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Delaware's General Corporation Law: Proposed Changes

From the Experts

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On May 12 the Delaware Senate passed four amendments to the Delaware General Corporation Law (DGCL). The state's House will consider the legislation in early June, and if the amendments pass (as is considered likely), they are expected to become effective in August. They would have a significant impact on corporate America, as more than 50 percent of U.S. publicly traded companies and 64 percent of the Fortune 500 companies are incorporated in Delaware, and over one million business entities make Delaware their legal home.

The proposed amendments would change forum selection provisions in the certificates of incorporation or bylaws of Delaware corporations, would invalidate fee-shifting provisions and would make two important changes in the appraisal statute.

Forum Selection

Many public companies have adopted "internal affairs" forum selection provisions in their certificates and bylaws in recent years in an attempt to limit duplicative litigation filed in multiple jurisdictions. Multiple forum litigation is expensive, distracting and frequently the result of jockeying among plaintiffs' lawyers to obtain a "seat at the table" in lawsuits challenging mergers. These forum selection provisions had never been the subject of legislation in Delaware; however, beginning in 2013 the Delaware Court of Chancery upheld several forum selection provisions, including one requiring that litigation involving a Delaware corporation take place in North Carolina.

The proposed amendments would add a new Section 115 to the DGCL, authorizing the certificate of incorporation or bylaws of a Delaware corporation to include forum selection provisions for "internal corporate claims," including derivative actions. Internal corporate claims are claims based on a violation of a duty by a current or former director or officer or stockholder in such capacity, and other claims as to which the DGCL confers jurisdiction upon the Delaware Court of Chancery. Section 115 would authorize certificate or bylaw provisions requiring that lawsuits asserting internal corporate claims be brought solely and exclusively in the Delaware courts (including the federal court).

Section 115 does not expressly prohibit certificate or bylaw provisions that select a forum other than the Delaware courts as an additional forum in which an internal corporate claim may be brought. But the new Section 115 would invalidate any provision selecting only non-Delaware courts, or any arbitral forum, to the extent the provision would prohibit litigation of internal corporate claims in the Delaware courts. Thus, for example, it would be permissible for a Delaware corporation having its principal place of business or corporate headquarters in Illinois to adopt a charter or bylaw provision making Illinois and Delaware the exclusive fora to bring these claims, but it would be impermissible for the certificate or bylaw provision to prescribe only Illinois as the exclusive forum.

It also is important to keep in mind what this amendment does not do. It does not prohibit a provision selecting a forum other than Delaware as the exclusive forum if placed in a stockholders' agreement or other writing signed by a stockholder against whom the

forum selection provision is sought to be enforced. And, it does not shield from judicial review a claim that the provision operates unreasonably under the circumstances, or that the manner in which the provision was adopted was inequitable.

Fee-Shifting

Many public companies adopted or proposed adopting "fee-shifting" bylaws following a Delaware Supreme Court decision last year upholding the facial validity of fee-shifting bylaws in a nonstock corporation. The proposed amendments would invalidate fee-shifting provisions in certificates of incorporation and bylaws of Delaware stock corporations. New DGCL Section 102(f) would provide that a certificate of incorporation may not contain any provision imposing liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an "internal corporate claim" as defined in new Section 115. A similar proscription would be added to Section 109(b), which addresses what provisions may be included in the bylaws of a Delaware corporation. The legislation also would amend Section 114 to provide that the proscription against fee-shifting provisions does not apply to nonstock corporations. Importantly, the proposed amendments would not proscribe a fee-shifting provision in a stockholders' agreement or other writing signed by a stockholder against whom the provision is sought to be enforced, nor would they impact other types of business entities, such as limited partnerships or limited liability companies, that are governed by separate statutory provisions.

This approach was the end result of a year-long debate over whether fee-shifting provisions should be allowed in any form, and if so, how to draft a statute that would draw bright-line distinctions that would deter meritless litigation, yet not chill the bringing of all "internal corporate claim" actions that may have plausible merit. In the end the task proved too difficult and led to the proposed blanket proscription for all stock corporations, whether publicly or privately held.

Appraisal

In addition, the Senate passed two important amendments to the Delaware appraisal statute—each designed to solve a different problem.

The first, intended to limit de minimis appraisal claims in certain public company transactions, would require the Delaware Court of Chancery to dismiss an appraisal proceeding as to all stockholders otherwise entitled to appraisal if: (i) the total number of shares seeking appraisal is less than 1 percent of the outstanding number of shares of the class or series entitled to appraisal; (ii) the value of the consideration for that total number of shares is $1 million or less; and (iii) the merger took the form of a "short form" merger under Sections 253 or 267 of the DGCL. ("Short form" mergers would not be subject to the "de minimis carve-out" because appraisal may be the only remedy available in such a merger.) Moreover, the carve-out would only apply where the shares were listed on a national securities exchange immediately before the merger or consolidation.

The second proposed amendment is intended to address the "appraisal arbitrage" issue. Many in the corporate legal community advocated a solution whereby the appraisal statute would be amended to require that a stockholder must hold its shares as of the record date for the merger vote. This approach was rejected, however, in favor of a provision that would afford surviving corporations the option of limiting the accrual of statutory interest on appraisal awards. This would allow the company to make an early payment of a sum of money in any amount determined by the company, at any time before entry of judgment in the appraisal proceeding.

When a company makes such a payment, no interest will accrue on that amount from the date of that early payment. Instead, interest will accrue only on the amount by which the ultimately adjudicated appraisal award exceeds the amount that was prepaid. (Under the current law, interest accrues on the entire amount of the appraisal award.) Corporations using this approach must make the payment to all appraisal claimants, except claimants for which the corporation has a good faith basis to contest their entitlement to seek appraisal, and no inference will be drawn from the amount prepaid when determining the fair value of the shares seeking appraisal.

Although this approach will not eliminate altogether the ability of an investor to buy stock of the to-be-merged corporation after the record date and then seek appraisal, it does enable the corporation to eliminate much of the economic incentive to do that, at least in the current (low interest rate) economic environment in which the statutory interest rate is 5 percent over the Federal Reserve rate, compounded quarterly.

Jack Jacobs, a former Justice of the Delaware Supreme Court, joined Sidley Austin as senior counsel in September 2014. He had served on the Delaware Supreme Court since 2003 and, before that, as vice chancellor of the Delaware Court of Chancery since 1985. He is an adjunct professor at several law schools, including New York University, Columbia University and the University of Pennsylvania. He focuses on corporate governance and acquisition matters, shareholder derivative and class action litigation, and Special Committee investigations. Hille Sheppard co-chairs the firm's securities and shareholder litigation practice. She is an experienced litigator who specializes in defending companies, their officers and directors, and accounting firms in high-stakes securities class actions, shareholder derivative litigation and shareholder demands. Hille also has extensive experience with SEC investigations and enforcement proceedings.