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In this issue, we discuss Delaware court developments, including the first-ever dismissal of a SPAC disclosure complaint, as well as rulings pertaining to financial advisor conflict and disclosure law, state laws involving controllers and *Caremark* claims.

Court of Chancery Issues First Dismissal of a SPAC Disclosure Complaint

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In January 2022, Vice Chancellor Lori Will of the Delaware Court of Chancery issued a groundbreaking opinion in *In re MultiPlan Corp. Stockholders Litigation* that paved the way for SPAC stockholders to bring direct breach of fiduciary duty claims against SPAC boards and sponsors. In the ruling, the court clarified that "well-worn fiduciary principles" under Delaware law would apply to SPAC board decisions. The court went on to deny a motion to dismiss largely based on what it held were misleading disclosures that interfered with a common SPAC stockholder's redemption right — *i.e.*, the ability to decide whether to redeem their shares in connection with a de-SPAC merger. In January 2023, Vice Chancellor Will again declined to dismiss so-called "*MultiPlan* claims" on a similar basis in *Delman v. GigAcquisitions3, LLC*, but expanded on her earlier ruling. Among other things, the court held that (i) the SPAC sponsor, even though it controlled less than 25% of the SPAC's voting power, was a controlling stockholder; (ii) the SPAC's redemption feature is a "bespoke check on the sponsor's self-interest" and the "primary means protecting stockholders" from an ill-conceived forced investment; and (iii) *Corwin* cleansing did not apply to SPAC mergers because stockholders' voting interests were decoupled from their economic interests as a result of the redemption feature. Since the 2023 ruling, numerous other decisions from the chancellor and other vice chancellors have denied motions to dismiss *MultiPlan* claims.

In *In Re Hennessy Capital Acquisition Corp. IV Stockholder Litigation*,[1] Vice Chancellor Will again focused on a post-closing SPAC challenge that took issue with disclosures

[1] *In re Hennessy Cap. Acquisition Corp. IV S'holder Litig.*, --- A.3d ---, 2024 WL 2799044 (Del. Ch. May 31, 2024).

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impacting SPAC stockholder redemption rights. Unlike all of the prior SPAC rulings, the court issued its first opinion dismissing a *MultiPlan* claim at the pleadings stage. Reflecting on the impact of the groundbreaking *MultiPlan* decision, Vice Chancellor Will observed that "[t]he success of a few cases begat a host of others. Though the SPAC market has contracted, SPAC lawsuits are ubiquitous in Delaware. Remarkably similar complaints accuse SPAC directors of breaching their fiduciary duties based on flaws in years-old proxy statements that became problematic only when the combined company underperformed." Here, however, the plaintiff went "all in" on allegedly false disclosures based on "post-closing developments, strained inferences, and documents that contradict his theories." The court concluded that "[i]rrespective of the standard of review, the plaintiff has failed to plead a reasonably conceivable breach of fiduciary duty claim against the SPAC's fiduciaries. It cannot fairly be inferred that the defendants withheld knowable information material to public stockholders deciding whether to redeem or invest in the combined company. To allow this faulty claim to proceed would fuel perverse incentives and invite strike suits."

A brief summary of the ruling follows.

Background

Hennessy Capital Corp. IV was formed as a SPAC (the SPAC). In August 2020, the SPAC and Canoo Holdings Ltd. (the Target), an electric vehicle start-up company, executed a merger agreement. The SPAC and the Target jointly announced the merger agreement through a press release and conference call. An investor presentation attached to the press release described the company's three projected revenue streams: engineering services, business-to-consumer and business-to-business. Two months later, the SPAC and the Target announced that Tony Aquila, a prominent figure in the automotive technology sector, had become the Target's executive chairman. The Target also hired an outside consultant, McKinsey and Company, to review its business (though McKinsey would not present its findings until months after the merger closed). On December 4, 2020, the SPAC issued a proxy statement recommending that its investors approve the merger with the Target. Among other things, the proxy highlighted the company's anticipated revenues from the three aforementioned prongs of its business plan. In December 2020, the SPAC's stockholders voted to approve the business combination and the merger closed the same day, with Hennessy changing its name to Canoo Inc. (Canoo). The former members of the SPAC's board resigned except for the president/chief operating officer, who remained a member of the post-closing board.

Three months after closing, Canoo's board received a presentation on the company's business strategy, financial performance and investor relations where Mr. Aquila announced that Canoo was "re-casting" its "vision and strategy." Mr. Aquila also explained that Canoo's original approach was "complex" and "lacked diligence," and that with a "new leadership team in place" the company could move away from certain business segments and focus on others. This announcement coincided with McKinsey's presentation of the results of its "External Analysis," which "identified the most attractive segments to focus on." During an earnings call held three days after that board meeting, Mr. Aquila announced the decision to deemphasize Canoo's engineering services segment. After the announcement, the company's stock price dropped, recovered briefly and then continued to drop over time. The plaintiff, a SPAC stockholder at the time of the merger, sued the Canoo board on behalf of the stockholder class. The plaintiff's complaint was very similar to those in other SPAC lawsuits and asserted four counts: two counts of breach

of fiduciary duty, unjust enrichment and aiding and abetting (against the entity that controlled the SPAC sponsor). In general, the plaintiff argued, much like other SPAC lawsuit plaintiffs before him, that the redemption right was undermined by faulty proxy disclosures. The defendants moved to dismiss all counts.

Analysis

Regarding the breach of fiduciary duty claims, the court began its analysis with an overview of "*MultiPlan* claims." Accordingly, the court distinguished the "narrow" *MultiPlan* claim — which is only directed at disclosure or other actions impacting the exercise of the SPAC stockholders' redemption rights — from complaints about overpayment or the substantive fairness of the merger, stating that "[t]he linchpin of *MultiPlan* was ensuring that a public stockholder's decision to redeem shares or participate in the merger be freely exercisable and fully informed. Although the fiduciaries' misaligned interests implicated the duty of loyalty, a claim premised solely on these conflicts would seemingly be non-viable if public stockholders had a fair opportunity to exercise their redemption rights. The alleged unfairness of the de-SPAC transaction itself also could not support a direct claim, since corporate overpayment claims are classically derivative."

In *In re Hennessy*, the plaintiff cited "a single impairment of the redemption right: allegedly false disclosures" related to the Target's revenue streams. Though all parties agreed that entire fairness was the appropriate standard of review, the court rejected the plaintiff's insistence on a "relaxed" pleading standard in the context of SPAC claims, stating "[e]ntire fairness … is not a free pass to trial" and noting that "[p]oor performance is not, [] indicative of a breach of fiduciary duty. Conflicts are not a cause of action. And pleading requirements exist even where entire fairness applies."

The court found a "critical distinction" between the alleged disclosure deficiencies at issue and the disclosures in *MultiPlan*. The *Hennessy* plaintiff failed to allege that the information purportedly omitted from, or misleadingly disclosed in, the proxy statement was "known or knowable" by directors and officers of the SPAC prior to the closing of the merger. Rather, the complaint "address[ed] actions by Canoo's post-closing board — a body made up of directors who were (with one exception) not on the SPAC's board." In sum, the court found that "no well pleaded facts support[ed] a reasonable inference that changes to [the Target's] business model were known or knowable by [the SPAC's] board before the merger closed. That is, no unfair dealing vis-à-vis, the redemption right is pleaded. [Plaintiff] therefore failed to state a breach of fiduciary duty claim." Since the plaintiff's unjust enrichment claim was entirely premised on his breach of fiduciary duty claim, that claim failed as well. In addition, the court summarily dismissed the plaintiff's aiding and abetting claim for lack of a predicate fiduciary breach.

Key Points

- Since *MultiPlan*, the Court of Chancery has taken a negative view of de-SPAC transactions, and — until *Hennessy* — has unanimously denied motions to dismiss in every de-SPAC case on the grounds that the redemption right was diminished because of faulty disclosures. At a minimum, the court's ruling in *Hennessy* provides a possibility that future challenges to a de-SPAC transaction may not always survive a motion to dismiss.
- The court's ruling was, in part, informed by the flood of de-SPAC challenges that have occurred over the past few years, to the point where lawsuits have become ubiquitous at the same time the SPAC market itself has contracted. The court recognized that plaintiffs have been filing "[r]emarkably similar complaints" that are "based on flaws in years-old proxy statements that became problematic only when the combined company underperformed." However, the court was quick to caution that "[p]oor performance is not, however, indicative of a breach of fiduciary duty."
- The court also directly confirmed that purported conflicts by the pre-SPAC fiduciaries, and any alleged "unfairness of the de-SPAC transaction itself," fail to support a direct class action claim. This is because the SPAC is actually the buyer in a de-SPAC transaction and "corporate overpayment claims are classically derivative." In order to state a *MultiPlan* claim, which is "narrow," there needs to be some level of interference with the stockholders' redemption right, which usually takes the form of disclosure claims.
- Given that the court has previously determined that SPAC founders are controllers with unique interests due to their "founder shares," the court has held that entire fairness review applies to the transaction. Many interested parties believed that this would effectively give stockholder plaintiffs a pass when alleging disclosure claims in this context. In *Hennessy*, the court rejected this notion, concluding it was the result of the plaintiff's "misperception" of the pleading standard, which requires pleading "some facts indicating unfairness," and that "[e]ntire fairness … is not a free pass to trial." Accordingly, conclusory assertions that disclosure is inadequate cannot sustain a breach of fiduciary duty under any standard of review.
- *Hennessy* also makes clear that disclosure claims based on hindsight, where material facts were not known or knowable by the defendants at the time the de-SPAC proxy was issued, are inadequate. Plaintiffs also cannot simply "overlook the flaws" in their complaint "by characterizing them as 'fact-based' matters that cannot be resolved on a motion to dismiss."

Recent Updates in Delaware Disclosure Law

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The Delaware Supreme Court recently issued two opinions weighing in on the scope of disclosures involving board advisors in connection with M&A transactions that warrant close attention. In both rulings — each written *en banc* — the Delaware Supreme Court reversed the lower courts' dismissals of all claims because (among other reasons) certain material information about the target companies' advisors was not disclosed. The Delaware Court of Chancery recently cited both rulings in denying motions to dismiss disclosure claims against directors and aiding and abetting claims against financial advisors. Companies and financial advisors alike should be aware of the court's rulings and changes to Delaware law, as they will undoubtably have an impact on disclosures with regard to advisors' prior and current engagements, as well as any proprietary equity holdings of merger parties.

In one of the two Delaware Supreme Court cases,[1] the Court of Chancery had originally dismissed a challenge to a $3.3 billion squeeze-out transaction under the *MFW* doctrine, holding that the transaction met *MFW*'s requirements for dismissal because it was conditioned *ab initio* on, and received, approval by (i) a fully independent and empowered special committee formed at the outset of the process and (ii) a fully informed and uncoerced majority of the minority shares of the target company. On appeal, the court reversed the dismissal because it found that the minority stockholders of the target company were not fully informed prior to when they voted to approve the transaction. The court held that information pertaining to conflicts involving financial advisors on the special committee involved in the sale should have been disclosed to the target's minority stockholders when soliciting their approval of the transaction, including:

- The special committee's financial advisor held $470 million of equity in the controller for its own accounts, even though that amount accounted for only .1% of the advisor's portfolio value. This figure, and the fact that the financial advisor held the interest on a proprietary basis, was not disclosed.
- The proxy statement disclosed that the financial advisor "may have committed and may commit in the future to invest in private equity funds managed by [controller] or its affiliates," when in fact the advisor had already had done so. The court concluded this disclosure was "misleading" and also was grounds for reversal.

In its rulings, the Supreme Court commented that "'[b]ecause of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, [the Court of Chancery] has required full disclosure of investment banker compensation and potential conflicts.'" The court further explained that "[i]t does not matter whether the financial advisor's opinion was ultimately influenced by the conflict of interest; the presence of an undisclosed conflict is still significant."

Following its ruling in *City of Dearborn*, the Delaware Supreme Court again reversed a dismissal from the Court of Chancery under the *MFW* doctrine in a case challenging the $7.3 billion acquisition of a controlled company by a consortium

[1] *City of Dearborn Police & Fire Revised Ret. Sys. (Chapter 23) v. Brookfield Asset Mgmt., Inc.*, --- A.3d ---, 2024 WL 1244032 (Del. Mar. 25, 2024).

of third-party private equity buyers.[2] In *Inovalon*, the CEO of the target company (Inovalon) controlled 64.1% of the voting power of the company. The CEO and another director (together owning approximately 86% of Inovalon's voting power) agreed to roll over their equity while the minority stockholders were cashed out, with 99% of the minority stockholders voting to approve the transaction.

In its ruling, the court reversed the Court of Chancery's decision because of inadequate disclosure related to the financial advisors of Inovalon board and special committee. Stating that "[a] special committee's advisor's conflicts are uniquely important considerations for minority stockholders when deciding how to vote," the court held that the proxy statement should have disclosed the following information:

- Affiliates of the special committee's financial advisor were concurrently representing the primary buyer and another member of the equity consortium in unrelated transactions.
  - The court, referring to its prior opinion, held that the proxy statement was "misleading" when disclosing that the advisor and its affiliates "may" provide services to those parties because "there was an actual concurrent conflict" involving services to those parties.
- The specific amount of fees that the Inovalon board's financial advisor stood to earn from its concurrent representations of the primary buyer and another member of the equity consortium in unrelated transactions.
  - Here, the court held that it was not enough for the proxy statement merely to disclose that the advisor would receive "customary compensation" for such representations.
- The specific amount of fees earned over the last two years by the Inovalon board's financial advisor from all members of the equity consortium (which totaled approximately $400 million).
  - The court found it misleading for the board's financial advisor to omit the fees from all members of the equity consortium and disclose only that the financial advisor would make $15.2 million in fees earned from work performed for the primary buyer.

The Delaware Supreme Court also compared the proxy statement disclosures to the minutes of relevant special committee meetings (obtained through a books and records demand), focusing specifically on the work performed by the special committee's financial advisor. According to the court, if the minutes were assumed to be accurate, then the proxy statement "overstated" the role of the committee's financial advisor in the process. Nevertheless, the court determined that it "need not 'pile on' another basis for reversal," though it cautioned that "the Proxy's description of [the committee's advisor's] role in the market outreach efforts do[es] not sit comfortably with the corresponding accounts set forth in the minutes. 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."

Finally, the Delaware Court of Chancery recently refused to dismiss breach of fiduciary duty claims against directors for failing to disclose certain financial advisor conflicts, and refused to dismiss aiding and abetting claims against those advisors.[3] Citing the recent statements from the Delaware Supreme Court on the importance of disclosing financial

[2] *City of Sarasota Firefighters' Pension Fund v. Inovalon Hldgs., Inc.*, --- A.3d ---, 2024 WL 1896096 (Del. May 1, 2024).

[3] *Firefighters' Pension Sys. of City of Kansas City v. Found. Bldg. Mats., Inc.*, 2024 WL 2795026 (Del. Ch. May 31, 2024).

advisor conflicts, the Court of Chancery held that the Information Statement issued in connection with a merger failed to disclose all material information by omitting, among other things, that the compensation for the financial advisors for the target board and the special committee was tied, in part, to the value of a non-ratable benefit flowing to the controller of the target. This compensation structure was also used, among other things, to sustain aiding and abetting claims against both financial advisors.

Key Points

- When the Delaware Supreme Court issues not one, but two, opinions on financial advisor conflict issues and related disclosures, practitioners and M&A participants must take notice. In particular, the court has made clear that there is risk in failing to disclose specifics around prior and concurrent work performed by the financial advisors in an M&A process, as well as regarding fees earned or expected to be earned for such work. Accordingly, previously accepted disclosure language may no longer be sufficient.
- Moreover, the scope of such disclosures depends on who the participants are in the transaction, as the requirements are not as simple as stating "buyer" and "seller." In certain circumstances, disclosure requirements may extend to affiliates and/or members of a group, such as affiliates of the financial advisor, and other deal participants on the buy side, including members of a consortium.
- In consultation with legal counsel, directors and officers should seek updates regarding conflicts from their financial advisors throughout the process, as well as take reasonable steps to ensure that public filings disclose all material information.
- Directors and officers must be mindful about the description of events in the proxy statements and ensure they accurately reflect the content of the company's internal meeting minutes.
- Financial advisors must consider the risk that a third party could view a compensation structure as containing embedded conflicts.
- The Delaware courts' recent decisions highlight the need for directors, officers, companies and financial advisors to seek expert legal advice about the scope of disclosure for conflicts and descriptions of a financial advisor's role in the transaction process. In certain circumstances, the role of legal advisers may need to be analyzed as well, particularly if a target board or special committee's legal advisers are concurrently representing the buyer, a controller or other material deal participants.

Under Control: Recent Delaware Decisions on Controller Transactions, Standards of Review and Disclosure Obligations

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The first half of 2024 has been a watershed moment for the development of controller law in the Delaware courts. Among the highlights, the Delaware Supreme Court reexamined and confirmed that transactions involving a conflicted controller will invoke entire fairness review, and that the *MFW* framework is the only method in that context to secure business judgment review.[1] The Court of Chancery also broke new ground in controller law, articulating duties for controllers that exercise stockholder-level voting rights and applying entire fairness review to a controlled company's attempt to reincorporate from Delaware to Nevada. The Court of Chancery also issued a ruling that voided, post-trial, what may be the largest-ever executive compensation package, based on the court's determination that the CEO/controller fell short of complying with *MFW* under an entire fairness analysis.

In light of these recent cases, controlled companies, boards of directors and their financial advisors should pay close attention to these rulings and continue to monitor additional developments. Below, we examine each of the recent decisions.

Match Group: Delaware Supreme Court Confirms That *MFW* Must Be Satisfied To Secure Business Judgment Review in Controller Transactions

In re Match Group, Inc. Derivative Litigation[2] concerned a challenge to a "multi-step reverse spinoff" of online dating website Match.com by the company's then-controlling stockholder. At the trial level, the primary question for the Court of Chancery was whether the reverse spin-off complied with *MFW.* In its ruling, the court concluded that "the process as pled satisfied *MFW*" and dismissed the stockholder case under the business judgment rule. The plaintiffs appealed, claiming that the court erred when dismissing the case. In response, the defendants raised a new argument — that *MFW* was not always required to secure business judgment review, particularly when the challenge was to a controlling stockholder transaction that did not involve a freeze-out merger. This argument prompted the Delaware Supreme Court to take the rare step of requesting supplemental briefing "in the interests of justice to provide certainty to boards and their advisors who look to Delaware law to manage their business affairs."

In an *en banc* opinion, the Delaware Supreme Court analyzed the development of *MFW* and how it has been utilized. Importantly, the court emphasized that it is "important to recognize that 'an interest conflict is not in itself a crime or a tort or necessarily injurious to others.' In other words, 'having a "conflict of interest" is not something one is guilty of.' Indeed, a corporation and its stockholders may benefit from a controlling stockholder's influence." The court then went on to reaffirm *MFW* as the only method to reduce entire fairness review to business judgment, concluding that, even outside the freeze-out context, "in a suit claiming

[1] In addition, the Delaware Supreme Court, in two separate decisions, emphasized a need for more robust "conflict" disclosures, with a particular emphasis on those involving special committees and financial advisors. See our article "Recent Updates in Delaware Financial Advisor Conflict and Disclosure Law" from this edition of *Insights: The Delaware Edition for information on these two opinions.*

[2] -- A.3d --, 2024 WL 1449815 (Del. Apr. 4, 2024).

that a controlling stockholder stood on both sides of a transaction with the controlled corporation and received a non-ratable benefit ... [i]f the controlling stockholder wants to secure the benefits of business judgment review, it must follow all *MFW*'s requirements." The other significant issue addressed in *Match Group* concerned the special committee prong of *MFW*. Specifically, the court held that all members of a special committee in a conflicted controller transaction — not just a majority of the committee, as some courts have held — must be independent in order for the committee to pass muster under *MFW*.

Further Developments in Controller Jurisprudence

Sears: Controllers may owe duties and be subject to enhanced scrutiny when exercising stockholder-level rights.

In *In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation*,[3] the Court of Chancery addressed the standard of fiduciary conduct for controllers exercising stockholder-level voting rights.

As the court explained, in *Sears*, an independent committee of Sears' board endorsed a plan to liquidate a segment of the company's business. The company's controller believed that this liquidation plan would destroy value and tried to convince the committee not to have it implemented. When the committee refused to back down, the controller took action by written consent to (i) adopt a bylaw amendment that prevented the board from implementing the liquidation plan without two separate board approvals (from 90% of the board), 30 business days apart, and (ii) remove two (of three) committee members who he believed were the most insistent on pursuing the liquidation plan (the Controller Intervention). Thereafter, the sole remaining special committee member did not believe the status quo was viable for the company and negotiated an end-stage transaction with the controller that eliminated the minority stockholders' interest in the company (the Transaction). Minority stockholders then sued the controller, contending that he breached his fiduciary duties by using his stockholder voting power to effectively block the liquidation plan (through the Controller Intervention) and later forcing the company to enter into the Transaction.

The Court of Chancery analyzed both Delaware Supreme Court and its own precedent to discern when a controller owes fiduciary duties, what duties the controller owes and how a court should review the exercise of controller power for compliance with those duties. In considering the Controller Intervention-related issues, the court focused on the duties owed by a controller when exercising stockholder-level rights (rather than the controller wielding its power over the board and causing the corporation to act). According to the court, "[a] controller can say 'no' to a sale, thereby maintaining the status quo, without engaging in a fiduciary act. An affirmative sale, however, implicates the controller's fiduciary duties, albeit to a limited degree" (such as not selling the company to a "looter"). Moreover, a "controller does not owe any enforceable duties when declining to vote or when voting against a change to the status quo … [b]ut if the majority stockholder seeks to change the status quo, then the majority controller cannot harm the corporation knowingly or through grossly negligent action." More specifically, when voting to change the status quo, the court said "a controlling stockholder owes a fiduciary duty of loyalty which requires that the controller not intentionally harm the corporation or its minority stockholders, plus a fiduciary duty of care that requires that the controller not harm the corporation or its minority stockholders through grossly negligent action."

[3] 309 A.3d 474 (Del. Ch. 2024).

The court then examined which standard of review should apply when a controller exercises voting power, concluding that enhanced scrutiny should apply to the Controller Intervention in light of the fact that the controller "t[ook] action to impair the rights of the directors or a stockholder minority." The court reasoned that "enhanced scrutiny applies when directors amend bylaws or otherwise intervene in elections or voting contests touching on corporate control. Enhanced scrutiny also should apply when a controller does something comparable." In order to prevail, a controller must show that they acted in good faith for a legitimate objective, had a reasonable basis for believing the action was necessary and selected a reasonable means for achieving their legitimate objective.

Referencing these concepts and taking the controller's trial testimony into account, the court found that the controller did not intend to harm the company and was acting in good faith to protect the company from the threat of value destruction. The court further found that the controller identified a threat after a reasonable investigation and that the Controller Intervention was a reasonable means to neutralize the special committee's unilateral implementation of the liquidation plan. Thus, the court held, when the controller exercised his stockholder-level voting power to carry out the Controller Intervention, he did not breach his fiduciary duties. "If nothing else had happened, and if the Company had merely continued operating as it had before the Controller Intervention, then judgment would be entered for the defendants … [h]owever, after the Controller Intervention, the Company did not simply continue operating as it had before. The status quo was not sustainable, and the Transaction resulted." Accordingly, the court found that the Transaction yielded both an unfair price and process, and entered judgment for the plaintiffs.

TripAdvisor: Reincorporating from Delaware to Nevada may confer a non-ratable benefit to a controller.

In *Palkon v. Maffei*,[4] stockholders challenged the conversion of two controlled Delaware corporations to Nevada corporations, seeking an injunction to prevent the conversions from closing. The Court of Chancery held that it was reasonably conceivable that the conversion of a Delaware corporation into a Nevada corporation conferred a non-ratable benefit on the controller because Nevada stockholders have less "litigation rights ... than what Delaware provides." While the court left open the possibility that the defendants could later prove that Delaware and Nevada offer equivalent rights, at the pleading stage it was reasonable to infer "that Nevada law provides greater protection to fiduciaries and confers a material benefit on the defendants." Finding that the controller had benefitted from the conversion to the detriment of the other stockholders, the court applied entire fairness review and denied in part the motion to dismiss, highlighting that this result "fulfills important public policies" and ensures that "litigation rights cannot become second-class rights."

The court granted the motion to dismiss as to injunctive relief, declaring that an injunction preventing the conversion was "off the table." While the court made clear that this opinion "does not mean that corporations cannot leave Delaware," it also indicated that in order to avoid litigation risk, the conversion of a controlled corporation would need to be conditioned on the protections of *MFW*.[5]

[4] 311 A.3d 255 (Del. Ch. 2024), *cert. denied*, 2024 WL 1211688 (Del. Ch. Mar. 21, 2024).

[5] As of the date of publication of this article, this case is pending appeal to the Delaware Supreme Court.

Controller Stripped of Facially Earned Compensation Package After Failing MFW

The Court of Chancery, in *Tornetta v. Musk*,[6] ordered rescission of Tesla CEO Elon Musk's $55.8 billion compensation plan after concluding that the defendants failed to prove at trial that the compensation package (the Grant) was entirely fair. Though Mr. Musk, who maintains 21.9% of Tesla's voting power, lacked mathematical voting control, the court found that he "exercised transaction-specific control over the Grant." The court also declined to shift the burden of proving entire fairness to the plaintiff because there was "no well-functioning committee of independent directors" and the stockholder vote was tainted by a "materially deficient" proxy statement. With respect to the latter, the proxy failed to disclose, among other things, the Compensation Committee's potential conflicts with Mr. Musk. Specifically, the court found that rather than disclose certain committee members' personal and other business relationships with Mr. Musk, the proxy repeatedly described the Compensation Committee as "independent." The court noted that the proxy could have disclosed "the relevant relationships while stating that the Board did not view them as serious impediments to independence thereby allowing stockholders to make their own assessment."

The court also held that the defendants fell short on both the fair dealing and fair price analyses. With respect to fair dealing, the court observed that the committee engaged in a "'cooperative and collaborative' process antithetical to arm's-length bargaining." Regarding fair price, the defendants argued that the Grant was "all upside" for the stockholders, and urged the court to evaluate the price by comparing what Tesla "gave" against what Tesla "got." Instead, the court held the "principal defect" with fair price was the failure to explain — "why did Tesla have to 'give' anything in these circumstances? Musk owned 21.9% of Tesla at the time of the Grant. If the goals were retention, engagement, and alignment then Musk's pre-existing equity stake provided a powerful incentive for Musk to stay and grow Tesla's market capitalization." However, based on public statements, the court found that Mr. Musk had no intention of leaving the company, regardless of his compensation package. Ultimately, the court rescinded the Grant in its entirety as a remedy.[7]

[6] 310 A.3d 430 (Del. Ch. 2024).

[7] On June 13, 2024, Tesla announced that stockholders had again approved Elon Musk's rescinded pay package. No appeal has yet been taken in this matter.

Key Points

Delaware controller law has been impacted by significant case law developments issued in a relatively short time period. Though the Delaware Supreme Court has ruled on certain issues, the Court of Chancery decisions are either on appeal or may potentially be appealed. Nevertheless, in light of these recent rulings:

- Controlled companies should be mindful of further case law developments in this area.
- When considering using *MFW*, boards should consider whether *all* directors slated for committee membership are truly independent.
- Traditional proxy statement disclosures concerning conflicts may need to be revisited.
- Enhanced scrutiny may apply where a conflicted controller takes stockholder-level action that impacts or influences the board.
- Controlled Delaware companies contemplating reincorporation in other states should consider the outcome in *TripAdvisor*, including the potential risk of additional litigation and remedies as part of any such process.

Caremark Developments: Business Risk Versus *Massey* Claims

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Delaware case law recognizes that directors and officers owe a duty of oversight, and failure to adequately exercise such duty may result in liability. Such claims — known as "*Caremark* claims" after the seminal decision in *In re Caremark Int'l Inc.* (Del. Ch. Aug. 16, 1996) — have developed over the years, with stockholders asserting such claims derivatively on behalf of the corporation.

The Delaware Court of Chancery and Delaware Supreme Court have recognized that recently alleged *Caremark* claims tend to fall into two categories — claims alleging failure to properly oversee or monitor business risk and those alleging failure to oversee a corporation's affirmative violation of positive law. Regarding the business risk category, the Court of Chancery has recognized that "the *Caremark* doctrine is not a tool to hold fiduciaries liable for everyday business problems,"[1] and frequently dismisses claims seeking to hold fiduciaries liable either for ordinary business risks that did not turn out as planned or for financial struggles. However, for the second category of claims, the court has looked to the language of *In re Massey Energy*, which sustained *Caremark* claims and reiterated that "Delaware law does not charter law breakers." Referring to these as "*Massey* claims," the court has found that when there are "violations" of positive law such that it "supports a pleading-stage inference that management is operating an enterprise based on recidivous law breaking,"[2] the claims will survive.

Case Dismissals Based on Business Risk

The Court of Chancery has continued to dismiss claims it views as hindsight-motivated challenges to a board's response to ordinary business problems or business risks.

Walgreens:[3] The plaintiffs brought claims alleging breach of fiduciary duty by members of Walgreens' board after the board settled a lawsuit tied to an internal system's default billing practices for a single pharmaceutical product. Walgreens' internal system set the minimum dispensable quantity of insulin pens at five because the manufacturer put five pens in a single box. Thus, if a patient was prescribed fewer than five pens, the system required various levels of resubmission of claims which "prompted premature refill reminders and unnecessary refills for government health care program beneficiaries." A lawsuit was eventually filed regarding this practice and a Department of Justice (DOJ) civil investigation was initiated. The Walgreens board's Audit Committee met numerous times and communicated with the full board to discuss the lawsuit and the DOJ investigation. The board then required the internal system be adjusted to eliminate the default setting for minimum dispensable quantity and resolved both the lawsuit and investigation. Stockholders then sued derivatively, alleging oversight failures by the board in connection with the company's billing practices. In evaluating the motion to dismiss, the court noted many recent *Caremark* cases "fall outside the narrow confines of the *Caremark* doctrine. Fueled by hindsight bias, they seek to hold directors personally liable for imperfect efforts, operational struggles,

[1] *Segway Inc. v. Cai*, 2023 WL 8643017 (Del. Ch. Dec. 14, 2023).

[2] *In re Facebook, Inc. Derivative Litig.*, C.A. No. 2018-0307-JTL, Trans. at 4 (Del. Ch. May 10, 2023).

[3] *Clem v. Skinner*, 2024 WL 668523 (Del. Ch. Feb. 19, 2024).

business decisions, and even when the corporation is the victim of a crime. The present lawsuit is an unexceptional member of this broader group." The court dismissed the claim for failure to plead demand futility, emphasizing that "[t]he Board was required to exercise good faith oversight — not to employ a system to the plaintiffs' liking." The court also noted that as soon as problems with the company's insulin billing became apparent, "information was conveyed to the Board" and it addressed the problems swiftly and appropriately. In sum, the court found that the plaintiffs simply sought to "hold the Board accountable for not addressing a government overbilling practice sooner," which is insufficient to sustain a *Caremark* claim.

Segway Inc. v. Cai:[4] The plaintiff, Segway Inc., brought claims against its former president, Judy Cai, alleging that she breached her duty of oversight. Specifically, Segway pointed to accounting discrepancies that showed an excess of $5 million in accounts receivable that were improperly recorded or booked. Segway argued that "Cai should be held liable for failing to address these [accounts receivables] matters or advise the board about them." The court found "[t]hese allegations are an ill fit for a *Caremark* claim." Segway could point to no actual wrongdoing by Ms. Cai, but "merely asserts that Cai learned (at some point) about 'issues'" with the accounts receivable. "Such generic financial matters are far from the sort of red flags that could give rise to *Caremark* liability if deliberately ignored," the court reasoned, noting as well that "[b]ad things can happen to corporations despite fiduciaries exercising the utmost good faith." The court reiterated that "[l]iability can only attach in the rare case where fiduciaries knowingly disregarding this oversight obligation and trauma ensures. Despite a proliferation of modern jurisprudence, bad faith remains a necessary predicate to any *Caremark* claim. Segway's attempt to hold a corporate officer accountable for unexceptional financial struggles flouts these enduring principles." The court thus dismissed Segway's claim.

In re ProAssurance Corp.:[5] The plaintiffs alleged that the board of ProAssurance, a holding company for property and casualty insurance companies, breached its oversight duties after ProAssurance announced that its loss reserves were inadequate. At the outset, the court noted that "[t]hese events, quite obviously, involve a commercial decision that went poorly — the stuff that business judgment is made of" while cautioning that "[o]versight claims should be reserved for extreme events." The court noted that "[i]nsurance underwriting is, by its very nature, uncertain and risky" and the plaintiffs' "conflation of a bad business outcome with 'bad faith on the part of the Board' necessarily fails." The plaintiffs argued that the board "engaged in bad faith by ignoring risks associated" with new large accounts, but the court reasoned that "[e]valuating business risk is 'the quintessential board function.'" While *Caremark* claims may be tenable in the context of violations of positive law, the court noted that "[b]usiness risks are shades of gray" such that "even if one could envision 'an extreme hypothetical' where the failure to monitor business risk could yield director oversight liability, a showing of bad faith would be a prerequisite." The court dismissed the complaint for failure to plead demand futility, explaining that "[t]his hindsight second-guessing of a business decision that turned out poorly cannot reasonably support an inference of bad faith."

[4] *Segway Inc. v. Cai*, 2023 WL 8643017 (Del. Ch. Dec. 14, 2023).

[5] *In re ProAssurance Corp. S'holder Derivative Litig.*, 2023 WL 6426294 (Del. Ch. Oct. 2, 2023).

Cases That Survived Dismissal

The Court of Chancery and Delaware Supreme Court have sustained *Caremark* claims where the plaintiffs alleged persistent violations of positive law (*Massey* claims).

In re Facebook:[6] The plaintiffs alleged that Facebook had previously agreed to a settlement with the Federal Trade Commission that required the company to end illegal privacy practices. Among other things, the settlement required Facebook to implement procedures reasonably designed to ensure that covered information could not be accessed by third parties from servers under Facebook's control. The complaint alleged that, rather than comply with the decree, the company enacted a policy of monetizing user data by providing partners with access to such data. The court found that there were a "string of red flags that were readily apparent, particularly to insiders like the directors, that related to Facebook's practices." The court additionally held that the complaint "tells a story of directors who were on notice of the law breaking, and who either affirmatively went along with it or consciously disregarded it," and that it was not "isolated" or "immaterial violations," but rather "alleged wrongdoing on a truly colossal scale." The court noted that this was not simply a case involving business risk, and cautioned that "you cannot take legal risk on the theory that we are violating the law, but it's not likely to come back to haunt us." Thus, the court held the plaintiffs stated a claim regarding the defendant's failures of oversight for "knowingly violating the consent order."

AmerisourceBergen:[7] AmerisourceBergen, a major wholesale distributor of opioid pain medication, was sued derivatively stockholders of the company. The plaintiffs alleged that AmerisourceBergen's directors and officers failed to "adopt, implement, or oversee reasonable policies and practices to prevent the unlawful distribution of opioids, and repeatedly failing to act when undeniable evidence of widespread illegal opioid sales emerged." As a result, the plaintiffs alleged that the company suffered "billions of dollars of fines and harms." The Court of Chancery held that the plaintiffs pleaded a viable *Caremark* claim; namely, there was an inference that the "[d]efendants knew that AmerisourceBergen was reporting astoundingly low levels of suspicious orders … and went through the motions of providing oversight while consciously deciding not to take any action." However, the Court of Chancery dismissed the complaint, taking judicial notice of an opinion from a West Virginia court issued after the complaint was filed that found that the company's anti-drug diversion controls were legally compliant. The Court of Chancery therefore held it was unlikely that the plaintiffs' claims posed a substantial threat of liability and demand was therefore not excused. On appeal, the Delaware Supreme Court reversed, finding the Court of Chancery erred in using judicial notice to "effectively adopt the factual findings of another court." The Delaware Supreme Court reiterated the plaintiffs' allegations that "the AmerisourceBergen board, having fostered a 'culture of non-compliance,' was complicit in the Company's evasion of its obligation to monitor orders so as to reduce the likelihood that opioids would be diverted for non-medical use, in violation of the Controlled Substances Act." Additionally, the Delaware

[6] *In re Facebook, Inc. Derivative Litig.*, C.A. No. 2018-0307-JTL, Trans. at 4 (Del. Ch. May 10, 2023).

[7] *Lebanon Cnty. Emps.' Ret. Fund v. Collis*, 311 A.3d 773 (Del. 2023).

Supreme Court noted that "[t]his theory draws its support from former Chief Justice, then Vice-Chancellor Strine's oft-quoted affirmation in *In re Massey Energy Co.*, that 'Delaware law does not charter law breakers' and was dubbed a '*Massey* Theory' or '*Massey* Claim' by the Vice Chancellor here." Since the Delaware Supreme Court "agree[d] with the Court of Chancery's evaluation of the complaint's *Caremark* claims as well-pleaded" and "reject[ed] the court's negation of that assessment in light of the West Virginia Decision," the Delaware Supreme Court reversed the Court of Chancery's dismissal of the complaint and remanded for further proceedings.

Walmart:[8] The plaintiff asserted several derivative claims against Walmart's directors and officers in connection with the company's operations of pharmacies that dispensed prescription opioids and prior acts as a wholesale distributor of prescription opioids. The plaintiffs alleged that "the directors and officers of Walmart breached their fiduciary duties to the corporation and its stockholders by (i) knowingly causing Walmart to fail to comply with a settlement between the U.S. Drug Enforcement Agency (DEA) and Walmart (the DEA Settlement), (ii) knowingly causing Walmart to fail to comply with its obligations under the federal Controlled Substances Act and its implementing regulations (collectively, the Controlled Substances Act) when acting as a dispenser of opioids through its retail pharmacies, and (iii) knowingly causing Walmart to fail to comply with its obligations under the Controlled Substances Act when acting as a wholesale distributor of opioids for its retail pharmacies." One of those claims — the *Massey* claim — was that "Walmart's directors and officers knew that Walmart was failing to comply with its legal obligations and made a conscious decision to prioritize profits over compliance." The court noted that a "*Massey* Claim looks for or implies an affirmative decision to violate the law, which is similarly a decision to act in bad faith." The court also stated that "[a] strong pattern of conduct can support an inference that the corporate fiduciaries intentionally decided to cause the corporation to violate the law, typically because the costs and other burdens associated with compliance would cut into profits. 'The inference that corporate fiduciaries made a decision to violate the law is the foundation for a *Massey* Claim.'" In light of these findings, the court held that the plaintiffs stated a viable claim regarding compliance with Walmart's DEA settlement because the "pleading-stage record supports an inference that the directors … consciously chose not to take action to achieve compliance [with the DEA settlement]." Thus, the court held that the "pleading-stage record also points to a motive for the conscious decision not to devote more resources to compliance" because "[d]evoting more resources to achieving compliance with the DEA Settlement would have cost money and undercut [other] initiatives." The court also sustained the derivative claims relating to Walmart's compliance with its obligations as a dispenser under the Controlled Substances Act, but found that the plaintiffs did not adequately plead that the demand was excused with respect to claims relating to the company's compliance with its obligations as a distributor under the act.

[8] *Ontario Provincial Council of Carpenters' Pension Trust Fund v. Walton*, 2023 WL 3093500 (Del. Ch. Apr. 26, 2023).

Key Points

Over the past several years, *Caremark* claims have tended to fall into two categories — those alleging harms to the corporation based on "business risk" and those alleging harm to the corporation based on affirmative violations of positive law (*i.e.*, *Massey* claims). The court carefully examines *Caremark* claims. While there have been recent *Massey* claims that have survived dismissal, the Court of Chancery has reiterated that "[l]iability can only attach in the rare case where fiduciaries knowingly disregard [their] oversight obligation and trauma ensues. Despite a proliferation of modern jurisprudence, bad faith remains a necessary predicate to any *Caremark* claim."

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