Westlaw Today

Delaware state assembly moves to stop DExit in its tracks

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MARCH 4, 2025

Delaware has long held its status as of one of the most business-friendly jurisdictions in the United States, drawing business owners to incorporate there with corporation laws that provide freedom to operate, significant protection from liability, and a low tax burden.

The state also boasts the specialized Court of Chancery that is dedicated to exclusively and expertly handling corporate cases, and is known for fair, predictable, and speedy decisions for businesses. All of this has led more than 60% of Fortune 500 companies (https://bit.ly/3Ayoknv) to incorporate in Delaware. Indeed, over 90% of companies that went public in recent years were incorporated in Delaware.

The proposed legislation is an effort to bring "clarity and balance" back to the state's corporate laws.

Several recent and highly controversial court decisions have led to concern over what is being called "DExit" — an exodus of companies leaving Delaware for states such as Texas and Nevada that are increasingly attracting companies.

This presents a problem for Delaware, which generates around $2 billion in annual revenue from companies incorporated within the state, mostly from franchise taxes, and the governor and lawmakers are taking action. A new Delaware bill aims to put an end to all the talk of DExit and preserve their status as the dominant state for incorporation.

Senate Bill 21 (https://bit.ly/4imK3iT) was filed this week by a bipartisan coalition of state lawmakers and with the endorsement of Delaware Governor Matt Meyer. The bill's primary sponsor is Senate Majority Whip Brian Townsend.

According to Delaware Public Media (https://bit.ly/3QI0cUh), the proposed legislation is a departure from the "routine annual corporate law update," and instead is an effort to bring "clarity and balance" back to the state's corporate laws.

So, what does SB21 propose? The bill aims to ensure, among other sweeping changes, that controlling stockholders or control groups won't be liable for monetary damages in the case of a breach of the duty of care. It also will limit shareholder access to internal records, impacting their ability to file suit.

A director deemed independent under NYSE or Nasdaq rules would now be presumed disinterested unless strong, particularized evidence proves otherwise.

Here is the rundown on proposed changes under SB21 to Delaware General Corporation Law Section 144 on insider transactions:

- **Simplify the process to do "control" deals**. Through a web of interconnected Delaware Chancery Court decisions, unless the legislature successfully steps in and changes things, all controlling stockholder transactions must satisfy a number of complex and highly subjective procedural protections. If they fail any of them, they can be stuck with an "entire fairness" review, where the controlling stockholder must prove to a judge that both the process and the resulting price are fair (and the court can disregard the market's judgment in favor of its own), which can only happen after a long (read "expensive") trial. Under SB21, in the case of controlling-stockholder transactions, the existing tests would be jettisoned in favor of a simple bright line test that is EITHER: (a) The deal is approved by a special committee that does not have to be fully independent, only "majority disinterested" (an insider could thus participate in the special committee that evaluates the controlling-stockholder deal and alternatives without imperiling the process); or (b) the deal is approved by disinterested stockholders, counting only those votes that are actually cast (abstentions would not count as opposition as they currently do). If either the special "majority disinterested" committee of the Board approves the deal or disinterested stockholders approve by majority, not counting abstentions at all, the deal can proceed. Controlling stockholders would no longer be required to seek and obtain both approvals.
- **Defining "controlling stockholder" threshold at one-third**. Due to recent Delaware case law, the standard for who is a "controlling stockholder" is highly subjective. SB21 provides a proposed bright-line rule: A stockholder is a controller only if

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the stockholder owns a majority or holds at least one-third plus managerial authority equivalent to a majority owner.

- **Presumption of independence for exchange-listed directors**. Under SB21, a director deemed independent under NYSE or Nasdaq rules would now be presumed disinterested unless strong, particularized evidence proves otherwise. Furthermore, a director's nomination by an interested party would not, in and of itself, render the director an "interested" director under Delaware General Corporation Law.
- **Definition of "fair as to the corporation"**. SB21 would define fairness, which is the test used in a controlling stockholder transaction, as providing a benefit to the corporation or stockholders AND is comparable to what might have been obtained in an arm's-length deal. This codifies the two-pronged fairness test (fair price + fair process) and lowers the bar to the searching analysis that Delaware judges have done to substitute the market judgment for their own. On the downside, it lacks detail, especially when compared with decades of entire fairness jurisprudence. It leaves open several questions: How "comparable" must the deal terms be? What evidence satisfies this? Courts will likely need to interpret these gaps in future litigation. Delaware should try and do better here.
- **New definitions of "material interest" and "material relationship."** Under recent Delaware cases, what constitutes a material interest or material relationship, triggers that could impair independence, could be literally anything that a finder of fact could reasonably view as impairing a director's objectivity. For stockholders, it's defined more broadly as anything material to them personally. SB21 would jettison court-led, fact-intensive and contextual analysis of director independence with simple statutory definitions. If adopted as proposed, these should substantially limit challenges to board independence.

Here is the rundown on proposed changes under SB21 to Delaware General Corporation Law Section 220 that should limit stockholder nuisance litigation:

- **New procedural hurdles for books and records demands**. SB21 would force complainants to satisfy new procedural hurdles before a stockholder could try to make a Section 220 books and records demand on a Delaware corporation. Not only would a demand have to be triggered by a "proper purpose," but this purpose would be to be described with reasonable particularity and show that the requested materials are "specifically related" to that purpose. This should provide Delaware corporations more arrows in their quiver to hit back against nuisance requests.
- **Delaware corporations could force stockholders to agree to confidentiality**. Under SB21, Delaware corporations could mandate confidentiality for produced records and require shareholders to incorporate them by reference in any lawsuit based on the demand. This should discourage fishing expeditions and limit the extraneous use of 220 materials to force a settlement.
- **Narrow the scope of "books and records" requests**. SB21 would limit the records susceptible of being produced in a DGCL Section 220 request to a specific list of items that stockholders can seek access to — charters, bylaws, stockholder meeting minutes, communications to stockholders, board minutes, board materials, annual financial statements, and a limited scope of agreements. This restricts what stockholders can request in a 220 demand, which would exclude emails, text messages, or informal board communications, which can be incriminating or embarrassing for businesses for reasons unrelated to derivative litigation and cause parties to settle at exorbitant amounts.
- **Limiting books and records demands to a three-year lookback period**. Under SB21, the time period for a valid Section 220 request for books and records would be limited to three years. This should limit the expense of complying with historical fishing expeditions.

The bill's sponsors issued a joint statement saying, "This legislation restores Delaware law to what it was historically known for being: balanced as to the relevant stakeholders, protective of stockholder rights and interests, workable for corporate leaders, and empowering of directors who act in good faith with appropriate process and in accordance with their fiduciary duties."

> *Delaware has an opportunity to make fundamental changes here that could have long-term, positive implications for the state.*

In a concurrent effort to put out the flames of another burning issue triggering DExit, Senate Concurrent Resolution 17 (https://bit.ly/3Dgw3ID) was introduced to require the Corporation Law Section of the State Bar Association to issue a report by the end of March to make recommendations on awards of attorney's fees to ensure they are not so excessive that they act as a "counterproductive toll" on Delaware companies.

SB21 could be heard by the state legislature as early as next month, but it will have to pass both the House and Senate before it makes its way to the Governor's desk for signature, who has already stated he fully supports the legislation.

As the legislation has significant bipartisan support and there is a great deal of income for the state at stake, there is a sense of urgency to act and act quickly. Texas, Nevada, and other states have already taken measures to attract more companies, and those are making an impact. Delaware has an opportunity to make fundamental changes here that could have long-term, positive implications for the state.

Time will tell whether the legislation will pass, and whether it will ultimately stop the fire that is driving companies to DExit, or exit Delaware, for what might look like greener pastures in Texas and Nevada. This is one to watch closely.

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This article was first published on Westlaw Today on March 4, 2025.

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