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Delaware Tells Companies: 'Let's Stay Together'

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Key Points

- While there have been some vocal critics of Delaware corporations law, few major companies have reincorporated in other states, and Delaware incorporation continues to offer substantial benefits to companies and stockholders.
- Recent amendments to Delaware's corporations law create safe harbors for companies, controlling stockholders, directors and officers involved in transactions where there are possible conflicts of interest if they follow newly clarified procedural steps.
- The statutory changes provide greater clarity and certainty and should help reduce litigation over transactions.

Over the past few years, Delaware corporations law has been criticized for lacking certainty and predictability in the standards associated with transactions, particularly ones where conflicts arise. This has coincided with an uptick in public discussion over a possible exodus of Delaware companies to other states. But few major companies have reincorporated elsewhere and the alleged shortcomings of Delaware law were seldom relevant to most public companies. They mainly affected companies with controlling stockholders.

Whatever the merits of the criticisms, they have been laid to rest by amendments this spring to the state's corporation law that clarify and simplify the procedures for approving transactions involving controlling stockholders, or where directors or management have conflicts. The amendments create procedural safe harbors that should protect those deals from challenge and insulate directors, officers and controlling stockholders from liability if the statutory steps are followed.

The changes also clarify what constitutes a disinterested director, and a controlling stockholder or controller group. These terms, which were not previously defined by statute, had generated a great deal of litigation in recent years.

In addition, the kinds of company documents that stockholders can access outside of the discovery process in litigation have now been restricted, making it hard for stockholders to obtain informal communications such as texts and emails before filing suit.

In short, the new statutory definitions and standards provide greater clarity and certainty for transactions involving conflicts and for books and records demands. The changes should make it easier for companies to plan transactions that will fall within the new statutory safe harbors, and efficiently resolve books and records demands, avoiding unnecessary litigation costs.

There are many reasons Delaware has been a mecca for companies. The state's courts have a well-deserved reputation for being business savvy and reaching decisions quickly. And the amendments highlight the importance the executive and legislative branches of Delaware's government place on keeping the state's corporations law in tune with business realities.

So why all the public talk of reincorporation? Here are answers to some basic questions.

Delaware's Continued Dominance
• S&P 500 companies that have left Delaware since January 2020: 2 (Tesla, TripAdvisor)* • S&P 500 companies that have moved to Delaware since January 2020: 3 (including Cisco and Caesars Entertainment) • Portion of S&P 500 companies incorporated in Delaware: 67.6% • Publicly traded entities incorporated in Delaware in 2024: 2,451 (+85 over 2023) • IPO companies incorporated in Delaware in 2024: 80% **TripAdvisor dropped out of the index before its reincorporation was completed. Excludes WestRock, which reincorporated in Ireland when it merged with an Irish company.* *Sources: Deal Point Data; Delaware Secretary of State*

What were the complaints about Delaware law?

Delaware law has long protected minority stockholders in transactions involving a controlling stockholder, and where directors' or officers' interests could conflict with other stockholders (*e.g.*, in a take-private where management is going to be retained). But there were complaints that, as the law had evolved, it was impeding legitimate transactions by setting unrealistically high independence standards for directors and demanding disclosures that were not clearly material.

In practice, virtually every transaction involving controlling stockholders was challenged in court, and many suits alleged (often with little factual basis) that directors who the company considered independent of management and controlling stockholders were not independent for purposes of approving transactions with possible conflicts. And the law had developed so that many of the issues could not be dealt with at an earlier, pleading stage of the lawsuit.

Stockholders' requests for pre-litigation access to corporate books and records had also become long, drawn out affairs and, in many cases, had turned into pre-lawsuit mini-discovery. This also spawned a significant amount of litigation over the scope of those requests. Companies found themselves spending significant amounts of time, money and focus on fighting over a process that had long been viewed as routine and limited.

What's changed for directors?

Under the amendments, directors of public companies who meet stock exchange criteria for independence are presumed to be independent if they are not involved in the transaction — even those named to the board by a person with an interest in the transaction. This presumption is "heightened" and can only be rebutted by "substantial and particularized facts" that a director has a material interest in the act or transaction, or has a material relationship with an interested party.

This change will make it much harder to challenge the independence of directors on dubious grounds.

The amendments also set out clear definitions of a controlling stockholder and a control group which, likewise, should reduce litigation.

How does this affect transactions where there may be conflicts? How do the safe harbors work?

Under the revised statutes, in most cases, where the interests of a controlling stockholder, controlling group, directors or officers may diverge from those of other stockholders, the deal can be "cleansed" if ***any*** *one of these three conditions is met*:

- The transaction is approved or recommended in good faith by a majority of directors on a committee with at least two disinterested directors.
- The deal is approved by a majority of fully-informed and disinterested stockholders.
- The transaction is fair to the corporation and its stockholders.

In the case of controlling stockholder (as now defined) take-private transactions, the standard is higher: Those must (a) be approved by both disinterested directors and stockholders, or (b) be fair to the corporation and stockholders. Before the amendments, the Delaware courts had applied this

higher standard to all deals or decisions involving controlling shareholders. With the amendments, this higher standard applies only to take-privates.

If the statutory safe harbors are met, the deal "may not be the subject of equitable relief" (*e.g.*, cannot be enjoined) and will not give rise to a damages award. The clear statutory procedures also will help make the outcome of transactions more predictable for corporations and their boards, and make it less likely that stockholders will routinely file litigation over nearly every transaction that involves a controlling stockholder or control group.

Can directors still be sued over such deals?

If the safe harbor rules are followed for these types of transactions, directors, officers and controllers will not be subject to equitable relief or liable for money damages. Similarly, the new statutory terms protect controlling stockholders and control groups against liability for breaching a duty of care to other stockholders.

What do the amendments mean for books and records demands?

The new amendments specify a limited number of corporate books and records that can be accessed, including: the company's certificate of incorporation and bylaws, stockholder communications, minutes of board and committee meetings (and any materials provided to directors in connection with board actions), annual financial statements and certain contracts with stockholders, plus a few other enumerated categories.

The revised statute also requires that requests be made in good faith and for a proper, stated purpose.

If a stockholder can demonstrate a compelling need for the records beyond those specified, and they are for a legitimate purpose related to their investment, the stockholder can go to court and request an order granting them access, but the burden will be on the stockholder to show their need.

Among other goals, the changes are intended to streamline and reduce the expense and burden on companies of responding to books and records demands, and will likely curtail litigation over invasive demands for informal communications such as texts and emails.

Will the changes reduce litigation against companies and directors?

The expectation is that the safe harbors and the additional clarity on crucial standards and procedures will reduce the number of suits against companies, controllers and directors that have engaged in a corporate transaction or act. The safe harbors are also designed to provide greater certainty for transaction planners, and the expectation is that, if the statutory requirements are met, more cases will be dismissed at an early stage.