights, powers, and duties, including any core governance functions, to manage and control the business and affairs of a Delaware LLC, Delaware LP, or Delaware GP, as applicable.

### Participation in Control Safe Harbors Expanded

A key policy of the LP Act is the protection of limited partners of a Delaware LP from liability for the debts and obligations of the Delaware LP. Section 17-303 of the LP Act sets forth the statutory framework with respect to the liability of limited partners to third parties. Pursuant to Section 17-303(a) of the LP Act and except as otherwise provided in a partnership agreement, a limited partner of a Delaware LP is not liable for the debts and obligations of the Delaware LP unless (i) it is also a general partner of the Delaware LP, or (ii) in addition to the exercise of its rights and powers as a limited partner, it "participates in the control of the business" of the Delaware LP. If a limited partner does participate in the control of the business, it is liable only to persons who transact business with the Delaware LP reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.

Section 17-303(b) of the LP Act creates a fairly broad safe harbor from liability for limited partners of a Delaware LP by providing a non-exclusive list of activities that can be undertaken by a limited partner without such limited partner being deemed to be "participating in the control of the business" of a Delaware LP. Section 17-303(b)(1) of the LP Act was amended to confirm that limited partners of a Delaware LP may hold any type of interest in a general partner of a Delaware LP without being deemed to be participating in the control of the business of a Delaware LP within the meaning of the LP Act by virtue of such relationship.

### Substantial Compliance

Delaware LLCs and Delaware LPs are entities that must be formed in accordance with the requirements of the LLC Act or the LP Act. In addition to adopting a limited liability company agreement or a partnership agreement, as the case may be, in order to properly form a Delaware LLC or Delaware LP, an appropriately executed certificate of formation of a Delaware LLC or certificate of limited partnership of a Delaware LP containing the information required under the LLC Act or the LP Act must be filed in the office of the Secretary of State of the State of Delaware. The LLC Act and the LP Act provide that a Delaware LLC or Delaware LP is formed at the time the filing of the applicable certificate is effective if there has been "substantial compliance" with the requirements of Section 18-201 of the LLC Act or Section 17-201 of the LP Act, as applicable.

Section 18-201(a)(2) of the LLC Act and Section 17-201(a)(2) of the LP Act require that a certificate of formation of a Delaware LLC and a certificate of limited partnership of a Delaware LP identify (i) the address of the registered office of such Delaware LLC or Delaware LP in the State of Delaware, and (ii) the name and address of the registered agent for service of process on such Delaware LLC or Delaware LP in the State of Delaware. The LLC Act and the LP Act were amended to confirm and clarify that a certificate of formation of a Delaware LLC and a certificate of limited partnership of a Delaware LP substantially comply with the requirements set forth in the LLC Act and the LP Act if they contain the name of the registered agent and the address of the registered office, even if the applicable certificate does not expressly designate such person as the registered agent or such address as the registered office or the address of the registered agent.

These amendments reflect Delaware's continuing commitment to maintaining statutes governing Delaware LLCs, Delaware LPs, and Delaware GPs that effectively serve the business needs of the national and international business communities. The amendments to the LLC Act, the LP Act, and the GP Act are contained in Senate Bill Nos. 72, 71, and 70, respectively. ◆

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