INSIGHTS

The Corporate & Securities Law Advisor

VOLUME 39, NUMBER 4, APRIL 2025

Wolters Kluwer
www.WoltersKluwerLR.com

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The Corporate & Securities Law Advisor

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INSIGHTS (ISSN No. 0894-3524) is published monthly by Wolters Kluwer, 28 Liberty Street, New York, NY 10005. To subscribe, call 1-800-638-8437. For customer service, call 1-800-234-1660 or visit www.wolterskluwerlr.com.

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STATE LAW

Delaware's Rocky Year: What Lies Ahead?

By Mark E. McDonald, Roger A. Cooper, and Peter Carzis

For the first time in as long as anyone can remember, people began to seriously question whether Delaware would retain its dominance as the go-to jurisdiction for incorporating companies. There was an uproar following several decisions by the Delaware Court of Chancery that seemed to shake the market's confidence in Delaware law's venerable predictability.

One such decision invalidated shareholder agreement provisions that had long been commonplace and another found that a board had not validly approved a merger agreement because, as is typical, the board had not received a draft in final form. At the same time, a certain well-known CEO's $50 billion compensation package was struck down, leading him to publicly declare "Never incorporate your company in the state of Delaware."[1]

In the face of this public pressure, the Delaware legislature moved at unprecedented speed to amend the Delaware General Corporation Law (DGCL) in order to "overrule" several of the decisions that caused the most immediate concern (to the consternation of many, including the judges who had decided the cases that were overruled). But a sense of unease persists, especially regarding the Delaware courts' recent perceived hostility towards controlling stockholders.

For this reason, several controlled companies already have elected to leave Delaware for other jurisdictions such as Nevada or Texas. In one such case, the Delaware Court of Chancery found the decision to leave should be reviewed under the entire fairness test, although the Delaware Supreme Court quickly accepted an interlocutory appeal (which remains pending) to reconsider that issue.

Still, notwithstanding the turbulence in Delaware, there has been no mass "DExit."[2] In large part, that is because it remains unclear whether other jurisdictions would "solve" the perceived problems Delaware is facing. Nevada and Texas, among others, have publicly sought to lure companies away from Delaware, including by setting up dedicated business courts intended to operate like the Delaware Court of Chancery and pointing to differences in their corporate statutes.

But it remains to be seen how these courts will operate in practice, and numerous questions abound as to how these states' corporate laws will be applied in the seemingly countless circumstances that have been addressed by Delaware's statutory and decisional law over many decades. Meanwhile, notwithstanding the grumbling, Delaware courts remain unparalleled in their sophistication on corporate issues and in their ability to decide complex cases expeditiously.

Below we summarize some of the key developments in Delaware law over the past year and give a preview of what we think is coming in 2025.

Moelis, Activision, Crispo, and the 2024 DCGL Amendments

Much of the controversy and uncertainty that characterized Delaware's acrimonious 2024 stemmed from three decisions in particular that many believed upset the status quo on key points of corporate law, and which, in turn, were legislatively overruled by Delaware lawmakers. The decision that garnered the most attention was *West Palm Beach Firefighters'*

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Pension Fund v. Moelis & Co,[3] in which the Court of Chancery held that stockholder agreement provisions imposing a pre-approval requirement on certain board actions, which are common, were facially invalid under the DGCL.[4]

Following the decision's announcement, many observers noted an apparent misalignment between this outcome and conventional assumptions about the validity of such provisions—even the court tacitly conceded as much, chiding: "[w]hen market practice meets a statute, the statute prevails."[5] In response, the summer 2024 amendments to the DGCL added a new provision aimed at restoring the validity of that "market practice" by expressly permitting provisions that restrict or prohibit the corporation from taking specific actions.[6]

The legislative amendments also addressed the Court of Chancery's February 2024 decision in *Sjunde AP-fonden v. Activision Blizzard, Inc*.[7] In *Activision*, the court held that the Defendant's board had approved an insufficiently complete merger agreement, again as is common practice.[8] Here too the court eschewed alignment with market practice—warning that "[w]here market practice exceeds the generous bounds of private ordering afforded by the DGCL, then market practice needs to check itself."[9] Again, Delaware lawmakers responded with a return to what many believed had been the status quo: the DGCL was amended so as to pare back the specific requirements for "essentially complete" merger agreements for purposes of board approval.[10]

Finally, the DGCL amendments likewise overruled the Court of Chancery's decision in *Crispo v. Musk*,[11] in which the court had held that a merger agreement's lost-premium provision (giving the target company the right to seek lost premium damages against the buyer on behalf of its stockholders) was not enforceable either by the target company's stockholders or by the company itself.[12] In response to the perceived problems created by this decision (including that buyers may be able to walk away from a deal without having to pay the full costs of doing so), Delaware lawmakers amended the DGCL to permit parties to a merger agreement to allow the target company to sue the buyer for damages equal to "the loss of any premium or other economic entitlement" that the target stockholders would have received if the deal were consummated.[13]

Judicial Scrutiny of "Conflicted Controller" Transactions

2024 saw also a year in which the Delaware Courts directed increased skepticism toward controlling stockholders whose interests they perceived as in conflict with those of the corporation, including by increasing the scrutiny with which the fairness of conflicted-controller transactions is assessed. In *In re Match.com Derivative Litigation*,[14] for example, the Delaware Supreme Court expressly declined to review conflicted controller transactions outside of the "squeeze out" context under the Business Judgment Rule if they were approved by an independent committee of directors.

Instead, the Supreme Court held that the only way for defendants to shift the standard of review for such transactions from Entire Fairness to the Business Judgment Rule, as in the squeeze out context, is to comply with the full "MFW" framework (that is, the controlling stockholder commits "ab initio" to subject the transaction to the approval of both (a) an independent committee and (b) a majority of the minority stockholders).[15]

The Court of Chancery also arguably expanded what constitutes a "conflict" (or "non-ratable benefit" received by the controlling stockholder) in *Palkon v. Maffei*.[16] This decision concerned TripAdvisor's decision to leave Delaware and reincorporate in Nevada, an action motivated in part (as acknowledged in the proxy statement) by the controlling stockholder's and directors' desire for the greater legal protection afforded fiduciaries in Nevada.[17]

The *Palkon* Court held that the decision to relocate in this case was subject to the Entire Fairness standard since the transaction conferred a non-ratable benefit upon the Company's controller and other corporate fiduciaries, even though there was no threatened litigation at the time.[18] The Delaware

Supreme Court, however, accepted an interlocutory appeal from this decision; that appeal remains pending.

The Court of Chancery's decision in *In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation* further expanded the responsibilities and challenges controllers face by holding that they may owe fiduciary duties to other stockholders even when they act purely as stockholders.[19] This dispute emerged when the corporation's majority shareholder disagreed with certain board members over a proposed liquidation plan that the controller believed would destroy value; ultimately, the controller prevented the plan from coming to fruition by taking action as a stockholder to remove two directors, and amend the bylaws to require that certain board actions be approved by at least 90 percent of the directors in two separate votes taken at least thirty business days apart.[20]

Minority stockholders then claimed that the controller had breached his fiduciary duties as a controlling stockholder by taking such action. Even though it has been traditionally understood that stockholders, even controlling stockholders, owe no fiduciary duties when exercising their stockholder-level powers (such as the right to vote their shares), the court held that "when exercising voting power affirmatively to change the status quo, a controlling stockholder owes a fiduciary duty of loyalty which requires that the controller not intentionally harm the corporation or its minority stockholders, plus a fiduciary duty of care."[21] The court thus reviewed the controller's removal of directors and changes to the bylaws under enhanced scrutiny. The court ultimately held that the controller's actions were not done in breach of his fiduciary duties because the controller demonstrated that he acted properly and in good faith to prevent the destruction of value that he believed the liquidation would cause.[22]

Finally, this expansion of a controlling stockholder's duties was coupled with a parallel expansion of what it means to *be* a controlling stockholder in the first place. In *Tornetta v. Musk*, a dispute over the Tesla's CEO's compensation, the Court of Chancery emphasized that a "mathematical majority of the corporation's voting power" represents only one of a number of "indicia of control."[23]

Arriving at a multifactorial analysis that "call[s] for a holistic evaluation of sources of influence," the court weighed pure voting power alongside additional criteria including "the right to designate directors," "decisional rules in governing documents that enhance the power of a minority stockholder or board-level position," and "the ability to exercise outsized influence in the board room, such as through high-status roles like CEO, Chairman, or founder."[24] As a result, the Chancery Court held that Musk was a controlling stockholder of Tesla despite holding only 21.9 percent of voting power, suggesting that a more capacious conception of the conflicted controller transaction may be ascendant in Delaware courts.[25]

Plaintiff Lawyer-Driven Attacks on Common Bylaw Provisions

Finally, 2024 also saw Delaware courts invalidate a number of provisions common among advance notice bylaws in *Kellner v. AIM Immunotech Inc.*, leading to attempts by plaintiffs' firms to challenge these and other bylaw or charter provisions in hopes of collecting fees.[26] The *Kellner* case stemmed from a longstanding proxy contest between AIM's board and certain activist stockholders; amidst this proxy contest, AIM amended its bylaws to add "advance notice" provisions that are common among public companies and designed to ensure stockholders are fully informed about any insurgent-backed slate.[27] Relying on these amendments, the board then rejected the alternate slate's nomination on the basis that the notice submitted in connection with their candidacy was deficient, and the stockholders challenged the amended provisions' validity.[28]

The Court of Chancery declared a number of these provisions invalid, finding that they stood to "inequitably imperil the stockholder franchise to no legitimate end."[29] These included provisions

requiring that the nominating stockholder disclose all arrangements, agreements or understandings (AAUs), which was expansively defined, among others.[30] Ultimately, however, the court found the board's rejection of the nomination to be valid due to the Plaintiffs' breach of certain other provisions that the court found to be enforceable.

On appeal, Delaware Supreme Court clarified that when bylaw provisions are facially challenged (that is, in the absence of a live proxy contest or similar dispute), the bylaws should be upheld if there is any circumstance in which they could be enforceable.[31] However, given the live proxy contest in this case, the Supreme Court applied enhanced scrutiny to the provisions at issue and agreed with the Court of Chancery that they were unenforceable, albeit only on an as-applied basis.[32]

While the Supreme Court's *Kellner* decision gives companies a powerful defense when stockholders assert facial challenges to their bylaw provisions, it has not stopped plaintiffs' firms from making such challenges, often in the form of "demand letters," and sometimes escalating into lawsuits.[33] Regardless of the focus of plaintiffs' firms, the *Kellner* decision provides important guidance for boards as they plan on a "clear day" for a potential proxy contest in the future.

Key Takeaways

- We expect the debate over the direction of Delaware corporate law to continue. Notwithstanding the enactment of the DGCL amendments in summer 2024, the controversy surrounding them and other issues has continued to spark lively discussions that go to the core of Delaware corporate law. Should Delaware provide corporate entities and their constituents–stockholders, boards, management, etc.–greater contractual freedom to order their affairs and enter into transactions as they see fit?

  Or should Delaware courts be more ready to intervene to ensure compliance with statutory and fiduciary duties and the fairness of transactions to minority or disinterested stockholders? While Delaware has historically sought to balance these priorities, they are undeniably in tension with each other. How to balance them will continue to be subject to the push-and-pull dynamic of evolving case-law and a vigorous debate.
- At the same time, boards should pay attention to developments in Nevada, Texas and other states that seek to challenge the dominance of Delaware in the corporate law realm. As noted above, there are many unanswered questions as to how those states will deal with the corporate law issues that will inevitably arise. Over time, as more companies are incorporated in those states, some of those questions may be answered.
- Meanwhile, in Delaware, we expect in the near-term that transactions involving a controlling stockholder (or stockholder with arguably controlling influence) whose interests are in conflict (or arguably do not align) with the remaining stockholders will continue to attract the attention of the plaintiffs' bar.

  While the Delaware Supreme Court declined to provide a practical method of cleansing such transactions in the *Match.com* case, it remains to be seen whether the Delaware courts will nonetheless pare back such cases, for example by narrowing the type of "non-ratable benefits" that trigger entire fairness or tightening the standard for finding a stockholder to have control.
- We also expect continued focus by the plaintiffs' bar on commonplace bylaw provisions that are perceived to be in tension with the DGCL or otherwise subject to challenge. While the Delaware Supreme Court cut back on the circumstances in which stockholders can successfully challenge such provisions in the absence of a live dispute, boards may want to consider whether any amendments are desirable in advance of a potential dispute.

Notes

1. *See* the post from Elon Musk on X (January 30, 2024).
2. *See* Stephen Bainbridge "DExit Drivers: Is Delaware's Dominance Threatened?" (September 6, 2024).
3. West Palm Beach Firefighters' Pension Fund v. Moelis & Co, 311 A.3d 809 (Del. Ch. 2024).
4. *Id.* at 870.
5. *Id.* at 881.
6. DGCL § 122(18).
7. Sjunde AP-fonden v. Activision Blizzard, Inc., No. 2022-1001-KSJM, 2024 WL 863290 (Del. Ch. February 29, 2024), *as corrected* (March 19, 2024).
8. *Id.* at *8-10.
9. *Id.* at *6.
10. DGCL § 268.
11. Crispo v. Musk, 304 A.3d 567 (Del. Ch. 2023).
12. *Id.* at 584-585.
13. DGCL § 261(a)(1).
14. In re Match.com Derivative Litigation, 315 A.3d 446 (Del. 2024).
15. *Id.* at 462-463.
16. Palkon v. Maffei, 311 A.3d 255 (Del. Ch. 2024), *cert. denied*, No. 2023-0449-JTL, 2024 WL 1211688 (Del. Ch. March 21, 2024).
17. *Id.* at 263-264.
18. *Palkon*, 311 A.3d, 283-284 (Del. Ch. 2024).
19. In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation, 309 A.3d 474 (Del. Ch.), *modified on reargument* (Del. Ch. 2024).
20. *Id.* at 492-504.
21. *Id.* at 516.
22. *Id.* at 518, 537-539.
23. *Id.* at 500.
24. *Id.* (*quoting* Basho Techs. Holdco B, LLC v. Georgetown Basho Invs., LLC, No. CV 11802-VCL, 2018 WL 3326693 at *27 (Del. Ch. July 6, 2018), *aff'd sub nom.* Davenport v. Basho Techs. Holdco B, LLC, 221 A.3d 100 (Del. 2019)).
25. *Id.* at 500-502.
26. Kellner v. AIM Immunotech Inc., 320 A.3d 239 (Del. 2024).
27. *Id.* at 246-251.
28. *Id.* at 251-252.
29. Kellner v. AIM ImmunoTech Inc., 307 A.3d 998, 1006 (Del. Ch. 2023), *judgment entered*, (Del. Ch. 2024), *and aff'd in part, rev'd in part*, 320 A.3d 239 (Del. 2024).
30. *Id.* at 1027-1035.
31. *Id.* at 258-263.
32. *Id.* at 263-266.
33. *See* Leslie Pappas, "Resignation Letter Bylaws Targeted In Five Del. Class Actions" (May 23, 2024).