

Delaware Chancery Court holds *Corwin* cleansing does not cover defensive measures subject to *Unocal*

May 31, 2023 | Client Update | 6-minute read

The recent *In re Edgio, Inc. Stockholders Litigation* decision highlighted concerns when a public company involved in a business combination adopts defensive measures that would continue for a significant period of time post-closing. The court declined to apply *Corwin* cleansing despite a fully informed stockholder vote.

In a decision on “enhanced scrutiny” under *Unocal Corp. v. Mesa Petroleum Co.* as evolved in the activist era, the Delaware Chancery Court denied a motion to dismiss in a case brought by plaintiff stockholders who sought to enjoin certain defensive measures adopted by a public company that would continue for a significant period of time post-closing in connection with a business combination transaction. Further, despite there being a fully informed stockholder vote on the business combination, the court declined to find the board actions cleansed (and, accordingly, did not subject the board’s actions to the deferential “business judgment rule”) under *Corwin v. KKR Financial Holdings LLC*.

The business combination resulted in a 35% stockholder, who was contractually obligated post-closing to vote in favor of the board’s slate

Edgio involved Limelight Network, a public company, that acquired a business from College Parent, a third party, in exchange for a 35% stake in Limelight’s common stock. In connection with that transaction, Limelight and College Parent signed a stockholders agreement providing that College Parent would: (1) receive proportional nomination rights for up to 1/3 of the director seats on Limelight’s board for so long as College Parent held 10% or more of Limelight’s stock; (2) vote in favor of all directors recommended by the Limelight board (and vote as recommended by the board or pro rata with Limelight’s other stockholders on all other non-routine matters) until the date that was 90 days after the earlier of College Parent ceasing to own at least 35% of Limelight’s stock and ceasing to have any rights to nominate directors; (3) not transfer its shares to anyone for 2 years (and for one year thereafter not to any “SharkWatch 50” activist or competitor of Limelight); and (4) be subject to a customary standstill that was coterminous in duration with the voting covenant. The terms of the stockholders agreement were disclosed in the proxy with respect to the business combination transaction, and Limelight’s stockholders approved the share issuance (as required under the so-called “20% rule” of the Nasdaq Stock Market) at a stockholder meeting.

Plaintiff stockholders sue and claim board entrenchment

The plaintiff stockholders brought suit post-closing alleging Limelight’s pre-closing directors, by entering into the transaction and the stockholder agreement, breached their fiduciary duties by entrenching themselves in violation of *Unocal* and asked the court to enjoin the stockholders agreement provisions described above (other than the standstill).

The plaintiff stockholders contended that the provisions interfered with the stockholder franchise and established a 35% voting block contractually committed to protect the Limelight board and deter and defeat any activist threats to the incumbent directors. Limelight responded that due to stockholder approval, the claims of the plaintiff stockholders were cleansed under *Corwin*, and moved to dismiss the litigation.

Unocal* and *Corwin

Unocal's core function is to evaluate whether defensive measures should be enjoined. If directors take defensive measures in response to a perceived threat to corporate policy and effectiveness, then the actions taken must be reasonable in response to the threat posed (and per the *Unitrin* gloss, cannot be coercive or preclusive). The court noted that while the *Unocal* enhanced scrutiny standard was a product of the hostile takeover wave of the 1980s, *Unocal* also applies in the activist investor setting.

Corwin and its progeny provide that a transaction which is subject to enhanced scrutiny will be reviewed instead under the business judgment rule if the transaction is approved by a fully informed, uncoerced, vote (or tender) of a majority of the disinterested stockholders. *Corwin* provides that such a stockholder vote extinguishes or cleanses claims as to post-closing economic damages (other than as to a successful claim of waste). In other words, there should not be judicial second guessing when disinterested stockholders have a free and informed chance to decide on the economic merits of a transaction.

Corwin* held to not cleanse defensive measures that would entrench a board in contravention of *Unocal

Vice Chancellor Zurn stated that *Unocal* (and *Revlon*) were designed to give stockholders and the court the tool of injunctive relief to address important M&A decisions in real time, and were not designed with post-closing money damages in mind. While Limelight had claimed that there was no threat that would trigger *Unocal*, the Vice Chancellor observed that it was reasonable to infer that Limelight was concerned about the threat of activist stockholders based on, among other things: pre-deal analyst reports noting that Limelight was likely an activist target; Limelight's negotiation of a specific provision prohibiting transfers to "SharkWatch 50" activists; and post-deal news statements that the arrangement with College Parent could serve as a white squire arrangement if activists pursued Limelight. The court also determined that the provisions at issue in the stockholders agreement were defensive measures that would make it markedly more difficult for activists to prevail in a proxy contest. Because the decision was at the motion to dismiss stage, the court did not rule on the reasonableness of these defensive measures or determine whether the measures were in fact motivated by concerns regarding an activist threat.

As to Limelight's contention that, under *Corwin*, the stockholder vote cleansed any purported fiduciary duty breaches under *Unocal*, the Vice Chancellor noted that the function of *Corwin* is post-closing damages actions and that *Corwin* was never designed to cleanse entrenchment claims seeking injunctive relief under *Unocal*. Additionally, she looked to *In re Santa Fe Pacific Shareholder Litigation*, where the Delaware Supreme Court held that a stockholder vote on a merger did not extinguish *Unocal* claims as to defensive measures. As a result, the court denied the motion to dismiss.

Considerations when adopting defensive measures as part of a business combination

The *Edgio* decision is instructive for Delaware corporations when considering defensive measures. As the decision reiterates, outside of the shareholder rights plan context, *Unocal* applies only when there is a threat to corporate policy and effectiveness. Accordingly, companies should consider whether defensive measures are being adopted in the absence of a threat (on a so-called "clear day"), or in response to a threat. The latter will face more scrutiny from the courts, and a fully developed record of the board's process and careful crafting of the defensive measure will be important to establish the basis for the board's action.

Finally, close consideration of the specific terms of the defensive measures is warranted and should be evaluated on a holistic basis to understand the aggregate impact on stockholders. While *Edgio* involved a 35% stockholder combined with a voting covenant and no-transfer restrictions, the measures may be more likely to be held reasonable under *Unocal* if they cover a lower percentage ownership level or a shorter time period. Had the voting commitment been for a less overwhelming bloc (such as 10-15%) and for a shorter term (such as one year), the Court may have been more inclined to find that the plaintiff's claim would not have survived a motion to dismiss.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

William H. Aaronson

+1 212 450 4397
william.aaronson@davispolk.com

Andrew Ditchfield

+1 212 450 3009
andrew.ditchfield@davispolk.com

James P. Dougherty

+1 212 450 4330
james.dougherty@davispolk.com

Darren M. Schweiger

+1 212 450 4575
darren.schweiger@davispolk.com

Paul S. Scrivano

+1 650 752 2008
+1 212 450 4304
paul.scrivano@davispolk.com

H. Oliver Smith

+1 212 450 4636
oliver.smith@davispolk.com

William L. Taylor

+1 212 450 4133
william.taylor@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.