

# Stockholder Agreement Terms Invalidated in Delaware

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It has been common market practice for private equity sponsors and other controlling stockholders to retain governance rights over a controlled company after an IPO, often through a stockholder agreement with the IPO issuer. Within the last year, a number of lawsuits have been filed in Delaware challenging the legitimacy of elements of such arrangements. Last week, in the first decision to address the merits of a plaintiff's challenge (*W. Palm Beach Firefighters' Pension Fund v. Moelis & Co.* (Feb. 22, 2024)), the Delaware Court of Chancery found multiple provisions of a stockholder agreement entered into at the time of the company's IPO to be facially invalid on the ground that the provisions operated to deprive the company's board of directors of a significant portion of its authority in contravention of Sections 141(a) and 141(c) of the Delaware General Corporation Law (the "DGCL"). The court commented that "[w]hen market practice meets a statute, the statute prevails."

The case concerns a stockholder agreement between Moelis & Co. and its founder, Ken Moelis ("Moelis"), that was executed at the time of the company's IPO.

The stockholder agreement gave Moelis—through his control of Holdings—a series of challenged rights:

- pre-approval rights that required the board to obtain Moelis's prior written consent for any of 18 actions, including, among others, the incurrence of indebtedness in excess of \$20 million, the issuance of any preferred stock, the entry into a new line of business requiring an investment in excess of \$20 million, the adoption of a stockholder rights plan, and the removal or appointment of any Section 16 officer;
- board composition rights, including, among others, the right to consent to any change in the size of the board and the right to designate a majority of the board; and
- committee representation rights, providing the right to have designees on each board committee in proportion to the representation of Moelis designees on the board as a whole.

The parties filed cross-motions for summary judgment on plaintiff's claim that the challenged provisions were facially invalid under DGCL Section 141(a)—and, in the case of the committee composition provisions, DGCL Section 141(c). To succeed on such a facial challenge, a plaintiff must show that there are no circumstances in which the provisions could operate without running afoul of the DGCL.

DGCL Section 141(a) provides 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.*”

The court surveyed prior decisions under DGCL Section 141(a) and divined a two-part test. First, to determine whether a challenged provision implicates DGCL Section 141(a), the court must ask whether the provision “constitutes part of the corporation’s internal governance arrangement,” as opposed to an external commercial contract. If so, the court must evaluate the challenged provisions under the test set out in *Abercrombie v. Davies*, 123 A.2d 893, 899 (Del. Ch. 1956), which held that governance restrictions violate DGCL 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 . . . .’”

In this case, the court readily concluded that the challenged provisions are part of an internal governance arrangement subject to DGCL Section 141(a). The court then analyzed the provisions under the *Abercrombie* test.

**The Pre-Approval Requirements.** The court found that the pre-approval requirements, viewed collectively, were facially invalid because they “have the effect of removing from the directors in a very substantial way their duty to use their own best judgment on virtually every management matter.” In the court’s view, the provisions “are so all-encompassing as to render the Board an advisory body.” The court rejected the defendants’ argument that the pre-approval requirements did not constrain the board unless actually exercised, finding that the requirements are nonetheless constraints under Delaware law that have a chilling effect on the board’s exercise of its judgment. Notably, the court treated pre-approval requirements as legally indistinguishable from consent or veto rights, and thus its analysis would apply equally to both types of provisions.

**The Board Composition Provisions.** The court found that three of the board composition provisions violated DGCL Section 141(a) because they “remov[e] from the directors in a very substantial way their duty to use their own best judgment on a management matter.” *First*, the court found invalid the requirement that the board

recommend Moelis's designees for election, because it substantially impedes the directors from exercising their best judgment as to who should serve as a director. *Second*, for the same reason, the court found invalid the requirement that the board fill a vacancy created by the departure of a Moelis designee with another Moelis, reasoning that the certificate of incorporation gives the board the exclusive power to fill vacancies and that includes the power to freely select the person to fill it. *Third*, the court found invalid the requirement that the board size not exceed 11 directors without Moelis's approval because the certificate of incorporation and bylaws provide that the board can fix the number of directors by majority vote.

The court found that the three remaining board composition provisions were not facially invalid. A provision permitting Moelis to specify individuals as candidates for election to the board as long as certain conditions are met was not facially invalid because "[i]t does not force the Board or the company to do anything with the designees." A provision requiring the company to "nominate" Moelis's designees for election by including them in the company's slate was not facially invalid because "[n]ominating a candidate means enabling them to stand for election," not "endorsing their candidacy." Finally, a provision requiring the company to use reasonable best efforts to "cause the election" of the Moelis candidates was not facially invalid because the company can agree to take "ministerial steps to ensure that stockholders can consider Moelis's nominees" without "meaningful infringement" on the board's authority under DGCL Section 141(a). The court noted that "[t]here might be situations when an as-applied challenge" to the nomination and efforts requirements "could succeed," but the existence of scenarios in which those provisions could operate legitimately was sufficient to defeat a facial challenge.

**The Committee Representation Provision.** The court found that the committee representation provision was facially invalid under DGCL Section 141(a) as well as DGCL Section 141(c), which provides that the board of directors "may designate 1 or more committees," because it prevents the board from exercising its judgment to form and populate a committee. The provision was also contrary to the company's bylaws. The court concluded that provision thus "remove[s] from the directors in a very substantial way their duty to use their own best judgment" in determining who should serve on a committee. The court noted that this provision would prevent the board from forming an independent committee without Moelis's consent.

The court observed that Moelis did not need to establish his governance arrangements through a stockholder agreement, but "could have accomplished the vast majority of what he wanted through the company's certificate of incorporation." The court noted that one way this could be accomplished by the board would be by using its blank check authority to issue a single "golden share," in which case the certificate of designations

for the new preferred stock would become part of the company's certificate of incorporation.

## Takeaways

With two other similar cases pending, and this decision subject to appeal, the *Moelis* decision may not be the final word on the topic of stockholders agreements and consent and board rights. We note that the rationale of the decision would apply to a stockholders agreement for any Delaware corporation, even a private company. However, for purposes of these takeaways, we will focus on considerations for public companies and companies that are contemplating going public:

- The decision emphasizes that pre-approval rights that would be impermissible in a stockholder agreement may be acceptable if included in a company's certificate of incorporation. Therefore, pre-IPO companies should consider putting stockholder rights that restrict board action in the company's certificate of incorporation, either directly or in a certificate of designations governing a series of preferred stock, a so-called "golden share." While the court noted that some restrictions on board action may be invalid even if in the certificate of incorporation—for example, a provision that purports to override a mandatory provision of the DGCL—the court stated that *Moelis* "could have accomplished the vast majority" of its rights through the company's charter.
- The court analyzed the pre-approval conditions collectively, rather than individually, and *Moelis* had a significant number of pre-approval rights. Further court decisions may provide guidance as to the validity of individual pre-approval or consent and it is possible that some individual requirements may be more readily defensible as implicating commercial, rather than governance, concerns. Accordingly, public companies operating under stockholder agreements with more limited pre-approval requirements may wish to wait to see how the cases develop before taking remedial action. Nevertheless, public companies with these kinds of stockholder agreements may be inviting targets for stockholder litigation in the wake of the *Moelis* decision. In addition, although the court proposed a solution in the form of the "golden share", replacing a potentially invalid stockholder agreement with a preferred stock instrument containing comparable terms will implicate important governance and fiduciary duty considerations that will need to be reviewed carefully.

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We would be happy to discuss the considerations related to the Court of Chancery decision and the options for companies and controlling stockholders party to stockholders agreements with consent or pre-approval rights.



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