Delaware Corporate Law
2021 Year in Review

Potter Anderson Corroon LLP

YOUR DELAWARE ADVANTAGE

2021: DELAWARE CORPORATE JURISPRUDENCE IN REVIEW

2021 was a year of change. It brought not only important developments to Delaware's body of corporate law, but also change to the composition of the Court of Chancery. First, on changes to the Court, in April, Chancellor Bouchard retired as Chancellor after seven years of exemplary service to the Court. Chancellor Bouchard oversaw the expansion of the number of members of the Court, presided over numerous high-profile cases, and authored rulings that have proven beneficial to Delaware and corporate practitioners. His rulings in *Trulia* and *KKR*, which led to the Delaware Supreme Court's *Corwin* decision, come to mind as ones that will have a lasting and positive impact on deal litigation in Delaware.

With the retirement of Chancellor Bouchard, Vice Chancellor Kathaleen McCormick was elevated to the Chancellor position. As a result, she became the first woman ever to hold the title of Chancellor of the Court of Chancery. Chancellor McCormick has done a superb job in taking over at the helm during the pandemic, while managing the Court's resources to handle an ever-increasing docket. The vacancy her appointment as Chancellor created was filled by Lori Will, a partner in the Wilmington office of Wilson Sonsini Goodrich and Rosati. Finally, as we entered the early days of 2022, Vice Chancellor Slights announced that he will be retiring this spring. As a firm, we are extremely grateful for his long service to the State of Delaware, both as a judge on the Superior Court and as a Vice Chancellor. His intellect, demeanor, work ethic, and sense of fairness will be missed, and of course we wish him the best as he embarks on his next stage.

Notwithstanding these significant changes to the composition of the Court of Chancery, it was an extremely busy year for the Court, and, in turn, the Supreme Court of Delaware. 2021 saw a continuation of the phenomenon seen in 2020 of "busted deal" cases stemming from the pandemic, as well as *Caremark* claims surviving motions to dismiss. Several of these cases are discussed below and are must-reads for corporate practitioners. Moreover, the Supreme Court had occasion to address long-standing precedent surrounding stockholder derivative actions, including dispensing with the *Gentile* "dual-natured" exception and refining the test for determining demand futility. These too are discussed below, together with those decisions that we view as the most noteworthy of 2021 and early 2022.

Delaware Supreme Court Cases

Morris v. Spectra Energy Partners (DE) GP, LP
246 A.3d 121 (Del. 2021) (Chief Justice Seitz)

In *Morris*, the Delaware Supreme Court reversed and remanded the Court of Chancery's dismissal of a direct claim challenging the validity of a $3.3 billion merger. Plaintiff alleged that the merger eliminated a derivative claim, purportedly worth $661 million and arising from an earlier reverse-dropdown transaction, without providing sufficient value for that claim. Under the framework set forth in *In re Primedia Inc., Shareholders Litigation*, the Court of Chancery determined that the derivative claim was immaterial to the merger after discounting it and dismissed the claim for lack of standing.

On appeal, the Supreme Court held that the *Primedia* framework is the appropriate test for evaluating post-merger challenges based on a defendant's alleged failure to secure value for derivative claims. Under *Primedia*'s three-part test, a plaintiff must first plead an underlying derivative claim that has survived a motion to dismiss or which otherwise states a claim on which relief could be granted. Second, the value of the derivative claim must be material in the context of the merger. Third, the complaint challenging the merger must support a pleading-stage inference that the acquirer would not assert the underlying derivative claim and did not provide value for it. In *Morris*, the parties did not dispute the viability of the underlying derivative claim or that the acquirer would not assert it and had provided no value for it. The issue on appeal was whether the Court of Chancery had properly evaluated the materiality of the claim under a motion to dismiss standard of review.

The complaint alleged that plaintiff could recover $661 million for prevailing on the underlying derivative claim. The Court of Chancery, after twice discounting the value of the derivative claim, found the claim to be immaterial. The first discount—a reduction in value to $112 million—reflected the minority unitholders' 17% interest in any recovery. The second discount, to $28 million, was based on the Court of Chancery's estimation that the claim had a one-in-four chance of prevailing.

In reversing, the Supreme Court explained that the Court of Chancery committed error in two ways when it analyzed the materiality prong under *Primedia*. First, by reducing the value of the claim to account for litigation risk, the Court of Chancery did not accept the complaint's well-pleaded facts as true and draw all reasonable inferences in plaintiff's favor, as it was required to do in connection with a motion to dismiss. Thus, the Court of Chancery, at the motion to dismiss stage, should have reasonably inferred that plaintiff could recover at least $661 million if he were to prevail. Second, even if a discount were appropriate to account for the minority unitholders' proportional interest in the partnership, the Court of Chancery should have evaluated the materiality of that value in relation to the minority's proportional interest in the merger. Thus, the Court of Chancery should have evaluated whether the minority unitholders' $112 million proportional interest in the recovery was material to the minority unitholders' $561 million proportional interest in the merger. Accordingly, the Supreme Court held that plaintiff had adequately pleaded that the extinguished derivative claim was material and that the Court of Chancery had improperly dismissed the direct *Primedia* claim.

Takeaway

Litigation risk discounts are not appropriate for extinguished derivative claims: The Delaware Supreme Court reversed and remanded because it found that the Court of Chancery improperly applied a litigation discount risk, despite its obligation to accept the reasonable factual allegations of the complaint as true. If courts cannot discount a well-pleaded derivative claim for litigation risk at the motion to dismiss stage, that increases the likelihood that claims will be deemed material under the *Primedia* test. Parties should consider this when evaluating transactions that would eliminate derivative claims and be wary of applying litigation discounts when considering whether they need to attempt to obtain value for those claims. Instead, parties should carefully evaluate whether a derivative claim would survive a motion to dismiss, and, if so, what value would be assigned to those claims under the plaintiff-friendly motion to dismiss standard.

Manti Holdings, LLC v. Authentix Acquisition Company, Inc.
261 A.3d 1199 (Del. 2021) (Justice Montgomery-Reeves)

In this landmark decision, the Delaware Supreme Court held that Delaware law permits an *ex ante* waiver of appraisal rights by sophisticated and informed investors in a Delaware corporation who were represented by counsel in the negotiations resulting in the waiver. Petitioners sought appraisal of their shares in connection with a cash merger in which they received little to no compensation for their stock. Petitioners had previously entered into a stockholders agreement (the "Agreement") in connection with an earlier acquisition of the corporation, which, among other things, required them to refrain from exercising their appraisal rights in connection with certain transactions and under certain conditions (the "Refrain Obligation").

After rejecting threshold contractual arguments that petitioners had not waived their appraisal rights under the Agreement, the Supreme Court addressed whether Delaware statutory law and public policy permitted a Delaware corporation to enforce an *ex ante* waiver of appraisal rights against its stockholders. The Court first held that the Refrain Obligation was not a stock restriction that, under Section 151(a) of the General Corporation Law of the State of Delaware (the "DGCL"), must be included in a Delaware corporation's certificate of incorporation or in a board of directors' authorizing resolutions. The Court also concluded "that Section 262 [of the DGCL] does not prohibit sophisticated and informed stockholders, who were represented by counsel and had bargaining power, from voluntarily agreeing to waive their appraisal rights in exchange for valuable consideration." In arriving at that conclusion, the Court interpreted the plain language of Section 262 and public policy concerns implicated by virtue of waiving this statutory right and held that neither the plain language of Section 262 nor public policy considerations barred such a waiver under the circumstances presented. Finally, the Court confirmed that Section 218(c) of the DGCL did not bar Delaware corporations from seeking to enforce stockholders agreements.

Notably, Justice Valihura issued a dissenting opinion. In it, she explained that she would have found that the waiver of appraisal rights *ex ante* "contravenes the DGCL" and, even if not contravening the DGCL, is a "a term [that] goes to the heart of corporate governance and can only be contained in a corporate charter, not a bylaw or stockholders agreement." Justice Valihura also expressed concerns that permitting *ex ante* waiver of appraisal rights would "transform the corporate governance documents into gap-filling defaults and collapse the distinction between a corporation and alternative entities."

Takeaways

***Ex ante* waivers of appraisal rights by sophisticated and informed investors, represented by counsel, are valid under Delaware law:** As Justice Valihura's dissenting opinion states, the inclusion of *ex ante* waivers of appraisal rights in stockholders agreements for certain types of M&A transactions and under other qualifying circumstances have become a common practice in the private company sector. The Supreme Court had not squarely addressed the validity of these waivers until this case. Practitioners now have some comfort that, in negotiating these provisions in stockholders agreements, Delaware courts will uphold their validity, assuming that the other parties to the stockholders agreements are sophisticated and informed investors and represented by counsel.

The Supreme Court's opinion raises additional questions regarding potential waivers of other statutory and common law rights by stockholders of a Delaware corporation: Petitioners argued that permitting a waiver of appraisal rights by stockholders of a Delaware corporation would have cascading consequences for stockholder rights in a Delaware corporation, opening the door to authorizing blanket waivers of the rights of stockholders to seek books and records of the corporation, challenge director elections, compel an annual meeting of stockholders, and/or file suit for breaches of fiduciary duty. In response to this argument, the Court explained that "there may be other stockholder rights that are so fundamental to the corporate form that they cannot be waived *ex ante*, such as certain rights designed to police corporate misconduct or to preserve the ability of stockholders to participate in corporate governance." Although the Court acknowledged that there may be certain fundamental rights that could not be waived *ex ante*, it did not provide clear guidance on what those fundamental rights are, and, thus, practitioners must await further guidance from the Court and the Court of Chancery identifying those fundamental rights.

Brookfield Asset Management, Inc. v. Rosson
261 A.3d 1251 (Del. 2021) (Justice Valihura)

In this opinion, the Delaware Supreme Court overturned *Gentile v. Rosette*, ("*Gentile*"). *Gentile* held that a stockholder who allegedly suffers dilution as a result of a controlling stockholder increasing its holdings had standing to pursue a direct claim because a corporate dilution/overpayment claim was "dual-natured" (*i.e.*, direct and derivative). The *Brookfield* Court put to rest the *Gentile* dual-natured exception in favor of *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, ("*Tooley*"), and thereby made clear that stockholder plaintiffs will now need to satisfy the demand requirement under Court of Chancery Rule 23.1 in controller dilution cases.

In June 2018, Brookfield Asset Management, Inc. ("Brookfield") acquired $650 million shares of TerraForm Power, Inc. ("TerraForm" or the "Company") through a private placement, increasing Brookfield's interest in TerraForm from 51% to 65.3%. Plaintiffs asserted claims that TerraForm issued stock for insufficient value in the private placement, diluting the minority stockholders' economic and voting interests both directly and derivatively. In July 2020, Brookfield affiliates acquired all outstanding stock of the Company not already owned by Brookfield, and plaintiffs lost standing to pursue the derivative claims. In October 2020, the Court of Chancery found that plaintiffs' claims were derivative under *Tooley* and were also direct under *Gentile*'s exception to *Tooley*.

On an interlocutory appeal, the Supreme Court acknowledged three ways in which *Gentile* was in tension with *Tooley*. First, the Court found tension in *Gentile*'s conclusion that economic and voting dilution was an injury to stockholders independent of the corporation. Second, the Court found that *Gentile*'s explicit reliance on *In re Tri-Star Pictures, Inc. Litigation*, 643 A.2d 319 (Del. 1993) ("*Tri-Star*") created tension with *Tooley* because *Tri-Star* relied on opinions applying the "special injury" test that *Tooley* expressly rejected. Third, the Court noted that *Gentile*'s reliance on the presence of a controlling stockholder conflicted with the *Tooley* test, which solely focuses on who suffered harm and who would recover rather than the nature of the wrongdoer.

The Court then identified practical concerns with *Gentile*. First, the carve-out for dual-natured claims in *Gentile* was unnecessary because there are other avenues stockholders could use to assert fiduciary duty claims in change-of-control transactions or challenge the fairness of a merger. Second, because both the corporation and stockholders could recover for harm under *Gentile*, there was a risk of double recovery.

Next, the Court explained why *stare decisis* did not prevent overturning *Gentile*. The Court found that fifteen years of grappling with *Gentile* was sufficient to determine that the difficulties that it created were unworkable and that *Gentile* was a substantial departure from *Tooley*. The Court also found that the Supreme Court's statements casting doubt on the continued viability of *Gentile* in *El Paso Pipeline GP Co. v. Brinckerhoff* meant that parties could anticipate that *Gentile*'s status was in jeopardy.

Because the Court determined that *Gentile* was no longer good law, it found that plaintiffs' claims were derivative and Brookfield's acquisition of all outstanding Terraform stock extinguished those claims.

Takeaways

Cash-out mergers will extinguish *Gentile*-style claims: Because *Gentile*-style claims are now purely derivative, mergers which eliminate minority stockholders will also eliminate those claims. This creates more certainty for buyers and sellers. One important corollary, however, is that stockholders may also be able to pursue claims pursuant to *Primedia* that the merger extinguished the derivative claim for insufficient value. Thus, sellers and their advisors should consider whether the transaction is extinguishing any *Gentile*-style claims and evaluate how to proceed in light of the Supreme Court's holding in *Spectra*.

Special litigation committees can handle *Gentile*-style claims: One recent trend has been an increase in the number of special litigation committees created to handle derivative claims. The holding that *Gentile*-style claims are purely derivative also means that companies should consider whether they have board members who could serve on a special litigation committee for pending or potential derivative claims and have a plan to add directors who could do so if the need arises.

United Food and Commercial Workers Union v. Zuckerberg

262 A.3d 1034 (Del. 2021) (Justice Montgomery-Reeves)

In 2010, Facebook, Inc. ("Facebook") CEO Mark Zuckerberg took the "Giving Pledge" to donate the majority of his wealth to philanthropy. To fund the pledge, he urged Facebook to create a new class of nonvoting stock that would permit him to sell shares of Facebook stock without surrendering his voting control. The board's approval of the new class of stock sparked several lawsuits, which Facebook mooted by withdrawing the plan before trial. Facebook spent almost $22 million defending the lawsuits and paid a $68.7 million settlement. Following settlement, plaintiffs sued Zuckerberg and Facebook's board for breach of their fiduciary duties in approving the new class of stock and seeking to recoup the amount of the settlement. Defendants moved to dismiss under Court of Chancery Rule 23.1, arguing that plaintiffs should have made a litigation demand on the board. The Court of Chancery dismissed for failure to plead that demand was futile. In reaching that decision, the Court of Chancery proposed a new universal three-part test for determining demand futility.

On appeal, the Delaware Supreme Court evaluated the two traditional tests for determining whether directors are independent and disinterested for the purpose of considering a litigation demand (the so-called "*Aronson*" and "*Rales*" tests).

The Court found that developments in Delaware corporate law since the advent of the *Aronson* test in 1984—including enhanced scrutiny, controlling stockholder standards, and Section 102(b)(7) exculpation clauses—had rendered it outmoded. While the *Rales* test often provided a viable alternative, it, too, was limited in the circumstances in which it could apply. As a result, the Court adopted the Court of Chancery's modified tripart test, mandating that "from this point forward, courts should ask the following three questions on a director-by-director basis when evaluating allegations of demand futility: (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 faces a substantial likelihood of liability on any of the claims that would be 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 would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand." Applying this test, the Supreme Court affirmed the Court of Chancery's dismissal under Rule 23.1.

Takeaways

Delaware has a new, consolidated standard for demand futility: The Supreme Court announced the tripart test as "the universal test for assessing whether demand should be excused as futile." Both plaintiff and defense counsel should be aware that Delaware courts will apply this test to a board of directors as it exists at the time the demand would have been made to evaluate the board's ability to consider the litigation demand. Counsel should evaluate demand futility under this test and no longer needs to determine whether the *Aronson* test or the *Rales* test applies.

Decisions analyzing demand futility under *Aronson* or *Rales* are still good law: The Supreme Court emphasized that the new test "is consistent with and enhances" both the *Aronson* and *Rales* tests, rather than overruling them. Decisions applying the *Aronson* or *Rales* tests for demand futility therefore remain good law, and practitioners may rely upon them in litigating demand futility issues.

Allegations of exculpated duty of care violations do not excuse a pre-suit demand as futile: In analyzing demand futility, the Supreme Court clarified that allegations of an exculpated breach of the fiduciary duty of care against a director do not disable that director from considering a demand. Because duty of care claims can be exculpated under 102(b)(7) clauses, these claims do not lead to a substantial likelihood of liability. One potential consequence of this holding is that derivative plaintiffs will likely assert more claims that a majority of the demand board acted disloyally or in bad faith.

Broken-Deal Litigation

Bardy Diagnostics, Inc. v. Hill-Rom, Inc.

C.A. No. 2021-0175-JRS (Del. Ch. July 9, 2021)
(Vice Chancellor Slights)

Hillrom, Inc. ("Hillrom") and Bardy Diagnostics, Inc. ("Bardy"), a single product healthcare company that manufactured a cardiac monitoring patch, entered into an agreement pursuant to which Hillrom would acquire Bardy. Because Bardy's patch represented a relatively new technology, the Centers for Medicare and Medicaid Services ("CMS") had not yet established permanent Medicare pricing. Instead, Novitas, a Medicare Administrative Contractor, set temporary pricing. Novitas's pricing was "notoriously opaque." A large portion of Bardy's revenue came from Medicare reimbursements.

At the time the parties began negotiating the transaction, they anticipated CMS would establish permanent pricing for Bardy's patch, introducing stability and predictability into Bardy's business. CMS, however, declined to set pricing and instead deferred to Novitas. Nevertheless, the parties believed Novitas would set pricing at its "historically stable" levels. After signing an agreement and plan of merger, Novitas significantly dropped the reimbursement rates, causing an approximately 86% decline in Bardy's revenue. Believing the rate was set in error, the parties attempted to work with Novitas to no avail. Hillrom later declared a material adverse effect ("MAE").

The Court found Hillrom failed to establish that an MAE was reasonably expected to occur. The Court assumed that the reimbursement rate decrease constituted an MAE, and instead focused its analysis on whether that MAE would be durationally significant. After weighing expert testimony, the Court found that Hillrom did not meet its burden of establishing that CMS and/or Novitas would not significantly increase the reimbursement rate in the near future.

Takeaways

When it comes to proving durational significance, the burden of proof matters: Whether the rate decrease was durationally significant turned on whether Novitas would revise the rates, or whether CMS would set permanent pricing at or around Novitas's historical pricing. Neither party was sure why CMS did not set permanent rates, and neither was sure if Novitas would revise the rates upward, particularly due to the known lack of transparency in Novitas's pricing decisions. Indeed, the Court itself described Novitas's pricing process as a "black box" and noted that "in unprecedented times, history makes for a poor guide." Nevertheless, the Court noted that, while the effects of the rate change "*might* be durationally significant," Hillrom had failed to meet its burden to prove that it was. Consequently, a party considering declaring an MAE should consider the difficulties in proving that a change will remain in effect long enough to remain durationally significant.

Courts will read MAE provisions according to their terms: The MAE provision contained a disparate impact exception that included the phrase "similarly situated." The Court noted this qualifier was absent from other MAE clauses Delaware courts have analyzed, which typically included only industry and location qualifiers. The Court read this language as limiting the universe of companies to a subset of companies in the same industry, focusing on companies with a similar product mix. Ultimately, the Court limited this group of companies to only one, reasoning the language indicated that the parties intended the group to be small. When drafting MAE clauses, the parties should be aware that any deviation from "standard" MAE language will introduce uncertainty into any subsequent litigation. If parties to an agreement decide to include language Delaware courts have not yet analyzed, they should carefully define the language to avoid unnecessary uncertainty.

Snow Phipps Group, LLC v. KCAKE Acquisition, Inc.
C.A. No. 2020-0282-KSJM, (Del. Ch. Apr. 30, 2021) (Vice Chancellor McCormick)

In January 2020, Kohlberg & Company LLC ("Kohlberg") and Snow Phipps Group LLC ("Snow Phipps") signed an agreement under which Kohlberg would purchase DecoPac, a supplier of cake-decorating ingredients and products. The purchase agreement included a material adverse effect ("MAE") provision that exempted changes "arising from or related to" government regulations, as well as an ordinary course covenant that required Snow Phipps to run the business consistent with past practices through closing.

The COVID-19 pandemic caused DecoPac's sales to suffer a steep decline early in 2020, before quickly recovering. Nevertheless, Kohlberg "began to develop buyer's remorse" and eventually refused to close, claiming the financial decline gave rise to a reasonable expectation that an MAE would occur. The Court disagreed. Despite DecoPac's sales precipitously declining, they recovered in

the two weeks before Kohlberg declared an MAE, casting doubt on Kohlberg's assertion that the decline would be sustained. Moreover, the decline in sales was caused by various government responses to the pandemic, including shut-down orders, so the event fell within the MAE provision's exceptions. The Court likewise rejected Kohlberg's ordinary course argument, finding that DecoPac's draw of a revolving credit facility did not alter "the total mix of information available to the buyer."

Takeaways

Triggering an MAE provision continues to be difficult: There is still no bright-line test as to whether a particular event has caused an MAE. In determining whether a financial decline in a company has caused an MAE, the Court looks to whether the adverse change in the company's business was consequential to the company's long-term earnings power over a commercially reasonable period. Such determination is context specific and should be material when viewed from the longer-term perspective of a reasonable acquiror. While noting that DecoPac's decline in sales during the early stages of the pandemic response was "dramatic when viewed against the baseline," the Court found that a general agreement among almost all models that the company's revenues would recover swiftly during the remainder of 2020 and into 2021 constituted persuasive evidence that the "blip" in sales was not reasonably likely to result in a MAE. This was in contrast to the facts in *Akorn, Inc. v. Fresenius Kabi AG*, where the Court found that an MAE had occurred where there had been a "sudden and sustained drop in Akorn's business performance."

Further, in this case, the financial decline would not have triggered the MAE provision in any event because it was found to fall within the exception of an MAE provision because it arose from or was related to changes in any laws, rules, regulations, orders, enforcement policies or other binding directives issued by any governmental entity. Exceptions to MAE provisions should be carefully drafted to avoid inadvertently carving out events that are intended to be covered by an MAE provision.

For purposes of an ordinary course covenant, whether a change is material depends on whether "the total mix of information" was altered: The Court found DecoPac did not breach the ordinary course covenant. The purpose of an ordinary course covenant is to ensure "the business the buyer is paying for at closing is essentially the same as the one it decided to buy at signing." In reviewing a provision that includes the phrase "in all material respects," a court does not require a showing equivalent to an MAE, nor a showing equivalent to the common law doctrine of material breach. Rather, such court seeks to exclude small, *de minimis*, and nitpicky issues that should not derail an acquisition. Under this standard, "[t]o qualify as a breach, the deviation must significantly alter the total mix of information available to the buyer when viewed in the context of the parties' contract." Put differently, the materiality standard at issue asks whether the business deviation would significantly alter the buyer's belief as to the business attributes of the company it is purchasing.

Snow Phipps argued that because DecoPac drew $15 million of its $25 million from its revolving loan, the largest amount withdrawn to date, the company failed to operate in the ordinary course. The Court, however, determined that DecoPac operated in the normal course of business, as its draw of the revolving credit facility—cash which sat unused until repaid—was related "solely to a [Snow Phipps] policy implemented broadly among its portfolio companies," and the cost-cutting measures were consistent with actions DecoPac's management took during other economic downturns. Therefore, there was no breach of the ordinary course covenant.

AB Stable VIII LLC v. MAPS Hotels & Resorts One LLC

No. 71, 2021 (Del. Dec. 8, 2021) (Chief Justice Seitz)

In this opinion, the Delaware Supreme Court affirmed the Court of Chancery's opinion that held that a buyer was entitled to terminate a merger agreement because the seller violated an ordinary course covenant.

Mirae Asset Financial Group ("Mirae") contracted to purchase AB Stable VIII LLC's ("AB Stable") subsidiary, Strategic Hotels & Resorts LLC, which owns luxury hotels. The merger agreement between the parties included a material adverse effect ("MAE") provision and a covenant providing AB Stable must operate the business "only in the ordinary course of business, consistent with past practice in all material respects." AB Stable, however, could make changes to its business if it first obtained Mirae's consent. Starting in early 2020, in response to the COVID-19 pandemic, AB Stable closed two hotels and laid off thousands of employees, among other things. AB Stable did not request Mirae's consent before making these changes. Mirae argued the changes violated the ordinary course covenant.

AB Stable made three arguments on appeal: (1) the ordinary course covenant did not preclude AB Stable from making "reasonable, industry-standard changes in response to the pandemic," (2) the Court of Chancery erred because its decision did not account for the parties' allocation of pandemic risk to Mirae through the MAE provision, and (3) AB Stable's breach of the notice requirement in the ordinary course provision was immaterial.

The Supreme Court affirmed the Court of Chancery's ruling on all issues. The Supreme Court read the ordinary course covenant according to its terms, which did not include qualifiers relating to industry practices or reasonableness. The Supreme Court further reasoned that MAE provisions and ordinary course covenants are designed to allocate different risks, and when read in the context of the agreement, the parties intended for the provisions to address different risks. Lastly, the Supreme Court emphasized the importance of notice requirements in connection with ordinary course covenants, rejecting the argument that a failure to comply is immaterial.

Takeaway

Ordinary course covenants are not one-size-fits-all—Courts will read them according to their plain language: The Supreme Court read the ordinary course covenant according to its terms, which in this case did not allow AB Stable to make changes consistent with industry standards. Likewise, the parties did not include a reasonableness qualifier in the ordinary course covenant, so whether or not the actions taken by AB Stable in response to the pandemic were reasonable was irrelevant. Because the ordinary course covenant required compliance consistent with "past practices," only AB Stable's operational history was relevant in determining whether it operated in the ordinary course. Parties negotiating ordinary course covenants should consider whether to include reasonableness qualifiers or provisions.

Caremark Litigation

In re Boeing Company Derivative Litigation

C.A. No. 2019-0907-MTZ (Del. Ch. Sep. 7, 2021)
(Vice Chancellor Zurn)

In *Boeing*, the Court of Chancery held that demand was excused under Rule 23.1 because plaintiffs alleged facts that showed that a majority of the Boeing Company ("Boeing" or the "Company") board of directors (the "Board") faced a substantial likelihood of liability for *Caremark* claims related to compliance with airplane safety regulations in connection with the crash of two Boeing 737 MAX airplanes between 2018 and 2019. Those crashes forced Boeing to ground its entire fleet for twenty months and exposed the Company to substantial potential regulatory, criminal, and civil liability.

Plaintiffs alleged that Boeing developed the 737 MAX quickly and inexpensively to keep up with competition. The Company reconfigured the older 737 NG model by adding larger engines, cutting costs related to regulatory approval and pilot training. The placement of the larger engines caused the planes to tilt upward or "pitch up" during flight. The Company addressed this issue with stabilization software ("MCAS") that would push the tail of the plane upward when sensors were triggered. However, there was a risk of MCAS activating upon a single false sensor reading. Engineers proposed fixes, but managers rejected them due to costs.

Plaintiffs alleged the company failed to disclose the MCAS issues to the Federal Aviation Administration ("FAA") and received approval for a less extensive, less costly level of pilot training. The 737 MAX went to market without training or manual guidance on the potential MCAS issues. On October 29, 2018, a new 737 MAX crashed in Indonesia after repeated MCAS activations, killing all 189 people aboard. The Board declined to start an internal investigation. On March 10, 2019, another 737 MAX crashed in Ethiopia after repeated MCAS activations, killing all 157 people aboard. The FAA grounded the entire fleet of 737 MAX. The Board adopted safety oversight measures in April 2019.

The Court found that plaintiffs adequately pleaded *Caremark* claims under both prongs. On the first *Caremark* prong, the Court found that airplane safety regulatory compliance is "essential and mission critical" to Boeing, yet the Board failed to "rigorously exercise" its board oversight duties. Plaintiffs fairly alleged that: (i) the Board had no committee responsible for monitoring airplane safety, (ii) the Board did not regularly address airplane safety, (iii) there was no regular process for employees to report on safety to the Board and the Board only received favorable information in management reports, (iv) management was aware of safety red flags that did not reach the Board, and (v) the Board knew that it should have structures for reporting and consideration of safety concerns.

Concerning the second *Caremark* prong, plaintiffs fairly alleged that the Board ignored red flags about safety with the 737 MAX. The Court noted that unlike a typical prong two claim, where a reporting system brings to light red flags that are then ignored, plaintiffs alleged that there were no reporting structures in place. Despite the lack of any reporting system, plaintiffs pleaded that the Board was or should have been aware of MCAS issues after the first 737 MAX crash in Indonesia and that it failed to investigate the potential defects based on that information.

Takeaways

Public relations creates *Caremark* risks: While it is often difficult to show scienter in a *Caremark* claim, the Court found that allegedly false statements that the Chairman of Boeing's Board made about the Board's response to the Indonesia crash, including that "that the Board was immediately contacted and met 'very, very quickly' after the [Indonesia crash]; participated in evaluating the 737 MAX's safety risks; considered grounding the 737 MAX after the [Indonesia crash]; met within twenty-four hours of that crash to consider grounding; and recommended grounding[,]" were evidence of scienter, as it suggested the Board knew what it "should have been doing all along." The Court also criticized Boeing's Board for treating "the crash as an 'anomaly,' a public relations problem, and a litigation risk, rather than investigating the safety of the aircraft and the adequacy of the certification process." Directors should carefully consider their public statements in the immediate aftermath of a crisis. While crises often require a quick response, statements that directors intend to help with the public response to a crisis may ultimately bolster a *Caremark* claim.

Boards should consider non-management reporting of risks: *Caremark* analyses often focus on whether the board has implemented a system for management to report risks. *Boeing* also focused on the relationship between the Company's Board and management. However, the Court also stated that "[t]he lack of Board-level safety monitoring was compounded by Boeing's lack of an internal reporting system by which whistleblowers and employees could bring their safety concerns to the Board's attention." When evaluating whether risk monitoring systems satisfy *Caremark*'s requirements, boards should consider whether to implement sources of risk reporting other than management.

Other *Caremark* Cases

While *Boeing* was the most noteworthy *Caremark* decision, in part because of the result, the Court recently considered and dismissed *Caremark* claims in several other cases: *Fisher on Behalf of LendingClub Corp. v. Sanborn*, (Del. Ch. Mar. 30, 2021); *Pettry on behalf of FedEx Corp. v. Smith*, (Del. Ch. June 28, 2021); *Genworth Fin., Inc. Consol. Derivative Litig.*, (Del. Ch. Sept. 29, 2021); *Firemen's Ret. Sys. of St. Louis on behalf of Marriott Int'l, Inc. v. Sorenson*, (Del. Ch. Oct. 5, 2021). These rulings show that, despite the high-profile cases in which *Caremark* claims survived dismissal, it is still difficult for plaintiffs to plead *Caremark* claims.

***Caremark* requires monitoring cybersecurity risk:** *Sorenson* dismissed *Caremark* claims against directors of Marriott International, Inc. arising from a data security breach that allegedly exposed the personal data of up to 500 million guests. While the Court dismissed the claims, it noted that "[c]ybersecurity has increasingly become a central compliance risk deserving of board level monitoring at companies across sectors." Thus corporate directors should carefully consider what cybersecurity risks they face and ensure that they have implemented systems to monitor those risks.

Active participation in wrongdoing is not a *Caremark* claim: In *Genworth*, plaintiffs alleged that the directors knew of wrongdoing and participated in it by permitting and endorsing misleading disclosures and refusing to correct them. At certain points, the parties characterized that claim as a *Caremark* claim. The Court, however, held that it was not a *Caremark* claim, but rather a claim that defendants acted in bad faith, in breach of their duty of loyalty, by actively participating in a violation of positive law. The Court further acknowledged, however, that courts have on occasion analyzed similar claims under *Caremark*, given the similarities between the scienter element of an oversight claim and the bad faith analysis in connection with allegations that defendants knowingly violated positive law. Parties should carefully analyze claims relating to violations of positive law to determine whether they plead conscious disregard of a red flag or active involvement by directors in the violation, and, therefore, whether they are *Caremark* or bad faith claims.

Control Group Cases

In re Pattern Energy Group Inc. Stockholders Litigation
C.A. No. 2020-0357-MTZ (Del. Ch. May 6, 2021)
(Vice Chancellor Zurn)

In this case, stockholder plaintiffs challenged the sale of Pattern Energy Group, Inc. ("Pattern") to the Canada Pension Investment Board ("Canada PIB"). In its motion to dismiss decision, the Court of Chancery acknowledged that the sales process was run by a disinterested and independent special committee that was advised by an unconflicted banker and counsel and that conducted a process that attracted numerous suitors, who the committee "pressed for value." Nevertheless, the Court denied the motion to dismiss, crediting allegations that the special committee ultimately selected a lower bid from a buyer preferred by private equity fund Riverstone. Riverstone had formed Pattern to operate energy projects and, although it did not have an equity stake in Pattern at the time of the merger, it controlled Pattern's upstream supplier of energy projects, referred to in the motion to dismiss decision as "Developer 2."

In the sale process, the bidding had come down to two final offers: (i) a stock-for-stock combination with a potential buyer that offered a 45% premium for Pattern's stockholders and (ii) an all-cash deal at a 14.8% premium proposed by Canada PIB. Riverstone allegedly preferred the lower bid because it came with an offer to buy Developer 2 while still allowing Riverstone to maintain equity in Developer 2, and it allowed management (who was "simultaneously tethered" to Riverstone, Developer 2, and another Riverstone affiliate) to stay in place.

In its motion to dismiss decision, the Court addressed alleged bad faith conduct by the individual defendants (crediting allegations that directors and officers acted in bad faith by elevating Riverstone's preferences over Pattern's stockholders); the cleansing power of *Corwin* (finding *Corwin* did not apply because a stockholder whose vote was necessary to approve the deal contracted to vote in favor of the transaction before the terms were set and had the option to roll its shares, and therefore was not fully informed nor disinterested); and proxy statement preparation oversight (crediting allegations that the board delegated to conflicted officers the preparation of the proxy statement that contained false and misleading disclosures).

The Court also addressed allegations that Riverstone, Developer 2, and certain officer defendants constituted a control group, despite Riverstone and Developer 2 holding no equity in Pattern and the entire "control group" holding only approximately 10% of Pattern's stock. The Court discussed the possibility that a non-stockholder could be a "controller" under Delaware law, noting that "[f]iduciary duties arise from the separation of ownership and control" such that "surely an 'outsider' that controls something it does not own owes duties to the owner." The Court noted that several indicia of "soft power" were present: Developer 2's consent right over certain Pattern corporate decisions; Developer 2 being a substantial part of Pattern's supply chain; and the historical ties between Riverstone, Developer 2, and Pattern and the various overlapping fiduciaries. However, recognizing that "control" is a fact-intensive finding, the Court declined to find that the alleged control group in fact exercised control over Pattern at the motion to dismiss stage.

Takeaways

A non-stockholder can be part of a control group: Relying on the principle that "[f]iduciary duties arise from the separation of ownership and control," the Court found that despite owning no stock in Pattern, both Riverstone and Developer 2 could be part of a control group. While one typically associates control with some level of stock ownership, the Court focused the inquiry not on ownership but on "sufficient sources of influence." The Court's decision, while not finding a control group in fact existed at this stage of the proceeding, is a warning that sufficient "soft power" (*i.e.*, influence apart from "hard" majority stock ownership)—even without owning a single share of stock—can lead to a finding of control that imposes fiduciary duties on the controller.

Several factors, including how others interact with the alleged control group, can be indicia of "soft power": While noting the more customary indicators of "soft power"—consent and veto rights, significant commercial relationships, overlapping directors or officers, managerial influence, the power to appoint directors—the Court also was influenced in its control analysis by how one bidder's conduct suggested Riverstone was a controller. That bidder first tried to structure a transaction that would not have triggered Riverstone's consent right. But the special committee and the bidder became concerned that Riverstone would sue if they went forward with that transaction. The bidder relented, deciding it would only go forward with a transaction with Riverstone's consent, and the Court cited that bidder's conduct as support for plaintiff's allegation that there was a control group.

The Court will consider contractual obligations and *Corwin*: In assessing whether *Corwin* has been satisfied, the Court will analyze whether stockholders voting in favor of the transaction had reason to do so other than the merits of the transaction. Among other things, the Court will consider the existence of contractual obligations requiring the stockholder to vote in favor of the transaction, whether the stockholder at issue entered into that contractual obligation before knowing all material terms of the transaction, and whether the nature of that obligation offers the stockholder financial incentives to approve the transaction for reasons other than its merits.

In re Tilray, Inc. Reorganization Litigation
C.A. No. 2020-0137-KSJM (Del. Ch. June 1, 2021)
(Chancellor McCormick)

In 2013, Privateer Holdings, Inc. ("Privateer") founded Tilray, Inc. ("Tilray") for purposes of entering the marijuana processing industry. Tilray eventually went public. The plaintiff stockholders alleged that Privateer's three founders (the "Founders") sought to facilitate the more efficient disposition of Tilray stock through a "downstream merger" reorganization that resulted in Privateer's stockholders owning Tilray stock directly, rather than Privateer owning it, while not triggering "significant tax liabilities" for Privateer's stockholders. A Tilray stockholder challenged the reorganization, alleging that the Founders acted as a control group and breached their fiduciary duties. The Court applied the "legally significant connection" standard, which requires a showing that the members of the alleged control group had an agreement to work toward a shared goal. The Court held that it was "reasonably conceivable" the Founders had a shared goal that they agreed to work toward structuring the reorganization to avoid "massive tax liabilities." The Court relied on the Founders' longtime personal and professional connections, including, among other things, that they were "former classmates and long-time friends," served on the Privateer board together, currently shared office space, jointly retained tax advisors in connection with the reorganization, decided to distribute a certain class of stock only to themselves, planned to divide managerial authority of Privateer's portfolio companies following the reorganization, and that two of the three Founders jointly negotiated the transaction.

The Court also held that plaintiffs adequately alleged that the reorganization was a conflicted transaction because the tax benefits were a unique, non-ratable benefit the Founders obtained through the reorganization, even though the tax benefits were never available to Tilray or its stockholders. The Court then held that plaintiffs had pleaded demand futility, as plaintiffs had adequately pleaded that three of the five board members were either allegedly interested in the reorganization or lacked independence from the Founders.

Takeaways

The Court will sometimes allow a plaintiff to "glom on" additional stockholders to bolster a control group finding: The Court rejected defendants' arguments that one of the Founders was a controlling stockholder rather than part of a control group because he held 41% of Privateer's stock, while the other two Founders each held 16%. The Court reasoned that because the Founders divided managerial authority and responsibility over Privateer's portfolio companies following the reorganization, it was reasonably conceivable that all three Founders were needed to "keep the rapidly growing businesses afloat." The Court distinguished this case from *Almond v. Glenhill Advisors, LLC* and *Gilbert v. Perlman*, which both rejected what the Court dubbed a "glom on theory" because plaintiffs pleaded only a concurrence of self-interest.

Special committees must be aware of changes in its members' relationship with controllers: Plaintiffs successfully argued that the chair of the Special Committee that negotiated the reorganization was not independent because, during the negotiations, she took a position with a U.S. affiliate of a consulting firm that did work for Tilray and Privateer. Advisors to special committees should keep themselves apprised of any changes in circumstances that may undermine the independence of any committee member, and, where necessary, change the composition of the committee.

Boards need to exercise leverage, even when they are not competing with controllers: The Court held that plaintiffs pleaded that entire fairness applied and that Tilray failed to exercise leverage it had over the Founders, even though the Founders were not obtaining anything otherwise available to Tilray or its minority stockholders through the reorganization. Boards considering transactions that will confer a benefit upon a controller should consider what leverage they have in those negotiations and whether they can extract reasonable compensation from the controller even if the consideration to the controller is not something that would be available to the company or its other stockholders.

Patel v. Duncan
C.A. No. 2020-0418-MTZ (Del. Ch. Sept. 30, 2021)
(Vice Chancellor Zurn)

Two venture capital firms, Riverstone Holdings, LLC ("Riverstone") and Apollo Global Management ("Apollo"), collectively held a majority of the stock of Talos Energy Inc. ("Talos"). Stockholder plaintiffs challenged a 2020 transaction in which Talos purchased the assets of Castex Energy Inc., which was an affiliate

of Riverstone. Plaintiffs alleged that Riverstone and Apollo caused Talos to overpay for the Castex assets to benefit Riverstone. Apollo allegedly approved the Castex transaction because it was the *quo* in a *quid pro quo* arrangement between Riverstone and Apollo. The alleged *quid* was a 2018 transaction—not challenged by plaintiffs—in which Talos acquired a company in which Apollo affiliates were secured lenders. Plaintiff further alleged that the two funds constituted a control group pointing to the funds' historical relationship, an alleged "admission" in Talos's registration statement that it is "controlled by Apollo Funds and Riverstone Funds," a stockholders agreement permitting board appointees, and that fund representatives attended board meetings discussing the Castex transaction.

The Court found that the historical ties between the funds was weak, that the NYSE-compelled disclosure was not strong evidence of control, that the stockholders agreement dealt only with director elections and did not bind the funds as to the Castex transaction, and that the fund representatives' passive presence at board meetings did not support an inference that they were tied to each other.

Takeaways

Context matters when considering disclosures regarding control: Plaintiffs argued that Riverstone and Apollo constituted a control group in part due to filings that stated that Talos was a "controlled company" under NYSE rules. While the Court acknowledged that disclosures can be "plus factors" that contribute to a finding of control in some circumstances, here, the disclosure was required under an NYSE rule providing that a company is a "controlled company" if more than 50% of the voting power is controlled by a group. The disclosures here, therefore, were not as persuasive as repeated public statements regarding control in other cases.

A *quid pro quo* theory requires specific allegations: Plaintiffs' transaction-specific tie between Riverstone and Apollo was that they allegedly had an unspoken *quid pro quo* agreement. But plaintiffs' only support for their *quid pro quo* theory was that the transaction was so unfair that it must have been the product of a *quid pro quo*. The Court found that support wanting and rejected the *quid pro quo* theory. *Patel* confirms that Delaware courts will not infer a *quid pro quo* in order to find a control group absent specific allegations giving rise to an inference or allegations identifying actual transaction-specific ties.

Special Purpose Acquisition Company (SPAC) Litigation

In re MultiPlan Corp. Stockholders Litigation
C.A. No. 2021-0300-LWW (Del. Ch. Jan. 3, 2022)
(Vice Chancellor Will)

In October 2019, Churchill Capital Corp. III was formed as a special purpose acquisition company (the "SPAC" or the "Company"). The SPAC was sponsored by Churchill Sponsor III, LLC (the "Sponsor"), an entity Michael Klein controlled. The Sponsor received shares of Class B common stock (*i.e.*, "founder" shares) that represented 20% of the SPAC's outstanding stock for a nominal price as well as 23 million warrants of the SPAC for $1 per warrant (the "Private Placement Warrants"). Klein, through his control of the Sponsor, selected the SPAC's directors, and they were compensated with economic interests in the Sponsor. Meanwhile, the SPAC's initial public stockholders purchased IPO units consisting of one share of Class A common stock and a quarter of a warrant for $10 per unit. Upon the consummation of a business combination, the founder shares would convert into shares of Class A common stock. The SPAC had twenty-four months from its IPO to complete a business combination. If no business combination was consummated in the "completion window," the founder shares and the Private Placement Warrants would be worthless. Collectively, the foregoing are distinctive features of a typical special purpose acquisition company.

The SPAC identified MultiPlan, Inc. ("MultiPlan" or "Target") as its acquisition target and subsequently completed a de-SPAC merger with MultiPlan in October 2020 (the "Merger"). In connection with the Merger, the public stockholders were entitled to (i) vote on the Merger and (ii) redeem their Class A shares of the SPAC for approximately $10.04 per share if the Merger was consummated (the "Redemption Right"). The public stockholders overwhelmingly voted in favor of the Merger and less than 10% elected to redeem their shares. Plaintiffs alleged that the SPAC's fiduciaries impaired the public stockholders' ability to make an informed decision regarding the exercise of the Redemption Right by withholding material information indicating that MultiPlan's largest customer was building an in-house platform to compete with MultiPlan and would move all its key accounts in-house by the end of 2022. When an equity research firm later released that information, the market price of the post-de-SPAC shares dropped to $6.27, a price significantly lower than the $10.04 per share for which the stockholders could have redeemed their shares in connection with the Merger.

Defendants moved to dismiss plaintiffs' claims pursuant to Rule 23.1 for failure to plead demand futility and under Rule 12(b)(6) for failure to state a claim upon which relief can be granted. The Court rejected defendants' arguments that plaintiffs' claims were (i) derivative, not direct; (ii) purely contractual such that plaintiffs could not bootstrap breach of fiduciary duty claims to the underlying claims; and (iii) holder claims that defendants wrongfully induced them to hold stock rather than to sell it, which could not receive class action treatment. In rejecting these arguments, the Court likened the decision to exercise the redemption to other investment decisions like purchasing and tendering stock or making an appraisal election, to which the duty of disclosure attaches.

In evaluating plaintiffs' breach of fiduciary duty claims, the Court found plaintiffs alleged facts supporting two independent bases upon which entire fairness review applied: (i) the Merger, including the opportunity to redeem, was a conflicted controller transaction because the Class B shares and Private Placement Warrants would be worthless if the SPAC failed to complete a business combination and (ii) a majority of the Board was conflicted either due to self-interestedness or a lack of independence from Klein. In finding that it was reasonably conceivable that the directors were self-interested, the Court cited the unique benefit the holders of Class B shares received and noted that the directors, through their economic ownership in the Sponsor, stood to gain from any business combination as indirect holders of Class B shares even if the public stockholders suffered losses. The directors were not independent because (i) Klein appointed and had the power to remove each director and the directors were compensated with interests in the Sponsor, (ii) many of the directors had also been appointed to serve as directors for several of Klein's other special purpose acquisition companies, and (iii) each of the directors had personal or employment relationships or received lucrative business opportunities from Klein.

The Court similarly allowed the breach of fiduciary duty claims against Klein in his capacity as a controlling stockholder and as the CEO of the SPAC to proceed, but it dismissed the claims against the SPAC's CFO due to a lack of any allegations of actions that could expose him to liability for breach. The Court did not dismiss the aiding and abetting claim against The Klein Group, which served as a financial advisor with respect to the Merger, because it was under common control with Klein, and the Court imputed Klein's knowledge to it.

Takeaways

Director compensation in SPACs can render directors interested in de-SPAC transactions: Like many SPACs, Churchill compensated directors through an interest in the Sponsor. The Court found that the directors were interested in the transaction because they also held an interest in the Sponsor, which would benefit from even a value-losing transaction. SPACs should consider if there are other forms of compensation for directors that would more closely align their interests with the non-affiliated stockholders to reduce the risk that a court will find that they are interested in the transaction.

Serial sponsors can create independence risks: Klein, like many SPAC founders, created numerous SPACs. The Court found that some directors were not independent because they served as directors for other Klein SPACs. When evaluating a transaction, SPACs should consider whether ties to other SPACs with the same sponsor will compromise directors' independence.

Coupled with appropriate disclosure, the redemption right may—*or may not*—undermine entire fairness claims: The Court noted that its decision may have been different, notwithstanding the fact "that the fiduciaries were necessarily interested given the SPAC's structure," if stockholders had been provided adequate disclosures regarding the transaction and "had chosen to invest rather than redeem." Many market participants and practitioners have argued that the redemption right is a substantial protection for public stockholders and, coupled with adequate disclosure both about the de-SPAC transaction and the potential conflicts affecting corporate fiduciaries, should result in a less exacting standard of review. In *MultiPlan*, the Court acknowledged that argument without accepting or rejecting it.

Stockholder Rights Plan Litigation

Williams Companies Stockholder Litigation
C.A. No. 2020-0707-KSJM (Del. Ch. Feb. 26, 2021)
(Chancellor McCormick);
affirmed by Williams Companies, Inc. v. Wolosky
No. 139, 2021 (Del. Nov. 3, 2021)

In early 2020, the COVID-19 pandemic and a global oil price war caused the Williams Companies' (the "Company") stock price to decline dramatically. The Company's board believed the stock price no longer reflected the Company's intrinsic value and became concerned the Company was vulnerable to opportunistic stockholder activists. In response, the board voted in favor of a stockholder rights plan, which was intended as a "one-year moratorium" on all stockholder activism. At the time, the board was not aware of any stockholder who was acquiring large amounts of stock and no stockholder had attempted to engage with the Company.

The rights plan itself contained several unusual provisions: (1) it was triggered once a stockholder, or group of stockholders acting in concert, acquires beneficial ownership of more than 5% of the company's outstanding stock; (2) the definition of "beneficial ownership" included derivative interests like warrants and options; (3) the definition of "acting in concert" included both parallel conduct and a "daisy chain" concept; and (4) the exception for passive investors was narrow. The plan would remain in place for one year.

A plaintiff-stockholder sought to permanently enjoin the rights plan, and the Court of Chancery granted the injunction. In a post-trial opinion, the Court affirmed that *Unocal* applies to a board's decision to adopt a rights plan outside of a proxy battle or an attempt to preserve NOLs. Further, the Court reasoned Delaware law does not permit a board to adopt a rights plan based on the threat of stockholder activism generally, nor the hypothetical threat of an activist's short-term agenda distracting management. The Court assumed the potential for an activist to acquire more than 5% of the company's stock without the board's knowledge could be a threat, but went on to hold the company's rights plan was not proportional to that threat.

On appeal, the Delaware Supreme Court affirmed the decision by summary order.

Takeaways

Regardless of a board's reason for adopting a rights plan, the *Unocal* standard of review applies: The Court rejected defendants' argument that the business judgment rule should apply because the concern that directors are acting only to entrench themselves is not present where the plan is meant to deter stockholder activism as opposed to a hostile takeover attempt. The Court reasoned that this position is contrary to a Delaware Supreme Court opinion applying the *Unocal* standard to a rights plan intended to preserve NOL assets. The Court concluded it is "settled law" that *Unocal* applies to any board decision to adopt a rights plan.

Hypothetical stockholder activism is not a cognizable threat for purposes of *Unocal*: The Court rejected defendants' argument that because the company's stock price was artificially low, any stockholder activism posed a threat to the company. In doing so, the Court referred to this argument as "hypothetical" and a manifestation of the "know better justification." The Court acknowledged that certain forms of stockholder activism, including short-termism and disruption, might constitute a threat under *Unocal*, but concluded "hypothetical versions of those justifications cannot."

A gap-filling rights plan with a 5% trigger may be viable: The Court did not find the rights plan was disproportionate to the threat because it included a 5% trigger. Section 13(d) of the Exchange Act requires non-passive stockholders to report their ownership in a company within ten days of acquiring more than 5% of the company's stock. Gap-filling rights plans are designed to prevent these large acquisitions of stock without the board knowing. The Court noted that, although rights plans using a 5% trigger were rare, this threshold was "not the most problematic aspect of the plan." Rather, the Court focused on the provision defining acting in concert, which gave the board discretion to include a wide range of stockholder communication. However, a rights plan with a low threshold like 5% is more likely to be unreasonable than a plan with a higher threshold, so any board considering a 5% rights plan should carefully examine the other provisions of the plan.

Section 220 Litigation

Pettry v. Gilead Sciences, Inc.
(Del. Ch. Nov. 24, 2020) (Vice Chancellor McCormick)
&
Pettry v. Gilead Sciences, Inc.
(Del. Ch. July 22, 2021) (Chancellor McCormick)

In the twenty years since Gilead Sciences, Inc. ("Gilead") developed a successful therapy for treating HIV, it has been the market leader for HIV drugs and derived a substantial portion of its revenue from these sales. During that time, Gilead became the subject of several lawsuits alleging, among other things, illegal protection of its market share by preventing generic versions and safer alternatives from entering the market. Five plaintiffs sought books and records from Gilead under Section 220 of the General Corporation Law of the State of Delaware. Gilead did not produce any documents in response. After trial, the Court of Chancery ruled in plaintiffs' favor, emphasizing the low standard to obtain books and records under Delaware law.

The Court found that the allegations in the other lawsuits against Gilead, some of which had survived motions to dismiss, constituted a credible basis to suspect wrongdoing. During litigation, Gilead argued that plaintiffs' purposes in seeking books and records were not their own but those of their law firms. Gilead also defended its refusal to produce books and records by arguing that plaintiffs would lose any follow-on litigation because they did not own shares at the time of the alleged wrongdoing, and any claims would be time-barred or exculpated by Gilead's Section 102(b)(7) charter provision. The Court rejected each of these defenses as without merit and found that Gilead improperly introduced substantive defenses into the books and records litigation. Moreover, plaintiffs had not limited their use of the books and records to bringing a derivative action. The Court granted plaintiffs nearly all requested categories of books and records, including categories beyond Gilead's formal board materials.

The Court invited plaintiffs to seek fee shifting based on Gilead's litigation conduct. It noted that a company's resistance to producing books and records increases the costs for plaintiffs seeking documents to support their investigation while often having little downside for the company. Fee shifting, the Court commented, was one avenue to recalibrate the risks.

In a subsequent decision, the Court shifted plaintiff's attorneys' fees onto Gilead. The Court ruled that plaintiffs did not need to demonstrate subjective bad faith on the part of Gilead to shift fees. Rather, "glaringly egregious" litigation conduct, including Gilead's refusal to produce any books and records in response to the demands, followed by its overly aggressive positions and defenses at each stage of the litigation, sufficed.

Takeaways

Filings in other litigation can meet Delaware's low threshold of a credible basis to suspect wrongdoing: Plaintiffs' basis for suspicion of wrongdoing arose from litigation in other courts. Even where these cases had not yet survived motions to dismiss, the Court recognized the substantive nature of the allegations and found the allegations sufficient to form a credible basis to suspect wrongdoing.

Companies should be cautious of overly aggressive resistance to producing books and records: While admitting there is a fine line between aggressive litigation and the glaringly egregious conduct required to find bad faith, the Court found that Gilead's actions, viewed collectively, crossed this line. The Court noted that it did not need to inquire into Gilead's subjective state of mind to find bad faith but could shift fees based on the totality of the record. Companies should be cautious of resisting production of any books and records in response to a demand when it appears a stockholder may have a credible basis. If litigation commences, companies should be cautious in introducing substantive defenses and should avoid misconstruing a plaintiff's stated purpose. Doing so may provide sufficient basis for the Court to shift fees.

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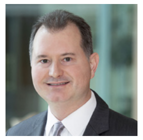

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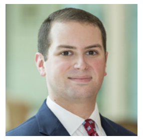

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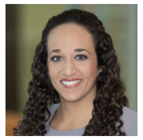

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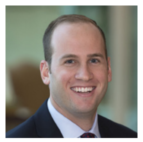

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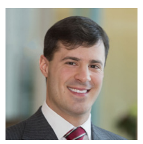

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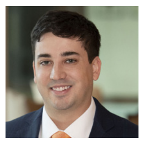

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