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REPRINTED FROM:
CORPORATE DISPUTES MAGAZINE
JAN-MAR 2022 ISSUE

www.corporatedisputesmagazine.com

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PERSPECTIVES

DELAWARE SUPREME COURT 2021 CORPORATE LAW UPDATE

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Any time the Delaware Supreme Court issues a decision on corporation law, there is a significant chance that the law will be shaped in a way that reverberates throughout the M&A bar and the corporate community at large. In that regard, 2021 did not disappoint.

Throughout the year, the Court issued numerous important corporate law-related decisions that have had an immediate impact on a number of key topics. The decisions are reviewed below and relate to the following subjects: books and records inspection rights, the demand futility test, stockholder standing, inequitable conduct, insurance coverage for fraudulent conduct and waiver of statutory appraisal rights.

On the cusp of 2021, the Court affirmed its view that stockholder rights to inspect corporate books and records are broad (see *AmerisourceBergen Corp. v. Lebanon Cty. Emps.' Ret. Fund* (2020)). Pursuant to the Delaware General Corporation Law (DGCL) section 220, stockholders may demand inspection of corporate books and records for a number of proper purposes. Typically, stockholders seek these documents to purportedly investigate director and officer wrongdoing in order to pursue derivative litigation on behalf of a company.

To obtain such documents in a 220 proceeding, a stockholder must demonstrate a credible basis of wrongdoing – known as the lowest burden in Delaware law. In *AmerisourceBergen*, the Court discussed the assertion of merits-based defences to defeat a 220 complaint where the stated purpose was to investigate wrongdoing. Such defences might include, for example, where a 102(b)(7) exculpatory provision would bar recovery for certain purported wrongdoing or where directors were protected under DGCL 141(e) for relying on an expert's opinion. These have been successful in prior 220 actions.

The Court disagreed and held that a stockholder need not demonstrate that the alleged wrongdoing is "actionable", reaffirming that merits-based defences are inappropriate in a 220 proceeding. However, the Court stated that where a stockholder's sole purpose in investigating wrongdoing is to pursue litigation, procedural defences like standing or statute of limitations may justify denial of the inspection.

Typically, books and records actions precede derivative claims brought by stockholders. Although a corporation's defences of a 220 action are limited after *AmerisourceBergen*, all procedural and merits-based defences are fair game in a follow-on

derivative case. Defendants typically assert, under Rule 23.1, that a stockholder failed to plead with particularity that a litigation demand on the board would have been futile, disabling the stockholder from pursuing derivative claims on behalf of the company.

For decades, there were two different demand futility tests. The first question was which should apply: the two-prong *Aronson* test applicable where the complaint challenges a decision made by the board, or the single-prong *Rales* test applicable in all other circumstances. That has now changed. In *United Food and Com. Workers Union v. Zuckerberg* (2021), the Court adopted a refined three-part demand futility test, as the "universal test for assessing whether demand should be excused as futile".

Going forward, courts evaluating demand futility should assess on a director-by-director basis whether at least half the board: (i) received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) faces a substantial likelihood of liability on any of the claims that are the subject of the litigation demand; and (iii) lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.

A threshold question in any corporate dispute, even before a demand futility analysis, is whether a stockholder has standing. Certain claims do not belong to a stockholder personally and instead inhere in the security itself. In those instances, when a stockholder no longer owns such stock, the stockholder loses standing. The Court addressed two cases this year clarifying the nature of dilution claims involving a controller for standing purposes. The Court held that such claims are not personal to the stockholder and are exclusively derivative. When a stockholder is divested of such stock through a sale or merger, the stockholder loses standing to pursue such claims.

"Where the right inheres in the stock, a stockholder may not pursue the claim when they no longer hold the stock, even under the Court's expansive view of the stockholder books and records inspection right."

In *Urdan v. WR Cap. P'rs*, LLC, 244 A.3d 668 (2020) – decided on the cusp of 2021 – stockholders

asserted, among other things, a direct breach of fiduciary duty claim for economic dilution. While the lawsuit was pending, parties entered into a partial settlement. In connection with the settlement, the plaintiff stockholders sold all "right, title and interest" in their stock to the company. The Court of Chancery dismissed the claim for lack of standing. The Court agreed and explained that whether the dilution claims were direct, derivative or both, such a claim is not a wrong personal to the stockholder and instead follows the stock.

Thereafter, in *Brookfield Asset Mgmt., Inc. v. Rosson* (2021), the Court further clarified the law in connection with dilution claims involving a controller, holding that the nature of such claims are exclusively derivative. In this case, stockholders challenged a company's private placement of stock to its controlling stockholder, asserting direct claims that the transaction undervalued the stock and diluted both the financial and voting interests of the minority stockholders. After plaintiffs filed the complaint, the controlling stockholder acquired the company's remaining shares.

Fifteen years ago, in *Gentile v. Rossette*, the Court held that overpayment/dilution claims involving a controller were both derivative and direct. After extensive discussion and justification in *Brookfield*, the Court overruled its *Gentile* decision and held that these claims are exclusively derivative under its *Tooley* decision. Therefore, the plaintiffs in this case lacked standing to pursue what they had styled as direct claims when the now-exclusively derivative claims followed the stock and passed to the buyer.

The Court again addressed dilution claims in *Coster v. UIP Cos., Inc* (2021) but this time in the context of inequitable conduct. The Court emphasised the strong policy that under Delaware law, "inequitable action does not become permissible simply because it is legally possible". In *Coster*, a board issued a one-third interest in the company to a director to dilute a stockholders' ownership interest below 50 percent and block her attempts to elect directors. The motive for the stock sale was not seriously disputed. The Court of Chancery held that because the stock sale satisfied the onerous entire fairness standard, the board did not breach any fiduciary duties to the diluted stockholder.

The Court disagreed and held that the entire fairness analysis did not substitute for further equitable review. Instead, if the board approved the stock sale for inequitable reasons (interfering with stockholder voting rights to entrench themselves in office), the Court of Chancery should have cancelled it. And if the board acted in good faith by approving the stock sale for the primary purpose of thwarting the stockholder's vote to elect directors or reduce her leverage, the board must demonstrate a compelling justification for such action to withstand judicial scrutiny.

The Court again addressed Delaware's intolerance for deceptive conduct, in *Bäcker v. Palisades Growth*

Cap. II, L.P. (2021). The Court held that equity can void deceptive conduct even where there were no technical violations of the DGCL. In this case, an ousted chief executive affirmatively misled his fellow board member into attending a board meeting in order to establish a quorum, and then sprung a surprise agenda on the board in order to seize control and reinstate himself as chief executive, among other things. The Court of Chancery invalidated the board's actions, calling the chief executive's conduct an "ambush" and describing evidence of affirmative deception. The Court agreed and emphasised that "Delaware law does not countenance deception designed to manufacture a quorum or otherwise induce director action".

Although fraud and deception are impermissible under Delaware law, in 2021, in *RSUI Indem. Co. v. Murdock*, the Court held that Delaware public policy allows insurance coverage for fraudulent conduct. The Court emphasised yet again that it does not condone fraud, but reaffirmed the Court's "respect for the right of sophisticated parties to enter into insurance contracts as they deem fit". The Court explained that Delaware does not have a "public policy against the insurability of losses occasioned by fraud so strong as to vitiate the parties' freedom of contract".

The Court again affirmed its respect for bargained-for rights in *Manti Holdings, LLC v. Authentix Acquisition Co., Inc.* (2021), when it decided that statutory appraisal rights may be contractually waived in exchange for valuable consideration. Although it stated that there are certain features of a corporation that cannot be waived, the individual right to seek appraisal is not one of them. Specifically, the Court explained that "Section 262 does not prohibit sophisticated and informed stockholders, who were represented by counsel and had bargaining power, from voluntarily agreeing to waive their appraisal rights in exchange for valuable consideration".

In short, these cases reflect the following themes, among other things. Standing is an ever-important threshold question. Where the right inheres in the stock, a stockholder may not pursue the claim when they no longer hold the stock, even under the Court's expansive view of the stockholder books and records inspection right. Equity is alive and well in Delaware and the Court is intolerant of deception. Finally, the Court's strong respect for agreements entered into by sophisticated parties for valuable consideration supports insurance of impermissible fraud and the waiver of statutory appraisal rights. CD

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