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CLIENT MEMORANDUM

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Delaware Supreme Court Affirms Two-Condition *MFW* Roadmap to Obtain Business Judgment Review of Controller Transactions

In an *en banc*, unanimous opinion in *In re Match Group, Inc. Derivative Litigation*, the Delaware Supreme Court declined to provide a less burdensome path to business judgment review for self-interested controlling stockholder transactions that are not full "squeeze-out" mergers. Instead, the court's opinion, by Chief Justice Collins J. Seitz, Jr., confirms that, in all transactions where the controller stands on both sides and receives a non-ratable benefit (including in non-squeeze-outs), entire fairness is the presumptive standard of review and defendants must demonstrate that they satisfied *both* prongs of the framework set forth in *Kahn* v. *M & F Worldwide* Corp. ("*MFW*") to obtain business judgment review of the transaction. In addition, the opinion confirms that in the *MFW* setting, to replicate arm's-length bargaining, *all* committee members, not just a majority of the committee, must be independent of the controller. *Match* therefore affirms that *MFW* remains the only path under Delaware law to invoke business judgment review in self-interested controller transactions and clarifies the need to ensure the independence of each special committee member in order to rely on *MFW*'s protections. For more, see here.

Delaware Court of Chancery Holds That Activision Merger Approval Process Violated DGCL

In *Sjunde AP-fonden* v. *Activision Blizzard, Inc., et al.* (an opinion by Chancellor Kathaleen St. J. McCormick), the Delaware Court of Chancery declined to dismiss claims that common market practices used by the Activision Blizzard, Inc., board in approving its merger agreement with Microsoft Corporation resulted in a Delaware General Corporation Law (DGCL) violation. The opinion interprets the statutory requirements strictly, invalidating established market practice, which at least in the short term will result in disruption to deal parties and practitioners. Unless and until this opinion is further clarified in subsequent decisions by the Chancellor or on appeal, parties to merger agreements would be well served to have final "clean up" board meetings (or actions by unanimous written consent) after they send the directors a complete merger agreement with all schedules and exhibits, including the surviving corporation charter, attached and all blanks (including real names rather than code names for the parties and the cash value or exchange ratio) filled in. For more on *Activision*, see here. A legislative fix has been approved by the Corporation Law Section of the Delaware State Bar Association. However, this is a preliminary step and there is no assurance that the proposed amendments will be adopted in their current form by the full Delaware State Bar Association, the Delaware General Assembly and ultimately signed by the governor. If enacted as proposed, the amendments would be effective August 1, 2024, and apply retroactively to agreements and other documents approved or entered into previously. While civil actions or proceedings completed or pending before August 1, 2024 would still be permitted to stand, they are likely to have less impact if the amendments are adopted.

Delaware Court of Chancery Holds That Controllers May Owe Fiduciary Duties When Exercising Stockholder Rights

In *In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation* (an opinion by Vice Chancellor J. Travis Laster), the Delaware Court of Chancery clarified that, when exercising stockholder rights to alter a corporation's status quo, controllers owe duties not to harm the corporation or its minority stockholders intentionally or through gross negligence. If a controller acts as a stockholder to impair the rights of directors or the minority stockholders, the court will apply enhanced scrutiny review, requiring the controller to show that he or she acted in good faith for a legitimate objective, had a reasonable basis for believing that action was necessary and selected a reasonable means for achieving the legitimate objective. Prior to this, it had been clear that controlling stockholders owe fiduciary duties when using their influence over the board and management to cause the corporation to act, but there were competing lines of authority regarding whether any duties were owed when controllers act solely as stockholders. Analyzing this open question, the *Sears* decision, which remains subject to appeal to the Delaware Supreme Court, held that controllers are subject to fiduciary constraints when exercising their stockholder rights to alter a corporation's status quo but reiterated that controllers do not owe fiduciary duties when they exercise the right to vote or sell stock to defend themselves from corporate actions and preserve the status quo. The decision further clarified that, unlike fiduciary duties owed by directors, controlling stockholders may continue to act in their own self-interest as opposed to promoting the best interests of the corporation, so long as they do not act intentionally or with gross negligence to harm the corporation or minority stockholders. For more, see here.

Delaware Court of Chancery Applies Entire Fairness to Controlled Company's Move to Nevada

In *Palkon, et al.* v. *Maffei*, *et al.* (an opinion by Vice Chancellor J. Travis Laster), the Delaware Court of Chancery denied a motion to dismiss claims that the directors and controlling stockholder of TripAdvisor and its parent entity breached their fiduciary duties of loyalty when they decided to convert the two entities—both Delaware corporations—into Nevada corporations. The court held that the conversions are subject to review for entire fairness because the entities' controlling stockholder is alleged to receive a non-ratable benefit (i.e., reduced litigation exposure) not shared by the common stockholders. Nevertheless, the court explained that, even if the plaintiffs prevailed on the merits, it would not enjoin the conversions because any resulting harms could be compensated by monetary damages based on any decline in the valuation of the company after announcement of the conversion. Although *Maffei* applies traditional controlling-stockholder doctrine to the potential benefit of changing the entity's state of incorporation, the decision demonstrates that the Court of Chancery is unlikely to award the extreme remedy of enjoining the conversion if there is any potential that monetary damages could compensate the harm.

Delaware Court of Chancery Holds That Director Was Not Permitted to Share Confidential and Privileged Information with Affiliated Stockholder

In *Icahn Partners LP* v. *deSouza* (an opinion by Vice Chancellor Paul A. Fioravanti Jr.), the Delaware Court of Chancery held that a director elected to the board after a proxy contest run by a 1.4% stockholder of the corporation was not entitled to share confidential or privileged information about the corporation received in his capacity as a director. In connection with his election to the board, the director signed a questionnaire in which he agreed to comply with the corporation's code of conduct, including a requirement that directors not share privileged or confidential company information. The director nevertheless gave such information to the stockholder who nominated him, and the stockholder used the information in a lawsuit against the corporation. The corporation then moved to strike the information from the complaint. The court granted the motion, holding that the director breached his duties in sharing the information. The court held that directors may share privileged or confidential information in two scenarios: (i) where the director is designated pursuant to a contract or the stockholder's voting power and (ii) where the director serves in a controlling or fiduciary capacity with the stockholder. This latter category includes what the court called "one brain" situations (i.e., where the director is the controller of the corporation or a fiduciary to the controller and is of "one mind" in the sense that it cannot be expected that he or she not use the information known in his or her capacity as a director in his or her decision-making as a stockholder or stockholder fiduciary). Here, the stockholder did not have a contractual right (or the voting power) to appoint the director, and the director did not owe a fiduciary duty to the stockholder (he was an employee of the stockholder with no fiduciary duties to it). Therefore, it was a breach of his duty to share the confidential and privileged information with the stockholder and the court granted the motion to strike.

Delaware Supreme Court Enforces Forfeiture-for-Competition Provision

The Delaware Supreme Court in *Cantor Fitzgerald, L.P.* v. *Ainslie*, sitting *en banc*, relied on the State's strong policy toward enforcing contracts as written to enforce a forfeiture-for-competition provision in a limited partnership agreement, and in so holding, reversed an earlier decision of the Delaware Court of Chancery (discussed here). Plaintiffs, former limited partners of the defendant, agreed to a so-called "forfeiture-for-competition" provision in which they would be paid balances in their capital accounts in installments over four years after their withdrawal as partners, but would forfeit these payments if they engaged in certain conduct, including "Competitive Activity" during the four-year period following their withdrawal for any reason. The restricted Competitive Activity encompassed both non-competition and employee and customer non-solicitation covenants. Following the limited partners' voluntary withdrawal from the partnership, the partnership determined that the limited partners were all ineligible to receive the payments because each had engaged in Competitive Activity and withheld amounts from just under $100,000 to over $5 million from the limited partners. In its earlier decision, the Court of Chancery ruled that the limited partnership agreement's forfeiture-for-competition provision should be reviewed for reasonableness, rather than enforced on its terms, and concluded that it was unenforceable as "an unreasonable restraint built on unreasonable restrictive covenants." On appeal, the Delaware Supreme Court, in an opinion by Justice Gary F. Traynor, reversed, noting Delaware's strong public policy in favor of freedom of contract, particularly as embodied in the Delaware Revised Uniform Limited Partnership Act, and holding that the forfeiture-for-competition provision at issue was enforceable and not subject to a reasonableness review. For more, see here.

Delaware Court of Chancery Rescinds Elon Musk's $55.8 Billion Compensation Package

In *Tornetta* v. *Musk* (a post-trial opinion by Chancellor Kathaleen St. J. McCormick), the Delaware Court of Chancery held that the board of directors of Tesla, Inc. breached its fiduciary duties in awarding the company's CEO and 21.9% stockholder, Elon Musk, an equity compensation package that was ultimately valued at $55.8 billion. The package, which was approved by the stockholders, included 12 tranches of equity awards, each worth 1% of Tesla's outstanding shares and vested for each $50 billion increase in Tesla's market capitalization (along with EBITDA and revenue requirements). Except for limited changes, the package resembled one that Musk himself had initially proposed.

First, the court determined that the award of the compensation package was a conflicted controller transaction, and thus subject to entire fairness review. In so holding that Musk controlled Tesla as to the grant, the court cited his 21.9% interest (noting that in other contexts like DGCL Section 203 and poison pill triggers, there is a presumption of control at 20%). The court also looked to other indicia of control, including that Musk wielded power over the board through "high-status roles" and "managerial supremacy." He was a "Superstar CEO" who directors, investors and markets believe makes a unique contribution to the company's value. The court also considered Musk's freedom to use company resources for personal projects, the fact that a majority of the board was not independent from him due to extensive business and personal relationships, with some owing a substantial portion of their wealth to him. The court also noted the committee's deference to Musk during the process leading to his compensation package.

With entire fairness as the applicable standard, the court determined that the stockholder vote did not shift the burden of proof away from the defendants to prove the package was fair because stockholders were not fully informed in their vote, as the proxy called the compensation committee "independent," which the court noted was inaccurate based on the failure to disclose conflicts and a mischaracterization of a conversation between Musk and the committee's chair. Finally, the court held that the defendants did not prove that the compensation package was entirely fair, holding that neither the process leading to its approval nor the price was fair. The size of the award was not necessary to achieve the board's goal of retaining and engaging Musk with Tesla, noting that his 21.9% equity holdings already provided enough incentive to stay and grow Tesla's market capitalization. Therefore, the court ordered full rescission of the grant. The opinion is subject to appeal to the Delaware Supreme Court.

M&A Markets

The following issues of *M&A at a Glance*, our monthly newsletter on trends in the M&A marketplace and the structural and legal issues that arise in M&A transactions, were published this quarter. Each issue can be accessed by clicking on the date of each publication below.

2023 Annual Round-Up	February 2024	March 2024

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:

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

Ross A. Fieldston
+1-212-373-3075
rfieldston@paulweiss.com

Andrew G. Gordon
+1-212-373-3543
agordon@paulweiss.com

Jaren Janghorbani
+1-212-373-3211
jjanghorbani@paulweiss.com

Andrew D. Krause
+1-212-373-3161
akrause@paulweiss.com

Brian Scrivani
+1-212-373-3271
bscrivani@paulweiss.com

Kyle T. Seifried
+1-212-373-3220
kseifried@paulweiss.com

Cullen L. Sinclair
+1-212-373-3483
csinclair@paulweiss.com

Laura C. Turano
+1-212-373-3659
lturano@paulweiss.com

Krishna Veeraraghavan
+1-212-373-3661
kveeraraghavan@paulweiss.com

Counsel Frances F. Mi and Legal Consultant Cara G. Fay contributed to this memorandum.

Our M&A Group

The Paul, Weiss M&A Group consists of approximately 40 partners and 125 counsel and associates based in New York, Washington, D.C., Wilmington, London, Los Angeles, San Francisco, Toronto, Tokyo, Hong Kong and Beijing. The firm's Corporate Department consists of more than 75 partners and roughly 300 counsel and associates.

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