ALERT MEMORANDUM

Corwin Cleansing Denied In Action For Post-Closing Injunctive Relief Under *Unocal*

May 10, 2023

On May 1, 2023, the Delaware Court of Chancery addressed an unsettled question under Delaware law—whether a fully informed, uncoerced vote of disinterested stockholders (so-called "*Corwin* cleansing"[1]) can be applied to defeat claims to enjoin defensive measures under *Unocal Corp. v. Mesa Petroleum Co.*

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In an opinion by Vice Chancellor Zurn, the Court held that *Corwin* cleansing does not apply to claims for post-closing injunctive relief under *Unocal*. The case, *In re Edgio, Inc. Stockholders Litigation*, has potentially significant implications for corporations and their boards in the negotiation of investment agreements with significant stockholders.

In reaching its decision, the Court found that certain voting commitments and transfer restrictions in a stockholders' agreement between Limelight Networks, Inc. (n/k/a Edgio, Inc.) ("Limelight" or the "Company") and its 35% stockholder were defensive measures that, at least for purposes of ruling on a motion to dismiss, it was reasonable to infer were implemented in order entrench Limelight's directors against a perceived threat of shareholder activism. As a result, the Court reviewed the challenged provisions with enhanced scrutiny under *Unocal*. The Court found it reasonably conceivable at the pleadings stage that Limelight's directors breached their fiduciary duties in obtaining these defensive provisions, and thus denied defendants' motion to dismiss plaintiff's claims to enjoin those provisions (plaintiff is not seeking damages). While the ruling remains subject to appellate review by the Delaware Supreme Court, and the Court may ultimately decline to enjoin the provisions on a more developed record, in the meantime it provides important guidance for boards negotiating the terms of an investment by a major stockholder.

[1] Named for the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015). In *Corwin*, the Delaware Supreme Court ruled that approval of a transaction by a fully informed, uncoerced vote of disinterested stockholders could cleanse a post-closing claim for damages. Where the *Corwin* doctrine applies, such a vote will result in Delaware courts reviewing the transaction under the highly deferential business judgement rule, which will generally lead to dismissal of the claim.

Background

Limelight provides network service for delivery of digital media content and software. The case arose out of a 2022 stock-for-stock transaction in which the Company acquired a portfolio company of Apollo Global Management, Inc. ("Apollo") in exchange for newly issued Company common stock representing 35% of its pro forma shares outstanding.

At the time of transaction, Limelight's stock price had been in steady decline since its July 2020 all-time high, suffering from Limelight's earnings misses and underperformance relative to analysts' consensus estimates.[2] By early 2021, Limelight had pursued a number of turnaround initiatives (including hiring a new CEO, implementing a turnaround plan and retaining a consultant), but these measures were unsuccessful. Market commentators began speculating that the Company may be a target for activist investors.[3]

Around this time, Limelight was approached by Apollo to discuss the potential combination of Limelight with Edgecast, Inc. ("Edgecast").[4] Edgecast's parent company, College Parent, L.P. ("College Parent"), was owned approximately 90% by Apollo funds and 10% by Verizon Communications, Inc. Following a period of negotiation and due diligence, in March 2022, the parties executed a purchase agreement pursuant to which Limelight would acquire Edgecast in exchange for newly issued Limelight common stock, which would result in College Parent owning 35% of Limelight's outstanding common stock after the closing of the transaction (the "Acquisition").[5] In connection with the Acquisition, the parties agreed on a form of stockholders' agreement (the "Stockholders' Agreement") that would govern the terms of College Parent's investment following the closing. Nasdaq listing rules required Limelight to obtain stockholder approval for the issuance of the stock consideration in the Acquisition.[6] In advance of the vote, the Company issued a proxy statement that summarized the Acquisition and Stockholders' Agreement (which was also publicly filed), including the provisions that would become the subject of the litigation.[7] On June 9, 2022, the Company's stockholders voted overwhelmingly in favor of the stock issuance. At closing of the Acquisition one week later, the parties entered into the Stockholders' Agreement.[8]

After the closing, two Company stockholders filed suit in Chancery Court against the Company and its Board of Directors (the "Board"), claiming the Stockholders' Agreement included defensive measures that created a significant and enduring stockholder block designed to entrench the Board and shield it from stockholder activism.

Stockholders' Agreement – The Challenged Provisions

Plaintiffs focused on three provisions in the Stockholders' Agreement (the "Challenged Provisions") that allegedly warranted enhanced scrutiny under *Unocal*. First, the agreement requires College Parent to vote in favor of the Board's recommendations on director nominations (and against any nominees not recommended by the Board) and other routine matters, such as "say on pay" and auditor ratification.[9] Second, for other non-routine matters submitted for a stockholder vote, College Parent was required to vote either in favor of the Board's recommendation or pro rata with all other Company stockholders.[10] Each of these voting agreements remain in place until 90 days after the earlier of (i) College Parent ceasing to own at least 35% of the stock issued to it at closing and (ii) College Parent ceasing to have the right to designate nominees to the Board.[11] Third, College Parent is restricted from transferring its shares for two years from closing of the transaction, subject to customary exceptions, and for

[2] *In re Edgio, Inc. Stockholders Litigation, C.A. No. 2022-0624-MTZ (Del. Ch. May 1, 2023).*
[3] *Id.* at 6.
[4] *Id.* at 7.
[5] *Id.* at 8-9.
[6] Nasdaq Rule 5635(d)
[7] *In re Edgio, Inc.* at 12.
[8] *Id.* at 13.
[9] *Id.* at 10.
[10] *Id.* at 10-11.
[11] *Id.* at 11.

an additional year thereafter is prohibited from transferring its shares to any transferee known to be a Company competitor or listed on the most recently published "SharkWatch 50" list of activist investors.[12]

The Parties' Arguments

Plaintiffs claimed that the Company's directors breached their fiduciary duties by "prioritizing their own personal, financial, and/or reputational interests" in approving the Acquisition and the Stockholders' Agreement, "which they used to entrench themselves."[13] In sum, they argued that these provisions established a 35% voting bloc contractually committed to protecting the Board and deterring and defeating any activist threats. Plaintiffs asked the Court to enjoin the Challenged Provisions, but did not seek damages.[14] The Company moved to dismiss the Complaint on the grounds that the Board's decisions concerning the Challenged Provisions are protected by the business judgment rule.[15] Additionally, the defendants argued that even if enhanced scrutiny does apply, the Court must dismiss the Complaint under *Corwin* because a fully informed, uncoerced majority of the Company's stockholders approved the stock issuance for the Acquisition, of which the Stockholder's Agreement was an integral part, cleansing any alleged breaches of fiduciary duty and restoring business judgment review.[16]

The Decision

The Court denied the motion to dismiss. The Court began its analysis with a discussion of *Corwin*, noting that Delaware courts have not clearly resolved the question of whether *Corwin* can apply to a claim that is seeking injunctive relief. V.C. Zurn found that "a careful reading of *Corwin's* text and other authorities compels the conclusion that *Corwin* was not intended to cleanse a claim to enjoin a defensive measure under *Unocal* enhanced scrutiny."[17] The Court pointed to language in *Corwin* itself, limiting its holding to post-closing damages claims, as reiterated by the Delaware Supreme Court in *Morrison v. Berry*.[18] V.C. Zurn also noted that *Corwin* left untouched earlier Delaware Supreme Court precedent, *In re Santa Fe*, that appears to suggest a stockholder vote cannot cleanse claims for injunctive relief brought under *Unocal*.[19] Finally, the Court asserted that applying *Corwin* to claims for injunctive relief would not serve *Corwin's* underlying public policy rationale of allowing stockholders to make free and informed choices based on the economic merits of a transaction.[20]

In so holding, the Court was confronted with two prior Delaware Supreme Court decisions, *Stroud v. Grace*[21] and *Williams v. Geier*[22], which are inconsistent with the Court's reading of *Corwin.* Both held (before *Corwin* was decided) that a stockholder vote can lower the standard of review for enjoining defensive measures from enhanced scrutiny to the business judgment rule.[23] While acknowledging this inconsistency, V.C. Zurn reasoned that, unlike *Santa Fe*, neither *Stroud* nor *Williams* was acknowledged in relevant part in the *Corwin* decision.[24] She determined that she was bound by *Corwin* and *Morrison,* which she interpreted as implicitly overruling *Stroud* and *Williams* while preserving *Santa Fe*.

The Court then turned to whether the claims as pled prompted enhanced scrutiny under *Unocal*. Outside of the poison pill context (where such a motivation is inferred), triggering *Unocal* enhanced scrutiny requires pleading the board acted with a subjective motivation of defending against a perceived threat. A court may consider all relevant circumstances to discern the directors' motivations.[25] In this case, the Plaintiffs asked the Court to infer a subjective entrenchment

[12] *Id.* at 11.
[13] *Id.* at 14.
[14] *Id.* at 14.
[15] *Id.* at 15.
[16] *Id.* at 15.
[17] *Id.* at 18.
[18] *Id.* at 27.
[19] *See In re Santa Fe Pacific Corp. Shareholder Litigation,* 669 A.2d 59 (Del. 1995).
[20] *In re Edgio, Inc.* at 27.
[21] *Stroud v. Grace,* 606 A.2d 75 (Del. 1992).
[22] *Williams v. Geier,* 671 A.2d 1368 (Del. 1996).
[23] *In re Edgio, Inc.* at 33-34.
[24] *Id.* at 36.
[25] *Id.* at 39.

motivation from the Company's underperformance, market commentary that the Company was a likely target for activists, the timing of the transaction in relation to these developments and the terms of the Challenged Provisions themselves.[26] The Court found that the Challenged Provisions had a defensive effect and, applying plaintiff-friendly inferences at the pleading stage, determined it was reasonable to infer that the Board had such a defensive motivation.[27] The Court noted that it reached these conclusions cautiously because "[i]nferring subjective defensive intent from the objective characteristics of a defensive measure is not very different than the per se trigger of *Unocal* that to date has been reserved for rights plans."[28]

Analysis of the Decision

It is unclear why Delaware courts should apply *Unocal* scrutiny to an alleged defensive device when it has been approved by a fully informed, uncoerced vote of the disinterested stockholders. After all, in such a scenario, the concern of *Unocal* and its progeny that the board took "unilateral action" is absent. The Court also emphasized *Corwin's* purported policy rationale of allowing stockholders to have "the free and informed chance to decide on the *economic merits* of a transaction for themselves" (Court's emphasis), contrasting the "economic" decision to approve a merger with a vote on entrenching measures, which the Court characterized as unsuitable for economic valuation because of the potential for irreparable harm. But it is unclear why stockholders were less capable of approving this stock issuance and related terms than any number of other transactions that are capable of ratification by stockholder vote. Delaware law has long held that, outside of the controlling stockholder context, approval of an interested transaction by an informed, non-coerced majority of the disinterested stockholders will invoke the business judgement rule. The decision also did not address the ways in which the Challenged Provisions may have benefitted the public stockholders.

It is also unclear whether the decision would have been different if the defensive measures were put to a separate vote, where approval of those measures was not a condition to approval of the stock issuance. In each of *Stroud* and *Williams*, the alleged defensive measures were included in charter amendments that were put to a standalone vote, whereas in *Santa Fe* the challenged deal protections were part of a sale agreement where stockholders were only asked to approve the transaction as a whole. It is possible the Court viewed the bundling of the defensive measures with the approval of the stock issuance as coercive, on the basis shareholders would have had to accept the former in order to obtain the benefits of the latter. But any M&A transaction is a product of numerous bargains, and it is difficult—and not always possible or advisable—to subject the component parts of a negotiated whole to independent approvals. In focusing on how the Stockholders' Agreement may have defended the Board against an activist, the decision does not address the ways in which that agreement may have protected the corporation and the rest of the stockholders from a new major investor, whose interests may not fully align with public stockholders as a whole. Even for a value enhancing transaction and even if it expected stockholders to approve the voting and transfer restrictions, a board may be reluctant to agree to a transaction that would result in such a large concentration of ownership if the board did not have certainty of some protection against such a significant stockholder exerting outsized influence on corporate governance and policy, or creeping toward control without payment of a control premium, or enabling someone else to do the same. And as commentators have noted, *Corwin* itself involves a certain bundling—where shareholders who vote to approve a transaction are also effectively required to absolve fiduciaries of breaches they committed in the course of its execution.

Finally, one could question whether the Court overestimated the insulating effect of the restriction on transfers to known activists. In order to amass their

[26] *Id.* at 41.
[27] *Id.* at 42-43.
[28] *Id.* at 45.

position, typically activists must accumulate shares on the open market, which can take time. An accumulation of greater than 5% of the outstanding shares must be disclosed within 10 days under current SEC rules. Any activist was free to acquire public shares that were not subject to the Stockholders' Agreement, just as they were prior to closing of the Acquisition. But the Acquisition created a newly issued, concentrated block that, following expiration of the lockup, could have made it much easier for an activist to acquire a very significant stake without advanced disclosure. Such a transfer restriction might be more accurately characterized as partially neutralizing what might otherwise have given activists a significant advantage, rather than putting activists at a disadvantage. While *Unocal* and its progeny restrict boards from entrenching themselves against activist stockholders, it's not clear it should require boards to lay down the red carpet. Furthermore, as is customary, the provision only restricted a trade to an investor who was *known* to be on the SharkWatch list. This would not have restricted College Parent from sales on the open market after the lockup expired, through which any activist could have acquired shares, directly or indirectly. The strongest activist deterrent was not the transfer restriction but rather the presence of such a large investor in the stock in the first place, which was not at issue in the case.

Key Takeaways for Corporations and their Boards

– **At least for now, boards cannot rely on a fully informed, uncoerced stockholder vote to avoid enhanced scrutiny of defensive measures under *Unocal*.** As described above, it is unclear why Delaware courts should apply *Unocal* scrutiny to an alleged defensive device when it has been approved by a fully informed, uncoerced vote of the disinterested stockholders. But at least for now, boards cannot rely on the effect of such a vote to "cleanse" (or ratify) any provision that could be subject to challenge under *Unocal*. Thus, boards considering adopting such provisions should be prepared to defend them under *Unocal*.

– **But that does not mean *Unocal* will always apply.** Notably, the terms of the Stockholders' Agreement that were most at issue in this case are generally customary for significant equity investments and are seen in many PIPE transactions. But this decision does not mean that every case will be susceptible to a *Unocal* challenge. Indeed, in a footnote, V.C. Zurn noted that "it is unlikely that the nature of the Challenged Provisions alone would be sufficient to trigger *Unocal*."

- A few facts of this case seem to have driven the result, including that the Company was by all accounts vulnerable to activist attack at the time it agreed to the Challenged Provisions, leading to an inference that the Board was subjectively motivated to seek to fend off potential activists. It is worth noting, however, that the Court inferred this largely from the Company's performance and market commentary—there was no evidence that an activist had actually emerged or that the Board had specific reason (*e.g.*, from observation of unusual trading activity) that an activist engagement was imminent. While in this case the Stockholders' Agreement arose from an acquisition, such agreements are common in large equity investments and it is frequently the case that issuers in those transactions have faced some operational or financial headwinds (which is often accompanied by the type of activism vulnerability commentary seen here).
- Size of the investment probably also mattered to this decision. While it is common for issuers to obtain voting commitments and trading lockups from significant investors, the entrenching effect of such provisions likely looks different with a 35% stockholder than it would with, *e.g.*, a 10% or perhaps even 20% stockholder. The length of the lockup period will also likely be reviewed with this in mind.
- In addition, it is important to note that this decision was on a motion to dismiss, and the

Court's ruling was limited to finding it "reasonably conceivable" that the stockholder plaintiffs could prove their claim and so they should be permitted to proceed to discovery. After discovery, including into the Board's subjective motivations, the Court may reach the opposite result.

- **Spotlight on Activist Transfer Restrictions.** It is worth noting the outsized role the provision restricting transfer to the "Sharkwatch 50" played in the Court's decision. The Court intimated that it was reasonable to infer from that provision that the Board's subjective motivation was to defend against an activist threat. As described above, we believe this provision likely received undue focus. In our experience such provisions usually are motivated by more benign considerations (*e.g.*, avoiding giving an activist an easy way to acquire a large bloc without advance notice). And the provision at issue here would not have restricted College Parent from selling on the open market (where any activist could have been a direct or indirect buyer). Ultimately, the strongest activist deterrent was the presence of such a large investor in the stock in the first place. Nevertheless, it is worth considering whether the benefits of such a provision outweigh the costs in light of this decision.
- **Importance of Building the Record.** It is important to establish a clear and thorough record of the board's deliberations regarding, and rationale for seeking, protections of the type at issue here. Outside of the poison pill context, application of *Unocal* requires a showing that the board acted with a subjective motivation of defending against a perceived threat. While board minutes and other internal documents directly reflecting the subjective motivation of the directors were absent from the record at the motion to dismiss stage (because the plaintiff declined to seek books and records under DGCL § 220 prior to filing suit), such records will presumably be produced in discovery and will be part of the record for summary judgment or trial. In addition to shedding light on the Board's motivation for entering into the transaction and agreeing to the terms of the Stockholders' Agreement, such records may discuss the ways in which the Challenged Provisions benefitted the public stockholders, including by preventing creeping control by the investor without payment of a control premium, or dumping the stock in the near term following the transaction. It is important for boards to document such rationales, if they exist, in addition to establishing other non-defensive motivations.

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