Harvard Law School Forum on Corporate Governance

Delaware Courts Are Asking Just When a Stockholder Vote Is 'Fully Informed'

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Key Points

- Delaware courts are scrutinizing disclosures made to obtain stockholder approvals, particularly where there is an alleged conflict of interest in the decision-making.
- If disclosures for a vote are incomplete or misleading, directors may not enjoy the benefit of the business judgment rule if their decisions are later challenged in court.
- Some alleged conflicts have involved directors' relationships with the counterparty or management, or financial or legal advisors' work for the counterparty.
- Courts have allowed suits to go forward where a controlling person allegedly steered the board to a particular bidder in ways that were not disclosed.

A fully informed stockholder vote can help protect a company and its directors from lawsuits challenging a transaction. Under Delaware law, board decisions may enjoy deference under the business judgment rule where stockholder approval is obtained after they have received all material information. And, if the business judgment rule applies, it is easier to get a stockholder suit dismissed at the pleadings stage, before burdensome discovery.

But that hinges crucially on the stockholders being *fully informed*. And when a transaction or other board action approved by stockholders is challenged, Delaware courts have been closely scrutinizing the disclosures the company made. The state's courts have invalidated a number of stockholder approvals in recent years and allowed stockholder suits — typically naming directors — to go forward where disclosures were found to be incomplete or misleading.

Here is what boards need to know about the situations where companies and their boards were deprived of the "cleansing effect" of a stockholder vote and were left open to litigation.

A Quick Legal Primer

The Delaware Supreme Court has held that, in general, where a non-controller transaction is "approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies."

Where a "controller" — a majority stockholder or someone who in other ways controls decision-making at the company — is involved, the business judgment rule will not apply to transactions with the controller unless the parties agree (before economic negotiations begin) to condition the deal on approval of both an independent, disinterested and empowered special committee and a majority of the minority stockholders. Otherwise, it will be subject to court review under the more onerous "entire fairness" standard and the company and its board will have the burden of proving "that the challenged act or transaction was entirely fair to the corporation and its stockholders."

These doctrines were spelled out in state Supreme Court decisions in 2014 and 2015, but have been applied and clarified in a number of more recent rulings. Crucially for boards, courts have stressed that the vote must be *fully* informed, and they look closely at the materiality of disclosures (and omissions) and ask whether missing information would significantly alter the total mix for a reasonable investor.

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Advisor Conflicts

Disclosures about conflicts of interest or relationships between the board of directors and its financial and legal advisors have tripped up some companies.

This year, for example, the Delaware Supreme Court reversed the Court of Chancery (the trial court) in a case challenging a squeeze-out merger. The lower court had dismissed the challenge, finding that the special committee and the vote by disinterested stockholders were sufficient to offset the underlying conflict of interest in the controller transaction.

On appeal, the Supreme Court held that the stockholder vote was not fully informed because the proxy statement failed to disclose:

- That the special committee's financial advisor had a $470 million stake in the controller and its affiliates.
- That the special committee's legal advisor had prior and ongoing representations of the controller.

- The benefits the controller would obtain from the transaction.

The court found that those conflicts were material to the stockholder vote. As a result, the case was remanded to the trial court to examine the transaction under the onerous entire fairness standard.

In another case this year involving advisors' conflicts, the Supreme Court reversed the lower court's dismissal, citing the fact that the proxy statement did not disclose that both financial advisors to the company had prior business relationships with other parties to the transaction. While the proxy disclosed that one of the advisors "may provide" services to counterparties in the transaction, the court found this misleading because the company knew that the advisor was actually providing these services.

"Boards, committees, and their advisors should take care in accurately describing the events and the various roles played by board and committee members and their retained advisors," the court wrote.

Board Interactions With, and Preferences for, Particular Bidders

Delaware courts have taken a similar approach to disclosures involving interactions with bidders, and efforts by directors or executives to steer a deal to one bidder.

A 2022 decision held that a filing in response to a tender offer was misleading and incomplete with respect to meetings between two directors, the acquirer and its financial advisors, and refused to dismiss the case. The court found a pattern of inaccuracies designed to obscure the fact that the entire board was not aware of these meetings, and to cover up insider trading activity. It found two other material omissions, as well: The conflicted directors had purchased shares in the acquiring company and the proxy did not contain reliable financial projections.

Similarly, in 2018, the Delaware Supreme Court reversed the dismissal of a stockholder's suit where the plaintiff alleged these material omissions about conflicts of a director-founder of the target:

- That the director-founder had expressed a clear preference for and commitment to the eventual acquirer and reluctance to entertain other potential bids.
- The reasons why the director-founder wanted to sell the company and why he believed the board should pursue a sale.

Because of these omissions, the court found that the stockholders' decision to tender their shares was not fully informed.

In a 2023 case, the Court of Chancery found that a stockholder vote was not fully informed because the proxy did not disclose:

- That other bidders were subject to standstill provisions preventing them from acquiring more stock of the target and from requesting waivers of their standstills.
- That the acquirer repeatedly breached its standstill agreement and the target's management did not enforce it.
- Details regarding the target officers' retirement plans and the impact of those on the officers' motivations.

As a result, the court found that the officers might have breached their fiduciary duties to the stockholders during the merger negotiations and it allowed the suit to go forward.

Director and Officer Conflicts

Another area of disclosure Delaware courts continue to pay particularly close attention to is the conflicts of interests of directors and officers, including details regarding compensation, post-transaction employment and relationships with a company's controlling stockholder.

In 2020, the Court of Chancery found a stockholder vote was not fully informed because the proxy did not adequately disclose the conflicts of the CEO or provide the company's correct earnings guidance. Private interactions and discussions concerning prospective future employment for the CEO were material facts that needed to be disclosed, the court found, so the stockholder vote did not insulate the transaction from challenge under the business judgment rule. (The CEO was later found liable for breaches of fiduciary duty.)

In a case this year, the Court of Chancery allowed a stockholder challenge to the equity compensation for a CEO and controlling shareholder notwithstanding the fact that a majority of disinterested stockholders had approved the package. The court found that the compensation was subject to an entire fairness review because the stockholders were not fully informed for two reasons:

- The proxy inaccurately described key directors as independent, when several of them had extensive, long-standing personal and professional relationships with the CEO and owed much of their personal wealth to him.
- The proxy omitted details about the process by which the compensation grant was approved, including material preliminary conversations between the CEO and the compensation committee chairman.

As a result, the court invalidated the compensation package notwithstanding the stockholder approval.

Other Disclosure Issues

Disclosures involving conflicts of interest are not the only ones getting a close look. Other examples where stockholder approval did not immunize a deal from challenge in the Court of Chancery included:

- Where the proxy statement did not include all sale prices proposed by a special committee; mispresented the expertise of the special committee's financial advisors and their compensation arrangement; and misrepresented a prior valuation of the classes of stock.
- Where "intrinsic value" was mentioned 15 times in the proxy statement but the board did not disclose the specific figure reflecting that value despite recommending the transaction. (The case was dismissed on other grounds.)
- Where stockholders of a SPAC challenged its merger with an operating company (the target), the proxy statements failed to disclose that the target's largest customer was building an in-house platform to compete with the target.

Conclusion

These cases demonstrate the care with which Delaware courts are approaching disclosures where they are alleged to be inadequate. In order for a board to get the benefit of judicial deference to its decisions under the business judgment rule, the company's disclosures about the circumstances surrounding the transaction must be complete and not misleading.