Paul | Weiss

CLIENT MEMORANDUM

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Transformative Amendments Proposed to Delaware General Corporation Law

For well over half a century, Delaware has taken a balanced and predictable approach to corporation governance and resolving business disputes. While the law has changed at times, those changes have been evolutionary and, with rare exceptions, met the common sense test. The high level of clarity and certainty Delaware statutory law and judicial decisions historically provided led two-thirds of Fortune 500 companies to choose Delaware as their legal home and to stay there.

But over the past year, boards of directors of public companies and key stockholders of companies about to go public[1] have been reconsidering whether to domicile in Delaware. These discussions have been prompted by a number of recent decisions of the Delaware courts. Some called into question the validity of decades-old practices with respect to stockholder and merger agreements, which was met with a swift legislative response in 2024.[2] Others broke new ground on a range of other issues, including standards of review for controlling stockholder and other interested transactions and the ability of plaintiffs' lawyers to obtain an ever-expanding set of corporate documents to fish for reasons to sue public companies. The scope, speed and substance of these decisions surprised key stakeholders and threaten to undermine the predictability and precedential reliability that traditionally has been the hallmark of Delaware courts.

In view of these developments, a bipartisan coalition of Delaware lawmakers has proposed legislation to amend the Delaware General Corporation Law ("DGCL") to restore greater clarity and predictability in structuring controller and other interested transactions and to protect against frivolous litigation by narrowing stockholder access to corporate books and records. While it is still in the early stages and changes to the bill may be proposed as the legislative process moves forward, we believe the amendments in their current form make a great deal of sense and would significantly bolster confidence in Delaware among key stakeholders.

Separately, the same lawmakers sponsored a Senate concurrent resolution that asks the Council of the Corporation Law Section of the Delaware State Bar Association to provide a report by March 31, 2025 with recommendations for additional legislation to address excessive fee awards to plaintiffs' attorneys while still incentivizing stockholder litigation that is protective of stockholder rights. We believe change is urgently needed in this area as well, particularly given several recent nine-figure fee awards, including one for $345 million.

We will continue to monitor these developments.

Proposed Amendments Regarding Controlling Stockholder and Interested Transactions

Background on Current Legal Framework

The default standard of review in Delaware for reviewing fiduciary conduct is the business judgment rule, which presumes that directors make decisions in good faith, on an informed and independent basis, and free of material conflicts of interest. However, when a controlling stockholder stands on both sides of a transaction and receives a non-ratable benefit, the far more onerous standard of entire fairness applies.

Entire fairness review places the burden on defendants to prove that the challenged transaction was entirely fair, taking into account both process and financial considerations. Entire fairness also applies to a transaction if a plaintiff demonstrates that a majority of the directors were interested in the transaction or were not independent from someone interested in the transaction.

The only way to obtain business judgment review in conflicted controller transactions is for the parties to follow the "*MFW* framework." That standard requires that the controller condition the transaction on the approval of *both* (1) a wholly independent,[3] fully-empowered special committee that meets its duty of care and (2) a fully informed, uncoerced vote of a majority of the minority stockholders ("MoM vote").

Issues with Current Framework

Although the above principles may seem straightforward and sensible, the *MFW* framework and other jurisprudence concerning controller and interested transactions have become increasingly difficult for parties to successfully comply with in order to obtain pleadings-stage dismissals, thus driving up litigation expense even where the transactions are ultimately determined to be entirely fair. This trend is the result of a string of recent court decisions that have taken a far more expansive view of what constitutes a controlling stockholder and what rises to the level of a non-ratable benefit than traditionally had been the case.[4] As a result, the decision-making of independent directors who have no financial interest in the transactions they approve has been subjected to entire fairness review where their actions are susceptible to being second-guessed and plaintiffs' lawyers gain undue leverage to extract expensive and unnecessary litigation settlements.

The proposed amendments to DGCL Section 144 would reset the standards governing controller and interested transactions to provide more predictability, give greater deference to independent directors and rebalance litigation incentives in a beneficial way. In particular, the proposed amendments would make the following key changes.

- <u>Non-squeeze out mergers with controllers and other interested transactions would have to satisfy only one prong of a modified *MFW* framework to receive protection from liability</u>. The MoM vote required by the *MFW* framework not only may add significant deal risk to a transaction depending on the stockholder profile of the target, it also adds significant litigation risk because legal challenges concerning the adequacy of disclosures to stockholders and whether a stockholder vote was coerced increasingly have been effective to defeat dismissals of lawsuits where a transaction was conditioned on the *MFW* framework.[5] The proposed amendments would mitigate these risks (and the attendant expense of costly, post-pleading litigation) for both controller transactions that do not involve squeezing out minority stockholders and for any other "interested transaction" because defendants would only need to satisfy *one* prong of a modified *MFW* framework to benefit from a new safe harbor that would protect directors, officers and controllers from liability and equitable relief. Thus, in these transactions, a proper special committee process will invoke the safe harbor, so that decision-making by independent directors cannot be second-guessed and litigation can more easily be dismissed at the pleadings stage. Only in controller mergers where the minority stockholders are being squeezed out would both prongs of the modified *MFW* framework be required.

- <u>Sets a floor on controller status</u>. Under Delaware law, controlling stockholder status attaches when a stockholder either (1) controls a majority of the corporation's voting power or (2) controls less than a majority of the corporation's voting power, but has effective control over the business and affairs of the corporation. Decisions determining controller status in the latter circumstance have been liberally applied recently, to the point that a strong CEO or Chair who controls less than 22% of a company's voting power could nevertheless be viewed as a controlling stockholder.[6] The proposed amendments would attach controller status to non-majority stockholders only if the stockholder controls at least one-third of the corporation's outstanding voting power *and* has the power to exercise managerial authority of the business and affairs of the corporation. The proposed amendments also clarify that an agreement, arrangement or understanding must exist for stockholders to constitute a control group.

- <u>Defines director disinterestedness</u>. The case law concerning director independence and disinterestedness has become increasingly unpredictable,[7] which has made it more difficult to successfully implement a proper special committee process. The proposed amendments would provide greater clarity in this area for purposes of DGCL Section 144 by statutorily defining a "disinterested director" in a common sense way as a director who lacks a "material interest" in the transaction or a "material relationship" with a person that has a material interest in the transaction. While these definitions would leave room for judicial interpretation, they limit the court's ability to engage in intensive and contextual fact finding on these issues under its existing precedents and should make director independence determinations more predictable.

- Provides favorable presumption with respect to director disinterestedness. The proposed amendments would add further predictability to director disinterestedness determinations. Over the past few years some decisions have expressed skepticism over director independence as a result of what many have viewed as non-material, non-economic connections to a controller. The amendments address this concern by adding a presumption that directors of public corporations are independent with respect to a transaction if they are not party to the transaction and the board determines that such director is independent or satisfies the criteria for director independence under applicable stock exchange rules.[8] In addition, the amendments provide that a director's nomination or election to the board by a person with a material interest in a transaction would not, by itself, be evidence that the director is not disinterested as to that transaction.

- Only a majority of directors on a special committee must be disinterested. The Delaware Supreme Court recently imposed a requirement that every director on a special committee formed for *MFW* purposes must be independent, as opposed to a majority of such directors being independent. While this appears reasonable, it creates the risk that an entire process would be invalidated if a court were to decide after the fact that just one committee member (despite being a minority voice) was not disinterested. The proposed amendments would eliminate that risk by requiring that only a majority, rather than every member, of a special committee must be disinterested.

- Special committee review or a MoM vote can be implemented at any time during the deal process. The *MFW* framework requires that both the special committee and MoM vote conditions be put in place *ab initio*, *i.e.*, before the start of substantive economic negotiations. The failure to condition a transaction *ab initio* on the satisfaction of both protections has resulted in the denial of pleadings stage dismissals in about one-third of the cases where Delaware courts determined that compliance with the *MFW* framework was not met.[9] The proposed amendments would eliminate this *ab initio* requirement.

- "Votes cast" standard for MoM votes. The proposed amendments impose a "votes cast" standard for a MoM vote, rather than a majority of the outstanding stock held by minority investors, for controller transactions and other interested transactions. This lower threshold provides greater certainty that a MoM vote can be achieved, particularly for corporations that have a significant number of investors who fail to sign and return proxies.

- Alternative safe harbor for fairness. As an alternative to complying with one or both of the modified *MFW* protections, the proposed amendments create a safe harbor to obtain protection from liability and equitable relief for a controlling stockholder or other interested transaction if such transaction is "fair as to the corporation." The amendments define this term to mean that the transaction, as a whole, is beneficial to the corporation or its stockholders taking into account whether the transaction is fair in terms of the relevant fiduciary's dealings with the corporation and approximates an arm's length transaction.[10] This alternative basis for the safe harbor would be particularly helpful in situations where the parties are confident that the deal price is market, but want to avoid the risks that the *MFW* protections may impose.[11]

Proposed Amendments Regarding Books and Records Demands

In recent years, stockholder demands for corporate books and records under Section 220 of the DGCL have been overwhelming the docket of the Court of Chancery. One study indicates that the number of Section 220 cases increased by thirteenfold from the 1981 to 1994 period to the 2004 to 2018 period,[12] and the pace has only increased since then. Further, Section 220 demands have broadened in their scope, requesting an ever-expanding range of documents, *e.g.*, requests for emails and text messages of directors and employees, including from personal devices.[13] The proposed amendments to the DGCL would help curb abuse of Section 220 by plaintiffs' lawyers on "fishing expeditions" and provide much needed relief to corporations overburdened by these demands and the litigation expense associated with them.

- Narrows accessible books and records. Disputes between corporations and stockholders often arise over whether stockholders are entitled to documents beyond formal corporate and board records. The Delaware Supreme Court commented in 2019 that corporations should not have to produce electronic documents in response to Section 220 demands if they maintain traditional, non-electronic records (*e.g.*, board minutes and presentations) sufficient to satisfy a proper purpose for inspection,[14] but Section 220 demands have continued to pursue electronic information aggressively even when traditional records are available. The amendments would appropriately reduce the burden of responding to overly aggressive Section 220 demands by limiting "books and records" to a specified list of traditional corporate and board documents that would exclude internal emails, texts or other electronic communications and for some documents limit production to a three-year lookback.[15]

- Tightens procedural requirements. Delaware law currently provides that stockholders can demand books and records for a "proper purpose." The proposed amendments would further require that the demand must be made in good faith, and must describe with "reasonable particularity" the stockholder's purpose and the records the stockholder seeks to inspect. If properly applied, these requirements should reduce the burden on public companies and curb frivolous books and records demands.

- Imposes confidentiality restrictions and permits redactions. Under the proposed amendments, corporations may impose reasonable restrictions on the confidentiality, use or distribution of any books and records that are produced and may redact portions of documents unrelated to the stockholder's purpose. Although Delaware courts currently have the ability to employ these measures, the proposed amendments would provide corporations with the ability to do so themselves.

Senate Concurrent Resolution Requesting Recommendations on Fee Awards

Delaware courts have recently approved some astronomical plaintiffs' fee awards, with some amounting to nine figures.[16] For example, this past December in *Tornetta* v. *Musk*, the case that rescinded Elon Musk's $55.8 billion Tesla compensation package, the Court of Chancery approved a plaintiffs' attorneys fee award of $345 million,[17] equating to $17,692 per hour of time worked by the plaintiffs' lawyers.[18] Such excessive fee awards are an unreasonable toll on Delaware corporations and their stockholders.

In response, the same coalition of Delaware lawmakers proposing the amendments discussed above sponsored a Senate concurrent resolution requesting that the Council of the Corporation Law Section of the Delaware State Bar Association, which annually reviews and recommends amendments to Delaware's corporate statutes, provide a report by March 31, 2025 with recommendations for legislative action to ensure that court awards of attorney's fees incentivize stockholder litigation that is appropriately protective of stockholder rights without being excessive to the detriment of Delaware corporations and their stockholders.

Takeaways

We believe that the proposed amendments would be highly beneficial to corporations and their stockholders. The proposed revisions to Section 144 would provide greater clarity and predictability in structuring controller and other interested transactions and would appropriately restore greater deference to the decision-making of independent directors. The proposed revisions to Section 220 would curtail frivolous books and records demands, streamline the process of responding to them, and reduce the burdens they impose on corporations. As noted, the proposed legislation is in its early stages. We will continue to monitor developments.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Scott A. Barshay
+1-212-373-3040
sbarshay@paulweiss.com

Andre G. Bouchard
+1-302-655-4413
abouchard@paulweiss.com

1 Typically, many companies planning to go public are in the tech industry and often have a visionary founder as a controller, and many others are former leveraged buyouts that will for some period of time have one or more private equity firms as a controlling stockholder or control group.

2 In 2024, the Court of Chancery's decisions in *West Palm Beach Firefighters' Fund* v. *Moelis & Co*., 311 A.3d 809 (Del. Ch. 2024), and *Sjunde Ap-Fonden* v. *Activision Blizzard, Inc.*, 2024 WL 863290 (Del. Ch. Feb. 29, 2024), surprised many practitioners, and the legislature responded with swift statutory reforms (discussed here).

3 *See In re Match Group, Inc. Deriv. Litig.*, 315 A.3d 446 (Del. 2024) (discussed here).

4 *See infra* note 6. *See also Palkon* v. *Maffei*, 311 A.3d 255 (Del. Ch. 2024) (while ultimately reversed by the Delaware Supreme Court, the Court of Chancery initially held that the directors received a non-ratable benefit through the reduction of future liability exposure that justified the application of entire fairness to the corporation's redomestication from Delaware to Nevada), *rev'd*, 2025 WL 384054 (Del. Feb. 4, 2025).

5 *See* discussion in Paul, Weiss, Rifkind, Wharton & Garrison LLP, *Considering MFW for Controller Transactions?*, PRIVATE EQUITY DIGEST (Nov. 2024). Also, compare *City of Dearborn Police & Fire Revised Retirement Sys.* v. *Brookfield Asset Mgmt. Inc*., 314 A.3d 1108 (Del. 2024) (invalidating a MoM vote in an *MFW* analysis in part because the proxy failed to adequately disclose the financial advisor's $470 million stake in the acquirer held in its own account because that level of investment was material to a stockholder in deciding how to vote, although it amounted to only 0.10% of the advisor's total investment portfolio and was likely not material to it) with *In re Micromet, Inc. S'holders Litig*., 2012 WL 681785 (Del. Ch. Feb. 29, 2012) (holding that the financial advisor's 0.16% investment in the acquirer, which was largely held on behalf of its clients, was not material, and therefore not required to be disclosed).

6 *Compare Tornetta* v. *Musk*, 310 A.3d 430 (Del. Ch. 2024) (controller status at 21.9%); *FrontFour Cap. Grp. LLC* v. *Taube*, 2019 WL 1313408 (Del. Ch. Mar. 11, 2019) (controller status at 15%); *In re Zhongpin Inc. S'holder Litig.*, 2014 WL 6735457 (Del. Nov. 26, 2024) (controller status at 17%) *with In re Oracle Corp. Deriv. Litig.*, 2023 WL 3408772 (Del. Ch. May 12, 2023), *aff'd,* 2025 WL 249066 (Del. Jan. 21, 2025) (no controller status at 28.8%); *Sciannella* v. *AstraZeneca UK Ltd*., 2024 WL 3327765 (Del. Ch. Jul. 8, 2024) (no controller status at 26.7%); *In re GGP, Inc. S'holder Litig.*, 2021 WL 2102326 (Del. Ch. May 25, 2021), *aff'd on other grounds*, 282 A.3d 37 (Del. July 19, 2022) (no control at 35.3% with unexercised right to increase stake up to 45%).

7 Traditionally, Delaware jurisprudence focused on financial factors to assess a director's independence, and there was a high bar to pleading interestedness through non-economic interests. *See, e.g., Beam ex rel Martha Stewart Living Omnimedia, Inc.* v. *Stewart*, 845 A.2d 1040 (Del. 2004) (requiring a derivative complaint to plead with particularity facts creating "a reasonable doubt that a director is . . . so 'beholden' to an interested director . . . that his or her 'discretion would be sterilized.'") (citing *Rales* v. *Blasband*, 634 A.2d 927 (Del. 1993)). More recently, however, Delaware courts have been increasingly willing to find that non-economic relationships meet this test. *See, e.g., Marchand* v. *Barnhill*, 212 A.3d 805 (Del. 2019) (stating that courts "cannot 'ignore the social nature of humans' or that they are motivated by things other than money, such as 'love, friendship, and collegiality.'") (citing *In re Oracle Corp. Deriv. Litig*., 824 A.2d 917 (Del. Ch. 2003)). *See also Sandys* v. *Pincus*, 152 A.3d 124 (Del. 2016) (holding that the ownership of a plane alone justified a finding of lack of independence because it "requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship.").

8 Under the proposed amendments, plaintiffs could rebut such presumption only by alleging "substantial and particularized" facts that show the director has a material interest in the transaction or a material relationship with a person that has a material interest in the transaction.

9 *See* Bouchard, Andre G., *MFW Meets Its Match*, DIRECTORS & BOARDS (Sept. 13, 2024).

10 The full definition of "fair as to the corporation" in the proposed amendments is "the act or transaction at issue, as a whole, is beneficial to the corporation, or its stockholders in their capacity, as such given the consideration paid to or received by the corporation or its stockholders or other benefit conferred on the corporation or its stockholders and taking into appropriate account whether the act or transaction meets both of the following: a. It is fair in terms of the fiduciary's dealings with the corporation. b. It is comparable to what might have been obtained in an arm's length transaction available to the corporation."

11 For example, this would be particularly helpful in a situation where a hedge fund obtains holdup value by acquiring enough of the minority shares to block a deal subject to a MoM vote.

12 *See* Cox, James D. et al., *The Paradox of Delaware's "Tools at Hand" Doctrine: An Empirical Investigation*, 75 BUS. LAW. 2123 (2020).

13 *See, e.g.*, *Amalgamated Bank* v. *Yahoo! Inc.*, 132 A.3d 752 (Del. Ch. 2016) (abrogated on other grounds by *Tiger* v. *Boast Apparel, Inc.*, 214 A.3d 933 (Del. 2019)) (granting access to electronic documents and emails stored in a director's personal email account).

14 *KT4 Partners, LLC* v. *Palantir Technologies Inc.*, 203 A.3d 738 (Del. 2019).

15 The proposed amendments would define "books and records" to include corporate charters, bylaws, stockholder meeting minutes and actions by consent, written and electronic transmission communications to stockholders, board and committee meeting minutes(and records of action taken at such meetings), board and committee materials, annual financial statements, DGCL Section 122(18) contracts (*e.g.*, stockholder agreements)

and director and officer independence questionnaires. Stockholder meeting minutes and actions by consent, written and electronic transmission communications to stockholders and annual financial statements would be required to be produced only for the three years preceding the date of the demand.

16 *E.g., Tornetta* v. *Musk*, 326 A.3d 1203 (Del. Ch. 2024) (approving a $345 million fee award to plaintiffs' counsel); *Police & Fire Retirement Sys. of the City of Detroit* v. *Musk*, C.A. No. 2020-0477 (Del. Ch. Jan. 8, 2025) (Transcript) (approving $176.16 million fee award to plaintiffs' attorneys); *In re Dell Techs. Inc. Class V S'holders Litig.*, 326 A.3d 686 (Del. 2024) (approving a $266.7 million incentive fee award to plaintiffs' attorneys).

17 *Tornetta*, 326 A.3d 1203.

18 *See Delaware Chancellor Whacks Elon Musk Again. The Latest in the Tornetta* v. *Musk Saga,* ProfessorBainbridge.com (Dec. 2, 2024).