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Delaware Court of Chancery Confirms Enforceability of NVCA Covenant Not to Sue for Breach of Fiduciary Duty

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In *New Enterprise Associates 14, L.P. v. Rich*, the Delaware Court of Chancery held that a covenant not to sue for breach of fiduciary duty, which was contained in a stockholder's agreement and modeled after the NVCA model voting agreement, was enforceable against sophisticated counterparties under the facts of the case.

Background

Fugue, the corporation in question, underwent a recapitalization led by investor George Rich (Rich). The recapitalization included: (i) the conversion of existing preferred stock into common stock; (ii) the issuance of a new class of preferred stock to Rich and a few other stockholders; and (iii) the execution of a voting agreement (the voting agreement). While the plaintiffs in this case (the funds) declined the opportunity to participate in the new preferred round, they, along with Rich and several other preferred holders, executed the voting agreement, which contained a drag-along provision that could be exercised by the Fugue board of directors and a majority of the new preferred stockholders in the event of a sale of Fugue. Importantly, this drag-along provision also included a covenant that the signatories would not sue Rich, his affiliates, or his associates in any drag-along transaction, including through claims for breach of fiduciary duty (the Covenant). A few months later, the Fugue board, which consisted only of Rich, a director appointed by stockholders that received new preferred stock, and the Fugue CEO, approved a subsequent closing of the recapitalization that included the same terms as the first recapitalization, as well as new stock grants to the three directors. Shortly thereafter, a drag-along sale of Fugue closed. After closing, the funds refused to approve the sale or sign the related transaction documents, and sued Rich and the Fugue directors for, among other claims, breach of the duty of loyalty related to the sale.

Analysis

After an extensive analysis of Delaware common law, the Delaware General Corporation Law (DGCL), and trust and agency principles, the court held that covenants not to sue for breach of fiduciary duty are enforceable if they are sufficiently specific and meet a nonexclusive five-part reasonableness test as previously articulated by the Delaware Supreme Court.

Applying the first prong of the analysis, the court noted that the Covenant only applied where a drag-along sale met eight specific criteria enumerated in the voting agreement, which led the court to hold that the Covenant was sufficiently specific. By contrast, the court pointed out that a broad waiver of fiduciary duties without specificity would be unenforceable. Applying the second prong of the analysis, the court noted that the Covenant must involve: (i) a written contract formed through actual consent; (ii) a clear provision; (iii) knowledgeable stockholders who understood the provision's implications; (iv) the funds' ability to reject the provision; and (v) the presence of bargained-for consideration. The court held that the Covenant met all five of those criteria, and accordingly upheld the Covenant as reasonable. However, the court was careful to limit its holding to the facts of the case. In this regard, the court noted that a covenant not to sue for breach of fiduciary duty utilized in the following scenarios would face "deep skepticism" and "a steep uphill slog" in the eyes of the court: (i) an agreement binding a retail stockholder; (ii) an employee stock grant; (iii) a dividend reinvestment plan; (iv) an employee stock compensation plan; (v) a stock transmittal letter; and (vi) a transaction that offered an election between base consideration and incremental consideration, plus a covenant not to sue.

As part of its analysis, the court was also careful to note that its holding would not have been the same had the Covenant appeared in Fugue's certificate of incorporation or bylaws. Because the Covenant appeared in a stockholders agreement, and was consistent with recent Delaware Supreme Court precedent holding appraisal rights waivers enforceable in stockholders' agreements, the court found that stockholders are free to voluntarily agree to restrictions on rights that they would otherwise have under the DGCL and the common law, subject to public policy concerns. According to the court, those public policy concerns required that a carve-out be read into the provision for intentional or bad faith breach of fiduciary duty. Thus, the benefits of such a Covenant would only be available in self-dealing transactions if the fiduciary took the action in the good faith belief that the action was in the best interests of the corporation and its stockholders.

Takeaways

Delaware corporations and controlling stockholders seeking an enforceable covenant not to sue for breach of fiduciary duty should strictly adhere to the criteria delineated in this opinion. As the court makes clear in its decision, the analysis into whether such a covenant is enforceable is highly fact-specific and, like in the noncompete context, the court will not mechanically uphold these provisions.

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