ALERT MEMORANDUM

The Long Way Out: Court of Chancery Holds Conversion from Delaware to Nevada by Conflicted Controller Is Subject to Entire Fairness Review, But Declines to Enjoin the Transaction

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February 28, 2024

Last week, the Delaware Court of Chancery refused to enjoin the conversion of a Delaware corporation, TripAdvisor, Inc. ("TripAdvisor"), into a Nevada corporation but declined to dismiss claims for monetary damages against the company's controlling stockholder in connection with the conversion, holding the conversion should be reviewed under the "entire fairness" standard. In a February 20, 2024 memorandum opinion, Vice Chancellor J. Travis Laster held in *Palkon v. Maffei*[1] that it was reasonably conceivable that Nevada law accords corporate fiduciaries greater protection from legal liability than Delaware and that minority stockholders therefore would suffer an abridgement of their "litigation rights." The controller thus faces potential liability for monetary damages unless he can prove at trial that the conversion

[1] *Palkon v. Maffei*, 2024 WL 678204, at *1 (Del. Ch. Feb. 20, 2024).

was substantively and procedurally fair to the minority. And though the Court took pains to note its decision "does not mean that corporations cannot leave Delaware,"[2] the decision leaves open questions as to how the Court will determine monetary damages caused by re-domiciling in another jurisdiction.

The decision follows on the heels of two other recent Court of Chancery decisions that express the Court's expansive view of its role in reviewing the conduct of controllers.[3] Decisions such as these have raised questions, including from former members of the Delaware judiciary, as to whether this recent jurisprudence threatens Delaware corporations with increased costs of meritless litigation that outweigh any purported benefits to minority stockholders.[4] It also comes against the backdrop of at least one controller, Elon Musk, announcing that he will cause corporations under his control to move to Nevada or Texas.[5] After the *Palkon* decision, any controlling stockholder who is considering proposing a conversion away from Delaware should proceed with caution. Absent a pending intervention by the Delaware Supreme Court, leaving Delaware, while not impossible, may prove costly.

Procedural Posture

In *Palkon v. Maffei*, stockholders of TripAdvisor challenged the proposed conversion by TripAdvisor and its parent company ("Holdings") into Nevada corporations. The conversion was proposed by TripAdvisor and Holdings management. As required by the Delaware corporations law, the conversion was approved by the respective boards and a majority of outstanding voting power of both corporations. Plaintiffs challenged the transaction on the grounds that the directors and beneficial owner of the majority voting power of both entities, Gregory B. Maffei, "approved the conversion to secure the litigation protections for themselves."[6] Plaintiffs sought to enjoin the transaction and asserted monetary damages against all defendants. The defendants moved to dismiss, which the Court denied except with respect to the plaintiff's injunction request.

[2] *Id.* at *2.

[3] *See In re Sears Hometown & Outlet Stores, Inc. S'holder Litig.*, 2024 WL 262322, at *23–28 (Del. Ch. Jan. 24, 2024) (Laster, V.C.) (noting that "some Delaware decisions assert that a controller can exercise [its] stockholder-level rights free of fiduciary constraint" but instead applying the enhanced scrutiny standard to review the controller's exercise of its voting power to pass bylaws that constrains the board of directors and "change[s] the status quo"); *Tornetta v. Musk*, 2024 WL 343699, at *1–4 (Del. Ch. Jan. 30, 2024) (McCormick, C.) (finding, in a "decision [that] dares to boldly go where no man has gone before," that Elon Musk controlled Tesla Inc. and extracted equity-based compensation from the company that was not entirely fair to its stockholders, and that plaintiff stockholders are entitled to rescission of the equity awards (internal quotation marks removed)). We use the term "controller" because the Court of Chancery has also held that a non-stockholder can be deemed to hold fiduciary duties that traditionally attach to majority stockholders. *See Blue v. Fireman*, 2022 WL 593899, at *16 (Del. Ch. Feb. 28, 2022) (Zurn, V.C.) (noting that "holding stock is not a prerequisite to exercising voting control that carries the weight of fiduciary duties"); *In re Pattern Energy Grp. Inc. S'holders Litig.*, 2021 WL 1812674, at *1 (Del. Ch. May 6, 2021) (recognizing the possibility than an "investor, supplier, and management stockholders formed a control group, given the investor's consent right and other pervasive sources of soft power over the Company and its sales process" although "neither the investor nor the supplier owned Company stock").

[4] *See* Lawrence Hamermesh, Jack B. Jacobs and Leo E. Strine, Jr., *Optimizing The World's Leading Corporate Law: A 20-Year Retrospective and Look Ahead*, 77 Bus. Law. 321, 322 (2022) (arguing that recent developments in the Court of Chancery's controller jurisprudence create unnecessary litigation costs and urging the Delaware Supreme Court to deescalate the standard of review for certain conflicted controller transactions). *But see* Greg Varallo, Andrew Blumberg, and James Janison, *"Optimizing" and Match: Bad Policy Threatens to Drive Bad Law*, Harvard Law School Forum on Corporate Governance (Nov. 13, 2023), https://corpgov.law.harvard.edu/2023/11/13/optimizing-and-match-bad-policy-threatens-to-drive-bad-law/ (arguing that "Delaware should not try to outrace Nevada to create a 'judgment-free zone' for corporate controllers").

[5] *See* Tom Krisher, *Elon Musk's Neuralink Moves Legal Home to Nevada After Delaware Judge Invalidates His Tesla Pay Deal*, Associated Press (Feb. 10, 2024, 1:03 PM), https://apnews.com/article/elon-musk-neuralink-brain-implant-corporate-move-nevada-delaware-09c2eee269beebccf9a701f21ea2b9f7; Lora Kolodny, *SpaceX Files to Move Incorporation Site From Delaware to Texas*, CNBC (Feb. 14, 2024, 8:12 AM), https://www.cnbc.com/2024/02/14/spacex-files-to-move-incorporation-site-from-delaware-to-texas.html.

[6] *Palkon,* 2024 WL 678204, at *1.

Conversion of a Controlled Company to a Jurisdiction that Provides Fiduciaries with Greater Liability Protection Found Subject to Entire Fairness Scrutiny

The Court held that the decision of a controlled company to relocate to Nevada is subject to entire fairness scrutiny because the transaction confers a non-ratable benefit upon the Company's controller and other corporate fiduciaries. This portion of the opinion may be unsurprising in light of Delaware jurisprudence in recent years. The Court of Chancery has previously held that a transaction that makes it less likely for pending claims against a fiduciary to be litigated confers a non-ratable benefit on the fiduciary and must be tested for entire fairness.[7] Accordingly, defendants sought to limit the scope of the test, arguing that it only applies to current or future claims arising from the controller's prior but not *future* conduct. The Court rejected that distinction as arbitrary and formalistic, analogizing to both insurance premiums and the options market as examples of situations where the market puts a current value on merely "potential" future events. Instead, Vice Chancellor Laster held that the test for the benefit to the fiduciary should hinge on the materiality of the benefit, rather than when it is to be obtained. "Under Delaware law," the Court asserted, "a controller or other fiduciary obtains a non-ratable benefit when a transaction materially reduces or eliminates the fiduciary's risk of liability."[8]

Vice Chancellor Laster made clear that he was not deciding whether Nevada law actually provides corporate fiduciaries greater protection than Delaware. The Court instead held only that it was "reasonably conceivable" for purposes of a motion to dismiss that Nevada law offers greater protection to corporate fiduciaries and that such protection would be material to such fiduciaries in this case.[9] In making the determination, the Court cited to TripAdvisor's board materials, as well as TripAdvisor's own proxy statement with respect to the transaction, which advised stockholders that the conversion "will result in the elimination of any liability of an officer or director for a breach of the duty of loyalty unless arising from intentional misconduct, fraud, or a knowing violation of law."[10]

The Court also rejected the notion that judicial review of the conversion discriminates against Nevada entities, noting that it would apply the same framework to review a conversion of a Delaware corporation into a Delaware limited liability company.

Reframing the "Fair Price" Analysis of the Entire Fairness Test

The Court also rejected the defendants' argument that entire fairness categorically cannot apply "outside of a transaction in which stockholders received cash for their shares."[11] The Court cited to a list of cases in which the Delaware Supreme Court applied entire fairness scrutiny to transactions outside of that context.[12] Likening the conversion to a stock-for-stock merger (here, one in which stockholders received shares in a Nevada corporation in exchange for their shares in a Delaware corporation), the Court noted the test for "fair price" (or "substantive" fairness) in this

[7] *See In re AmTrust Fin. Servs., Inc. S'holder Litig.*, 2020 WL 914563, at *10 (Del. Ch. Feb. 26, 2020) (Bouchard, C.) (holding that a controller squeeze-out did not satisfy the conditions necessary to obtain business judgment review because the merger would extinguish pending derivative claims against "three of the four members of the Special Committee" who therefore "had a material self-interest in the [t]ransaction."); *In re Primedia, Inc. S'holders Litig.*, 67 A.3d 455, 487 (Del. Ch. 2013) (Laster, V.C.) (holding that a controller stockholder, a private equity firm, received a non-ratable benefit in a merger because the buyer who acquired the claims "would be reluctant" to press the claims against the seller).

[8] *Palkon*, 2024 WL 678204, at *8.

[9] *Id.* at *2.

[10] *Id.* at *5. The Holdings board reviewed similar materials and its proxy statement made similar representations.

[11] *Id.* at *14.

[12] The Vice Chancellor marshalled the same line of cases for the proposition that the MFW framework is required for cleansing controller conflict transactions other than squeeze-out mergers in *In re Ezcorp Inc. Consulting Agreement Derivative Litig.*, 2016 WL 301245, at *12-13 (Del. Ch. Jan. 25, 2016) (Laster, V.C.).

context is "whether stockholders receive at least the substantial equivalent in value of what they had before."[13] The Court framed this prong of the entire fairness test as follows: "Before the conversion, the stockholders held shares carrying the bundle of rights afforded by Delaware law, including a set of litigation rights. After the conversion, the stockholders owned shares carrying a different bundle of rights afforded by Nevada law, including a lesser set of litigation rights."[14] The Court found it reasonably conceivable that this meant the stockholders do not possess at least the substantial equivalent of what they possessed before.

With respect to process, the Court noted that "[t]he defendants did not make any effort to replicate arm's length bargaining."[15] Noting that the Court of Chancery has previously cited to the informed vote by unaffiliated minority stockholders in favor of a conflicted controller transaction as non-dispositive evidence of its fairness, Vice Chancellor Laster observed that the affirmative vote against the transaction by the informed minority stockholders—with only 5.4% of such holders at TripAdvisor, and 30.4% of holders at the Holdings level, voting in favor of the conversion[16]—supported a pleading-stage inference that the transaction was not entirely fair.[17]

Availability of a Potential Monetary Remedy Leads to Dismissal of Demand for Injunction

Though holding that plaintiffs had a well-pled claim for breach of fiduciary duty by the corporate fiduciaries, the Court nevertheless declined to enjoin the conversion. Even as the Court asserted that it has the authority to enjoin conversions and will maintain jurisdiction over the defendants even after the transaction closed, the Court concluded that plaintiffs had failed to demonstrate that monetary damages would be inadequate in this case. "The remedial challenge," according to the Court, "will be to quantify the extent of the harm, if any, that moving from Delaware to Nevada imposes on the unaffiliated stockholders."[18] To quantify the potential economic harm caused by the conversion, the Court suggested that it could look to changes in the Company's stock price before and after the conversion (or upon the announcement of the conversion, given the *fait accompli* of approval presented by the controller's majority vote), noting that "the announcement of the conversion should have a relatively clean price impact."[19] At the same time, however, the Court also suggested that the absence of a stock price drop may not necessarily operate as a safe harbor for controllers, injecting potential unpredictability into the analysis.[20]

Delaware at an Inflection Point?

The *Palkon* decision arrives just as the Delaware Supreme Court has taken under advisement in the *Match Group* litigation a question as to whether to relax the requirements that controllers must follow to insulate certain conflict transactions from entire fairness review.[21] Under the so-called *MFW* framework, in order to escape entire fairness review, controlling stockholders that engage in conflict transactions must condition the transaction *ab initio* on both the recommendation by an independent and disinterested special committee and the fully informed and uncoerced approval of the corporation's disinterested stockholders. In the *Match Group* case, the defendants have urged the Delaware Supreme Court to limit the *MFW* framework to squeeze-out

[13] *Palkon*, 2024 WL 678204, at *14 (quoting *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 114 (Del. 1952)).

[14] *Id.* at *1.

[15] *Id.* at *17.

[16] *Id.*, at *5.

[17] *Id.* at *17.

[18] *Id.* at *22.

[19] *Id.*

[20] *See id.* ("That does not make the price reaction the be all and end all").

[21] *See In re Match Grp., Inc. Deriv. Litig.*, C.A. No. 368, 2022, at 2 (Del. May 30, 2023) (ORDER) (ordering supplemental briefing as to whether the MFW framework applies to conflicted controller transactions other than controller squeeze-outs).

mergers and hold that in all other "conflicted controller transactions" (such as moving from Nevada to Delaware, as in this case) either of the procedural protections, even without the other, would be adequate to convert the standard of review to business judgment. If the Delaware Supreme Court agrees, that could provide a path for other controlled companies to avoid the result in this case. Watch this space.

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