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Delaware Corporate and Commercial Case Law Year In Review – 2021

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Our 2021 Top 10 list summarizes decisions from the Delaware courts likely to affect business transactions and business litigation going forward. Our criteria for selection are that the decision either meaningfully changed Delaware law or provided clarity or guidance on issues relevant to corporate and commercial litigation in Delaware. This year's list includes decisions regarding whether a stockholder's claim for alleged breaches of fiduciary duty is direct or derivative, the new test for assessing demand futility in derivative litigation, busted merger litigation arising out of the pandemic, and *ex ante* waivers of statutory appraisal rights afforded to stockholders of Delaware corporations. Before detailing the decisions, one topic warrants special emphasis.

In 2021, the Delaware Supreme Court and the Court of Chancery issued several decisions certain to affect the future investigation and prosecution of derivative claims. Following the attorney fee-shifting decision in *Pettry v. Gilead Sciences, Inc.,* 2021 WL 3087027 (Del. Ch. July 22, 2021), corporations opposing stockholder books-and-records inspections exploring potential derivative claims will need to reevaluate defense strategies that may be perceived as overly aggressive. Under *Brookfield Asset Management, Inc. v. Rosson,* 261 A.3d 1251 (Del. 2021), stockholder plaintiffs pursuing overpayment or dilution claims against alleged controllers must proceed derivatively—such claims are no longer dual-natured derivative and direct claims under the now-abandoned rule of *Gentile v. Rosette.* Under *Morris v. Spectra Energy Partners* (DE) GP, LP, 246 A.3d 121 (Del. 2021), the *Primedia* test provides the framework to evaluate standing to pursue a post-merger claim challenging a merger's fairness based on the alleged failure to secure value for derivative claims. Finally, under *Food Industry Employers Tri-State Pension Fund v. Zuckerberg,* 2021 WL 4344361 (Del. Sept. 23, 2021), Delaware now utilizes a single, unified three-part test for assessing demand futility in derivative litigation, obviating the need to choose between the tests set forth in *Aronson and Rales.* Summaries of these and other important decisions follow.

TOP TEN

ONE: *Food Industry Employers Tri-State Pension Fund v. Zuckerberg, et al.*, --- A.3d ----, 2021 WL 4344361 (Del. Sept. 23, 2021).

Under Delaware law, a derivative claim for harm to the corporation is a corporate asset that the board of directors has the right to control unless half or more of the directors lack impartiality on the claim's subject. When a stockholder plaintiff sufficiently pleads that half or more of the directors are conflicted, demand is excused as futile and the plaintiff may advance the claim in litigation.

Delaware law has long recognized two tests used to determine the demand futility question, each applied to different circumstances—*Aronson* and *Rales*. Fundamentally, the two tests address the same question of whether the board can exercise its business judgment for the corporation. Over time, decisions observed their substantial equivalence, with *Rales* encompassing *Aronson*.

The derivative claims in *Zuckerberg* arose from a stock reclassification approved by the board of Facebook and related class action lawsuits. The Court of Chancery dismissed the claims for failure to plead demand futility, while finding that exculpated duty of care claims do not excuse demand under the second prong of the *Aronson* test. In reaching its conclusion, the trial court opined that, considering Delaware's evolving jurisprudence, maintaining separate tests under *Aronson* and *Rales* could create doctrinal confusion. The trial court therefore proposed a single, unified three-part test for assessing demand futility, which it applied to dismiss the case at bar.

On appeal, the Delaware Supreme Court agreed with the trial court's determinations, including the trial court's articulation of a new universal demand futility test. The Supreme Court likewise cited developments in the law since the articulation of *Aronson* and *Rales*, such as the adoption of Section 102(b)(7) of the Delaware General Corporation Law (DGCL), which authorizes exculpation of duty of care claims, and the rule of *In re Cornerstone Therapeutics Inc., Stockholder Litigation*, 115 A.3d 1173 (Del. 2015), which allows for pleading stage dismissals of claims against directors protected by exculpatory provisions regardless of the underlying standard of review for the challenged conduct. The Supreme Court adopted the Court of Chancery's test, which asks on a director-by-director basis: "(i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand; and (iii) whether the director lacks independence from someone 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." Importantly, as the Supreme Court observed, "this refined standard is consistent with *Aronson*, *Rales*, and their progeny" and "cases properly applying those holdings remain good law."

> ***Key Takeaway***: *Zuckerberg* establishes a single, unified test for assessing demand futility, obviating the need to choose between *Aronson* and *Rales*.

TWO: *Brookfield Asset Mgmt., Inc. v. Rosson*, 261 A.3d 1251 (Del. 2021)

Whether a stockholder's claim is direct or derivative is potentially outcome-determinative, such as when a stockholder's derivative standing is eliminated by a merger. In *Tooley v. Donaldson, Lufkin & Jennette, Inc.,* 845 A.2d 1031 (Del. 2004), the Delaware Supreme Court created a new test to distinguish direct and derivative claims and to clarify jurisprudence. *Tooley* asks who, between the company and the stockholders individually, suffered the alleged harm and would benefit from any recovery or remedy? Under that test, dilution claims have been described as "classically" derivative, or the "quintessence" of a claim belonging to the corporation. In *Gentile v. Rossette,* 906 A.2d 91 (Del. 2006), the Delaware Supreme Court recognized an exception to *Tooley* under which a plaintiff could assert a dual-natured direct and derivative claim against a controlling stockholder for a corporate overpayment that extracts economic value and voting power from the minority stockholders. *Gentile* was criticized and limited by subsequent decisions, including dissents at the Delaware Supreme Court level, but had yet to be overturned.

In *Brookfield*, the plaintiffs challenged an equity financing involving the company's controlling stockholder. The Court of Chancery found that the plaintiffs' claims were direct under *Tooley* but also fell under the *Gentile* carve-out. Constrained by *stare decisis*, the trial court applied *Gentile* and denied defendants' motion to dismiss. On appeal, the Delaware Supreme Court reversed that decision and expressly overruled *Gentile*, eliminating its carve-out from the *Tooley* test. The Court examined pre- and post-*Gentile* decisions and found that "the difficulty courts have had in applying *Gentile* in a logically consistent way, along with *Gentile*'s erosion of *Tooley*'s simple analysis" warranted abandoning *Gentile*. The Court also cited the availability of other legal remedies to address claims covered by *Gentile*, and the potential for dual-natured claims to complicate the fashioning of remedies. The Court therefore established a consistent rule that, absent a shift of control from the diversified public to a controller potentially giving rise to a direct *Revlon* claim, equity overpayment/dilution claims are exclusively derivative.

> ***Key Takeaway*:** Under *Brookfield*, when a corporation is alleged to have exchanged equity for assets of a controlling stockholder for allegedly inadequate consideration, the overpayment or dilution claim is exclusively derivative in nature.

THREE: *Manti Holdings, LLC, et al. v. Authentix Acquisition Co., Inc.*, 261 A.3d 1199 (Del. 2021)

Delaware law makes available appraisal rights in certain merger transactions, meaning a statutory process under Section 262 of the DGCL that allows stockholders to forgo a merger's financial consideration in favor of a judicially-determined appraisal of fair value. *Manti Holdings* presented the novel question of whether common stockholders may agree to an advance waiver of their appraisal rights. The decision arose out of an appraisal proceeding relating to the acquisition of Authentix Acquisition Company, Inc. The petitioners were parties to a stockholders' agreement that purported to waive their appraisal rights. They had entered into that agreement as a condition of an earlier merger involving a private equity firm. The Court of Chancery found the waiver enforceable and dismissed the appraisal proceeding, holding, *inter alia*, the waiver was not a stock restriction that needed to be included in the corporation's charter under another section of the DGCL. On appeal, alongside other contentions, the petitioners argued that statutory appraisal rights are one of the fundamental features of corporate identity and should be nonwaivable under Delaware law and public policy.

The Delaware Supreme Court affirmed the dismissal, finding the stockholders' voluntary and informed waiver valid and enforceable by the company in the circumstances of this action. The Supreme Court recognized that while certain fundamental features of a corporate identity might be nonwaivable, appraisal rights are not among them. According to the Court, neither Section 262 nor Delaware public policy prohibits "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." The Court's reasoning principally rested on the DGCL's nature as a broad enabling statute that permits "immense freedom for private ordering." The Court clarified that upholding this particular waiver against these particular stockholders "does not mean that all *ex ante* waivers of appraisal rights are enforceable or that the waiver of any other stockholder right would be enforceable."

> ***Key Takeaway***: Under *Manti Holdings*, appraisal rights are waivable under the right set of circumstances.

FOUR: *RSUI Indemnity Company v. Murdock*, 248 A.3d 887 (Del. 2021)

Delaware law provides indemnification and advancement rights for directors and officers of Delaware corporations, as reflected in Section 145 of the DGCL. Delaware law strongly favors indemnification and advancement, which together promote the important policy of encouraging capable individuals into board service. Notably, Section 145 is not a blanket authorization for indemnification in all circumstances and may be denied where an indemnitee is shown to have acted in bad faith. When it comes to director and officer insurance, however, Section 145(g) permits Delaware corporations to obtain insurance coverage for potential liability "whether or not the corporation would have the power to indemnify such person against such liability under this section." This dispute implicates this statutory scheme and addresses whether Delaware recognizes a public policy against the insurability of losses involving fraud.

Murdock involved an insurance dispute arising out of various lawsuits concerning a going-private transaction for the Dole Food Company, which implicated duty of loyalty claims occasioned by fraud. An excess insurer objected to coverage, leading to litigation in the Delaware Superior Court. The trial court found in favor of coverage and against the insurer, holding that Delaware law applied and rejecting the insurer's contention that insurability for claims involving fraud violated Delaware public policy.

On appeal, the Delaware Supreme Court agreed with the trial court's conclusions. For the choice of law question, the Court highlighted Delaware's "specific policies" affecting the subject matter expressed in Section 145, as well as the company's "status as a Delaware corporation and the individual insureds' status as directors and officers, all operating under the authority and guidance of Delaware law." Regarding fraud, the Court reaffirmed "the right of sophisticated parties [under Delaware law] to enter into insurance contracts as they deem fit in the absence of clear indicia that a countervailing public policy exists." According to the Court, although Delaware law abhors fraud, Delaware public policy does not consider fraud uninsurable and trump the freedom of contract in this context. The Court's reasoning included Section 145's authorization for insurance coverage for liability beyond indemnification's reach, which stops at bad faith. The Court also expressed concern that excluding coverage for breaches of fiduciary duty based on fraud "would leave many injured parties without a means of recovery," conflicting with the policy favoring "the compensation of innocent victims."

> ***Key Takeaway***: Under *Murdock*, Delaware law authorizes director and officer insurance policies that cover losses occasioned by a fiduciary's fraud.

FIVE: *Morris v. Spectra Energy Partners (DE) GP, LP*, 246 A.3d 121 (Del. 2021)

Stockholders generally lose standing to bring a derivative claim for alleged harm to the company when they cease to hold stock, such as by consequence of a merger, through which derivative claims pass to the buyer. But former stockholders may directly challenge a merger based on the board's failure to obtain value in the transaction for an underlying derivative claim, as a corporate asset. In *In re Primedia, Inc. Shareholders Litigation*, 67 A.3d 455 (Del. Ch. 2013), the Court of Chancery articulated a three-part test for determining whether stockholder plaintiffs have adequately pled such a claim for standing purposes. The *Primedia* test requires that plaintiff allege (i) a viable derivative claim (ii) material to the overall transaction (iii) that will not be pursued by the buyer and is not reflected in the merger consideration.

Morris involved a viable derivative claim that had survived a motion to dismiss but for which derivative standing was extinguished by a merger. It presented an opportunity for the Delaware Supreme Court to weigh in on the *Primedia* test. The Court of Chancery had dismissed the direct claims on standing grounds for failing to satisfy *Primedia*, finding they were immaterial under *Primedia*'s second prong. On appeal, the Supreme Court formally endorsed the *Primedia* test but it disagreed with the trial court's application. In doing so, the Supreme Court clarified a trial court's proper materiality assessment. First, the Supreme Court explained that, after considering the merit of plaintiff's derivative claims, the trial court should not apply a further litigation risk discount when assigning value. Second, if the trial court discounts damages for those claims to reflect the plaintiff's *pro rata* interest in the potential recovery, the court should compare that *pro rata* interest to the proportional interest in the merger's consideration, rather than the overall merger consideration, to achieve an apples-to-apples comparison.

> ***Key Takeaway:*** Under *Morris, Primedia* provides the framework to evaluate standing to pursue a post-merger claim challenging a merger's fairness based on the alleged failure to secure value for derivative claims.

SIX: *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*, 2021 WL 5832875 (Del. 2021)

Important provisions in the mergers and acquisitions context, particularly broken deal litigation, include "material adverse effect" (MAE) clauses, "ordinary course" covenants, and "best efforts" provisions. The COVID-19 pandemic led to several important busted deal decisions from the Delaware courts wrestling with these provisions. *AB Stable* implicated a "material adverse effect" clause and "ordinary course" covenant.

The decision involved a $6 billion deal for luxury hotels sidetracked by the pandemic. The buyer terminated the purchase agreement in the midst of the pandemic, citing, among other issues, circumstances related to the pandemic. The notable part of the MAE analysis concerned whether the pandemic fell within the MAE's exceptions. The Court of Chancery found it did, meaning the pandemic did not excuse the buyer's performance. Excepted from the MAE clause were "natural disasters and calamities." Relying on dictionary definitions, the risk allocation structure of the clause at issue, expert testimony, and industry practice, the Court found that a pandemic fell within the meaning of the word "calamities," and thus could not trigger an MAE excusing the buyer's performance.

On the second issue, however, the Court of Chancery found that the seller breached its covenant to conduct its business in the ordinary course, consistent with past practices. The pandemic did not excuse the seller's adherence, yet the seller made extensive operational changes to the hotels, like closing or limiting operations, slashing employee headcount, and minimizing marketing spends. While these may have been reasonable steps to take in unprecedented circumstances, they were not ordinary course and nothing in the agreement excused the seller's performance. This breach excused the buyer from the obligation to close. The seller's claim for specific performance therefore failed and the buyer recovered its deposit and other funds in accordance with the parties' agreement.

On appeal, the Delaware Supreme Court affirmed the trial court's judgment, agreeing that the seller's drastic operational changes without the buyer's consent breached the "ordinary course" covenant and excused closing. In reaching that conclusion, the Supreme Court rejected, among other arguments, the seller's contention that it "was justified in taking reasonable, industry-consistent steps to preserve the business" in response to the pandemic under the "ordinary course" covenant. The Court reasoned that the covenant measured compliance by the company's own operational history, not that of its industry. Further, the covenant was absolute, lacking a reasonableness qualifier of the type present in other provisions in the same agreement. The Court also observed that the seller had the option but neglected to seek the buyer's pre-approval (not to be unreasonably withheld) before making drastic changes.

> ***Key Takeaway***: *AB Stable* demonstrates the Delaware courts' interpretation and application of MAE clauses and "ordinary course" covenants.

SEVEN: *Snow Phipps Grp., LLC v. KCake Acquisition, Inc.*, 2021 WL 1714202 (Del. Ch. Apr. 30, 2021)

Snow Phipps is another busted deal decision arising out of the COVID-19 pandemic. The litigation implicated a "material adverse effect" clause, "ordinary course" covenant, and "best efforts" provision. The case involved a $550 million deal signed in early 2020 for a cake company that serviced supermarkets. The buyer tried to renege, but with a different outcome than *AB Stable*—the buyer was ordered to close the transaction. As in *AB Stable*, the Court of Chancery held that the buyer failed to prove an MAE. Here, the pandemic-related business decline was not durationally significant, as the industry took a hit at the pandemic's outset but was soon on the upswing. Further, the decline qualified for the MAE exception covering events "related to" government orders, and the decline did not disproportionally affect the target within its industry.

Unlike *AB Stable*, the Court found that the seller did not breach the "ordinary course" covenant. Here, the buyer claimed that the seller's drawdown on its credit facility and its cost-cutting measures were outside the ordinary course. The Court disagreed, distinguishing the more extreme changes in *AB Stable*, finding, among other things, that the changes were not material for this company in light of its historical operations. The company drew from its credit facility in the past and did so here only out of an abundance of caution. Additionally, the company's effort to decrease labor costs in line with decreased production was a historical practice. Finally, the buyer itself breached the efforts clause concerning financing. The buyer had signed onto a debt commitment letter. But when it got cold feet, the buyer developed new, unsupported, overly pessimistic projections and demanded more favorable terms from the lenders. The lenders rejected the new terms but would proceed on the old ones. The buyer declined and failed to line up new lenders. The buyer's breach prevented it from claiming that the deal's financing condition failed.

> ***Key Takeaway***: In the Court's words, the decision in *Snow Phipps* "chalk[ed] up a victory for deal certainty."

EIGHT: *Pettry v. Gilead Sciences, Inc.*, 2021 WL 3087027 (Del. Ch. July 22, 2021)

Section 220 of the DGCL grants stockholders a qualified right to inspect the corporate books and records that are necessary to satisfy a proper purpose. Investigating suspected mismanagement to explore initiating plenary claims is one such proper purpose. Section 220 rights have gained significance following the development of various doctrines that pose pleading stage hurdles to stockholder plaintiffs, such as the decision in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015).

Gilead involved circumstances where the plaintiffs' credible basis to suspect mismanagement was strong and easily overcame the minimal standard of proof for inspection. But the defendant nonetheless offered a host of defenses, including some bordering on "absurd," with the Court finding the defense strategies "overly aggressive." More broadly, the Court opined that the defendant's conduct "epitomize[d] a trend," explaining that "defendants are increasingly treating Section 220 actions as 'surrogate proceeding[s] to litigate the possible merits of the suit' and 'place obstacles in the plaintiffs' way to obstruct them from employing it as a quick and easy pre-filing discovery tool.'" The Court's response was to highlight the potential downside for overly aggressive defenses—its "power to shift fees as a tool to deter abusive litigation tactics." Here, the Court both granted inspection and gave plaintiffs leave to request fee-shifting under the bad faith exception to the American rule.

The plaintiffs requested fee-shifting, and with this decision the Court granted it. There is no single definition of bad faith conduct sufficient to warrant fees and Delaware courts utilize the "glaring egregiousness" standard. The Court found the standard satisfied here based on defendant's conduct collectively, which included misrepresenting the record in certain respects, advancing a defense lacking evidentiary support, and taking aggressive discovery positions in what is supposed to be a narrow, expedited summary proceeding. The Court explained there was no need to launch "a fact-intensive investigation into the offending party's state of mind." Rather, "a showing of glaringly egregious litigation conduct is enough." Further, "[t]o the extent that a finding of bad faith is necessary, then the court can infer bad faith based on the litigation conduct alone." According to the Court, such an inference was appropriate here.

> ***Key Takeaway***: As *Gilead* illustrates, the Court of Chancery will police and punish overly aggressive defense strategies in summary books-and-records proceedings.

NINE: *Firefighters' Pension System of The City of Kansas City, Missouri Trust v. Presidio, Inc.*, 251 A.3d 212 (Del. Ch. 2021)

Under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173 (Del. 1986), a target's board managing a sale must employ a reasonable decision-making process and take reasonable actions aimed at obtaining the best price reasonably available for the stockholders. Besides a possible failure at the board level, there are numerous potential pitfalls implicating other parties involved in the M&A process. Examples include target executives charged with negotiating a deal while harboring a personal interest in potential employment with the bidder, financial advisors with personal business interests in mind, and bidders either aware of or encouraging a steering of the process in their direction. Presidio involved all three scenarios.

The suit in *Presidio* arose out of the merger of a controlled company to an unaffiliated third party. On defendants' motion to dismiss, the Court of Chancery upheld a breach of fiduciary duty claim against an executive who allegedly tilted the sale process to a preferred bidder and withheld material information from the board. It also upheld aiding and abetting claims against the target's financial advisor and the acquirer regarding the tilted sale process.

After finding *Corwin* cleansing unavailable due to deficient disclosures regarding flaws in the sales process, the Court reviewed the transaction using enhanced scrutiny under *Revlon*. The Court found that plaintiff's allegations supported a finding that the sale process fell outside the required range of reasonableness and stated fiduciary duty claims for damages. One bidder planned to retain the target's chairman and CEO on lucrative terms while another did not. The executive, motivated by this personal conflict, allegedly steered the sales process towards his preferred bidder. The target's financial advisor allegedly aided this effort, most problematically by secretly tipping off the winning bidder about the details of a competing bidder's offer. The winning bidder got a leg up when restructuring its bid, resulting in a price below what the target's board might have otherwise achieved. The winning bidder likely must have known the advisor's tip was wrongful, but nonetheless used it to its advantage. While the Court dismissed the board generally and the company's controlling stockholder from the action, the Court found that the plaintiff's allegations stated claims against these three actors.

> ***Key Takeaway***: *Presidio* illustrates potential perils in the deal process leading to litigation if a plaintiff can plead that officers, advisors, and acquirers acted in their self-interest.

TEN: *The Williams Companies Stockholder Litigation*, 2021 WL 754593 (Del. Ch. Feb. 26, 2021)

Poison pills are one defensive tool available to boards of potential acquisition targets. A poison pill is a tactic, taking various forms, through which a company makes itself a less desirable target. A "flip-in" pill strategy, for instance, grants stockholders other than the acquiror the right to purchase shares of the company at a discount when triggered, thereby diluting the acquiror's interest. The Delaware Supreme Court first recognizing poison pills as legally valid in *Moran v. Household Intern., Inc.*, 500 A.2d 1346 (Del. 1985), while establishing intermediate scrutiny under *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) as the legal framework for poison pill challenges.

The Williams Companies involved such a challenge. The litigation concerned a pill adopted by an energy company at the pandemic's outset during a global oil price war. The pill featured terms more extreme than pills that Delaware courts previously evaluated and failed to overcome intermediate scrutiny. *Unocal* is a two-part analysis that asks, first, whether the board had reasonable grounds for identifying a threat to the corporate enterprise, and second, whether the board's response to that threat was reasonable.

The Court of Chancery assumed for sake of analysis that one of the board's proffered justification for the pill's adoption satisfied the first prong—specifically, that activists might stealthily and rapidly accumulate over 5% of the company's stock. But the Court found that the pill failed the second prong. The Court's reasoning highlighted several of the pill's features. For instance, the pill had a 5% trigger threshold that was well below the typical 10-20% threshold. Second, the pill's definition of stockholders "acting in concert" was broad and more expansive than the comparable definition under the rules of the U.S. Securities and Exchange Commission disclosure regime, capturing, among other things, parallel conduct between stockholders. Third, and similarly, the definition of a "passive investor" within the pill's carveout departed from the comparable and broader definition under the SEC rules. In the Court's words, the plan's terms "increase[d] the range of [the company's] nuclear missile range by a considerable distance beyond the ordinary poison pill." Together, these terms rendered the company's pill disproportionate to the alleged threat and outside the range of reasonable responses permitted under *Unocal*'s second prong.

> ***Key Takeaway***: *The Williams Companies* is important poison pill jurisprudence illustrating out-of-bounds pill provisions.

The guidance offered by these decisions already is affecting pending litigation in Delaware, including in the high-profile action against Tesla CEO, Elon Musk, for alleged breach of fiduciary duty in connection with the Solar City merger. With the consent of plaintiff, the Court of Chancery relied upon Brookfield to decertify the class, allowing the action to go forward solely as a derivative claim. Drafters, no doubt, are recrafting merger agreement provisions affecting risk allocation to better address public health related emergency circumstances. And respondent companies in books and records litigation are more carefully considering their oppositions to what may be deemed reasonable requests for information related to credible allegations of mismanagement. How practitioners and the courts react to the 2021 Top 10 decisions will be a key storyline of 2022.