ALERT MEMORANDUM

Delaware Chancery Court Highlights Tension Between Freedom of Contract and Corporate Fiduciary Duties

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May 12, 2023

In a recent decision, the Delaware Court of Chancery grappled with the question whether—and to what extent—claims for breach of fiduciary duty can be waived ex ante in a corporate shareholder agreement. Specifically, in New Enterprise Associates 14 LP v. Rich, the court denied a motion to dismiss claims for breach of fiduciary duties brought against directors and controlling stockholders of Fugue, Inc. (the "Company") by sophisticated private fund investors who had agreed to an express waiver of the right to bring such claims.[1] Importantly, the court found that fiduciary duties in a corporation can be tailored by parties to a shareholders agreement who are sophisticated, and were validly waived by the voting agreement in this case (which specifically addressed the type of transaction at issue). The court, however, held that public policy prohibits contracts from insulating directors or controlling stockholders from tort or fiduciary liability in a case of intentional wrongdoing, which the court found was plausibly alleged in this case. The court's opinion has implications for sophisticated investors in venture capital and other private transactions involving Delaware corporations. The opinion cautions against overreliance on express contractual waivers, on the one hand, while also serves as a reminder that at least in some circumstances sophisticated parties can contract around default legal principles (including fiduciary duties), even with respect to corporations.

[1] *New Enter. Assocs. 14 LP v. Rich*, C.A. No. 2022-0406-JTL (Del. Ch. May 2, 2023).

Legal Context

The principle of freedom of contract, which allows sophisticated parties to freely negotiate the terms of their agreements and to rely on the enforceability of such agreements is a cornerstone of Delaware law. In Abry Partners, the Delaware Court of Chancery held that "sophisticated parties" can and should "make their own judgments about the risk they should bear," and Delaware courts are "especially chary about relieving sophisticated business entities of the burden of freely negotiated contracts."[2] In Libeau, the court emphasized that "Delaware law is strongly inclined to respect" negotiated agreements and "will only interfere upon a strong showing that dishonoring the contract is required to vindicate a public policy interest even stronger than freedom of contract" (i.e., in the case of fraud).[3]

That said, it is widely understood that while fiduciary duties can be modified or waived in the alternative entity space, they are effectively immutable in a corporation. This view is not entirely accurate. The Delaware courts have recognized that while a certificate of incorporation or corporate bylaws must respect rights provided by the Delaware General Corporation Law (*e.g.*, the right to seek appraisal), sophisticated investors may agree among themselves, whether in stockholders agreements or M&A agreements, to contractually modify, limit or waive certain statutory or common law rights, including the right to sell shares,[4] the right to vote,[5] and the right to seek appraisal.[6] Importantly, and as has been well-discussed among M&A practitioners in the private equity space, the court permits parties (especially sophisticated parties) to tailor, but not wholly eliminate,[7] the scope of fraud claims that may be brought against a seller in an M&A transaction.[8] The *New Associate Partners* case extends a similar principle to waivers of fiduciary duty claims agreed in a stockholders agreement.

Background and Court Decision

In *New Associate Partners*, the plaintiffs, who were sophisticated investors, agreed to a drag-along provision in a voting agreement with the Company and certain other stockholders, which included a covenant not to sue for breach of fiduciary duties in the event the drag-along provision was validly employed.[9] The drag-along provision allowed the Company's board of directors and a majority of its preferred stockholders to drag other stockholders in a sale of the Company (subject to certain specified criteria for the sale). The plaintiffs acknowledged that the covenant not to sue, if enforceable, would preclude their claims against the Company's directors and majority stockholders, but argued that this provision was facially invalid, as it conflicted with Delaware law and as a matter of public policy. The court disagreed with the plaintiffs' position regarding facial invalidity, concluding that the "covenant operates permissibly within the space for fiduciary tailoring that Delaware corporate law

[2] *Abry P'rs V, L.P. v. F&W Acq. LLC, 891 A.2d 1032*, 1061–62 (Del. Ch. 2006).
[3] *Libeau v. Fox*, 880 A.2d 1049, 1056 (Del. Ch.), aff'd in part, rev'd in part on other grounds, 892 A.2d 1068 (Del. 2006).
[4] *8 Del. C.* § 202(b).
[5] *Id.* § 218(c).
[6] *Manti Holdings, LLC v. Authentix Acquisition Co.*, 261 A.3d 1199 (Del. 2021).
[7] *See, e.g., In re Altor Bioscience Corp.*, C.A. No. 2017-0466-JRS (Del. Ch. May 15, 2019); *Manti; Abry*.
[8] *See, e.g., Express Scripts, Inc. v. Bracket Holdings Corp.*, 248 A.3d 824 (Del. 2021) (the Delaware Supreme Court rejected an attempt to hold a party liable for reckless statements when the purchase agreement expressly limited liability to intentional fraud); *Infomedia Grp., Inc. v. Orange Health Sols., Inc.*, 2020 WL 4384087 (Del. Super. Ct. July 31, 2020) (observing that Delaware courts routinely enforce anti-reliance provisions, which preclude a plaintiff from using extra-contractual evidence to support breach-of-contract and fraud lawsuits).
[9] The covenant not to sue is included in the National Venture Capital Association's form voting agreement. The associated footnote commentary states that the provision is included due to the increased incidence of suits by minority and junior classes of investors for fiduciary duty claims in the context of drag-along transactions where such investors receive no consideration for their shares, and notes that such suits are unlikely to be dismissed at an early stage.

provides, particularly in a stockholder-level agreement that only addresses stockholder-level rights."[10]

Relying on the decisions in *Manti* and *Altor Bioscience*, the court adopted a two-step analysis for evaluating a provision like the covenant not to sue. First, the provision must be narrowly tailored to address a specific transaction that otherwise would constitute a breach of fiduciary duty (otherwise, it may be facially invalid). Next, the provision must survive close scrutiny for reasonableness. Here, the court considered a non-exhaustive list of factors, including that the plaintiff stockholders were sophisticated, received legal advice and understood the impact of the covenant not to sue, they had the opportunity to reject the provision, and the provision itself would only be triggered upon a specific set of circumstances (invocation of the drag-along in accordance with the voting agreement). On this basis, the court concluded that the covenant not to sue was not facially invalid.

Nevertheless, the court refused to dismiss all of the claims based on the allegations contained in the complaint, as it found that the covenant's scope extended beyond what Delaware law allows and "cannot insulate the defendants from tort liability based on intentional wrongdoing."[11] Analogous to the reasoning in *Abry* and *Online HealthNow*[12], where the court disallowed complete elimination of fraud claims to the extent the contract itself was an "instrument of fraud," the court in *New Enterprise Associates* reasoned that the covenant not to sue was ineffective to bestow immunity on a fiduciary who engaged in intentional wrongdoing (as opposed to a merely grossly negligent or reckless breach of fiduciary duty). However, the court cautioned that this holding was based on the specific facts of the case and language being interpreted.

Key Takeaways

— *New Enterprise Associates* affirms that Delaware law allows sophisticated parties to agree to certain limitations on stockholder-level rights that would otherwise be available to them under statute or common law. It also permits "fiduciary tailoring," most pertinently through provisions agreed by "*uber*-sophisticated"[13] parties that specifically authorize a fiduciary to engage in a type of transaction that might otherwise constitute a breach.[14] However, in its decision to deny the motion to dismiss the claims for fiduciary breach, the court emphasized that the parties cannot contractually eliminate liability for intentional wrongdoing.

— The court's opinion illustrates that sophisticated investors should not assume that the background principles of Delaware law will protect them notwithstanding an agreement to waive fiduciary duty claims. In particular, the opinion makes clear that Delaware law does allow for significant tailoring of fiduciary rights, even in a corporation, especially where sophisticated parties are agreeing to such matters in a stockholder-level agreement (as opposed to a company's certificate of incorporation or bylaws). Investors with an interest in preserving fiduciary duty claims (*i.e.*, minority investors or investors with junior stock), should not take undue comfort in the inviolate nature of fiduciary duties in a corporation and should recognize that Delaware courts, where sophisticated investors agree with "eyes wide open," may enforce limitations on broad-based fiduciary duty claims.

— By the same token, majority stockholders and corporations should not assume that an express waiver of fiduciary duty claims by a sophisticated stockholder is an impermeable shield against potential liability. While the court recognized that it will respect narrowly tailored, specific waivers of fiduciary duties confined to a particular factual circumstance and entered into by a sophisticated stockholder, it does not seem that the court will

[10] *New Enter. Assocs.* at 129.
[11] *Id.* at 8.
[12] *Online HealthNow, Inc. v. CIP OCL Investments, LLC*, C.A. No. 2020-0654-JRS, mem. op. (Del. Aug. 12, 2021).
[13] *New Enter. Assocs.* at 125.
[14] Similar provisions are seen, for example, in the renunciation of the corporate opportunity doctrine in stockholders agreements.

bless extracting such a waiver with one hand and then abusing the waiver by way of intentional wrongdoing with the other. Consequently, maintaining processes and making decisions in a manner likely to pass muster in the face of breach of duty of loyalty claims remains best practice.

— The court's opinion leaves open a number of nuanced questions, and practitioners may expect additional negotiating points involving the appropriate scope of a proposed fiduciary waiver involving a Delaware corporation. It also bears mention that a similar type of negotiation (and resultant potential exposure) occurs in the context of alternative entities, such as limited liability companies.[15] There, Delaware law is clear that the implied covenant of good faith and fair dealing may not be waived by contract, though matters that may constitute a breach of such covenant are the subject of litigation based on the facts involved. Indeed, in this case, the court held that the covenant not to sue would foreclose claims of breach of fiduciary duty for engaging in self-dealing transactions in the good-faith belief they were in the best interest of the company, or similar claims based on reckless disregard for the best interests of the company.[16] It remains unclear whether challenges to fiduciary duty waivers in the context of a corporation would depend more on the contractual language used or the alleged wrongdoing, but a similar principle in both alternative entities and corporations is clear: there is an irreducible core of fiduciary (or fiduciary-type) protection under Delaware law as against certain bad acts.

— This decision is particularly noteworthy for venture capital fund and growth equity investors, which enter into transactions where voting agreements and the language at issue is common. But it also has implications for private equity investors, especially in a dealmaking environment like we are experiencing currently, where there is increasing reliance on co-investments, co-sponsorship and continuation fund transactions where such agreements may be in play.

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[15] Plaintiffs in the *New Enterprise Associates* case also argued that permitting stockholders to waive claims for breach of fiduciary duties through a private agreement would blur the distinction between corporations and LLCs, where near elimination of fiduciary duties, other than the implied covenant of good faith and fair dealing, is permissible (*see* 6 *Del. C.* § 18-1101(e)). The court concluded that the fundamental differences between LLCs and corporations lie in the formation documents and not at the stockholder agreement level.

[16] *New Enter. Assocs.* at 128-9.