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Stockholder Agreements in Focus: Analyzing *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.*

On February 23, 2024, the Delaware Court of Chancery issued a decision in *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.* emphasizing the primacy of the board of directors' responsibility to manage a Delaware corporation and invalidating certain provisions in a stockholder agreement that improperly restricted such authority. Section 141(a) of the Delaware General Corporation Law (DGCL) requires that the business and affairs of a Delaware corporation be managed by its board of directors, "except as may be otherwise provided in the DGCL or in its certificate of incorporation."

In response to the Court's opinion in *Moelis*, the Delaware legislature has proposed amendments to the DGCL to clarify that such agreements limiting a board's management authority are permissible. Additionally, the National Venture Capital Association (NVCA) recently updated its model legal documents to incorporate changes driven by the *Moelis* opinion.

West Palm Beach Firefighters' Pension Fund v. Moelis & Co.

In *Moelis*, the founder, CEO, and then controlling stockholder of Moelis & Company, a Delaware corporation, entered into a stockholder agreement with the corporation the day before its initial public offering. The agreement contained provisions constraining the management authority of the corporation's board of directors so that (i) the board would be required to obtain the prior written consent of the founder before it could approve or take certain material corporate actions, (ii) the board would be required to remain of a certain size and be comprised of a majority of directors chosen by the founder, among other board composition requirements, and (iii) any

committee of the board would be required to include a certain number of the founder’s designated directors in proportion to their overall representation on the board.

The plaintiff, a minority stockholder of the corporation, challenged the contractual restrictions and argued in its motion for summary judgment that such provisions impermissibly violated the board’s management authority mandated by Section 141(a) of the DGCL.

In analyzing whether the contested provisions went too far in restricting the board’s authority, the Court distinguished between contractual restrictions imposed as part of an internal governance arrangement as opposed to an external commercial contract, which is a fact-based analysis. If the imposed restrictions are deemed part of an external commercial contract to which the corporation is a party, then they are deemed valid and not subject to Section 141(a) of the DGCL. On the other hand, if they are part of an internal governance arrangement, such restrictions are subject to Section 141(a) of the DGCL. In *Moelis*, the Court found that the contested restrictions were clearly part of a typical internal governance arrangement.

Delaware courts have long used the *Abercrombie* test to assess whether contractual limitations on a board’s authority violate Section 141(a) of the DGCL. In *Abercrombie v. Davies* (Del. Ch. 1956), the Court found that such restrictions violate Section 141(a) of the DGCL when they either “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 . . .”

Applying *Abercrombie*, the Court in *Moelis* found that regardless of whether structured as requiring “prior consent” or as a “veto right,” the pre-approval requirement in the agreement went too far in stripping the board of its ability to freely exercise its powers, as it could not effectively act without the founder’s prior consent. The restriction ultimately resulted in the founder managing and directing the business of the corporation as opposed to the board, which failed the *Abercrombie* test.

With respect to the board composition requirements, the Court found that the limitations on the board’s size, the requirement that the board must recommend the founder’s chosen director designees, and the founder’s authority to fill vacancies each failed the *Abercrombie* test on their face and violated Section 141(a) of the DGCL. The Court also determined that the committee composition provision did not pass the *Abercrombie* test because the composition of a board committee falls solely within a board’s authority.

Because Section 141(a) of the DGCL includes an explicit carveout for provisions contained in a corporation’s certificate of incorporation, the contested restrictions in *Moelis* would have been valid if they had been contained within the corporation’s certificate of incorporation. The court also noted in dicta that the board could have simply issued a single share of preferred stock to the founder, with the

underlying preferred stock delegation containing the contested limitations on board authority, and the restrictions would have been valid under Section 141(a) of the DGCL as such delegation would be deemed a part of the corporation's certificate of incorporation.

Delaware's Proposed Legislative Amendments to the DGCL

In response to the *Moelis* opinion, the Delaware legislature recently proposed certain amendments to Section 122 of the DGCL that would largely have the effect of nullifying the holding of the *Moelis* opinion. If enacted, the DGCL amendment will make clear that a Delaware corporation has the express authority (unless otherwise provided for in its certificate of incorporation) to enter into contracts with current or prospective shareholders (in their capacity as such) in exchange for such minimum consideration as determined by the board.

The DGCL amendment clarifies that a Delaware corporation can agree in such contracts to (i) restrict or prohibit specific future corporate actions, even if board approval for such actions is required, (ii) require approval of one or more persons or bodies (including the board of directors, one or more specific directors, or stockholders or beneficial owners of stock) before the corporation can take specific actions, and (iii) covenant that the corporation (or such other persons or bodies) will take or refrain from taking certain actions in the future. Thus, the *Moelis* pre-approval requirement and board and committee composition requirements would become valid under the proposed DGCL amendment. However, there are some important considerations to note from the proposed DGCL amendment:

The DGCL amendment clarifies that any delegation of authority by a board of directors to an officer or agent is still subject to Section 141(a) of the DGCL and Delaware's breadth of over-delegation of duties cases.

The DGCL amendment does not authorize a board of directors or individual directors to enter into these contracts directly. Also, no legal remedies can be imposed on a board or any individual directors for a corporation's failure to comply with a restriction in a stockholder's agreement. However, a stockholder party to such a contract may seek remedies against a corporation that fails to take actions as required by the contract, though such remedies will be limited by equitable principles.

The DGCL amendment does not alter a director's, officer's, or stockholder's fiduciary duties when deciding and approving such a contractual arrangement. It also does not alter such duties in deciding whether or not the corporation will take or refrain from taking future actions (whether in violation of the contract or otherwise).

The ability of a corporation to covenant that it will affirmatively take specific actions does not overrule any other approval rights for such actions required under the DGCL. However, as noted above, stockholders may have remedies for a breach of contract in the event a corporation fails to take such action.

A corporation's certificate of incorporation can override the express powers granted to its board by the DGCL amendment.

If enacted, the amendments will become effective August 1, 2024, and will apply to all contracts made by a corporation, all agreements, instruments, or documents approved by the board of directors, and all agreements of merger or consolidation entered into by a corporation, in each case whether made or approved before or after August 1, 2024, except that the amendments shall not apply to or affect any civil action or proceeding completed or pending on or before such date.

What this means to you

The *Moelis* opinion remains subject to appeal, and the effectiveness of the DGCL amendment could largely override the holding of the opinion.

The NVCA has recently updated its model legal documents to incorporate changes driven by the *Moelis* opinion.

Pending the adoption of the DGCL amendment, Delaware continues to reinforce the bedrock principle that a corporation shall be managed and directed by its board of directors, as codified under Section 141(a) of the DGCL, with an express exception for restrictions on a board's authority that are placed in the certificate of incorporation.

A contractual restriction on a board's authority in an internal governance arrangement need not deprive the board of all of its authority to violate Section 141(a) of the DGCL. Constraints on a single area of board authority can be sufficient to be held invalid.

Practitioners should remember that standard market practice is not an eligible defense to acts in violation of Delaware law.

Contact us

Husch Blackwell continues to monitor case law and legislation affecting the governance of Delaware corporations for our clients. Should you have any questions, please do not hesitate to contact Remy Fesquet, Kirstin Salzman, Lucas Whited, Matti Mortimore, or your Husch Blackwell attorney.