Delaware Chancery Denies Motion To Dismiss Where "Allegations As A Whole Suggest Inequitable Conduct" On The Part Of Corporate Decisionmakers

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September 27, 2023 - On August 24, 2023, the Delaware Chancery Court, in an opinion delivered by Vice Chancellor J. Travis Laster, denied a motion to dismiss a lawsuit filed by a shareholder of GoDaddy, Inc. ("GoDaddy") on behalf of the corporation against certain of its directors and its CFO for allegedly overpaying its pre-IPO investors for a buyout of their right to payments under tax receivable agreements. GoDaddy paid the pre-IPO investors $850 million for their rights, even though its audited financial statements had recently valued its liability under the agreements at only $175 million. The decision provides useful guardrails for transactions between a corporation and former significant shareholders to which corporate decisionmakers have more than insignificant business or personal ties.

GoDaddy's "Up-C" IPO and Founding Investors' Exit

GoDaddy went public in 2015 using an "Up-C" structure in which GoDaddy (a new public corporation) acquired an interest in the pre-IPO limited liability company that was operating the business ("OpCo"). IPO investors received Class A shares in GoDaddy, entitling them to both economic and governance rights, while pre-IPO investors received Class B shares, entitling them to governance rights only, and retained their economic rights as membership interests in OpCo that were intended to be the economic equivalent of GoDaddy Class A shares.

When certain pre-IPO investors exited, among them private equity funds sponsored by KKR, Silver Lake and TCV (the "Founding Investors"), they would have to exchange their OpCo interests and Class B shares for Class A shares, which they would then sell. That exchange would create a step-up in GoDaddy's tax basis in the portion of the assets of OpCo underlying the exchanged OpCo interests, enabling GoDaddy to increase its depreciation expense and thus reduce its tax liability in years in which it had sufficient taxable income to use the deductions. Pursuant to tax receivables agreements (the "TRAs"), GoDaddy was obligated to pay 85% of such savings to the Founding Investors (the "TRAClaims") as they were realized (*i.e.*, over the course of many years). The value of the TRA Claims was dependent

upon the timing of depreciation deductions as well as projections of when GoDaddy would have sufficient taxable income to use the deductions.

TRA Claims Buy-Out and Shareholder Derivative Suit

Shortly after their exit, the Founding Investors asked GoDaddy to buy out the TRA Claims. GoDaddy's board formed a special committee of independent directors which negotiated a purchase price of $850 million. The purchase price was based on, among other things, the CFO's representations to the special committee and to KPMG, the special committee's financial advisor, that GoDaddy would likely use the depreciation deductions in full, as well as a discount rate based on GoDaddy's weighted average cost of capital. However, the $850 million price was significantly higher than the $175 million at which GoDaddy's most recent audited financial statements had valued the TRA Claims. The CFO had represented to Ernst & Young, GoDaddy's auditors, that GoDaddy was unlikely to utilize much of the depreciation deductions due to an expected lack of taxable income.

Pointing to this discrepancy between the valuation in the audited financials and the actual price paid by the company, a GoDaddy shareholder sued the voting directors and the CFO derivatively on behalf of GoDaddy for breach of fiduciary duty and corporate waste. Under principles of Delaware law, the corporation and not its shareholders would generally determine whether to pursue litigation against its directors or officers.[1] However, a shareholder may do so on behalf of the corporation if he can show that the directors would be incapable of making an impartial decision on whether or not to bring such litigation, which would be the case if they were likely to face personal liability in it.[2] The plaintiff here pleaded that the defendants had acted in bad faith, which would result in their personal liability.

Court Finds Pleaded Facts Inferring Bad Faith of Corporate Decisionmakers Sufficient to Move the Case Forward

The court found that the complaint pleaded facts which, when read together, and assuming they are true, supported an inference of bad faith and enabled the case to survive pleading-stage review.

Interestingly, the court applied a holistic bad faith analysis, rejecting what it called the defendants' attempt to "*tick through a checklist*". The defendants argued that under Aronson v. Lewis[3], absent an abuse of discretion, the court could not second-guess a decision that was made (i) by a majority of disinterested and independent directors, and (ii) on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation, the former reflecting the directors' duty of loyalty, the latter their duty of care. The defendants argued that prong (i) was fulfilled - since the directors who approved the transaction were disinterested in the buyout and independent of the Founding Investors, and prong (ii) was fulfilled as well - since there was a rational business purpose for the buyout (and the plaintiffs did not plead care violations to begin with). The court disagreed and clarified that both (i) and (ii) are aspects of a holistic good faith analysis that must consider the totality of the circumstances and *"can consider, for example, indications of interestedness that are not disqualifying in themselves but which nevertheless color the actions that the board took."*

This interpretation allowed to court to avoid a detailed analysis of the defendants' disinterestedness and independence and to consider various alleged facts suggesting that the buyout may have been guided by improper motives on the part of the defendants. In doing so, the court looked with disfavor at the following alleged circumstances, among others:

- there was no record explaining the difference between the $850 million purchase price and the $175 million valuation of the TRA Claims in the audited financials;
- the sharp contrast between the representations the CFO made to the auditors and the audit committee regarding GoDaddy's likely inability to use the depreciation deductions and the representations he made to the special committee that all depreciation deductions could likely be used;
- the CFO conveyed to the special committee that it needed to move quickly to lock in the price because the Founding Investors had a "peak interest" for liquidity, and there was no evidence that he attempted to use that fact as

leverage in his negotiations against the Founding Investors, and instead making the special committee work on the Founding Investors' schedule;
- the special committee allegedly did not obtain a fairness opinion, but merely a valuation analysis by its financial advisor, who was not present at the meeting approving the buyout;
- the meeting approving the buyout lasted only 30 minutes; and
- the Founding Investors had sold their GoDaddy equity only recently, management and certain directors had business ties with them, such as co-investments or directorships on portfolio companies, and the special committee was not composed of the directors with the fewest such ties.

While subject to appeal, the opinion has significant implications for transactions between a corporation and a third party to which directors or management have more than insignificant business or personal ties. It shows that even where such ties are insufficient to establish that decisionmakers were not disinterested and independent, shareholder derivative suits challenging such transactions are not easily dismissed on the pleadings. At the same time, the decision provides useful guardrails for navigating such transactions, which a corporation should do with assistance of counsel.

Additional "Up-C" Litigation

The "Up-C" IPO structure has recently come under increased scrutiny. Pullan v. Skonnard[4], a case involving early TRA termination in the context of a take-private transaction settled for additional disclosure, while recent restructurings at private equity sponsors Apollo (Anguilla Social Security Board v. Black)[5] and Carlyle (City of Pittsburgh Comprehensive Municipal Trust Fund v. William E. Conway Jr.)[6] involving early payments for TRA claims to their founders are in ongoing litigation.

Also ongoing is Schumacher v. Mariotti[7], a suit alleging that founding investors unfairly benefit twice from the operating company's distributions, both by receiving their pro rata share on account of their membership interests and by selling shares in the corporation that received the remainder. Defendants argue that such structure was fully disclosed to the public investors.

References

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1 See Empls. Tri-State Pension Fund v. Zuckerberg (Zuckerberg II), 262 A.3d 1034, 1059 (Del. 2021).

2 Id; Court of Chancery Rule 23.1.

3 473, A.2d 805, 811 (Del. 1984).

4 Case No. 2021-0043 (Del. Ch.).

5 Case No. 2023-0846 (Del. Ch.).

6 Case No. 2022-0664 (Del. Ch.).

7 Case No. 2022-0051 (Del. Ch.).

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