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2021 Delaware Corporate Law Year in Review - Part 3 of 3

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The Delaware Supreme Court, Court of Chancery, and Complex Commercial Litigation Division of the Superior Court continued to serve as the preeminent courts for corporate and M&A litigation in 2021. The courts issued a historic volume of opinions, orders, and transcript decisions that provide valuable guidance regarding issues highlighted in this GT Update, including potential liability of board advisors, officers, and buyers in M&A; limits on stockholder voting, communications, and takeover activities; interpretation of M&A provisions related to material adverse effects, ordinary course operation, and fraud claims; the scope of protections for directors acting in reliance on experts; and access to director emails, texts, and records via statutory demands and litigation discovery. We expect this level of activity and development of corporate law principles to continue in 2022.

Stockholder Voting and Takeover Activities

Stockholder voting rights and takeover activities emerged as an important topic in 2021. Delaware courts are vigilant in protecting the stockholder franchise, while also enforcing limits on stockholders' ability to engage in potentially abusive takeover activities that seek to circumvent the board. The courts saw numerous cases in 2021 addressing both sides of that equation.

Protection of the stockholder franchise. Board authorization of a stock issuance in a way that suggests it is tilting the results of a stockholder vote raises the specter of inequitable conduct. The Delaware Supreme Court ruled that a dilutive stock issuance, which was intended to eliminate a deadlock between a corporation's two stockholders and had been found by the Court of Chancery to have been entirely fair, was still subject to review as to whether it had been approved by the board for the primary purpose of interfering with the diluted stockholder's voting rights.[79] If so, the board would have the burden of showing a compelling justification for its action. In another case, where the board received a stockholder consent seeking to replace directors and a letter requesting that the board fix a record date for that consent, the court rejected the board's attempt to fix a later record date that would follow a newly authorized issuance of a significant amount of stock.[80] After noting the concerns with the board's ability to fix a later record date that would allow for potentially entrenching actions, the court held that under the DGCL the delivery of the first consent cut off the board's power to fix a

record date, and therefore the newly issued shares would not be counted for approval of the consent. In another case, a stockholder with a successful record of activism launched and ultimately settled a proxy contest in exchange for the company's repurchase of stock, three board seats, and a note convertible into 3% of the company's stock.[81] A fiduciary duty claim challenging the board's approval of that settlement was allowed to proceed on the basis that the directors, including the CEO and directors who were not up for re-election, may have been motivated by personal concerns about the tenacity of the activist and about losing their seats. The court took particular note of the impact of the convertible note on stockholder voting going forward. And in another case, a securities purchase was conditioned on the company (including its stockholders) authorizing an increase in its authorized shares, while requiring the company to pay a fee and the stockholders to periodically re-vote if the stockholders failed to approve the increase.[82] The structure related to the re-vote may have been coercive because a rational stockholder may have been unable to afford to vote down the proposal.

Statutory voting issues. In a year of few DGCL amendments, Section 160(c), which excludes shares of a corporation's stock held by itself or a corporate subsidiary for voting and quorum purposes, was extended to cover shares held by a non-corporate subsidiary.[83] In litigation regarding Section 271, which generally requires stockholder approval of a sale of substantially all assets, the court clarified that a common law exception to that requirement applies only to an insolvent—and not a merely unprofitable—company.[84] And the Delaware Supreme Court affirmed that Section 218 does not prohibit a corporation from entering into or enforcing a stockholder agreement that is drafted and negotiated by sophisticated stockholders represented by counsel.[85]

Limits on stockholder communications and takeover activities. Section 203 of the DGCL generally prohibits business combinations between a 15% interested stockholder (including related parties) and the company for three years unless the stockholder first obtained board approval or subsequently obtained supermajority stockholder approval. Historically, there has not been extensive case law regarding Section 203, so the handful of such decisions in 2021 are valuable. Guidance includes that the three-year prohibition on business combinations with a new affiliate of a longtime interested stockholder would be treated as if it had lapsed, because it had lapsed for the interested stockholder;[86] that stockholders didn't have standing to enforce a securities purchase agreement containing a Section 203 waiver, standstill provision, and no third-party beneficiary disclaimer and to which they were not parties;[87] and that Section 203 concerns were not implicated when an interested stockholder approached the board to negotiate a potential business combination with the company's noteholders.[88] Two other cases addressed whether an agreement, arrangement, or understanding had been formed between an interested stockholder and a potential buyer before a merger without prior board approval (which can cause attribution of ownership of the stockholder's shares to the potential buyer and prohibition of the merger under Section 203). Such an understanding may have arisen where a potential buyer began negotiating a commercial contract with an interested stockholder in advance of a merger,[89] but in another case there was not such an unapproved understanding where the interested stockholder rejected a voting agreement before agreeing to a revised version after the board approved the merger and where the potential buyer had sent the board a draft merger agreement that referenced the anticipated voting agreement before reaching an agreement with the interested stockholder.[90] The litigation where there may have been an agreement, arrangement, or understanding was resolved by settlement and supermajority approval by disinterested stockholders as contemplated by Section 203, while another case involving alleged fiduciary duty breaches and Section 203 violations resulted in a settlement obligating the significant stockholder to reduce the gap between his disproportionately small economic ownership and his outsized voting power.[91]

Stockholder rights plans, or "poison pills," can also discourage unfair, creeping, or coercive takeover

activities, while driving potential acquirers to negotiate directly with the board. But terms of a stockholder rights plan can go too far in prohibiting stockholders from reasonable communication or engagement in legitimate activities that don't animate concerns with unfair takeovers. Such a rights plan was enjoined where it was triggered by 5% beneficial ownership, which included derivatives without voting power and shares held by other stockholders, directly and indirectly, acting in concert, only exempted a narrow group of passive investors, was adopted in the absence of takeover indications when the company's stock was deeply depressed.[92] That plan did not satisfy enhanced scrutiny for defensive measures, because it was not a reasonable or proportional response in relation to a threat, and the board's concern with activism did not constitute a reasonable perception of a threat to corporate policy and effectiveness. Another company's rights plan with similar terms, except that there was a 10% ownership threshold, was also challenged and resulted in a settlement where the provisions mentioned above were removed or amended (e.g., the ownership threshold increased to 15%).[93] Advance-notice bylaws, which can present a hurdle to a stockholder agitating for control of board seats, were also the subject of litigation, where the court confirmed that stockholders must closely follow the relevant timing and content requirements.[94]

Redemptions, Repurchases, and Dividends

As in recent years, the Court of Chancery continued to address important issues related to redemptions, repurchases, and dividends. The issues can be particularly important to companies given the potentially significant impositions that may be placed on the company's finances, and to directors who face heightened exposure to personal liability in this area.[95] In a protracted litigation, a preferred stockholder sought default interest on shares that had not been redeemed when a mandatory redemption was triggered.[96] The court largely rejected the claim for interest, finding the board had latitude to determine how much capital was available for the redemption. The company was not obligated to operate on the brink of insolvency but rather the board had discretion to determine requirements for remaining as a going concern. In other cases related to redemptions and repurchases, the court noted limits on protections available to stockholders to ensure their access to available funds,[97] and denied standing of stockholders who purchased shares in an IPO to challenge repurchases of insiders' stock that were financed by IPO proceeds.[98] In an important decision applying DGCL protections against director liability when relying on advisors, the board was given significant deference when determining the amount of surplus for repurchases and dividends, despite a later finding that the company had lacked surplus.[99]

Judicial Dissolution and Winding Up

The DGCL allows dissolved companies to use a judicial winding-up process under Section 280. Although there has not been extensive case law arising from such proceedings, a lengthy opinion has provided useful guidance regarding those actions and how the statute will be applied.[100] There, the dissolved company was ordered to reserve enough funds to cover potential liabilities in case a class action litigation settlement was overturned on appeal. The company failed to carry its burden of proving the sufficiency of a lesser amount of security, and uncertainties must be resolved in favor of creditors over stockholders. In another case, involving a Puerto Rico LLC, the court lacked jurisdiction to determine the dissolution of a non-Delaware LLC under the DLLCA or under equitable principles.[101]

Defective Actions, Corporate Ratification, and Judicial Validation

Legal principles continued to develop around the validity of actions taken by LLCs and validation of

actions taken by corporations. In light of the contractual nature of Delaware LLCs, actions that are statutorily within the power of the LLC, permitted by authorizing provisions under the LLC's operating agreement, and not expressly made void for failure to obtain proper authorization, but are taken without authorizations required by the operating agreement will only be voidable—not void—and therefore susceptible of equitable defenses and ratification. Thus, when a conversion of a Delaware LLC to a Puerto Rico LLC was not validly approved under the operating agreement, the plaintiff-minority member was prevented by waiver, acquiescence, and estoppel from challenging the conversion.[102] In a second case, the LLC failed to give notice of a capital call to a member, who otherwise was aware of the capital call, and the capital call led to dilution of that member's interest and corresponding termination of the member's right to designate a member of the LLC's management committee.[103] The failure to follow the operating agreement requirements, however, did not allow for setting aside the capital call; rather it was subject to ratification, waiver, and estoppel when the diluted member later executed a note agreement that included an exhibit showing the diluted ownership level. To allow potentially void actions to be ratified or validated, however, Section 18-106(e) of the DLLCA, Section 15-202(g) of the DRUPA, and Section 17-106(e) of the DRULPA were added to those statutes in 2021. Like Sections 204 and 205 of the DGCL, the new subsections provide for ratification and judicial validation of void or voidable acts taken by LLCs, partnerships, and limited partnerships.

In a judicial validation proceeding under Section 205 of the DGCL, a public company conceded that mistakes, identified by a plaintiff-stockholder, had been made when tabulating stockholder votes regarding a charter amendment and an increase in authorized shares.[104] Despite potential difficulties in determining which shares were valid and which were invalid, the stockholders were sufficiently protected by the company's agreement both to supplement its proxy materials with an explanation of the issue, and to delay the issuance of stock or options and the filing of another charter amendment until the court had addressed the prior defective amendment. In two other cases, the court confirmed Section 205 is a remedial statute and not intended to invalidate corporate actions,[105] and examined the complexities of the corporate conversion statutes and the benefits of judicial validations.[106]

FOOTNOTES

[79] *Wetherald v. Mahoney*, C.A. No. 2021-0194-MTZ (Del. Ch. Mar. 12 & Apr. 1, 2021) (TRANSCRIPTS) [Taronis Fuels].

[80] *Orlando Police Pension Fund v. Dorsey*, C.A. No. 2021-0041-JTL (Del. Ch. Sept. 10, 2021) (TRANSCRIPT) [Twitter].

[81] *Hammann v. CytRx Corporation*, C.A. No. 2021-0676-PAF (Del. Ch. Aug. 11, 2021) (TRANSCRIPT) [CytRx].

[82] 83 Del. Laws 60, § 1 (June 30, 2021).

[83] *Stream TV Networks, Inc. v. SeeCubic, Inc.*, C.A. No. 2020-0766-JTL (Del. Ch. Dec. 8, 2021).

[84] *Authentix*.

[85] *Hollywood Firefighters' Pension Fund v. Dolan*, C.A. No. 2021-0468-KSJM (Del. Ch. July 2,

2021) & (July 6, 2021) (TRANSCRIPT) [Madison Square Garden Entertainment].

[86] *Pandora*.

[87] *Mamakas v. Iconix Brand Group, Inc.*, C.A. No. 2021-0632-KSJM (Del. Ch. July 26, 2021) (TRANSCRIPT) [Iconix Brands].

[89] *Hawkes v. Bettino*, C.A. No. 2020-0360-PAF (Del. Ch. Apr. 1, 2021) (TRANSCRIPT) [TD Ameritrade].

[90] *Flannery v. Genomic Health Inc.*, C.A. No. 2020-0492-JRS (Del. Ch. Aug. 16, 2021) (TRANSCRIPT) [Genomic Health].

[91] *Hollywood Firefighters' Pension Fund v. Malone*, C.A. No. 2020-0880-SG (Del. Ch. Nov. 8, 2021) [GCI Liberty].

[92] *In re The Williams Cos. Stockholder Litig.*, C.A. No. 2020-0707-KSJM (Del. Ch. Feb. 26, 2021) [Williams].

[93] *Vladimir Gusinsky Revocable Trust v. Tribune Publishing Company*, C.A. No. 2020-0716-KSJM (Del. Ch. Apr. 15, 2021) (TRANSCRIPT) [Tribune Publishing].

[94] *Hammann v. Adamis Pharmaceuticals Corporation*, C.A. No. 2021-0506-PAF (Del. Ch. June 17, 2021) (TRANSCRIPT) [Adamis Pharmaceuticals]; *Rosenbaum v. CytoDyn Inc.*, C.A. No. 2021-0728-JRS (Del. Ch. Oct. 13, 2021) [CytoDyn].

[95] 8 Del. C. §§ 102(b)(7), 174.

[96] *Cont'l Investors Fund LLC v. TradingScreen, Inc.*, C.A. No. 10164-VCL (Del. Ch. July 23, 2021) [TradingScreen]; see also *The Frederick Hsu Living Trust v. ODN Holding Corporation*, C.A. No. 12108-VCL (Del. Ch. Jan. 5, 2021) (TRANSCRIPT) [Oversee.net].

[97] *Tetragon Financial Group Limited v. Ripple Labs Inc.*, C.A. No. 2021-0007-MTZ (Del. Ch. Jan. 15 & Mar. 5, 2021) (TRANSCRIPTS) [Tetragon Financial].

[98] *In re SmileDirectClub, Inc. Deriv. Litig.*, C.A. No. 2019-0940-MTZ (Del. Ch. May 28, 2021) [SmileDirectClub].

[99 *Chemours*.

[100] *In re Altaba, Inc.*, C.A. No. 2020-0413-JTL (Del. Ch. Oct. 8, 2021); see also *In re Swisher Hygiene, Inc.*, C.A. No. 2018-0080-SG (Del. Ch. Mar. 5, 2021) (TRANSCRIPT).

[101] *In re Coinmint, LLC*, C.A. No. 2019-0983-MTZ (Del. Ch. Aug. 12, 2021).

[102] *Coinmint*.

[103] *Produced Water Transfer, LLC v. Pilot Water Solutions LLC*, C. A. No. 2021-0178-JTL (Del. Ch. Mar. 8, 2021) (TRANSCRIPT) [Pilot Water Solutions].

[104] *Stein v. Pickens*, C.A. No. 2021-0322-JRS, C.A. No. 2021-0380-JRS (Del. Ch. Apr. 27, 2021) (TRANSCRIPT) [Astrotech].

[105] *Amgine Technologies (US), Inc. v. Miller*, C.A. No. 2020-0537-JRS (Del. Ch. Nov. 29, 2021) [Amgine Technologies].

[106] *In re Covalent Group, Inc.*, C.A. No. 2021-0680-KSJM (Del. Ch. Sept. 1, 2021) (TRANSCRIPT).

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