



Comparative Playbook: Navigating Conflicts in Delaware and Nevada

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Completing your initial public offering (IPO) is an exciting time, with capital inflows taking you to the next level. But if you are getting ready to go public – or recently closed your IPO – it is important to recognize the litigation risks that come with selling stock to the public and operating as a public company. Those risks are amplified in some ways if controlling stockholders, interested directors or officers are in the mix, which is not uncommon, especially for tech companies. Among other things, the US Securities and Exchange Commission’s rules require disclosing related-party transactions and other relationships. Minority stockholders tend to scrutinize decisions that appear to benefit some holders more than others and may challenge them as unfair.

Your best defense is not a heroic legal argument after the fact. It is boring excellence in process and disclosure, especially in the run-up to and during significant transactions and fundraising rounds. That begins with understanding how corporate law safe harbors and guardrails would apply to the company’s circumstances in various scenarios. Tracking ownership thresholds and approvals, along with the following baseline good practices – such as keeping careful minutes and disclosing accurate information to the board and stockholders – can save you from trouble down the road.

The playbook below shows steps for assessing transactions that may be “conflicted” for Delaware corporations and Nevada corporations. In addition to this paraphrased summary, we have also included an even briefer “cheat sheet” at the end of this blog if you want a very high-level summary of the applicable legal standards.

Use this as a starting point to help you understand the lay of the land. Work with your Cooley legal counsel to apply the law to your specific circumstances. Keep in mind that special approval processes may apply in other contexts as well, such as when using defensive tactics to prevent a change in control.

Delaware

Nevada

1. Understand how courts review board decisions

If a stockholder challenges a board decision, Delaware courts generally defer to the board's judgment – but in some circumstances the court will look more closely at the terms of the transaction itself.

One of those situations involves “conflicted” transactions – i.e., a director or officer has an interest in the transaction, or the transaction involves or disproportionately benefits a controlling stockholder. In these situations, unless the board follows a safe harbor process to approve the transaction, the company may have to prove that the terms of a transaction are “entirely fair” to stockholders.

If the board does not follow the safe harbor process and is unable to prove fairness, the court could void the transaction and/or award damages. Moreover, the directors may face personal liability if a stockholder proves they breached their duty of loyalty.

This chart outlines how to follow the safe harbor process in different scenarios. Keep in mind that the safe harbor is a protective measure, not a requirement. Companies that are unable to meet the safe harbor may still have a basis to defend “conflicted” transactions – for example, by relying on defenses and protections available under common law – but it may be more challenging to do that on the back end.

Nevada's corporations statute codifies a deferential business judgment standard of review – and the way it is structured gives a lot of autonomy to boards. For example:

- Courts assume the board acted in good faith and on an informed basis
- There is no heightened scrutiny standard just because a transaction involves a controlling stockholder

However, for transactions with or benefiting a director, unless the board follows a safe harbor process to approve the transaction, the company may have to prove that the terms of a transaction are fair to stockholders.

If the company is unable to prove fairness, the court could void the transaction. Liability for directors is generally limited to situations where there is intentional misconduct, fraud or a knowing violation of law.

This chart outlines how to follow the safe harbor process for transactions with or benefiting directors, and highlights what to consider doing in other scenarios.

2. Analyze whether directors or officers have a financial interest in the transaction

Boards may face heightened liability risks, and transactions may be voidable, when a director participates in decisions about matters that affect them. Boards should follow and document rigorous processes for any act or transaction where any director or officer:

- Is a party
- Has a financial interest
- Is a director, officer, manager, member or stockholder, or has a financial interest in, a company or an organization that is a party

Except for **going-private** deals, a board will get deferential review for a transaction with interested directors or officers if:

- The interest is known to the board or committee
- The transaction is approved by a majority of disinterested directors of the board or committee
- The board or committee acts in good faith and without gross negligence

Deferential review is also available if the transaction is approved by a fully informed vote of disinterested stockholders.

Tip: When a majority of directors are interested, the above safe harbor is only available if a special committee and/or fully informed disinterested stockholders voted to approve it (i.e., a board cannot rely on a vote by the full board). See below for more details on special committees.

Tip: When getting board or committee authorization, be clear who is disinterested and only count the votes of disinterested directors.

Transactions may be voidable when a director participates in decisions about matters that affect them. Boards should follow and document rigorous processes for any act or transaction where any director or officer:

- Is a party
- Has a financial interest in a company or other organization that is a party
- Is a director or officer of a company or other organization that is a party

A board will get deferential review for a transaction with interested officers or directors if:

- The interest is known to the board or committee
- The transaction is approved **or ratified by** a majority of disinterested directors or committee members
- The board or committee acts in good faith

Deferential review is also available if the transaction is approved by a fully informed vote of stockholders, including the votes of the interested directors, or if the interested director did not know of their interest at the time the board acted.

Tip: Nevada's safe harbor does not require a special committee (even if a majority of directors are interested). However, setting up a special committee and/or getting approval from a fully informed majority vote of stockholders can still be a good idea. See below for more details on special committees.

Tip: For listed companies, there is a heightened presumption that directors whom the board determines are “independent” under applicable stock exchange listing standards are not interested in a transaction.

Tip: Although plaintiffs may allege that directors appointed by significant investors are interested in transactions that benefit those investors, that fact alone is not sufficient to render the directors interested or not independent.

Tip: When getting board or committee authorization, be clear who is disinterested and only count the votes of disinterested directors (but approval is not invalidated just because an interested director participated in the vote).

Tip: Plaintiffs may allege that directors appointed by significant investors are interested in transactions that benefit those investors.

3. Understand who could be a ‘controlling stockholder’

For transactions with a “controlling stockholder,” boards need to follow special processes to fall within the safe harbor if the transaction is later challenged in court. Make sure to involve legal counsel and pay special attention to transactions with a person, entity or group that meets either of these tests:

- Owns one-third or more of voting power and the power to exercise managerial authority
- Owns a majority of the voting power or has the right or voting power to elect a majority of directors

Controllers themselves may also face litigation risks if a minority stockholder alleges that they received a non-ratable benefit in the transaction.

Except for going-private deals, a board will get deferential review for a transaction involving or disproportionately benefiting a controlling stockholder if it is:

- Approved in good faith by a disinterested, fully informed and empowered special committee of at least two directors
- Conditioned upon and approved or ratified by a fully informed vote of disinterested stockholders

Tip: Cap table modeling can help you spot situations that may need extra attention – far enough in advance to do something about it. Run scenarios at 15%, 33% and 50% ownership to map out stockholder rights, board seats, optics of “control” and how Delaware anti-takeover measures could apply.

Even with Nevada’s deferential review standard, boards should be aware of who could be considered a controlling stockholder and understand the safe harbor protections that can apply. Nevada law prohibits controlling stockholders from exerting undue influence over any director or officer where:

- The influence would cause the director or officer to breach a fiduciary duty
- The breach relates to a transaction with the controlling stockholder or materially financially benefiting the controlling stockholder

In this context, a controlling stockholder is someone with the power to elect at least a majority of the company’s directors – either through their relative ownership of shares or under the articles of incorporation. Controlling stockholders have protection against liability if a transaction is approved (or recommended to the board for approval) by a committee of at least one independent director.

Tip: Nevada also has anti-takeover laws that can apply to stockholders whose ownership crosses certain voting thresholds, which go beyond what you may be familiar with seeing in Delaware. It is a good idea to model ownership scenarios at 10%, 20%, 33% and 50% to understand rights, board seats, optics of “control” and how anti-takeover measures could apply.

4. Confirm it is not a ‘going-private’ transaction

For going-private transactions with a controlling stockholder (i.e., “squeeze-out mergers”), courts defer to the board’s business judgment only if a special committee **and** fully informed disinterested stockholders approved the deal.

Under the statute, “going private” includes:

- For listed companies, a Rule 13e-3 transaction, which includes any purchase of securities, tender offer, merger, recapitalization or other transaction where the company becomes eligible to terminate or suspend its registration or reporting obligations
- For other companies, any controlling stockholder transaction in which all or substantially all of the shares held by disinterested stockholders are canceled, converted or purchased

No special standard of review applies to board decisions on “squeeze-out mergers” involving controlling stockholders, but:

- The board must communicate conflicts of interest to stockholders when submitting any merger plan to a vote
- The controlling stockholder considerations above continue to apply, including being aware of Nevada’s anti-takeover statutes

5. Make the special committee real (and documented)

Boards can rely on a safe harbor to get deferential review for potentially conflicted transactions. Generally speaking (and as explained in more detail throughout this chart), other than going-private deals, the safe harbor applies if the transaction is approved by a special committee **or** by disinterested stockholders – and for going-private deals, a special committee **and** disinterested stockholders must approve it.

Under Delaware law, “special committee” means:

- At least two directors
- No committee members are a party to the act or transaction
- No committee members have a material interest in the act or transaction
- No committee members have a material relationship with a person who has a material interest in the act or transaction

Tip: For listed companies, to take advantage of the heightened presumption of disinterest, the board must determine if a director is “independent” under applicable stock exchange listing standards with respect to the company, and if applicable, with respect to the controlling stockholder.

Tip: Delaware law does not require separate stockholder approval or ratification when you have followed the above procedures – but it can still be a good idea, and it may be required for other reasons.

Tip: This safe harbor gives you more certainty on the front end – if you actually build the record. Even if a director meets the above criteria, stockholders can challenge whether they were disinterested, which, for stock exchange “independent” directors of listed companies, requires showing substantial, particularized facts that the director had a material interest in the act or transaction (either directly or through a material relationship with someone else who had a material interest). Document a conflicts analysis and the work of the special committee in contemporaneous minutes.

Tip: For private and venture backed companies with fewer than two independent directors, recruit early and empower a two director committee who could review conflicted transactions. This will also give you a jump-start on analyzing and meeting public company director independence requirements for your IPO.

As noted above, special committee approval can reduce risk for transactions with interested directors or officers, and for transactions with controlling stockholders.

For transactions with interested directors, consider using a special committee with these parameters:

- At least one director
- No committee members are a party to the act or transaction
- No committee members have a financial interest in the act or transaction
- No committee members are a director or officer of a company or other organization that is a party to the act or transaction

To provide liability protection to controlling stockholders, consider using a special committee with these parameters for committee members:

- At least one director
- No committee members are a party to the act or transaction
- No committee members have a material and non-speculative financial interest in the act or transaction
- Committee members satisfy the audit committee independence standards of the applicable stock exchange

Tip: Nevada law does not require stockholder approval or ratification when you have followed the above procedures – but it can still be a good idea, and it may be required for other reasons. Nevada law also makes it easier to get a favorable stockholder vote, because the votes of the interested parties are counted toward achieving majority approval.

Tip: This safe harbor gives you more certainty on the front end and is more lenient than Delaware’s process – but a robust record will still enhance protection. Document a conflicts analysis and the work of the special committee in contemporaneous minutes.

Tip: For private and venture backed companies with no independent directors, recruit early and bring aboard at least one director who could review conflicted transactions.

Delaware Versus Nevada: Cheat Sheet for Approving Conflicted Transactions

Regardless of where your company is incorporated, a well-documented process will do more to reduce your litigation risk than a clever after-the-fact argument. To ensure that your record and disclosures hit the right points, involve counsel who understands the nuances of both state and federal law.

TOPIC	DELAWARE	NEVADA
Interested directors/officers	Documents rigorous process; the safe harbor requires a special committee if a majority of directors are interested	Special committee optional but recommended
Controlling stockholder transactions	Heightened scrutiny; other than going-private deals, the safe harbor applies if approved by disinterested special committee (at least two directors) or by an informed disinterested stockholder vote	Business judgment rule applies; liability only for intentional misconduct or fraud; the safe harbor is available via committee with at least one disinterested and independent director
Going-private deals	Requires approval by disinterested directors and informed disinterested stockholders to cleanse the transaction	No special standard; disclose conflicts in the merger plan
Special committee requirements	At least two disinterested directors; independence per stock exchange standards (for listed companies) and cannot be a party to or materially benefit from the transaction	At least one independent director; cannot be a party to or have a financial interest in the transaction