Securities Regulation Daily Wrap Up, CORPORATE GOVERNANCE—Del. Ch.: Chancery invalidates stockholder agreement that tied board's hands, (Feb 26, 2024)

By Anne Sherry, J.D.

A cornerstone of Delaware's corporate law is that the corporation is managed by its directors, not its shareholders.

The Delaware Court of Chancery struck down parts of a stockholder agreement that constrained the board's authority to act. While Delaware allows corporations to contract, stockholder agreements containing veto rights and other restrictions conflict with the state's board-centric model of governance. Provisions that compelled the board to recommend the stockholder's designees for election; compelled filling a vacancy created by a departing designee with another designee; and enabled the stockholder to prevent the board from increasing the number of director seats were facially invalid under the General Corporation Law (*West Palm Beach Firefighters' Pension Fund v. Moelis & Company*, February 23, 2024, Laster, J.).

New-wave agreement. The court observed that stockholders have long contracted among themselves to address how they will exercise their stockholder rights. However, a "new wave" of agreements goes beyond this practice to enshrine extensive veto rights and other restrictions on corporate action. The new-wave agreement in this case required the board to obtain the stockholder's prior written consent before taking virtually any action; ensured that the stockholder could select a majority of directors; and forced the board to populate committees with the same proportion of the stockholder's designees as the full board.

These contracts are in tension with DGCL Section 141(a), which states that "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." Even when a corporation has a controlling stockholder, Delaware corporations are managed by the board.

Section 141(a) claims. The court undertook an exhaustive review of Delaware cases analyzing Section 141(a) claims. These cases involved challenges to stockholder or director agreements; rights plans; CEO employment agreements; improper delegations of board power; termination of merger agreements; and bylaws. Only one case, *Sample v. Morgan* (Del. Ch. 2007), argued for ignoring the Section 141(a) framework entirely and evaluating contractual restrictions exclusively for compliance with fiduciary duties. This case "stands alone and on dubious ground" for acknowledging the twice-tested framework of Professor Berle and then discarding the first test—compliance with the technical rules governing the dispute.

Reviewing the Section 141(a) decisions led the court to formulate a two-step inquiry. First, is the challenged provision part of an internal governance arrangement? If so, then under *Abercrombie v. Davies* (Del. Ch. 1956), does the provision impose a restriction that violates Section 141(a)?

Governance factors. The court gleaned several factors that indicate a contract is part of a governance arrangement. Governance agreements frequently have a statutory grounding in a section of the DGCL (for example, stockholder agreements are rooted in Section 218(c) and (d)). Unlike in a standard commercial contract, counterparties in a governance agreement are likely to be officers, directors, or stockholders. The challenged provisions may seek to specify the terms on which intracorporate actors can authorize the corporation's exercise of its power.

A fourth factor that distinguishes a governance agreement from a commercial contract is that the former does not reveal an underlying commercial exchange. Relatedly, the governance rights are not there to protect a commercial bargain; they are the point of the contract. The presumptive remedy of a governance arrangement will be equitable

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relief enforcing the bargained-for control rights. Finally, a governance arrangement is more likely than a commercial agreement to have durable, indefinite duration.

The case at hand. The preapproval provisions in this case leaned more towards governance arrangements. They were obviously included to preserve the stockholder's control even in the event that his voting power dropped below a majority. They amounted to "prototypical governance provisions in a prototypical governance agreement."

Accordingly, applying the *Abercrombie* test, the court held that the provisions were facially invalid. Because they expressly required the stockholder's prior approval before the board could act, they went even further than the voting provision in *Abercrombie*, which threatened directors with removal after they acted. The provisions were "so all-encompassing as to render the Board an advisory body."

The court rejected the company's argument that the provisions could operate legitimately. Setting aside the deterrent effect of the requirements, the provisions do not formally constrain the board as long as the stockholder and the directors agree. But there would be no need for the provisions if the parties were in agreement. "In every setting where [the stockholder] enforces one of the Pre-Approval Requirements, the provision will operate invalidly to constrain the Board."

Similarly, several of the agreement's provisions relating to board and committee composition were facially invalid. Others, though, such as one giving the stockholder the right to propose a specific number of director candidates, did not impose any restriction on the board in violation of Section 141(a).

The case is No. 2023-0309-JTL.

Attorneys: Thomas Curry (Saxena White P.A.) for West Palm Beach Firefighters' Pension Fund. John P. Ditomo (Morris, Nichols, Arsht & Tunnell LLP) for Moelis & Co.

Companies: Moelis & Co.

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