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2017 Delaware Corporate Law Year in Review

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Editor's note: David Berger, Amy Simmerman, and Brad Sorrels are partners at Wilson Sonsini Goodrich & Rosati. This post is based on a WSGR publication by Mr. Berger, Ms. Simmerman, Mr. Sorrells, Katherine Henderson, Lori Will, and Shannon German, and is part of the Delaware law series; links to other posts in the series are available here.

In 2017, the Delaware courts once again issued many substantive corporate law decisions covering a wide range of issues critical to boards, stockholders, and officers. In addition, decisions from recent years continued to impact Delaware litigation, especially in the reduction of disclosure-based, settlement-driven M&A litigation as a result of the Court of Chancery's *Trulia* decision. At the same time, the Delaware judges' dockets remained so busy with other types of litigation that a proposal to increase the five-member Court of Chancery by two judges is currently under consideration. Alongside developments from the Delaware courts, we continue to see various trends in practice relating to Delaware law issues.

This post covers these important trends, which will shape practice in 2018.

M&A Litigation

Aside from appraisal litigation, which is discussed in the next section, we saw four themes in M&A litigation in 2017 to highlight.

First, as in prior years, several Delaware decisions addressed post-closing fraud claims following acquisitions of private companies. Those decisions underscore the importance of, among other things, the careful drafting of "anti-reliance" clauses and fraud exceptions in agreements and how they allocate risk between the parties—particularly concerning whether sellers, and which seller parties, can have liability for statements made during diligence.

Second, several cases continued to explore the proposition that in deals where there is *not* a controlling stockholder that receives a special, "non-ratable" benefit, a fully informed, uncoerced vote of disinterested stockholders can cleanse the transaction from fiduciary duty challenges. This so-called "*Corwin*" doctrine is powerful, resulting in the dismissal of several deal cases. That said, for parties to get the benefit of this doctrine, it is important that disclosures be properly crafted so that stockholders are considered fully informed. In a recent case, for example, the proxy statement was found to be inadequate where it failed to disclose who led deal discussions for a target company and two founders were alleged to have conflicting interests. It is also important that the stockholder vote be uncoerced, meaning, among other things, that stockholders get a clean up or down vote on the deal at hand, without the vote being unduly muddled by other issues or proposals. In addition, one Court of Chancery decision (discussed in the Books-and-Records Demands section that follows) reinforced that this doctrine does not necessarily cut off stockholders' ability to bring books-and-records inspection demands investigating a deal approved by stockholders, if a demand otherwise satisfies the statutory requirements.

Third, litigation over alleged controlling stockholder conflicts steadily continues in Delaware, including in the deal context. In litigation challenging the sale of Martha Stewart Living Omnimedia, for example, the Court of Chancery rejected a claim that Martha Stewart, as a controlling stockholder, received an improper special benefit in the sale by way of her post-acquisition arrangements. The court also held that even if Martha Stewart did receive such a benefit, the company followed the so-called "*MFW*" framework—properly using an independent committee of the board and a minority stockholder vote to cleanse a controlling stockholder conflict. In another decision, the Court of Chancery rejected the claim that a venture-backed public company had a control group composed of founders and venture funds that had a conflict in a deal.

Finally, the Delaware courts continued to issue decisions in the busted, multi-billion-dollar deal between The Williams Companies and Energy Transfer Equity (ETE), particularly relating to how the merger agreement addressed tax issues in the deal, "best efforts" requirements in the merger agreement, and whether or not ETE was entitled to a termination fee (it was not). As with the private company deal case law noted above, these decisions highlight the importance of careful drafting in merger agreements and giving attention to how risk is allocated between the parties.

Appraisal Litigation

The past year saw a number of significant decisions in appraisal litigation, in which, following a deal, stockholders seek to adjudicate the "fair value" they should have been paid in the deal. Delaware courts strongly signaled that transaction price may be the best indication of fair value in many contexts, but held that deal price is not conclusive and that courts will consider "all relevant factors" in determining fair value, as required by the appraisal statute. Two Delaware Supreme Court decisions in particular—one regarding the Dell going-private transaction and the other regarding the purchase of DFC Global by a third-party private equity buyer—concluded that the deal price was the "best evidence" of fair value. However, those cases and other notable decisions from the Court of Chancery demonstrate that the outcome of an appraisal case is fact-dependent.

In the *DFC Global* opinion,8 the Delaware Supreme Court strongly telegraphed that the merger price should be viewed as a robust measure of fair value in the third-party merger context. The court also emphasized that the Court of Chancery has discretion to weigh multiple valuation methodologies, and declined to establish an express presumption in favor of the deal price. But it critiqued the Court of Chancery's decision to give just one-third weight to the deal price, while also giving equal weight to an adjusted discounted cash flow analysis and a comparable companies analysis, resulting in a fair value of 8.4 percent above the merger price. The Supreme Court focused on the "objective factors"—that other buyers had declined to pursue the company during the lengthy sales process, that the company had not met its own projections, and that the sales process was conflict free. The court recognized the "economic reality" that "the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and that second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous."

The Delaware Supreme Court continued the theme of giving "heavy weight" to the deal price in the Dell case, which involved a management-led buyout. The Court of Chancery had adopted its own discounted cash flow analysis and held that the fair value of Dell was 30 percent higher than the merger price based on, among other things, the court's view that the price reflected the constraints of an "LBO pricing model." The Supreme Court dismissed concerns about whether private equity buyers' internal pricing models should put into question the reliability of the deal price and instead focused on the "compelling" evidence of a strong sales process and market efficiency that indicated the merger price was the best evidence of Dell's fair value.

Although certain Court of Chancery decisions in the past year kept with the trend of increased reliance on the merger price, the court has also continued to apply discounted cash flow analyses or other valuation methodologies to determine fair value in other cases. For example, in the appraisal lawsuit involving the buyout of Clearwire by Sprint Nextel, the court found that Clearwire's fair value was less than half of the market price, basing its determination entirely on the respondent's expert's discounted cash flow analysis.

It remains to be seen whether the spike in appraisal lawsuits will slow in 2018 as a result of the *Dell* and *DFC Global* opinions, or whether the fact- and expert-dependent nature of an appraisal case will lead to continued challenges to transaction prices.

Recapitalizations and Multi-Class Structures

Many companies have continued to adopt multi-class capital structures or revise the capital structures they have in place—including by adding to their dual-class structures a class of non-voting or very low-vote stock. Snap, of course, received considerable attention for the issuance of non-voting stock in its IPO. Facebook and IAC/InterActive each announced that it was adding a class of non-voting stock to its dual-class structure. However, after fiduciary duty litigation in the Court of Chancery ensued, both companies chose not to pursue such plans and, instead, opted to settle the litigation. In the Facebook litigation, discussions over the plaintiff's attorneys' fees are ongoing as of the publication date of this review.

In litigation involving another company, however, the Court of Chancery issued a watershed opinion in this arena. In that opinion, which involved a company's decision to add a class of very low-vote stock to its dual-class structure, the court held that the difficult entire fairness standard of review would apply to the recapitalization, as opposed to lesser standards of review such as the deferential business judgment rule. The court reasoned that even though the recapitalization treated all stockholders the same by giving each existing share the same amount of the new stock, the record supported an inference on a motion to dismiss that the recapitalization was designed to provide a unique benefit to the controlling stockholder, whose control had eroded over time due to the company's issuance of stock in acquisitions. The court determined that a controlling stockholder conflict therefore existed. At the same

time, the court went on to conclude that the company had properly used the *MFW* framework—involving an independent committee of the board and a disinterested stockholder vote, for purposes of restoring the application of the business judgment rule under the case law—and dismissed the litigation.

These developments underscore that as many companies continue to explore various forms of capital structures, they will want to take into account Delaware litigation and governance concerns, in addition to potential reactions from regulators and the investor community.

Stockholder Activism

Public companies across the spectrum continue to navigate stockholder activism, with that trend reflected in the Delaware courts. In late 2017, for example, the Court of Chancery issued a decision finding that, based on the facts before it, a company had reached an enforceable, verbal agreement to settle a proxy contest with an activist and add two of the activist's directors to its board, even though the company later reneged on the arrangement and never entered into a written agreement with the activist.15 Separately, Wilson Sonsini Goodrich & Rosati represented Deckers Outdoor in the Court of Chancery, after activist stockholder Marcato challenged fiduciary aspects of the board's decisions concerning provisions in its equity and compensation plans during the proxy contest.

Stepping back and examining practice and litigation in 2017, there are a few overarching themes. To start, activist matters will often find their way into the Delaware courts, whether claims are brought on technical or fiduciary grounds. Activists themselves often institute such litigation, although sometimes other stockholders bring litigation relating to how the board handles an activist situation. These matters can inject not only legal issues, but also PR battles, into the courtroom and the financial press. Finally, we would caution companies to be aware of two key Delaware law issues that often arise in the area of stockholder activism. First, companies should keep their governing documents carefully up to date to prevent activists or stockholders from seeking to exploit loopholes in them—for example, pertaining to the call of stockholder meetings, stockholder actions by written consent, or the appointment or removal of directors. Second, we regularly see companies confront information-sharing issues among directors when some directors on the board are affiliated with activists—in particular, relating to how information is shared with the various directors on the board and implications for the attorney-client privilege. These issues should be carefully considered against various Delaware cases touching on these issues.

Private Company Issues

Delaware corporate law decisions often have applications for both private and public company clients, especially as fewer companies go public and as large, sophisticated private companies become increasingly prevalent. That said, there are a few recent Delaware case law trends, not otherwise discussed in this year in review, that are especially pertinent to private companies. These cases addressed both technical issues and fiduciary, conflict-of-interest issues.

On the technical front, there were two particularly noteworthy Court of Chancery decisions from 2017. In one, the court addressed restrictions on secondary trading—an important issue, given that many companies continue to adopt such transfer restrictions. This case serves as a valuable reminder that, in order for such transfer restrictions to be enforceable under Delaware statutory law, one of three conditions must be met: 1.) for shares represented by stock certificates, stock certificates must set forth an appropriate legend; 2.) for uncertificated shares, stockholders must receive a proper notice in lieu of a legended stock certificate; or 3.) absent those conditions, a stockholder must be shown to have had actual knowledge of the underlying restrictions at the time the stockholder acquired the shares. The court decided in this recent case that none of those conditions had been met and, therefore, that the restrictions were unenforceable.

In another case, the Court of Chancery interpreted preferred stock terms in the context of a sale of a company. The parties had interpreted a provision in the certificate of incorporation to mean that preferred stockholders were entitled to a liquidation preference in a sale. In a post-closing appraisal proceeding, the court disagreed. The court held, based on older Delaware precedent and the facts and arguments before it, that the provision only provided that the company could not be sold for a certain amount of consideration unless requisite preferred stockholders consented to the transaction—which they did in that instance—but that it did not mandate payment of a particular “waterfall” of proceeds in the sale. Accordingly, the court determined that, for purposes of appraisal, the preferred and common stockholders should be treated on a pro-rata basis, contrary to how the merger consideration was distributed in the transaction. Often, preferred stock terms are drafted in a way that sidesteps this issue, but this decision offers insight into potential drafting and interpretation issues, especially when acquiring a company and analyzing its terms.

As for fiduciary considerations, conflict-of-interest issues continue to percolate through the courts and practice. There are two key principles at play in this regard. One principle is that where a plaintiff can allege that at least half of the board has a conflict in a given situation—for example, as members of management or as principals of funds with a divergent interest compared to stockholders generally—then the board as a whole is no longer considered disinterested and independent. In that scenario, the difficult entire fairness standard of review applies, absent the appropriate use of an independent board committee or disinterested stockholder vote (where such mechanisms are even available). In general, Delaware law does not distinguish between private and public companies, including in assessing director independence. Because private companies frequently have fewer independent directors—in part because many private companies cannot pay directors—it is much easier for private companies to face the entire fairness standard as a practical matter. A second, related principle is that where preferred stock terms address an issue and a board exercises discretion, the board should prefer the interests of common stockholders, which the Delaware courts view as unprotected by contractually negotiated-for provisions, over the interests of the preferred.

There were two significant Delaware cases in 2017 involving these issues. One involved the sale of a private company whose value had fallen, with a common stockholder alleging that conflicts existed. The other case involved a company’s redemption of preferred stock, based on a charter-based put right that a substantial stockholder held and invoked. The plaintiff in that case has alleged that the stockholder in question is a controlling stockholder and that the board had a conflict, such that various decisions made by the company after the stockholder invoked the redemption provisions should be subject to the entire fairness standard. The former case settled. The latter case is still pending, after the Court of Chancery refused earlier this year to dismiss the litigation.

It is important to be aware of the Delaware case law in this area from the last decade and to consider potential process measures that can be used to mitigate risk—weighed against the realities confronting a company's fiduciaries and the likelihood of serious litigation.

Technical Validity and Ratification

In the last 15 years, Delaware courts have tended to take a formal, strict approach when assessing whether companies properly took foundational corporate steps, such as when issuing stock, granting equity awards, effectuating stock splits, otherwise amending their charters, and so forth. At the same time, some Delaware decisions have cast doubt on whether companies can cure missteps in this area by way of common law, "soft" ratification. Because the case law had trended in a rather exacting direction, in 2014, Delaware adopted statutory provisions—Section 204 and 205 of the Delaware General Corporation Law (DGCL)—providing companies with a clear path to fix nearly any technical infirmity. Section 204 sets forth "self-help" ratification procedures that Delaware corporations can use, and Section 205 sets forth court-based procedures that companies and certain of their constituents can use to adjudicate the technical validity of corporate acts.

In 2017, the Delaware courts interpreted these provisions, giving continued early guidance in these areas. The courts have taken a fairly strict approach to whether ratifications are appropriately conducted under Section 204, and they continue to refine precisely when Section 205 is an appropriate vehicle to address validity. Meanwhile, in practice, Section 204 is used quite commonly, especially to rectify problems in a company's early corporate history where formalities are less likely to be appreciated and followed. Section 204 is not painless, as it involves, at a minimum, detailed board resolutions and notice to stockholders—and sometimes stockholder approval and filings with the Delaware Secretary of State, depending on the nature of the underlying defective corporate act. But Section 204 is generally effective in eliminating doubt and remediating certain problems. Section 205 is used sparingly but can be a helpful tool.

Board and Management Compensation

In late 2017, the Delaware Supreme Court issued a decision that could make it easier for stockholders to bring fiduciary challenges against board and management compensation decisions.

An important background principle to the case is that even though directors can set their own compensation, the Delaware case law views their discretionary decisions in this context as inherently self-dealing and subject to the entire fairness standard of review, rather than the deferential business judgment rule, in the event of litigation. As a way out of this conundrum, the case law provides that companies can seek stockholder approval of director compensation to "bless" director compensation decisions and cleanse them of fiduciary challenges.

In this recent decision, the Delaware Supreme Court held that a stockholder vote can bless director compensation decisions if stockholders are asked to approve specific compensation awards or if stockholders approve a plan with hardwired, self-effectuating formulas. The court, however, called into question Court of Chancery decisions holding that stockholder approval is also effective where stockholders approve "meaningful limits" within which directors can exercise discretion. In the same case, the court also permitted the plaintiff stockholder to challenge management compensation for executive members of the board, where the board had conducted deliberations and approvals of board compensation and such members' executive compensation at the same time.

Given this case, companies will potentially want to decide whether to seek more specific forms of stockholder approval of director compensation, weighed against litigation risk and their given stockholder base. Companies may also want to consider the manner in which boards review and approve management compensation for directors who are also officers.

Books-and-Records Demands

Companies continue to receive stockholder demands to inspect certain corporate information ("books and records") pursuant to Section 220 of the DGCL. In 2017, the Delaware courts issued several decisions that likely will shape stockholder books-and-records demands and companies' responses to those demands going forward.

Last month, the Court of Chancery held that a company cannot assert a *Corwin* defense—relying on the ratifying effect of a fully informed stockholder vote—to refuse an otherwise proper stockholder demand for books and records to investigate whether wrongdoing and mismanagement took place in connection with a merger.

Emphasizing "the very low bar" for demonstrating a credible basis from which the court could infer wrongdoing, the court explained that it would not "prematurely adjudicate a *Corwin* defense when to do so might deprive a purported stockholder plaintiff of the ability to use Section 220 as a means to enhance the quality of his pleading… ." Also of note, the court endorsed the use of Section 220 to investigate direct stockholder claims, particularly in a class action challenging a merger or tender offer transaction, but reiterated that demanding stockholders must move promptly to enforce Section 220 rights prior to the merger closing.

This year, the Court of Chancery also addressed a commonly used "proper purpose" for seeking inspection—to value one's shares. In that case, the court denied the plaintiff (a stockholder and former CEO) inspection of books and records for the purpose of valuing his stock in a privately held corporation because the plaintiff had failed to identify a reason *why* he needed to value his interest. The court accepted the defendant corporation's argument that the plaintiff's true purpose for seeking inspection was to use the information in an employment lawsuit against the company and to pursue a personal vendetta against it. The court did, however, grant inspection on the ground that the plaintiff had stated a credible basis to suspect mismanagement.

In another notable opinion, the Court of Chancery scrutinized the role of "entrepreneurial plaintiffs' counsel" in coming up with a stockholder's stated purpose for seeking books and records.

The court found that the stockholder had not stated a proper purpose because his counsel had identified the issues in the demand that the stockholder was purporting to investigate. After reviewing the stockholder's deposition transcript and litigation conduct, the court concluded that the purposes articulated in the demand were not the stockholder's "actual" purposes and that the stockholder had simply "lent his name to a lawyer-driven effort by entrepreneurial plaintiffs' counsel." The court also noted that the stockholder had been represented as a plaintiff by the same firm in at least seven other lawsuits where he had been similarly uninvolved.

Finally, companies negotiating confidentiality agreements with stockholders in connection with a books and records demand can fairly insist on an “incorporation-by-reference” provision conditioning the company’s production of books and records on the stockholder’s agreement that the production be incorporated by reference into any subsequent complaint filed in reliance on those materials. These provisions can later help a company in having a broader universe of facts and documents on which to rely in seeking to dismiss the litigation. The Court of Chancery required such a condition in at least three decisions in 2017.

Alternative Entity Issues and Public Benefit Corporations

The use of alternative entities—including limited liability companies—continues to increase, with the case law reflecting that trend as well. In 2017, a significant number of Delaware cases involving alternative entities focused on the drafting of their governing documents and whether contractual provisions were ambiguous. Importantly, Delaware law permits alternative entities to modify and eliminate traditional fiduciary duties, including by replacing fiduciary duties with other standards of conduct. Many of the cases touched on these issues. The cases all applied and confirmed long-standing principles of contract interpretation under Delaware law. These principles provide that, where there is only one reasonable interpretation of a contractual provision when the language is given its commonly understood meaning, that language will control and Delaware courts will enforce the contract as written. Only in circumstances where a court concludes that a provision is susceptible to multiple reasonable interpretations will the court look to extrinsic evidence.

In recent years, many of the Delaware alternative entity cases have involved the master limited partnership (MLP) structure, where parties to the governing documents typically eliminate fiduciary duties and contractually create standards of conduct. These cases are relevant to other forms of alternative entities, such as LLCs. In early 2017, the Delaware Supreme Court issued a notable decision relating to the challenge of a merger transaction involving an MLP. Departing from the courts’ typical approach in prior MLP cases, the facts of the case led the court to invoke its equitable powers and the sparsely used implied covenant of good faith and fair dealing to fill contractual gaps in order to uphold the apparent intentions and reasonable expectations of the parties.

While the cases decided in 2017 did not create significant changes in alternative entity law, they did confirm the importance of clear and concise drafting of governing documents and the necessity of reading such documents as a whole to avoid the risk and expense of litigation.

In addition, the 2017 amendments to the Delaware alternative entity statutes confirmed and clarified certain requirements, distinctions, and limitations within the statutes in order to ensure that the statutes remain user-friendly and address issues faced by Delaware practitioners and their alternative entity clients. For example, one of the amendments confirmed that certificates of formation and certificates of limited partnership that contain the name of the registered agent and the address of the registered office will meet the substantial compliance standard for a properly filed certificate, even if they do not expressly designate that such person is the registered agent or that such address is the registered office or the address of the registered agent. The amendments also confirm the broad authority of managing persons of LLCs and partnerships to delegate any or all of their management authority, including “core governance functions.”

Finally, although there were no specific case law developments in 2017, there was an increasing level of discussion about public benefit corporations (PBCs). The DGCL was amended in 2013 to authorize PBCs—Delaware corporations that are otherwise governed in all respects by the DGCL, but that are managed in a way that balances the pecuniary interests of stockholders (the usual focus of a Delaware corporation) along with the best interests of those materially affected by the corporation's conduct and a public purpose specified in the charter of a given PBC. There may be developments in this area in the year ahead, both in law and in practice.

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The complete publication, including footnotes, is available here.