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Delaware courts simplify rules for derivative actions, analyze SPAC fiduciary duty review and clarify books-and-records obligations

By Edward B. Micheletti, Esq., Arthur R. Bookout, Esq., Lauren N. Rosenello, Esq., and Ryan M. Lindsay, Esq., Skadden, Arps, Slate, Meagher & Flom LLP*

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Takeaways

- The Delaware Supreme Court simplified the pleadings-stage test applied to derivative suits where no demand has first been made on the board.
- Disputes about stockholder books-and-records requests focus increasingly on whether companies must provide documents beyond formal board records.
- In two cases, the Court of Chancery found it reasonably conceivable that companies had not followed the test laid out in the Delaware Supreme Court's decision in *MFW* to ensure negotiations over a transaction involving a controlling stockholder are overseen by an independent committee and subject to a minority vote from the first substantive talks.
- The Court of Chancery held that public SPAC stockholders could bring direct claims for breach of fiduciary duty against a SPAC sponsor and directors involving misleading proxy information regarding a merger, and that standard SPAC structuring may lead to an "entire fairness" review.

Delaware's business courts continued to operate largely unaffected by the pandemic in 2021 and issued several notable decisions. Here is what we saw last year and what we are watching for in 2022.

Delaware Supreme Court simplifies derivative litigation

In two decisions in 2021, the Delaware Supreme Court (1) simplified the demand standard for derivative cases and (2) overruled prior case law that allowed for certain claims to confer both direct and derivative standing.

Demand futility. In *United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg* (Zuckerberg), the Delaware Supreme Court adopted a three-part "universal test" for evaluating whether a stockholder can bring a derivative lawsuit without first making a litigation demand on the board.

While taking care not to overrule 40 years of precedent, it blended the tests set forth in the seminal cases *Aronson v. Lewis* and *Rales v. Blasband* and held that a demand will be deemed futile where at least half of the directors of a corporation:

- "received a material personal benefit from the alleged misconduct that is the subject of the litigation demand";
- faced "a substantial likelihood of liability on any of the claims that are the subject of the litigation demand"; or
- are not independent of another director "who received a material personal benefit from the alleged misconduct that is 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."

By overruling Gentile, *the court removed an exception to the general rule that overpayment claims are "quintessential derivative claims."*

While this new test simplifies the questions for litigants and the courts, we expect the Delaware courts will continue to refine its application in 2022.

Transactions with controlling stockholders. In *Brookfield Asset Management, Inc. v. Rosson*, the Delaware Supreme Court overruled *Gentile v. Rossette*, bringing more clarity to a confusing area of the law that had been long criticized.

Under *Gentile*, if a controlling stockholder was alleged to have caused a company to issue shares and overpay for an asset owned by the controller — thereby transferring both economic value and voting power from minority stockholders to the controller — such a claim could be considered both "direct" and "derivative," allowing

stockholders to bring lawsuits challenging the transaction without first making a demand on the board or adequately pleading why demand would be futile.

By overruling *Gentile*, the court removed an exception to the general rule that overpayment claims are "quintessential derivative claims." We will be watching in 2022 to see if plaintiffs attempt to find new and creative ways to avoid the demand futility pleading requirements under *Zuckerberg*.

Court of Chancery continues to grapple with books-and-records requests

In several recent cases, including the Delaware Supreme Court's 2020 *AmerisourceBergen Corp. v. Lebanon County Employees' Retirement Fund and Teamsters Local 443 Health Services & Insurance Plan*, the state's courts have made clear they will not tolerate substantive defenses and overly aggressive litigation in response to a stockholder books-and-records demand made for a well-established proper purpose.

In 2022, we expect deal litigation to continue to increase as M&A activity remains heavy.

Not surprisingly, in 2021 litigants and the courts shifted focus to scope-related issues, such as when stockholders are entitled to records beyond formal board-level materials.

In 2019, in *KT4 Partners LLC v. Palantir Technologies Inc.* (*Palantir*), the Delaware Supreme Court held that, while the default scope for books-and-records actions should be production of formal board materials, courts can require additional records.

These can include electronic communications, if the corporation "conduct[s] formal corporate business largely through informal electronic communications" so that board-level materials do not provide stockholders with the information they are entitled to by statute.

Two cases in 2021 tested the limits of that holding — one where the company was ordered to turn over other types of documents and communications, and one restricting the demand to formal board records.

- In *Employees' Retirement System of Rhode Island v. Facebook, Inc.*, a Facebook stockholder sought books and records related to an investigation by the Federal Trade Commission (FTC) into a data breach and whether the company had overpaid in agreeing to a record-breaking $5 billion settlement with the agency in order to shield its CEO from personal liability. Even though Facebook produced more than 30,000 pages of board-level records in response to the stockholder's demand, the Court of Chancery granted the plaintiff additional records because the materials produced offered "only a basic outline of the Board's process and the resulting negotiations with the FTC leading to the 2019 Settlement." Thus, the court concluded that "if such information exists, it will be in the nonprivileged electronic communications."
- In contrast, in *Jacob v. Bloom Energy Corp.*, the Court of Chancery denied access to materials beyond formal board presentations and minutes where stockholders submitted a demand after a short-seller alleged in a report that the company had misrepresented its financials. The court held that the plaintiffs had failed to meet their burden to show that anything other than formal board materials were necessary and essential for their stated investigatory purpose.

We expect the case law to continue to evolve in 2022 as plaintiffs seek additional avenues to obtain records beyond formal board materials.

A resurgence of deal litigation

After a dip in 2020, 2021 (and January 2022) saw a resurgence of deal litigation touching on several areas of Delaware law, including the interpretation of *Corwin v. KKR Financial Holdings LLC, Kahn v. M&F Worldwide Corp.* (*MFW*), and issues of first impression applying Delaware fiduciary duty law to SPAC transactions.

***Corwin*/officer liability under *Revlon*.** In *Firefighters' Pension System of the City of Kansas City, Missouri Trust v. Presidio, Inc.*, the Court of Chancery dismissed claims against directors of Presidio, Inc. and its controlling stockholder arising out of the company's sale, while sustaining breach of fiduciary duty claims related to so-called "*Revlon* duties" against Presidio's chairman/CEO, and aiding-and-abetting claims against the buyer and Presidio's financial advisor.

The court credited allegations that the CEO favored the buyer because it would retain him in his position and allow him to roll over equity. In addition, the court credited allegations that Presidio's financial advisor "tipped" the buyer about a competing offer, and the buyer used that information to prevail in the negotiations.

The court also held that the failure to disclose the "tip" to stockholders precluded dismissal of the viable fiduciary duty and aiding-and-abetting claims under the *Corwin* cleansing doctrine.

By contrast, in *Kihm v. Mott*, the Court of Chancery dismissed *Revlon* duty claims against directors and officers under the *Corwin* doctrine where the plaintiff's primary alleged disclosure deficiencies were the failure to disclose (1) slightly higher projections for the target company and (2) analyses by the target's banker of other strategic alternatives.

MFW criteria. Two recent rulings denying motions to dismiss provide additional guidance for directors, officers and advisers attempting to comply with the criteria set forth by the Delaware Supreme Court's 2014 decision in *MFW* in conflicted controller transactions.

- In *In re Pivotal Software, Inc. Stockholders' Litigation*, the Court of Chancery held that negotiations failed to satisfy the "ab initio" requirement of *MFW*, which requires irrevocable commitment to *MFW*'s procedural conditions, including establishment of an independent committee and minority vote approval, before the first substantive economic negotiations

occur in a transaction. While the initial offer in *Pivotal* was conditioned on the satisfaction of the *MFW* requirements, allegations of months of diligence between the two companies prior to that offer "support[ed] a reasonable inference that substantive economic discussions or negotiations between [buyer] and Pivotal occurred before [the first offer]."

- In *The MH Haberkorn 2006 Trust v. Empire Resorts, Inc.*, the Court of Chancery held that negotiations failed to satisfy the requirement to condition negotiations "irrevocably" on compliance with *MFW*. In *Haberkorn*, the *MFW* requirements were enshrined in a letter agreement between buyer and seller. However, the relevant terms of the letter agreement were scheduled to expire in February 2020. The court held that, even though the parties negotiated the deal in 2019, when the *MFW* requirements identified in the letter agreement were indisputably applicable, the buyer's refusal to commit to honoring the *MFW* terms past February 2020 precluded dismissal at the pleadings stage because the expiring conditions did not "mitigate concerns of retribution" by the controlling stockholder in the event its offer was rebuked.

SPAC litigation. In the first Delaware case analyzing the intersection of fiduciary duty principles and SPACs, on January 3, 2022, the Court of Chancery denied a motion to dismiss a complaint *In re MultiPlan Corp. Stockholders Litigation*, allowing claims for breach of fiduciary duty to survive against a SPAC's sponsor and its directors and officers.

The plaintiffs alleged that the sponsor-controller (which was controlled by the CEO of the SPAC), as well as the directors and officers of the SPAC, breached their fiduciary duties to public stockholders by issuing a materially misleading proxy statement in connection with a proposed merger with MultiPlan. That allegedly impaired the public stockholders' ability to make an informed determination of whether to redeem their shares under the SPAC's charter or to own shares in the post-merger entity.

Under "well-worn fiduciary duty principles," the court found that public stockholders could bring such claims directly. It also held that dual class structure of the SPAC — which provided its sponsor and directors with a separate class of "founder" shares — made it reasonably conceivable that the sponsor and directors had "misaligned incentives" because they would profit in a merger even if the transaction were unfair to public stockholders.

Thus, the court held that the stringent entire fairness standard of review applied to the plaintiffs' fiduciary duty claims. However, the court expressly stated that it was not addressing a scenario "where the disclosure is adequate and the allegations rest solely on the premise that fiduciaries were necessarily interested given the SPAC's structure."

In 2022, we expect deal litigation to continue to increase as M&A activity remains heavy, and we expect that plaintiffs will continue to aggressively assert claims against officers and use books-and-records actions and increasingly creative arguments to attempt to avoid dispositive motions under *Corwin* and *MFW*.

Furthermore, it remains to be seen how the *MultiPlan* decision will be applied to other SPACs, or if it will give rise to additional SPAC litigation, including in situations where plaintiffs cannot allege a material disclosure claim.

About the authors




(L-R) **Edward B. Micheletti** is a litigation partner at **Skadden, Arps, Slate, Meagher & Flom LLP**, representing clients in significant business litigation matters at both the trial court and appellate levels in Delaware. **Arthur R. Bookout** is a litigation counsel at the firm and represents directors, officers and corporations in litigation involving corporate governance and federal securities matters. **Lauren N. Rosenello** and **Ryan M. Lindsay** are litigation associates at the firm. All of the authors are based in the firm's Wilmington, Delaware, office. This article was originally published Jan. 19, 2022, on the firm's website. Republished with permission.

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