SIGNIFICANT 2022 DECISIONS AFFECTING PRIVATE COMPANY M&A

arnoldporter.com

Arnold&Porter

Table of Contents

Decisions

Fiduciary Duties

Governance and Process

Remedies

D&O Insurance

D.G.C.L. Amendments

Miscellaneous

February 2023

Significant 2022 Decisions Affecting Private Company M&A

By: Nicholas O’Keefe, Tracy Belton, Ed Deibert, Ben Fackler, Arthur Luk, Bill Perdue, Carmela Romeo, Carlyn Williams, Jim Walther, Jennie McLellan, Matt Bemis, Claire Frost, Elliot Rosenwald, Queenie Sun, Stefan Weidemann

This newsletter is our ninth annual review of significant state court decisions relevant for private company M&A transactions and related governance matters and disputes.

** Esther Ju contributed to this Advisory. Ms. Ju is a graduate of the University of Illinois College of Law and is employed at Arnold & Porter's New York office as an Associate. Ms. Ju is admitted only in Illinois. She is not admitted to the practice of law in New York.*

Manti Holdings, LLC v. Carlyle Grp. Inc., C.A. No. 2020-0657-SG, 2022 WL 444272 (Del. Ch. Feb. 14, 2022)

Summary

In a case involving a challenge to an alleged contractual waiver in a stockholders agreement of breaches of corporate directors’ and controllers’ fiduciary duties of loyalty, the Delaware Chancery Court held that the disputed language in the stockholders agreement did not satisfy the exacting standards under Delaware law to constitute a waiver of fiduciary duties. In dictum, the court also raised significant doubt that a corporate director’s fiduciary duty of loyalty could properly be waived by contract in advance.

Background

The plaintiffs, former stockholders of Authentix Acquisition Company, Inc. (Authentix), brought a post-closing damages action challenging alleged breaches of fiduciary duty by the defendants in connection with the sale of Authentix in 2017 (the Sale). The defendants were preferred stockholders of Authentix and affiliated entities, who were alleged to be controllers of Authentix, and three alleged associated persons who were former directors and officers of Authentix. The Sale was opposed by the plaintiffs on the basis that it was prompted not by a desire to realize value for the common stockholders of Authentix, but instead by the strong desire of the defendants to cash out their preferred stock investment prior to a self-imposed deadline in September 2017.

The plaintiffs sued the defendants for breach of fiduciary duties and certain related claims. The defendants moved to dismiss the plaintiffs’ claims, based in part on plaintiffs having allegedly waived their rights to challenge the Sale pursuant to a stockholders agreement that pre-dated the Sale. Specifically, the defendants relied on the following provision of the stockholders agreement:

> "In the event that . . . a Company Sale is approved by the Board and . . . the holders of at least fifty percent (50%) of the then-outstanding Shares . . . each Other Holder shall consent to and raise no objections against such transaction. . ."[1]

The Court's Decision

Noting that the court had held in a prior stage of the litigation that the Sale constituted a "Company Sale" as referred to in the above-quoted provision of the stockholders agreement, and further noting that there was no dispute among the litigants that the Sale had been approved by the board and at least 50 percent of the then-outstanding shares or that the plaintiffs were "Other Holders" as defined by the stockholders agreement, the court's opinion stated that the pertinent question was whether the plaintiffs' post-closing damages action breached their obligation under the stockholders agreement to "consent to and raise no objections against" the transaction.[2] The court held that it did not because the disputed language in the stockholders agreement did not constitute a waiver of rights to seek damages for breaches of fiduciary duty. In this connection, the court noted that under Delaware law "waiver is the intentional relinquishment of a known right,"[3] that the facts relied upon to prove a waiver must be "unequivocal"[4] and that the purported waiver must be "clear and unambiguous."[5] Further, as Delaware courts have noted with respect to fiduciary duty waivers in the limited liability company context (in which fiduciary duty waivers are specifically permitted by the applicable statute), drafters must "make their intent to eliminate fiduciary duties plain and unambiguous for such waivers to be effective."[6]

In its analysis, the court pointed out that the Authentix stockholders agreement made no reference to fiduciary duties, while it did specifically prohibit the plaintiffs from voting against the transaction, asserting appraisal rights, or refusing to execute certain transaction documents. The court said that a more reasonable interpretation of the disputed language (than it being an attempt to waive the possibility of redress for duty of loyalty breaches) is that the language was intended solely to preclude the plaintiff stockholders from taking actions that would impede or delay the closing of the transaction, such as voting against a transaction, refusing to execute transaction documents, or asserting rights that would arise from any company sale transaction. In other words, the language was intended to waive objections to the transaction itself, rather than waiving objections to fiduciary duty breaches arising in connection with the transaction. As characterized by the court, the plaintiffs were not objecting to the Sale; they were instead seeking redress for purported breaches of fiduciary duty that led to the Sale.

---

[1] *Id.* at *3.
[2] *Id.*
[3] *Id.* at *2 (citing *Minna v. Energy Coal S.p.A.*, 984 A.2d 1210, 1214 (Del. Nov. 16, 2009)).
[4] *Id.* (citing *Bantum v. New Castle Cnty. Vo-Tech Educ. Ass'n*, 21 A.3d 55, 50 (Del. May 18, 2011)).
[5] *Id*.
[6] *Id.* (citing *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, C.A. No. 3658-VCS, 2009 WL 1124451 at *9 (Del. Ch. Apr. 20, 2009)).

Based on its reading of the disputed stockholder agreement language, the court concluded that it did not need to rule on the question of whether contractual waivers of breaches of fiduciary duty are permissible under Delaware corporate law. The court nonetheless stated in footnote 45 to its opinion that finding such waivers to be effective "would blur the line between LLCs and the corporate form and represent a departure from norms of corporate governance . . ."[7]

Additional Guidance in Subsequent Decisions

In *Totta v. CCSB Fin'l Corp.*, issued a few months later and described elsewhere in this Advisory, the Court of Chancery considered whether a charter provision that empowered a board of directors to interpret and enforce a 10 percent vote limitation and that purported to make the board's decision "conclusive and binding," foreclosed judicial review for breach of fiduciary duties.[8] The court noted that fiduciary duties arise in equity, that the Delaware legislature could replace equity standards with statutory law, and that "Delaware corporations may not . . . default fiduciary obligations unless authorized to do so by statute."[9] The court held that in contrast to alternative entities, such as limited liability companies and limited partnerships, Delaware corporations only have very limited ability to modify or eliminate fiduciary duties, such as the ability under DGCL Section 102(b)(7) to eliminate monetary damages for breach of the duty of care. *Totta* therefore appears to answer in the negative the question left open in *Manti Holdings* regarding whether corporate directors' and controllers' fiduciary duties of loyalty may be waived in advance by contract.

Support for that conclusion is also found in *Delman v. Gigacquisitions3, LLC*,[10] a case against a SPAC sponsor and board members alleging breach of fiduciary duties in connection with a value-destructive de-SPAC transaction. The defendants in that case argued that the plaintiff could not bring a fiduciary duty claim because the plaintiff had implicitly agreed to the conflicts of interest inherent in the SPAC structure and disclosed in the IPO prospectus when he invested in the IPO and again in the proxy statement provided to stockholders in connection with the solicitation of their approval of the de-SPAC transaction. The court rejected that argument, holding that it was inconsistent with the fundamental principles of Delaware law and that "Delaware corporate law does not allow for a waiver of the directors' duty of loyalty."[11]

Takeaways

As implied in *Manti* and stated more directly by the courts in *Totta* and *Delman*, advance contractual waivers of the fiduciary duty of loyalty of Delaware corporate directors and controllers are unlikely to be enforceable. One of the situations where this frequently arises is exit transactions. Controlling investors should assume that they cannot rely on pre-existing drag-along provisions or redemption provisions in stockholders agreements or corporate documents to override fiduciary challenges to mergers or other corporate transactions. Accordingly, controlling investors and board members should be conscious of structuring exit transactions in a way that complies with their fiduciary duties, particularly transactions where the

---

[7] *Id*. at *4 n.45.
[8] *Totta v. CCSB Financial Corp.*, C.A. No. 2021-0173-KSJM, 2022 WL 1751741 at *14 (Del. Ch. May 31, 2022).
[9] *Id*. at *16.
[10] *Delman v. GigAcquisitions3, LLC*, C.A. No. 2021-0679-LWW, 2023 WL 29325 (Del. Ch. Jan. 4, 2023).
[11] *Id*. at *1.

holders of common stock receive little or no value and may therefore be predisposed to initiate fiduciary duty challenges.

Totta v. CCSB Financial Corp., C.A. No. 2021-0173-KSJM, 2022 WL 1751741 (Del. Ch. May 31, 2022)

Summary

The constitutive agreements of a Delaware corporation cannot modify fiduciary duties of directors and officers, or the standard of review applicable to their actions, unless expressly authorized by act of the Delaware legislature, which to date has created only limited exceptions to these equitable principles.

Background

Totta v. CCSB Financial Corp. focuses on the actions of the board of directors of CCSB Financial Corp. (CCSB) in the context of a contested director election at the company's 2021 annual stockholders meeting. At the center of the case was a provision in CCSB's charter that capped the voting power of any stockholder at 10 percent in any election. For purposes of calculating this voting limitation, the charter allowed the aggregation of the holdings of stockholders "acting in concert."[12] Importantly, the charter provision also contained a provision that any determination by the CCSB board in respect of this voting limitation that was made in good faith and on the basis of reasonably available information was conclusive and binding on the company and its stockholders.

Park G.P., Inc., a long-time stockholder in CCSB controlled by David Johnson, nominated a short slate of directors for election at the 2021 meeting. At the time of nomination, Johnson and his affiliates (the Johnson Group) held shares representing more than 10 percent of the voting power of CCSB. Prior to the record date, the Johnson Group completed the sale in a privately negotiated transaction of sufficient shares to bring the group's holdings below the 10 percent voting limitation. The Johnson Group sold these excess shares to DEW LCC, an investment vehicle owned by David Watson, the father of one of Park's nominees (the Watson Group). In a letter in response to an inquiry from the CCSB board, the Watson Group affirmed that, while it intended to vote the shares in favor of at least one of the Park nominees, it had no agreement to vote the shares with any other stockholder. The Johnson Group separately affirmed to the CCSB board that, while it previously held shares representing more than 10 percent of the voting power, the group's beneficial ownership was below the 10 percent threshold as of the record date for the 2021 meeting as a result of a share sale.

At the eve of the 2021 stockholder meeting, based on the results of the proxy solicitation, the Johnson Group was poised to have its nominees elected to the CCSB board. However, on the morning of the meeting, the CCSB board met and determined that the Johnson Group and its nominees were acting in concert with the Watson Group. Accordingly, the board instructed the inspector of elections to disregard the votes of the combined shareholding group in excess of

[12] *Id*. at *1.

the 10 percent limit. With the excess votes nullified, the election tipped back in favor of the incumbent slate, and the board's nominees were declared victorious. Plaintiffs brought suit against the company challenging the board's actions.

The Court's Decision

After a trial on the merits, the Delaware Chancery Court found that the incumbent board improperly applied the aggregation provisions of the charter provision to disenfranchise Park. The court also found that the board had violated its fiduciary duties in its application of the voting limitation.

The court reviewed the board's actions under the traditional "twice tested" standard for board determinations, examining both the legal validity and equity of the action.[13] Importantly, in light of the fact that the board action at issue affected the stockholder franchise, the court determined that the appropriate standard of review for the equitable test was enhanced scrutiny, as articulated in *Blasius Industries, Inc. v. Atlas Corp*.[14] In making this determination, the court rejected the defendant's argument that the charter's conclusive and binding provision effectively shifted the standard of review to the more-deferential business judgment rule (the language of which the charter provision itself tracked). The court ruled that "[t]he constitutive agreements that govern an entity can only eliminate or modify fiduciary duties and the attendant judicial standards of review to the extent expressly permitted by an affirmative act of the Delaware General Assembly."[15] Unlike the operative statutes governing other forms of entities in Delaware, the Delaware General Corporation Law contains only narrow areas in which the Delaware legislature has acted to limit specific default rules of equity.[16] The current circumstances were not within one of those categories, and the default equitable principles controlled over any alternative standard of review in the constitutive documents of the company.

In analyzing the legal validity of the board action, the court found that the CCSB board improperly determined that the Watson Group was acting in concert with the Johnson Group and its nominees. Noting that the term "acting in concert" was not defined in the charter, the court determined that this term should be read to track the "general corporate law understanding that persons act in concert when they have *an agreement, arrangement or understanding* regarding the voting or disposition of shares" (emphasis added).[17] The sacrosanct nature of stockholder voting rights requires any limitation on those rights to be clear and unambiguous and narrowly read. The stockholders' plan to vote the same way, acquaintance, and even business relationships were not sufficient to establish they were acting in concert. Citing various factors, including the contract evidencing the share sale by the Johnson Group to the Watson Group at a price that no party had challenged as discounted, the fact that the Johnson Group had reported the sale of the shares on its amended tax returns (thus demonstrating its

---

[13] *Id*. at *11 (citing *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439-40 (Del. Supr. Nov. 29, 1971).

[14] *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. July 25, 1988).

[15] *Totta*, C.A. No. 2021-0173-KSJM, 2022 WL 1751741 at *14 (Del. Ch. May 31, 2022).

[16] The court gave several examples, including Section 102(b)(7) (permitting the corporation to limit the monetary liabilities of directors and officers for breach of the duty of care); Section 122(17) (permitting corporations to renounce any interest or expectancy in, or opportunity to participate in, specified business opportunities); and Section 152 (providing that, with respect to stock issuances, the judgment of directors as to the value of the consideration for such stock shall be conclusive in the absence of fraud).

[17] *Id*. at *24.

disposition of the shares), and the non-objection of the Federal Reserve to the transaction, the court found that there was insufficient evidence presented to support the board's determination that those two groups were acting in concert as a matter of law.

Turning to the equitable analysis under *Blasius*, the court found that it was self-evident that the primary purpose of the board's action was to interfere with the ability of certain stockholders to vote their shares in a contested election of directors. The court rejected the defendant's argument that its primary purpose was to protect the stockholders from a corporate takeover, noting that this was the justification for the action, not the purpose. Given the primary purpose triggered the first part of the *Blasius* test, the court then analyzed whether the board had a compelling justification for its actions. Under the second-step of the *Blasius* test, the company was required to demonstrate that the board's actions were reasonable in relation to its legitimate objective and did not preclude the stockholders from exercising their right to vote. The court found that the sole justification proffered by CCSB was to protect stockholders from the Johnson Group's attempts to take control and cause the board to consider selling the company. The court noted that the election of the dissidents' short slate would not confer control, and, even if it did, the board's belief that they knew better than stockholders who should serve on the board, and what strategy those directors should pursue, is not a legitimate justification for interfering with the stockholders' right to vote in an election of directors. Indeed, the sole justification offered by the company was "perhaps the only justification [CCSB] could possibly have raised that is foreclosed under Delaware law."[18]

Takeaways

The *Totta* decision has several key lessons for Delaware corporations and their counsel.

- A Delaware corporation cannot modify the fiduciary duties applicable to its directors and officers *or* the equitable standard of review applicable to their decisions, except as expressly authorized in the Delaware General Corporation Law. And the Delaware legislature has only authorized limited exceptions to this rule. This differs in significant respects from entities such as limited liability companies and limited partnerships, which are authorized by statute to create variances in fiduciary duties and standards of review in their constitutional documents. While not directly at issue in *Totta*, the reasoning supporting this decision would appear to limit the ability of stockholders to limit or modify fiduciary duties or standards of review applicable to directors and officers of corporations not just in charter and bylaw provisions, but also in stockholder agreements and other contracts.

- Corporations should be consistent and neutral in their application of voting limitations, bylaw advance notice and director information provisions, and other measures that potentially affect stockholder franchise. While the voting limitation in *Totta* had been enacted on a "clear day"[19] when no proxy contest was on the horizon, the court noted that the CCSB board had never before applied the voting limitation, even when, in at least one prior election, a stockholder holding in excess of 10 percent of the voting power voted all of its shares. Moreover, the court also noted that the CCSB board did

[18] *Id*. at *29.
[19] *Id*. at *21.

not examine whether any other stockholder could be in breach of the voting limitation, notwithstanding the fact that in advance of the annual meeting the company's chairman and CEO reported owning shares in excess of 10 percent as the record date of the meeting, and failed to include in this calculation the beneficial ownership of shares held by his daughter.

- Good board process is essential. It is imperative that board discussions be well informed, fulsome, and well documented, with involvement of counsel. Moreover, if the board minutes are limited in content or inconsistent with any contemporaneous notes taken at the meeting or with director testimony after the fact, a court may treat them as ex post justification and therefore suspect.

- Practitioners should be explicit in drafting charter and bylaw provisions that impact director elections, such as advance notice and director nomination bylaws. Given the "sacrosanct"[20] nature of stockholder voting rights in director elections, any limitations must be clearly drafted or risk being read narrowly. The term "acting in concert,"[21] if undefined, may be read like the *Totta* provision to reach only agreements, arrangements, or understandings regarding the voting or disposition of shares, effectively the standard for determination of groups under Section 13(d) of the Securities Act. If the information requirements in director nomination bylaws are intended to broaden disclosure beyond formal Schedule 13D groups, for example, the relevant bylaw provisions will need to be clearly drafted to do so, rather than relying on undefined or general terms of art.

Blue v. Fireman, C.A. No. 2021-0268-MTZ, 2022 WL 593899 (Del. Ch. Feb. 20, 2022)

Summary

Delaware Chancery Court held that a creditor that was not a stockholder could nonetheless be deemed a target's controller, owing fiduciary duties to the target's stockholders, by virtue of holding proxies that represented voting control, and that a conflicted transaction between the creditor and the target was therefore subject to review under entire fairness.

Background

In spring of 2020, Left Coast Ventures, Inc., a leading cannabis operator in California (Target), was in talks with a potential buyer, TPCO Holding Corp., a SPAC (the Buyer). At the time, Fireman Capital Partners, LLC and its affiliate, Fireman Capital Partner III, L.P. (collectively, Fireman Capital) were a creditor of Target, having invested $10 million in Target's approximately $25 million convertible notes offerings (the 2019 Notes). Defendants Bassler Co Corp. (Bassler) and Crocket Resources S.A. (Crocket) also invested in the 2019 Notes.

[20] *Id*. at *25.
[21] *Id*.

The COVID-19 Pandemic delayed Target's merger negotiations with Buyer, and Target needed more money to fund its operations during this delay. In July of 2020, Fireman Capital offered $10 million in bridge financing and solicited other holders of the 2019 Notes to participate. Eighty-eight percent of the July 2020 financing came from Fireman Capital, Crocket, and Bassler. In connection with the July 2020 financing, Fireman Capital required and received several things from Target, including (i) improvements on the 2019 Note terms, (ii) a new note to secure the new July 2020 loan, (iii) new warrants to purchase Class A shares at $0.01 per share (the 2020 Warrants), (iv) three board appointments for Target's five person board, and (v) an irrevocable proxy to vote the founders' Class B high vote shares (the Class B Proxy), which represented 83 percent of the aggregate voting power of Target.

In August of 2020, the key terms of the merger with the Buyer were being negotiated. By October 2020, the deal was almost finalized when Fireman Capital began making demands for favorable amendments to the 2019 Notes and 2020 Warrants, including that the 2020 Warrants' exercise price be reduced from $0.01 per share to less than $0.0001 per share (collectively, the Amendments). Fireman Capital refused to vote in favor of the merger unless its demands were met. The non-Fireman Capital board members determined that the transaction's closing would be compromised unless they agreed to Fireman Capital's demands. The board agreed to the demands, and the merger, valued at between $120 million and $130 million dollars, closed on January 15, 2021.

The Plaintiffs allege that, as a result of the Amendments, consideration was diverted from common stockholders (approximately $40 million) and the optionholders to the Defendants, claiming that:

I. Fireman Capital and its affiliates, as controllers, and the director Defendants breached their fiduciary duties by approving the Amendments;
II. The Defendants tortiously interfered with the optionholders' expectancies in their options by approving Amendments and causing options to be worthless;
III. Fireman Capital, Crocket and Bassler conspired in connection with breaches of fiduciary duty alleged in Count I; and
IV. Fireman Capital, Crocket and Bassler conspired in connection with the tortious interference alleged in Count II.

Fireman Capital and the director Defendants filed motions to dismiss claiming that (i) all claims were derivative claims that Plaintiffs lacked standing to assert after the merger and (ii) all counts failed to state claims upon which relief could be granted.[22]

The Court's Analysis

The court emphasized that the touchstone "to survive a motion to dismiss is reasonable 'conceivability.'"[23]

---

[22] *Id*. at *4.

[23] *Cent. Mortg. Co. v. Morgan Stanley Mortg. Cap. Hldgs. LLC*, 27 A.3d 531 at 537 (Del. Aug. 18, 2011).

Did the Plaintiffs Have Standing?

The court first addressed Defendants' assertion that all of Plaintiffs' claims were derivative claims, noting that the issue was outcome-determinative because the Plaintiffs would lack standing to assert derivative claims after the merger. The court discussed the history of Delaware case law on distinguishing between derivative and direct claims, and concluded that the rule statement from *Parnes v. Bally Entertainment Corp.*[24] remained the best formulation: a target stockholder retains direct standing after a merger has closed to challenge the fairness or validity of the merger itself. The court stated that it "must distinguish between direct challenges to a merger's fairness and derivative challenges to wrongs merely associated with the merger."[25] The court further noted that to be direct, a side transaction must (a) "divert merger consideration from stockholders, rather than the acquirer," (b) be "improper," and (c) "materially affect the merger's process or price."[26] With this rule in mind, the court concluded that Plaintiffs' breach of fiduciary duty claim (Count I) was direct since Plaintiffs challenged the merger's fairness by alleging that the Board's decision to approve the Amendments diverted the merger proceeds to the controller in a way that tainted the merger's fairness and materially reduced the merger consideration for Target's other shareholders.

The court similarly concluded that Count II was direct because tortious interference implicates an individual harm, separate from any injury to Target itself. It is an allegation that the options are worthless. The court concluded that Counts III and IV were also direct because they were based on Counts I and II, which were both direct claims.

Did Fireman Capital Owe Fiduciary Duties to the Common Stockholders?

Count I alleged that Fireman Capital owed fiduciary duties to the common stockholders as a controller. The court held that a controller analysis "take[s] into account whether the stockholder, as a practical matter, possesses a combination of stock voting power and managerial authority that enables him to control the corporation, if he wishes."[27] The court held that control can be direct or indirect, and it involves a fact specific inquiry. The court held that control can be established through showing that a stockholder can exercise more than 50 percent of a company's voting power.[28]

The moving Defendants' motion to dismiss argued that Fireman Capital was a creditor and not a controller. A creditor, in contrast to a controller, does not owe fiduciary duties to stockholders, even if the creditor owns a majority of the corporation's debt.[29] The court rejected this argument because Fireman Capital held both debt and the Class B Proxy and had control, not because it held most of Target's debt, but because it held the vote. The court held that it did not matter that Fireman Capital obtained the voting power through its creditor status. The court also

---

[24] *Parnes v. Bally Entertainment Corp.*, 722 A.2d 1243 (Del. Jan. 25, 1999).
[25] *Blue*, C.A. No. 2021-0268-MTZ, 2022 WL 593899 at *11 (Del. Ch. Feb. 20, 2022)
[26] *Id*. (referencing *Golaine v. Edwards*, C.A. No. CIV.A. 15404, 1999 WL 1271882 (Del. Ch. Dec. 21, 1999)).
[27] *Id.* (citing *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 553 (Del. Aug. 15, 2003)).
[28] *Id.* (citing *Voigt v. Metcalf*, C.A. No. 2018-0828-JTL, 2020 WL 614999 at *11 (Del. Ch. Feb. 10, 2020)).
[29] *Hamilton Partners, L.P. v. Highland Capital Management, L.P.*, C.A. No. 6547–VCN, 2014 WL 1813340 at *11 (Del. Ch. May 7, 2014).

emphasized that a non-stockholder can exercise control.[30] Fireman Capital's Class B Proxy gave it the ability to exercise a majority of Target's voting power which, based on that fact alone, made it a controller.

Once Fireman Capital's status as a controller was determined, Delaware law dictates that it owed fiduciary duties to the corporation and its minority stockholders and was prohibited from exercising corporate power to advantage itself while disadvantaging the corporation.[31] The court determined that Fireman Capital's procurement of the Amendments triggered entire fairness review because the business judgment rule's protection was rebutted given that Fireman Capital, as a controller, had engaged in a conflicted transaction by "extracting a different benefit (the Amendments) out of the merger consideration."[32] The court did not determine, at this stage of the proceeding, whether the entire fairness should apply to the merger or only to the Amendments.[33]

Is there a Claim for Tortious Interference?

In Count II, Plaintiffs alleged all Defendants tortiously interfered with the Class A optionholders' reasonable probability of receiving positive value for their options from Target. A claim for tortious interference with a prospective business opportunity must include the following allegations "1) the reasonable probability of a business opportunity; 2) the intentional interference by defendant with that opportunity; 3) proximate causation; and 4) damages."[34] The moving Defendants argued, and the court agreed, that the Plaintiffs did not establish the first element. Plaintiffs' identified business opportunity was their hoped-for upside on their option contracts. The court held that "Plaintiffs' speculation or hope that they picked the right side of their bet is not, standing alone, sufficient to establish a reasonable probability of a business relationship" and granted the motion to dismiss with respect to Count II.[35]

Conspiracy Claims

The moving Defendants' motion to dismiss Count III was predicated on the notion that Fireman Capital did not take an unlawful act in furtherance of the conspiracy. Since the court already determined that there were grounds for the unlawful act claimed in Count I, this motion to dismiss was denied. The motion to dismiss Count IV was granted since a claim for civil conspiracy must be predicated on an underlying wrong and, here, the court had already determined to dismiss Count II, the alleged underlying wrong.

---

[30] As support, the court cited a 1919 US Supreme Court decision where a corporation was deemed to control another corporation even though stock was held through a subsidiary of the controlling corporation. *See S. Pac. Co. v. Boger*, 250 US 483, 491–92 (S.Ct. June 9, 1919) (noting the control doctrine "does not rest upon such technical distinctions").

[31] *Carr v. New Enter. Assocs., Inc.*, C.A. No. 2017–0381–AGB, 2018 WL 1472336 at *22 (Del. Ch. Mar. 26, 2018).

[32] *Blue*, C.A. No. 2021-0268-MTZ, 2022 WL 593899 at *17 (Del. Ch. Feb. 20, 2022).

[33] The court noted the anomaly of requiring Fireman Capital to prove the fairness of the merger when it was not a party to the merger.

[34] *Agilent Techs., Inc. v. Kirkland*, C.A. No. 3512-VCS, 2009 WL 119865 at *5 (Del. Ch. Jan. 20, 2009) (citing *DeBonaventura v. Nationwide Mut. Ins. Co.*, 419 A.2d 942, 947 (Del. June 18, 1980), aff'd, 428 A.2d 1151 (Del. Apr. 1, 1981)); accord *Beard Rsch., Inc. v. Kates*, 8 A.3d 573, 608 (Del. Apr. 23, 2010), aff'd sub nom. *ASDI, Inc. v. Beard Rsch., Inc.*, 11 A.3d 749 (Del. Nov. 23, 2010); *Empire Fin. Servs., Inc. v. Bank of NY*, 900 A.2d 92, 98 n.19 (Del. Apr. 17, 2006).

[35] *Blue*, C.A. No. 2021-0268-MTZ, 2022 WL 593899 at *18 (Del. Ch. Feb. 20, 2022).

Takeaways

The case serves as a warning to creditors (and potentially other third parties) that they may be deemed to be controllers, with the same exposure for conflicted transactions under an entire fairness standard of review as applies to controlling stockholders, even without ownership of any shares. Here, holding proxies that conferred more than 50 percent of the voting power was sufficient to establish controller status. There were also other indicia of control, such as the right to designate a majority of board members, which the court did not need to address. That does not mean that creditors should not obtain proxies or board representation to protect their rights. But if they do obtain these protections, they should be mindful of the risk of being deemed a controller and the consequent fiduciary duties that would be owed to minority stockholders.

Goldstein v. Denner, C.A. No. 2020-1061-JTL, 2022 WL 1671006 (Del. Ch. May 26, 2022)

Summary

Goldstein arose out of the alleged breach of fiduciary duties by directors and officers of a company in connection with its cash sale. The Delaware Chancery Court, in denying a motion to dismiss breach of fiduciary duty claims against certain of the company's directors and officers, noted allegations of multiple serious process and disclosure issues, including the existence and concealment of large stock purchases by a director and an affiliated investment fund in violation of the company's insider trading policy and manipulation of the sale process by them to obtain a quick profit. The decision provides important guidance for officers, directors, investment fund sponsors, and practitioners in connection with sale transactions.

Background

In May 2017, Sanofi S.A. (Sanofi) approached two directors of Bioverativ, Inc. (the Company), Alex Denner (Denner) and Brian Posner (Posner), regarding a potential acquisition of the Company. The directors indicated the Company was not for sale, without informing the other board members. Days later, Denner and his fund, Sarissa Capital Management (Sarissa), purchased more than one million shares of the Company's common stock without informing Company management or other board members and in apparent violation of the Company's insider trading policy. After several other approaches by Sanofi, Denner invited Sanofi to make an offer in a single bidder process, again apparently without informing the other directors.

In early November 2017, Sanofi offered to acquire the Company for $98.50 per share. The offer price was considerably lower than the approximately $150 per share valuation derived by Company management and the Company's financial advisors from updated management projections (the November Projections), which were presented at a late November 2017 board meeting discussing the Sanofi proposal. As part of the board's discussion at that meeting, it was noted that a tax restriction relating to the Company's spin-off from another company in early 2017 would lapse in January 2019, increasing the field of potential bidders. The Company rejected Sanofi's initial bid.

In December, management presented the board with the Company's 2018 annual plan, which incorporated the November Projections with slight modifications. Separately, Sanofi countered with a $101.50 per share offer. At an early January board meeting, the board was presented with a $158 per share valuation of the Company, based on management's 2018 annual plan. After a subsequent board meeting, the board countered with a $105 per share proposal, which Sanofi accepted. Company management then significantly cut back the November Projections, notwithstanding the fact that there was not a negative change in the Company's business. The Company's financial advisors delivered fairness opinions based on these lowered projections (the Final Projections) at a board meeting on January 21, 2018, and the board approved the deal. The merger agreement, providing for a two-step tender offer, was signed the same day. The transaction closed on March 7, 2018.

In the ensuing class action lawsuit, the plaintiff alleged: (i) breach of fiduciary duty by all directors based on misstatements and omissions in the Schedule 14D-9 and for failing to obtain the highest value reasonably available for stockholders, (ii) breach of fiduciary duty by the CEO, the CFO, and the Chief Legal Officer for disclosure violations in the Schedule 14D-9 and for falsifying the record in the Schedule 14D-9 and the board minutes, (iii) breach of fiduciary duty against Denner for insider trading, and (iv) aiding and abetting by Sarissa.[36]

The Court's Decision

Inapplicability of Corwin

The court held that the fiduciary duty claims should not be dismissed under *Corwin*[37] because of multiple disclosure flaws. The court noted omissions and inaccurate disclosures in the Schedule 14D-9 in connection with meetings involving Denner and Posner, and Sanofi or Sanofi's financial advisor, Lazard, which appeared intended to obscure the fact that the board was not informed of those meetings or of the stock purchases in violation of the Company's insider trading rules and to cover up the insider trading. The court noted that statements in the Schedule 14D-9 that the board was informed of some of these meetings, and of directions to management on how to respond to Sanofi, were not supported by board minutes and email records.

The court held that several other misstatements and omissions in the Schedule 14D-9 also rendered *Corwin* inapplicable:

- The Schedule 14D-9 failed to reference the purchase by Denner and Sarissa of over one million shares after Sanofi's initial approach.
- The Schedule 14D-9 did not disclose the practical implications of the tax restriction stemming from the Company's spin-off, which limited the field of potential bidders until the restriction lapsed.

---

[36] The court's decision to which this summary relates only addressed the first two claims. *Id.* at *17. The third breach of fiduciary duty for insider trading (*Brophy*) claim, and fourth aiding and abetting by Sarissa claim, were addressed in another decision by the court on June 2, 2022. *Goldstein v. Denner*, C.A. No. 2020-1061-JTL, 2022 WL 1797224 (Del. Ch. June 2, 2022).

[37] *Goldstein*, C.A. No. 2020-1061-JTL, 2022 WL 1671006 at *19-28 (citing *Corwin v. KKR Fin. Hldgs. LLC*, 125 A.2d 304 (Del. 2015)).

- The November Projections were reliable and should have been disclosed in the Schedule 14D-9.

Fiduciary Duty Claims Under Enhanced Scrutiny

Analyzing under the enhanced scrutiny standard of review applicable to cash sales, the court held that it was reasonably conceivable that Denner's conflicts caused the sale not to achieve the best price reasonably available. The complaint alleged that Denner was conflicted because he wanted a quick sale "as part of his activist playbook." The court noted that the complaint detailed the way Denner had operated as an activist on multiple occasions in the past. According to the court, Denner's purchase of stock, the addition of two individuals to the board who had reason to be loyal to Denner, and Denner's role in the negotiations with Sanofi and orchestrating a single bidder process, which culminated in a sale in which Sarissa made a profit of $49.7 million, were in accordance with this playbook. The court held that at the motion to dismiss stage, plaintiff was entitled to an inference that Denner was following his playbook.

The court held that it was "reasonably conceivable that Mr. Denner's conflicts tainted the sale process." The court also held that it was "reasonably conceivable that Mr. Denner's conflicts affected the price negotiations with Sanofi," where Denner was central to the negotiation process, and he led the counteroffer that resulted in a $105 per share deal price when Company information supported a valuation of over $150 per share. The court held that the 64 percent deal premium over market price did not support the price as being the best price reasonably available where, as here, the complaint alleged that the market did not fully value the Company. Similarly, the court held that the absence of a topping bid did not justify the deal price, noting that the argument was premised on potential acquirors recognizing the true value of the Company despite not having access to non-public information. Defendants' argument also ignored the fact that some entities may have been precluded from bidding because of the tax issue.

The court held that the last minute preparation of the Final Projections with significant downwards adjustments, which appeared intended to support the fairness analysis of the deal price, supported an inference, for purposes of the motion to dismiss, that the management defendants acted in bad faith.

Non-Exculpated Claims Against Director Defendants

The court held that in light of the exculpation provision in the Company's charter, to survive a motion to dismiss, claims against directors must be based on allegations the directors were "interested in the [t]ransaction, lacked independence, or acted in bad faith."[38] The court held that plaintiff's allegations were adequate to support non-exculpated claims against all of the directors, aside from Mr. Paglia, through the following inferences:

- It was reasonably conceivable Denner acted in bad faith through purchasing shares in violation of the insider trading policy, concealing the illicit stock purchases and

[38] *Id.* at *39 (quoting *In re Cornerstone Therapeutics Inc. S'holder Litig.*, 115 A.3d 1173, 1179-80 (Del. 2015)).

discussions with Sanofi and Lazard from the board, and manipulating the sale process to obtain a quick personal gain.

- It was reasonably conceivable Mr. Cox was interested as a result of the $72.3 million severance payment he would receive, when compared to his $11.6 million average annual compensation.[39]

- It was reasonably conceivable Posner acted in bad faith as a result of having concealed his early discussions with Sanofi from the board.

- While a close call, it was reasonably conceivable Ms. Protopapas acted in bad faith as a result of a combination of factors relating to her ties to Denner and flaws in the Company's sale process. Her ties included having been nominated by Denner to serve on the board of another company, which yielded her $2.2 million in the sale of that company, and her role as the President and CEO of Mersana Therapeutics, Inc., a company in which Sarissa was one of the three largest stockholders.

- While a close call, it was reasonably conceivable Mr. Germano acted in bad faith for similar reasons to those for Ms. Protopapas, including his appointment by Denner to other boards.

The court held that there was no showing that Denner played any role in Mr. Paglia's appointment to the Company's board. The court held that Denner's appointment of Mr. Paglia to the board of a special purpose acquisition corporation after the Company's sale to Sanofi was insufficient to show Mr. Paglia lacked independence.

Claims Against Officer Defendants

The court held that the complaint sufficiently alleged that Messrs. Cox and Greene acted disloyally in their capacities as CEO and CFO, respectively, by failing to disclose Sarissa's share purchases to the board and by participating in creation of the Final Projections, so that they could each receive significant payouts in the deal. Mr. Greene was eligible to receive more than $18.4 million in severance and accelerated equity awards in the deal, which was more than four times his annual compensation.[40]

The court held that the complaint sufficiently alleged that the Company's chief legal officer breached her duty of loyalty given that her payout from severance and accelerated equity awards was more than four times her annual compensation, and that the complaint alleged she fabricated part of the legal record in order to enable the transaction to close.

[39] The court noted that the Chancery Court had previously found severance equal to twice annual salary was sufficiently material to support an inference that the individual was interested. *Id.* at *42. The court held that, to the extent prior case law indicated that severance could not be deemed material if it was pursuant to existing agreements, such an interpretation of case law was incorrect. *Id.* at *43.

[40] In addressing the defendants' argument that the November Projections were lowered "in response to board dialogue," the court held that even if the Board had instructed Mr. Greene "to slash the projections, Mr. Greene did not have a duty to comply if it would have caused him to breach his fiduciary duties." *Id.* at *54.

Disclosure Claims

The court held that, in addition to the fiduciary duty claims above regarding the sales process, plaintiff had adequately alleged breach of the duty to "disclose fully and fairly all material information with the board's control when it seeks shareholder action."[41] The court held that plaintiff had adequately pleaded damages by alleging that that damages equaled the difference between the deal value and the value implied by the November Projections.

Takeaways

This decision by Vice Chancellor Laster is similar in many respects to his earlier decision in *In re PLX Technologies Inc. S'holder Litig.*[42] Both concerned board breaches of fiduciary duty when an activist fund's board representative allegedly manipulated a sale process, including by withholding material information from other directors, to force through an expedited sale that appeared to be contrary to the best interests of the stockholders as a whole. *Goldstein* also has lessons that extend beyond classic activist funds: [43]

- Investment funds and their portfolio companies should be mindful that a fund's appointment of an individual to serial boards, or the expectation of such appointments, can create conflicts that cause fiduciary duty claims against the directors to lose the benefit of exculpation.

- Investment funds should be mindful that their investment strategy and thesis concerning a particular company, if capable of being presented as short-term in nature, may be used under this line of cases to allege a conflict with the interests of other investors.

Individuals selected by funds for board appointments should also take note. Non-exculpated fiduciary duty claims expose them to personal loss, unless those losses are covered by D&O insurance or indemnification. Such individuals should remain cognizant that their fiduciary duties are owed to the corporation on whose boards they sit, and to the corporation's stockholders as a whole.

Goldstein also serves a warning to inside and outside deal counsel about the importance of accurate board minutes. For several meetings, the minutes did not reference that Denner or Posner had updated the directors about discussions with Sanofi or Lazard. If they had provided such an update, it would have been important to include that in the minutes. Equally important, some minutes appeared to be materially inconsistent with contemporaneous emails. Accurate board minutes could make the difference between whether or not directors and officers prevail on a motion to dismiss.

---

[41] *Id.* at *55 (quoting *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992)).

[42] *In re PLX Technologies Inc. S'holder Litig.*, 2018 WL 5018535 (Del. Ch. Oct. 16, 2018). *PLX* involved a post-trial decision on the merits. By the time of the decision, all of the defendant directors had settled and the decision only involved an aiding and abetting claim against the activist. A summary of *PLX*, begins on p. 25 of this Arnold & Porter newsletter.

[43] Sarissa is not a dedicated activist fund, but often acts more like a sophisticated life sciences private equity fund. Mr. Denner did not seem to have joined the Company's board in an activist capacity.

Goldstein also reinforces some of the lessons from *PLX*. It is critical that directors fully disclose to other board members any discussions they hold with potential acquirors. It is important that boards do an evaluation at the outset regarding potential conflicts of interest of the board members and put in place a process so as to minimize the impact of any conflicts. Having the board member with the most significant conflicts have such a central position in the sale process was problematic in both *Goldstein* and *PLX*. Another problem in *Goldstein* was Mr. Denner's concealment of his and Sarissa's share purchases, particularly given that shareholder ownership was discussed at one board meeting. While those purchases were concealed from the other directors, it would presumably have been simple to have directors expressly confirm the accuracy of the share ownership information in connection with setting up and maintaining the board sale process. Another lesson common to both cases was the apparent acceptance of management's original, higher financial projections by the board without significant challenge and the problem of lowering projections in a way that appeared intended to justify the deal price. The importance of solid, realistic projections, including regular updates to those projections as needed, cannot be overstated, even in the absence of any planned sale process. Deal counsel should inquire as to the existence and status of projections at the outset. If internal non-deal projections are overly optimistic, a documented process should be implemented to prepare revised projections early in the process, preferably in connection with the initial valuation work conducted by financial advisors, and in any event in advance of price discussions.

A fuller discussion of the decision is contained in our previously published alert.[44]

Twitter, Inc. v. Musk, C.A. No. 2022-0613-KSJM, 2022 WL 4140502 (Del. Ch. Sept. 13, 2022)

Summary

In denying motion to compel production of documents, Delaware Chancery Court held Musk had reasonable expectation of privacy in his Tesla and SpaceX email accounts, in part because no one at either company was permitted to access his emails without his consent. Given time pressure, the court did not address the merits of defendants' argument urging a course correction in Delaware law, but noted questions about the applicability of the Asia Global *test outside the employer/employee context.*

Background

The ruling stemmed from Twitter's action for specific performance in connection with Musk's agreement to acquire Twitter. Musk[45] asserted attorney-client privilege over emails in his SpaceX and Tesla email accounts, which he used to communicate about the Twitter transaction, and Twitter moved to compel production.

[44] *Goldstein v. Denner*: Delaware's Latest Guidance for When a Fund's Representative on the Board Seeks to Force Through a Quick Sale.

[45] There were several defendants in the litigation. For convenience, this summary just refers to Musk.

The Court's Decision

In addressing the protections of the attorney-client privilege under Delaware Rule of Evidence 502, the court looked to whether Musk had a reasonable expectation of privacy. The court used the framework for analyzing privilege waiver through email communications set forth in *In re Asia Global Crossing, Ltd*. (*Asia Global*),[46] the leading case that addressed the issue in the context of employer-employee disputes, and weighed the following four factors:

> "(1) does the corporation maintain a policy banning personal or other objectionable use, (2) does the company monitor the use of the employee's computer or e-mail, (3) do third parties have a right of access to the computer or e-mails, and (4) did the corporation notify the employee, or was the employee aware, of the use and monitoring policies?"[47]

Twitter argued that because both SpaceX and Tesla had policies that provided for company monitoring of work email accounts, and Tesla's policy stated that email users had no expectation of privacy, under *Asia Global*, Musk could not have had a reasonable expectation of privacy when using his work email accounts for private business.

The court noted Musk's argument that the *Asia Global* test should not apply where the party challenging the privilege is not part of the employer group that owns the email accounts. The court noted that Vice Chancellor Laster had raised doubts about the applicability of *Asia Global* in that context in *In re Inform. Mgmt. Servs., Inc. Deriv. Litig.*,[48] although the test had been applied in that context in the more recent *In re WeWork Litig.* (*WeWork*) decision.[49] The court noted that the issue was "worthy of extensive discussion" although decided to forego such a discussion and apply *Asia Global* given time constraints.[50]

The court noted that the factors comparable to those referenced by Twitter had been held to weigh in favor of production under the *Asia Global* test in *WeWork*. The court then noted a number of mitigating factors in this case. First, both companies had policies that required approval of the legal and HR departments prior to accessing employee emails, and emails were only accessed if necessary to investigate a specific issue or conduct (such as when an employee leaves the company).[51] Second, Musk argued that both companies had rules specific to him: no one at either company was permitted to access his emails without his consent, except, at Tesla, to the extent "legally necessary."[52] The court held that these two facts weighed against production of the documents under the first *Asia Global* factor.

The court held that the second factor also weighed against production because personnel at the two companies had "never monitored, accessed, or reviewed Musk's email except for purposes he had preauthorized or as legally necessary."[53] The court held the third factor was duplicative

[46] *In re Asia Global Crossing, Ltd.*, 322 B.R. 247 (Bankr. S.D.N.Y. 2005).
[47] *Twitter, Inc.*, C.A. No. 2022-0613-KSJM, 2022 WL 4140502 at *5 (Del. Ch. Sept. 13, 2022) (citing *In re Asia Global Crossing, Ltd.*, 322 B.R. 247, 257 (Bankr. S.D.N.Y. 2005)).
[48] *In re Inform. Mgmt. Servs., Inc. Deriv. Litig.*, 81 A.3d 278 (Del. Sept. 3, 2013).
[49] *In re WeWork Litig.*, C.A. No. 2020-0258-AGB, 2020 WL 7624636 (Del. Ch. Dec. 20, 2020). For a detailed description of that decision, see our advisory available here
[50] *Twitter, Inc.*, C.A. No. 2022-0613-KSJM, 2022 WL 4140502 at *5 (Del. Ch. Sept. 13, 2022).
[51] *Id*. at *6.
[52] *Id*. at *1.
[53] *Id*. at *7.

of the first two in the situation at hand. The court held that Musk had knowledge of the policies, for purposes of the fourth factor, and that this weighed in his favor. The court therefore held that Musk had a reasonable expectation of privacy in his emails, under the *Asia Global* test.

Takeaways

The court's decision turned on Musk's special treatment under the email monitoring policies of both Tesla and SpaceX. That type of special treatment is unlikely to exist in most other companies, so in that sense the outcome of the decision is unlikely to have broad applicability. What is more important is that the court applied the *Asia Global* test outside the employer/employee dispute context, which was new ground broken in *WeWork.* The court also expressed a willingness to reconsider that under the appropriate circumstances. Practitioners should therefore continue to view *WeWork* as good law—including its broader implications for director email accounts that were described in our prior Advisory—and note the willingness of Delaware courts to reconsider the decision at an appropriate time in the future.

In re Aerojet Rocketdyne Holdings, Inc., C.A. No. 2022-0127-LWW, 2022 WL 2180240 (Del. Ch. June 16, 2022)

Summary

Deadlock among eight-member board required to be resolved by stockholders; neither faction had the power to take action on behalf of the corporation and management could not cause the corporation to favor one side over the other.

Background

In a case the Delaware Chancery Court described as "a cautionary tale about the perils that can befall a board with an even number of directors,"[54] the court addressed the actions of a deadlocked board in a proxy contest. The dispute grew out of a disagreement between the CEO and Executive Chairman of Aerojet Rocketdyne Holdings, Inc. (the Company), a manufacturer of propulsive systems for space, defense, civil, and commercial applications, in its approach to a potential acquisition of the Company. The parties had differing views on the Company's strategic direction if the sale fell through, among other things.

The CEO objected to the Executive Chairman's initial proposal that seven of the eight incumbents be named as director nominees in the event the acquisition failed. When the Federal Trade Commission sued to block the acquisition, the Executive Chairman then proposed an agreement between Steel Partners, a longtime stockholder in the Company controlled by the Executive Chairman, and the Company, which confirmed the slate of the seven incumbents. No agreement was reached, and with the stockholder nomination deadline looming, Steel nominated a slate of seven director candidates that included the Executive Chairman and three of the incumbents. The CEO then used company resources to form a response to Steel's nomination, including by filing a press release with the Securities and

[54] *Id.* at *1.

Exchange Commission and sending it to the Company's largest stockholders, which purported to express the Company's disappointment in Steel's nomination, disclosed that there was an internal investigation involving the Executive Chairman, and alleged that the Executive Chairman had ulterior motives. The CEO also used the Company's outside counsel to threaten litigation against the incumbents nominated on Steel's slate.

The Executive Chairman and three incumbent directors filed suit against the CEO and the other three incumbents, seeking declaratory judgments addressing the inability of people to take action on behalf of the Company without board approval. The plaintiffs also sought, and were granted, a temporary restraining order preventing either group of directors from using the Company's name or resources to advantage itself in the election. A three-day trial was held, commencing May 23, 2022.

The Court's Decision

Invalid Board Action

The court first considered whether certain of the defendants' actions in connection with the contested election were unauthorized. The court noted that, under Delaware law, a corporation's board is responsible for managing the business and affairs of the corporation. The court noted that under the Company's bylaws, and consistent with the default standards under Delaware law, board action requires either approval of a majority of directors at a meeting at which a quorum is present, or action by unanimous written consent. Where only four members of an eight person board is present, a quorum does not exist and any board action taken is invalid.

The defendants acknowledged that their actions were taken without board approval, but nonetheless argued that they believed in good faith that they were valid. The court rejected this argument because such a good faith belief would not provide legal authorization to act. The court also rejected the defendants' argument that actions were taken pursuant to the CEO's authority to run the Company's day-to-day operations. The court held that the challenged actions, including issuing a press release questioning the Executive Chairman's motives and disclosing an ongoing internal investigation, and retaining counsel to bring litigation against half of the board members, were not ordinary course.

Neutrality Principle

The court then considered whether defendants' conduct violated Delaware's neutrality principle. According to the court:

> "a Delaware corporation must remain neutral when there is a legitimate question as to who is entitled to speak or act on its behalf. Where a board cannot validly exercise its ultimate decision-making power, neither faction has a greater claim to the company's name or resources. The corporation—the 'neutral res'—cannot take sides while the

> control dispute is unresolved . . . It does not fall to management to step into the power vacuum in the interim."[55]

The court held that the neutrality principle applied to the present dispute, and the Company accordingly had to remain neutral with respect to the outcome of the election. The defendants acknowledged that the neutrality principle applied to a "typical board deadlock situation,"[56] but claimed that the principle did not apply where there was a duty to defend the corporation in the face of an activist that paralyzes the board. The court refrained from addressing which faction would be authorized to respond to such a threat if it existed. The court held that such a threat did not exist here, given that Steel Partners had been a stockholder of the Company since 2000, and its slate included one-half of the current board.

The defendants also claimed that the neutrality principle did not apply because of the Executive Chairman's desire to entrench himself. The court rejected this claim as not supported by the facts. Accordingly, the court held that the principle of corporate neutrality applied and was violated. The court then imposed an injunction, similar in scope to the TRO previously awarded, until the Company's stockholders had elected a new board.

Takeaways

As expressly stated by the court, the decision serves as "a cautionary tale about the perils that can befall a board with an even number of directors."[57] Where there is an even number of directors and there is gridlock due to a dispute between the two halves of the board, under Delaware's neutrality principle, management cannot use the corporation's resources to favor one side in the dispute over the other.

Hawkins v. Daniel, 273 A.3d 792 (Del. Apr. 4, 2022)

Summary

Delaware Chancery Court held that an irrevocable proxy did not "run with the shares" (i.e., it would not bind subsequent owners of the shares) because it did not contain clear language specifying that it would do so. Accordingly, unless the buyer bound itself to the irrevocable proxy, the proxy would terminate once the shares were sold.

Background

The plaintiff owned 88 percent of the outstanding equity interests of MedApproach, L.P. (MedApproach), which was a Delaware limited partnership that dissolved in February 2021. MedApproach owned 75 percent of the issued and outstanding shares (the Shares) of N.D.

---

[55] *Id.* at *36 (citing *In re TransPerfect Global, Inc.*, C.A. No. 9700-CB, 2014 WL 6810761 (Del. Ch. Dec. 3, 2014) and *Pearl City Elevator, Inc. v. Gieseke*, C.A. No. 2020-0419-JRS, 2020 WL 5640268 at *88 (Del. Ch. Sept. 21, 2020)).
[56] *Id*. at *15 (citing Defs.' Post-Trial Br. 36-37).
[57] *Id.* at *1.

Management, Inc. The predecessor to MedApproach (for simplicity, also referred to as MedApproach) purchased the Shares as part of a settlement agreement.

Pursuant to the settlement agreement, the original owner of the Shares transferred the voting power for the Shares to three individuals (the Holders) pursuant to an irrevocable proxy (the Proxy) with the intent to then sell the Shares in two steps. One of the Holders was one of the defendants, Daniel. In order to accomplish the sale quickly, as part of a revised settlement agreement, MedApproach instead purchased the Shares in a single transaction. In connection with that purchase, the parties to the settlement agreement wanted to ensure that the voting arrangement created by the Proxy continued and that MedApproach was bound to it as the new owner of the Shares. As a result, the parties prepared an addendum to the Proxy pursuant to which MedApproach agreed to be bound by the Proxy once it became the owner of the Shares.

MedApproach dissolved in February 2021 pursuant to the terms of the limited partnership agreement. The partnership agreement provided that its general partner, which was controlled by Daniel, was obligated to convert noncash assets of the partnership to cash as the general partner deemed necessary and to determine the closing capital accounts of the partners. Given value implications for any sale of the Shares, the plaintiff brought an action against Daniel seeking a declaratory judgment that MedApproach must market and sell the Shares free and clear from the Proxy.

The Court's Analysis

The court noted that a proxy not only creates an agency relationship, but also decouples voting power from economic ownership. Given concerns associated with this decoupling's impact on maximizing stockholder welfare, courts have historically interpreted proxies narrowly and ambiguities are construed against granting authority to the proxyholder.[58] The court noted that an irrevocable proxy is especially concerning, and the terms of an irrevocable proxy must be "plain and unambiguous."[59] Departing from traditional contract interpretation tenets, the court noted that interpretation of a proxy arrangement cannot look to extrinsic evidence, especially when analyzing an irrevocable proxy relationship. The court stated that in order for the Proxy to run with the Shares, the language of the Proxy must plainly indicate that.[60]

The court analyzed each provision of the Proxy, and held that it does not run with the Shares because it neither clearly states that it does, nor explicitly reserves voting power to the Holders after a sale of the Shares. The court held that, at best, the Proxy language was ambiguous, and ambiguity is interpreted against the grant of proxy authority.

Preamble and Recitals

The court noted that the preamble defines the "Stockholder"[61] granting the Proxy only as the original holder of the Shares and not subsequent owners. The court noted various interpretive

---

[58] *TR Investors, LLC v. Genger*, C.A. No. 3994-VCS., 2010 WL 2901704 at *20 (Del. Ch. July 23, 2010), aff'd 26 A.3d 180 (Del. July 18, 2011).
[59] *Genger*, C.A. No. 3994-VCS., 2010 WL 2901704 at *20 (Del. Ch. July 23, 2010).
[60] *Daniel*, 273 A.3d 792 (Del. Apr. 4, 2022) (citing *Genger*, C.A. No. 3994-VCS., 2010 WL 2901704 at *20 (Del. Ch. July 23, 2010)).
[61] *Daniel*, 273 A.3d 792, 808 (Del. Apr. 4, 2022).

arguments Daniel made, extrapolating from the recitals, but held that the recitals merely provided definitions and background information without showing that the Proxy runs with the Shares.

Appointment Provision

Next, the court analyzed the following appointment language in the Proxy (emphasis added):

> "The Stockholder hereby constitutes and appoints each Holder, during the term of this Irrevocable Proxy, as ***the Stockholder's*** true and lawful proxy and attorney-in-fact, with full power of substitution, to vote all of the Shares plus any additional Shares ***which Stockholder may own or hold*** as of the date of any such vote (and any all [sic] securities issued or issuable in respect thereof) which ***Stockholder*** is entitled to vote (collectively, the "Proxy Shares"), for and in the name, place and stead of ***the Stockholder***, at any annual, special or other meeting of the stockholders of the Company, and at any adjournment or postponement thereof, or pursuant to any consent in lieu of a meeting or otherwise."[62]

Consistent with the court's holding in *Genger,*[63] the court found that the appointment provision in the Proxy did not include language clearly stating that it extends to subsequent owners of the Shares. The use of the singular "Stockholder" throughout the appointment provision tracked the language analyzed by the court in *Genger*. The court held that the Proxy only authorized the Holders to vote "in name, place and stead of the Stockholder," suggesting that such authority does not extend to subsequent owners of the Shares.[64]

Irrevocability Provision

The court next reviewed the following language of the Proxy establishing its irrevocability and duration:

> "All power and authority hereby conferred is coupled with an interest and is irrevocable. In the event any applicable law imposes a mandatory limit on the period of time for which a proxy or other rights as referenced herein may be granted, it is the intention of the parties that this Irrevocable Proxy and the related rights granted herein shall expire on the latest date permissible under such applicable law, and the parties hereto hereby waive any such time limitation to the fullest extent waivable and hereby extend and/or agree to extend such time limit (by amendment, renewal or otherwise) to the fullest extent extendable under such law."[65]

The court rejected Daniel's argument that, because the Proxy was irrevocable and provided for the maximum duration permitted by law, the Proxy must run with the Shares. In doing so, the

[62] *Id*. at 814.
[63] *Genger v. TR Investors, LLC*, 26 A.3d 180, 198 (Del. July 18, 2011).
[64] *Daniel*, 273 A.3d 792, 814 (Del. Apr. 4, 2022).
[65] *Id*. at 816.

court distinguished between the concepts of irrevocability, duration, and running with the shares.

8 Del. C. § 212(e) provides that a proxy is "irrevocable if it states that it is irrevocable and if, and only as long as, it is coupled with an interest sufficient in law to support an irrevocable power."[66] The court interpreted irrevocability as meaning the grantor cannot revoke the proxy during the term of the proxy. Separately, under DGCL Section 212, the default term for a proxy is three years unless the proxy provides for a longer or shorter period. In this case, the Proxy said the term was as long as permitted by applicable law. This court held that while this provision of the Proxy addressed irrevocability and duration, it was silent on whether the Proxy ran with the Shares.

Termination Provision

Daniel argued two termination circumstances specifically set forth in the Proxy were the only two circumstances under which the Proxy would terminate, and therefore the Proxy must run with the Shares. The court disagreed, noting that this argument again conflated two different concepts: termination and running with the Shares.

The Non-Termination Provision

Next the court analyzed the non-termination provision of the Proxy:

> "The Stockholder agrees that such Irrevocable Proxy is coupled with an interest sufficient in law to support an irrevocable power and shall not be terminated by any act of the Stockholder (other than in connection with the termination provisions of Section 4 hereof), by death or disability of the Stockholder, by lack of appropriate power or authority or by the occurrence of any other event or events other than as provided in Section 4 hereof."[67]

The court noted various arguments advanced by Daniel to the effect that the above language prevented the Stockholder from terminating the Proxy except in accordance with the termination provisions, and thus the Stockholder could not terminate the Proxy through a transfer of the Shares. The court rejected this interpretation, given the lack of any explicit reference to the transfer of shares. The court held that a better interpretation, in light of common law and the context in which the Proxy was granted, would be that the Stockholder could not terminate the Proxy while owning the Shares.

Assignment Provision

The court then analyzed the language regarding assignment of the Proxy:

> "This Irrevocable Proxy and the rights of the Holders under this Irrevocable Proxy may not be assigned, except that (a) any Holder may, with the consent of the remaining Holders, transfer such Holder's rights to any person who is, or is

---

[66] 8 Del. C. § 212(e).
[67] *Daniel*, 273 A.3d 792, 818 (Del. Apr. 4, 2022).

> affiliated with, a limited partner of the Partnership, and (b) the Holders may act pursuant to this Irrevocable Proxy, in voting the Proxy Shares or otherwise, through any duly authorized officer or employee of the Company. This Irrevocable Proxy shall be binding upon and inure to the benefit of Stockholder and the Holders and their respective heirs, devises, legatees, personal representatives, agents and permitted assigns."[68]

The court noted the absence of the word "transferees"[69] from the list of future parties that would be bound by the Proxy. Further, applying the rule of the last antecedent, the court rejected Daniel's argument that "their" in the last sentence must refer to both the Stockholder's and the Holders' "permitted assigns."[70] Lastly, the court noted that "assigns" and "transferees" are not synonymous,[71] with transfer being a broader term encompassing all aspects of ownership of the property at issue. In contrast, assign is generally limited to a narrow set of specified rights. Finding that a subsequent owner of the shares would be a transferee and not an assignee, the court held that the language of the assignment provision in the Proxy did not bind a transferee of the Shares.

Addendum

The court reiterated a point it made several times in its opinion that the fact that MedApproach was made to sign an addendum when it purchased the Shares indicated that the parties believed at that time that the Proxy did not run with the Shares. The court also considered the wording of the addendum, and held that it prohibited transfers by MedApproach to affiliated entities unless they agreed to be bound by the Proxy.

Takeaways

The *Hawkins* decision serves as a guide for drafters of voting proxies. Drafters should be mindful that ambiguities are construed against the grant of authority, and so the language of the proxy needs to be clear and precise as to the parties' intent. If a proxy is intended to bind subsequent owners of the shares, it must state so using "plain and unambiguous language."[72] Language susceptive to differing interpretations, as was present in *Hawkins*, will not suffice. Further, each provision of the proxy should be carefully analyzed to ensure it is consistent with the idea that future holders of the shares take the shares subject to the proxy. One context where this may arise is the use of irrevocable proxies in connection with a drag-along provision. Unless the proxies clearly specify that they run with the shares, the drag-along obligations could be evaded through transferring the shares.

---

68 *Id*. at 823.
69 *Id*. at 824.
70 *Id*. at 825.
71 *Id*. at 824.
72 *Id*. at 795.

Level 4 Yoga, LLC v. CorePower Yoga, LLC, C.A. No. 2020-0249-JRS, 2022 WL 601862 (Del. Ch. Mar. 1, 2022)

Summary

Delaware Chancery Court granted seller's request for specific performance under asset purchase agreement, where the agreement contained no conditions to closing or express rights to terminate, and rejecting arguments to avoid closing based on an implied contractual right to terminate and various common law theories invoking alleged material adverse effect and breach of interim operating covenant.

Background

CorePower Yoga LLC and CorePower Yoga Franchising, LLC (together, CorePower) operate the largest chain of yoga studios in the United States, of which Level 4 Yoga, LLC (Level 4) was its largest franchisee. In April 2019, CorePower was purchased by private equity firm TSG Consumer Partners LLC (TSG). Under a "Call Option Agreement"[73] between CorePower and Level 4, the TSG acquisition was considered a "Control Event,"[74] triggering a call option for CorePower's new owner, TSG, to acquire all of Level 4's studios. In May 2019, following the acquisition, TSG and CorePower exercised the call option. Important to the court's analysis described below, under the Call Option Agreement, Level 4 had negotiated specifically for and obtained a commitment from CorePower that if the call option was ever exercised, it would require the purchase of *all*, and not just some, of Level 4's studios.

Given that TSG would be purchasing 30 studios at once on exercise of the call option, CorePower asked Level 4 for accommodations such as staggered closings and removing certain studios. Level 4 was reluctant to amend the Call Option Agreement but agreed to do so; however, important here, the amended Call Option Agreement (called the Call Option Exercise Agreement)[75] provided for no closing conditions or any express right to terminate. The parties then entered into the Asset Purchase Agreement (APA) as of November 27, 2019,[76] which provided for the acquisition of 34 yoga studios in staggered closings, the first to occur on April 1, 2020 and the last on October 1, 2020.

On March 15, 2020, after onset of the COVID-19 pandemic, CorePower directed that its franchisees' yoga studios close for two weeks. As CorePower was contractually able to regulate Level 4's daily operations under the franchise agreement, Level 4 closed its studios in accordance with this announcement. A few days later, CorePower drew down $36.5 million under a revolving credit facility to account for the closures of its studios and those of its franchisees due to the pandemic, and in doing so, had to certify to its lenders that CorePower had not experienced—and was not reasonably likely to experience—a material adverse effect (MAE).

---

[73] *Id*. at *4.
[74] *Id*. at *5.
[75] *Id*.
[76] *Id*. at *1.

At a March 20, 2020 meeting of CorePower's board of directors, management forecasted that studio closures would likely last six weeks (not the original two weeks) and the board decided to delay the Level 4 acquisition. A TSG representative thereafter reached out to Level 4 claiming that Level 4 was not operating in the ordinary course of business in breach of the APA because of the closure of its studios and proposing that the APA's closing dates be delayed. Level 4 disputed that it had breached the APA and refused to delay closing. A few days later, CorePower reached out to Level 4 again and claimed that Level 4 had "disavowed"[77] certain of the APA's representations and warranties, declaring that CorePower's contractual obligations had been "discharged."[78] The first closing date came and went, and after CorePower refused to proceed, Level 4 brought suit seeking declaratory relief, specific performance, and money damages. In its answer, CorePower sought a declaratory judgment that it was Level 4 who had repudiated the APA and that, therefore, CorePower's performance under the APA was excused. The court held a five-day trial and ruled as follows.

The Court's Decision

No Express or Implied Contractual Right to Terminate

Central to much of the court's decision was its analysis of whether the APA was a "one-way gate"[79] that obligated the parties to close. The court held that it was, given that the APA unambiguously contained no closing conditions and no right to terminate, and further, there were no provisions implying a pre-closing right to terminate. In fact, to the contrary, the court noted that the APA provided CorePower with specific recourse options in the event of a Level 4 breach, including a purchase price adjustment mechanism, post-closing indemnities, and the absence of any sandbagging language that would prevent claims for known breaches.[80] The APA also provided that Level 4's franchise agreement would terminate on "the applicable *Closing Date*" and not upon the applicable "*Closing*."[81] This supported the view that the APA was a "one-way gate"[82] because a failure to close the sale of the applicable studios on the Closing Date would have resulted in the franchise agreement's termination for those studios and led to the absurd result of Level 4 being unable to operate these CorePower-branded studios after CorePower had failed to purchase them.

The court also rejected CorePower's argument that the APA's specific performance provision—which stated that, in addition to specific performance, the parties could pursue "any other remedy to which [they] may be entitled, at law or in equity"[83]—reflected an intent to provide a termination right. The court noted that this provision was in the APA's "Miscellaneous" section and did not contain the word "terminate" or a similar word.[84] Moreover, the court held that even assuming *arguendo* that CorePower's interpretation was correct, CorePower would still not have been able to terminate under the facts at hand given, as the court held elsewhere in its decision, Level 4 had not breached the APA.

---

[77] *Id*. at *17
[78] *Id*. at *2.
[79] *Id*.
[80] *Id*. at *13.
[81] *Id*.
[82] *Id*. at *14.
[83] *Id*. at *7.
[84] *Id*. at *14.

Finally, CorePower claimed that the APA's "materiality scrape" language evidenced a termination right.[85] Specifically, CorePower claimed that "because materiality is not a condition to a post-closing indemnification claim, the parties must have included "materiality" within the representations and warranties for some other purpose—namely, to reflect those representations that, if breached, would justify preclosing Termination of the agreement."[86] The court disagreed, finding that this argument ignored other purposes served by the materiality and MAE provisions, such as defining the scope of what was required to be included on the disclosure schedules and setting forth circumstances under which a party could seek specific performance.

No Common Law Doctrine Excused CorePower's Contractual Performance

CorePower next claimed that it was not required to perform under the APA because Level 4 had repudiated the APA, the APA's purpose had been frustrated, and Level 4 had materially breached the APA.

No Repudiation

The court explained that repudiation can arise through "statements when [a party's] language, reasonably interpreted, indicates that it will not or cannot perform . . . [or] through a voluntary and affirmative act rendering performance apparently or actually impossible."[87] No such words or action existed under the facts in this case.

First, CorePower claimed that Level 4's March 19, 2020 e-mail stating that COVID-19 had resulted in Level 4's "operating mode no longer [being] in the ordinary course of business" evidenced an unconditional intent to repudiate the APA.[88] The court rejected this argument, noting that the e-mail, considered as a whole (as CorePower selectively quoted from it), demonstrated a commitment to close. Further, Level 4 sent an e-mail a few days later to make clear "on [Level 4's] expectations and the terms of the APA," including that Level 4 "[has] and will continue to operate the Business in the ordinary course" and that it was ready to close on the parties' agreed-upon timeline.[89]

Next, CorePower invoked a series of APA provisions to demonstrate that Level 4 repudiated the APA.

- **Material Loss ("no material loss . . . affecting the Business . . . with a value in excess of $50,000).**[90] As to this provision, the court held that while neither side proffered a reasonable argument as to how this provision either did or did not apply, CorePower nonetheless had failed to show any evidence of a material loss as of March 20, 2020, when CorePower's board tried to delay the APA's closing, or as of March 26, 2022, when CorePower invoked its purported termination right in an e-mail to Level 4.

---

85 *Id*.
86 *Id*.
87 *Id.* at *16 (quoting *W. Willow-Bay Court, LLC v. Robino-Bay Court Plaza, LLC*, C.A. No. 2742–VCN, 2009 WL 458779 at *5 (Del. Ch. Feb. 23, 2009)).
88 *Level 4 Yoga, LLC*, C.A. No. 2020-0249-JRS, 2022 WL 601862 at *17 (Del. Ch. Mar. 1, 2022).
89 *Id*.
90 *Id*. at *6.

- **Studio Closures ("not terminated or closed any facility, business or operation").**[91] The court outright rejected CorePower's argument that Level 4 had repudiated the APA pursuant to this provision by closing its studios during the pandemic because it only did so pursuant to CorePower's express direction under the franchise agreement and also as required by governmental order. Repudiation required a "voluntary act,"[92] of which this conduct was not. Further, the court concluded that, based on CorePower's own forecasts, CorePower management expected the closures to last no more than six weeks, which did not indicate "outright refusal and inability to perform".[93]

- **Material Adverse Effect (the "No-MAE Representation").**[94] The court held that the determination of whether an MAE had occurred required showing a material downward deviation in the company's performance, the effect of which would "substantially threaten the overall earnings potential of the target in a durationally-significant manner."[95] Taking aside the parties' "dueling perspectives regarding whether the COVID-19 pandemic significantly impacted the value of Level 4's business," however, the court held it "need not decide who has the better of the evidence on this issue . . . because even if the effect ultimately was significant, *at the time* CorePower purported to invoke the No-MAE Representation, there was absolutely no basis for CorePower to conclude that the business effects of COVID-19 were then, or later would be, significant."[96] (emphasis added). Relevant facts included that CorePower certified to its lenders that it had not suffered an MAE as of March 19, 2020 and that CorePower predicted a closure of studios for only six weeks but at the same time decided to not proceed with the APA's closings. In other words, as of the relevant time, the evidence actually showed that CorePower believed COVID-19 would only be a "short-term hiccup in earnings" and not durationally significant.[97]

- **"Ordinary Course of Business" Requirement.**[98] The court also rejected CorePower's argument that repudiation was demonstrated by Level 4's failure to comply with its covenant to operate in the ordinary course of business. Here, again, Level 4's operation of its studios was dictated by CorePower under the franchise agreement, which Level 4 historically complied with. Level 4's closure of its studios was thus at CorePower's express direction. Further, CorePower had laid off ninety-eight percent of its own employees and provided its franchisees with a script to follow for laying off their own employees. The court thus held that "while the layoffs may have been extraordinary, the practice of following the direction of the franchisor was entirely ordinary and consistent with past practice."[99]

---

91 *Id*.
92 *Id*. at *20. (quoting *W. Willow-Bay Court, LLC v. Robino-Bay Court Plaza, LLC*, C.A. No. 2742–VCN, 2009 WL 458779 at *5 (Del. Ch. Feb. 23, 2009)).
93 *Level 4 Yoga, LLC*, C.A. No. 2020-0249-JRS, 2022 WL 601862 at *17 (Del. Ch. Mar. 1, 2022) (citing *PAMI-LEMB I Inc. v. EMB-NHC, L.L.C.*, 857 A.2d 998, 1014 (Del. June 21, 2004)).
94 *Level 4 Yoga, LLC*, C.A. No. 2020-0249-JRS, 2022 WL 601862 at *20 (Del. Ch. Mar. 1, 2022).
95 *Id.* at *21 (quoting *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 68 (Del. June 18, 2001)).
96 *Level 4 Yoga, LLC*, C.A. No. 2020-0249-JRS, 2022 WL 601862 at *21 (Del. Ch. Mar. 1, 2022).
97 *Id.* at *23 (quoting *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 68 (Del. June 18, 2001)).
98 *Level 4 Yoga, LLC*, C.A. No. 2020-0249-JRS, 2022 WL 601862 at *23 (Del. Ch. Mar. 1, 2022).
99 *Id*. at *25.

No Frustration of Purpose

As to frustration of purposes, the court explained that doctrine is difficult to invoke, Delaware courts are reluctant to use it, and it requires a showing that: "(1) there is substantial frustration of the principal purpose of the contract; (2) the parties assumed that the frustrating event would not occur; and (3) the [d]efendant is not at fault."[100] Here, the court found that as Level 4 had not repudiated the contract nor materially breached the APA, there could be no frustration of purpose. Further, CorePower could not claim frustration of purpose where it was CorePower who had directed Level 4 to take the actions on which CorePower based its frustration of purpose defense.

No Material Breach

As to CorePower's material breach arguments, the court found these to be ever-evolving and raised in the midst of litigation. To show material breach, CorePower must show that the breach "goes to the root or essence of the agreement between the parties, or touches the fundamental purpose of the contract and defeats the object of the parties in entering into the contract."[101] Here, many of the claimed material breaches overlapped with the court's decisions on repudiation and frustration of purpose. In broad overview, the acts complained of either did not show a loss as of the time CorePower terminated the APA or they were not substantial nor touched the fundamental purpose of the APA such that the purpose could be said to have been defeated.

Specific Performance and Money Damages

The court held that Level 4 was entitled to specific performance because the APA was a valid contract providing for specific performance in the event of breach, the court found it was CorePower that was the breaching party, and finally, the balance of the equities favored Level 4.[102]

As for money damages, the court credited Level 4's expert witness that the amount of the purchase price, pursuant to the APA's methodology was $26,366,159. The court also held CorePower responsible for any losses incurred by the studios after the applicable closing dates and for pre-judgment interest on all amounts and losses.

Takeaways

Given Delaware courts' "pro-contractarian stance," the court's refusal to find an implied contractual right to avoid a closing in the absence of an express provision or other conditions to closing is not surprising. In particular, the Level 4 court accepted Level 4's view that the parties

---

[100] *Id*. at *26 (quoting *CRS Proppants LLC v. Preferred Resin Hldg. Co., LLC*, C.A. No. N15C–08–111 MMJ CCLD, 2016 WL 6094167 at *7 (Del. Super. Sept. 27, 2016)).

[101] *Level 4 Yoga, LLC*, C.A. No. 2020-0249-JRS, 2022 WL 601862 at *27 (Del. Ch. Mar. 1, 2022) (quoting *Mrs. Fields Brand, Inc. v. Interbake Foods, LLC*, C.A. No. 12201–CB, 2017 WL 2729860 at *28 (Del. Ch. June 26, 2017)).

[102] *Level 4 Yoga, LLC*, C.A. No. 2020-0249-JRS, 2022 WL 601862 at *30 (Del. Ch. Mar. 1, 2022) (citing *Simon Mills II, LLC v. Kan.Am. USA XVI Ltd. P'ship,* C.A. No. 8520–VCG, 2017 WL 1191061 at *32 (Del. Ch. Mar. 30, 2017)).

intentionally omitted closing conditions and termination rights because they intended the APA to serve as a "one-way gate."[103] One important point to note is that the Level 4 court did not look at the APA in a vacuum, and closely considered the parties' negotiating history leading up to the contract at issue.

The court's decision also shows that buyers typically face an uphill battle when seeking to escape contractual obligations based on common law theories of repudiation, frustration of purpose, and material breach—particularly where the buyer's allegations are based on conduct that it instructed of the seller and also where the parties are in a franchisor-franchisee relationship that permits the franchisor to direct the conduct of the franchisee.[104]

Another interesting note is that regarding the MAE provision, CorePower's own actions contributed to the impression that any claimed adverse changes to Level 4's business were immaterial. As is fairly common for private equity portfolio companies in a significant downturn, CorePower drew down on its credit facility. In order to do that, it had to represent that it had not experienced, and was not reasonably likely to experience, an MAE. Given that it was in the same business as Level 4, this was evidence that the yoga studio business generally was not experiencing an MAE. A second fact that was problematic for CorePower was that on March 20, 2020, CorePower's management team forecast in a board presentation that the yoga studio closures would last only six weeks, and as the court noted, this showed that CorePower expected the disruption to be minimal overall.

Accordingly, a takeaway for acquirors is that there is no substitute for clear contractual closing conditions and termination rights. Acquirors should also be conscious of actions that they take with respect to their own businesses and how that may impact the analysis of whether or not the target has materially breached the purchase agreement or suffered a material adverse effect. For targets, this is another case demonstrating the benefit of specific performance clauses.

***AB Stable VIII LLC v. Maps Hotels and Resorts One LLC,* C.A. No. 2020-0310-JTL, 2020 WL 7024929 (Del Ch. Nov. 30, 2020)** (AB Stable I)**, aff'd, 268 A.3d 198 (Del. Supr. Dec. 8, 2021)** (AB Stable II)

Summary

The Supreme Court of Delaware affirmed the Court of Chancery's opinion below holding that whether or not seller's business was conducted in the ordinary course consistent with past practice during the executory period of an acquisition agreement depended on whether there had been a change in the routine operations of seller's business under normal circumstances,

---

103 *Level 4 Yoga, LLC*, C.A. No. 2020-0249-JRS, 2022 WL 601862 at *1 (Del. Ch. Mar. 1, 2022).

104 This differentiated the case from *AB Stable VIII LLC v. Maps Hotels and Resorts One LLC*, C.A. No. 2020-0310-JTL, 2020 WL 7024929 (Del Ch. Nov. 30, 2020) (*AB Stable I*), aff'd, 268 A.3d 198 (Del. Supr. Dec. 8, 2021), where Vice Chancellor Laster held that whether or not there was a violation of the interim operating covenants was evaluated relative to routine operations, and not whether actions taken were in response to outside factors such as a pandemic. In *Level 4*, in contrast, the court acknowledged that Level 4's actions were a significant departure from routine operations, but the court instead evaluated them in terms of whether they were consistent with Level 4's ordinary course compliance with the franchise agreement.

regardless of whether such changes were reasonable responses to the COVID-19 pandemic and consistent with the actions of others in the same industry.

Background

AB Stable VIII LLC (Seller) and MAPS Hotels and Resorts One LLC (Buyer) entered into a Purchase and Sale Agreement (Agreement) on September 10, 2019, pursuant to which Buyer agreed to acquire all of the membership interests in Strategic Hotels & Resorts LLC (Strategic). Strategic owned 15 limited liability companies, each of which owned a luxury hotel. On the scheduled closing date, Buyer notified Seller that a number of Seller's representations and warranties were inaccurate and that Seller had failed to comply with its covenant to operate its business only in the ordinary course, consistent with past practice in all material respects. Specifically, Buyer argued that Seller's temporary closure of two of its hotels in response to low demand and governmental orders due to COVID-19 and reduced operations in other hotels in response to the pandemic deviated from the ordinary course of business. As a result, Buyer told Seller that it was not obligated to close, prompting Seller to file a lawsuit in the Delaware Court of Chancery seeking an order of specific performance requiring Buyer to close.

The Court of Chancery issued a post-trial decision ruling that Buyer was excused from closing because Buyer showed that Seller's response to the COVID-19 pandemic materially breached the ordinary course covenant. Specifically, the covenant required that "unless the Buyer shall otherwise provide its prior written consent (which consent shall not be unreasonably withheld, conditioned or delayed), the business of the Company and its Subsidiaries [are to be] conducted only in the ordinary course of the business consistent with past practice in all material respects. . ."[105] Focusing on the words "only" and "consistent with past practice,"[106] the Court of Chancery interpreted the covenant to require a comparison of the post-pandemic changes in operations to the pre-pandemic day-to-day operations. Seller appealed to the Supreme Court of Delaware.

The Court's Decision

The Ordinary Course Covenant

The Supreme Court of Delaware affirmed the Court of Chancery's judgment, finding that the court correctly concluded Seller's changes to its hotel operations in response to COVID-19 without obtaining Buyer's consent, breached the ordinary course covenant, and excused Buyer from closing. The Supreme Court cited Black's Law Dictionary as defining "ordinary" in conjunction with the phrase "course of business" to be "[t]he normal routine in managing a trade or business" as the proper standard in determining the case. The Supreme Court also noted that Delaware courts have interpreted "ordinary course" as "[t]he normal and ordinary routine of conducting business."[107] Deferring to the Court of Chancery's factual findings, the Supreme Court found that there was a "fully-supported" factual finding that Seller had materially deviated from its routine business operations.[108]

105 *Id.* at *65.
106 *Id*.
107 *AB Stable II*, 268 A.3d 198, 210 (Del. Supr. Dec. 8, 2021) (citing Course of Business, Black's Law Dictionary (11th ed. 2019)).
108 *Id*. at 215.

The Supreme Court acknowledged that Seller's response to the pandemic was reasonable and consistent with industry-wide practices. However, the Supreme Court found that the ordinary course provision required Seller to operate in the ordinary course of its own business, and "the parties did not choose the actions of industry participants as the yardstick to measure the Seller's actions."[109] The Supreme Court also noted that the covenant was absolute and did not contain a "reasonableness qualifier" and that comparing Seller's actions in response to COVID-19 to other hotels would be more analogous to a commercially reasonable efforts provision.[110] The Agreement contained such provisions elsewhere, but not with respect to the ordinary course covenant. The Supreme Court also noted that Seller should have sought consent from Buyer before making its changes, and if consent was "unreasonably" withheld, Seller could have challenged such denial.[111]

Interplay With Material Adverse Effect Provision

The Supreme Court also rejected Seller's argument that the MAE provision in the Agreement allocated pandemic risk to Buyer, and thus business changes in response to the pandemic could not violate the ordinary course covenant. Firstly, the parties did not restrict a breach of the ordinary course covenant to events that would otherwise qualify as an MAE. The Supreme Court noted that the parties were sophisticated enough to have done so as evidenced by MAE qualifiers in other provisions of the Agreement. Second, the parties chose different materiality standards for the ordinary course covenant and the MAE provision. According to the court, the MAE standard is a much higher standard than the "materiality" standing in the ordinary course covenant, demonstrating that the provisions were to operate independently of one another.[112] The Supreme Court also held that the MAE provision and the ordinary course covenant served different purposes—namely that an ordinary course covenant is to "reassure the Buyer that the target company has not materially changed its business or business practices"[113] during the interim, while an MAE provision "allocates the risk of changes in the target company's valuation."[114] The Supreme Court noted that buyers want to know that the business being acquired is both operating the same between signing and closing and that its valuation is being preserved, and these are two distinct concerns. In response to Seller's argument that the ordinary course covenant should not be interpreted to require it to run the business into the ground prior to closing, the Supreme Court noted that the Agreement simply required Seller to seek Buyer consent before making operating changes, and Buyer's consent could not be unreasonably denied.

Takeaways

After the lower court's decision in 2020, practitioners quickly changed market practice and started carving out pandemic-related responses from interim operating covenants. Given the Supreme Court's affirmation of the decision, that practice is here to stay. The covenant at issue in AB Stable was phrased as obligating Seller to continue to operate the business in the

---

109 *Id*. at 212
110 *Id.*
111 *Id*. at 215.
112 *Id*. at 218.
113 *Id.* at 216 (citing *Anschutz Corp. v. Brown Robin Capital, LLC*, C.A. No. 2019-0710-JRS, 2020 WL 3096744 at *11 (Del. Ch. June 11, 2020)).
114 *Id.* at 216-7.

ordinary course “consistent with part practice” in all material respects.[115] If the covenant had not contained the words “consistent with past practice,”[116] the decision would likely have come out differently. Buyers should note the importance of including that language in interim operating covenants.

AB Stable stands in contrast to Level 4 Yoga, also summarized in this Advisory, where the court held that significant pandemic responses did not violate a covenant to operate in the ordinary course of business consistent with past practice. But that case can be viewed as turning on its specific facts. There, the yoga studio business was operated under a franchise agreement, and the pandemic-related changes were taken at the direction of the franchisor. The Level 4 Yoga court held that the interim operating covenant was not breached because “the practice of following the direction of the franchisor was entirely ordinary and consistent with past practice.”[117] Instead of undermining AB Stable, Level 4 Yoga can therefore be seen as a cautionary note to buyers that they should consider whether the specific business context creates gaps in the interim operating covenant that need addressing.

Sorenson Impact Found. v. Continental Stock Transfer & Trust Co., C.A. No. 2021-0413-SG, 2022 WL 986322 (Del. Ch. Apr. 1, 2022)

Summary

After hackers successfully diverted merger consideration due to certain target company stockholders, the Delaware Chancery Court, in denying a motion to dismiss breach of contract claims, found it was reasonably conceivable that the merger agreement required the buyer to ensure final payment reached the target company stockholders despite no explicit language to that effect in the merger agreement.

Background

Sorenson involved the diversion of merger consideration by third-party hackers, non-party to the case (the Hackers). The Hackers intercepted the email communications of legal counsel (H&K),[118] which represented one of the parties in the acquisition of Graduation Alliance, Inc. (Graduation Alliance) by Tassel Parent, Inc. (Tassel) in a reverse triangular merger (the Merger). In connection with the Merger, Tassel engaged Continental Stock Transfer & Trust Company (CST) to distribute the Merger consideration delivered by Tassel to Graduation Alliance’s stockholders pursuant to a paying agent agreement (the PAA). The merger agreement (the Merger Agreement) required Graduation Alliance’s stockholders to surrender their existing stock certificates to CST, along with an executed letter of transmittal (LOT), in order to receive their portion of the Merger consideration.

---

115 *AB Stable II*, 268 A.3d 198, 208 (Del. Supr. Dec. 8, 2021)
116 *Id*.
117 *Level 4 Yoga, LLC v. CorePower Yoga*, *LLC*, C.A. No. 2020-0249-JRS, 2022 WL 601862 at *25 (Del. Ch. Mar. 1, 2022).
118 The entity the law firm represented was a disputed issue. *Id.* at *1 n.4. It seems most likely that it represented Graduation Alliance pre-merger, given that another firm represented Tassel. *See id.* at *3 n.20.

Former stockholders of Graduation Alliance, Sorenson Impact Foundation and James Lee Sorenson Family Foundation (together, the Sorenson Entities), surrendered their Graduation Alliance securities[119] and submitted their copies of the LOT, which included wire instructions directing payment to a bank in Utah. The Hackers intercepted the Sorenson Entities' email communications with H&K. Posing as the Sorenson Entities, the Hackers asked that payment of the Merger consideration instead be made to an international account in Hong Kong. About a week later, the Hackers emailed a revised LOT, stock certificates, and an authorization letter fraudulently providing that payment instead be made to the Hong Kong bank account in the name of Hongkong Wemakos Furniture Trading Co. Limited.

The LOT instructions provided that if payment was to be made to a name other than that appearing on the applicable certificate, such certificate would require a medallion signature guarantee[120] by a qualified guarantor. CST informed H&K of the need for a medallion signature guarantee and then, after further discussion, provided three options: (i) provide the medallion signature guarantee, (ii) provide CST with a letter of instruction from the Sorenson Entities including hold harmless language for the benefit of CST, or (iii) change the name to Hongkong Wemakos Furniture Trading Co. Limited on the payment schedule required to be delivered by Tassel to CST under the PAA.[121] H&K chose the last option, allegedly in a rush to finalize documentation necessary to meet the closing date under the Merger Agreement. In connection with closing and in compliance with the explicit requirements of the Merger Agreement, Tassel paid the Merger consideration to CST, which in turn wired the consideration due to the Sorenson Entities to the account designated by the Hackers.[122]

Never having received any of the Merger consideration, the Sorenson Entities brought suit against Graduation Alliance, Tassel, and CST for various claims, including breach of contract, unjust enrichment, negligence, and breach of fiduciary duty. CST moved to dismiss for lack of personal jurisdiction.[123] Graduation Alliance and Tassel moved to dismiss for failure to state a claim and failure to join H&K as a necessary and indispensable party. CST's motion was granted, while Graduation Alliance and Tassel's motion was denied in part and continued in part.

---

[119] Sorenson Impact Foundation also held an outstanding convertible note issued by Graduation Alliance and the court assumed, without deciding, that the process for receiving consideration for such note did not change the outcome. *Id.* at *2, *3 n.22, *4.

[120] A medallion signature guarantee certifies the signature as genuine and the signer's legal capacity and authority to sign. *Id.* at *3.

[121] This appears to have been Schedule A to the PAA, which was different from the consideration schedule under the Merger Agreement. *See id.* at *4 n.34.

[122] CST appears to have first raised the need for a medallion signature guarantee on February 21, 2020, and funds were wired to the Hackers on February 25th, so the Merger presumably closed between those two dates. *See id.* at *5.

[123] CST also moved to dismiss for failure to state a claim, but the court did not rule on such motion since CST's motion to dismiss for lack of personal jurisdiction was granted. *Id.* at *10. The court noted that it made no finding as to whether CST had any contractual duties arising from the Merger Agreement, PAA or the LOT, including any fiduciary duties as paying agent. *Id.* at *6 n.72.

The Court's Decision

No Personal Jurisdiction Over CST

The court granted CST's motion to dismiss for lack of personal jurisdiction. The Sorenson Entities asserted that CST was contractually bound by the Delaware forum selection clauses in the Merger Agreement and LOT, even though it was not a signatory to either, because the PAA attached the LOT as an exhibit and the LOT attached the Merger Agreement as an exhibit. The court rejected these arguments because (i) CST was not a party to the Merger Agreement or LOT, (ii) the PAA did not contain an "explicit manifestation of intent" to incorporate by reference the Delaware forum selection clauses, (iii) the PAA contained a provision expressly denying that CST was bound by any provisions of the Merger Agreement, and (iv) the LOT did not constitute a contract.[124] While not dispositive, the court also noted that CST, a New York domiciliary, bargained for the application of New York law to the PAA without submitting to Delaware jurisdiction.

The court also rejected the argument of the Sorenson Entities that Delaware's long-arm statute provided for jurisdiction over CST, holding that CST did not have sufficient minimum contacts with Delaware for exercise of personal jurisdiction to be appropriate. CST submitted evidence that every action taken by CST in connection with the Merger occurred in New York, and CST otherwise did not have any business or activities in Delaware.

Tassel May Be Contractually Liable for Not Ensuring Payment to the Sorenson Entities

The court declined to dismiss the Sorenson Entities' breach of contract claims against Tassel, in light of Delaware's liberal "notice" pleading standard. The court held that the Merger Agreement imposed duties on Tassel and it was reasonably conceivable (the standard for a motion to dismiss) that it provided third party beneficiary rights to the Sorenson Entities. The court noted that Tassel had complied with its obligation under the Merger Agreement to pay the Merger consideration to CST, but based on a holistic reading, it was reasonably conceivable that the Merger Agreement imposed on Tassel an obligation "to do more than make a payment to its agent [CST]," and to ensure that payment was made to the security holders.[125] The court held that on a review of the entire complaint, the complaint gave Tassel sufficient notice that it was being sued for breach of this obligation.

No Vicarious Liability for Breach of Contract by Tassel's Agents

The court dismissed the Sorenson Entities' claim against Tassel for breach of the LOT by its alleged agents, CST and H&K.[126] The court noted that, although a principal may be vicariously

[124] The court referenced *Cigna Health & Life Ins. Co. v. Audax Health Sols., Inc.*, 107 A.3d 1082, 1088–91 (Del. Ch. Nov. 26, 2014), which determined that a letter of transmittal lacked consideration necessary to create an enforceable contract, and *Roam-Tel Partners v. AT&T Mobility Wireless Operations Holdings Inc.*, C.A. No. 9405-VCP, 2010 WL 5276991, at *6 (Del. Ch. Dec. 17, 2010), which found in the context of appraisal, that there was no consideration for a stockholder's "alleged promise to accept the merger consideration," and therefore no valid contract was formed. *Id.* at *7 n.79.

[125] *Id.* at *12.

[126] The court also dismissed the Sorenson Entities' claims against Tassel for breach of the PAA by its alleged agents, despite such claims not being explicitly set forth in the Complaint and the Sorenson Entities having only attempted

liable for torts committed by its agent, vicarious liability does not extend to breach of contract or other non-tortious conduct. While the Sorenson Entities pleaded that CST was negligent, the court noted that they did not allege that Tassel was vicariously liable for such negligence. This implies that, had the Sorenson Entities made such an allegation, a vicarious liability claim could have survived the motion to dismiss.

Other Claims

The Sorenson Entities pleaded unjust enrichment claims against each of Tassel and Graduation Alliance.[127] Unjust enrichment occurs where there is "(1) an enrichment, (2) an impoverishment, (3) a relation between the enrichment and impoverishment, (4) the absence of justification, and (5) the absence of a remedy provided by law."[128] The court, without discussion, noted that it was difficult to see how the Company "can have liability apart from breach of contract."[129] However, the court, "mindful of the alternative nature of the claims," indicated that it was "bow[ing] under the weight of precedent" and declined to dismiss the unjust enrichment claims "at this time" leaving them for "consideration on a record."[130]

The court delayed ruling on the motion of Tassel and Graduation Alliance to dismiss for failure to join H&K, as a necessary party, pending supplemental briefing regarding the absence of CST as a party.

Takeaways

Given the prevalence of cybercrimes, it was only a matter of time before a case like this was filed in Delaware. The decision serves as a timely caution to deal practitioners that they need to be vigilant to the risk of cyber criminals infiltrating the deal process and appropriating deal proceeds.

There is also a lesson here for buyers. What appears to have happened is that sell-side counsel was duped into changing the wiring instructions in the payment schedule that was attached to the paying agent agreement. That schedule is typically consistent with the payout schedule delivered by sellers to buyers prior to closing, although the former includes wiring information and the latter often does not. The latter often also forms the basis of a line item indemnity in the acquisition agreement (frequently capped at the purchase price). Buyers should expand the line item indemnity to also include all information delivered in the payment schedule to the paying agent. That would not protect against all incidences of theft of deal consideration, and obviously indemnities are not the answer in no-recourse deals. But had that been done here, Tassel could

---

to allege in briefing and argument that Tassel's agents breached contractual provisions other than those in the LOT, including provisions in the PAA. *Id.* at *11.

127 The unjust enrichment claim against Tassel was pled in the alternative to the breach of contract claim against Tassel. *Id.* at *13.

128 *Id.* at *13 (citing *Nemec v. Shrader*, 991 A.2d 1120, 1130 (Del. Apr. 6, 2010)).

129 *Id.*

130 *Id.* (citing *Lockton v. Rogers*, C.A. No. 2021-0058-SG, 2022 WL 604011, at *16–17 (Del. Ch. Mar. 1, 2022), a recent decision of the court, which held that the "absence of justification" element for unjust enrichment may be satisfied by other claims brought by plaintiffs and declined to dismiss an unjust enrichment claim "entirely coterminous" with other claims brought by plaintiffs).

have been entitled to indemnification for any losses ultimately owed to the Sorenson Entities, in addition to the costs in defending the legal proceeding.

Buyers could also insert language into the Merger Agreement providing that Buyer is entitled to rely on the information in the payment schedule attached to the paying agent agreement and neither Buyer nor any of its agents or representatives (including the paying agent) shall have any liability to any securityholder or other person for any deal consideration paid in accordance with that payment schedule. While the language could be challenged (e.g., as potentially not binding on securityholders), it would nonetheless provide another useful line of defense.

First Solar, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, 274 A.3d 1006 (Del. Mar. 16, 2022)

Summary

Delaware Supreme Court held that an insurance claim arising out of an opt-out from a securities class action, though not identical in form or substance to the securities class action, was "related" to the insurance claim submitted for the securities class action.[131] *As a result, the insurance claim for the opt-out action was deemed first made at the time of the insurance claim submitted for the securities class action—not under a subsequent directors-and-officers (D&O) policy for the policy period when the opt-out complaint was filed.*

Background

First Solar, Inc. (First Solar), an American solar technology company that manufacturers solar panels and installs photovoltaic power plants globally, sought insurance coverage for two securities lawsuits filed by its stockholders. In each lawsuit, stockholders alleged that First Solar violated federal securities laws by making false misrepresentations about the cost-per-watt of its solar power and its ability to achieve "grid parity"[132]—the ability to produce solar electricity at costs comparable to conventional energy production.

In March 2012, First Solar stockholders filed a class action (*Smilovits*), alleging, among other things, that First Solar made false or misleading public disclosures about its solar power manufacturing costs. First Solar submitted an insurance claim for *Smilovits*, and its primary D&O insurer provided coverage under the then-in-force 2011-2012 policy.

In June 2015, while *Smilovits* was still pending, certain First Solar stockholders opted out of the *Smilovits* action and filed their own securities action alleging violations of the same federal securities laws. The opt-outs went further, however, also alleging violations of state securities statutes and common law and arguing that other statements First Solar made were false and misleading.

[131] *Id*. at 1007.
[132] *Id*. at 1011.

First Solar again sought insurance coverage, this time seeking coverage for the opt-out action under its then-in-force 2014-2015 D&O policy. However, the 2014-2015 policy included a "Related Claims" provision for "a Claim alleging, arising out of, based upon or attributable to any facts or Wrongful Acts that are the same as or related to those that were . . . alleged in a Claim made against Insured."[133] Under the 2014-2015 policy's plain language, a Related Claim relates back to any earlier-reported, related claims such that "Claims actually first made or deemed first made prior to the inception date of the policy . . . are not covered under the policy."[134]

First Solar's primary and excess D&O insurers applied the 2014-2015 policy language and determined that, because the follow-on opt-out action was "related" to the earlier *Smilovits* action, it was a "Related Claim" under the 2014-2015 policy and was covered only under the 2011-2012 policy.[135] Because First Solar had exhausted the full coverage limits under the 2011-2012 policy, however, it did not receive any additional policy benefits to cover the related opt out action.

First Solar initiated coverage litigation and argued that, under Delaware law, the follow-on opt out action was not sufficiently related to the *Smilovits* action, and thus, the Related Claims provision did not apply. The Delaware Superior Court granted the insurers' motion to dismiss, but did not definitively resolve the applicable standard for determining relatedness under Delaware law. First Solar subsequently appealed the Superior Court's decision to the Delaware Supreme Court.

The Court's Decision

The Delaware Supreme Court affirmed the Superior Court's judgment in favor of the insurers. In so holding, the court clarified the current state of the law in Delaware regarding "claim relatedness" under D&O policies.[136]

First, the Delaware Supreme Court reaffirmed that a D&O policy's plain language governs the relatedness inquiry. As the court explained, several lower court opinions erroneously applied a "fundamentally identical" standard to determine relatedness, notwithstanding the plain language of the policy at issue.[137] The Delaware Supreme Court rejected the "fundamentally identical" standard once and for all, clarifying that "[w]hether a claim relates back to an earlier claim is decided by the language of the policy, not a generic 'fundamentally identical' standard."[138]

Second, the *First Solar* opinion provides insight into how Delaware courts may resolve relatedness questions moving forward. The court compared the *Smilovits* and opt-out complaints and analyzed the similarities between the two cases (including the named defendants, time period, overall case theory, an illustrative sampling of relevant statements, and each class's claimed damages). Based on this analysis, the court concluded that *Smilovits* and the opt-out action were related because they each focused on First Solar's misrepresentations about the cost of solar power.

---

133 *Id*. at 1008-9.
134 *Id*. at 1009.
135 *Id*.
136 *Id.*
137 *Id*. at 1007.
138 *Id*. at 1013.

Lastly, the court explained that the proper inquiry is whether the claims allege the same or different "Wrongful Acts" under the policy.[139] In other words, even if the underlying class plaintiffs rely on different misrepresentations or evidence to support their claims, the claims are related so long as they allege, arise out of, are based upon, or are attributable to the same "Wrongful Acts."[140] The same analysis is true for claims that allege different damages: claims are related when "the thrust of the Wrongful Acts alleged . . . is the same . . . regardless of how damages are claimed."[141]

Takeaways

After nearly a decade of uncertainty, the Delaware Supreme Court's *First Solar* opinion clarifies the "claim relatedness" landscape: the insurance policy's language—not an extracontractual "fundamentally identical" standard—governs the coverage analysis.[142] As a result, claim relatedness is a case-by-case inquiry that interprets and applies policy language. And more generally, *First Solar* serves as an important reminder: while D&O insurance policies are generally "claims made" policies that respond to claims made during their policy periods,[143] "Related Claim" provisions may operate to relate a claim to an earlier submitted claim—and thus place coverage for that later claim under an earlier insurance policy that responded to a previous, related claim.[144] That earlier policy, in turn, may be exhausted or have other provisions that could limit coverage.

***Stillwater Mining Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA,* C.A. No. 24, 2022, 2023 WL 165968 (Del. Supr. Jan. 12, 2023)** (Stillwater)

Summary

Stillwater *was a D&O coverage dispute that arose from an appraisal action related to a merger. While* Stillwater *was pending in Delaware Superior Court, the Delaware Supreme Court held in an unrelated case that Delaware appraisal actions do not trigger "Securities Claim" coverage—foreclosing the policy interpretation Stillwater sought.*[145] *Stillwater then (1) asked the Superior Court to dismiss its case to allow it to pursue recovery in Montana State Court, which the Superior Court denied, and (2) argued that Montana law should apply, which the Superior Court rejected. Stillwater appealed, but the Delaware Supreme Court affirmed the Superior Court and held that Delaware law applied and that Stillwater's complaint should be dismissed.*

---

139 *Id*. at 1013.
140 *Id*. at 1013.
141 *Id*. at 1017.
142 *Id*. at 1007.
143 *Id*. at 1008.
144 *Id*. at 1008-9.
145 *Id*. at *2.

Background

In 2017, Stillwater Mining Company (Stillwater)—then a publicly traded, Delaware-incorporated mining company with a principal place of business in Montana—was acquired by and merged into a South African mining company, becoming a wholly owned subsidiary. When the merger closed, certain shareholders sued in Delaware Chancery Court seeking an appraisal of the value of their shares. After trial, the Chancery Court declined to order an adjustment to the deal price (a decision ultimately affirmed by the Supreme Court in October 2020). Nevertheless, Stillwater incurred about $20 million in defense costs, plus statutory interest.

Stillwater sought coverage from its D&O carriers for its expenditures related to the appraisal action. The insurers declined coverage on the ground that an appraisal action does not allege a "violation" of any law and thus could not fall under the policy definition of a "Securities Claim." At the time Stillwater's coverage suit was initially brought, however, the Delaware Superior Court had recently held in *Solera Holdings, Inc. v. XL Specialty Ins. Co.* (*Solera I*), 213 A.3d 1249 (Del. July 31, 2019) that an appraisal action does involve an alleged "violation" of law and therefore can qualify as a Securities Claim.[146] Presumably to take advantage of *Solera I*, in its initial complaint and an early dispositive motion Stillwater argued that Delaware law should apply. While Stillwater's case was pending in the trial court, however, the Delaware Supreme Court issued its decision in *In re Solera Insurance Coverage Appeals* (*Solera II*), 240 A.3d 1121 (Del. Oct. 23, 2020), reversing *Solera I* and holding that an appraisal action does ***not*** involve a "violation" of law.[147]

After *Solera II*, Stillwater moved to voluntarily dismiss its Delaware Superior Court case so it could pursue a suit in Montana State Court instead. The trial court denied this motion. The insurers then moved to dismiss on the ground that Stillwater's complaint did not state a claim under Delaware law in light of *Solera II*. Stillwater responded that, in fact, Montana law should apply to the coverage dispute. The Superior Court sided with the insurers, finding Delaware law applicable and dismissing Stillwater's complaint. Stillwater appealed to the Supreme Court.

The Court's Decision

On appeal, the Delaware Supreme Court affirmed the Superior Court's application of Delaware law and dismissal of Stillwater's complaint. Relying on its earlier decision in *Certain Underwriters at Lloyds, London v. Chemtura Corp.*, 160 A.3d 457 (Del. Mar. 23, 2017), the court applied its three-part test for choice-of-law questions.[148] First, it determined (non-controversially) that there was no choice-of-law provision in the relevant insurance policies. Second, the court held that Stillwater had plausibly identified a conflict between Montana law, which recognizes the policyholder-friendly "coverage by estoppel" theory, and Delaware law, which does not.[149] This left the third, and more intensive, step of assessing which state had the "most significant relationship to the contract and the parties to the contract using the considerations in the *Restatement (Second) of Conflict of Laws*."[150]

---

[146] *Solera I*, 213 A.3d 1249, 1254 (Del. July 31, 2019).
[147] *Solera II*, 240 A.3d 1121, 1123 (Del. Oct. 23, 2020).
[148] *Certain Underwriters at Lloyds, London v. Chemtura Corp.*, 160 A.3d 457 (Del. Mar. 23, 2017).
[149] *Stillwater*, C.A. No. 24, 2022, 2023 WL 165968 at *6 (Del. Supr. Jan. 12, 2023).
[150] *Id.* (citing *Certain Underwriters at Lloyds, London v. Chemtura Corp.*, 160 A.3d 457, 463 (Del. Mar. 23, 2017)).

To determine the state with the most significant relationship, the court began with section 193 of the *Restatement*, which provides a presumption for insurance cases in favor of the law of the state where the "insured risk" is located.[151] Under the Delaware Supreme Court's recent decision in *RSUI Indemnity Co. v. Murdock*, 248 A.3d 887 (Del. Mar. 3, 2021), however, that presumption is "not conclusive" as to D&O policies that "are part of a comprehensive program insuring risks that are not confined to a single jurisdiction."[152] Accordingly, the court turned to the choice-of-law factors identified in section 188 of the *Restatement*, as well as the "overarching choice-of-law considerations" in section 6 of the *Restatement*.[153] The court applied those factors and considerations to a D&O policy in *Murdock* and concluded that the state of incorporation (often, Delaware) has "strong interests at stake for D&O policies."[154] While Stillwater attempted to distinguish *Murdock*, the court rejected Stillwater's arguments, which emphasized the location of Stillwater's headquarters in Montana, the fact that the policies had been procured there, and the fact that the policies contained certain Montana amendatory endorsements. Those factors, the court found, were insufficient to tip the balance toward Montana and away from Delaware.

The court also rejected Stillwater's "main argument" that Delaware's interest is lessened in a case based on "claims handling" rather than "policy coverage."[155] First, the court disagreed that the case mainly related to claims handling rather than the meaning of the parties' insurance contract. Second, the court held that the Montana legislature intended Montana claims-handling rules to apply only if performance of the contract occurred in Montana, but here, the policy could be performed anywhere in the world—including Delaware, where the underlying appraisal action was litigated.

It bears mentioning that, in addition to its doctrinal choice-of-law analysis, the court also expressed "discomfort" and "concern" with "how Stillwater's claims and positions have shifted over time."[156] When "*Solera I* improved its chances of success," "Stillwater was more than content to apply Delaware law," but after *Solera II*, "Stillwater disavowed Delaware law and argued that Montana law should apply."[157] While the court did not rely on Stillwater's change of position in its doctrinal analysis, the court nevertheless viewed it as framing its analysis.

For all these reasons, the court affirmed the dismissal of Stillwater's complaint. The court also affirmed the denial of Stillwater's motion for voluntary dismissal, as well as a belated motion it had filed to stay the Delaware coverage action in deference to the Montana action.

Takeaways

Stillwater confirms the Delaware courts' view that Delaware law generally governs the interpretation of D&O policies for Delaware-incorporated entities. That said, the Delaware Supreme Court in *Stillwater* carefully considered the specific facts of the particular dispute at issue, potentially leaving room for the application of non-Delaware law in some cases.

---

151 Restatement (Second) of Conflict of Laws § 193 (Am. L. Inst. 1971).
152 *RSUI Indemnity Co. v. Murdock*, 248 A.3d 887 (Del. Mar. 3, 2021); *Stillwater*, C.A. No. 24, 2022, 2023 WL 165968 at *7 (Del. Supr. Jan. 12, 2023).
153 Restatement (Second) of Conflict of Laws § 6, § 188 (Am. L. Inst. 1971).
154 *Stillwater*, C.A. No. 24, 2022, 2023 WL 165968 at *7 (Del. Supr. Jan. 12, 2023).
155 *Id.* at *8.
156 *Id.* at *5.
157 *Id*.

In addition, *Stillwater* also highlights the importance of avoiding litigation tactics that could have the appearance of gamesmanship. Stillwater's reversal on choice-of-law was not formally a factor in the Supreme Court's analysis, but both the Supreme Court and the Superior Court made a point to mention their concerns with Stillwater's opportunistic change of position.

DGCL Amendments

A number of significant amendments to the Delaware General Corporation Law (DGCL) were enacted in 2022.

Captive Insurance (DGCL Section 145(g))

Amendments to DGCL Section 145(g) were adopted that expressly permit captive insurance arrangements to be used to provide directors and officers (D&O) liability insurance coverage. D&O insurance provides Delaware corporations with an important mechanism to fill holes in their D&O indemnification protection, such as providing coverage against judgments and settlements in derivative actions brought by stockholders (for which Delaware corporations may provide indemnification only in certain circumstances). Captive insurance arrangements may provide a viable alternative to normal independent insurance for corporations for whom D&O insurance cost increases become prohibitive or that are otherwise unable to purchase D&O insurance.

The amendments permit insurance provided directly or indirectly (including through fronting[158] and reinsurance arrangements) by or through a captive insurance company organized and licensed through the laws of any jurisdiction. Coverage is not permitted, however, for claims involving:

- "personal profit or other financial advantage;" or
- deliberate criminal or deliberate fraudulent acts, or a knowing violation of law.

For purposes of the above exclusions, the conduct of one insured person is not imputed to another. Also, the exclusions only apply if the relevant facts indicating their existence are established in a final non-appealable adjudication. Captive insurance can nonetheless be provided if and to the extent that indemnification is permitted in the specific case under DGCL Section 145.

Any determination to make payment under the captive insurance with respect to a claim against an officer or director must be made by a third party administrator or in accordance with DGCL Section 145(d)(1) through (4) (by majority vote of independent directors, committee of such directors, independent legal counsel, or stockholders). Before any insurance payment in connection with actions brought by or in the right of the corporation, if stockholder notice is required, the notice must reference payment being made under the captive insurance.

[158] "Fronting" involves using a third-party licensed insurer where, through contractual arrangements, all or part of the risk of loss is borne by the captive insurer.

Officer Exculpation (DGCL Section 102(b)(7))

Since its adoption in 1986, DGCL Section 102(b)(7) has permitted corporate charters to provide for exculpation (elimination of exposure to personal liability) of directors, but not officers, for certain fiduciary duty breaches. This has permitted directors, but not officers, to obtain dismissal at the motion to dismiss stage of claims based on breaches of the duty of care. Following an increase in the amount of litigation exploiting this disparate treatment of directors and officers by targeting officers rather than directors for the same or similar conduct, DGCL Section 102(b)(7) has now been amended to also permit exculpation of officers (defined as described below).

As with directors, exculpation is not available for officers for:

- breach of the duty of loyalty;
- acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; or
- with respect to a transaction from which the officer derived an improper personal benefit.

Exculpation is also not available for officers (but remains available for directors) in any action brought by or in the right of the corporation.

As used in the officer exculpation provisions of DGCL Section 102(b)(7), the term "officer" is defined by reference to the Delaware "long arm" statute for service of legal process (DGCL Section 3114(b)(1)) and includes:

- a corporation's president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer, or chief accounting officer;
- a person identified in the corporation's Securities and Exchange Commission filings because the person is or was one of the corporation's most highly compensated executive officers; and
- a person who has consented by written agreement with the corporation to be identified as an officer of the corporation for purposes of the Delaware long arm statute.

Stockholder Consents (DGCL Section 228(c))

DGCL Section 228(c) was amended in 2014 to clarify that stockholders or members of nonstock corporations giving consents may provide, through instruction to an agent or otherwise, that the consent is to become effective at a future time, including a time determined by the happening of a future event, occurring not later than 60 days after the instruction is given or provision is made. Section 228(c) was further amended in 2022 to clarify that the person giving the consent need not be a stockholder or member of record when the consent is executed, but must have that status on the record date for determining stockholders or members entitled to consent. As amended, this more closely tracks the provisions governing board consents under DGCL Section 141(f).

Corporate Conversions (DGCL Section 266)

DGCL Section 266, which governs the conversion of Delaware corporations to other entities, has historically provided that such conversions require the approval of all outstanding shares, whether voting or non-voting. This provision was amended in 2022 to reduce the required vote threshold to a majority of the outstanding shares entitled to vote thereon. If the corporation is converting to a partnership with one or more general partners, the approval of each stockholder who will become a general partner is also required.

A grandfather provision specifies that provisions in charters of corporations incorporated before August 1, 2002, and provisions in voting trust agreements or other stockholder agreements that predate August 1, 2022, in each case where the provisions restrict, condition, or prohibit consummation of a merger or consolidation, shall also be deemed to apply to conversions to other entities unless expressly provided otherwise. Practitioners should consider the advisability of including conversions in protective provisions going forward.

Appraisal Rights (DGCL. Section 262)

DGCL Section 262 has been amended in several respects, including the following:

- A new Section 262(d)(3) permits beneficial owners to demand appraisal of their beneficially owned shares directly, without involvement of the record holder of the shares, provided that the beneficial owner complies with certain requirements, including continuous ownership of the shares through the applicable merger or other transaction date, and reasonably identifies the record holder of the shares for which appraisal is demanded.
- Section 262 now provides an appraisal right in connection with conversions under DGCL Section 266. Appraisal rights were not previously necessary for the protection of stockholders of a converting corporation due to the former unanimous share approval requirement.
- A copy of Section 262 is no longer required to be provided to stockholders in the stockholder meeting or consent notice. Instead, the required information can be provided by directing the stockholders to a publicly available electronic resource through which Section 262 can be accessed.
- Amendments to Section 262(j) provide that a court may charge stockholder expenses incurred in the appraisal proceeding pro rata against the value of all shares entitled to appraisal that have not been dismissed from the appraisal process.
- Amendments to Section 262(k) clarify that a stockholder can make an appraisal demand with respect to some, rather than all, of the stockholder’s shares and can withdraw an appraisal demand with respect to some, rather than all, of the shares for which the demand was made.

Kodiak Bldg. Partners v. Adams, C.A. No. 2022-0311-MTZ, 2022 WL 5240507 (Del. Ch. Oct. 6, 2022)

Summary

Delaware Chancery Court held that a contractual provision providing that noncompetition and nonsolicitation restrictive covenants entered into in connection with acquisition of a business were presumptively reasonable was contrary to public policy; that the restrictive covenants were unenforceable because they were overly broad and did not advance a legitimate business interest where the scope extended beyond the target's business to the whole of the acquiror's business lines; and, importantly, declined to "blue pencil" the covenants even though defendant appeared to have engaged in some competing activity that would have been tied to a legitimate business interest of the acquiror.

Background

Plaintiff Kodiak Building Partners, LLC (Kodiak) operated in the construction industry through a large number of companies that it had acquired in different industry segments. Defendant Adams was a former shareholder and employee of a roof truss company, Northwest Building Components, Inc. (Northwest), one of the Kodiak-acquired companies. Along with the stock purchase agreement covering Northwest, Defendant Adams signed a restrictive covenant agreement (RCA), which included, among other terms, a noncompetition provision, a nonsolicitation provision, and confidentiality restrictions for a period of 30 months from closing. A few months after closing, Defendant resigned and began to work for a different roof truss and lumber company, located 24 miles from the Northwest facility. Kodiak moved for a preliminary injunction to enforce the RCA's noncompete and nonsolicitation provisions.

The Court's Decision

The court first considered Kodiak's argument that Defendant Adams had waived his right under the RCA to challenge the reasonableness of the restrictive covenants. Specifically, the RCA provided that each restraint "[wa]s necessary for the reasonable and proper protection of the goodwill, Confidential Information, trade secrets and other legitimate interests of [Kodiak], other members of the Company Group and the Business" and was also "reasonable in respect to subject matter, length of time, scope of activity and geographic area."[159] While the court acknowledged Delaware's "contractarian nature" favoring enforcement of agreements as drafted, it concluded that it did not apply where "enforcement [would be] inimical to public policy."[160] Thus, the court found that "an employee's promise not to challenge the reasonableness of his restrictive covenants cannot circumvent this court's mandate to review those covenants for reasonableness."[161]

[159] *Id*. at *5.
[160] *Id*. at *6.
[161] *Id*.

No Legitimate Interest

The court next considered whether the restrictive covenants advanced a legitimate business interest. Here, the court held that legitimate interests include protection of employer goodwill and confidential information from misuse and that in a sale of a business, "the acquirer has a legitimate economic interest with regard to the assets and information it acquired in the sale."[162] The court noted that the RCA's restrictive covenants applied within the states of Idaho and Washington and within a 100 mile radius of any other location in which Northwest *or any member of the "Company Group"* had sold products or services within the 12 months prior to closing, and also applied to any business that was similar to or competitive with the "Business."[163] As for the RCA's nonsolicitation provision, the court noted that the provision applied with respect to any customer or prospective customer of *any member of the "Company Group"* or of the "Business" at any time during the twelve months prior to closing.[164] The definition of "Confidential Information" was similarly expansive, applying to information of any "Company Group" member or the "Business."[165] "Business" was similarly broadly defined to include aspects of construction that far exceeded the narrow industry segment that Northwest was engaged in.[166] Finally, "Company Group" was defined as Kodiak and each of its business lines.[167]

The court acknowledged that Kodiak had a legitimate business interest "in protecting what it purchased" from Northwest "and [its] investors, including Adams," but it flatly rejected Kodiak's argument that it had a legitimate interest in protecting not only the goodwill of the acquired business itself (e.g., Northwest) but also that of Kodiak and its other business lines from other acquisitions.[168] The court held that "[t]he acquirer's valid concerns about monetizing its purchase do not support restricting the target's employees from competing in other industries in which the acquirer also happened to invest."[169]

The court additionally rejected Kodiak's argument that the broader scope of the restrictive covenants was justified by the need to protect confidential information of the acquiror's whole "Business" (e.g., Kodiak and Northwest, as well as all of Kodiak's lines of business).[170] The court held that Defendant Adams worked only in areas of Kodiak's business relating to roof trusses and that Kodiak had not identified any confidential information relating to the non-truss business lines to which Defendant Adams had access. Accordingly, the court held that Kodiak did not have a legitimate economic interest in protecting confidential information that was unrelated to truss and lumber operations sufficient to justify the restrictive covenants.

162 *Id*. at *8.
163 *Id.*
164 *Id.*
165 *Id*. at *9.
166 *Id*.
167 *Id*. at *6.
168 *Id*. at *9-*10.
169 *Id*. at *10.
170 *Id*.

Restrictive Covenants Unreasonable in Scope

With regard to geographic scope and the scope of activities covered, the court held that the restrictive covenants were unreasonably broad. Reasonableness is determined "by reference to the area in which a covenantee has an interest the covenants are designed to protect."[171] In addition, while restrictive covenants in connection with the sale of a business are more permissively construed than those in the employer-employee context, such covenants must nonetheless be "essential for the protection of the [acquirer's] economic interests."[172] In this case, the court held that the "noncompete provision is overbroad to the extent it prohibits competition in geographic areas around subsidiaries other than Northwest and the nonsolicit provision is overbroad to the extent it covers customers, clients, or prospective customers and clients of subsidiaries other than Northwest."[173] Similarly, the court held that the restricted activities were overbroad because they encompassed "more than just Northwest's industry segment of roof trusses."[174]

No Blue Penciling

Another key point is that the court declined to "blue pencil" the restrictive covenants at issue in this case.[175] Specifically, the court stated while courts sometimes engage in "blue penciling" of restrictive covenants to make them "reasonable," Delaware courts are hesitant to do so.[176] This in part reflects a desire to avoid creating a "no lose" situation for employers, who could otherwise seek to impose overly broad restrictive covenants on their employees knowing that they will be modified by the court, but not invalidated altogether, if found to be overly broad.[177] Thus, even though the court noted that Defendant Adams appeared to have engaged in conduct that would have violated restrictive covenants had they been appropriately written to cover Kodiak's legitimate business interests, as they were overly broad, they were simply unenforceable in their entirety.

Takeaways

The Kodiak decision serves as a useful reminder that under Delaware law, restrictive covenants that are ancillary to the sale of a business should be written to reflect the scope of the purchased business and not that of the acquiror more broadly. Further, Delaware courts are inclined to find overly broad restrictive covenants unenforceable in their entirety even if some alleged activity is violative of an acquiror's legitimate business interest and not "blue pencil" the covenants to save a portion of them.[178] Finally, another key takeaway is that Delaware will not enforce self-serving waivers to judicial review of the reasonableness of restrictive covenants.

---

171 *Id*. at *11 (citing *Weichert Co. of Pa. v. Young*, C.A. No. 2223-VCL, 2007 WL 4372823 at *3 (Del. Ch. Dec. 7, 2007)).
172 *Kodiak Bldg. Partners*, C.A. No. 2022-0311-MTZ, 2022 WL 5240507 at *11 (Del. Ch. Oct. 6, 2022) (citing *FP UC Hldgs., LLC v. Hamilton*, C.A. No. 2019-1029-JRS, 2020 WL 1492783 at *7 (Del. Ch. Mar. 27, 2020)).
173 *Kodiak Bldg. Partners*, C.A. No. 2022-0311-MTZ, 2022 WL 5240507 at *12 (Del. Ch. Oct. 6, 2022).
174 *Id*.
175 *Id*. at *4.
176 *Id*.
177 *Id*. (citing *Del. Elevator, Inc. v. Williams*, C.A. No. 5596–VCL., 2011 WL 1005181 at *11 (Del. Ch. Mar. 16, 2011)).
178 *Kodiak Bldg. Partners*, C.A. No. 2022-0311-MTZ, 2022 WL 5240507 at *4 (Del. Ch. Oct. 6, 2022).

Stream TV Networks, Inc. v. SeeCubic, Inc., 279 A.3d 323 (Del. June 25, 2022)

Summary

This case involved an asset transfer by an insolvent corporation and the question of whether there was a "board-only" insolvency exception to the stockholder approval requirements under Section 271 of the Delaware General Corporation Law (DGCL) and the corporation's charter. In reversing the decision of the Court of Chancery, the Delaware Supreme Court held that a common law insolvency exception, to the extent one ever existed in the state, did not survive the enactment of Section 271 of the DGCL.

Background

Stream TV Network, Inc. (Stream) was a corporation founded in 2009 to develop and commercialize 3D viewing technology. By the time the relevant facts to this case developed in 2020, Stream had yet to bring in any revenue. Stream was primarily controlled by Mathu Rajan and Raja Rajan (the Rajan Brothers), through their ownership of high-vote Class B shares. The Court of Chancery noted that Stream had "virtually nonexistent" corporate governance practices.[179]

Stream supported its operations through a combination of debt and equity investment. Stream pledged its assets as collateral for secured loans from each of SLS Holdings VI, LLC (SLS) and Hawk Investment Holdings Limited (Hawk, together with SLS, the Creditors).

In 2019, the equityholders of Stream (the Equityholders), with Alistair Crawford serving as their representative, began discussions with the Creditors and the Rajan Brothers regarding a restructuring of Stream. Crawford proposed the formation of a new company (which would later be SeeCubic, Inc. (SeeCubic)) that would acquire Stream's assets. He provided the Rajan Brothers with a draft Omnibus Agreement to affect this restructuring, but they refused to agree to the restructuring.

In February 2020, Stream defaulted on its debt obligations to the Creditors and they filed suit. At the urging of the Creditors and Crawford, the Rajan Brothers expanded the board so that it included four independent directors in addition to the Rajan Brothers. In May, the board (over the abstentions of the Rajan Brothers) approved the creation of a Resolution Committee, which was granted with the full power of the board to resolve claims related to default, litigation, or threats thereof on behalf of Stream, and the proposal was approved. The Resolution Committee then proceeded to approve the Omnibus Agreement.

The Omnibus Agreement provided that Stream would assign all its assets to SeeCubic in exchange for the Creditors dropping their foreclosure claims against Stream. It also gave holders of Stream's Class A Common Stock (other than the Rajan Brothers) the right to receive

[179] *Id*. at 1033.

shares of SeeCubic's common stock in exchange for shares of their Stream Class A Common Stock. Stream was to receive one million shares of SeeCubic Class A Common Stock.

The Court's Decision

Court of Chancery

Stream filed suit seeking a temporary restraining order (TRO) against SeeCubic to prevent the enforcement of the Omnibus Agreement. SeeCubic counterclaimed, requesting expedition and its own TRO. In December 2020, the Court of Chancery issued a preliminary injunction in favor of SeeCubic, effectively barring Stream, the Rajan Brothers, or anyone acting on their behalf from interfering with SeeCubic's rights under the Omnibus Agreement.[180] A key question before the court was whether the Omnibus Agreement required a shareholder vote, pursuant to either Section 271 of the DGCL or a class voting provision of the Class B shares in Stream's certificate of incorporation.

As explained in our prior Advisory (at pp. 13-16), the Court of Chancery first looked to DGCL Section 271 to see whether it required stockholder approval for the transactions under the Omnibus Agreement. The Court of Chancery held that the language in Section 271 was ambiguous, and so it looked to legislative history and held that it retained the "failing business" exception to the common law prohibition on the sale of all of a corporation's property without unanimous stockholder approval.[181] The court also considered the 1967 revisions to the DGCL, which added DGCL Section 272 in order to clarify that the mortgage or pledge of a corporation's assets does not require stockholder approval, unless provided for in the charter. The Court of Chancery reasoned that it would not make sense to require stockholder approval to foreclose on such arrangements because it would give stockholders leverage against creditors and undermine the value of the security arrangement. The court also noted that, while DGCL Section 271 had evolved over time with respect to the type of consideration that was permissible under the rule, the amendments never included forgiveness of indebtedness. Accordingly, transfers of assets in consideration for forgiveness of secured loans should not fall within DGCL Section 271.

The Court of Chancery then considered Stream's argument that the Omnibus Agreement required approval of the Class B shares under Stream's charter. The Court of Chancery noted that the language in the class voting provision closely tracked DGCL Section 271. Accordingly, the Court of Chancery held that it should be interpreted consistently with DGCL Section 271, and therefore was not triggered by the transactions at issue.

Supreme Court

The Supreme Court first looked to Stream's charter to see whether the Omnibus Agreement triggered a class vote of the Class B shares, reasoning that the Court should only first look to the DGCL if a company's charter conflicts with the requirements of the DGCL. The charter provided for a class vote in the event of an "Asset Transfer," which was defined under the charter to include a "sale, lease or other disposition of all or substantially all of the assets or

---

[180] *Id.* at 1033.
[181] *Stream TV Networks, Inc.*, 279 A.3d 323, 344 (Del. June 25, 2022).

intellectual property of [Stream] . . . "[182] The Supreme Court noted that the phrase "sale, lease or other disposition" tracked DGCL Section 271, except for its use of "other disposition" instead of the word "exchange."[183] The Supreme Court held that the term "other disposition" was materially broader than the term "exchange."[184] Accordingly, the Supreme Court held that there was no need to look to DGCL Section 271 for interpretive guidance. The Supreme Court considered various dictionary definitions of "disposition" and held that the term "other disposition" encompassed the transfer of assets under the Omnibus Agreement.[185] Reversing the Court of Chancery, the Supreme Court held that the charter language was unambiguous, and thus it was not necessary to use extrinsic evidence to interpret it.

In dictum, the Supreme Court addressed the issue of whether any common law "board-only" insolvency exception to DGCL Section 271 existed.[186] The Supreme Court reviewed several treatises written prior to the enactment of Section 271 and found that at least five supported the existence of such an exception at one time. However, the Supreme Court noted that, while case law from at least 15 states supported the existence of such an exception, Delaware courts had not expressly addressed or adopted the exception.

In determining whether Section 271 superseded the common-law insolvency exception (assuming one existed), the Supreme Court applied a three part test: "(a) does explicit language in the statute supersede or limit the common law; (b) does the statutory scheme evidence a legislative intent to occupy the field; and (c) does the statutory scheme actually conflict with the common law."[187] The Supreme Court found that with regards to (a) and (b), Section 64(a), Section 271's predecessor, unambiguously replaced the common-law unanimity rule with regards to asset transfers or sales. The Supreme Court held that if the unanimity requirement in the common-law rule was superseded, the better view, as supported by the plain language of Section 271, was that the insolvency exception to the rule was also superseded. Finally, the Supreme Court also found that creating a "board-only" insolvency exception would be contrary to public policy, as it would remove some of the predictability that makes Delaware law favorable to corporate entities.[188]

Takeaways

This decision provides useful clarity on the no-longer outstanding question of whether an insolvent corporation's board can avoid a shareholder vote on a plan to transfer all or substantially all of its assets. Boards should consider whether an asset transfer triggers a voting requirement under either or both of DGCL Section 271 and the corporation's charter. If it does, boards may not rely on the board-only exception that may have existed at common law to avoid the voting requirement.

---

[182] *Id*. at 333.
[183] *Id*. at 338.
[184] *Id*.
[185] *Id*. at 334.
[186] *Id*. at 343.
[187] *Id*. at 352 (applying *A.W. Fin. Servs., S.A. v. Empire Res., Inc.*, 981 A.2d 1114, 1123 (Del. Sep. 15, 2009)).
[188] *Id*. at 343.

Arwood v. AW Site Servs., LLC, C.A. No. 2019-0904-JRS, 2022 WL 705841 (Del. Ch. Mar. 9, 2022), rev'd, C.A. No. 2019-0904-JRS, 2022 WL 973441 (Del. Ch. Mar. 31, 2022)

Summary

Delaware, historically, has been regarded as a "pro-sandbagging" jurisdiction.[189] *"Sandbagging" refers to a buyer who knows a seller has breached a representation, yet proceeds to close and then seeks recovery post-closing for damages related to the breach.*[190] *The Delaware Supreme Court, however, called that into question in* Eagle Force Holdings, LLC v. Campbell*, when Justice Valihura noted, in a footnote, that there is "debate over whether a party can recover on a breach of warranty claim where the parties know that, at signing, certain of them were not true" and that the Delaware Supreme Court has "not yet resolved this interesting question."*[191] *In* Arwood*, the Delaware Court of Chancery reviewed the issue and Vice Chancellor Slights has found that Delaware is indeed a "pro-sandbagging" jurisdiction.*[192]

Background

John Arwood owned or co-owned several companies that comprised his business (Arwood Waste) which brokered the rental of portable toilets and roll-off dumpsters. Private equity firm Broadtree Partners, LLC approached Arwood regarding an acquisition of Arwood Waste. Although Arwood built a successful business, he was an unsophisticated seller. In fact, he did not maintain any financial records for his business or know how to prepare them. After agreeing to an initial purchase price for Arwood Waste, Sean Mahon, a Broadtree principal and general partner, was granted unfettered access to Arwood Waste's financial records, customer information, and general ledger, as well as Arwood's personal financials. From this access, Mahon was able to prepare a detailed set of financials for the business. As a result of negative information uncovered during the diligence process regarding expected revenue and costs, Broadtree and Arwood agreed to reduce the purchase price by nearly 25 percent and AW Site Services, LLC (AWS), the Broadtree special purpose affiliate, ultimately purchased Arwood Waste's assets.

Post-closing, Mahon noticed profits from the business were materially lower than what was anticipated prior to the acquisition based mainly on two factors: Arwood Waste had a practice of charging excessive overage fees to dumpster customers based on fabricated documentation and Arwood Waste improperly charged customers lien fees and placed unwarranted mechanics' liens against customers who did not pay their overage fees. Customers were charged lien fees even if Arwood Waste did not file a lien on the business. When these practices were not continued post-closing, profits declined.

[189] *Arwood*, C.A. No. 2019-0904-JRS, 2022 WL 705841 at *3 (Del. Ch. Mar. 9, 2022).
[190] *Id*.
[191] *Eagle Force Holdings, LLC v. Campell*, 187 A.3d 1209, 1236 n.185 (Del. May 24, 2018).
[192] *Arwood*, C.A. No. 2019-0904-JRS, 2022 WL 705841 at *3 (Del. Ch. Mar. 9, 2022).

Invoking the indemnification provisions in the purchase agreement, AWS asserted Arwood was liable for at least $11.8 million in damages, based in large part on the fraudulent billing scheme, and instructed the escrow agent not to release the portion of the purchase price placed into escrow at closing to secure Arwood's indemnity obligations. Arwood sued seeking an order to release the escrowed funds. AWS counterclaimed asserting, among other claims, fraud and breach of contract.

The Court's Decision

Focusing on AWS's counterclaims, the court first found that AWS did not establish its claim for fraud. AWS was unable to prove Arwood's scienter or AWS's justifiable reliance on the representations regarding Arwood's business practices given the unfettered access Arwood had provided to Mahon during the diligence process, Arwood's rollover stake and involvement with the business post-closing, and the significant diligence that Mahon had conducted.

The court then turned to the breach of contract claims based on Arwood's breach of representations, including representations regarding Arwood Waste's financial statements, the validity of accounts receivable, compliance with laws, and disclosure of all employees of the business. Arwood's chief defense to AWS's claims was that AWS knew that these representations were not true or had reckless indifference to the truthfulness of representations and therefore was prohibited from bringing a claim.

The court held that, although the Delaware Supreme Court has not ruled on the issue, Delaware is a "pro-sandbagging" state.[193] The court found support for this position given Delaware's contractarian nature and willingness to enforce agreements, whether good or bad. The court also noted: "reliance is not an element of a claim . . . for breach of any of the representations or warranties in the agreement."[194] Noting that, although some may view sandbagging as unfair or "ethically questionable"[195] and that it is unsettling for a buyer to hold a breach claim he knew before closing he would bring against a seller, this risk is like any other risk and can be managed through an express agreement between the parties. In a definitive agreement, the parties can expressly agree to allow sandbagging, expressly prohibit it, or remain silent on the issue.[196] If the parties remain silent, however, the default rule in Delaware, as affirmed by the court in *Arwood*, will be to permit sandbagging.

In the end, however, the court found that sandbagging was not actually an issue in this case. Even if Delaware were an anti-sandbagging state, the court found Arwood failed to prove that AWS knew the representations in the agreement were false. The court found that sandbagging is only implicated when a buyer has actual knowledge a representation is false. It is not enough that a buyer should have known a representation was false but did not actually know or acted with reckless indifference regarding the truth of the representations.

---

[193] *Id*. at *29.
[194] *Id*. at *30 (citing *Gloucester Hldg. Corp. v. U.S. Tape & Sticky Prods., LLC*, 832 A.2d 116, 127-128 (Del. Mar. 18, 2003).
[195] *Arwood*, C.A. No. 2019-0904-JRS, 2022 WL 705841 at *30 (Del. Ch. Mar. 9, 2022)(citing Stacey A. Shadden, *How to Sandbag Your Opponent In the Unsuspecting World of High Stakes Acquisitions*, 47 CREIGHTON L. REV. 459, 474 (2014))
[196] *Arwood*, C.A. No. 2019-0904-JRS, 2022 WL 705841 at *30 (Del. Ch. Mar. 9, 2022).

As Arwood had breached the purchase agreement, the court awarded AWS damages equal to the cap on recovery set forth in the purchase agreement.

Takeaways

The decision provides helpful confirmation that Delaware is a pro-sandbagging state. Pro-sandbagging language is often included in acquisition agreements as a *quid pro quo* for non-reliance language, so this decision should not impact that practice. The decision also provides useful guidance that sandbagging is only at issue where the buyer had actual knowledge that seller's representations and warranties were false. Where, for example, the buyer was merely recklessly indifferent to the accuracy of the representations and warranties, recovery for breach would not be foreclosed even if the acquisition agreement contained anti-sandbagging language.

The implications of the decision are different in a deal where the buyer is relying on representation and warranty insurance, given that such policies typically preclude recovery if the buyer had knowledge of the breach (depending on whether the breach was discovered prior to signing or prior to closing).