Delaware Senate Bill 21: A Comprehensive Analysis and Proposals for Improvements

Introduction: The DExit Controversy

Delaware's proposed Senate Bill 21 (SB21) has ignited intense debate within corporate law circles. The bill aims to fundamentally restructure fiduciary duty analysis for controlling stockholders, officers, and directors in Delaware corporations. As evidenced at the Tulane Corporate Law Institute's recent annual conference, the energy surrounding this proposed legislation is palpable, with corporate law practitioners engaged in uncharacteristically confrontational discussions.

SB21 emerged against the backdrop of what some call "DExit" – the potential exodus of corporations from Delaware to other states like Nevada or Texas. Proponents argue the bill is necessary to prevent this migration, while critics contend it would undermine Delaware's competitive advantage of predictable case law interpreted by skilled judges. This essay consolidates multiple perspectives on SB21, examining its key provisions, the problems it aims to solve, critiques of the approach, and alternative proposals.

The Current State of Delaware Law and Its Problems

In recent years, Delaware courts have exhibited growing skepticism of transactions involving controlling shareholders. This skepticism has manifested in several problematic trends:

1. Overly Broad Definition of "Controller"

Under Delaware law, control traditionally required a majority of voting power. Shareholders with less than 50 percent of stock were not considered controlling unless additional evidence of actual control over corporate conduct was demonstrated. This standard required proof that a minority shareholder exercised significant influence over the corporation, beyond mere stock ownership. While proving control over day-to-day operations was not necessary, plaintiffs had to demonstrate control over the specific transaction being challenged. Historically, this requirement was stringent, making it challenging to classify minority shareholders as controlling unless their influence was clearly dominant in the relevant context.

Delaware courts have significantly expanded who qualifies as a "controlling shareholder" beyond those with majority voting power. Courts increasingly find control in shareholders with significantly less than 50% ownership, as exemplified by the "superstar CEO" doctrine from *Tornetta v. Musk*, which allows finding control based on managerial rather than voting power.

Courts now emphasize "soft control" through contractual rights, commercial relationships, and other non-voting mechanisms. This expanded definition creates uncertainty and may eventually lead to finding someone a controller even without stock ownership.

These trends have created ambiguity, with courts emphasizing influence over formal voting control, leading to broader interpretations of who qualifies as a controlling shareholder.

2. Problems with Standards for Reviewing Conflicted Transactions

Delaware courts have departed from the *Sinclair Oil* threshold test, which required showing that a controller received a benefit at both the expense of and to the exclusion of minority shareholders. Courts now apply the exacting "entire fairness" standard whenever a controller stands on both sides of a transaction or receives a unique or non-ratable benefit, even without harm to minority shareholders. This expansion has led to treating many ordinary commercial transactions between controllers and controlled entities as inherently suspect.

3. Excessive Scrutiny of Director Independence

Courts have made cleansing conflicted transactions increasingly difficult through heightened scrutiny of director independence. The definition of independence has expanded to emphasize personal relationships that might influence objectivity. The inquiry has become highly subjective, contextual, and fact-specific, creating uncertainty. Courts have shown growing skepticism of independent directors in controlled companies, and the indeterminate standard allows judges to find bias in an increasing variety of relationships.

These trends have led to significant consequences, including increased litigation, uncertainty in transaction planning, deterrence of potentially beneficial transactions, and controllers threatening to reincorporate outside Delaware (as with Elon Musk and Tesla).

I discuss these trends in much more detail in my article, A Course Correction for Controlling Shareholder Transactions. In that article, I proposed four course corrections, pursuant to which the courts: (1) should narrow the definition of controller; (2) should not attempt to sort out in which cases controllers owe fiduciary duties to the minority from those in which they do not, but instead hold that a controller always owes fiduciary duties to the minority; (3) narrow the class of cases under which entire fairness is the standard of review by adopting a reinvigorated Sinclair Oil threshold test under which entire fairness is triggered only when the controller receives a benefit at the expense of and to the exclusion of the minority; and (4) improve the regime for cleansing transactions in which entire fairness applies. These changes will reduce costs and encourage beneficial investment, while also enhancing Delaware's position as the state of choice for incorporation. Accordingly, I argued, if the courts fail to adopt them, the Delaware legislature should consider doing so by statute. Which Delaware's legislature has now done. SB21 is largely consistent with the proposals I made in my article.

A Critique of Key Provisions of SB21

1. Definition of "Controlling Stockholder"

SB21 creates a new DGCL § 144(e)(2), defining a controlling shareholder as:

1. Any person that, together with affiliates and associates, owns or controls a majority in voting power of the outstanding stock entitled to vote in director elections; or

2. Has power functionally equivalent to a majority stockholder by virtue of owning at least one-third of voting power and having the power to exercise managerial authority over the business and affairs of the corporation.

This definition establishes a presumption of control for majority holders while setting a bright-line requirement of at least one-third ownership for minority shareholders to be deemed controllers.

Like my proposal, SB 21 creates a presumption of control for holders of a majority of the corporation's voting power. As for minority shareholders, SB 21's functional equivalence language likely would lead to the same results as my practical certainty proposal. Finally, also like my proposal, SB 21 requires stock ownership, but goes further by supplementing the functional equivalence standard by creating a brightline rule by requiring a controller to own at least one-third of the company's voting power.

2. Definition of "Controlling Stockholder Transaction"

SB21 defines a controlling shareholder transaction as "an act or transaction between the corporation or one or more of its subsidiaries, on the one hand, and a controlling stockholder or a control group, on the other hand, or an act or transaction from which a controlling stockholder or a control group receives a financial or other benefit not shared with the corporation's stockholders generally."

3. **Cleansing Standards**

SB21 modifies the *MFW* cleansing standard in several ways:

1. It treats going private transactions differently from all other conflicted controller transactions
2. For non-going-private transactions, it allows cleansing via either approval by disinterested directors or disinterested shareholders
3. It eliminates the "vestigial waste claim" if a transaction is properly cleansed

4. Director Independence

SB21 addresses the Chancery Court's narrow definition of director independence through several provisions:

1. "Disinterested director" is defined to mean "a director who is not a party to the act or transaction and does not have a material interest in the act or transaction or a material relationship with a person that has a material interest in the act or transaction."
2. "Material interest" is defined as "an actual or potential benefit... that would reasonably be expected to impair the objectivity of the director's judgment..."
3. "Material relationship" is defined as "a familial, financial, professional, employment, or other relationship that... would reasonably be expected to impair the objectivity of the director's judgment..."

4. Directors of listed companies are presumed independent if the board determines they meet exchange criteria for independence, with this presumption only rebuttable by "substantial and particularized facts."

5. Changes to Director and Officer Conflicts

SB21 makes significant changes to provisions governing conflict of interest transactions involving directors and officers.

1. It expands the scope from "contracts or transactions" to "acts or transactions"
2. It provides that properly cleansed transactions "may not be the subject of equitable relief, or give rise to an award of damages or other sanction"
3. It clarifies that interested directors or officers may participate in the transaction negotiations

Books and Records Inspection Rights

SB21 significantly restricts shareholder inspection rights under Section 220:

1. It narrows the definition of books and records subject to inspection, largely limiting materials to board-level documents
2. For access to below-board-level documents (emails, contracts, etc.), the shareholder must:
    - Identify specific documents
    - Prove a "compelling need" for the documents
    - Demonstrate "by clear and convincing evidence" that such records are "necessary and essential"

These changes raise a number of difficult questions:

- What level of specificity is required when identifying documents (see, e.g., the Yahoo case discussed on my blog)?
- How a stockholder demonstrates a "compelling need"?
- Whether proving a "compelling need" inherently satisfies the "necessary and essential" requirement?

They also substantially undermine the Delaware Supreme Court's repeated guidance that shareholder books and records inspections be used routinely to satisfy the requirement that derivative suits be pled with particularity. How they will impact pleading in derivative litigation will be a major interpretative question.

Critiques of SB21 and Proposed Fixes

1. Is DExit a Real Threat?

Some argue that SB21 is unnecessary because the prospect of mass DExit is overblown. I agree with their factual premise, but not the conclusion they draw from it.

Despite concerns about a mass corporate exodus from Delaware, evidence suggests DExit may be more hype than reality:

1. The number of firms that have moved from Delaware is tiny, barely amounting to a trickle
2. For most firms, Delaware remains the preferred choice
3. The only plausible risk is from a small number of publicly traded firms with controlling shareholders, who have faced greater liability risk due to recent Delaware decisions
4. Professor Andrew Verstein's research on entity formations shows that even major legal changes (like New Jersey's early 20th century corporate law reforms) don't cause immediate mass migrations

Delaware has strong incentives not to race to the bottom like Nevada:

1. Unlike Nevada's focus on small firms, Delaware caters to larger firms paying higher franchise fees
2. Institutional investors and venture capitalists prefer Delaware incorporation
3. Federal preemption remains a significant threat if Delaware weakens shareholder protections too much

Having said that, however, I think something like SB21 is necessary. As noted above, the Delaware case law on conflicted controller transactions has gone seriously awry. Current law desperately needed a course correction and SB21 is a solid effort to effect such a correction.

I discuss the DExit phenomenon at much greater length in my article, DExit Drivers: Is Delaware's Dominance Threatened?

2. The Problematic Definition of Controlling Shareholder Transaction

The definition of controlling shareholder transaction in SB21 is both under- and over-inclusive:

1. **Over-inclusive**: SB21 captures all transactions between a controller and the controlled entity, treating many ordinary commercial transactions as conflicted even when they're common business interactions. It also treats any controller transaction in which the controller receives a benefit to the exclusion of the minority as conflicted, whereas *Sinclair Oil* required both exclusion of and expense to the minority. My article argues that the *Sinclair Oil* court was correct to do so. Second, and more importantly, SB 21 treats any controller transaction in which the controller receives a benefit to the exclusion of the minority as conflicted. Under *Sinclair Oil*, however, a transaction is only deemed conflicted if the controller's benefit comes both to the exclusion of and at the expense of the minority. I would prefer to see SB21 embrace my proposal for a revitalized *Sinclair Oil* test under which a controller transaction only triggers entire fairness review (i.e., is deemed to involve self-dealing) if the controller receives a benefit that comes at the expense of and to the exclusion of the minority.
2. **Under-inclusive**: SB21 doesn't clearly capture transactions between subsidiaries of a parent corporation, which were subject to entire fairness review in *Sinclair Oil*.

3. The Definition of Controlling Shareholder Needs Tweaking

SB21 should explicitly state that someone who owns less than one-third of voting stock is not a controlling shareholder and owes no fiduciary duties to the entity or other shareholders.

4. Questions About Fairness Definition

SB21 defines "fair to the corporation" as beneficial to the corporation or stockholders given the consideration paid or received, taking into account whether the transaction:

1. Is fair in terms of the fiduciary's dealings with the corporation
2. Is comparable to an arm's length transaction

This definition essentially tracks the existing common law fairness test, raising questions about why it's included in the statute.

5. Equitable Concerns

The *Schnell v. Chris-Craft Industries, Inc.* doctrine holds that "inequitable action does not become permissible simply because it is legally possible." SB21 states that properly cleansed transactions may not "be the subject of equitable relief," potentially foreclosing judicial review under *Schnell*. However, this depends on whether "equitable relief" encompasses all remedies based on a court's inherent equitable powers.

6. Tornetta v. Musk and SB21

There's debate about whether *Tornetta v. Musk* (the Tesla CEO compensation case) would be decided differently under SB21. The case involved a CEO (Musk) with approximately 21.9% of Tesla's stock. Under SB21, a minority stockholder must own at least one-third of voting power to be considered a controller, which Musk did not. However, SB21's provisions regarding officer conflicts might still apply, requiring only that one director qualify as "disinterested" to cleanse the transaction. Given that *Tornetta* was the straw that broke the camel's back, triggering the drafting of SB21, one would think the statute should more clearly address this issue.

7. Clarify the Director and Officer Provisions

Prior Section 144(a) was limited to a contract or transaction between the director or officer and the corporation (direct conflicts) or between the corporation and an entity that the director or officer served as a director or officer or had a financial interest in (indirect conflicts). As amended, the pertinent language will read: "An act or transaction involving or between a corporation and 1 or more of its directors or officers, or involving or between a corporation and any other [entity] in which 1 or more of its directors or officers are directors, partners, managers, members, or officers, or have a financial interest . . .." SB 21 thus swaps "act" for contract. It also adds "involving" to between.

What work do these provisions do?

Director acts or transactions implicate the duty of loyalty and thus trigger entire fairness review when a director stands on both sides of a transaction or receives "a unique financial benefit to the exclusion of the shareholders." The highly respected Folk treatise on the DGCL claims that cleansing under the pre-SB 21 version of Section 144 extends only to the former type of self-dealing. Does the addition of "involving" extend cleansing to the latter type of self-dealing? The drafters should clarify their intent in this regard.

8. Clarify the Entities Covered by the Director and Officer Provisions

SB21 amends current section 144(a) to update the statute to reflect the burgeoning number of entities—such as LLCs—that Delaware has recognized since Section 144 was first adopted back in 1969. Curiously, however, the statute has not been amended to deal with a longstanding lacuna, namely, family conflicts of interest. Consider, for example, the facts of *Bayer v. Beran*, in which the corporation hired the wife of its president. Their spousal relationship gave the president an indirect interest in the transaction. The court applied common law conflict of interest principles to resolve the case. It has always seemed curious that Section 144 does not address these sorts of family-based conflicts, apparently leaving them to the common law. It seems even more curious that the legislature does not use this opportunity to close that gap in the statutory scheme.

9. Clarify How Many Directors Must Approve the Transaction

There was an interesting distinction between the general director voting rule set out in DGCL Section 141(b) and that set out in pre-SB 21 Section 144(a)(1). The former looks to whether the proposed action was approved by a "majority of the directors present at a meeting at which a quorum is present." The latter requires the "affirmative votes of a majority of the disinterested directors." Note the absence of the qualifying word "present" in the latter. Suppose the corporation has five directors, one of whom is interested in the transaction. Two of the four disinterested directors attend the board meeting at which the transaction is to be approved. Because the interested director counts towards a quorum, they can proceed to vote. Assume both disinterested directors vote to approve the transaction, while the interested director abstains. A majority of the directors present at the meeting voted for the transaction, so it is properly approved for purposes of Section 141(b). Yet, two out of four disinterested directors are not a majority and, as such, the transaction seemingly has not been approved for purposes of Section 144(a)(1). Cf. Beneville v. York, 769 A.2d 80, 82 (Del.Ch.2000) (noting that under "traditional rules of board governance" a motion on which the board is evenly divided fails). Presumably the transaction therefore would have to pass muster under Section 144(a)(3). This should be fixed.

Alternative Proposals: A Contractarian Approach

Professors Eric Talley and Jeffrey Gordon have proposed an alternative "opt-in" approach to SB21:

1. Talley's Proposal

Rather than replacing existing law with a mandatory rule, Professor Talley suggests:

1. Creating a new Section 144A offering relaxed safe harbor for transactions involving interested parties, but only for corporations whose charters expressly adopt it

2. Adding a new enabling provision (Section 102(b)(8)) authorizing corporations to adopt the safe harbor through charter amendments

This approach draws inspiration from Delaware's successful Section 102(b)(7), which allows corporations to waive monetary liability for breaches of duty of care.

2. Gordon's Refinements

Professor Gordon builds on Talley's proposal by adding:

1. For dual-class companies, requiring majority approval from each class of shares
2. For single-class companies, requiring majority approval from disinterested shareholders
3. Allowing controllers to lower the threshold for "facts and circumstances" control determination when opting into the new regime

3. Benefits of the Contractarian Approach

The contractarian solution would:

1. Preserve Delaware's flexibility while addressing concerns from both sides
2. Allow corporations to choose the governance framework that best suits their needs
3. Avoid alienating corporations that prefer the predictability of current law
4. Serve as a market test for the new fiduciary regime

Conclusion

Delaware SB21 represents a significant attempt to rebalance Delaware corporate law in the context of controlling shareholder transactions. The bill addresses legitimate concerns about the expansion of fiduciary duties and the uncertainty created by recent court decisions and, as such, I broadly endorse it.

A contractarian approach, as proposed by Professors Talley and Gordon, offers a promising alternative. By allowing corporations to opt into the new rules rather than imposing them universally, Delaware could preserve its longstanding tradition of flexibility while addressing the concerns that prompted SB21 in the first place.

Bibliography

This essay draws on many posts at ProfessorBainbridge.Com

- A Comment on Larry Cunningham's Weinberg Center Program on SB 21: Would Tornetta Come Out the Same Way?
- A Question About Delaware SB 21 and Fairness
- Another Delaware SB 21 drafting problem
- Could the Chancery Court End-Run SB 21?
- Is Delaware SB 21 the Start of a Race to the Bottom?

- Delaware SB 21 and Director and Officer Conflict of Interest Transactions: The Good, the Bad, and the Missed Opportunities
- Preliminary Reaction to Delaware SB 21 and Comparison to the Proposals I Made in A Course Correction for Conflicted Controller Transactions
- Professor Talley Poses a SB 21 Question: I resort to AI
- DExit is a trickle not a flood and is unlikely to become a cascade
- Courts are not omniscient and/or sacrosanct. Not even Delaware courts. The law governing conflicted controller transactions needs a legislative fix.
- The Badly Drafted Books and Records Provisions of Delaware SB 21: What Documents Can Shareholders Inspect?
- Talley and Gordon on contractarian solutions to the conflicted controller debate surrounding Delaware SB 21, which I endorse