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CLIENT ALERT

Recent Delaware Major Corporate Law Decisions

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During the past few months, the Delaware Chancery Court has issued a number of important corporate law decisions, including two last week. Below is a summary of the recent court decisions arising out of (i) the acquisition of Activision Blizzard, Inc. by Microsoft Corporation, (ii) certain governance arrangements between Moelis & Company and Ken Moelis, (iii) a compensation plan issued by Tesla, Inc. to Elon Musk, and (iv) certain transactions between Edward Lampert and Sears Hometown and Outlet Stores, Inc.

Sjunde AP-Fonden v. Activision Blizzard, et. al.[1]

Summary. This dispute in the Delaware Court of Chancery arose from the acquisition of Activision Blizzard, Inc. by Microsoft Corporation. The plaintiff, which owned stock in Activision pre-merger, claimed that the defendants violated multiple provisions of the Delaware General Corporation Law (the "DGCL") governing board negotiation and board and stockholder approval of merger agreements. The defendants moved to dismiss these claims and, in a February 29, 2024 decision, Chancellor McCormick allowed all but one of the claims to proceed.

Factual History. Microsoft approached Activision about a business combination in November 2021 and in December 2021 the parties agreed to a tentative purchase price and entered into an exclusivity agreement. On January 17, 2022, the Activision Board met to approve the merger and the draft merger agreement. The draft merger agreement approved by the Activision Board did not include the following attachments: (i) the company disclosure schedules, or (ii) the certificate

1 *Sjunde AP-fonden v. Activision Blizzard, Inc., et al.*, C.A. No. 2022-1001-KSJM (Del. Ch. February 29, 2024).

of incorporation for the surviving entity. In addition, the draft merger agreement had a placeholder for the amount of consideration and listed “Denali” (the deal code name for Activision) as the seller.

The draft merger agreement also did not address the ability of Activision to pay dividends while the merger was pending. At the January 17th Activision Board meeting, the Board delegated this issue to an *ad hoc* committee of the Board, which committee subsequently approved the amount of dividends permitted to be paid during the pendency of the transaction.

On January 18, 2022, the parties executed the merger agreement. In March 2022, Activision filed a proxy statement seeking shareholder approval of the merger. The merger agreement attached to the proxy statement did not contain the disclosure schedules or the certificate of incorporation for the surviving entity.

Activision stockholders approved the merger at a stockholder meeting on April 22, 2022 with more than 98% of stockholders present voting in favor. During 2023, the transaction received the requisite regulatory approvals and the merger closed on October 13, 2023.

On November 3, 2022, Sjunde AP-Fonden filed this action against the Activision Board, Microsoft, the Microsoft Board, and the merger sub, alleging violations of Sections 251(b), 251(c), 251(d) and 141 of the DGCL and defendants moved to dismiss.

<u>Legal Analysis</u>. Section 251(a) of the DGCL requires a board to adopt a resolution approving an “agreement of merger” compliant with Section 251(b).[2] Chancellor McCormick agreed with the plaintiff that Section 251(b) requires the target board to approve “at a bare minimum” an “essentially complete” version of the merger agreement. While acknowledging that this interpretation runs counter to established market practice, the Chancellor stated that “[w]here market practice exceeds the generous bounds of private ordering afforded by the DGCL, then market practice needs to check itself.” The Chancellor also cited Vice Chancellor Laster’s recent Moelis decision in reaching this conclusion.

Chancellor McCormick focused on the six elements required by Section 251(b) to be included in a merger agreement, and found that given the omission of the consideration, the disclosure schedules, the certificate of incorporation of the surviving entity and the dividend provision, the merger agreement approved by the Activision Board was not essentially complete. Thus, the motion to dismiss the Section 251(b) claim was denied. However, the Chancellor did leave open the possibility that the disclosure schedules might not be required for an essentially complete merger agreement.

The Chancellor also denied the motion to dismiss the Section 251(c) claim. This section requires that a notice of the stockholder meeting to approve a merger agreement contain a copy of the merger agreement required by Section 251(b) or a summary thereof.[3] The Chancellor held that the notice sent to Activision stockholders did not attach a compliant copy

[2] 8 Del. C. § 251(a).
[3] 8 Del. C. § 251(c)(7).

of the merger agreement as the certificate of incorporation of the surviving entity was not attached and the summary of the merger agreement was contained in the proxy statement and not in the notice.

The Chancellor dismissed the Section 251(d) claim; this section prohibits any amendment of any term or condition of the merger agreement if that change has an adverse effect on a class of stockholders.[4] The plaintiff argued that the defendants violated this section by agreeing not to exercise the termination right in the merger agreement without Activision stockholder approval, which agreement would adversely affect stockholders since the closing would be "substantially delayed." The court found that these allegations were not reasonably conceivable at the time of filing of the amended complaint as the plaintiff alleged no facts to support the assertion.[5]

Finally, the Chancellor denied the motion to dismiss the Section 141(c) claim. Section 141(c)(2) provides that a board of directors may designate a committee to exercise all powers of the board, except (i) approving or recommending to the stockholders any matter (other than the election or removal of directors) expressly required by the applicable chapter of the DGCL to be submitted to stockholders for approval or (ii) adopting, amending or repealing bylaws.[6] Section 251(b) discussed above imposes a duty on a board of directors to approve the terms of a merger agreement. Thus, Section 141(c)(2) does not permit a committee to approve any merger agreement or its terms.

Chancellor McCormick found that the plaintiff had adequately alleged that the Activision Board violated Section 141(c) by delegating approval of the dividend provision to a committee. She found that the dividend provision was a term of the merger and that it is reasonably conceivable that the committee alone approved the dividend provision.

Key Takeaways. M&A practitioners often do not attach the charter of the surviving entity (which will become a wholly owned subsidiary of the buyer and not be relevant to target stockholders) as an exhibit to the version of the merger agreement distributed to the target board of directors. Additionally, the Activision board would have been informed of the final merger price by the company's counsel and financial advisors at the Board meeting approving the merger agreement (this would be reflected in the applicable Board minutes and in the bankers' book presented to the Board in connection with the fairness opinion). A substantially final draft of the disclosure schedules would typically be distributed to the target board by counsel during the course of the negotiations, though these disclosure schedules would not typically be viewed as part of the merger agreement requiring approval under Section 141. Exclusion of the disclosure schedules and the charter of the surviving entity from the proxy statement relating to the transaction is also market practice. Also, the exception to the dividend restrictions in the interim operating covenants would often be contained in the disclosure

4 8 Del. C. § 251(d).

5 After filing of the amended complaint, Defendants executed a letter agreement agreeing to extend the outside termination date, but the plaintiff did not amend its pleading to challenge the letter agreement.

6 8 Del. C. § 141(c)(2).

schedules (though in the Activision merger agreement it was contained in the merger agreement in the interim operating covenants).

This decision, coupled with the Moelis decision described below, shows an increasing focus on complying with the formalities of the DGCL. Until such time (if any) as the Delaware Supreme Court adjusts this opinion or the Delaware legislature amends Sections 141 and 251, M&A practice will need to adjust to this opinion, including by:

- having the target board receive and approve a final execution version of the merger agreement (including all disclosure schedules and exhibits);
- attaching the charter of the surviving entity to the execution version of the merger agreement that is attached to the proxy statement;
- incorporating the proxy statement into the notice to stockholders; and
- having the full board of directors ratify or adopt any action taken by a committee with respect to the merger agreement.

West Palm Beach Firefighters' Pension Fund v. Moelis & Company.[7]

Summary. The plaintiff in this matter in the Delaware Court of Chancery is a holder of Class A common stock of Moelis & Company (the "Company"). It filed suit challenging certain governance arrangements between the Company and Ken Moelis, which arrangements are set forth in a Stockholder Agreement executed in 2014 the day before the Company's initial public offering ("IPO"). There is agreement that the provisions in the Stockholder Agreement were fully disclosed to the public at the time of the IPO. Mr. Moelis is the founder and CEO of the Company and Chairman of its Board of Directors.

Under the terms of the Stockholder Agreement, the Board must obtain Mr. Moelis' prior written consent before taking eighteen different categories of action (the "Pre-Approval Requirements"). The Stockholder Agreement also contains another set of provisions intended to ensure that Mr. Moelis can select a majority of the members of the Board (the "Board Composition Provisions") and a further set of provisions requiring the Board to populate any Board committee with a number of Mr. Moelis' designees proportionate to the number of his designees on the Board (the "Committee Composition Provisions").

The plaintiff contended that these provisions violate Section 141(a) of the DGCL and that the committee provisions referenced above also violate Section 141(c). The plaintiff and the Company filed cross motions for summary judgment. In his 132-page decision issued February 23, 2024, Vice Chancellor Laster granted plaintiff's motion for summary

[7] *West Palm Beach Firefighters' Pension Fund v. Moelis & Company*, C.A. No. 2023-0309-JTL (Del. Ch. February 23, 2024).

judgment as to the facial invalidity of the Pre-Approval Requirements, the Committee Composition Provisions and certain of the Board Composition Provisions. Vice Chancellor Laster granted the Company's motion for summary judgment as to the remainder of the Board Composition Requirements.

Factual History. The Company has two authorized classes of stock. In the IPO, the Company issued Class A common stock to the public and Class B common stock to Moelis & Company Partner Holdings LP ("Holdings"). Mr. Moelis and other employees of the Company and its affiliates own the equity in Holdings and Mr. Moelis controls Holdings. Holdings also directly owns equity interests in the Company's main operating subsidiary, which equity interests are convertible into Class A common stock. Each share of Class A common stock has one vote and so long as Mr. Moelis meets certain ownership requirements, has not been convicted of certain crimes and has not had his employment agreement terminated for certain reasons (the "Class B Voting Conditions"), each share of Class B common stock has 10 votes. The Stockholder Agreement is drafted so that it will remain in effect unless there is a failure of a Class B Voting Condition (with a smaller applicable ownership requirement).

The Pre-Approval Requirements run in favor of Mr. Moelis or Holdings and include amendments to the certificate of incorporation, certain debt incurrences, certain equity issuances, removal or appointment of Section 16 officers, adoption of budgets and business plans, mergers, asset sales, liquidations, material contracts, material litigation, and the declaration and payment of dividends. Vice Chancellor Laster said that these requirements mean the Company Board "must get Moelis' signoff in advance for virtually any action the directors might want to take."[8]

There are six Board Composition Provisions: (i) a requirement for the Company to use best efforts to maintain a Board of not more than 11 directors; (ii) the right of Mr. Moelis to designate a number of persons equal to a majority of the Board (reduced to one quarter of the Board if the Class B Voting Conditions fail to be met); (iii) the Company must nominate Mr. Moelis' designees for election as directors; (iv) the Board must recommend in favor of Mr. Moelis' designees; (v) the Company is required to take all reasonable actions within its control to cause designees of Mr. Moelis to be elected to the Board; and (vi) the Company is required to take all actions necessary to cause any vacancy created by the departure of a designee of Mr. Moelis to be filled by a new designee of Mr. Moelis.

In addition to the Committee Composition Provisions noted above, the Board is not authorized to create a committee of non-Moelis designees.

After the IPO, Mr. Moelis controlled 96.8% of the Company's voting power. In February 2021, his voting power fell below 50%, and Mr. Moelis has been annually waiving his right to designate a majority of the Board to ensure compliance with NYSE rules for non-controlled companies. Mr. Moelis currently owns approximately 6.5% of the outstanding equity and

[8] *Id.* at 20.

has the right to obtain additional shares, bringing his ownership interest to approximately 11.5%. The Class B Voting Conditions continue to be satisfied and thus Mr. Moelis' voting power is approximately 40.4%.

The plaintiff owns Class A common stock purchased in 2014. It seeks declarations that the Pre-Approval Requirements, the Board Composition Provisions and the Committee Composition Provisions are invalid as they facially violate Section 141(a) of the DGCL (and, as to the Committee Composition Provisions, Section 141(c) of the DGCL). To succeed on a facial challenge, the plaintiff must show that the challenged provisions cannot operate lawfully with respect to Section 141(a) under any circumstances. Section 141(a) provides that the business and affairs of a corporation shall be managed by or under the direction of the board of directors, except as may otherwise be provided in its certificate of incorporation or in the applicable chapter of the DGCL.[9] Section 141(c) relates to committees of boards.

Legal Analysis. The opinion examines in detail Section 141(a) precedents and provides that these precedents show that a court applying Section 141(a) must first determine whether the challenged provision constitutes part of the corporation's internal governance arrangements and if it does, then the court will apply the test set forth in *Abercrombie*.[10] This test examines whether the provision (i) has the effect of removing from the directors in a very substantial way their duty to use their own best judgment on management matters or (ii) tends to limit in a substantial way the freedom of directors to make decisions on management policy matters.

Vice Chancellor Laster concluded that the Stockholder Agreement and the challenged provisions therein "offer a prototype for what a governance arrangement looks like." He noted that Delaware decisions regularly recognize that ordinary commercial contracts typically do not raise Section 141(a) concerns and that the most controversial decisions have involved challenges to merger agreement provisions where an internal affairs arrangement overlapped with the contract rights of the buyer.[11]

After determining that the challenged provision constitutes part of the Company's internal governance arrangements, Vice Chancellor Laster then applied the test from *Abercrombie*. After applying the test, he concluded that (i) the Pre-Approval Requirements are facially invalid under Section 141(a), (ii) the recommendation, board size and board vacancy Board

9 8 Del. C. § 141(a).

10 *Abercrombie v. Davies*, 123 A.2d 893, 899 (Del. Ch. 1956), rev'd on other grounds, 130 A.2d 338 (Del. 1957).

11 Vice Chancellor Laster proposed the following seven factors to assist in determining whether a contract has provisions constituting part of the corporation's internal governance arrangements. First, governance agreements often have a statutory grounding in the DGCL. Second, the corporation's counterparties in a governance agreement hold roles as intra-corporate actors and are likely to be officers, directors, stockholders or their affiliates. Third, the challenged provisions seek to specify the terms on which the intra-corporate actors can authorize the corporation's exercise of its corporate power. Fourth, a governance agreement does not readily reveal an underlying commercial exchange. Fifth, in a governance agreement the governance rights are the point of the agreement, while in a commercial agreement they seek to protect the underlying transaction. Sixth, in a commercial transaction the typical remedy will be damages while in a governance agreement the typical remedy will be equitable in nature. Seventh, a commercial agreement is more likely to be terminable or to have a limited duration while a governance agreement is more likely to be enduring.

Composition Provisions discussed above are also facially invalid under Section 141(a), (iii) the Committee Composition Provisions discussed above are facially invalid under Section 141(a) and Section 141(c), and (iv) the designation, nomination and efforts Board Composition Provisions discussed above are not facially invalid under Section 141(a) because they could operate legitimately.

Vice Chancellor Laster concluded that the Pre-Approval Requirements are explicit and direct limitations on the ability of the Board to take action and are "so all-encompassing as to render the Board an advisory body."[12] As to the recommendation requirement, the board size requirement, the board vacancy requirement and the Committee Composition Provisions, he concluded they each violate the Abercrombie test by removing from directors in a substantial way their duty to use their own best judgment on management matters such as who should serve as a director or a committee member and the size of the Board.

Key Takeaways. The Company argued that many corporations have stockholder agreements containing similar provisions and that settlement agreements resolving proxy contests with activist investors often contain provisions resembling the Board Composition Provisions. Vice Chancellor Laster noted that a Section 141(a) assessment of provisions in an activist settlement must await a proper case but that board provisions like those found in this decision to be facially invalid "could be problematic."[13]

The Vice Chancellor also noted that while other companies have entered into similar stockholder agreements with internal actors, (i) "to date the number of companies using this structure remains low relative to the total number of companies in the market," (ii) this ruling will not be "overly disruptive, particularly when statutorily permissible alternatives exist"[14] and (iii) market practice is not law.

Vice Chancellor Laster noted on page 12 of his opinion that Mr. Moelis could have accomplished the vast majority of what he wanted through the Company's certificate of incorporation (though even a charter amendment cannot override a mandatory feature of the DGCL) and that the Board could still use its blank check authority to issue Mr. Moelis preferred

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12 *Supra* note 7, at 108.

13 On March 3, 2024, Crown Castle Inc. announced that it had entered into an amendment to its letter agreement, dated December 19, 2023, with Elliott Investment Management, L.P. and two Elliott affiliates. The amendment (i) eliminates limitations on the size of the board of directors of Crown Castle and certain committees, (ii) provides that Elliott will vote its shares of Crown Castle common stock pro rata in accordance with the vote of other Crown Castle stockholders at the 2024 annual meeting (subject to certain exceptions), and (iii) provides that if the board of directors of Crown Castle determines in good faith that its fiduciary duties require recommending a vote "against" (or rescinding a recommendation "for") either or both of two specified candidates for director, the board may change its recommendation and accordingly will have no obligation to solicit proxies with respect to any such director candidate it is no longer recommending. Crown Castle Inc. (Mar. 3, 2024). *Form 8-K*. Retrieved from SEC EDGAR website https://www.sec.gov/Archives/edgar/data/1051470/000095014224000618/eh240454086_8k.htm.

14 *Supra* note 7, at 126-127.

stock carrying a set of consent and director rights, with the certificate of designations becoming part of the charter as a matter of law. Because the provisions would appear in the charter, they would comply with Section 141(a).[15]

For companies with existing stockholders agreements, the ruling calls into doubt many common features, including consent and veto rights and director rights, as well as standard provisions not mentioned in the opinion, such as drag-along rights. While we believe that an amendment to the charter approving the stockholders agreement (including through the potential issuance of a "golden share of preferred stock") will likely fix most of those provisions, the decision to implement the fix will itself be subject to a fiduciary duty analysis. Especially in cases where the controller does not own a majority of the voting stock, it may be difficult for controllers to find a "give" sufficient to justify the "get" of a fix to the stockholders agreement. We would not be surprised to see the plaintiffs' bar commence suits against public companies with problematic agreements. Because each situation will vary based on the particular terms of the charter and the stockholders agreement, we urge interested parties to consult with counsel.

Going forward, we expect to see more governance structures added to corporate charters, including more dual-class stock and board structures as well as incorporation by reference of stockholder agreements.

Richard J. Tornetta v. Elon Musk, et al.[16]

Summary. This dispute in the Delaware Court of Chancery arose from the issuance of a compensation plan by Tesla, Inc. to Elon Musk. Mr. Musk is founder and CEO of Tesla. The plaintiff filed a derivative suit, claiming that Tesla's directors breached their fiduciary duties by awarding Mr. Musk a performance-based equity-compensation plan.

After a trial before Chancellor McCormick, she entered judgment for the plaintiff, finding that the compensation plan was subject to review under the entire fairness standard, the defendants bore the burden of proving that the compensation plan was fair, and they failed to meet their burden, and as a remedy the court rescinded Mr. Musk's compensation plan.

Factual History. In 2004, Mr. Musk led Tesla's Series A financing round, investing $6.5 million. At that time, Tesla was a startup producing small quantities of the Tesla Roadster, a battery-powered sports car. Tesla went public in 2010, raising $226.1 million. By 2022, Tesla had nearly 100,000 full-time employees and its market capitalization was over $1 trillion.

Prior to the challenged transaction, Mr. Musk received two compensation plans from Tesla, one in 2009 and one in 2012. Mr. Musk achieved all of the 2009 grant's performance milestones by the end of 2013. The 2012 grant involved ten tranches, each offering options representing 0.5% of Tesla's outstanding common stock as of August 2012. In 2017, Tesla was nearing completion of the 2012 milestones,[17] which prompted a discussion between the Board and Mr. Musk

[15] The Chancellor noted that while some might find it bizarre that the DGCL would allow one means of accomplishing a goal while prohibiting another, this is what is required by the doctrine of independent legal significance.

[16] *Richard J. Tornetta v. Elon Musk et al*., C.A. No. 2018-0408-KSJM (Del. Ch. January 30, 2024).

[17] In the five-year period since the issuance of the 2012 grant, Tesla's market capitalization grew from $3.2 billion to $53 billion.

that led to the 2018 compensation plan at issue in the case. At the time of the 2018 grant, Mr. Musk beneficially owned 21.9% of Tesla's common stock.

During the period of discussion and approval of the 2018 grant, Tesla had a nine-person Board and a Compensation Committee of four directors.

In 2017, one of the directors reached out to Mr. Musk to ask if he was "ready to recommit" to Tesla and subsequently Mr. Musk put forward the terms of a new compensation plan. The process of developing and negotiating the 2018 grant stopped and started during the remainder of 2017, with the timing being driven by Mr. Musk.

On January 21, 2018, the Board unanimously approved the 2018 grant, with Board approval being conditioned on approval of the 2018 grant by a majority vote of disinterested stockholders. Mr. Musk and one other director recused themselves and one director was on leave.

The 2018 plan provided Mr. Musk the opportunity to secure 12 total tranches of options, each representing 1% of Tesla's total outstanding shares as of January 21, 2018. For a tranche to vest, Tesla's market capitalization must increase by $50 billion and Tesla must achieve either an adjusted EBITDA target or a revenue target in four consecutive fiscal quarters. The plan has a maximum value of $55.8 billion and a grant date fair value of $2.6 billion, and is the largest potential compensation opportunity ever observed in public markets by multiple orders of magnitude.

The proxy statement for approval of the 2018 grant described all of the Compensation Committee members as "independent" and did not disclose the financial or personal connections between the members of the Compensation Committee and Mr. Musk. Tesla prepared three sets of projections during the process; under the July 2017 projections approved by the Audit Committee, Tesla would achieve three of the revenue milestones and all of the adjusted EBITDA milestones during 2020, and under projections from December 2017 reviewed by the Board, by 2020 Tesla would achieve eleven operational milestones. These projections were not disclosed in the proxy statement.[18]

The stockholders approved the 2018 grant at a special meeting on March 21, 2018 with 73% of the votes cast at the meeting voting in favor. In its Form 10-Q for March 31, 2018, Tesla disclosed that one revenue and two adjusted EBITDA milestones were considered "probable of achievement," which disclosure was made for accounting purposes and based on the March 2018 projections.

As of June 20, 2022, all market capitalization milestones had been achieved and all adjusted EBITDA milestones had been achieved.

[18] In March 2018 (after issuance of the proxy statement), the Board was presented with a third set of projections, which were more pessimistic than the prior projections but still showed achievement of two revenue and four adjusted EBITDA milestones by the end of 2020.

Legal Analysis.[19] Chancellor McCormick held that the entire fairness standard governs because Mr. Musk exercised control over the 2018 grant. Delaware law imposes fiduciary duties on those who control a corporation. A plaintiff can establish fiduciary status by showing that the defendant controlled the particular transaction at issue; this is referred to as "transaction-specific" control.

The Chancellor held that given Mr. Musk's stock ownership, "boardroom and managerial supremacy" as a "superstar CEO," and relationships with the Board, and the process in determining the 2018 grant (Mr. Musk controlled the timing, there was no meaningful negotiation over the size or other terms of the grant, there was no benchmarking analysis comparing the 2018 grant to plans at comparable firms, and the directors leading the process for the Compensation Committee viewed the process as a "collaboration" with Mr. Musk), Mr. Musk exercised transaction-specific control over the 2018 grant and thus entire fairness is the standard of review and defendants bear the burden of proof.

In *Kahn v. Lynch Communication Systems, Inc.*, the Delaware Supreme Court held that defendants may shift the burden of persuasion by either showing that the transaction was approved by a well-functioning committee of independent directors, or showing that the transaction was approved by an informed vote of a majority of the minority shareholders.[20] The Chancellor found that there was no well-functioning committee of independent directors and that the stockholder vote was not fully informed as the stockholders were not apprised of all material information relating to the 2018 grant, including by failing to disclose in the proxy statement the Compensation Committee members' potential conflicts with Mr. Musk, material information concerning the process and information in the Company's possession regarding the likelihood of achieving the grant metrics.

The opinion provides that the description of the Compensation Committee members as independent was "decidedly untrue" as to one director and "proved untrue" as to the other directors and that "all of the directors acted under a controlled mindset, calling into question the disclosure as to each of them."[21] The opinion provides an analysis in detail of the possible conflicts between Mr. Musk and each other director deemed independent by Tesla, and the Chancellor notes that Mr. Musk had a 15-year relationship with the Compensation Committee chair and that the other Compensation Committee member on the working group had business dealings with Mr. Musk for over 20 years and vacationed with Mr. Musk's family on a regular basis.

As to process, the opinion provides that (i) stockholders are entitled to a complete and accurate description of the material steps in the board or committee process that resulted in the 2018 grant, including a description of the parties' bargaining positions and a discussion of the level of control Mr. Musk exercised over the process, and (ii) when a plaintiff proves process defects as significant as those present in this case, the defendants will generally find it difficult to prove that the

[19] In addition to the analysis described below, the 200-page opinion also discusses in detail Mr. Musk's settlement with the SEC in 2018 and the acquisition of Twitter.

[20] *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

[21] *Supra* note 16, at 150.

stockholder vote was fully informed. The Chancellor also rejected the defendants' argument that the stockholder vote was fully informed because all of the material economic terms were disclosed.

Thus, the defendants retained the burden under the entire fairness standard, and the Chancellor determined that the defendants failed to prove that the 2018 grant was the product of fair dealing or at a fair price. As to fair dealing, the court looked at how the deal was started and timed, how it was negotiated and structured, and how it was approved. For the reasons discussed above, the defendants failed to meet the fair dealing test.

As to fair price, the court looked at the economic and financial considerations of the 2018 grant to determine if it was substantively fair and noted that "process can infect price" and that where the pricing terms of a transaction with an unfair process cannot be justified by comparison to substantial precedent transactions, it will be very difficult to persuade the court as to fairness of price.

The defendants argued that the 2018 grant provided Mr. Musk an opportunity to increase his Tesla ownership by about 6% (from about 21.9% to at most 28.3%) if he increased Tesla's market capitalization from approximately $50 billion to $650 billion, while also hitting the operational milestones tied to revenue or adjusted EBITDA growth, thus benefiting all stockholders. The opinion rejects this argument, finding that (i) Mr. Musk's existing equity position "gave him every incentive to push Tesla to levels of transformative growth," (ii) Mr. Musk made clear that he had no intention of leaving Tesla, (iii) the 2018 grant was not conditioned on Mr. Musk devoting any set amount of time to Tesla, (iv) defendants did not prove causation between the increase in market capitalization and the 2018 grant,[22] and (v) the "incredible size of the biggest compensation plan ever--an unfathomable sum"[23] seems to have been designed to help Mr. Musk achieve colonization of Mars, which Mr. Musk believes would be good for humanity.

As the defendants failed to meet the burden of proving that the 2018 grant was fair, as a remedy the court rescinded the 2018 grant. The Chancellor noted rescission is the preferred remedy for breach of fiduciary duty where one party has misled another, and requires a showing by the plaintiff that it is possible for all parties to the transaction to be restored to the position they occupied before the challenged transaction. She noted that the 2018 grant can be "unscrambled" as no third-party interests are implicated and the 2018 grant is unexercised. As to arguments from the defendants of the harshness of the remedy, she noted Mr. Musk has billions of dollars from his preexisting equity stake and the defendants have not offered a viable alternative.

[22] *Supra* note 16, at 6.

[23] *Supra* note 16, at 180.

Following issuance of the decision, Mr. Musk announced that Tesla will hold a shareholder vote on transferring its state of incorporation from Delaware to Texas.[24]

Last week, the three firms who represented the plaintiff filed a fee request for $6 billion, payable in Tesla stock. The filing acknowledged that the requested fee is unprecedented in terms of absolute size and works out to an hourly rate of $288,888.[25]

Key Takeaways. The decision has proven controversial. While some have argued that the decision is stunning,[26] others have applauded the verdict.[27]

The decision can be appealed to the Delaware Supreme Court once the parties agree on a final order and on fees for the plaintiff's attorneys, which will be paid by Tesla.

Regardless of what happens on appeal, the opinion provides some useful reminders to directors and legal practitioners.

First, the opinion makes clear that a 21.9% stockholder can be a controller (whether through a showing of "general control" or "transaction-specific control") and owe fiduciary duties to the other stockholders. In order to avoid a finding of "transaction-specific control" in a transaction with a large stockholder, process will be very important and independent directors should run the process on behalf of the company and the process should take the form of a negotiation and not a collaboration.

[24] Gareth Vipers, Ryan Felton and Ginger Adams Otis, *Elon Musk Wants to Move Tesla's Incorporation from Delaware to Texas*, The Wall Street Journal (Feb. 1, 2024 4:12 PM), https://www.wsj.com/business/tesla-to-hold-shareholder-vote-to-incorporate-in-texas-elon-musk-says-8eb78eef.

[25] Plaintiff's Opening Brief in support of Application for an Award of Fees and Expenses, *Richard J. Tornetta v. Elon Musk et al*., C.A. No. 2018-0408-KSJM (Del. Ch. Ct.).

[26] *See* Donald Kalfen, *Delaware Court Strikes Down Musk's $56 Billion Pay Package* ("this is the first time that a Delaware court has struck down an equity grant to a public company CEO." The outcome is "remarkable given that Delaware state courts typically afford significant judicial deference to corporate board decisions."), Meridian Compensation Partners Client Alerts (Feb. 16, 2024), https://www.meridiancp.com/insights/delaware-court-strikes-down-musks-56-billion-pay-package/; Colette Bennett, *Cathie Wood and Elon Musk Agree on One Key Problem* (citing statements made on X (formerly known as Twitter) by an investor named Cathie Wood describing the ruling as "un-American, an assault on investor rights, and an insult to the Board of Directors of one of the most stunningly successful companies in US history."), The Street (Feb. 5, 2024, 10:30 PM), https://www.thestreet.com/technology/cathie-wood-elon-musk-agree-on-one-key-problem; Jeb Bush and Joe Lonsdale, *Elon Musk and Donald Trump Cases Imperil the Rule of Law*; The Wall Street Journal (Opinion Column, Feb. 21, 2024 2:14 PM), https://www.wsj.com/articles/trump-and-musk-cases-imperil-the-rule-of-law-new-york-delaware-courts-business-266a5559?mod=article_inline.

[27] See Joseph N. DiStefano, *Why Is Elon Musk So Mad at Delaware?* (quoting Ann Lipton, a law professor at Tulane University School of Law, that rescission of the 2018 grant "would not have happened if Tesla had at least adhered to the basic formalities and appearances of ordinary corporate governance. Most corporate executives don't have a problem with that."), The Philadelphia Inquirer (Feb. 6, 2024), https://www.inquirer.com/business/elon-musk-delaware-chancery-court-reaction-20240206.html; Will Oremus and Rachel Lerman, *Meet the Delaware Judge Who Keeps Foiling Elon Musk*, The Washington Post (Feb. 19, 2024 8:00 AM) https://www.washingtonpost.com/technology/2024/02/18/delaware-judge-kathaleen-mccormick-elon-musk/; Professor Holger Spamann, *Delaware Shows That Elon Musk Isn't Above the Law*, The Wall Street Journal (Opinion Column, Feb. 27, 2024 12:42 PM), https://www.wsj.com/articles/delaware-elon-musk-case-compensation-law-b71d448c.

Second, in evaluating the independence of a director, the court will closely examine business and personal relationships with the large stockholder and will also examine how the directors acted toward the large stockholder in the process. In this case, the court looked closely at the personal and professional relationships between Mr. Musk and the other directors deemed by Tesla to be independent, including the amount of compensation received as a director relative to such person's net worth (this is a difficult test for a long-term director given the rapid increases in Tesla's stock price), the positive ramifications on a director's other businesses by virtue of their service on the Tesla Board, investments by a director in other Musk businesses, donations by a director to Musk charities, and personal time spent by a director with Mr. Musk or members of his family such as his cousins.

The court did note that directors with strong ties to a controller may demonstrate their independence, and directors without strong individual ties to a controller may have a "controlled mindset." This examination will be even stricter when the controller is a "Superstar CEO" with outsized influence in the boardroom. In this case, the Chancellor found that there was barely any evidence of negotiations.

Third, in evaluating the "fair price" element of the entire fairness test, the court noted the importance of benchmarking the grant to comparable companies, and that no benchmarking was done in this case. This analysis highlighted the importance in controller transaction of the need to properly identify and use comparable company metrics to support a fair price determination regardless of the nature of the transaction.

Finally, the court held that the defendants were not able to avail themselves of the benefits of shifting the burden to the plaintiff to prove the entire fairness of the 2018 grant, as the majority of the minority stockholder vote was not fully informed. In the proxy statement for such a vote, companies should endeavor to make comprehensive disclosures about director conflicts, including not only actual conflicts, but also potential conflicts and personal ties that the directors have with the controller.

<u>In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation</u>.[28]

<u>Summary</u>. Sears Hometown and Outlet Stores, Inc. (the "Company") conducted business through two segments, Hometown and Outlet. A special committee of independent directors of the Board of the Company endorsed a liquidation plan pursuant to which one business segment was to be liquidated and the other business segment would continue to operate. Edward Lampert, the Company's controlling stockholder, believed that the liquidation plan would destroy value. When Mr. Lampert was unable to convince the special committee not to implement the liquidation plan, Mr. Lampert used his voting power as a stockholder to (i) adopt a bylaw amendment preventing the Board from implementing the liquidation plan without two separate approvals and (ii) remove two Board members (they were also removed from the special committee).

[28] *In re Sears Hometown and Outlet Stores, Inc. Stockholder Litig*ation, C.A. No. 2019-0798-JTL (Del. Ch. January 24, 2024).

Two minority stockholders filed suit alleging that Mr. Lampert breached his fiduciary duties by using his voting power to block the liquidation plan. Vice Chancellor Laster held in a 119-page opinion that when exercising voting power as a stockholder to change the status quo, a controller owes a duty of good faith to not intentionally or in a gross negligent manner harm the corporation or its minority stockholders. Vice Chancellor Laster applied enhanced scrutiny but determined that Mr. Lampert believed in good faith that the liquidation plan would harm the Company and that when he exercised his voting power he acted consistent with his fiduciary duties.

However, Mr. Lampert subsequently negotiated with the special committee a different transaction, which transaction eliminated the minority stockholders. Mr. Lampert bore the burden of proving this transaction was entirely fair and Mr. Lampert failed to meet this burden. The Vice Chancellor awarded damages in an aggregate amount of approximately $18.3 million, which is equal to the difference between the fair value attributable to the shares of the minority stockholders and what the minority stockholders received in the transaction.

<u>Factual History</u>. In 2005 Mr. Lampert structured a merger that combined Sears, Roebuck and Co. and Kmart Corporation under the ownership of a new entity, Sears Holdings Corporation ("Holdings"), and funds controlled by Mr. Lampert owned a majority of the common stock of Holdings. Mr. Lampert was the CEO of Holdings until its bankruptcy. The Company began as a subsidiary of Holdings and was spun off as a separate, publicly traded entity in 2012 and funds managed by Mr. Lampert received a majority of the common stock of the Company. Mr. Lampert controlled the Company but neither he nor any officers from Holdings or any Lambert funds were on the Board. The Company relied heavily on Holdings for products, services and infrastructure.

After the spinoff, the Company's performance deteriorated and both segments performed poorly. The Company's stock price declined from $50 in 2012 to below $2 during extended time periods in 2017, 2018 and 2019.

In 2016, funds controlled by Mr. Lampert purchased more shares of Company common stock and Mr. Lampert was exploring strategic alternatives for the Sears flagship brands. The Board formed a special committee and empowered it with the exclusive authority to address any potential transaction that Mr. Lampert might propose, though none was proposed at this time. The special committee hired a financial advisor, who prepared a liquidation analysis projecting that the Company could realize 60% to 80% of the value of its inventory.

In 2018, Holdings' shares dropped in price approximately 15% on news that its lenders desired to liquidate Holdings. The Company's Hometown business segment depended on Holdings for 75% of its inventory and a Holdings bankruptcy could have resulted in a default under the Company's financing facilities. If Holdings declared bankruptcy, the Company's CEO believed that the Company needed to liquidate its Hometown business segment.

On October 15, 2018, Holdings filed for bankruptcy, and the bankruptcy caused the business of Hometown to decline though Outlet segment sales increased. At a December 12, 2018 Board meeting, management identified four alternatives if Holdings liquidated, one of which was the liquidation of Hometown, after which the Company would continue to operate the Outlet business. Management projected that Hometown could liquidate its inventory over an eight-week period for 95% of the cost, without any significant liabilities associated with the liquidation.

During January 2019, a new entity owned by the Lampert funds agreed to acquire substantially all of the assets of Holdings. However, during a subsequent January 2019 Board meeting, Company management continued to state that the liquidation plan remained the best option, regardless of what happened to Holdings.

During the next few months the Hometown business continued to deteriorate and the Board began pursuing a sale of the Company as well as the liquidation plan and the special committee had numerous conversations with advisors to Mr. Lampert. The special committee informed Mr. Lampert that the Company would liquidate Hometown if there was not a deal in place by April 15, 2019 to sell the Company. Mr. Lampert met with management and the Company's financial advisors on April 1, 2019 and informed them he did not like the liquidation plan, which he thought would destroy value, and he also noted that management was underestimating the liquidation costs and overestimating the ability of the Outlet segment to succeed on its own. Mr. Lampert agreed to make an offer to buy the Company.

On April 3, 2019, a representative from the Company's financial advisor suggested to Mr. Lampert a price in the "mid to high single digits"; on that day the stock price fell to $1.65. On April 5, 2019, a Lampert entity offered to buy the Company for $2.25 a share, and the offer letter criticized the liquidation plan. At an April 6, 2019 special committee meeting, the Company's financial advisor presented a valuation range of $6.04 to $8.05 per share based on a discounted cash flow valuation (based on management projections and accounting for the liquidation of Hometown) and the special committee rejected Mr. Lampert's offer.

After exploring a sale to Mr. Lampert of the Hometown inventory, the Board and the special committee each met with Mr. Lampert on April12, 2019; at this meeting he told each of them that the liquidation plan was a disaster and that he opposed the plan and Mr. Lampert agreed to modify his offer to add a contingent value right of $0.75 per share based on the Company achieving certain EBITDA in 2019. The special committee rejected this offer and a revised offer to buy the Hometown inventory and countered with a proposal to sell the Company to Mr. Lampert for $9.50 per share. Mr. Lampert was also informed that unless a deal was reached, the Company would proceed with the liquidation plan without a stockholder vote.

On April 19, 2019, Mr. Lampert acted by written consent (as majority stockholder) to amend the Company's bylaws to require that a Hometown liquidation receive approval from 90% of the Board, at two separate Board votes, taken at least thirty business days apart (the "Bylaw Amendment"). If the liquidation received the necessary vote at the first meeting, then the Board was required to disclose the result to the stockholders. While the Bylaw Amendment did not technically prevent the Board from pursuing the liquidation plan, Mr. Lampert testified at trial that he had no intention of letting the liquidation plan become effective.

Pursuant to the written consent, Mr. Lampert also removed two directors from the Board and thus the special committee (Mr. Lampert testified at trial that he thought these two directors were obstacles to a deal and driving the unrealistic ask for $9.50 per share) and filled the vacancies with two individuals recommended by a friend.

The actions by Mr. Lampert pursuant to the written consent are referred to herein as the "Controller Intervention." After the actions took effect, Mr. Lampert announced these actions in a letter to stockholders, and the opinion provides that for the Board and management, these actions "took the liquidation plan off the table."

After the written consent, the only remaining member of the special committee resumed negotiations with Mr. Lampert as this seemed to him as the only realistic path. Mr. Lampert wanted a whole-Company transaction with a contingent value right and the special committee suggested a whole-company transaction with a go-shop for the Outlet segment. On May 31, 2019, the special committee and the Board approved the merger agreement. The base price remained $2.25 per share.

On August 27, 2019, the Company entered into an agreement to sell the Outlet segment to a third party contacted pursuant to the go-shop, for consideration of $0.96 per share. On October 23, 2019, the sale of the Outlet segment closed, as did the merger transaction with affiliates of Mr. Lampert.

After announcement of the merger, two stockholder plaintiffs filed class actions challenging its terms, which claims were subsequently consolidated. On December 12, 2022, the Company filed a petition for bankruptcy, which proceeding was filed under Chapter 11 but converted to a Chapter 7 liquidation.

<u>Legal Analysis</u>. The plaintiffs contended that Mr. Lampert breached his fiduciary duties as a controller by engaging in the Controller Intervention. As Mr. Lampert owned over 50% of the Company's voting power, he controlled the Company and owed fiduciary duties to the Company and the minority stockholders.

Vice Chancellor Laster examined prior case law to determine if Mr. Lampert owed fiduciary duties when acting as a stockholder. He concluded that a controlling stockholder, when acting as a stockholder, owes fiduciary duties in two instances: (i) when deciding to sell (but not when declining to sell) its shares in a corporation[29] and (ii) when voting to change the status quo (but not when declining to vote or voting against a change to the status quo).[30]

When deciding to sell, a controlling stockholder, when acting as a stockholder, could breach its fiduciary duties by knowingly selling to a looter or being grossly negligent in doing so. When voting to change the status quo, a controlling stockholder, when acting as a stockholder, may not intentionally (or through grossly negligent action) harm the corporation or its minority stockholders.

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29 *Id.*, at 53.

30 *Id.*, at 57.

Under Delaware law, there are three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness. The Vice Chancellor concluded that enhanced scrutiny applied to the Controller Intervention; thus, Mr. Lampert was required to show that (i) he acted in good faith for a legitimate objective and had a reasonable basis for believing that action was necessary and (ii) he selected a reasonable means for achieving his objective.

The court concluded that clause (i) of the test was met as Mr. Lampert acted properly to prevent the destruction of value that he believed the liquidation plan would cause. The court held that Mr. Lampert had a reasonable basis formed after reasonable investigation for his belief and a good faith basis to be skeptical about the assertions of management regarding the operation of the Outlet segment business as a standalone company.

The court also concluded that clause (ii) of the test was met as "the Controller Intervention was drastic but necessary" as Mr. Lampert only engaged in the Controller Intervention after determining "that he had no viable alternative."[31] The Bylaw Amendment did not prevent the Board from acting, but it prevented the Board from unilaterally implementing the liquidation plan, and the director removal was limited to only two directors rather than the entire Board. Thus, the court found that Mr. Lampert did not breach his fiduciary duties when he engaged in the Controller Intervention.

However, that did not end the court's inquiry, as Mr. Lampert subsequently acquired the Company pursuant to the merger transaction, which transaction removed the minority stockholders and thus was reviewed under the entire fairness standard of review with the defendants having the burden of persuasion.[32]

Under Delaware law, the concept of fairness has two basic aspects, fair price and fair dealing, and Mr. Lampert failed to prove either aspect. For purposes of this analysis, the court also included the sale of the Outlet segment as part of its evaluation.

In evaluating fair price, the court looked at the economic and financial merits of the transaction. The court found that for the Outlet segment, the structure of the go-shop provided powerful evidence of fair value. As to the sale of the Hometown segment, at trial each side presented expert testimony and Vice Chancellor Laster ended up determining a value for the inventory, using a 72% realization rate suggested by Mr. Lampert, adding the proceeds for the sale of Outlet and the value of certain net operating losses and then subtracting net debt. This valuation indicated that Mr. Lampert underpaid the minority stockholders in the merger.

[31] *Id.*, at 73.

[32] The merger was negotiated by the special committee, but the court did not make a pretrial determination that the special committee performed in a manner such that the burden would shift.

As to fair dealing, the court found that the Controller Intervention "boxed in" the special committee and eliminated the liquidation plan as a viable alternative.[33] The Vice Chancellor found that while the Controller Intervention did not meaningfully go beyond the extent to which Delaware law already permits a controller to constrain a special committee, the "heavy-handed tactic" of removing two members of the special committee "casts a shadow over the balance of the negotiation."[34]

The court thus concluded that the negotiation process was unfair as Mr. Lampert failed to show that the special committee's efforts to bargain offset the blow of the Controller Intervention and its changing of the negotiating leverage.

As a result, Mr. Lampert was found liable for $1.78 per share, the difference between the $4.99 fair price determined by the court and the $3.21 per share received by the minority stockholders.

Key Takeaways. In most cases involving controlling stockholders, they assume the power of a director and are assumed to have the same fiduciary duties as directors. This opinion sets forth for the first time the limited fiduciary duties owed by a controlling stockholder of a Delaware corporation when the controller uses its voting power to change the corporation's status quo. The court did not discuss what constitutes a "change in the status quo," leaving open the risk for future plaintiff suits, especially as to companies in declining industries or in financial distress where the business imperative necessitates a change to the status quo. While any possible "change to the status quo" approved by the controller could increase the risk of a lawsuit by minority stockholders (which would be a factual determination), absent special circumstances such as those present in this case, we believe it is unlikely that a Delaware court would hold that the status quo was changed by controller actions such as simply voting to replace a director in the ordinary course of business.

After this decision, we would expect that a controller would be more likely to have a majority of the members of the board of directors of a controlled corporation comprised of affiliates of the controller, to lessen the risk that the controller feels obligated to replace directors or take other actions such as the Bylaw Amendment. In this case, Mr. Lampert was not on the Board and did not have any affiliates on the Board and the Board was taking extraordinary actions against the wishes of the controlling stockholder.

[33] *Supra* note 28, at 108.

[34] *Supra* note 28, at 111.

If you have any questions regarding this client alert, please contact any of the following attorneys or the Willkie attorney with whom you regularly work.

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