

A Reminder of Board Primacy: Delaware Court of Chancery Invalidates Stockholder Agreement Provisions Encroaching on Board-Level Decisions

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On February 23, 2024, the Delaware Court of Chancery issued an [opinion in *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.*](#) invalidating certain stockholder agreement provisions that gave a significant stockholder broad pre-approval rights over corporate actions. The opinion serves as a reminder of the contours of board authority under DGCL Section 141(a) and how contractual agreements may “improperly constrain a board’s authority.” It remains to be seen if the decision will be appealed, but at present, it should be evaluated by parties considering contractual provisions that may directly or indirectly limit director decision-making.

DGCL Section 141(a) states: “The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of the board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”

The agreement at issue was entered into by the Company and its founder (also CEO and then-controlling stockholder) the day before the Company’s initial public offering. A variety of terms of the agreement were at issue in the litigation:

- “Pre-Approval Requirements” requiring the prior written consent of the founder before the board may authorize 18 different types of actions, including: (i) the incurrence of debt above a specified amount, (ii) the issuance of common and preferred stock, (iii) the adoption of a stockholder rights plan, (iv) the removal or appointment of certain officers of the Company (including its founder/CEO), (v) the approval of annual budgets, (vi) the declaration of dividends, and (vii) entering material contracts.
- Board composition provisions, giving the founder a variety of rights:
 - The “Size Requirement” requiring the Company to use its best efforts to set the size of the board of directors at not more than 11 seats.
 - The “Designation Right” enabling the founder to specify individuals as potential candidates for election as a director, naming a number of directors equal to a majority

of the seats.

- The “Nomination Requirement” requiring the board to nominate the founder’s designees as candidates for director elections.
 - The “Recommendation Requirement” requiring the board to recommend that stockholders vote in favor of the founder’s nominees, whoever they may be.
 - The “Efforts Requirement” requiring the board to take reasonable efforts to ensure that the founder’s designees are elected and continue to serve as directors of the Company.
 - The “Vacancy Requirement” requiring the board to fill a vacancy of a designee with a new designee of the founder.
- The “Committee Composition Provision” mandating that the board include a proportionate number of the founder’s designees on each board committee, thereby limiting the board’s ability to create an independent committee unless the founder consents to its formation.

Stockholders sued and challenged the validity of the foregoing provisions under Section 141(a), arguing that the provisions restricted director primacy and were not included in the Company’s certificate of incorporation.

Vice Chancellor Laster’s 133-page decision is treatise-like. The Court surveyed Section 141 case law dating back decades to yield guiding principles for a Section 141(a) analysis:

First, one assesses whether the challenged provision is part of an internal governance arrangement within the ambit of Section 141(a) (as opposed to an external commercial agreement). If not, then no further inquiry is required.

The Court identified a number of factors to help distinguish internal governance arrangements from external commercial arrangements. These include whether the provisions: (i) have a statutory grounding in the DGCL; (ii) are agreed by intra-corporate actors; (iii) encompass how intra-corporate actors exercise corporate power; or (iv) reflect “an underlying commercial exchange” (*i.e.*, consideration).

Then, if the provision is part of an internal governance arrangement, the challenged provision is evaluated pursuant to the *Abercrombie* test, so-named for a 1956 Court of Chancery decision. *Abercrombie* asks whether the provision “[has] the effect of removing from [the] directors in a very substantial way their duty to use their own best judgment on management matters” or “tends to limit in a substantial way the freedom of director decisions on matters of management policy.”

With this framework in mind, the Court held that (i) the Pre-Approval Requirements, the Recommendation Requirement, the Vacancy Requirement, the Size Requirement and the Committee Composition Provision were facially invalid and (ii) the Designation Right, the Nomination Requirement and the Efforts Requirement were not facially invalid. The Court held that the facially invalid provisions violated the *Abercrombie* test by removing from directors the ability to exercise their judgment freely in the best interests of the stockholders. By contrast, the Designation Right, the Nomination Requirement and the Efforts Requirement did not impose restrictions on the board that were of such a nature that they violated Section 141(a), because they could potentially operate legally (*e.g.*, by allowing the

stockholder to designate directors or asking that the Company disclose information about directors nominees in its proxy statement).

The Court explained, however, that the Company could likely have achieved a similar result via other means. For example, by using its blank check authority to issue preferred stock and granting that preferred stock governance rights in the preferred stock's certificate of designations (which forms part of the company's certificate of incorporation). Section 141(a) itself suggests as much by mandating that corporations are managed by the board "except as may be otherwise provided in this chapter or in its certificate of incorporation."

It is unclear whether an appeal will be pursued. Pending any further decision, Vice Chancellor Laster's lengthy analysis should be considered by practitioners and clients alike when evaluating contracts that touch on board-level decision-making.

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