2019 DELAWARE CORPORATE LAW AND LITIGATION YEAR IN REVIEW
In 2019, the Delaware courts issued a broad range of important decisions addressing various corporate law and governance issues—including board compensation, controlling stockholder conflicts, board oversight obligations, M&A structuring issues, director liability for unlawful dividends, and advance notice bylaws. The case law from 2019 is relevant for both public and private companies—particularly because Delaware law generally does not distinguish between the two—and will help shape decision-making by boards, members of management, and investors in 2020. We provide an overview of these decisions—and related themes and issues that we are observing in practice—in our 2019 Delaware Corporate Law and Litigation Year in Review.

Alongside of the ever-evolving body of Delaware law, the Delaware judiciary has also continued to undergo transformation. The Chief Justice of the Delaware Supreme Court, Leo E. Strine, Jr., retired in October 2019, Justice Collins J. Seitz, Jr. took his place as Chief Justice, and former Wilson Sonsini partner Tamika Montgomery-Reeves was appointed and confirmed as a Justice to the Supreme Court from the Delaware Court of Chancery, replacing Justice Seitz. In early January 2020, Delaware Governor John Carney announced the nomination of practitioner Paul A. Fioravanti, Jr. to the resulting open seat on the Delaware Court of Chancery, which consists of one Chancellor and six Vice Chancellors following an expansion of the Court in 2018. We will continue to monitor developments in the Delaware courts in the year ahead.

Attorneys from Wilson Sonsini’s corporate governance practice and Delaware office contributed to the content of the 2019 Delaware Corporate Law and Litigation Year in Review. Contributing authors and editors included Wilson Sonsini partners Amy Simmerman (Wilmington, DE), Brad Sorrels (Wilmington, DE), Ryan Greecher (Wilmington, DE), Lori Will (Wilmington, DE), David Berger (Palo Alto), and Katherine Henderson (San Francisco/New York). Also contributing to the report were attorneys Andy Cordo, Shannon German, Nate Emeritz, Sara Pollock, Adrian Broderick, and Brian Currie, all located in Wilmington, Delaware.

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Board Conflicts of Interest

Conflicts of interest in the boardroom have remained a common area of focus in stockholder litigation. Where half or more of a board has a conflict in a given decision—either because board members themselves are receiving special benefits in a transaction or are affiliated with or beholden to particular parties who benefit from a decision—the protections of the deferential business judgment rule generally fall away. Absent a cleansing mechanism, such as proper approval by an independent board committee, a reviewing court will apply the exacting “entire fairness” standard of review to evaluate such a decision, which scrutinizes whether the board’s process and the terms of the decision were fair. The underlying purpose of such review is to determine if board members—and often other named defendants, such as officers and investors—breached their fiduciary duty of loyalty, with plaintiffs frequently seeking monetary damages from the defendants. Private company directors are particularly vulnerable to loyalty claims because typically private company directors are not paid for their service and instead join the board because they (or funds they are affiliated with) are investors in the company or have some other relationship with the company. In 2019, the case law highlighted several different situations in which a board conflict may exist.

Board Compensation

Consistent with prior years, stockholder litigation activity relating to board compensation decisions continued in 2019. On May 31, 2019, the Delaware Court of Chancery issued a decision addressing a stockholder’s challenge to the compensation paid to the Goldman Sachs board of directors. The Court reiterated two premises from prior case law: 1) when directors award compensation to themselves, the decision is inherently conflicted, even if the directors are otherwise independent, and 2) the only certain way to avoid an entire fairness challenge in such a circumstance, at least where all the directors are conflicted, is to have stockholders approve the specific amounts of compensation at issue or self-effectuating formulas for the compensation, rather than ranges or upper limits that leave discretion to directors. Importantly, the Court emphasized that despite these rules, a plaintiff must plead facts showing why the compensation actually might have been unfair. The Court determined that the plaintiff had satisfied that requirement where the outside directors were paid $600,000 each per year—a amount that was nearly twice the company’s peer group, even though the company’s net income and revenue were below its peer group.

In addition to the Goldman Sachs case, some companies have continued to receive private stockholder demand letters relating to director compensation, and our firm represented two clients in settling director compensation lawsuits in the Court of Chancery in 2019.

Option Repricing

On June 13, 2019, the Court of Chancery issued an opinion refusing to dismiss a stockholder’s claims challenging a compensation committee’s decision to reprice options for board members and members of management. The plaintiff’s central factual allegation was that the compensation committee decided to lower the exercise price of the options after a patent had been issued to the company but before the company publicly announced the issuance and the market absorbed the information. The Court concluded, at least for purposes of a motion to dismiss, that where four of five board members, and both members of the compensation committee, benefited from the repricing, the claim that the board was conflicted and had misused corporate information could go forward.

Private Company Transactions

In many cases over the last several years, the Delaware courts have found that private company transactions—such as a financing round, a sale of the company, or a recapitalization—involves a board conflict, such that the entire fairness standard of review applied. The courts have generally examined certain recurring issues to determine if the board has a conflict: whether a board member, or an affiliated fund, participated in a transaction or received unique benefits in a transaction compared to other stockholders, particularly common stockholders; whether a board member is a member of management who received special benefits in the transaction (without necessarily considering the benefits the members of management would have received if the company remained independent) or is beholden to other board members; and whether a board member, even if not directly affiliated with a fund or a stockholder, has a close personal or business relationship with a fund or stockholder that is uniquely benefiting from a decision. Importantly, in many circumstances, the courts view the rights of preferred stockholders as contractual in nature and expect directors to prefer the interests of common stockholders where possible. Accordingly, where directors or their funds hold preferred stock and receive benefits to the detriment of common holders, a conflict could exist.

On October 11, 2019, the Court of Chancery issued a decision in a litigation of this kind. There, a private company sold substantially all of its assets, with the consideration flowing exclusively to the preferred equity holders and not
to the common. The Court refused to dismiss claims brought by the common holders, reasoning that of the six-member board, three directors were principals of a venture fund that held preferred equity, which had received all of the consideration in the sale, and one director was the company’s CEO who had received a $600,000 severance payment (equal to twice his salary) in connection with the sale. Given the board conflicts—and that the company had not used a curative measure such as an independent board committee—the Court applied the entire fairness standard. The Court of Chancery reached the same decision in another case from 2019 involving a sale of a company by way of a merger and similar conflicts.

### Controlling Stockholder Conflicts of Interest

Aside from boardroom conflicts, controlling stockholder conflicts are another common way for a stockholder to assert a disabling conflict of interest compromised a board’s decision. Where a company engages in a transaction with a controlling stockholder or a controlling stockholder receives unique benefits in a decision, there are two important implications for litigation. First, the stockholder with an allegedly controlling interest becomes subject to fiduciary duties applicable to certain actions affecting the company (even though stockholders typically owe no duties to the company or other stockholders). Second, the entire fairness standard of review, rather than the business judgment rule, generally applies to claims—again, with the plaintiff stockholder asserting a breach of the duty of loyalty against the defendants and often seeking monetary damages.

Given the potential implications, whether a controlling stockholder is present is a crucial issue. A stockholder can be found to possess control either where the stockholder owns a majority stake or where—at less than a majority stake—the stockholder exerts control over the company’s decision-making as a factual matter. For example, in one case the Delaware Court of Chancery found that two brothers who collectively held approximately 15 percent of a corporation’s outstanding shares were controlling stockholders, even though they were required to vote their shares in proportion to other stockholders. Of importance to the Court was that the brothers had caused the company to engage in a transaction with other affiliated companies that they controlled and that, of the four-person special board committee established to negotiate the transaction, half of the members did not behave independently of the brothers.

In another lawsuit, the Court found that a 22 percent stockholder was potentially a controller based on his outsize influence at the company, his close relationships to several board members, and the occurrence of sensitive board discussions in his presence.

Delaware law recognizes the concept that two or more stockholders can constitute a control group. In 2019, the Delaware Supreme Court concurred with prior Court of Chancery decisions concluding that in order for a control group to exist, stockholders must be connected in a “legally significant way,” beyond a mere concurrence of self-interest. Accordingly, the Supreme Court found that venture funds that held 60 percent of the company’s stock were not a control group simply because they had aligned interests from a functional standpoint, acted by written consent to approve a transaction, and were parties to a customary voting agreement that set forth their respective board designation rights.

In 2019, the Delaware courts continued to address the types of transactions and decisions that can involve a controlling stockholder conflict. For example, the Court of Chancery determined that a significant executive compensation package that a company granted to its CEO would be examined under the entire fairness standard of review, on the basis that the CEO might be found to be a controlling stockholder. In another case, the Court held that a package of transactions that a company entered into with its controlling stockholder—involving a waiver of lockups to which the controller had been bound so that the controller could participate in a large secondary offering, a large repurchase of the controller’s stock by the company, and a renegotiation of the company’s commercial arrangements with the controller—involved controlling stockholder conflicts.

### Measures for Addressing and Curing Conflicts of Interest

Given that conflicts of interest can generate lasting and protracted stockholder litigation, a natural question is precisely what companies can do to mitigate or neutralize such conflicts. The 2019 case law continued to provide guidance on this topic.

### The “MFW” Framework for Addressing Controlling Stockholder Conflicts

Where a controlling stockholder conflict exists and the entire fairness standard of review would apply, recent case law has established that a company and stockholder can return judicial review of the underlying transaction to the deferential business judgment rule by using the “MFW” framework—referred
to as such after the seminal case that affirmed the concept. This framework requires that the parties declare, before "substantive economic negotiations" begin, that the transaction can only be effectuated if it is approved by 1) a fully empowered independent board committee with the power to say "no," and 2) stockholders who hold a majority of the minority shares and who are fully informed and uncoerced. The use of only one such protection may be a sign of fair process and can shift the burden of proof in litigation to the plaintiff, but the judicial standard of review will remain entire fairness.

An often vexing question in practice is just how early parties must declare the MFW conditions in order to avoid engaging in premature substantive economic negotiations. In 2019, the Delaware Supreme Court held that parties had imposed the conditions too late, where they engaged in months of discussions—including valuation discussions, the execution of a non-disclosure agreement, and multiple diligence sessions—before establishing the MFW conditions. Of particular concern to the Court was that the parties' discussions about valuation appeared to effectively establish the ultimate price range in which the transaction would occur and that board materials contained a presumed timeline and an assumed price before the conditions were put in place. Accordingly, even though the company obtained a minority vote and an independent board committee that met 16 times approved the deal, the protection of the business judgment rule was not available.

**The Effect of Fully Informed Approval Under "Corwin"**

The Court continued to utilize the so-called "Corwin" doctrine, under which fiduciary challenges to various types of transactions—including potentially where directors have a conflict—can be dismissed if the transaction was approved by a fully informed, uncoerced vote of disinterested stockholders. The Corwin doctrine does not apply to transactions involving a controlling stockholder conflict of interest, which are subject to the MFW standard discussed above. The cases considering the Corwin doctrine this year reaffirm that the Court will meticulously review corporate disclosures to ascertain whether the stockholders' decision was, in fact, fully informed—meaning that all facts material to the stockholders' decision to approve the transaction were disclosed completely and in a non-misleading way. Only if the disclosure stands up to this scrutiny can directors take advantage of the potent protections of the Corwin doctrine.

**Disclosures to Stockholders**

Even though the mere act of disclosing a conflicted transaction to stockholders may not alone affect the applicable standard of judicial review, a decision from 2019 illustrates the benefits that can result from such disclosures, in the right circumstances. In that decision, a private company engaged in an asset sale that involved all of the proceeds flowing to the preferred controller's ability to convert its notes into Series D preferred stock potentially giving it a better opportunity compared to stockholders as a whole.

**Rights Offerings**

Where a public or private company engages in an insider financing round and a conflict of interest exists, a question that frequently arises is whether a "rights offering"—giving all stockholders the opportunity to participate in the financing—effectively dissipates and cleanses the conflict. In 2019, the Court of Chancery, in an unpublished bench ruling, was unwilling to give a rights offering such effect, at least based on the facts before it. In particular, the company had engaged in a financing round with its majority stockholder that involved the issuance of bridge notes and the conversion of those bridge notes into a senior Series D preferred stock a month later. In refusing to apply the business judgment rule based on the use of a rights offering, the Court expressed concern that 1) the interests given to the controller were senior and beneficial to the controller, with the complaining stockholder losing its previously senior position in the company, and 2) the controller's ability to convert its notes into Series D preferred stock potentially gave it a better opportunity compared to stockholders as a whole.

**Abstention by Directors and Delegation to a Board Committee**

Abstention by potentially conflicted directors and delegation to a committee of disinterested directors by an otherwise conflicted board can be valuable methods for addressing board conflicts, but the Court of Chancery has explained that the details of these procedures are critical. In 2019, the Court addressed claims by stockholders against a company's controlling stockholder, challenging the company's
acquisition of one of the controller’s portfolio companies.\(^5\) In that case, the Court noted that Delaware courts focus on the process leading up to the board decision. Although the Court explained that director recusals from votes alone will not in most circumstances absolve directors from liability for a board decision, the opinion also left open the possibility that if a director were fully recused from both the process leading up to a decision and the vote, that could relieve a director from liability. In a subsequent transcript decision, the Court addressed whether delegation to an independent board committee had effectively cleansed any conflict in the board’s decision to authorize a repurchase of shares from the company’s controlling stockholder and a secondary offering by the controller.\(^6\) The company, as required by a stockholders agreement, had delegated the matter to a conflicts committee but retained final approval authority over the transactions. The Court rejected the argument that the board’s approval was a perfunctory formality or subject only to contractual (not fiduciary) terms.

**Corporate Opportunity Doctrine**

In several 2019 opinions, the Court of Chancery addressed fiduciary duty claims that were premised on alleged breaches of the corporate opportunity doctrine, which provides that fiduciaries cannot wrongly take potential opportunities from the corporation. The first such ruling involved a home healthcare service provider that had been seeking additional office space.\(^7\) The Court determined that the company’s president had usurped a corporate opportunity and breached his duty of loyalty by secretly acquiring and leasing a nearby building to the company. The Court rejected the president’s argument that the acquisition of real estate fell outside of the company’s expectations and business, giving broad construction to those elements of the corporate opportunity doctrine. In another case, the Court addressed the impact of a provision in an energy drink company’s charter renouncing certain corporate opportunities,\(^8\) other than those created or developed solely in a person’s capacity as a director. The Court found that, although a director had learned of a large retailer’s interest in a private-label energy drink in a meeting between the company and that retailer, the director’s creation of such an energy drink fell outside of his capacity as a director. In particular, the Court closely examined the context for the new drink’s brand name, labeling, formula, and development, finding that the director had been responsible for those elements of the product development in his personal capacity.

**The Fiduciary Obligation of Oversight**

The “Caremark” doctrine governing directors’ obligation of oversight received important treatment in 2019, with Delaware courts upholding claims against directors at the motion to dismiss stage in two cases. Oversight claims have long been described by Delaware courts as among the most difficult for a stockholder plaintiff to successfully pursue—requiring a plaintiff to plead that directors knowingly failed to implement an adequate system of controls or to respond properly to potential “red flags.” As such, the Court’s denial of motions to dismiss in these cases is particularly noteworthy.

In June 2019, the Delaware Supreme Court reversed the Court of Chancery’s dismissal of a Caremark claim regarding a listeria outbreak at an ice cream producer, allowing the case to proceed past the motion to dismiss stage to discovery.\(^9\) The Supreme Court emphasized that the company had a single product line—ice cream—making food safety one of the company’s “central compliance issues.” The plaintiff adequately alleged that the board failed in its oversight of that critical compliance issue by pointing to board minutes obtained in a books and records demand that did not reflect any discussion of potential food safety problems or board-level protocols for monitoring food safety issues. The Supreme Court reasoned that the lack of any discussion in the board-level documents was sufficient at the pleadings stage to suggest that the board had failed to put adequate systems in place.

Invoking that guidance from the Supreme Court, the Court of Chancery subsequently found that stockholder plaintiffs had stated an oversight claim against the board of directors of a biopharmaceutical company focused on developing an experimental cancer drug.\(^10\) The Court recognized that the board had implemented appropriate controls and reporting methods to monitor drug development. But the Court found that the plaintiffs had adequately alleged that the directors “ignored warning signs” suggesting that the company was misleading the market about the efficacy and likely FDA approval of the company’s “mission critical” product. In particular, the Court concluded that the board, which included “experts” in the industry, potentially should have noticed red flags indicating that the company’s practices and public disclosures did not meet the applicable industry protocol used to test the efficacy of the drug.

Fiduciary duty oversight claims remain difficult for plaintiffs to pursue, and the Court of Chancery has continued to reject these claims in other cases.\(^11\) But the two recent decisions allowing oversight claims to proceed offer some
important reminders. It is important that boards (and board committees, as appropriate) regularly identify and monitor existing and emerging compliance issues and understand and address industry-specific risks faced by the company. An appropriate reporting and compliance program is, of course, necessary, but a board still faces potential Caremark liability if directors fail to actively monitor corporate risk or address any “red flags” that might signal risk. The decisions also highlight the importance of having good board minutes with appropriate detail and being thoughtful about the materials presented to the board.

M&A Structuring Issues

In 2019, the Delaware courts issued a remarkable number of decisions on a wide range of deal structuring points and interpretive issues relating to acquisition agreements. Those cases offer several important lessons for future transactions.

Damages Available to Buyer After Seller Takes Superior Proposal

In one case, the Court of Chancery addressed whether a buyer—after the selling company terminated the merger agreement to accept a superior proposal—was limited only to receiving the termination fee as provided for in the merger agreement or whether the buyer could also seek damages from the seller. The seller argued that the termination fee, which the buyer had accepted, was the “sole and exclusive remedy” under the merger agreement. The buyer contended that its acceptance of the fee did not inherently foreclose a suit for damages and that the termination fee was only the sole and exclusive remedy if the seller terminated the agreement “pursuant to” and “in accordance with” the agreement. On the latter point, the buyer argued that the seller had not terminated the deal in accordance with the agreement because the seller breached the non-solicitation provision in pursuing the superior proposal. At least for purposes of a motion to dismiss, the Court concluded that monetary damages remained a possible remedy given allegations that the seller’s board had communicated furtively with the topping bidder and violated the non-solicitation provisions.

Material Adverse Changes Justifying Termination of a Transaction

In 2018, the Court of Chancery issued the landmark Akorn decision, later affirmed by the Delaware Supreme Court, which—for the first time in Delaware law history—permitted a buyer to terminate the acquisition of a public company on the basis that the company had undergone changes that had a material adverse effect (MAE). The facts in that case were severe, with the target confronting a number of regulatory issues with the U.S. Food and Drug Administration (FDA), receiving multiple whistleblower letters, and facing significantly reduced revenue.

In 2019, the Court of Chancery issued a decision in a separate transaction, finding that the facts there did not support the finding of an MAE—signaling that the Akorn decision did not mark a turning point in Delaware law and that buyers claiming MAEs still face a heavy burden in Delaware. The buyer terminated the agreement and claimed a breach of representations with an MAE after the target company discovered that an executive had falsified several documents, including submissions to the FDA, which resulted in the FDA imposing a remediation plan on the company. Because, however, the company ultimately received FDA approval for its one product, and the buyer had not shown a meaningful impact on the target’s business at trial, the Court rejected the MAE claim and entered an order of specific performance requiring the buyer to close the transaction.

Sales, Leases, and Exchanges of All or Substantially All of a Company’s Assets

Under Delaware law, where a corporation engages in a “sale, lease, or exchange” of “all or substantially all” of its assets, a stockholder vote is required. As a result—at least in certain types of asset dispositions—transaction planners often dedicate significant attention to whether that requirement is triggered, particularly where a stockholder vote would add significant complexity, uncertainty, or cost.

Although this area of the case law has been sparse in recent years, a 2019 Court of Chancery bench ruling provided some guidance. First, the Court indicated that a sublicense of assets and intellectual property may come within the meaning of “sale, lease, or exchange.” Second, although the Delaware statute provides that a disposition to a wholly owned subsidiary does not trigger a stockholder vote, the Court found that where such a disposition is sufficiently tied to a subsequent transaction conveying the assets to another party, a vote may be required. Finally, the Court signaled that where the governing Delaware statute is violated and parties fail to obtain a stockholder vote, the transaction may be null and void, without effect.

The Effect of 10b-5 Representations in Private Company Deals

In 2019, the Court of Chancery issued
a decision on a topic that has not been extensively addressed under Delaware law: the interpretation of a so-called “10b-5” representation. After the acquisition of a private company closed, the buyer discovered that the seller—an airline part supplier—had lost significant contracts with its primary customer. Both parties agreed that the seller had been unaware of the loss prior to closing. The buyer claimed that, in light of the negative development, the selling company had breached multiple representations and warranties in the acquisition agreement and that the sellers were required to indemnify the buyer under the agreement. The Court carefully parsed the language of the agreement and found that no specific representations about the target’s business actually had been breached. The Court then turned to the 10b-5 representation, which read as follows: “No representation or warranty made by Seller in this Agreement and no statement contained in the Disclosure Schedule to this Agreement or any certificate or other document furnished or to be furnished to Buyer pursuant to this Agreement, including the other Transaction Documents, contains any untrue statement of a material fact, or omits to state a material fact necessary to make the statements contained therein, in light of the circumstances in which they are made, not misleading.” The Court rejected the buyer’s efforts to rely on the representation to broaden the other more specific representations, reasoning that the buyer “cannot now rely on the . . . catchall provision to enforce a contractual right that it did not obtain for itself at the negotiating table.”

Private Company Indemnification Provisions and Statutes of Limitations

The Complex Commercial Litigation Division of the Delaware Superior Court issued a decision demonstrating when a selling company may be liable to indemnify a buyer for losses long after a transaction closes. The dispute in this case traced back to an asset purchase agreement from 1982, pursuant to which Westinghouse sold its lighting product business to another company. Waste disposal issues had been a significant issue in diligence, and Westinghouse broadly agreed to indemnify the buyer for related problems that arose post-closing. The buyer successfully obtained indemnification from Westinghouse in 2000. In 2017, after additional problems emerged, the buyer again sought indemnification from CBS, which had succeeded to the Westinghouse business by merger. CBS resisted, contending that the claims were time-barred under Delaware’s three-year statute of limitations for contract breaches. The Court held that CBS remained liable for indemnification, reasoning that the seller had flatly agreed to indemnify the buyer as losses arose, without any time limitation, and that the statute of limitations only begins to run at the time a claim accrues. The Court concluded that the moment of accrual occurred when the buyer demanded, and CBS refused to provide, indemnification.

The Treatment of the Attorney-Client Privilege in a Merger

A 2013 decision by the Court of Chancery established an important rule: under Delaware law, where a Delaware corporation is acquired by another company by merger, the acquiring corporation succeeds to the seller’s attorney-client privilege unless the parties provide otherwise in the merger agreement. Accordingly, in post-closing disputes—involving, for example, fraud claims or claims for breaches of representations—a buyer benefiting from that default rule can use the seller’s pre-closing communications, including privileged communications, in its favor.

In 2019, the Court of Chancery provided important additional guidance on the contours of this rule. In particular, the Court gave effect to a provision broadly specifying that the sellers retained privilege and assigned it to the stockholders’ representative, that the buyer agreed not to use the sellers’ privileged communications, and that the parties would take steps to preserve the sellers’ privilege. The buyer argued that despite this provision, the selling stockholders had waived their privilege by, as a factual matter, allowing the buyer to take physical possession of the communications. The Court disagreed, concluding that such a position would render the parties’ agreement—and the “contractual freedom” afforded to parties in this context—meaningless.

Waivers of Appraisal Rights and Other Claims

In 2019, the Court of Chancery addressed issues that can have a significant impact on litigation, particularly for private companies in the deal context: the enforceability of covenants not to sue and waivers of appraisal rights (i.e., stockholders’ rights to seek a judicial determination of the “fair value” of their shares in many mergers). The Court of Chancery held in a landmark ruling that stockholders, including common stockholders, can prospectively waive appraisal rights in a contract, at least where the stockholders are sophisticated. In another case in 2019, the Court provided related guidance, holding that a broad covenant not to sue did not constitute a waiver of appraisal rights and reasoning that a statutory right can only be waived if the waiver is “clearly and affirmatively expressed.” At the same time, the Court determined that the covenant not to sue would preclude that stockholder from bringing fiduciary duty claims in connection with the deal. The Court rejected arguments that such covenants were unenforceable on public policy grounds, noting that, in this circumstance, other stockholders

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could still separately bring such claims.

Books and Records Demands and Information Rights

This past year also saw a number of noteworthy decisions addressing stockholder demands for corporate books and records under Section 220 of the Delaware General Corporation Law. Broadly speaking, this provision of the statute allows stockholders that have a “proper purpose” and satisfy other statutory requirements to obtain corporate documents outside of the litigation context. The Court of Chancery also issued an important decision relating to the right of directors to demand information.

In one notable decision, the Delaware Supreme Court revisited whether companies must produce email and other electronic records in response to stockholder demands for books and records—the first time it has done so since 2014, when the Court first opened the door to requiring the production of such records in some circumstances. In its new decision, the Court held that stockholders are not necessarily entitled to email or other items beyond “traditional” corporate books and records, such as board minutes or actions by written consent. Rather, according to the Court, the analysis is whether traditional books and records are sufficient to accomplish the stockholder’s purpose. If companies fail to keep adequate traditional records to show what the board has done and why, a court may find that email and other electronic documents are necessary to accomplish the purposes of a demand. In another 2019 decision, the Court of Chancery determined that a stockholder was entitled to certain email and text messages because there was evidence suggesting that the controlling stockholder had back-channel communications with board members that were not reflected in traditional corporate documents.

The Delaware Supreme Court also addressed the common practice of conditioning production of Section 220 documents on the stockholder entering into a confidentiality agreement. The Supreme Court overruled several Court of Chancery decisions that presumed books and records should be treated as confidential and, instead, held that the Court of Chancery must weigh the stockholder’s interests in free communications against the company’s interests in confidentiality to determine the degree and duration of confidentiality protections. According to the Supreme Court, the imposition of non-disclosure and indefinite confidentiality protections should be the exception, not the norm, and the burden is on the company to show a basis for any restrictions that it seeks to have imposed on the documents it produces. We expect this authority to cause more stockholders pursuing Section 220 demands to push back on what were previously standard confidentiality restrictions.

In several other notable cases, the Court of Chancery examined the “credible basis” standard that a stockholder must meet to obtain books and records for the purpose of investigating mismanagement. The cases reemphasized that the credible basis standard remains a low bar but nevertheless requires a factual showing that, if borne out through investigation, could potentially lead to a cause of action.

For example, the Court permitted a stockholder to investigate potential claims that CBS’s majority stockholder, National Amusements, Inc., had improperly influenced the board of CBS to agree to a merger with Viacom. The stockholder carried its burden by alleging suspicious circumstances about the merger, including 1) the board’s unexplained change of heart to support the merger after repeatedly rebuffing the controller’s desire for the merger; 2) evidence suggesting that the controller proposed the merger in violation of a settlement agreement with the company; and 3) the CBS chief legal officer’s abrupt resignation after a board committee meeting at which the merger was proposed.

In another case, the Court allowed a stockholder to inspect books and records to investigate whether Facebook’s directors had satisfied their duties to oversee the company’s data security and privacy practices. Although, as we discuss above, oversight claims are difficult to establish and require a substantial factual basis, the stockholder was able to show a “credible basis” based on a host of alleged red flags regarding the company’s approach to data privacy. In contrast, in a separate case, the Court of Chancery declined to allow inspection regarding Facebook’s executive compensation practices because the stockholder lacked a factual basis to question the board’s independence or good faith in setting executive compensation or to indicate that the compensation was so extreme as to be wasteful. Thus, there was no viable reason to suspect wrongdoing that would overcome the deferential business judgment review afforded to typical executive compensation decisions.

Finally, earlier in the year in a case that garnered significant attention, the Court of Chancery largely allowed the founder of Papa John’s International, Inc. to inspect Papa John’s books and records in his capacity as a director. This case stands as a reminder that, unlike stockholder demands, directors are presumed to be entitled to books and records as needed to carry out their fiduciary duties. To resist production, the
company bears the burden of proving that the director’s purpose for seeking the books and records is improper. Highlighting the breadth of directors’ inspection rights, the Court held the Papa John’s founder’s purposes were proper despite ongoing litigation against his fellow directors and his antagonistic attitude toward them. The Court also ordered the production of directors’ emails and text messages because the directors conducted a significant amount of business by those means rather than in meetings with formal records. Finally, the Court ordered the documents to be produced without a confidentiality order on the basis that directors’ fiduciary duties include keeping company information confidential, making an order unnecessary.

**Special Litigation Committees**

Last year, Delaware courts decided an unusual number of cases involving the use of a Special Litigation Committee (or SLC)—an independent committee of the board that is appointed when the company faces a stockholder derivative action, as to which the board as a whole may be conflicted. Because Delaware law recognizes that derivative claims belong to the company, it gives broad authority to a properly formed SLC to investigate the claims and determine whether it is in the company’s best interest to pursue, or alternatively to terminate, the litigation. Consistent with Delaware’s deference as to what to do with derivative claims, Delaware courts routinely grant a reasonable stay of the litigation so that the SLC can investigate the claims free from interference by the stockholder plaintiffs. In a notable transcript ruling earlier this year, the Court of Chancery granted a stay over the argument of plaintiff’s counsel that the seriousness of the underlying allegations (illegal activity in the marketing and sale of opioids) warranted a departure from that authority. The Court emphasized that a stay remained the “default rule” because “[p]art of the idea of giving the SLC the first chance to decide what to do with the case, or a meaningful chance to decide what to do with the case, is that there are potential advantages to having the SLC control the litigation.”

In another decision last fall, the Court of Chancery departed from the “default rule” and denied an SLC’s motion to stay derivative litigation involving oversight claims against the directors of an ice cream producer. There, the company formed an SLC after the plaintiffs had successfully appealed a prior dismissal of those claims. The company was organized as a limited partnership and the Court of Chancery had already found that the general partner, which controlled the company—and which later delegated its decision-making authority to the SLC—was conflicted for purposes of assessing the claims. Because the Court of Chancery, under agency principles, found that the SLC (as an agent) was controlled by the conflicted general partner (the principal), it likewise found that the SLC could not render an impartial decision, and the stay was denied. Although the decision arose in an unusual scenario likely unique to limited partnerships and other alternative entities, it remains an important reminder that the court will look closely at the SLC’s authority and consider whether there are structural reasons why the SLC cannot operate independent of the subjects of its investigation. The decision is currently on appeal to the Delaware Supreme Court and we may soon get further guidance on such structural issues.

This past year also saw the rare circumstance where an SLC determined that derivative claims should not only proceed but also that the original plaintiff and its counsel (as opposed to the SLC) should prosecute those claims. A dispute then arose over whether the stockholder plaintiff was entitled to access documents that the company and other defendants had provided to the SLC during its investigation. The Court of Chancery engaged in a thorough discussion of the nature of SLCs and their role in managing, and in a sense improving, the “litigation asset” of the company through its investigation. The Court concluded that it would be incongruous to deny the plaintiff—who the SLC determined should pursue those claims on behalf of the company—the very documents that the SLC relied upon in assessing the claims. The Court was careful to note, however, that those documents could implicate certain attorney-client and work product privileges, including those of the SLC and the individual defendants, and that those documents could be properly withheld subject to resolving those privilege assertions.

**Advance Notice Bylaws**

In 2019, the Court of Chancery issued a decision concluding that a company, in the midst of a proxy contest, wrongly rejected a stockholder’s nomination. The heart of the dispute was that the company, pursuant to its advance notice bylaw, had demanded supplemental information from the stockholder—in the form of a 47-page questionnaire, consisting of nearly 100 questions—with a deadline of five days, as set forth in the bylaw. The Court of Chancery determined that two-thirds of the questionnaire was not relevant to the nominations and that the request was not “reasonably requested” or “necessary,” as the bylaws required. The Delaware Supreme Court subsequently reversed the Court of Chancery. The Supreme Court agreed with the Court of Chancery that much of the company’s
questionnaire did not relate to the nominees’ qualifications. Of importance to the Supreme Court, however, was that the stockholder failed to respond during the five-day period in the bylaw and only raised the concern identified by the Court of Chancery later in connection with litigation. Accordingly, the Supreme Court held that the stockholder’s nominations were invalid.

In another litigation in 2019, which has not yet resulted in a formal decision but has involved some bench rulings, parties have been battling over whether a stockholder that sought to nominate directors became a record holder—versus a beneficial owner—in time to submit nominations in accordance with the company’s advance notice bylaw.42

Dividends and Director Liability

The declaration of dividends involves several important rules under Delaware law. First, only the board or a board committee has authority to declare a dividend. Second, the payment of a dividend generally requires that the company have adequate surplus—an excess of assets over liabilities equal to at least the amount of the dividend—and will remain solvent. Third, where directors engage in a “negligent” or “willful” violation of the Delaware statute in paying dividends, they can face personal liability—for which the company is not permitted to provide exculpation or indemnification. Note that the last two rules apply to stock repurchases as well.

Against this backdrop, and against a dearth of recent case law on this topic, the Court of Chancery issued important guidance in 2019.43 As an initial matter, the Court held that potential contractual claimants against a company have standing, as potential creditors, to challenge a board’s payment of a dividend when the company has inadequate surplus. From there, the Court found that the plaintiff’s claims that the company lacked surplus for paying dividends was time-barred under the six-year statute of limitations that applies to such a challenge and that the statute of limitations is not subject to equitable tolling, or a discretionary extension, by a court. Finally, the Court nonetheless allowed the plaintiff to pursue a challenge to the dividends at issue under the theory of fraudulent conveyance—particularly given that the dividend payments largely benefited insiders.

Avoiding Technical Foot Faults and Defects under Delaware Law

For the last several years, the Delaware courts have steadily provided guidance on technical defects that can occur under Delaware law when engaging in foundational acts—such as the issuance or transfer of equity or the approval of a transformative transaction. The year 2019 was no exception.

Calculating Board Quorum

Under the Delaware statute, a board can act by written consent in lieu of a meeting to approve an action that would be “permitted to be taken at any meeting of the board,” as long as the company’s charter and bylaws do not limit that ability. In 2019, the Court of Chancery issued a significant decision holding that when a board acts by written consent, it must satisfy the same quorum requirements that would apply at a board meeting.44 For example, if a board has five directorships and the company’s governing documents provide that directors representing a majority of those seats must be present at a meeting to constitute a quorum, the board could not validly act by written consent if the board had three vacancies and only two directors could approve the action.

Transfer Restrictions and the Impact of “Null and Void” Language

Companies have increasingly adopted transfer restrictions regulating the secondary trading of equity. Those transfer restrictions also commonly provide that if parties transfer equity in violation of such restrictions, the transfer will be “null and void ab initio” and of no effect. In 2019, the Court of Chancery issued a decision stating that where a transfer restriction imposes such a penalty, the Court will give the language precisely that effect.45 Accordingly, the Court found that a transferee that had received equity in violation of a transfer restriction with such language was not an equity holder and could not pursue a books and records demand, even though the company and the parties had acted as though the transferee validly held equity. Likewise, in another case at the end of 2019 where assets and equity were allegedly sold in breach of a right of first refusal, the Court of Chancery granted a temporary restraining order and ordered expedited litigation, thereby setting up this legal issue for continued examination in 2020.46

Properly Approving a Merger

The Court of Chancery issued a decision providing insight into a grab bag of technical issues that can arise in the approval of a merger.47 The Court found that the merger agreement failed to specify the consideration stockholders were entitled to receive in two respects—by referencing a payment schedule that was not actually attached to the
The Court drew on corporate law principles in requiring technical precision to remove managers because the company adopted a corporate-like governance structure, rejecting arguments that certain provisions of the LLC agreement implied that managers could be more informally removed. The Court rejected the plaintiffs’ “managerial bump-out theory” for replacing managers—that by appointing three members to a board with only three

Developments in Alternative Entity Law

As in recent years, companies continue to take advantage of the flexibility of alternative entities—limited liability companies, partnerships, and statutory trusts—and we saw some significant developments in the case law this past year as the Delaware courts continue to consider issues in this contract-based framework.

The Effect of a Fiduciary Duty Waiver on Demand Futility

The well-developed corporate law relating to the demand requirement for a derivative action (requiring a plaintiff to make a pre-suit demand on the company or show that demand would be futile) generally applies by analogy to limited partnerships. In 2019, the Court of Chancery addressed demand futility where the partnership agreement eliminated fiduciary duties, which is permitted in the alternative entity context. The plaintiff unitholder of a publicly traded master limited partnership brought derivative claims in connection with an oil spill that resulted in substantial harm to the company. The Court applied the so-called “Rules” test for demand futility, which requires the plaintiff to allege particularized facts raising a reasonable doubt that the board could have properly exercised its independent and disinterested business judgment in response to the demand. The Court rejected the plaintiff’s argument that the defendant directors were interested because they faced a substantial likelihood of personal liability for alleged breaches of fiduciary duties. In particular, the Court held that there could not be a substantial likelihood of personal liability for breach of fiduciary duties because fiduciary duties had been eliminated in the partnership agreement and, as a result, that demand was not futile.

Technical Missteps Under the Statute and Governing Documents

As in recent years, companies continue to take advantage of the flexibility of alternative entities—limited liability companies, partnerships, and statutory trusts—and we saw some significant developments in the case law this past year as the Delaware courts continue to consider issues in this contract-based framework.

An LLC is required to have at least one member. Without a member, an LLC automatically dissolves under the statute. But a person acquiring LLC interests, whether in a direct issuance from the LLC or a transfer from an existing member, does not automatically become a member by virtue of the issuance or transfer. Instead, the additional step of admission, in accordance with the applicable terms of the LLC agreement (or, if none, the default provisions of the statute) is required. In 2019, the Court of Chancery addressed admission of members in the context of a purported transfer by the sole member of an LLC of its equity interest. The Court determined that the transfer document at issue was ineffective for lack of consideration but considered what the impact of the transfer could have been had it been effective. Because the LLC agreement was silent as to when admission of a transferee would be effective, the statutory default rule applied such that the transferee’s admission would have been effective when reflected on the LLC’s books and records. The Court concluded that the purported transferee of the interest was never admitted as a member because its admission was never reflected on the LLC’s books and records and therefore the LLC would have been dissolved because it lacked any members.

The Court of Chancery also issued a decision relating to technical issues surrounding the removal and replacement of managers of an LLC. The Court drew on corporate law principles in requiring technical precision to remove managers because the company adopted a corporate-like governance structure, rejecting arguments that certain provisions of the LLC agreement implied that managers could be more informally removed. The Court rejected the plaintiffs’ “managerial bump-out theory” for replacing managers—that by appointing three members to a board with only three
seats, the incumbents were bumped out—stating that such a theory does not have support under Delaware law because a manager cannot be appointed to a board with no vacancies. The Court acknowledged the informal nature of LLC’s and their use by lay persons, but declined to stray from corporate law principles when both sides relied on counsel in drafting the documents in question.

Distinguishing Waivers of Contractual Rights and Statutory Rights

Another notable LLC case from the Court of Chancery in 2019 distinguished waivers of contractual rights from waivers of statutory rights. In response to a books and records demand made by a member (who was formerly a managing member) of the LLC, the company argued that the member waived his right to bring an action in Delaware. The Court acknowledged that there are certain statutory rights that cannot be waived in an LLC agreement, including the right of “a member who is not a manager” to bring an action in the Delaware courts with respect to the internal affairs of an LLC. The Court explained that, in contexts where waivers are permissible, they are only enforceable when the waiving party is aware of the right and clearly expresses an intent to relinquish the right. The Court held that the forum selection provision in the LLC agreement providing that “any and all disputes relating to [the LLC agreement]” shall be brought in two specified New York courts did not apply as a waiver of the right to bring a books and records action in Delaware because the dispute was not solely about rights under the LLC agreement. Rather, the plaintiff sought to enforce his statutory books and records rights, and the forum selection provision was not a clear waiver of a member’s statutory right to bring a books and records action. The Court further held that the parties could not have intended the forum provision to apply to a member’s books and records action because such a waiver would have been enforceable only against managers, who would not need to bring a books and records action because they would have access to the LLC’s books and records in their managerial capacity.
About Wilson Sonsini’s Corporate Governance Practice

Wilson Sonsini’s corporate governance practice advises companies and their boards of directors on a full range of matters involving the implementation of best practices in corporate governance, navigation of director fiduciary duties, stockholder activism, and compliance with state and federal law. We frequently represent special committees of a board in negotiating transactions. We also conduct investigations on behalf of management, boards of directors, and special board or management committees, and represent companies faced with stockholder litigation demands and stockholder actions.

Our corporate governance practice applies a multi-disciplinary team approach to provide all areas of expertise that a board and/or senior management need to respond to today’s changing governance landscape. Members of the firm’s corporate governance team are also regularly called upon to help shape new laws and regulations, with our attorneys serving as advisors to major regulatory bodies in the areas of governance and disclosure.

Our attorneys include expert professionals in offices throughout the world, including in Delaware, California, New York, Washington, Brussels, and China. The firm’s office in Wilmington, Delaware includes 25 attorneys who focus their practice on corporate governance and Delaware law and litigation matters. The office is led by partners William B. Chandler III, Amy Simmerman, Brad Sorrels, Ryan Greecher, and Lori Will. Bill Chandler, who founded the Delaware office, is widely regarded as one of the world’s most influential and well-respected jurists on corporate law and governance matters. Also resident in the Wilmington office is former Delaware Supreme Court Justice Randy J. Holland, who joined the firm as Senior Of Counsel after retiring from the Delaware Supreme Court after serving more than 30 years.

For more information on the preceding publication or corporate governance-related matters, please contact your regular Wilson Sonsini’s attorney, or any member of the firm’s corporate governance practice or Delaware office.

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**Endnotes**


12. *See, e.g., Chester Cnty. Empls. ’Ret. Fund v. KCG Holdings, Inc.*, 2019 WL 2564093 (Del. Ch. June 21, 2019). Insight into the scope and impact of *Corwin* can be found in the *Morrison v. Berry* opinions from the Court of Chancery and Delaware Supreme Court—most recently resulting in the Court of Chancery permitting claims against officers to continue to go forward after the Supreme Court found that disclosures to stockholders were insufficient to extinguish claims under *Corwin*. *Morrison v. Berry*, 191 A.3d 268 (Del. 2018); *Morrison v. Berry*, 2019 WL 7369431 (Del. Ch. Dec. 31, 2019); see also *Garfield v. BlackRock Mortgage Ventures LLC*, 2019 WL 7168004 (Del. Ch. Dec. 20, 2019) (refusing to dismiss claims under *Corwin* at the pleadings stage of litigation when plaintiff presented a reasonably conceivable claim that a control group personally benefited from the challenged transaction).


37 In re Insys Therapeutics, Inc. Deriv. Litig., C.A. No. 12696-JTL (Del. Ch. Mar. 26, 2019) (TRANSCRIPT). The Court also rejected plaintiff’s challenges to the independence of the SLC members and its counsel based on decades-old business contacts and engagements, recognizing that such allegations are more appropriately dealt with at the conclusion of the SLC process under the review contemplated by Zapata v. Maldonado, 430 A.2d 779 (Del. 1981) into the independence of the SLC and the good faith of its investigation. But see Biondi v. Scrushy, 820 A.2d 1148 (Del. Ch. 2003) (refusing stay because of pervasive conflicts, including public statements by the SLC chairman vindicating the subject of the derivative claims at the outset of the investigation).


42 Bay Capital Finance, LLC v. Barnes and Noble Education, Inc., C.A. No. 0539-KSJM.


47 Mobile Posse, 2019 WL 2025231.


