Delaware Law for Venture-Backed Companies: 2017 Year in Review

Jeff Wolters
Morris, Nichols, Arsht & Tunnell LLP[1]

For many years Delaware corporate law was mainly public company law. But now there is a critical mass of case law relevant to private and venture-backed companies, with 2017 adding to that law perhaps more than any prior year. Below is a summary of highlights and issues to watch for in 2018.

1. Sea-Change in Delaware Litigation: Shift from Public to Private Company Cases

Continuing a trend that began in 2015-2016, stockholder litigation in Delaware involving public companies remains drastically down from previous levels. But the Court of Chancery's caseload is busier than ever, with the Court having requested the addition of two new judges to its current roster of five. What are all the cases? Many are lawsuits concerning private companies, often venture-backed, that were much less likely to be filed in years past – but are being filed today, perhaps due to a combination of higher valuations, larger capital tables and changing attitudes toward the efficacy of litigation in the private company sphere.

The cases of course include headline "unicorn" cases, epitomized by the much-publicized lawsuits brought in Delaware concerning Uber (e.g., Benchmark's governance dispute with Travis Kalanick, and the stockholder derivative suit against the Uber board relating to its self-driving car division). But the cases also include disputes over many of the "inside" issues that VC-backed companies face every day. Some of the main ones are discussed below. For better or worse, the new reality for practitioners is that there is a burgeoning Delaware case law creating both guidance and pitfalls for private company practice.

2. Transfer Restrictions

Many venture-backed companies, particularly successful ones with large cap tables, wish to prevent secondary markets from developing and expanding their stockholder base even more. Delaware law has long offered a mechanic to curb such expansion: Section 202 of the Delaware General Corporation Law (DGCL), which broadly authorizes transfer restrictions, including in a company's certificate of incorporation and bylaws.

However, certain statutory technicalities can cause problems. Notably, while Section 202 allows transfer restrictions to be adopted by charter/bylaw amendment, such restrictions are not binding on a holder of outstanding shares, or its transferee, without such holder's consent. Also, even if a

1 Jeff provides advice on Delaware law, often to venture-backed companies and their boards, investors and lawyers. He can be reached at jwolters@mnat.com. The views in this article are his.

restriction is validly in place, it is not binding against a transferee unless noted conspicuously on the stock certificate – a requirement that can cause special problems for a company that issues uncertificated shares. A 2017 Delaware decision tackled various of these issues, ultimately holding that the stockholder was not bound by the restrictions in question.[2]

Unfortunately the case did not address other issues relevant to venture-backed companies. These include the enforceability of "second tier" restrictions that purport to prohibit a change of control of the stockholder, and restrictions that purport not to bind existing holders but do apply to transferees. There is also the question whether restrictions are binding on all parties to an agreement if the restrictions are created pursuant to an amendment provision permitting amendments to be approved by less than all parties (e.g., an Investor Rights Agreement that provides that it is amendable by majority vote). Another lurking issue is the continued application and scope of the common law rule against "unreasonable" transfer restrictions.

3. Stockholder Information Rights

The Delaware courts considered several cases involving stockholder demands for information in 2017. Section 220 of the DGCL gives any stockholder broad rights to demand stocklist and cap table information, as well as "books and records" generally, for a "proper purpose." Case law has been favorable to the demanding stockholder, requiring extensive disclosure for such purposes as "valuation of stock" and "investigation of potential mismanagement." One notable case required disclosure of emails from the personal account of Yahoo's CEO to investigate a severance package awarded to a top officer.[3]

However, the pro-stockholder pendulum has swung back in recent cases. In one the court held that a purported purpose of investigating wrongdoing was not supported by the fact that Tesla had missed sales projections.[4] In another the court ruled that a director was not entitled to copies of email correspondence showing discussions among other directors.[5] And in yet another the court rejected a Section 220 demand after finding that the stockholder's stated purpose of investigating mismanagement was an "attorney driven" pretext.[6]

The Delaware cases have also made clear that even when information must be provided, companies generally may require a strict confidentiality agreement and a "no cherry picking" provision that allows a court to consider all the documents produced if the stockholder uses any as the basis for filing a lawsuit.[7]

2 *Henry v. Phixios Holdings, Inc.*, 2017 WL 2928034 (Del. Ch. July 10, 2017).

3 *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752 (Del. Ch. 2016).

4 *Haque v. Tesla Motors, Inc.*, 2017 WL 448594 (Del. Ch. Feb. 2, 2017).

5 *Chammas v. Navlink, Inc.*, 2016 WL 767714 (Del. Ch. Feb. 1, 2016).

6 *Wilkinson v. A. Schulman, Inc.*, 2017 WL 5289553 (Del. Ch. Nov. 13, 2017).

7 *Elow v. Express Scripts Holding Co.*, 2017 WL 2352151 (Del. Ch. May 31, 2017), *judgment entered sub nom. Elow v. Exp. Scripts Holding Co.* (Del. Ch. June 15, 2017), *and judgment entered sub nom. Khandhar v. Exp. Scripts Holding Co.* (Del. Ch. June 15, 2017).

One issue that the courts have not expressly tackled recently is the extent to which Section 220 rights may be waived by contract, and whether context may matter – for example, whether a waiver of Section 220 rights might be more enforceable if agreed to by a preferred stockholder in an Investor Rights Agreement that grants certain contractual information rights, as compared to a waiver given by an employee common stockholder in an option exercise form.

4. Director Fiduciary Duties

The marquee case on fiduciary duties for venture-backed companies is still the Delaware Chancery Court's 2013 decision in *Trados*.[8] There the court held that venture representatives on a board owed their primary fiduciary duties to common stockholders in considering a sale of the company that paid proceeds only to preferred stockholders and management. Simply "following the waterfall" in the charter was not a complete defense, when the board first had to make a discretionary decision whether to sell the company at all.

A 2017 decision from the same judge, Vice Chancellor Laster, doubles down on the rule that a board must consider how it can protect common stockholders even when a charter gives the preferred special rights.[9] The case involved a charter provision permitting preferred holders to demand redemption of their stock. In anticipation of this "put," the board began liquidating assets and hoarding cash. The court held that this was a breach of fiduciary duty, both by the preferred stock representatives on the board who had a self interest in favoring the preferred, and by the non-preferred directors who may have violated their duty of good faith. Liquidating the company to pay off the preferred was not in the best interests of the common. The court noted that although the charter did impose an obligation to sell assets and preserve cash to fund the redemption, this obligation was expressly contingent on compliance with fiduciary duties; further, the charter did not provide for a penalty such as accruing interest if the preferred was *not* redeemed (if it had, that might have provided a reason why "taking out" the preferred was in the best interest of common stockholders).

The *ODN* case was of course not the only major ruling in 2017 dealing with fiduciary duties and conflict of interest for boards with VC representatives. In a decision involving Zynga earlier in the year, the Delaware Supreme Court held that such directors might lack independence because of how their paths had crossed in Silicon Valley's high powered ecosystem of "mutually beneficial … ongoing business relationships."[10]

Interestingly, in both the Zynga case and *ODN*, the stockholder lawsuits – which sought personal damages against VC directors – might have been dismissed if an independent committee process had been used (a point also made in *Trados*). Use of committees and other conflict mitigation procedures may become more commonplace as legal exposure increases for the directors of high profile private companies. Stated differently, there may be greater impetus to employ public company-style governance measures as private company valuations and cap tables grow, particularly in transactions such as inside rounds or exits that do not benefit the junior equity.

8 *In re Trados Inc. S'holder Litig.*, 73 A.3d 17 (Del. Ch. 2013).

9 *Frederick Hsu Living Tr. v. ODN Holding Corp.*, 2017 WL 1437308 (Del. Ch. Apr. 14, 2017), *as corrected* (Apr. 24, 2017).

10 *Sandys v. Pincus*, 152 A.3d 124 (Del. 2016).

5. Director Equity Grants

Many companies, public and private, grant directors options or other equity for their service. A Delaware Supreme Court decision from late 2017 makes it easier for stockholders to attack such grants as a conflict transaction – which can in turn subject directors to personal damages unless they can prove the grants were "entirely fair."[11] The issue arises when a board approves grants to a majority of its members (perhaps more typical for public than private companies). The prior rule from case law had been that if the grants were made under a stockholder-approved equity plan, and if the plan included specific limits on the size of the grants that could be made to directors, then any grants under the ceiling were viewed as already approved by stockholders and essentially immune from attack. The Delaware Supreme Court changed that rule, holding that generally speaking, if a majority of the directors receives grants, they can be challenged under the entire fairness test regardless of any "director-specific ceiling" in the equity plan. The same reasoning presumably could apply to other compensation decisions. Of course, if a majority of the board approves compensation that is only received by some directors – for example, the CEO's salary and option grant – such a decision typically would be protected by the business judgment rule.

6. Drag-Along Rights

Although drag-along provisions remain common in private company stockholder agreements, Delaware case law continues to call into question their effectiveness. Such provisions typically require stockholders to vote in favor of a merger and waive appraisal rights. A merger, however, always requires board approval. That in turn raises the question, if a stockholder alleges that the board breached its fiduciary duties in approving the merger, does that fiduciary claim also undermine the applicability of the drag.

The Delaware Court of Chancery recently credited that theory and refused to enforce a contractual drag until after the fiduciary question was resolved.[12] The ruling may add to the doubt concerning drags created by an earlier case that both strictly construed a drag – holding that a provision triggered by a proposed transaction was not triggered by a consummated transaction – and noted that Delaware law had not addressed whether a waiver of appraisal rights was binding on common stockholders.[13]

7. Ratification Under Sections 204 and 205

Sections 204 and 205 of the DGCL allow a corporation to ratify and cure prior mistakes that might otherwise render its capital structure or board ineffective – for example, technical mistakes in authorizing prior stock issuances, option grants or director elections. Such ratification can be particularly important when a clean bill of health is necessary prior to a new round or a successful exit or IPO.

11 *In re Inv'rs Bancorp, Inc. Stockholder Litig.*, 2017 WL 6374741 (Del. Dec. 13, 2017), *as revised* (Dec. 19, 2017).

12 *In re Good Tech. Corp. Stockholder Litig.*, 2017 WL 2537347 (Del. Ch. May 12, 2017).

13 *Halpin v. Riverstone Nat'l, Inc.*, 2015 WL 854724 (Del. Ch. Feb. 26, 2015). The court did not suggest that an actual voting agreement (or proxy) would not be a waiver, given that the appraisal statute itself provides that any stockholder who approves a merger cannot assert appraisal rights.

Because the statutes are new – and were adopted against the backdrop of Delaware case law holding that ratification of past technical errors generally was *not* effective – there remain certain unanswered questions concerning their scope. One case from 2017 reasoned that while ratification generally was permissible if a company mistakenly failed to get the necessary authorization for a prior action (for example, the stockholder vote for a charter amendment), it was not necessarily permissible if the prior action was actually rejected.[14] This holding in turn implicated, but did not flesh out, the Delaware rules on whether and when a stockholder written consent can be rescinded, and what it means for a transaction to have been "rejected" as opposed to simply "not authorized." The upshot is that Sections 204 and 205 now allow most prior mistakes to be ratified and cured if properly identified and dealt with; but there are potential limits to the effectiveness of the statutes and the comfort they can provide.

8. Post-Closing Claims

Claims after the closing of an acquisition are increasingly being brought in Delaware. Such claims include appraisal, fiduciary claims and contract disputes. Appraisal has of course received much recent attention in public company deals, where different cases have come to very different conclusions on whether the market or deal price was also "fair value" under the appraisal statute.[15] The thing to remember in private company mergers is that every merger triggers appraisal rights, even if the consideration is stock (private or public) or if the only purpose of the merger is to amend the charter but not convert the existing stock. Given the lack of a market trading price, a court will almost always have to consider other indicia of value (projections etc.) to determine actual fair value.[16]

The other type of post-closing claim often encountered by private companies is contractual – that is, claims arising from the acquisition agreement such as disputes over indemnity, escrow, survival clauses, earn-outs and the like – as well as fraud claims (typically brought by a buyer against selling stockholders). The Delaware courts considered many such claims last year, including rulings on the interaction between indemnity provisions and post-closing price adjustments, the liability of selling stockholders and non-officer employees, indemnification for inaccurate representations, post-closing milestone payments, and the recurring issue of when does a non-reliance clause in an acquisition agreement bar post-closing fraud claims.[17]

14 *Nguyen v. View, Inc.*, 2017 WL 2439074 (Del. Ch. June 6, 2017), *reargument denied*, 2017 WL 3169051 (Del. Ch. July 26, 2017).

15 See, e.g., *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, 2017 WL 6375829 (Del. 2017).

16 Another key reminder: every merger that triggers appraisal rights also requires disclosure to non-consenting stockholders of "all material facts," which may include sensitive financial information.

17 *See Chicago Bridge & Iron Co. v. Westinghouse Electric Co. LLC*, 166 A.3d 912 (Del. 2017); *The Matrixx Group, Inc. v. River Associates Investments, LLC*, C.A. No. 12934-VCL (Del. Ch. Sept. 29, 2017); *HC Cos., Inc. v. Meyers Indus., Inc.*, 2017 WL 6016573 (Del. Ch. Dec. 5, 2017); *Fortis Advisors LLC v. Shire US Holdings, Inc.*, 2017 WL 3420751 (Del. Ch. Aug. 9, 2017); *EMSI Acquisition, Inc. v. Contrarian Funds, LLC*, 2017 WL 1732369 (Del. Ch. May 3, 2017); *Sparton Corp. v. O'Neil*, 2017 WL 3421076 (Del. Ch. Aug. 9, 2017).

9. Stockholder Protective Votes

A perennial "inside baseball" issue of Delaware law for venture-backed companies is what stockholder protective votes are required for a new round of financing – and in particular, when is a separate *series* vote required for a charter amendment that adversely affects an entire *class* of stock. The issue arises because Section 242 of the DGCL, and many charter protective provisions similar to Section 242, require a separate series vote if an amendment adversely affects a class of stock but does not "so affect" a particular series within the class.

The issue was litigated and briefed in 2017, in a case involving a "two step" pay to play: step one was a charter amendment converting all existing series of preferred into common; step two sold a new senior series to stockholders who chose to participate.[18] A preferred stockholder brought suit, arguing that the transaction was invalid because of the failure to get a separate series vote of a particular series that had a different liquidation preference and slightly different rights than other series. The case settled and the court did not resolve the question. What was apparent from the briefing, however, was that the issue remains a live one under Delaware law.

10. Blockchain and ICOs

Next year at this time the focus may be on blockchain, initial coin offerings (and tokens generally) and their potential interplay with traditional rules of Delaware corporate law and fiduciary duty, an area that Delaware courts have not tackled yet.[19] Potential issues include determining required board and stockholder consent rights for such matters and, depending on the terms, the extent to which settled Delaware rules governing "rights and options" (Section 157 of the DGCL) and the ability to state key terms of a charter or merger outside the relevant document (Section 102(d)) are implicated. It is also yet to be seen how many early adopters there are of blockchain technology for keeping stock records, which is now expressly permitted by Section 224 of the DGCL.

18 *See Pine River Master Fund Ltd. v. Intelepeer Holdings, Inc.*, 2017 WL 3610769 (Del. Ch. Aug. 16, 2017).

19 However, such issues featured prominently in the background of *R3 Holdco, LLC v. Ripple Labs, Inc.*, C.A. No. 2017-0652-JRS, transcript (Del. Ch. Oct. 13, 2017; filed Nov. 15, 2017).

ABOUT THE AUTHOR

JEFFREY R. WOLTERS
PARTNER
(302) 351-9352 T
jwolters@mnat.com

Jeff has practiced corporate law for almost twenty-five years, serving as "Delaware counsel" on hundreds of transactions involving both public and private companies. He has been involved in some of the most important litigation involving venture-backed companies, including the *Benchmark*, *Watchmark* and *Thoughtworks* cases. Jeff has taught courses on corporate law at University of Pennsylvania Law School and Villanova Law School.

Jeff is an editor of the leading treatise *Delaware Corporation Law and Practice* (Matthew Bender); his recent articles include *Private Company Financings: Delaware Court Provides Guidance for Boards and Venture Funds, Delaware Law Pitfalls in IPOs, Breacher Beware: Contract Damages in Delaware M&A Decisions*, and *Running a Proper Independent Committee Process.*