Insights:
The Delaware Edition

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

In this issue, we discuss recent Delaware court decisions further developing the bounds around books and records demands. Other articles focus on recent developments concerning advance notice bylaws and the standards used by the Delaware courts to assess their enforceability, as well as the expansion of *MFW*'s application to include a variety of transaction structures in which a controller receives a non-ratable benefit. Finally, we look at the need for boards to implement and monitor effective oversight systems for "mission critical" risks, despite recent cases that dismiss such *Caremark* claims.

Current Bounds on Books and Records Demands

Contributors

Jenness E. Parker / Partner

Bonnie W. David / Counsel

Lilianna Anh P. Townsend / Associate

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For decades, Delaware courts have encouraged stockholders to use the "tools at hand" — before initiating lawsuits — by obtaining corporations' books and records through 8 *Del. C.* § 220 (Section 220). As described in prior articles,[1] in recent years, stockholder plaintiffs utilized this tool with increased frequency, resulting in the Delaware courts issuing further guidance to litigants as they assess their rights and obligations under the statute.

Although Delaware courts have placed limits on defenses for companies in the Section 220 context over the past few years, decisions issued in recent months serve as a reminder that books and records demands are not an "open sesame" for stockholders. Delaware courts have reaffirmed that although the burden to demonstrate a "credible basis" to suspect wrongdoing before being allowed to access books and records is a low bar for stockholders to meet, it is not inconsequential. Delaware courts have also continued to emphasize that formal board-level materials are typically the starting point *and* ending point of a Section 220 inspection, rejecting stockholders' attempts to access emails and text messages through a books and records demand.

The Collar Around the Credible Basis Standard

Under Section 220, a stockholder plaintiff must have a proper purpose for seeking a corporation's books and records. When that purpose is to investigate possible wrongdoing, she bears the burden to demonstrate a "credible basis" to suspect that wrongdoing has occurred. Although the credible basis standard "sets the lowest possible burden of proof"[2] under Delaware law, three recent Section 220 decisions provide guidance regarding the type of evidence necessary to satisfy this burden, and reiterate that stockholders must allege *some* evidence to suggest that wrongdoing occurred.

[1] Edward B. Micheletti, Jenness E. Parker and Bonnie W. David, *Developments in Delaware Corporation Law*, Westlaw (Feb. 2, 2021).

[2] *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 123 (Del. 2006).

In *NVIDIA Corp. v. City of Westland Police & Fire Retirement System*,[3] the Delaware Supreme Court affirmed the Court of Chancery's holding that potential wrongdoing could be inferred. The Delaware Supreme Court accepted allegations that the defendants had potentially manipulated stock prices, "connecting the dots" based on public statements, timing of stock sales and the contents of a federal securities complaint. The Supreme Court explained that when demonstrating a credible basis to infer wrongdoing or mismanagement, a Section 220 plaintiff is not confined to one single theory of what wrongdoing occurred.[4] Further, the Supreme Court clarified that a stockholder plaintiff may rely on hearsay in a Section 220 proceeding if it is "sufficiently reliable."[5]

In *Hightower v. SharpSpring, Inc.*, Chancellor Kathaleen St. J. McCormick provided guidance on what does, and what does not, support a "credible basis" for wrongdoing[6] The court found a credible basis to suspect potential wrongdoing where discrepancies between proxy statement disclosures and board minutes revealed an executive's potential conflict in preserving value in a bonus pool from which he would have benefited in a merger.[7] On the other hand, the court rejected the plaintiff's argument that a director's resignation during the sale process provided a credible basis to infer wrongdoing, explaining that the resignation was "of no moment in the court's eyes" because "[s]ales processes happen all the time and can demand much from a director."[8]

Finally, in *Oklahoma Firefighters Pension & Retirement Systems v. Amazon.com, Inc.*,[9] Vice Chancellor Lori W. Will determined that a stockholder failed to prove a credible basis of wrongdoing. In so holding, the court explained that, despite being the "lowest" standard of proof under Delaware law, the credible basis standard nevertheless is "not inconsequential."[10] Rejecting the plaintiff's attempt to rely on government investigations and litigation against Amazon, the court explained that "Delaware law does not … provide that evidence of open inquiries and lawsuits alone necessarily begets a credible basis from which the court can infer possible mismanagement."[11] Rather, the severity or results of the inquiries must be considered, as well as whether "corporate trauma" occurred.[12] The court concluded that the investigations had not resulted in adverse outcomes and that the litigation either was ultimately dismissed or unrelated to alleged violations the plaintiff sought to investigate.[13]

Production of Formal Board Materials — No More and No Less

Delaware courts repeatedly have held that the starting point, and often the ending point, for a books and records inspection is typically "formal board materials" — minutes of meetings and supporting materials, such as presentations, that were provided to the board of directors or committees at official meetings.[14] In two recent decisions, the Court of Chancery reaffirmed this rule, particularly where companies voluntarily produced formal board materials prior to being in court on the Section 220 demand.

In *Amazon*, the court noted favorably that the company had produced sufficient board materials in response to the stockholder's demand, having taken "the lessons of [Delaware] case law to heart" and producing formal board materials despite questioning the basis for the plaintiff's demand.[15] After receiving formal board materials, the plaintiff pressed for informal records. The court found that in addition to the plaintiff's inability to demonstrate a credible basis to suspect wrongdoing, "the plaintiff [could not] prevail for another, simpler reason: the demand was satisfied. Amazon produced all necessary and essential

[3] No. 259, 2021 (Del. July 25, 2022).

[4] *Id.* at 46.

[5] *Id.* at 38.

[6] C.A. No. 2021-0720-KSJM, at *16 (Del. Ch. Aug. 31, 2022).

[7] *Id.* at 6-7, 15-16.

[8] *Id.* at 17.

[9] C.A. No. 2021-0484-LWW (Del. Ch. June 1, 2022).

[10] *Id.* at 16.

[11] *Id.* at 17.

[12] *Id.* at 19.

[13] *Id.* at 21-26.

[14] *Id.* at 30-31; *Hightower* at 20.

[15] *Id.* at 29.

documents related to the alleged wrongdoing discussed in the demand."[16] In its ruling, the court further noted that a company may redact board materials to the extent contents do not relate to the stockholder's stated purpose, which serves to balance companies' desire to cooperate and stockholders' entitlement to "necessary and essential" documents.[17]

Similarly, in *Frank v. National Holdings Corp.*,[18] Vice Chancellor Morgan T. Zurn explained that when a company has produced formal, board-level materials, as it did in this case, the plaintiff bears the burden to show that "the formal board materials and other documents he already has are not sufficient and that additional communications are necessary."[19] The court rejected the plaintiff's request for such communications, noting that "[h]ere, as in *Amazon*, extensive and sufficient materials and minutes were produced" and the company "produced over 30 sets of detailed meeting minutes, presentations from the special committee's financial advisor, and resolutions."[20]

[16] *Id.* at 2.

[17] *Id.* at 33.

[18] C.A. No. 2021-0160-MTZ (Del. Ch. July 22, 2022) (TRANSCRIPT).

[19] *Frank* at 19-20.

[20] *Id.* at 20.

Stockholders Cannot Shift Gears in Litigation

Delaware courts have held that if, after making a books and records demand, a stockholder expands the scope of documents she is seeking, then the corporation is improperly deprived of its ability to consider the request outside of litigation. In two recent cases, the Court of Chancery emphasized that a plaintiff may not use litigation to change her purpose or expand the scope of her demand.

In *Amazon*, the court made clear that a stockholder must assert evidence underlying her theories of possible mismanagement in her pre-suit demand or in her pleadings, not just prior to or at trial.[21] In *Frank*, the court explained that a stockholder cannot belatedly seek to expand the topics of documents sought in his demand once litigation has begun; rather, the company must be given an opportunity to respond to the demand before litigation is initiated.[22]

[21] *Amazon* at 23-25.

[22] *Frank* at 12-13.

Takeaways

- Recent Delaware decisions underscore that the credible basis standard, while low, is not inconsequential. Rather, the stockholder must establish, through documents, logic, testimony or otherwise, a possibility that wrong-doing occurred. In meeting that burden, a stockholder may rely on hearsay if it is sufficiently reliable.
- Delaware courts encourage the voluntary production of documents to resolve Section 220 demands or to limit the scope of litigation concerning a demand. However, the court will still assess whether a stockholder has stated a proper purpose for her demand even when the corporation has already agreed to produce a subset of the documents requested.
- Recent Delaware decisions further emphasize that formal, board-level materials are typically the beginning and end of a Section 220 request. Voluntarily producing formal board materials may position a corporation to assert in litigation that it has produced all documents necessary and essential to the stockholder's purported purpose.
- A plaintiff may not use litigation to change her purpose or expand the scope of her demand, which would deprive the company of the opportunity to assess the demand outside of litigation.

Advancing Forward — Delaware Courts Provide Further Guidance on Incumbent Board Enforcement of Advance Notice Bylaws

Contributors

Edward B. Micheletti / Partner

Ryan M. Lindsay / Associate

> See page 7 for key takeaways

In late 2021 and early 2022, two decisions from the Court of Chancery addressing advance notice bylaws reiterated, consistent with long-standing Delaware law, that clear and unambiguous advance notice bylaws will be enforced. These decisions also noted that application of such bylaws remains subject to equitable review to determine if the incumbent board acted manipulatively or otherwise inequitably in rejecting stockholder board nominees.[1] However, these decisions also articulated slightly different standards of review — with the court in the first decision holding that under the court's equitable review a stockholder could prove "compelling circumstances" justifying a finding of inequitable conduct, while the court in the second decision expressly applied enhanced scrutiny, placing the burden on the incumbent board to demonstrate it acted reasonably.[2]

The Court of Chancery's most recent decision on this topic further reiterates that clear and unambiguous bylaws will be enforced. Furthermore, the decision clarifies that enhanced scrutiny focusing on the reasonableness of incumbent board conduct is the standard of review that applies to the application of even validly enacted advance notice bylaws. Therefore, when assessing a board's application of an advance notice bylaw, the court will analyze whether the board has identified proper corporate objectives and has justified its actions as reasonable in relation to those objectives.

AIM ImmunoTech

In *Jorgl v. AIM ImmunoTech Inc.*,[3] the Court of Chancery rejected a request for preliminary, mandatory injunctive relief on behalf of a dissident stockholder and his proposed slate of board nominees by denying the plaintiff's motion for preliminary injunction in favor of the defendants, AIM ImmunoTech Inc. and the incumbent board.

The court's decision laid out the interesting factual circumstances of the plaintiff's director nominations, which occurred within the larger context of an ongoing attempt by a group, comprised of both stockholders and non-stockholders, to take over the company. As one part of this takeover attempt, the plaintiff, who had only acquired stock 10 days before his director nominations were submitted, put forth two non-stockholders for positions on the company's three-member board. The incumbent board was immediately suspicious, as one of the nominees was the same individual recently submitted as a director nominee by another stockholder. The board had rejected those nominations and suspected that a stockholder named Franz Tudor, who had allegedly been harassing the company for years, was secretly behind them. The short period and common nominee between the prior failed nominations and the plaintiff's current nominations prompted the board to investigate further. It discovered information leading it to conclude that Tudor and his allies were also behind the plaintiff's effort. Based on this undisclosed information, the board unanimously rejected the nomination notice, leading to litigation.

The court first analyzed the board's decision to reject the nomination notice by considering whether it complied with the company's advance notice bylaw. The court noted that Section 1.4(c) of the bylaws required disclosure by the nominating stockholder of "a description of all arrangements or understandings between such stockholder and each

[1] See *Skadden Discusses Delaware Court Rulings on Advance Notice Bylaws and Incumbent Director Conduct*, The CLS Blue Sky Blog, June 29, 2022; *see also Rosenbaum v. CytoDyn Inc.*, 2021 WL 4775140 (Del. Ch. Oct. 13, 2021); *Strategic Inv. Opportunities LLC v. Lee Enters., Inc.*, 2022 WL 453607 (Del. Ch. Feb. 14, 2022).

[2] *Rosenbaum*, 2021 WL 4775140, at *15; *Strategic Inv. Opportunities LLC*, 2022 WL 453607, at *14.

[3] 2022 WL 16543834 (Del. Ch. Oct. 28, 2022).

proposed nominee and any other person or persons (including their names) pursuant to which the nomination(s) are to be made."[4] The court reiterated that "[c]lear and unambiguous advance notice bylaw conditions act[] in some respects as conditions precedent to companies being contractually obligated to take certain actions."[5]

The court concluded that the plain meaning of "arrangements or understandings," as demonstrated by reference to dictionary definitions, required the stockholder "to disclose any advance plan, measure taken, or agreement — whether explicit, implicit, or tacit — with any person towards the shared goal of the nomination."[6] The court rejected the plaintiff's argument that "arrangements or understandings" required a *quid pro quo*.

Next, the court considered whether the nomination notice satisfied the unambiguous requirements of the bylaw. The court analyzed the record evidence that, behind the scenes of the plaintiff's nomination, both stockholders and non-stockholders, led by Tudor, were working together to devise legal strategy and to formulate a plan for a proxy contest in order to ultimately take control of the board. The court rejected the plaintiff's argument that the information in the notice was truthful and to the best of his knowledge at the time. Clearly doubting the veracity of the plaintiff's statements about his own knowledge, the court held that the disclosure about "arrangements or understandings" was at least misleading. The court also highlighted that, even if the plaintiff's knowledge of the extent of the roles of others in the nominations was limited, one of the proposed board nominees clearly knew the full information and was involved in preparation of the nomination notice, yet stayed silent. For all these reasons, the court held that the plaintiff failed to show that the nomination notice undisputedly met the bylaw's requirements.

The court then moved on to an equitable review of the incumbent directors' decision to reject the nomination notice, because "the Board's technical entitlement to reject the Notice does not necessarily mean that equity will allow it to stand."[7] The court noted that the parties agreed that some form of enhanced scrutiny was appropriate, but disagreed on the standard's label and requirements. The plaintiff argued that the defendants were required to show a "compelling justification" for their actions as set forth in *Blasius Industries, Inc. v. Atlas Corp.*[8] The defendants, on the other hand, argued that — "whether labeled as *Unocal*[9] or *Blasius*" — enhanced scrutiny review that looks to the reasonableness of the board's actions should be applied. Concluding that the "exacting review" of *Blasius* was not appropriate, the court noted that "[s]till, this court must 'reserve space for equity to address the inequitable application of even validly-enacted advance notice bylaws.'"[10] The court stated that "enhanced scrutiny requires a context-specific application of the directors' duties of loyalty, good faith, and care" and that to satisfy the standard "[t]he board must 'identify the proper corporate objectives served by their actions and justify their actions as reasonable in relation to those objectives.'"[11]

In applying enhanced scrutiny review, the court first addressed whether the corporate objectives served by the advance notice bylaw were reasonable. The court began by noting that "[a]dvance notice bylaws are 'commonplace' tools for public companies to ensure 'orderly meetings and election contests.'"[12] Notably, the plaintiff did not question the board's intentions in adopting the advance notice bylaw and it had been adopted on a "clear day.'" Instead, the plaintiff challenged the provision's potential breadth, arguing that if "arrangements and understandings" is not limited to circumstances where there is an exchange of promises, the standard is unworkable. The court rejected this position after concluding that the plain language of the company's bylaw was not so sweeping,

[4] *Id.* at *11.

[5] *Id.* (citation omitted).

[6] *Id.* at *12.

[7] *Id.* at *14.

[8] 564 A.2d 651 (Del. Ch. 1988).

[9] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

[10] *AIM ImmunoTech Inc.*, 2022 WL 16543834, at *15 (citation omitted).

[11] *Id.* (citation omitted).

[12] *Id.* (citation omitted).

that it was not unreasonable, that there were legitimate reasons why the board would want to know whether a nomination was part of a broader scheme to control the company and that the information would be important to stockholders in deciding which director candidates to support.

Finally, the court considered whether the board's rejection of the nomination notice was a reasonable response in relation to these corporate purposes. The defendants argued that they acted reasonably after the board surmised that the nomination notice was part of a broader scheme involving undisclosed arrangements and understandings. The plaintiff, for his part, contended that the board sought merely to entrench itself at the expense of his rights as a stockholder to nominate directors. The court sided with the defendants after considering issues undermining the plaintiff's position, such as the context in which the board received and considered the plaintiff's notice, as well as the legitimate grounds the board had to question the plaintiff's motives, including his having bought stock only 10 days before nominating two non-stockholders, one of whom was a nominee on a previously rejected nomination notice. Ultimately the court concluded that these factors, in addition to lingering factual disputes, prevented granting the plaintiff's motion as a matter of law.

Takeaways

- This most recent decision by the Court of Chancery involving advance notice bylaws further reiterates that unambiguous bylaws should be enforced according to their terms.
- Nonetheless, Delaware courts will continue to conduct an equitable review of an incumbent board's decision to reject a nomination notice even if that notice failed to comply with unambiguous terms of the advance notice bylaw.
- Prior Court of Chancery decisions approached the standard of review for this equitable review slightly differently. While the courts generally agreed equitable review was appropriate, not all expressly applied enhanced scrutiny. The decision in *AIM* expressly applied enhanced scrutiny and clarified that, in the context of an advance notice bylaw, the burden is on the incumbent board to demonstrate it acted reasonably by identifying proper corporate objectives and justifying its actions as reasonable in relation to those objections.
- However, this decision, consistent with the court's other recent decisions on advance notice bylaws, further indicates that, as a practical matter, clear and unambiguous bylaws adopted on a "clear day" in order to achieve the legitimate goal of an orderly corporate electoral process are unlikely to fail equitable review in the absence of specific evidence of inequitable conduct.
- Furthermore, this decision demonstrates that advance notice bylaws remain an important and legitimate tool for incumbent boards to protect the corporation and its stockholders from undisclosed arrangements by individuals or groups seeking corporate control.[13]

[13] Despite their acceptance by the Delaware courts, advance notice bylaws remain a continuing focus of litigation and dissident stockholders can be expected to continue challenging the adoption, amendment and/or scope of such bylaws when seeking to make director nominations. *See, e.g., Politan Capital Management LP v. Kiani*, 2022-0948-NAC (Del. Ch.).

Delaware Court of Chancery Applies *MFW* Factors to 'Reverse Spinoff'

Contributors

Cliff C. Gardner / Partner

Peyton V. Carper / Associate

> See page 10 for key takeaways

The Court of Chancery's decision in *In re Match Group, Inc. Derivative Litigation*[1] is the latest example of how the Delaware Supreme Court's watershed 2014 decision in *Kahn v. M & F Worldwide Corp.* (*MFW*)[2] has been applied to new and different transaction structures involving a controlling stockholder.

MFW

In *MFW*, the Delaware Supreme Court addressed which standard of review should apply to a controlling stockholder "squeeze-out" merger conditioned upfront on approval by both a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote. The Court concluded that in this limited category of controller mergers "where the controller voluntarily relinquishes its control — such that the negotiation and approval process replicate those that characterize a third-party merger," the deferential business judgment standard of review could apply.[3]

Specifically, a claim is subject to the business judgment standard of review if six prerequisites designed to protect the rights of the minority are present. Those prerequisites, now commonly known as the *MFW* factors, are:

1. the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders *ab initio*;
2. the special committee is independent;
3. the special committee is empowered to freely select its own advisers and to say no definitively;
4. the special committee meets its duty of care in negotiating a fair price;
5. the vote of the minority is informed; and
6. there is no coercion of the minority.

In the years since, the Delaware Court of Chancery and the Delaware Supreme Court have articulated the contours of the *MFW* requirements.

For example, in 2018, the Delaware Supreme Court explained in *Flood v. Synutra International, Inc.* that in order to satisfy *MFW*'s *ab initio* prong, a controller must condition a transaction on the approval of both an *MFW*-compliant special committee of independent directors and a majority-of-the-minority stockholder vote before economic negotiations begin.[4]

Then, in *Salladay v. Lev*, the Court of Chancery offered further clarification, explaining that the *ab initio* prong of *MFW* "requires the committee's empowerment prior to 'substantive economic negotiations,' which include valuation and price discussions if such discussions 'set the field of play for the economic negotiations to come.'"[5]

[1] 2022 WL 3970159 (Del. Ch. Sept. 1, 2022).

[2] 88 A.3d 635, 645 (Del. 2014).

[3] *Id.* at 639.

[4] *Flood v. Synutra Int'l, Inc.*, 195 A.3d 754 (Del. 2018).

[5] *Salladay v. Lev*, 2020 WL 954032, at *12 (Del. Ch. Feb. 27, 2020) (citation omitted).

In addition, Delaware courts have expanded the application of *MFW* to a number of other transactional contexts:

- In *In re EZCorp Inc. Consulting Agreement Derivative Litigation*, Vice Chancellor J. Travis Laster pointed out that *MFW* might apply to a broad range of transactions in which a controlling stockholder extracts a non-ratable benefit.[6]
- In 2017, in *In re Martha Stewart Living Omnimedia Inc. Stockholder Litigation*, Vice Chancellor Joseph R. Slights III applied *MFW* to a transaction in which a controller allegedly extracted disparate consideration from the transaction not shared with the common stockholders.[7]
- Later in 2017, in *IRA Trust FBO Bobbie Ahmed v. Crane*, Chancellor Andre G. Bouchard applied *MFW* to a stock reclassification, remarking that there was "no principled basis on which to conclude that the dual protections in the *MFW* framework should apply to squeeze-out mergers but not to other forms of controller transactions."[8]
- In *Tornetta v. Musk*, Vice Chancellor Slights applied *MFW* beyond "transformational" transactions, to other corporate decisions involving controlling stockholders, explaining that non-extraordinary transactions such as compensation decisions could be subject to business judgment review by following the procedures set forth in *MFW*.[9]

Match Group

Recently, Vice Chancellor Morgan T. Zurn applied *MFW* to a "multi-step reverse spinoff" in *Match Group*, dismissing breach of fiduciary duty claims after finding the controlling stockholder "reverse spinoff" complied with *MFW*'s dual protections and thus earned business judgment review.

IAC/InterActiveCorp (Old IAC or Controller) controlled Match Group, Inc. (Old Match). In 2019, in a series of transactions (the Separation) Old IAC separated its dating businesses (*i.e.*, Match.com and other websites) and some debt obligations (the Exchangeables) from the rest of its business. The Separation was accomplished by a transaction agreement dated December 19, 2019. In the Separation, Old IAC formed a subsidiary and spun its other businesses off to that subsidiary, IAC/Interactive Corp (New IAC). So divested, Old IAC held the Exchangeables and a stake in Old Match. Old IAC reclassified its two classes of high-vote and publicly traded stock into one class of common stock, and became known as MatchGroup Inc. (NewMatch). The reclassification decreased IAC's voting control in New Match. Then, Old Match merged with and into a New Match merger subsidiary; in that merger, minority Old Match stockholders received New Match stock. The merger subsidiary survived as a New Match subsidiary, and Old Match ceased to exist.

In the subsequent litigation, the court pointed out that "it [was] undisputed that the reverse spinoff was an interested transaction in which a controller obtained a nonratable benefit at the expense of the minority, presumptively subject to review under the exacting entire fairness standard." Thus, the central dispute before the court was whether the "reverse spinoff" satisfied *MFW*'s prerequisites. Because the plaintiff did not dispute the existence of the special committee or the uncoerced majority-of-the-minority vote, the court focused on *MFW* factors (2) through (5).

First, regarding the special committee's independence, the court found that just one of the three committee members lacked independence because he relied on the Controller or its affiliates as his primary employment for two decades and he made at least $58 million from those relationships. However, the court declined to find that this board member infected or dominated the other two committee members.

[6] *In re EZCorp Inc. Consulting Agreement Derivative Litig.*, 2016 WL 301245 (Del. Ch. Jan. 25, 2016).

[7] *In re Martha Stewart Living Omnimedia Inc. S'holder Litig.*, 2017 WL 3568089 (Del. Ch. Aug. 18, 2017).

[8] *IRA Tr. FBO Bobbie Ahmed v. Crane*, 2017 WL 7053964, at *11 (Del. Ch. Dec. 11, 2017).

[9] *Tornetta v. Musk*, 2019 WL 4566943 (Del. Ch. Sept. 20, 2019).

Second, the court concluded that the special committee was sufficiently empowered to choose its own advisers and say no.

Third, the court rejected the plaintiff's three duty of care arguments that the committee (1) had a "controlled mindset" and negotiated poorly; (2) hired a conflicted financial advisor; and (3) structured the Separation to extinguish derivative claims.

Finally, applying the materiality standard, the court determined that the minority vote on the Separation was fully informed. Because the Separation satisfied all *MFW* prerequisites, and the plaintiff did not even attempt to allege a claim for waste, the court dismissed the plaintiff's fiduciary claim.

With each new application of *MFW*, the Delaware courts offer "incentive for controllers to embrace the procedural approach most favorable to minority investors, with the incentive of obtaining the protection of the business judgment rule standard of review."[10]

[10] *Flood*, 195 A.3d at 756.

Takeaways

- Delaware courts continue to embrace the expansion of *MFW* beyond the squeeze-out merger context to include a variety of circumstances in which a controller receives a non-ratable benefit.
- Controllers and directors of controlled companies should consider the use of *MFW* in varying contexts.
- Controllers and directors should be mindful to ensure compliance with each *MFW* factor, including the *ab initio* requirement, as failure to satisfy even one factor would preclude dismissal at the pleading stage.

Court of Chancery Dismisses *Caremark* Claims Because of Reporting Systems

Contributors

Arthur R. Bookout / Counsel

Rupal Joshi / Associate

Gregory P. Ranzini / Associate

> See page 12 for key takeaways

Delaware courts have historically been reluctant to allow *Caremark* (or "board oversight") claims to gain traction, describing such a claim as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[1] More recently, however, Delaware courts have allowed a number of *Caremark* claims to survive a motion to dismiss.[2] Nevertheless, two recent decisions from this past year — *SolarWinds* and *NiSource* — dismissed *Caremark* claims regarding alleged "mission critical" risks because the board had implemented reporting systems and monitored risks in good faith, even though the monitoring of those systems was considered less than ideal based on the facts alleged.[3] One of those decisions also suggested that a failure to monitor mission critical "business risks" (in contrast to risks arising from violations of positive law), could, in an "extreme" case, give rise to a *Caremark* claim. The court's analysis in both cases underscores the important need for boards to implement and monitor effective systems for "mission critical" risks.

Pleading a *Caremark* Claim

To overcome the "demand" requirement of a *Caremark* claim, a plaintiff must plead facts under which it is reasonably conceivable to infer that the board acted in bad faith by (1) utterly failing to implement any reporting or information systems or controls; or (2) having implemented such a system or controls, consciously failing to monitor or oversee their operations, including ignoring "red flags." These are known as "prong one" and "prong two" of *Caremark*, respectively.

SolarWinds

In *Construction Industry Laborers Pension Fund v. Bingle* (*SolarWinds*), plaintiffs brought suit after SolarWinds (a software company) suffered a massive cyberattack. The *SolarWinds* plaintiffs claimed that the board failed to "monitor corporate effort in [a] way that prevented cybercrime." Although the court found cybersecurity to be "mission critical" for SolarWinds, it dismissed the claim because, based on the allegations, the director defendants (1) did not allow the company itself to violate positive law; (2) ensured the company had at least a minimal reporting system regarding corporate risk, including cybersecurity; and (3) did not ignore sufficient red flags of cyberthreats to imply a conscious disregard of their known duties.

The court distinguished SEC guidance and New York Stock Exchange guidance on cybersecurity disclosures from "positive law" addressing requirements for cybersecurity procedures and risks. The court observed that any failure to adhere to this "guidance" differed from violations of "positive law" alleged in recent cases where a *Caremark* claim survived a motion to dismiss. And while the *SolarWinds* decision acknowledged that no case in Delaware had previously imposed oversight liability based "solely on failure to monitor business risk," it noted the "increasing importance of cybersecurity" and that it is "possible" to conceive of an "extreme hypothetical" that could lead to liability, such as where directors act in bad faith regarding such a risk.

[1] *See In re Boeing Co. Derivative Litig.*, 2021 WL 4059934, at *24 (Del. Ch. Sept. 7, 2021).

[2] *See* Edward B. Micheletti, Bonnie W. David and Ryan M. Lindsay, *The Risk of Overlooking Oversight: Recent Caremark Decisions From the Court of Chancery Indicate Closer Judicial Scrutiny and Potential Increased Traction for Oversight Claims*, Skadden, Arps, Slate, Meagher & Flom LLP (Dec. 15, 2021); Stephen F. Arcano, Jenness E. Parker and Matthew P. Majarian, *'Mission Critical' Issues and 'Red Flags': What It Means for a Board To Exercise Oversight*, Skadden, Arps, Slate, Meagher & Flom LLP (Sept. 22, 2022).

[3] *Constr. Indus. Laborers Pension Fund v. Bingle*, 2022 WL 4102492, at *1 (Del. Ch. Sept. 6, 2022); *City of Detroit Police & Fire Ret. Sys. ex rel NiSource, Inc v. Hamrock*, 2022 WL 2387653 (Del. Ch. June 30, 2022).

With respect to the first prong, the court determined that SolarWinds did not "utterly fail[]" to have a reporting system in place for cybersecurity risks because both the Nominating and Corporate Governance (NCG) Committee and the Audit Committee were charged with oversight responsibility for cybersecurity and the NCG committee was alleged to have specifically discussed cybersecurity. While the court described the reporting system as "subpar" because the board did not receive any reports from either committee with respect to cybersecurity for over two years, such allegations were insufficient under prong one of the *Caremark* test.

The court also concluded that the board did not ignore any alleged "red flags" in violation of prong two. A cybersecurity briefing presented to the NCG Committee was not a "red flag," but "an instance of oversight" that shows the directors were monitoring risks. Other red flags identified by the plaintiffs were insufficient because those facts never rose to the director level, and thus the directors were not aware of them.

NiSource

In *City of Detroit Police and Fire Retirement System ex rel NiSource, Inc v. Hamrock* (*NiSource*), plaintiffs attempted to bring a claim under both *Caremark* prongs in the wake of a series of pipeline explosions.

The Court of Chancery rejected the plaintiffs' prong one challenge because books and records obtained by the plaintiffs demonstrated that the board established a system for monitoring and reporting on the "mission critical" risk of pipeline safety, which "demonstrate[d] the existence of a system rather than its absence."

The plaintiffs advanced two theories under prong two. Their first theory was that the board caused the company to "seek profit by violating the law" instead of spending the money necessary to comply with pipeline safety laws. The court rejected this theory because the plaintiffs did not allege a violation of positive law, but only that the NiSource directors had set too long a timeline to implement a compliance program. The court concluded that the board's decision regarding the implementation timeline — while "regrettable" — was a "legitimate business decision," not bad faith.

The court also rejected the plaintiffs' "red flags" theory, because the "red flags" were either too attenuated from the explosions underlying the complaint or they never rose to the board level. In particular, the court found that the failure of one NiSource subsidiary to comply with an "expansive regulation" could not have alerted the board to the specific risk at another NiSource subsidiary that led to the explosions underlying the complaint.

Takeaways

- Although *Caremark* claims have been more frequently pursued and sustained over the last few years, the Court of Chancery continues to stress the high bar for such claims.
- The decisions in both *SolarWinds* and *NiSource* indicate that a board's decision to implement a reporting system for a "mission critical" risk, and the board's good faith efforts to monitor that risk, may mitigate the threat that a board could face fiduciary duty liability, even if a court, in hindsight, could critique the board's performance in monitoring the risk.
- Whether *Caremark* liability can attach to failures related to mission critical "business risks," rather than those borne from violations of "positive law," remains an open question. Companies should therefore consult with outside counsel to ensure they have adequate controls and oversight in place for all "mission critical" risks.

Contacts

Litigation

Cliff C. Gardner
302.651.3260
cgardner@skadden.com

Paul J. Lockwood
302.651.3210
paul.lockwood@skadden.com

Edward B. Micheletti*
302.651.3220
edward.micheletti@skadden.com

Jenness E. Parker
302.651.3183
jenness.parker@skadden.com

Jennifer C. Voss
302.651.3230
jennifer.voss@skadden.com

Mergers & Acquisitions

Faiz Ahmad
302.651.3045
faiz.ahmad@skadden.com

Steven J. Daniels
302.651.3240
steven.daniels@skadden.com

Allison L. Land
302.651.3180
allison.land@skadden.com

Richard H. West
302.651.3178
richard.west@skadden.com

Corporate Restructuring

Joseph O. Larkin
302.651.3124
joseph.larkin@skadden.com

Carl Tullson
302.651.3180
carl.tullson@skadden.com

*Editor

Special thanks to **Stephen F. Arcano** and **Richard J. Grossman**.

One Rodney Square / 920 N. King St. / Wilmington, Delaware 19801 / 302.651.3000

One Manhattan West / New York, NY 10001 / 212.735.3000