GOVERNANCE ROUND-UP

July 9, 2024

SB 313 To Be Signed by Governor of Delaware

In June, Senate Bill 313 ("SB 313"), which effectively would overturn the Delaware Court of Chancery's decision in *W. Palm Beach Firefighters' Pension Fund v. Moelis & Co.*, was passed by the Delaware Senate. It now awaits an expected signature by Delaware Governor John Carney.

Moelis concerned a stockholder agreement between Moelis & Company and its founder, Ken Moelis, which was entered into at the time of the company's IPO. The court found multiple provisions of the stockholder agreement to be facially invalid on the ground that they operated to deprive the Moelis & Co. board of directors of a significant portion of its authority, contravening Delaware General Corporation Law Section 141's requirement that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of the board of directors, except as may otherwise be provided in this chapter or in its certificate of incorporation." The court found that controlling stockholder pre-approval requirements in the stockholder agreement, viewed collectively, were facially invalid because they "have the effect of removing from the directors in a very substantial way their duty to use their own best judgment on virtually every management matter."

In response, the Council of the Corporation Law Section of the Delaware State Bar Association proposed amendments to the DGCL, which now await signature by Delaware's governor. The amendments add a new Section 122(18) to the DGCL, expressly allowing corporations to enter into the types of stockholder contracts at issue in *Moelis*, even if the provisions are not set forth in a certificate of incorporation. Specifically, new Section 122(18) authorizes a corporation to enter into contracts with one or more of its stockholders or beneficial owners of its stock and provides a non-exclusive list of contract provisions by which a corporation may agree to (i) restrict or prohibit future corporate actions specified in the contract, (ii) require the approval or consent of one or more persons or bodies (including the board of directors or one or more current or future directors, stockholders or beneficial owners of stock) before the corporation may take actions specified in the contract and (iii) covenant that the corporation or one or more persons or bodies (including the board of directors or one or

more current or future directors, stockholders or beneficial owners of stock) will take, or refrain from taking, future actions specified in the contract.

SB 313 has been criticized by academics for its complexity as well as for the speed with which it was drafted and pushed through the legislative process and, in a letter to the Delaware State Bar Association, Chancellor Kathaleen McCormick expressed her view that SB 313 had been rushed and that the magnitude of the changes demanded more time for hearings and debate. Despite that, the bill passed through the Delaware Senate without debate or opposition.

Assuming that Governor Carney signs SB 313, the amendments will become effective on August 1, 2024 and will apply to any stockholder agreement made by a corporation whether or not the agreement was entered into on or before August 1. SB 313 does not apply to or affect any civil action or proceeding completed or pending on or before August 1. Law predating the amendments will apply to those cases.

Companies should keep in mind that Section 122(18) "does not relieve any directors, officers or stockholders of any fiduciary duties they owe to the corporation or its stockholders, including with respect to deciding to cause the corporation to enter into a contract with a stockholder or beneficial owner of stock and with respect to deciding whether to perform, or cause the corporation to perform, or to breach, the contract."

We previously published a Debevoise In Depth on *Moelis*, available here.

AI: Are Boards Paying Attention?

In the wake of a number of shareholder proposals, as well as first-of-their-kind enforcement actions and public statements by the U.S. Securities and Exchange Commission, many companies are considering how their use of artificial intelligence and the associated risks should be overseen and managed by the board.

A recent report by proxy advisor Institutional Shareholder Services analyzed S&P 500 company proxy statements filed between September 2022 through September 2023. ISS found that over 15% of companies filing those proxy statements disclosed board oversight of AI, including 38% of companies in the Information Technology sector and 18% of companies in the Health Care sector. Less than 13% of S&P 500 companies had at least one director considered by ISS as having AI expertise, based on, among other things, employment experience related to AI and formal AI certifications. Information Technology companies again led the way with over 30% having at least one director

with AI expertise. The study also found that AI is rarely the sole focus of a newly created committee. Most companies instead delegate oversight of AI to an existing committee, such as the audit committee or committees responsible for technology, corporate responsibility or risk management.

ISS concluded that AI's expansion will likely cause institutional investors to expect companies, particularly those in industries heavily impacted by AI, to establish appropriate processes for board oversight of AI risks and opportunities, including disclosure of "relevant board skills and oversight responsibilities."

Accordingly, boards of companies for which AI has become (or is likely to become in the near future) a mission-critical regulatory compliance risk should consider:

- **Board Oversight:** Board oversight over AI can reside with the full board, an existing committee or a newly formed committee dedicated to AI.

- **Board Expertise:** If the board is concerned that it does not have the necessary expertise to oversee AI opportunities and risks, it should consider offering training to existing directors or adding one or more directors with relevant experience.

- **Board Minutes and Materials:** Boards should ensure that their AI-oversight activities, as well as management's compliance efforts, are well documented in board minutes and supporting materials. Boards should also ensure that they are appropriately briefed on the company's response to serious AI incidents.

- **Compliance:** Boards should consider whether there are effective compliance and reporting structures to facilitate board oversight, which may include periodic AI risk assessments and monitoring of high-risk AI systems, as well as written AI policies, procedures and training.

In light of the SEC's focus on AI, particularly on "AI-washing"—hyperbolic or inaccurate AI disclosures, which may lead to fraud claims under existing provisions of the federal securities laws—we expect directors will be focused on AI and related disclosures. Public companies should prepare to face SEC scrutiny in connection with their AI disclosures, policies and procedures. For example, in March, the SEC brought enforcement actions against two investment advisers, Delphia (USA) Inc. and Global Predictions Inc., for marketing to their clients and prospective clients that they were using AI in certain ways when, in fact, they were not. In June, the SEC filed a complaint against the founder and Chief Executive Officer of Joonko Diversity, Inc. alleging that in

order to raise funds from investors, the founder marketed the company as having AI capabilities it did not have. The complaint is the SEC's first litigated AI-washing matter.

The full text of the ISS report is available here.

Exxon Lawsuit Against Activist Investors Dismissed

In January, ExxonMobil Corporation sued two investors, Arjuna Capital and Follow This, in an effort to block a proposal from being included in the company's proxy statement for its annual shareholder meeting. The proposal sought to accelerate the company's efforts to reduce greenhouse gas emissions. Although the shareholders in May withdrew the proposal that gave rise to the lawsuit, Exxon asked the U.S. District Court for the Northern District of Texas, Fort Worth Division, to proceed to trial.

In its request, Exxon claimed that the defendants "hijack the shareholder proposal process to advance their social causes with serial filings each year at the expense of investors who focus on generating returns." The lawsuit sought to bypass SEC Rule 14a-8, which allows companies to exclude shareholder resolutions from their proxy statements based on a list of specified grounds, including if a shareholder has presented a substantially similar proposal in the past. In this instance, Exxon claimed that its shareholders put forth substantially similar proposals in 2022 and 2023, which received only 27.1% and 10.5% of the vote, respectively.

On June 17, 2024, Judge Pittman dismissed the case, but only after Arjuna "unconditionally and irrevocably covenant[ed] to refrain henceforth from submitting any proposal for consideration by Exxon shareholders relating to GHG or climate change." In the court's view, Arjuna's covenant met "the burden imposed by the voluntary cessation test" because it was "unconditional and irrevocable," thus rendering the case moot. Exxon's claim against Follow This, an Amsterdam-based nongovernmental organization, had previously been dismissed due to lack of personal jurisdiction.

In his order, Judge Pittman went on to criticize Rule 14a-8, suggesting that it enables activist shareholders with minimal shares to push their agendas without considering other shareholders' interests, and noting that "[t]he SEC is behind the ball on th[e] issue" of shareholder activism.

It remains to be seen whether other public companies will pursue "direct-to-court" strategies rather than going through the typical process of seeking no-action relief from the SEC staff to exclude shareholder proposals from company proxy statements. The lawsuit comes at a time when the total number of shareholder proposals submitted to public companies has been increasing, although support for those approvals appears to be declining.

Exxon's complaint can be found here and Judge Pittman's order can be found here.

Audit Committees Urged to Focus on Audit Quality

Earlier this year, the SEC's Chief Accountant, Paul Munter, issued a statement urging audit committees to focus on audit quality and auditors' exercise of "professional skepticism", following what he described as a "troubling trendline in PCAOB inspections results." In its 2022 inspections of audits performed in 2021, the Public Company Accounting Oversight Board found that insufficient audit evidence was obtained to support the auditor's opinion in 40% of inspected audits. In its 2021 inspections, the deficiency rate was 34%, up from 29% in its 2020 inspections.

Mr. Munter stressed the role of the audit committee in ensuring audit quality, stating that "[i]n executing its responsibilities, an audit committee should prioritize, and aim to promote, audit quality, to protect investors."

To ensure quality, Mr. Munter noted that audit committees should frequently evaluate processes for assessing their auditor's performance, including by reference to (i) the results of the auditor's PCAOB inspections, (ii) whether the engagement team has appropriate industry expertise and whether the engagement partner is sufficiently engaged, (iii) the engagement team's total hours and staffing mix (including the use of specialists and the level of experience within the engagement team) and (iv) significant changes (or the lack thereof) in hours or staffing mix from previous audits. In addition, Mr. Munter reminded audit committees that proactively engaging with auditors can play an important role in supporting the auditor's independence and facilitating the auditor's exercise of professional skepticism.

The statement signals an increased focus by the SEC on public company audit quality. We expect the SEC to focus on issues identified by the PCAOB as having high rates of deficiency, including auditor testing of management review controls, auditors'

identification and selection of controls to test, and auditors' identification and selection of controls over the completeness and accuracy of information used in the operation of the controls. Mr. Munter's comments may also serve as a reminder for corporate secretaries and audit committees to review their audit committee charters, including to assess compliance with the requirements of the charter and documentation of their efforts in committee agendas and minutes.

Mr. Munter's statement is available here.

Entire Fairness Applicable to All Conflicted Controller Transactions

On April 4, 2024, the Delaware Supreme Court held in *In re Match Group, Inc. Derivative Litigation* that in a transaction where a controlling stockholder "stood on both sides of a transaction with the controlled corporation and received a non-ratable benefit, entire fairness is the presumptive standard of review." However, the controlling stockholder "can shift the burden of proof to the plaintiff by properly employing a special committee or an unaffiliated stockholder vote."

Match resolved a question relating to the application of the framework used in *Kahn v. M & F Worldwide Corp.*, referred to as the "*MFW* framework." In *MFW*, the Court held that in the context of mergers between a controlling stockholder and a corporate subsidiary, the business judgment standard of review applies "where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders." The *MFW* decision was ambiguous as to whether the *MFW* framework applied to all transactions. *Match* resolved that ambiguity, clarifying that the *MFW* framework applies to all controlling stockholder transactions where the controller obtains a non-ratable benefit and that a defendant must meet both elements of *MFW* in order to shift the judicial standard from entire fairness to business judgment review.

The *Match* case arose from a 2019 agreement by IAC/InteractiveCorp to separate its majority ownership of Match Group, Inc. The Delaware Court of Chancery held that the separation transaction was subject to business judgment review because it had been approved by not only an independent and disinterested "separation committee" of the Match board but also by an uncoerced, fully informed vote of a majority of the public minority Match shares—despite allegations by the plaintiffs that one member of the

separation committee was not independent of IAC. The Court of Chancery reasoned that the transaction was approved by an independent committee of the board, and no fact indicated that the non-independent special committee member "dominated" or "infected" the decision-making process.

On appeal, the Delaware Supreme Court held that the standard of review did not depend on the nature of the challenged transaction. In its decision, the Court reasoned that the controller has "inherently coercive authority over the board and the minority stockholders." Such inherent coercion can only be neutralized if the controller satisfies both requirements of the *MFW* framework.

The Delaware Supreme Court further held that the controlling stockholder's influence is not "disabled" if a special committee includes any member that is loyal to the controller. The Court reiterated that the special committee must be independent, not that only a majority of the committee must be independent. Importantly, the Delaware Supreme Court did not determine that the challenged director was not in fact independent or that the transaction was not entirely fair—instead it remanded the case to the Court of Chancery for further proceedings.

As we noted in our Special Committee Report, compliance with the *MFW* framework provides a controller significant protection against stockholder litigation. However, it also introduces additional completion risk, and potentially greater risk where the minority interest the controller seeks to acquire is relatively small. Relying solely on approval of the transaction by a properly constituted special committee, while not sufficient to avoid the entire fairness review, still has significant benefits to the controller: it shifts the burden of proof on the question of entire fairness to the stockholders challenging the transaction and, more importantly, is itself evidence of a fair process. However, for some controllers, the benefit of business judgment rule review may not be considered to be worth the additional risk created by a majority-of-the-minority vote.

Debevoise & Plimpton LLP acted as counsel to the Match separation committee in this transaction and the ensuing litigation.

MFW Framework Inapplicable Based on Conflict Disclosure Deficiencies

On May 1, 2024, the Delaware Supreme Court issued its decision in *City of Sarasota Firefighters' Pension Fund v. Inovalon Holdings, Inc.,* reversing a Court of Chancery decision dismissing challenges to the acquisition of Inovalon Holdings, Inc. by a consortium led by Swedish private equity firm Nordic Capital. The decision highlights the importance of adequate disclosure of financial advisor conflicts in order to obtain the benefit of the business judgment rule review under the *MFW* framework (described above in the section entitled "*Entire Fairness Applicable to All Conflicted Controller Transactions*" in this issue).

The Delaware Supreme Court held that Inovalon, its CEO and its board of directors failed to comply with the fully informed stockholder vote requirement of the *MFW* framework and therefore could not avail themselves of the benefit of the business judgment rule.

In connection with the transaction, Inovalon engaged two financial advisors. Each financial advisor provided relationship disclosure to the special committee, specifying work for Nordic on unrelated matters, although the first advisor's disclosure did not mention prior business with other members of Nordic's equity consortium.

Following closing, plaintiffs brought breach of fiduciary claims against the founder of Inovalon and the other Inovalon directors. On appeal, the Delaware Supreme Court held that the stockholder vote approving the acquisition of Inovalon had not been fully informed because the potential conflicts of interest of the financial advisors had not been adequately disclosed to the board or to stockholders in Inovalon's proxy statement.

The Court took issue with the disclosure concerning both financial advisors. With respect to the second advisor, the Court held that language in the proxy statement stating that the second advisor "may provide" services to Nordic and its co-investors was misleading given that the advisor was in fact providing such services, creating a concurrent conflict. In the case of the first advisor, the Court held that disclosure that the bank would receive "customary compensation" in connection with disclosed concurrent representations was insufficient because it kept stockholders from "contextualizing and evaluating" the conflicts. It also found that the proxy statement failed to disclose the first advisor's fees for prior work for members of Nordic's equity consortium, which amounted to nearly $400 million in the relevant two-year period.

The Delaware Supreme Court stated that while “there is no hard and fast rule that requires financial advisors to always disclose the specific amount of their fees from a counterparty in a transaction,” the question is subject to a materiality standard, which standard had been met in this case.

Earlier in the year, the Delaware Supreme Court held in *TerraForm Power v. Brookfield Asset Management, et al.* that a special committee should determine and disclose the material conflicts of interests of its financial and legal advisors. In claiming that a conflict should have been disclosed, a plaintiff does not need to allege facts showing that the conflict impacted the advisor’s analysis. Rather, the existence of a material conflict is itself sufficient: “[t]here is no rule that conflicts of interest must be disclosed only where there is evidence that the … advisor’s opinion was actually affected by the conflict.”

Inovalon and *Brookfield* both illustrate the importance of disclosing information beyond the mere existence of a conflict—companies must provide sufficient disclosure about potential conflicting relationships to allow stockholders to make their own informed decisions.

Delaware Court of Chancery Dismisses Suit Arguing That Directors Owe Fiduciary Duties to the Corporation and Its Stockholders as Diversified Equity Investors

On April 30, 2024, the Delaware Court of Chancery dismissed a suit by James McRitchie, a shareholder of Meta Platforms, Inc. who runs a website focused on corporate governance and shareholder activism, against Meta's directors, officers and controller alleging that they breached their fiduciary duties by managing the company to generate firm-specific value at the expense of the economy as a whole. McRitchie argued that under Delaware law, directors owe fiduciary duties to the corporation and its stockholders as diversified equity investors, not just as investors in the specific corporation.

The Meta defendants moved to dismiss the complaint, arguing that they manage Meta under a firm-specific model, as required by Delaware law. The Delaware Court of Chancery granted the defendants’ motion, holding that directors owe firm-specific fiduciary duties and that McRitchie’s argument was not supported by Delaware law,

which contemplates a single-firm model where directors owe duties to the stockholders as investors in that specific corporation.

Editors

Avi Gesser
Partner
+ 1 212 909 6577
agesser@debevoise.com

William D. Regner
Partner
+1 212 909 6698
wdregner@debevoise.com

Paul M. Rodel
Partner
1 212 909 6478
pmrodel@debevoise.com

Steven J. Slutzky
Partner
+1 212 909 6036
sjslutzky@debevoise.com

Joshua M. Samit
Counsel
+1 212 909 6414
jmsamit@debevoise.com

Amy Pereira
Associate
+1 212 909 6413
apereira@debevoise.com

Please address inquiries regarding topics covered in this publication to the editors.

All content (c) 2024 Debevoise & Plimpton LLP. All rights reserved. The articles appearing in this publication provide summary information only and are not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein. Any discussion of U.S. federal tax law contained in these articles was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax law.