Del. Dispatch: Efforts Clause Trumps Contractual Right

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In Chordia v. Lee, the Delaware Court of Chancery on Jan. 4 interpreted a stockholders' agreement entered into between Alphonso Inc. and its founders and other so-called key holders in conjunction with the acquisition by LG Electronics Inc. of a majority stake in Alphonso.

Of note, the court **held** that the efforts clause set forth in the agreement, requiring Alphonso to use reasonable efforts to effectuate the rights granted in the agreement, trumped Alphonso's right to fire its officers and employees — as, under the agreement, if no key holders remained as officers or employees, the key holders would lose their right to designate a minority of Alphonso's board of directors.

Key Points

Efforts Clause Trumped Contractual Right

The court held that, even assuming that the agreement granted the CEO an express right to fire employees, Alphonso had to give up that right to the extent it conflicted with Alphonso's efforts clause obligations under the agreement.

The court distinguished this case from those in which it has held that efforts clauses do not require parties to give up bargained-for contractual rights. In those cases, the court reasoned, a right was rendered illusory, while in this case the efforts clause only tempered the CEO's right to fire employees.

Board Not Bound by Company's Efforts Obligations

Although not necessary to the ruling, as the court found that Alphonso breached the agreement, the court addressed whether the board's firing of executive officers, which the agreement granted it the exclusive right to do, breached the efforts clause in the agreement.

The court noted that the efforts clause was stated in the agreement as applying to Alphonso — and also that the agreement appeared to reflect an intention by the parties to distinguish between Alphonso and its board.

The court held that the efforts clause applied only to Alphonso and not the board — and, therefore the board did not breach the efforts clause because the board could act without regard to the clause.

Sources of Post-Closing Friction

The case highlights typical sources of friction that can develop between an acquirer of a majority stake and the target's key stockholders — and the need for the parties to a

stockholders' agreement in this context to reach a clear understanding of their business arrangement and to reflect that arrangement clearly in their agreement.

Background

In December 2020, LGE acquired just over a 50% stake in Alphonso. In connection with the acquisition, key holders received considerable upfront payments — for some of them, several million dollars each — from LGE; and the key holders and Alphonso entered into the stockholders' agreement.

Liquidity Rights

Under the agreement, the key holders could demand an IPO after a specified date; and LGE agreed to conduct tender offers for Alphonso's shares on specified dates.

Director-Designation Right

The key holders could designate a minority of the board — the common directors — so long as at least one key holder remained an officer or employee of Alphonso and the key holders collectively continued to own at least a specified percentage of the shares.

Veto Right

The consent of at least one of the common directors was required for the board to postpone the IPO beyond a certain date; to postpone, or determine fair market value for, the scheduled tender offers; and, subject to exceptions, to enter Alphonso into related-party transactions with LGE.

Firing Executive Officers

The board had the exclusive right to fire executive officers.

After the acquisition, there were five key holders who were officers or employees — three of them executives, and two nonexecutives. The board comprised four directors designated by and affiliated with LGE; and three common directors.

Alphonso thrived post-closing, greatly exceeding LGE's targets and expectations. Nevertheless, friction soon developed between LGE, on the one hand, and the executive-officer key holders and common directors, on the other hand.

In 2022, LGE developed a plan "to remove all control from the Key Holders" by firing all of them who were officers or employees, so that the director-designation right would become null and void.

The board fired the three executive-officer key holders; the board replaced the CEO with a new interim CEO and, as directed by the board, he fired the two nonexecutive-officer key holders, although they were apparently exemplary and valued employees; the fired key holders were given buyout offers for their shares at an apparently very low price; and LGE then executed a written consent removing the common directors from the board.

This post-trial decision addressed the key holders' claim that the written consent removing the common directors was invalid because the firing of the key holders who were officers or employees breached the efforts clause by causing the designation condition to become

unsatisfied.

Vice Chancellor Nathan A. Cook ruled that the written consent was invalid and that the common directors remained in office — because the CEO's firing of the nonexecutive-officer key holders breached Alphonso's efforts obligations under the agreement.

While not necessary given that holding, the court also concluded that the board's firing of the executive-officer key holders did not breach the efforts obligations as the efforts clause did not apply to the board.

Discussion

CEO's Firing of Key Holders Breached the Efforts Clause

Alphonso, acting through its CEO, fired the nonexecutive-officer key holders. The court found that the CEO "exercised a power that he believed to be within the scope of the authority held by Alphonso's CEO," and that the CEO may also have had a contractual right under the agreement to fire nonexecutive officers.

"But," the court stated, the CEO "overlooked the express bargained-for contractual efforts obligation that Alphonso agreed to as a party to the [agreement]" — requiring Alphonso "to use 'reasonable efforts' to 'ensure' [the parties'] enjoyment of [the rights granted under the agreement]."

The court explained that, based on the efforts clause in the agreement, the agreement "never gave the CEO unfettered discretion [to fire non-executive officers]. It included an express limit on the exercise of the termination discretion to the extent such exercise could be seen to interfere with the other rights granted to the parties in the [agreement]."

Therefore, the court held, the CEO's firings breached the agreement.

Firing of Key Holders Did Not Breach the Efforts Clause

The board, exercising its exclusive right set forth in the agreement to fire executive officers, fired the executive-officer key holders.

The court emphasized that the efforts clause in the agreement, by its express terms, imposed an obligation on Alphonso, and that did not mean that the board was subject to the same obligation.

The court stated that, while ordinarily it might have reservations about such a distinction, in this case "the [agreement] itself distinguishes in various instances between Alphonso and the Board."

The court pointed to "instances [in which the agreement] refers separately to the Board and Alphonso in the same provision."

Accordingly, the court concluded that the obligation under the efforts clause, which expressly applied to Alphonso, did not apply to the board, nor to LGE.

Thus, the board's firings did not breach the agreement because the efforts clause did not apply to the board.

Alphonso's Efforts Obligations Trumped by Contractual Rights

The court distinguished its decisions — Akorn Inc. v. Fresnius Kabi AG in 2018 and Vintage Rodeo Parent LLC v. Rent-a-Center Inc. in 2019 — which had established that efforts clauses do not require the sacrifice of bargained-for contractual rights.

In Chordia, the court observed that in Akorn and Vintage Rodeo "the Court's concern was whether a party's contract rights [were] rendered illusory" by an efforts obligation.

In Chordia, by contrast, the court reasoned, Alphonso's right to terminate employees was not rendered illusory — rather, there was a precondition to the director-designation right that at least one key holder remained as an officer or employee, and Alphonso was restrained by the efforts clause from firing key holders because such action would cause the condition to that right to become unsatisfied.

The court stated that the efforts clause did not render the CEO's right to terminate employees illusory: "Indeed, [he] could terminate any … employee. Only when seeking to terminate [the two non-executive-officer Key Holders], however, was [he] required to use reasonable efforts first [under the efforts clause]."

In further commentary, the court drew a negative comparison with the defendants' approach to the plaintiffs' director-designation right.

The court wrote:
Although tempering the CEO's employee termination "right" comes nowhere near rendering the "right" ineffective or illusory, the same cannot be said for Defendants' reading of Plaintiffs' rights under the [agreement]. The Defendants seek to read the Director-Designation Right as, in essence, an illusory right. Or, at least, a right that LGE and Alphonso could terminate at their election. But that is not what the parties bargained for.

Distinguishing Features of the Case

We note that much of the court's discussion in this opinion constituted dicta. We note also the overall negative factual context, which may well have influenced the court.

The court found that the evidence established that:

- LGE's plan "was undertaken for the purpose of eviscerating the Key Holders' liquidity rights and the limited protections they had negotiated of those rights";

- The interim CEO was appointed by the board "as a warm body to do the dirty work that [the Board] could not" — i.e., firing nonexecutive officers;

- The interim CEO's own testimony indicated that he had no basis for terminating the nonexecutive-officer key holders other than "blindly following [LGE's] instructions"; and

- Although there apparently were numerous instances of serious misconduct by the executive-officer key holders and the common directors, Alphonso's recorded reasons for terminating them were "pretextual [and] backfilled," given their generic nature as set forth in what the court characterized as a playbook developed to implement LGE's plan to have them all fired, as well as LGE's misidentification of several officers and their titles and responsibilities.

Implied Covenant of Good Faith and the Schnell Doctrine

The court rejected the plaintiffs' arguments that the firings breached the implied covenant of good faith and fair dealing and were invalid under the Schnell doctrine, established by the Delaware Supreme Court in 1971.

As to the implied covenant, the court held that it did not apply because it was clear from the parties' bargaining history that they had considered and rejected providing additional protections to the key holders to prevent all of them being fired at any time.

As to Schnell, the court noted that the doctrine — under which the court has invalidated legal-but-inequitable actions affecting the stockholder franchise — has almost invariably been applied where a board "deliberately frustrates or completely disenfranchises a shareholder vote."

Chordia, arguably, did not involve a shareholder vote but the contractual rights of key stockholders. The court declined to delve further into "this complex area of the law" given that it had found Alphonso's firings invalid based on a contractual breach.

Practice Points

Clarity With Respect to Business Arrangements and Drafting

Chordia highlights the need for parties to stockholders' agreements — or joint venture, earnout or other bespoke business arrangement — to seek to develop a clear understanding of the arrangement and ensure that the drafting of their agreement accurately and unambiguously reflects the intended arrangement.

The more thoroughly and clearly an agreement addresses potential areas of post-closing dispute, the less likely such disputes will arise.

Whether an Efforts Clause Requires Sacrifice of Contractual Rights

Based on Chordia, parties should consider including in an efforts clause a statement to the effect that the efforts obligations will, or will not, require either party to sacrifice its rights, or any specified rights, set forth in the agreement.

Interplay Between an Efforts Clause and a Party's Right That is Subject to a Precondition

Based on Chordia, drafters of agreements should be mindful that, where a party's right is subject to a precondition, an efforts clause requiring efforts to ensure effectiveness of the parties' rights under the agreement may imbue the right-holder with protections against the company taking action such that the precondition would not be satisfied.

Thus, as in Chordia, without further clarification by the parties, a contractual right of key stockholders to designate directors, conditioned on at least one of them remaining an employee, may imbue them with protection against their being fired.

Accordingly, to the extent such protection is, or is not, intended, the parties should consider so stating in the agreement.

Distinctions Between the Company and the Board

Drafters of agreements should keep in mind that if the agreement refers to the company in some provisions and the board in others, the court may interpret the agreement as intending a divergence between the obligations or rights of the company and those of the board.

Accordingly, drafters should consider clarifying language stating whether such a distinction is, or is not, intended.

Potential Sources of Post-Closing Conflict

As highlighted in Chordia, common sources of post-closing conflict between an acquirer of a majority stake in a target company and the target's founders or other key stockholders, include disagreement over the general strategic direction for the company; the timing of an IPO or other liquidity rights; and related-party agreements.

Also, friction can arise based on a clash of corporate cultures — particularly where, as in Chordia, a more formal, traditional, hierarchical, company based outside the U.S. acquires a majority stake in or joint ventures with a U.S.-based startup company or other company with a more informal, free-wheeling, nonhierarchical culture.

In such cases, it may be helpful to set forth in the parties' agreement specifics with respect to corporate policies and expectations, including chains of command.

Necessary Context

We would observe that numerous problematic actions taken by Alphonso in Chordia could easily have been rendered nonproblematic.

For example, there were apparently good reasons to have fired the executive-officer key holders, yet the reasons the company recorded were generic and misidentified the officers, leading the court to conclude that they were pretextual.

Also, the interim CEO was hired without regard to his qualifications and abilities, and he then blindly followed the board's direction to fire executives, without any consideration of the issue or the possible applicability of the efforts clause.

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This article is part of a monthly column that delves into the most significant corporate law cases emerging from Delaware and offers practice points arising from recent court decisions.

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