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Delaware Court of Chancery Invalidates Common Governance Rights in Stockholder Agreement

WRITTEN BY

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In West Palm Beach Firefighters' Pension Fund v. Moelis & Company, the Delaware Court of Chancery invalidated a set of approval rights contained in a stockholder agreement as facially in conflict with Section 141(a) of the Delaware General Corporation Law (DGCL). These rights required a founder's prior written consent before the board of directors could take 18 different categories of action, ranging from the incurrence of debt and the issuance of stock, to the declaration of dividends and the consummation of any dissolution (the pre-approval requirements), as well as provisions that contractually obligated the board to (i) maintain its size unless the founder decided otherwise, (ii) recommend that stockholders vote in favor of the founder's designees, and (iii) fill vacancies left by prior founder designees with the founder's new designees (together, the board composition provisions). The court also invalidated a provision in the stockholder agreement that required the board to populate any committee with a number of the founder's designees proportionate to the number of designees on the full board (the committee composition provision) because it violated both Section 141(a) and 141(c) of the DGCL. Unless the decision is appealed and overturned, it will have a wide-ranging impact on companies that utilize stockholder agreements to organize their governance structures.

Background

In 2007, Ken Moelis (the founder) founded Moelis & Company (the company). Before the company's initial public offering in 2014, the company entered into a stockholder agreement, which granted the founder certain rights, including the pre-approval requirements, the board composition provisions, and the committee composition provision. The pre-approval requirements purported to directly bind the board itself. In 2023, a company stockholder brought suit, arguing that the pre-approval requirements and the board composition provisions violated Section 141(a) of the DGCL, and that the committee composition provision violated Sections 141(a) and 141(c) of the DGCL. Section 141(a) of the DGCL provides that the business and affairs of every Delaware corporation are managed by its board of directors, "except as may be otherwise provided in [the DGCL] or in its certificate of incorporation." Section 141(c) of the DGCL only permits the board, and not stockholders, to determine the composition of committees.

Analysis

As part of its decision, the court engaged in an extensive analysis of Delaware case law and articulated a two-part test, which relied upon the 1956 Delaware Court of Chancery case of *Abercrombie v. Davies* to determine whether a challenged provision is invalid under Section 141(a) of the DGCL:

- Does the challenged provision constitute part of the corporation's internal governance arrangements?
- Does the challenged provision have the effect of removing from the directors in a very substantial way their duty to use their own best judgment on management matters?

To determine whether the first factor has been met (and thus subject to Section 141(a) of the DGCL at all), the court also articulated a seven-part test:

- Does the agreement containing the challenged provision have a statutory grounding in a section of the DGCL? The court noted that stockholder agreements, stock issuance agreements, merger agreements, asset sale agreements, executive employment agreements, and bylaws all have a statutory grounding in the DGCL.
- Do the counterparties to the agreement containing the challenged provision hold roles as intra-corporate actors? In a governance arrangement, counterparties are likely to be officers, directors, stockholders, or affiliates as opposed to commercial actors like customers and suppliers.
- Do the challenged provisions seek to specify the terms on which intra-corporate actors can authorize the corporation's exercise of its corporate power? A governance arrangement may require voting or not voting in a particular way, forbid director action, or limit the ability of directors to act.
- Is there an underlying commercial exchange with respect to the agreement governing the challenged provision?
 A governance agreement, by contrast to a commercial contract, does not obviously reveal an underlying commercial exchange.
- What is the nature of the relationship between the contractual restrictions and a commercial purpose?
 Commercial agreements, such as credit agreements, often contain negative covenants that can function as prohibitions on corporations from taking certain action, but in a governance agreement, the governance rights are the crux of the agreement.
- What is the presumptive remedy for breach? Governance agreements will tend to involve equitable relief as opposed to monetary relief in the commercial context.
- What is the duration of the contract and is the corporation able to terminate it? A governance agreement is more likely to be indefinite in nature.

With respect to the stockholder agreement at issue, the court found that each factor heavily weighed in favor of characterizing the stockholder agreement as a governance agreement that is subject to Section 141(a) of the DGCL. This was so, according to the court, because, among other things, the stockholder agreement had statutory grounding in the DGCL, was entered into among the company and the founder, addressed the exercise of powers by intra-corporate actors, did not reflect any underlying commercial bargain, and the company lacked the ability to terminate it.

The court found that the second factor of the test had also been met because the pre-approval requirements were "so all-encompassing as to render the [b]oard an advisory body" and that the founder "not the Company, is running the show." Accordingly, the court held that the pre-approval requirements were facially invalid as they were in conflict with Section 141(a) of the DGCL. Similarly, the court held that the board composition provisions were facially invalid as in conflict with Section 141(a) of the DGCL because they removed the ability of the directors to use their best judgment to (i) communicate with stockholders as to who should serve as a director, and (ii) determine the size of the board. Finally, the court held that the committee composition provision was invalid as it was in conflict with Sections 141(a) and 141(c) of the DGCL, as it removed the ability of the directors to use their best judgment to determine who sits on a committee.

Takeaways

The court's decision is wide-ranging in its implications for Delaware corporations as it relates to their contractual arrangements with their stockholders. These provisions are particularly common in venture capital financings, including in the form documents of the National Venture Capital Association, where approval and consent rights are regularly included in stockholder agreements or other governance agreements.

The following takeaways can be derived from the opinion:

- Agreements With Stockholders vs. Agreements With the Corporation. The court's decision draws a sharp
 distinction between arrangements in which stockholders contractually agree to vote their shares to achieve a
 certain result and arrangements that purport to restrict the board directly,[1] including through imposing the
 restrictive obligation on the corporation itself.[2] Arrangements among stockholders are expressly authorized by
 Section 218(c) of the DGCL and are not impacted by the court's ruling.
- <u>Alternative Arrangements</u>. The court pointed out that "when restricting the board's authority, the tailoring must take place in the charter." Thus, under Section 141(a) of the DGCL and the court's decision, Delaware corporations looking to grant governance rights should consider doing so through the charter or through the issuance of a "golden share" of preferred stock.
- <u>Commercial Agreements</u>. The court's decision does not disturb commercial arrangements, such as negative covenants contained in credit agreements.
- <u>Market Practice</u>. Policy-based arguments concerning "market practice" are unpersuasive to the court when it comes to statutory compliance. As the court noted, "[w]hen market practice meets a statute, the statute prevails."
- Alternative Entities. The court's decision does not impact the terms of any governance arrangements that may
 be contained in a limited liability company agreement or partnership agreement. Companies should consider
 using alternative entities to avoid traps for the unwary.

- [1] "Provisions that expressly say that 'the board' cannot take a particular action or must take particular action are invalid. Provisions that purport to bind individual directors are similarly invalid."
- [2] The court noted that, although the pre-approval requirements purported to directly bind the board, the company was the party to the stockholder agreement, and not any of the directors. That did not eliminate the Section 141(a) issue because, according to the court, any challenged provisions would merely be analyzed as corporate-level restrictions, and a direct, corporate-level restriction in a governance agreement can violate Section 141(a) of the DGCL. We note that the plain terms of both of the board composition provisions and the committee composition provision bound the company, not the board.

Mike Swallow also contributed to this article. He is not licensed to practice law in any jurisdiction; bar admission pending.

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