Notable Chancery Decision Expands the Court’s Approaches on Director Independence, Severance-Related Conflicts, and Gaps in Board Minutes—Goldstein v. Denner

The Goldstein v. Denner (May 26, 2022) litigation arose out of the $11.6 billion cash acquisition of Bioverative, Inc. (which had recently been spun off from Biogen, Inc.) by Sanofi, S.A. The Delaware Court of Chancery held, at the pleading stage of litigation, that certain directors and officers of Bioverative may have breached their fiduciary duties in connection with the sale process. The plaintiff claimed that the defendant directors and officers sold the company (in a single-bidder process) too quickly after the spinoff; at a price far below the company’s stand-alone value (as indicated by the company’s projections prepared in the ordinary course of business); at a time when the universe of potential buyers was limited (due to tax-related restrictions following the Spinoff not expiring for another few months); and with materially inaccurate and misleading disclosure to the stockholders.

The sale process was led by an outside director, “D,” an activist investor, who allegedly was acting in accordance with his “usual playbook” of pressuring a public company into putting him on the board, then recruiting his “supporters” onto the board, and then forcing a near-term sale of the company. In this case, allegedly, he had “supercharged” the process by having the hedge fund he controlled (the “Fund”) buy a significant stake in the company after Sanofi first approached him about its interest in acquiring the company, and then waiting until the expiration period for disgorgement of short-swing profits under Section 16(b) of the Exchange Act to inform the board of Sanofi’s interest and initiate the sale process.

In an opinion that clarifies, and arguably expands, the court’s current approaches on important topics, Vice Chancellor Laster found, at the pleading stage of litigation, that it was “reasonably conceivable” (the standard for survival of claims at the pleading stage) that all of the defendant directors and officers committed unexculpated breaches of their fiduciary duties in connection with the sale process. The court reserved judgment for a future decision on the claim that D’s Fund aided and abetted D’s alleged fiduciary breach.

Continued on page 3
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Key Points

- The court suggested that “short-term investors”—at least when acting in accordance with a short-term “playbook”—may have an inherent disabling conflict of interest in a sale process. The court stated that investors with a “short-term investment strategy” have a divergent interest from the other stockholders based on which they may well favor a near-term sale when the best interests of the other stockholders would be served by remaining independent. The court amplified its recent erosion of the Synthes doctrine, stating flatly that an investor’s desire for liquidity may create a disabling conflict even if the investor does not have an “exigent need” for liquidity but simply wants “to redeploy capital” to a “different investment option.”

- The court suggested that directors appointed by activist funds—or by other “repeat players”—may inherently be non-independent. The court held that two of Bioverative’s four outside directors may not have been independent based on the likelihood of their gratitude to D for their Bioverative board seats and the likelihood that they expected that he would provide them with “future benefits” in the form of other board seats, as he was a “repeat player” in locating directors for his Fund’s portfolio companies.

- The court clarified that a director may have a disabling conflict based on a significant change-in-control entitlement even if the entitlement arises pursuant to a pre-existing agreement. Vice Chancellor Laster characterized previous Court of Chancery decisions as going “a step too far” in purportedly establishing a “rule of law” that change-in-control benefits cannot create a conflict of interest when they are paid out pursuant to a pre-existing agreement and are not triggered by the specific bidder or transaction. The Vice Chancellor stated that, even under such a scenario, whether a conflict exists depends on the facts and circumstances. He found that the $72.3 million severance payable to Bioverative’s CEO-director (“C”) was sufficiently material that it was reasonable to infer that C may have supported the near-term sale to Sanofi based on his self-interest in receiving the severance.

- The court refused to credit the company’s portrayal of certain material sale process events in the company’s disclosure to stockholders because the board minutes were silent with respect to those events. The court found it reasonably conceivable that “updates” to the board from D and another director regarding their conversations with Sanofi during the sale process, which were described in the company’s Schedule 14-D “Background of the Transaction,” had never happened given that they were not reflected in board minutes (or other books and records produced in response to the plaintiff’s Section 220 demand). Based on this (and other alleged disclosure flaws), the court ruled that Corwin (which would have “cleansed” any sale process fiduciary breaches) did not apply and that the applicable standard of review was enhanced scrutiny under Revlon.

- We note the importance of the overall factual context. Importantly, the court’s conclusions were reached in the context of a factual situation that included, allegedly, inopportune timing for the sale of the company; illicit stock purchases by D’s Fund (with the Fund standing to gain a profit of $35 million on those shares at the $90 per share price of Sanofi’s initial indication of interest); communications between D and Sanofi that were not disclosed to the board; a sale price that was significantly below the value indicated by the company’s projections prepared in the ordinary course; major revision to the projections to support the price, although there had been no changes in the company’s business; the lead director-negotiator acting consistently with a “usual playbook” of pressuring companies into near-term sales after obtaining board membership and recruiting “supporters” onto the board; and numerous alleged inaccuracies in the disclosure to stockholders. Presumably, the court’s approaches may have been different had the overall context not been apparently egregious (particularly as the court in some instances characterized its findings as “close calls” or emphasized that they were based on the plaintiff’s allegations “taken together”).
Background. After pressure from activist investor Carl Icahn, Biogen spun off Bioverative as a public company (the “Spinoff”) in 2017. Three months after the Spinoff, Sanofi approached two of Bioverative’s directors, D and “P,” to express interest in acquiring Bioverative for about $90 per share. At the time, Bioverative’s stock was trading in the mid-$50’s. D and P “demurred” and did not inform the Bioverative board about the approach. D then immediately caused his Fund to buy more than a million shares of Bioverative in the market. D did not disclose the purchases to the board and the purchases violated the company’s insider trading policy. When Sanofi approached D and P over the following few months, they continued to maintain that the company was not for sale. However, when Sanofi approached them just before the six-month period after which short-swing profits from the Fund’s market purchase of shares would no longer have to be disgorged under the securities laws, D, without the board’s knowledge or authorization, invited Sanofi to bid for the company as part of a pre-emptive, single-bidder process.

Sanofi then submitted an offer to the board to acquire the company for $98.50 per share. The board requested a higher bid; Sanofi offered $101.50; the board countered at $105; and Sanofi agreed. The $105 price was almost one-third below the company’s more than $150 per share standalone value based on the company’s internal projections in its long-range plan. Company management then “slashed” the company’s projections. A fairness opinion was obtained based on the revised projections and the Bioverative board approved the transaction. In the first-step tender offer, 62.5% of the outstanding common stock was tendered. After the closing of the second-step merger, the plaintiff inspected corporate books and records under a Section 220 demand and then brought suit.

The court’s holdings. The court held, at the pleading stage, that it was reasonably conceivable that:

- The disclosure to stockholders may have been materially inaccurate or misleading—therefore, Corwin was inapplicable and enhanced scrutiny under Revlon applied;

- Because of D’s actions and his and the other directors’ conflicts—which “steered the Company toward a quick sale to Sanofi to serve [D’s] own interests . . . at the expense of generating greater value through a competitive bidding process or by having the Company remain independent” — the sale process “did not have achieve the best value reasonable available to the stockholders”;

- D acted in bad faith (a) by concealing information from the board about his communications with Sanofi, and, separately, (b) by supporting the sale based on his own and his Fund’s self-interest in obtaining liquidity and a profit on the shares illicitly purchased by the Fund;

- P (an outside director) acted in bad faith by concealing information about his and D’s conversations with Sanofi;

- C acted in bad faith by supporting the sale based on his self-interest in obtaining a very significant severance award;

- “G” and “AP” (outside directors) acted in bad faith by supporting the sale to strengthen their relationship with D — due to likely gratitude for their board seats and a likely expectation that D would secure future board seats for them;

- All six directors (i.e., including the one outside director who the court deemed to be independent and not to have supported the sale based on self-interest) acted in bad faith in issuing disclosure to the stockholders about the sale process that they likely knew was materially inaccurate or misleading; and

- The defendant officers (the CEO, CFO and CLO) breached their fiduciary duties by assisting the defendant directors in conducting a flawed sale process — including by revising company projections to support the deal price when no changes had occurred in the business, “embellishing” the board minutes to make the sale process seem less flawed than it was, and participating in the drafting of inaccurate disclosure to the stockholders.
Discussion

The court rejected the defendants’ arguments that the significant premium reflected in the deal price, and the absence of a post-signing competing bidder, supported the reasonableness of the sale process. The court noted evidence that the defendants themselves believed that the market was not yet fully valuing Bioverative (which had only recently been spun off). The company’s projections (prepared in the ordinary course of business for its long-range plan) and the company’s valuations that supported higher values for the company were based on information about the company’s products and pipelines that had not been publicly disclosed. While Sanofi had access to the long-range plan, competing bidders would not have had access to it to inform their bids. In addition, several logical potential bidders could not participate given the timing of the sale process several months before expiration of the tax-related “restricted period” following the Spinoff.

The court found it reasonably conceivable that the disclosure in the Schedule 14D-9 was false or misleading—in some cases because sale process events depicted in the disclosure were not corroborated by the board minutes. The court found that the plaintiff’s allegations, “taken together,” supported a reasonable inference that there was “a series of incomplete or inaccurate disclosures” in the Schedule 14D-9 relating to (i) D’s and P’s early discussions with Sanofi; (ii) the stock purchases made by D’s Fund; (iii) the implications for the sale process of the Tax Matters Agreement entered into in connection with the Spinoff; and (iv) the company’s projections and revisions management made to them during the sale process. With respect to (i) above, the court noted that the board minutes (and contemporaneous emails produced by the company in response to the plaintiff’s Section 220 demand) were silent with respect to “updates” that the disclosure stated that D and P provided to the board with respect to their contacts with Sanofi during the sale process. The court noted that the defendants potentially could establish at trial (and, indeed, that there already was some evidence) that these events had occurred—but that the lack of corroboration in the minutes or other books and records gave rise to a reasonable inference at the pleading stage that the events did not occur. The court noted that “[a] lack of disclosure to the Board [was] also consistent with [D]’s successful efforts to keep secret [his Fund]’s illicit purchases of Company common stock.”

The court suggested that “short-term investors,” at least when acting in accordance with a short-term “playbook,” may have an inherent disabling conflict. The court acknowledged that, ordinarily, the Fund’s significant holdings of Bioverative shares would have helped to undermine any concern that D and the Fund might have had an interest that was divergent from the other stockholders’ interest in obtaining the best price reasonably available on a sale of the company. However, the court stated, “particular types of investors [who] espouse short-term investment strategies”—especially “activist hedge funds, which are the archetypal short-term investor”—“create[e] a divergent interest in pursuing short-term performance at the expense of long-term wealth.” While D’s association with an activist hedge fund alone was insufficient to infer that he had a disabling conflict, such a conflict was reasonably inferable based on “the playbook that [D] ha[d] followed on multiple occasions,” the court wrote. The plaintiff’s complaint detailed how D had previously targeted particular biopharma or healthcare companies; used a proxy contest or the threat of one to “force his way into the boardroom”; once on the board, had “recruit[ed] director allies in the form of [the Fund]’s insiders or supportive repeat players”; and then had pursued an outcome that facilitated the Fund’s short-term investment horizons, typically through a near-term sale of the company. As D’s actions were consistent with the “known playbook,” the plaintiff was entitled to an inference at the pleading stage that D was “following the playbook”—that is, that he was acting in furtherance of a short-term strategy that served the best interests of his Fund rather than the best interests of the company and its stockholders.

The court suggested that an investor’s desire for liquidity simply to redeploy capital can create a disabling conflict in a sale process. The court explicitly rejected the defendants’ “simplistic view” that, in a sale process, an investor “will always wait for a higher value later rather than taking a sure thing in the near term” unless the investor has an exigent need for liquidity that would lead it
to accept a “fire sale” price for the company. “That is just not true,” the court wrote, reaffirming other recent decisions in which the court has stated that the “extreme language” in Synthes (stating that a desire for liquidity creates a disabling conflict only if there is an “exigent need”) should be read “as reflecting the court’s reaction to a particularly deficient complaint” in that case, rather than reading Synthes as establishing a “general rule.” Vice Chancellor Laster, amplifying the erosion of the Synthes doctrine, wrote:

Investors follow different strategies, have different hurdle rates, and enjoy different reinvestment options. Near-term cashflows are more beneficial than outyear cashflows, precisely because they arrive sooner. An investor with attractive reinvestment options can redeploy those cash flows into other investments. An investor’s use of leverage also affects the decision. A leveraged financial investor might well seize a near term opportunity so that the profits can be deployed into an investment with a higher return. By the same token, an activist hedge fund may favor a near-term sale, followed by the redeployment of capital into another activist campaign. Yet for the common stockholders in the firm, the sounder choice may be for the firm to remain independent.

Notwithstanding this broad language, the court roots its holding to the specific factual context of the case, emphasizing D’s conflict of interest. Immediately following the language quoted above, the Vice Chancellor wrote:

The complaint supports a reasonable inference that [D] caused [the Fund] to make a significant investment in the Company’s common stock based on inside information indicating that the Company soon could be sold. Against that backdrop, the complaint supports a reasonable inference that [D] wanted the Company to be sold and that by shepherding the Company through a quick, non-competitive sale process with Sanofi, [D] could lock-in a sure gain on his illicit stock purchases. It is reasonably conceivable that by pursuing this strategy, [D] acted disloyally because he served his personal interests rather than pursuing the best interests of the Company and its stockholders.

The court rejected precedent indicating that change-in-control benefits cannot create a disabling conflict if paid pursuant to a pre-existing agreement. Vice Chancellor Laster acknowledged that, in Morrison v. Berry and In re Novell, the Court of Chancery held that change-in-control benefits cannot create a conflict of interest as a matter of law when those benefits (i) are paid out pursuant to a pre-existing agreement and (ii) there is no allegation that those benefits were triggered by the specific bidder or specific transaction. Those decisions, however, “go a step too far by converting fact-specific holdings into a rule of law,” the Vice Chancellor stated. He observed that it is the existence of a differential interest that creates a conflict, and “[t]he fact that [an] individual receives [a] payment or other differential interest because of an existing agreement does not change the fact that the individual receives the payment or other differential interest.” The Vice Chancellor commented, further, that “[i]t does not follow that the receipt of a pre-existing contractual benefit cannot give rise to a divergent interest simply because an existing contract calls for the payment is particularly strange for change-in-control payments, because one of their evident purposes is to create financial incentives for executives to favor transactions that otherwise might disrupt their employment and which they therefore might resist.” While the facts in any given case may establish that a change-in-control payment “did not give rise to a conflict of interest or that the fiduciary in question did not succumb to it, …[i]t does not follow that the receipt of a pre-existing contractual benefit, solely by virtue of being a pre-existing contractual benefit, cannot create a conflict as a matter of law.” The Vice Chancellor concluded that, in this case, as between a sale process that resulted in a near-term sale to Sanofi and the decision to continue operating on a stand-alone basis, C had a conflict of interest such that it was reasonable to infer that he may have been “happy to go along” with the sale based on his self-interest in obtaining $72.3 million in severance (which, the court noted, “dwarfed” his roughly $11 million in annual compensation).

The court highlighted that acceleration of a director’s options or restricted stock units may create a disabling conflict—but found against the plaintiff on this point as the complaint quantified only the value received under the accelerated awards and not the value of the acceleration itself. The court rejected the plaintiff’s assertion that P was
self-interested based on his receipt of $2.5 million through acceleration in the vesting of his options, and stated that Delaware courts are “rightly skeptical that director equity creates a disqualifying interest where, as here, the director received the same per-share consideration as all other stockholders.” However, the Vice Chancellor observed, “[t]hat does not mean that a disqualifying interest cannot exist” based on acceleration of options or RSUs. In this case, the Vice Chancellor found, the plaintiff did not plead facts sufficient to determine whether a disqualifying interest existed because the plaintiff had not “done the work” to quantify the amount of value conferred by the acceleration. The court explained that the value of the acceleration itself was different from (and less than, as it is only a component of) the $2.5 million aggregate value that P received from the accelerated awards.

The court’s discussion of director independence signals that directors appointed by activist funds—or by other “repeat players”—may face increased scrutiny with respect to their independence. Most notably, the court found it reasonably conceivable that certain outside directors supported the sale based on a desire to support D and strengthen their relationship with him (to be “on Team [D]”), based on their gratitude for their board seats and an expectation of future board seats or other “future benefits” from D. The court discussed recent scholarship suggesting that the court should take a more nuanced view of the personal dynamics at work when directors’ seats are secured with assistance from, and possibly for the purpose of supporting the objectives of, activist hedge funds, or controllers, venture capital firms or private equity firms, that are “repeat players.” The court noted that D and his Fund were “repeat players in the biopharma and healthcare sector”; that, for an activist fund, “the ability to secure board seats is a potent weapon”; and that, “[f]or that weapon to function, [the hedge fund] needs a pool of potential directors.” The court concluded:

It is reasonably conceivable that [D] cultivates symbiotic relationships in which he helps individuals secure lucrative directorships on the boards of the companies that [his hedge fund] targets or controls, and in return the individuals back [D]’s goals in his activist campaigns. A long-standing history of interactions would not be necessary for the carrot to have an effect. All that would be needed is a director’s desire to cultivate such a relationship. Nor would there need to be an explicit quid pro quo. The fund’s practice of rewarding directors would be a sufficient signal.

Importantly, notwithstanding the court’s broad language quoted above, the court’s holdings that two outside directors, AP and G, may have acted based on their “relationship with [D]” rather than on the best interests of the stockholders, was based not only on the relationship with D but also on the allegation that the “fast sale” to Sanofi was “at a price far below Company management’s assessment of the Company’s standalone value.” It was the combination of the relationship with the apparently low sale price that led to a reasonable inference that AP and G acted in their self-interest rather than in the interest of the stockholders. Also of note, the court characterized its holdings with respect to these directors as “close calls.”

With respect to AP, the court found that it was reasonably conceivable that “she supported a fast sale to Sanofi because she had benefitted from and wanted to keep participating in [D]’s activist campaigns.” Just weeks before joining the board, AP had received “a lucrative payout for helping [D] complete the sale of another company,” supporting an inference that she acted based on “a symbiotic relationship [with D] that she wanted to see continue.” With respect to G, the court noted that he was unemployed when D invited him to join the board, “which gave him an opportunity to restart his career”; and that, six months after G joined the board, D, after inviting Sanofi to bid for the company, secured a seat for G on the board of another company. The court noted that in a case not governed by enhanced scrutiny it would be “unlikely that a similar constellation of facts would be sufficient to overcome the presumption of good faith or to call a director’s independence into question.” For example, “the ‘reasonable doubt’ standard used in a demand futility analysis provides a higher hurdle for a plaintiff than the relatively lenient standard of review [(i.e., reasonable conceivability)] pursuant to Rule 12(b)(6),” the court wrote.
Unlike AP, G had no past history of involvement with D. However, the court applied the same analysis with respect to “a mutually beneficial relationship in which [G] supports [D]’s efforts, and D rewards [G].” D secured G’s seat on the board shortly after the Spinoff and just after Sanofi’s initial approach about a potential transaction with Sanofi. Six months later, after inviting Sanofi to make a bid, D used his position on the board of another company to secure a seat for G on that board. According to the complaint, G and D later “engineered a sale” of that company that earned G $3 million for his shares and options in that company after only two years on its board (and earned D’s Fund $364 million for its shares plus $3.7 million for D personally). Together, these facts made it reasonably conceivable that G supported the sale to Sanofi “to be supportive of [D].” The court found that it was reasonably conceivable that D, as the Chair of the Governance Committee, played a key role in the appointment of G to the Board; that the appointment “would have inspired some level of gratitude on [G]’s part since he had been out of a job since 2016”; and that G was aware of D’s “practice of looking out for his friends by helping them secure lucrative directorships.” The court found that, taken together, the allegations were “sufficient to support a rational inference that [G] acted in bad faith by supporting the Transaction out of gratitude for [D]’s help and an expectation of future rewards.”

The court found it reasonably conceivable that the officers breached their fiduciary duties. The court noted that the CEO, CFO and CLO each stood to reap very significant benefits from the transaction in the form of severance and/or acceleration of their options and restricted stock units. “Against that backdrop,” the court found that the plaintiff adequately alleged that these officers “breached their fiduciary duties by assisting the Director Defendants in achieving the quick sale to Sanofi as part of a defective sale process.” With respect to C and the CFO, the court found it was reasonable to infer that they acted disloyally when (i) failing to disclose to the board the Fund’s stock purchases (which they had reason to know may have been the result of inside information provided by D) and (ii) participating in revising the company’s projections to facilitate delivery of the fairness opinion (which involved management “systematically slashing” the projections after the board agreed to Sanofi’s $105 per share offer, although no changes had occurred in the business). With respect to the CLO, the court found it was reasonable to infer that she may have acted disloyally by “engaging in acts of creativity” when creating the record of the sale process, including by “embellishing [board minutes] to depict an idealized process rather than what actually occurred,” and by “participating in the drafting of an inaccurate Schedule 14D-9.” The court, noting inconsistencies between the board minutes and contemporaneous emails, stated that while there could be defendant-friendly explanations for them, they were sufficient at the pleading stage to state a claim.

Practice Points

- It bears continued emphasis that—particularly in light of the critical role disclosure plays in determining the standard of review at the pleading stage and the current prevalence of pre-litigation Section 220 demands—management and the board should pay special attention to board minutes, emails and other corporate books and records relating to a sale process. The benefits of more (rather than less) comprehensive board minutes should be considered—as “silence” in the minutes may lead to the court drawing negative inferences; and the court is less likely to grant access under a Section 220 demand to electronic communications of directors, officers or advisors to the extent that the board minutes and other official books and records are comprehensive. Directors should be counseled regularly and emphatically about the appropriate use and content of emails (as emails now often must be produced in response to Section 220 demands). The disclosure to stockholders should reflect the reality of what occurred (rather than an “idealized” version of events based on what should have occurred). The disclosure, minutes, contemporaneous emails, and other books and records should be consistent with one another. Indeed, in some decisions, the court has compared the disclosure line-by-line or word-for-word with board minutes and drawn negative inferences from even minor differences between the two.
It should be kept in mind that the court may view skeptically the independence of a director who was placed on the board under the auspices of an activist investor or other investor who may be viewed as a “short-term investor” or “repeat player.” An investor who places directors on boards should weigh the benefits of “serial” appointments of the same persons to numerous board seats as compared to the litigation benefit of not creating an expectation by the director of “future benefits” from the investor in the form of additional board seats. In all cases, directors should ask questions and seek information (which may be recorded in the board minutes) that evidence that the director’s consideration is focused on the best interests of the company and its stockholders rather than the director’s self-interest or the interest of any other director or other person (including the person who helped to secure the director’s board seat).

Again, overall context matters. The court may well decide “close calls,” or even reach in its analysis, in favor of the plaintiff where the overall factual context suggests a pattern of serious misconduct by the defendants.

Court of Chancery Reaches the Rare Conclusion that a Conflicted Controller Transaction, With a Flawed Sale Process, Met the “Entire Fairness” Standard—Tesla-SolarCity

In In re Tesla Motors, Inc. Stockholder Litigation (April 27, 2022), the stockholder-plaintiffs challenging the $2.1 billion stock-for-stock acquisition of SolarCity, Inc. by Tesla, Inc. (the “Acquisition”) claimed that Elon Musk was a controller of both companies and had caused Tesla to acquire the then-insolvent target company at an inflated price in order to salvage his (and his family members’) investment in it. The Delaware Court of Chancery, in a post-trial decision, found it unnecessary to rule on whether the entire fairness standard of review applied, given that there was “compelling evidence” that, even if that standard applied, the Acquisition satisfied it. The decision is notable for being one of only roughly a handful in recent years in which the Court of Chancery has found that a challenged conflicted controller transaction (or, in this case, a transaction assumed by the court for purposes of the decision to be such a transaction) met the entire fairness standard—and notably, in this case, the court so found notwithstanding that it viewed the process (which did not include a special committee) as “far from perfect.”

Key Points

- It is possible for a transaction subject to entire fairness review to be proven to be “entirely fair”—even if the sale process was flawed. The decision reinforces a trend of the court in recent years in emphasizing the fairness of the price as the predominant factor in an entire fairness inquiry over the fairness of the process. Although “entire fairness” requires a “unitary” determination of the fairness of both the price and the process, where it can be established based on market factors that the price paid was fair, the court has been reluctant to find that the transaction was not entirely fair. We note that there have been cases, however, in recent years in which the court has found a transaction not to meet the entire fairness standard notwithstanding a fair price when the process was found to be grossly unfair. Indeed, in this case, the process, while flawed, included a vote by the unaffiliated stockholders and the court found that Musk did not in fact dominate the process and the Tesla directors were well-motivated and pursued Tesla’s best interests.

- The decision suggests that the court will be hesitant to find that a transaction that was “highly beneficial” to the acquiring company was not entirely fair based on a flawed process. The court emphasized that the
Acquisition fulfilled Tesla’s long-term plan to transition from an electric vehicle producer to a renewable energy company and that it had proved “highly beneficial” to Tesla.

**Background.** At the time of the Acquisition, Musk was: the largest stockholder (owning approximately 22%) of both Tesla and SolarCity; Tesla’s co-founder and longtime Chairman and CEO, “direct[ing] Tesla’s operational and strategic decisions”; and the longtime Chairman of SolarCity (which had been founded by his cousins). Musk proposed the Acquisition and was a vocal proponent of it throughout the process. The transaction was approved by the Tesla board (without utilizing a special committee) and by a majority of the disinterested Tesla stockholders. The plaintiffs brought a post-closing suit alleging that Musk was a controller of both companies; that all but one of Tesla’s directors had conflicts with respect to the Acquisition; and that Musk had caused the board to approve the Acquisition, at a highly inflated price, in order to bail out his (and his family members’) floundering investments in SolarCity, which was insolvent at the time of the Acquisition. The plaintiffs brought suit seeking $13 billion in damages, claiming that: the Acquisition was a conflicted controller transaction that was accomplished by reason of Musk’s domination of a conflicted board; the entire fairness standard of review therefore applied; neither the price nor the process were fair; and the Tesla directors thus breached their fiduciary duties to Tesla’s stockholders. All of the defendants but Musk settled the claims against them before trial. After an 11-day trial, the court dismissed the claims against Musk. Vice Chancellor Slights concluded that, even if the entire fairness standard applied, there was “compelling evidence” that the standard was satisfied.

**Discussion**

The court found that the imperfect process was sufficient to satisfy entire fairness. The court declined to rule on whether the entire fairness standard applied—leaving unresolved the issues as to whether Musk was a controller of both companies, whether the Acquisition was a conflicted controller transaction, and whether the transaction was effectively ratified by the stockholder vote. The court held that, even if entire fairness were applicable, the transaction met the standard, notwithstanding that the process was “far from perfect.” The court reasoned that the Tesla board had “meaningfully vetted the Acquisition, and [Musk] did not stand in its way.”

The problematic aspects of the process included the following:

- the Tesla board did not use a special committee of independent directors to negotiate or consider the Acquisition;
- several Tesla directors had conflicts that, in the court’s view, “were not completely neutralized”;
- while Musk was recused from some of the board’s discussions about the Acquisition, he actively participated in others — according to the court, he “was more involved in the process than a conflicted fiduciary should be”; and
- without the board’s knowledge, Musk had several private discussions about the Acquisition with SolarCity and with Tesla’s financial advisor.

The aspects of the process that were protective of the unaffiliated Tesla stockholders were as follows:

- the Tesla board conditioned the transaction on approval by a majority of the unaffiliated stockholders although such vote was not required by Delaware law; and
- the Tesla board was advised by independent legal and financial advisors.

The court emphasized the fairness of the price as the predominant factor in the entire fairness test. While entire fairness entails a “unitary test” requiring fairness of both the price and the process, in the most recent few years the court has been
emphasizing the price aspect of entire fairness. In this case, the court viewed the challenged transaction as having “had both flaws and redeeming qualities” from a process point of view, but characterized “[t]he linchpin of the case” as being that “Musk proved that the price Tesla paid for SolarCity was fair — and a patently fair price ultimately carries the day.”

**At the same time, the court encouraged controllers to utilize procedural protections to achieve a fair process.** The court suggested that its opinion be viewed as “a parable of unnecessary peril [for Musk], despite the outcome.” Vice Chancellor Slights observed that Musk and the other Tesla directors “likely could have avoided this expensive and time-consuming litigation had they just adopted more objectively evident procedural protections” for the Tesla stockholders. As noted, while the board adopted one such protection, subjecting the transaction to a vote of the unaffiliated stockholders, it did not utilize a special committee to evaluate and negotiate the transaction. If it had, the transaction likely would have been subject to the deferential business judgment standard of review, resulting in dismissal of fiduciary claims at the early pleading stage of litigation. The court wrote: “That [Musk] and the Tesla Board failed to follow this clear guidance [from the Delaware courts as to deal techniques to provide stockholders with protections substantially equivalent to arm’s-length bargaining] and yet prevailed here should not minimize those incentives or dilute the implications of the onerous entire fairness standard of review. [The board’s] choices constricted the presumptive path to business judgment deference and subjected [Musk]’s conduct to post-trial judicial second-guessing.”

**The court found that the price was fair to Tesla.** The court emphasized, first, that the Acquisition effected a key part of Tesla’s long-term plan and had been “highly beneficial” to Tesla. The court credited Tesla’s view that the Acquisition was “a vital step forward” in Tesla’s realizing its long-time announced intention to “expand from an electric car maker to an alternative energy company” — that is, its objective that, after it succeeded in producing electric vehicles, it would seek to obtain the electricity through a renewable source of energy. The Acquisition was “part of this vision.” Indeed, Tesla’s “Master Plan,” which Musk had written ten years earlier, specified that Tesla eventually “would be co-marketing ‘moderately-sized and priced’ solar panels from SolarCity along with Tesla’s sports car.” Moreover, Tesla had previously tried to work with SolarCity on an arm’s-length basis, but had concluded at that time that, for the collaboration to be successful, the two companies would need to combine. The court also noted that Tesla’s stock price was just over $185 per share at the time of the Acquisition and had risen to $900 per share at the time of the court’s issuance of the decision.

Second, the court rejected the plaintiff’s contention that SolarCity was valueless at the time of the Acquisition. As both sides agreed that SolarCity’s liquidity challenges had been disclosed and that the stock traded in an efficient public market, the court relied on market indicia of value — particularly that the deal price represented a discount to Solar City’s unaffected stock price. The court noted that the offer price was “not near the low end of a range of fairness” and thus was “entirely fair in the truest sense.” In addition, the court found it “compelling” that “nearly 85% of the votes cast by Tesla stockholders — largely, extremely sophisticated institutional investors — were in favor of the Acquisition.” Moreover, contemporaneous documents indicated that Tesla anticipated synergies above the premium it was prepared to pay. The court, concluding that SolarCity was a valuable (although cash-strapped) company, found that the plaintiffs’ presentation with respect to damages was “incredible on its face” and that “SolarCity was, at a minimum, worth what Tesla paid for it….”

**Although the process was flawed, the board “vetted” the Acquisition, Musk “did not stand in the way,” and the lead negotiator and financial advisor were “unquestionably” independent of Musk.** The court found that the evidence at trial substantiated that the Tesla board’s consideration of the Acquisition was not for the purpose of “bail[ing] out” SolarCity but, instead, based on the “strategic rationale for the combination of solar and storage” for Tesla’s electric vehicles. Musk himself initially had advocated to Tesla’s board that the price to be paid should be in the mid-range of precedent premia paid in similar transactions so that the price would be “publicly defensible.” Tesla’s initial offer represented a 21-30% premium over SolarCity’s trading price at that time.
In addition, importantly, although Musk and SolarCity privately had discussed SolarCity’s need for a bridge loan in light of its liquidity crisis, and Musk had requested that the board include such a loan as part of the offer, the Tesla board did not include a loan in the initial offer, as the board had concluded that it would not be in Tesla’s best interest. The court characterized the process as having provided Musk with the “potential” and an “opportunity” to exert influence over the board’s decision, but found that in actuality Musk did not dominate the process and the Tesla directors were well-motivated and pursued Tesla’s best interests.

In addition, the court noted that the one Tesla director whose independence was unquestioned had led the negotiations with SolarCity; and that the independence of Tesla’s financial advisor, Evercore, also was unquestioned. The court observed that Evercore’s 10-member team had engaged in extensive due diligence and spent “thousands of hours” reviewing SolarCity’s financial condition, performing analyses, and negotiating with SolarCity’s financial advisor. Further, Tesla had lowered its offer price after completing due diligence and discovering that the extent of SolarCity’s liquidity challenges were more severe than Tesla had known. (The reduced offer was to pay 0.110 shares of Tesla stock for each SolarCity share—“well below” the initial offer range of 0.122 to 0.131, the court noted.) In addition, the reduced price fell within or below each of the seven stock price ranges Evercore had presented to the board.

**Practice Points**

- **Crafting a process for a conflicted controller transaction with procedural protections for the unaffiliated stockholders continues to provide the greatest legal protection for the controller.** However, when weighing the benefits and disadvantages of the sale process, a controller should take into consideration that it is possible for such a transaction to pass muster under the entire fairness test if (i) it can be established through market factors that the price was fair and (ii) it can be shown that the controller did not dominate the board or the process. The latter can be established, as in this case, by the board having rejected certain of the controller’s proposals with respect to the transaction without “push back” from the controller; the controller not having engaged in “threats, fits or fights”; and the lead negotiator and the financial advisor having been “unquestionably independent” of the controller.

- **It is only with the procedural protections in place that a challenge might be dismissed at the pleading stage of litigation.** The case underscores the litigation risk inherent in a board’s proceeding with a potential controller transaction without utilizing the procedural protections. Notwithstanding that Musk may not have been a controller and that the board may not have been influenced by Musk (and that it appeared to work to accomplish a fair transaction for the shareholders), the litigation challenging the transaction spanned half a decade.

- **The decision underscores the importance of credible, well-prepared witnesses who can establish a record of what occurred.** In several instances, the court found the Tesla witnesses’ testimony credible and credited their version of events. In particular, the court characterized Evercore as a “diligent advisor with no previous ties to Tesla” that “credibly explained and defended its work and advice.” The court stated with regard to the director who was the lead negotiator for Tesla: “If she said she was in charge, she was in charge.”
Sale of Portfolio Company Is Subjected to Entire Fairness Review Based Largely on the PE Sponsor’s Desire to Close Out Its Fund—Manti Holdings v. Carlyle Group

In Manti Holdings v. The Carlyle Group (June 3, 2022), the Delaware Court of Chancery held that entire fairness review would apply to the challenged sale of The Carlyle Group’s portfolio company, Authentix Acquisition Corp., due to the pressure Carlyle allegedly exerted to cause a quick sale so that it could close out its fund, Carlyle Holdings, that had invested in the company. The court acknowledged that controlling stockholders generally have the same incentive as other stockholders to maximize stockholder value in a sale to a third party and that, as a result, a controller’s desire for liquidity typically has not been a basis for rejecting business judgment review of a challenged transaction. In this case, however, the court viewed Carlyle’s alleged desire to close out its fund as having rendered it conflicted such that the more stringent entire fairness standard of review was applicable. Vice Chancellor Glasscock wrote: “[T]he reality is that rational economic actors sometimes do place greater value on being able to access their wealth than on accumulating their wealth.”

Key Points

- The decision reinforces the court’s trend in recent decisions in finding it plausible that a sponsor’s desire for liquidity may create a disabling conflict. Notably, however, the factual context in which the court reached its decision included the board not having established a special committee to exclude the sponsor-affiliated directors; testimony that Carlyle exerted pressure on the directors to approve the merger; and a non-ratable benefit from the merger for the sponsor in obtaining a profit on its preferred stock investment while the holders of the common stock received almost nothing.

Background. To encourage Carlyle to invest in and become a controller of Authentix, the stockholders had entered into a stockholders agreement pursuant to which they agreed not to oppose any sale of Authentix approved by the board and by a majority of the outstanding shares (in other words, approved by the board and Carlyle). In 2017, the board and Carlyle approved a sale of Authentix to Blue Water Energy for $70 million. Under the terms of the stockholders agreement, the holder of the company’s preferred stock was entitled to receive the first $70 million of consideration paid in a sale of the company. Thus, with a sale at $77.5 million, Carlyle (as the holder of Authentix’s preferred stock) would make a profit on its preferred stock investment but the common stockholders (including the plaintiffs) would receive almost nothing for their stock. Litigation ensued. In previous decisions in the case, the court held that the terms of the stockholders agreement (i) constituted a waiver by the common stockholders of their statutory appraisal rights and (ii) did not preclude the plaintiffs from bringing a fiduciary suit against Carlyle and the Authentix directors. In this most recent decision, the court held that the plaintiffs had adequately stated a claim for breach of fiduciary duties by Carlyle and the Carlyle-affiliated directors on the Authentix board.

The court found it reasonably conceivable that the sale was a conflicted controller transaction and entire fairness review thus applied. The five-person Authentix board included two directors closely affiliated with Carlyle. The court readily concluded that it was reasonably conceivable (the standard for the survival of claims at the pleading stage) that the two directors, together with three Carlyle entities (the fund owning a majority of Authentix’s stock, the general manager of the fund (which had a management agreement with Authentix), and the ultimate parent private equity firm), exercised control over Authentix. In addition, the court concluded that it was reasonably conceivable that Carlyle received a “unique benefit” from closing the sale quickly, which rendered the sale a conflicted controller transaction—and thus subject to entire fairness review.
The court found it reasonably conceivable that Carlyle derived a “unique benefit” from the sale and may have breached its fiduciary duties. The court noted the testimony of one of Carlyle’s representatives on the board that he was “under pressure” from Carlyle to sell the company quickly because it was one of the last investments still open in the applicable fund and Carlyle wanted to monetize and close the fund. This led the court to conclude that it was reasonably conceivable that Carlyle derived a unique benefit from the timing of the sale that was not shared by the other stockholders, in the context of the following factors:

- As noted, Carlyle received a non-ratable benefit in the merger from its holdings of Authentix preferred stock;
- Uncertainties about contracts that were key to Authentix’s business (and had resulted in several potential bidders dropping out of the process and all of the bidders including a large contingent component in their offer prices) were resolved, but Authentix nonetheless proceeded with the sale to Blue Energy without seeking to renegotiate or to reengage with other bidders; and
- The sole director who objected to the sale (initially urging that the timing be delayed until the contractual uncertainties were resolved, and later arguing against a sale price that would provide a profit to Carlyle while providing nothing for the other common stockholders) was ultimately excluded from the board’s deliberations on the sale.

The court found it reasonably conceivable that the Carlyle-affiliated Authentix directors may have breached their fiduciary duties. The court emphasized that these directors, as “dual fiduciaries” on both sides of the transaction, were “required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.” Despite their dual fiduciary status, the court noted, the board did not form a special committee to insulate the sale process from their influence and they in fact participated in the sale process throughout and voted to approve the sale. As discussed, one of them testified that he was motivated to sell Authentix because Carlyle wanted to close its fund. Also, as noted, the board allegedly excluded from the process the lone director opposing the sale. On this basis, the court concluded that the Carlyle-affiliated directors may have acted disloyally in connection with the sale.

Practice Points

- **Timing of the sale of a portfolio company should not be based solely on the PE sponsor’s desire to close out its investment fund.** A sponsor’s desire for liquidity does not necessarily negate an identity of interest with the common stockholders in maximizing the sale price of the company. However, such a desire, when combined with aspects of the sale process indicating a disregard for maximizing the sale price for the common stockholders, can support a reasonable inference of fiduciary breach. Where the sponsor has a desire for liquidity, its representatives and the other directors on the portfolio company board should understand the reasons motivating the sale other than the sponsor’s desire for liquidity and those reasons should be reflected in the record.

- **Directors generally should not exclude a dissenting voice in the boardroom.** Where a director opposes a proposed sale, absent a specific reason to exclude the dissenting director, the other directors generally should listen to and consider the dissenting director’s views although they may disagree with and ultimately reject them.
Board Authority to Interpret Charter Provision Did Not Modify Standard of Review Applicable to the Board’s Action—Totta v. CCSB Financial

In Totta v. CCSB Financial Corp. (May 31, 2022), the Delaware Court of Chancery, in a memorandum opinion issued after trial on a paper record, rejected the defendants’ argument that the board’s authority to interpret a provision in the company’s charter required that the court apply business judgment deference to the board action taken based on that interpretation. The court held that, as the board’s action affected the stockholder franchise, enhanced scrutiny under Blasius was the appropriate standard of review and the defendant directors did not have a “compelling justification” for their interpretation that interfered with the right of certain stockholders to vote.

CCSB Financial Corp.’s charter provided that a stockholder could not exercise more than 10% of the company’s voting power. The charter also provided that the board had authority to interpret the charter provisions and that its interpretations would be “conclusive and binding.” In the context of a live proxy contest, the board adopted “a new interpretation of that never-before-invoked provision . . . .,” which permitted the board to aggregate multiple stockholders’ holdings when calculating the 10% limit if the board perceived the stockholders to be acting in concert with one another. Based on that interpretation, the board instructed the inspector of elections not to count any votes above the 10% limit that were submitted by the insurgent, his slate of nominees, and an affiliated entity. As a result of that instruction, the insurgent lost the election.

In a post-trial opinion, Chancellor McCormack held that the board had “improperly applied the aggregation principles to the Voting Limitation to disenfranchise the plaintiffs”; and, further, that “the board’s conduct was invalid under equitable principles.” The court reasoned that a corporate charter, in contrast to an alternative entity’s organizational documents, cannot “alter the directors’ fiduciary obligations and the attendant equitable standards a court will apply when enforcing those obligations.” Applying Blasius, the court found that the board did not have a “compelling justification” for interfering with certain stockholders’ right to vote. The board’s “sole justification for its decision to exclude the votes at issue” was to “protect” the company’s shareholders from the effort by a “corporate raider” to take control and consider selling the company. The court cited “numerous deficiencies” with this argument, including that: (i) the company had a staggered 7-member board—thus, even if the insurgent’s three nominees were elected, they would not have constituted a majority that could force a sale of the company; and (ii) the decision whether to elect nominees who (allegedly) would propose to sell the company “must be left to the Company’s stockholders.” Not only does the board not have an obligation to “protect” stockholders against the election of insurgents who would attempt to sell the company, but “the Board has an affirmative obligation not to interfere with the stockholder franchise without a compelling justification, and its sole justification [in this case] is foreclosed under Delaware law.”

Non-compete Agreement in Non-Reportable Acquisition Attracts Antitrust Scrutiny Post-Closing—ARKO

The Federal Trade Commission announced on June 14, 2022, nearly a year after Arko Corp. acquired 60 Express Stop retail gas stations from Corrigan Oil Company, that the agency was “[taking] action to restore competition” in the gasoline and diesel fuel markets in Michigan and Ohio by challenging the breadth of the non-compete provisions in the transaction (which was not a “reportable” transaction under the Hart-Scott-Rodino Act). While ARKO acquired only 60 gas stations in the transaction, it had agreed in the merger agreement to non-compete provisions covering not only the acquired stations but more than 190 other stations where the seller had existing operations.

The FTC, first, concluded that the transaction was impermissibly anticompetitive in five local markets and the proposed consent order requires that ARKO return the five gas stations in these markets to the seller. Second, more notably, the proposed order requires that, for ten years, ARKO must obtain prior approval from the FTC before
acquiring gas stations within five miles of these returned stations. Third, most importantly, the proposed order requires that the parties amend the non-compete provisions to limit them to the acquired gas stations only, to a geographic area of three miles from those locations, and to a duration of three years. The proposed order also requires that ARKO not enter into or enforce any similar non-compete agreement that restricts competition solely around a retail fuel business already owned or operated by ARKO prior to the acquisition, and that it notify third parties subject to similar non-compete agreements that it cannot enforce those provisions. The FTC reasoned that the broad coverage of the non-compete “bore no relation” to the acquisition and was not reasonably limited in scope to protect a legitimate business interest. The action continues a trend by the FTC in the past few years of challenging what it considers to be overly broad non-compete provisions in merger agreements. Thus, merger parties should be aware that non-compete provisions entered into in connection with an acquisition, while common, may attract antitrust scrutiny (including post-closing and including with respect to non-reportable transactions). Accordingly, merger parties should carefully consider the scope and duration of such provisions in the context of the specific facts and circumstances of the transaction, including taking into account the potential risk that a challenge to the noncompete could include seeking to invalidate other similar already existing agreements.

The Chancery Decision Serves as a Reminder that Abstention from Voting Generally Will Not Insulate a Director from Liability if the Director Was Otherwise Involved in the Challenged Transaction — Harris v. Junger

In Harris v. Junger (May 25, 2022), the Delaware Court of Chancery (in a memorandum opinion) declined to dismiss the fiduciary claims made against a director of Fat Brands Inc. in connection with the merger of the company with its 81.2% controlling stockholder. The court had ruled in a previous decision that the merger, on its face, was “so inimical to Fat Brands that it constituted corporate waste or bad faith,” but had reserved judgment on whether the plaintiff’s complaint adequately stated a claim against the director. The director, “J,” due to conflicts of interest, including that he was also a stockholder of the controller, Fog Cutter Capital Group, Inc., did not serve on the special committee that recommended the merger and abstained from the board vote approving the merger.

In the years prior to the merger, Fat Brands made a series of loans to Fog Cutter Capital, which were used by Fog Cutter Capital to fund loans it made to its principal. The principal never repaid the loans; Fog Cutter Capital ultimately forgave about $16 million in advances to him; Fog Cutter Capital ultimately owed Fat Brands more than $36 million; and the principal then proposed the merger of Fat Brands and Fog Cutter Capital. A special committee of Fat Brands recommended, and the full board (with J abstaining) approved, the merger. After the merger closed, Fog Cutter Capital owned 71% of Fat Brands. The plaintiffs brought suit claiming that the merger was orchestrated to eliminate the debt between the companies.

The financial advisor to the Fat Brands special committee informed the committee that Fat Brands would lose $50.2 million in value from the merger due to its eliminating the obligations owed by Fog Cutter Capital. To mollify the minority stockholders, Fat Brands issued preferred stock to them in an amount that purportedly offset that loss. The financial advisor issued an opinion that the merger was fair to Fat Brand’s unaffiliated stockholders, but did not determine that the merger was fair to Fat Brands itself.

In this most recent decision, Vice Chancellor Glasscock held that J was not shielded from liability with respect to the merger. The Vice Chancellor noted that, although J had abstained from voting on the merger, he had been a member of an earlier special committee that had considered the transaction; that, after that committee disbanded, the full board, including J, without a special committee in place, had continued to discuss the potential merger (and during that time had approved a $1 million loan to Fog Cutter Capital); and that, even after a new special committee was established, the full board, including J, had continued to discuss the merger at regular board meetings. The Vice Chancellor concluded that “[These facts] gave rise to a reasonable inference that [J] was involved in the Merger negotiations, even if he did not participate in Special Committee meetings or vote to approve the Merger.” As directors who are “involved in negotiating a transaction cannot shield themselves from any exposure to liability by deliberately
absenting themselves from the directors’ meeting at which the proposal is to be vote upon,” the Vice Chancellor held that it was “reasonably conceivable at the pleading stage that [J] breached his duty of good faith by participating in negotiating a Merger that constituted corporate waste.”

2022 Amendments to DGCL are Adopted

Proposed amendments to the Delaware General Corporation Law have been passed by the Delaware General Assembly and, if signed by the Governor (as is expected), will become effective on August 1, 2022. Key aspects of the amendments include the following:

- **Exculpation of corporate officers.** Section 102(b)(7) will be expanded to permit corporations to provide in their charters for exculpation of officers. Since the adoption of Section 102(b)(7) in 1986, exculpation from personal liability for monetary damages for breaches of the fiduciary duty of care has been limited to directors. Fiduciary claims against officers have increased significantly in recent years, particularly in post-closing M&A challenges seeking monetary damages. Frequently, claims against directors for alleged fiduciary breaches have been dismissed at the pleading stage due to the directors being exculpated, but claims against officers for the same conduct have proceeded due to the officers being unexculpated; and claims against a person frequently have been dismissed for conduct taken in his or her capacity as a director, due to exculpation, but have not been dismissed for the same conduct taken in his or her capacity as an officer. Under the amendment, the scope of exculpation for officers would be similar to that currently permitted with respect to directors, except that an officer cannot be exculpated in actions brought by the corporation against the officer (including derivative actions).

- **Notice of meetings.** Section 222 will be expanded to clarify certain issues relevant to virtual meetings. It will provide that, unless the bylaws otherwise require, when a meeting is adjourned (including due to a technical failure to convene or continue the meeting by remote communication), notice need not be given if the time, date, and place of the meeting (and, as applicable, the means of remote communication) are announced at the meeting, displayed on the electronic network used for the virtual meeting during the time scheduled for the meeting, or set forth in the notice of meeting.

- **Stockholder list.** Section 219 will no longer require that the stockholder list be made available during stockholder meetings, nor, with respect to virtual meetings, that information required to access such list be included with the notice of meeting.

- **Appraisal rights.** Section 262 will be amended: (i) to permit beneficial owners to demand appraisal directly, in their own name, without having to go through brokers or The Depositary Trust Co.; (ii) to no longer require that a copy of the appraisal statute be attached to the notice that appraisal rights are available and, instead, to permit a company to provide directions to access the statutory text (“without subscription or cost”) at a “publicly available electronic resource”; and (iii) to make appraisal rights available in connection with any conversion of a corporation to another entity (in light of the amendment changing the vote required under Section 266 for approval of a conversion from a unanimous vote to a majority vote).

- **Delegation of authority to issue stock and options.** Sections 152, 153 and 157 will be amended to permit a board to delegate not only to the board or a board committee but to “any person or body” the authority to issue the corporation’s stock, sell treasury shares, and issue rights and options, so long as the board or board committee resolution delegating such authority fixes, with respect to the issuances or sales, (i) the maximum number of shares or options; (ii) the time period during which the issuances or sales can occur; and (iii) the minimum consideration. Generally, these parameters may be made dependent on “facts ascertainable,” but (a) if the board or a board committee approves the transaction that results in issuing stock or options, then a “fact ascertainable” can be a determination by any person or body, however, (b) if the board delegates to a person or body the decision to enter into the transaction that results in issuing stock or options, then determinations or actions by that person cannot be “facts ascertainable.”
Domestication of a non-U.S. entity to a Delaware corporation. Section 388 will be amended to permit the domesticating entity to adopt a “plan of domestication” that sets forth the manner of exchanging or converting the non-U.S. entity’s equity interests (in addition to setting forth the terms of the domestication). In addition, the plan may set forth corporate action to be taken by the domesticated corporation in connection with the domestication, which acts must be approved in accordance with applicable non-U.S. law before the effectiveness of the domestication. Once the plan of domestication is approved by the non-U.S. entity, all such corporate actions will be deemed to have been authorized, adopted and approved by the domesticated corporation and its board or members (as applicable) and will not require further actions by the board, stockholders or members of the domesticated corporation.

California Laws Requiring Diversity on Boards are Ruled Unconstitutional—But Board Diversity Remains a Focus

On May 13, 2022, a Los Angeles Superior Court judge ruled unconstitutional the California law, enacted in 2018, that required public corporations with principal executive offices in California to have at least one female director on their boards by the end of 2019 and up to three female directors by the end of 2021. The law subjected noncomplying companies to fines ranging from $100,000 for a first violation to $300,000 for subsequent violations (although no fines are known to have been levied). About a year after the law was enacted, the nonprofit advocacy group Judicial Watch brought suit challenging the constitutionality of the law on the basis that its gender-based quota violated the Equal Protection Clause of the California Constitution, as similarly situated people (men and women) were being treated differently based on their gender. The Superior Court concluded that the government failed to establish that the use of a gender-based classification was justified by a compelling government interest and that the law was not narrowly tailored to remedy gender discrimination. The California Secretary of State has stated that the decision will be appealed.

Before the law was overturned, it was credited with, at least in part, increasing gender diversity on boards of California-based public companies. In 2021, 31% of board seats of such companies were held by women—which was more than double the percentage before the law was passed in 2018. (In North America overall, 27% of board seats were held by women in 2021, up from 22% in 2019.) The number of California-based boards with no female directors at all dropped to 1% in 2021, down from 28% before the law was passed. Over half of California-based companies had three or more female directors in 2021, up from 11% in 2018.

In 2020, a similar California law was enacted that required companies to have at least a specified number of directors from “underrepresented communities.” Shortly thereafter, Judicial Watch brought suit challenging the constitutionality of this law as well, on the same basis. On April 1, 2022, a different Los Angeles Superior Court judge ruled that this law violated the Equal Protection Clause of the California Constitution.

While the California laws have been overturned, pressure on boards to diversify nonetheless continues from many fronts—including institutional investors, retail investors, proxy advisory firms, stockholder activists, and other stakeholders. In our experience, virtually all boards now consider the reputational risks associated with failing to have a diverse board along with the substantive benefits of diversity on the board. In addition, NASDAQ now requires that companies listed with it (i) publicly disclose board diversity statistics and (ii) either have at least two diverse directors (including one female director and one director who self-identifies as being from an underrepresented minority group or being LGBTQ+) or explain why this requirement has not been met. Also, in April 2022, new rules were adopted by the U.K. Financial Conduct Authority that will, among other things, establish for U.K.-listed companies an annual “comply or explain” reporting regime with respect to board and executive management diversity targets set by the FCA and will require annual disclosure in a prescribed format of certain information about board and executive management diversity.
Our Client Briefings Issued This Quarter

Court of Chancery Accepts, “With Trepidation,” at Motion to Dismiss Stage, a “Novel Theory” of Liability for Directors — Garfield

In Garfield v. Allen (May 24, 2022), the Delaware Court of Chancery accepted, “with admitted trepidation,” what it called a “novel theory” advanced by the plaintiff—namely, that a corporation’s directors may have breached their fiduciary duties to the stockholders by failing to reverse equity compensation awards made to the CEO after the board became aware, via the plaintiff’s litigation demand letter, that the awards violated a limitation set forth in the company’s equity compensation plan. Vice Chancellor Laster accepted, at the pleading stage, the plaintiff’s “novel” theory that a board’s failure to act to address a problem it learns of through a litigation demand letter may constitute a breach of the directors’ fiduciary duties. The Vice Chancellor declined to dismiss the plaintiff’s fiduciary claims (as well as certain contractual claims) against the directors who approved the awards; against the other directors (who did not approve the awards); and against the CEO who received the award. While the opinion strongly suggests that the theory should be applied in a limited factual context, it remains to be seen how the theory will evolve in future cases. In our Client Briefing, we discuss the court’s decision and its possible implications and offer related practice points.

Far-Reaching Rules Proposed by SEC Would Transform SPAC Process to Make It More Burdensome than a Traditional IPO

On March 30, 2022, the SEC proposed new rules that would eliminate many of the current benefits for a private company in going public through a merger with a SPAC rather than through a traditional IPO process. The proposed rules are more far-reaching than was expected and would transform the SPAC process, making it lengthier, more costly, and more complex, and imposing a greater risk of liability for the entities involved. While the SEC stated in the proposing release that the proposed rules are intended to provide investors with disclosures and liability protections comparable to those that would be present in a traditional IPO, we would observe that, arguably, the proposed rules are in fact significantly more burdensome than those applicable in a traditional IPO—in light of the requirements relating to the SPAC making a fairness determination with respect to the de-SPAC transaction and the significantly expanded potential liability for financial advisors and others with respect to de-SPACs. Even before issuance of the proposal, the SPAC market had been receding due to increased regulatory, judicial and investor scrutiny and skepticism. The proposed rules, if adopted, would accelerate this trend. In our Client Briefing, we summarize the proposed new rules; discuss their likely impact; and note open issues arising from the proposal.
2022 SECOND QUARTER HIGHLIGHTS

Practice Highlight: Corporate partners Steven Epstein and Matthew Soran were listed in BTI Consulting’s 2022 Client Service All-Stars list.

Counsel to a consortium of investors that included Permira and Hellman & Friedman, in the US$10.2b all-cash take private of Zendesk.

Counsel to Goldman Sachs Asset Management, alongside its joint venture partner Riverstone Holdings, in the US$3.55b sale of Lucid Energy to a wholly-owned subsidiary of Targa Resources Corp.

Counsel to Humana, Inc. in its US$3.4b definitive agreement to divest a majority interest in the Hospice and Personal Care divisions of Humana’s Kindred at Home subsidiary to Clayton, Dubilier, and Rice.

TAKEOVER DEFENSE: Mergers and Acquisitions

The Ninth Edition of Fried Frank’s “Takeover Defense: Mergers and Acquisitions,” a one-of-a-kind resource by corporate senior counsel Arthur Fleischer Jr. and Gail Weinstein and partner Scott B. Luftglass, has recently been published. The treatise is a comprehensive, must-have resource for practitioners representing any participant in M&A activity, including bidders, sellers, senior management, sponsors, and investment banks.