M&A Report: Delaware Court of Chancery Declines to Enforce a Covenant Not to Sue Upon Exercise of a Drag-Along Right for Public Policy Reasons

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On May 2, 2023, in a case challenging the fairness of a merger between a cloud security startup and a Boston-based cybersecurity company, the Delaware Court of Chancery denied a motion to dismiss breach of fiduciary duty claims relating to a drag-along merger despite plaintiff-investors' explicit covenant not to sue over a drag-along sale, including by raising claims of fiduciary duty breach. In a decision by Vice Chancellor J. Travis Laster, the court found that, as a matter of public policy, a covenant not to sue cannot shield defendants from tort liability for intentional harm. This decision follows a March 9, 2023 decision denying a motion to dismiss the same complaint for failure to state a claim. Although the court's decision may leave directors and controlling stockholders unable to fully protect themselves from bad faith breach of fiduciary duty claims after a drag-along transaction, it does provide some guidance for controllers relying on fiduciary claim waivers.

Background

The plaintiffs in *New Enterprise Associates 14, L.P. v. Rich*[1] are investment funds managed by venture capital firms, each holding an interest in cloud-security company Fugue, Inc. In early 2021, after an unsuccessful sale process and receiving plaintiffs' indication of unwillingness to provide additional financial support, the company's management concluded that a recapitalization led by George Rich was the only viable option for raising necessary capital. As a condition of his investment, Rich required the plaintiffs to enter into a voting agreement that, like typical NVCA-style voting agreements, included a covenant not to sue for a breach of fiduciary duty arising from a drag-along transaction. Notably, the plaintiffs declined an offer to participate in the recapitalization.

Following the recapitalization, Rich and his associates held a controlling interest in the company and controlled the board. In June 2021, the company was contacted by a potential acquirer. Soon after the company's independent directors resigned in July 2021, the board approved two equity issuances. First, the board issued additional preferred stock to many of the original recapitalization investors at the same distressed price per share as their original investment. According to the plaintiffs, the company both ignored the right of first offer (the "ROFO") of the plaintiffs found in a side letter signed in connection with the recapitalization and failed to deliver a notice of stockholder action to the plaintiffs under Section 228(e) of the Delaware General Corporation Law. Second, the board approved an issuance of stock options—mostly to themselves—with vesting provisions that accelerated upon a change of control. The plaintiffs allege these transactions were interested and not disclosed.

Shortly after these issuances, the company's management negotiated a merger with Snyk Limited, a private cybersecurity company. The plaintiffs were asked to join the merger, but

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refused when Rich and another director refused to attest that they had not communicated with the acquirer regarding a potential transaction before the recapitalization. After the merger closed, the plaintiffs learned of the interested transactions and sued the company, its board of directors, and affiliated entities for breach of fiduciary duty. Because the merger had extinguished the plaintiffs' standing to bring derivative claims, they instead filed a direct breach of fiduciary duty suit arguing that the merger consideration was inadequate since it did not include the valuable derivative claims that the company had against the defendants for the interested transactions.

In *New Enterprise I*, the Court of Chancery found that the plaintiffs established standing under *Primedia* because they had viable underlying derivative claims against the defendants (fiduciary claims regarding the interested transactions as well as disclosure claims), the derivative claims were material (almost 10% of the transaction proceeds), and it was unlikely the acquirer would assert the claims.[2] The court also found that the plaintiffs had adequately stated a claim for breach of fiduciary duty because the defendants were alleged to have a conflict of interest with respect to the merger which extinguished possible derivative causes of action against themselves. The court initially withheld ruling on the defendants' alternative argument that the drag-along covenant foreclosed the plaintiffs from bringing suit to challenge the merger.

Ruling

On May 2, 2023, in *New Enterprise II*,[3] the court addressed the defendants' argument regarding the drag-along covenant. In a detailed discussion of Delaware law, Vice Chancellor Laster clarified that a covenant not to sue for breach of fiduciary duty was not, on its own, facially invalid. Recognizing that Delaware corporate law allows some degree of private fiduciary tailoring, the court noted that "stockholders can agree to more constraints on their ability to exercise stockholder-level rights than corporate planners can impose through the charter or bylaws." The court also noted that the covenant was clear, specific, and limited to contractually outlined criteria for drag-along sales; it was part of a bargained for-exchange that included the recapitalization; and the parties were sophisticated repeat players who understood its application (one of the plaintiffs also being a member of the NVCA). Nonetheless, the court held that for reasons of Delaware public policy regarding contracts, the covenant could not "insulate the defendants from tort liability based on intentional wrongdoing," which the court found to be adequately pled.

Uncertain Path Forward

The court's decision allows for some fiduciary tailoring among stockholders, including through covenants not to sue. The court stated that the covenant could provide protection from claims that "the defendants engaged in self-interested transactions but believed in good faith that the transactions were not contrary to the best interests of the Company" or claims that "the defendants engaged in the self-interested transactions with reckless disregard for the best interests of the Company."

Moreover, the case at hand presented unique facts, as the plaintiffs agreed to the drag-along in the context of the recapitalization, but allegedly were not informed of subsequent interested transactions that altered their rights. The acts of intentional harm underlying the court's decision to deny the motion to dismiss did not occur directly as part of the drag-along and became choate only when the plaintiffs learned of the interested transactions and breaches of ROFO protections for which they had negotiated in the original recapitalization. This decision may leave practitioners wary of relying on covenants not to sue in connection with drag-along transactions. It remains to be seen how readily allegations of intentional torts, such as bad faith breach of fiduciary duty, that arise solely from a drag transaction among sophisticated parties (and without incriminating prior conduct similar to the alleged interested transactions) will overcome a similar NVCA-style covenant not to sue.

An immediate and practical takeaway for corporate practitioners is to ensure that contractual and statutory notices (whether preemptive rights notices or Section 228(e) notices) are properly delivered, so that stockholders have access to their negotiated and statutory rights in connection with the lead-up to and execution of the drag transaction.

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[1] *See New Enter. Assocs. 14, L.P. v. Rich (“New Enterprise I”)*, 2023 WL 2417271 (Del. Ch. Mar. 9, 2023).

[2] *Id.* at *29–40 (citing *In re Primedia, Inc. S’holders Litig.*, 67 A.3d 455 (Del. Ch. 2013)).

[3] *New Enter. Assocs. 14, L.P. v. Rich (“New Enterprise II”)*, 2023 WL 3195927 (Del. Ch. May 2, 2023).

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