Milbank

Insights

Public Company Advisory Group

Delaware Court of Chancery Rejects Validity of "New Wave" Stockholder Agreement Terms that Constrain Traditional Board Authority

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Summary

Founders and controlling stockholders often seek to retain control over their companies even after taking them public, typically via high-vote share classes or, as was at issue in this case, via stockholder agreements granting the pre-IPO owners broad governance rights.

In *West Palm Beach Firefighters' Pension Fund v. Moelis & Company*, the Delaware Court of Chancery recently held that a "new wave" stockholder agreement between Moelis & Company (the "Company") and its founder, CEO, and board chairman, Ken Moelis was invalid under Section 141(a) of the Delaware General Corporation Law (the "DGCL") because it contained "pre-approval rights" over a number of corporate actions, required the board to recommend individuals designated by Moelis for a majority of directorships and fill committee positions and board vacancies with Moelis designees, impermissibly constraining the board's ability to manage the business and affairs of the company—powers the statute does not allow the board to delegate via contract.[1]

Moelis is a strong reminder that the foundation of the corporate form in Delaware is the independent authority of a board of directors, elected by stockholders and entrusted to manage the business and affairs of the corporation as fiduciaries. Delaware will not permit this foundation to be eroded through contractual arrangements with stockholders.

[1] C.A. No. 2023-0309-JTL (Del. Ch. Feb. 23, 2024)

I. Background and Challenge

Ken Moelis formed a boutique investment bank in 2007, running the business as CEO and board chairman, and took his company public in 2014. One day before the IPO, the Company entered into a Stockholder Agreement (the "Stockholder Agreement") granting Moelis and his affiliates expansive rights, including: (1) pre-approval rights over 18 categories of board actions ranging from adopting an annual budget to liquidating the Company (the "Pre-Approval Requirements"); (2) requiring the Board to nominate and recommend that Company stockholders vote for Moelis' designees, and to fill vacancies with Moelis designees (the "Board Composition and Vacancy Provisions"); and (3) requiring the Board to appoint a majority of Moelis designees to all board committees (the "Committee Composition Provision" and collectively, the "Challenged Provisions").

In 2023, a public stockholder attacked this arrangement, arguing that the Challenged Provisions violate Section 141(a) of the DGCL, which states: "The business and affairs of every corporation […] 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."[2]

II. Legal Analysis and Holdings

Section 141(a) Claims Pertain to a Corporation's Internal Governance Arrangements

In ruling on the plaintiff's challenge, the Court of Chancery adopted what it called a "clear rule", stating that if "the challenged provision constitutes part of the corporation's internal governance arrangement […] then section 141(a) applies."[3]

The Abercrombie Test and Factual Determinations

Because it found that the Stockholder Agreement "self-evidently" regulates the Company's internal affairs, the Court of Chancery applied the longstanding "*Abercrombie* test,"[4] which states that "governance restrictions violate Section 141(a) when they have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters or tend to limit in a substantial way the freedom of director decisions on matters of management policy."[5]

The Court of Chancery found that most of the Challenged Provisions fail the *Abercrombie* test. In particular, as a result of the Pre-Approval Requirements (which the Court of Chancery considered as a whole), "[t]he directors only manage the Company to the extent Moelis gives them permission to do so."[6] The Court of Chancery also found that the Board Composition and Vacancy Provisions and the Committee Composition Provision improperly mandate Board or Company action and, therefore, violate Section 141(a).

Dicta on Certificates of Designation and Preferred Stockholder Rights

The Court of Chancery went on in dicta to make a significant observation with respect to other means of structuring internal governance arrangements, positing that a board could, pursuant to its blank check authority to issue preferred stock, issue a "golden share" of preferred stock carrying voting and director appointment rights.[7] Since a preferred stock certificate of designation forms part of a company's charter, this arrangement would not be subject to vulnerability under Section 141(a) (so long as the charter provisions themselves do not override a mandatory requirement of the DGCL).

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[2] 8 *Del. C.* § 141(a).
[3] C.A. No. 2023-0309-JTL (Del. Ch. Feb. 23, 2024). at 25.
[4] Id.at 5.
[5] Id.
[6] Id. at 9.
[7] Id. at 12-13.

III. Key Takeaways and Observations

- *Moelis* reinforces the long-held principle in Delaware that the bedrock of the corporate form is the role of directors as fiduciaries charged with managing the business and affairs of a corporation in the best interests of stockholders, which authority cannot be encroached even by stockholders.
- *Moelis* distinguishes "new wave" stockholder agreements that constrain board authority from traditional stockholder agreements that focus on covenants between and among stockholders in their capacity as such.
- Provisions in stockholder agreements that seek to constrain or control the actions or authority of the board of directors are vulnerable to DGCL Section 141(a) claims. We expect increased scrutiny and an uptick in stockholder litigation as plaintiff firms seek to bring similar claims with respect to other existing contracts.
- The holding in *Moelis* found only the Pre-Approval Requirements, the Board Composition and Vacancy Provisions, and the Committee Compensation Provision to be facially invalid, but corporations and stockholders party to stockholder agreements should review the agreements and the manner of implementation holistically in considering whether to make changes (in substance or structure) as a result of this opinion.
- Changes to existing stockholder agreements are likely warranted where the agreement contains provisions restricting the board's ability to exercise independent judgment with respect to:
    - determining the size of the board or composition of board committees;
    - recommending director nominees to stockholders;
    - filling vacant board seats; and
    - designating members of committees.
- Companies seeking to grant governance rights to significant stockholders should consider doing so through charter and preferred stock certificate of designation provisions, rather than contractual arrangements.
- Boards that are considering or have settled with activists through contractual agreements should consider the validity of those arrangements under *Moelis*, as complying with those agreements could in certain cases be viewed as a breach of the directors' fiduciary duties.

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