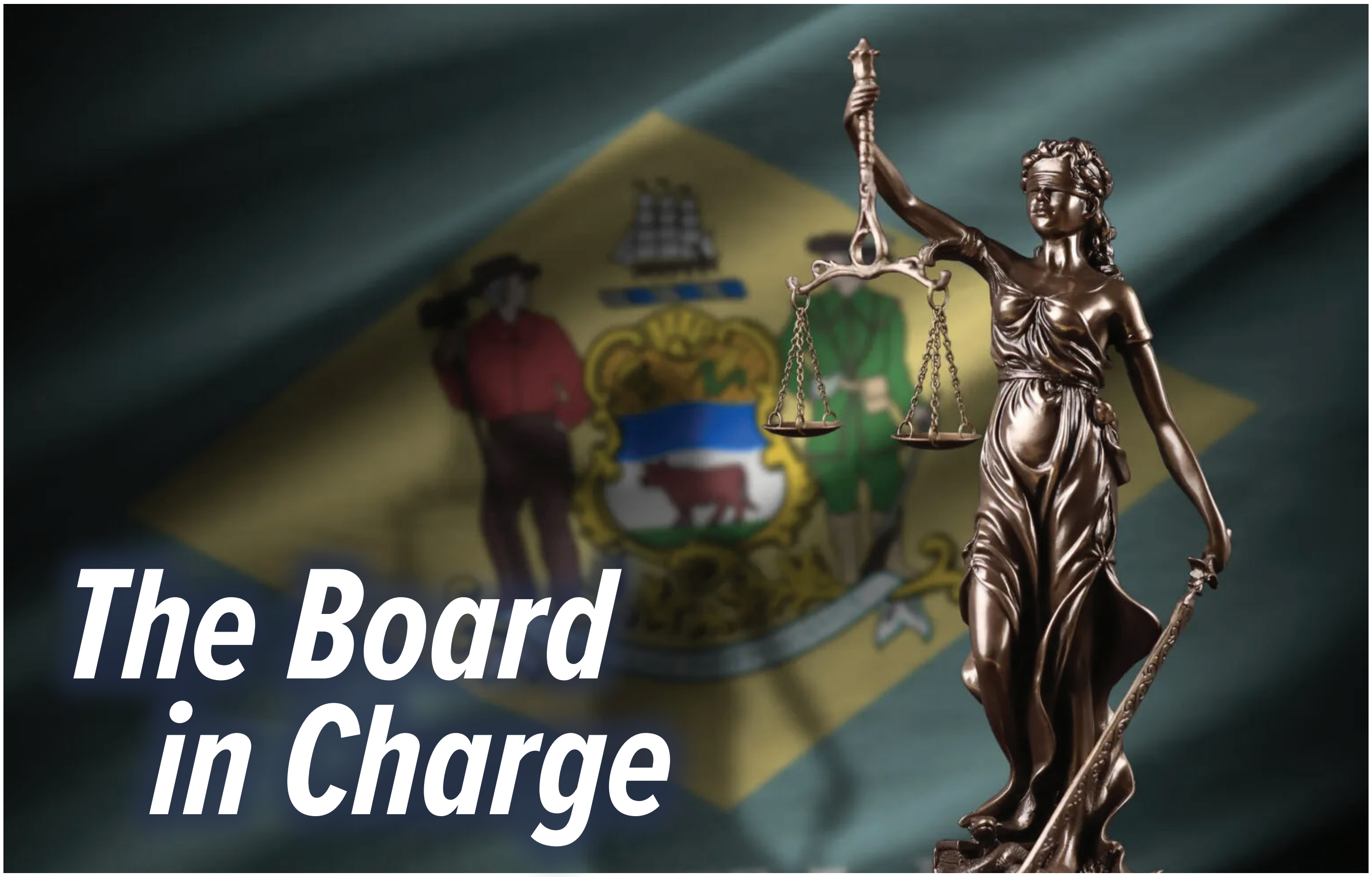

The Board in Charge

What happens when market practice meets a statute? **BY DOUG RAYMOND**

Companies with significant stockholders frequently have agreements with them addressing their rights to sell (or buy) shares, nominate directors and approve important corporate actions, such as hiring or replacing the independent auditors and senior management, paying dividends, and committing to significant acquisitions and divestitures. This has been very common with venture and strategic investments, activist settlements and situations where the corporation has a large stockholder. This market practice recently ran into the limitations of the Delaware law in an opinion from the Delaware Chancery Court, *West Palm Beach Firefighters' Pension Fund v. Moelis & Company*. That case addressed a challenge to a stockholders' agreement between a company and its founder, CEO and controlling stockholder. Despite the pervasiveness of the market practice, Vice Chancellor J. Travis Laster concluded that many of the stockholders' rights in the challenged agreement were invalid as overly impinging on the fundamental rights and responsibilities of the board to oversee the management of the corporation. Recognizing that his opinion could upend an established market practice, he all but asked the Delaware legislature to weigh in on this issue, stating that the "expansive use of stockholder agreements suggests that greater statutory guidance may be beneficial" and that he "would welcome additional statutory guidance." At the time of this article's release, the Delaware State Bar Association has recommended that the legislature do just that and has proposed an amendment to Delaware law that would validate many of the provisions that the court had found improper. It is likely that an amendment to this effect will be adopted later this year.

The court started its analysis with the fundamental principle, set out in the Delaware corporate statute, that the business and affairs of every corporation is managed by or under the direction of its board, unless otherwise provided in its certificate of incorporation. In a 130-page opinion, Vice Chancellor Laster invalidated many of the challenged provisions, starting with a group of 18 consent rights (which he considered only in the aggregate), including the stockholder's right to approve:

- Incurring debt above a specified amount or issuing equity.
- Removing or replacing senior officers.
- Approving annual budgets.
- Declaring dividends.
- Entering into material contracts.

Vice Chancellor Laster looked at these consent rights and concluded that they "rendere[ed] the board an advisory body" and violated Delaware law because they had the effect of "removing from directors in a very substantial way their duty to use their own best judgment on management matters" or limited in a substantial way the freedom of board action on matters of management policy. Chancellor Laster also invalidated, as unenforceable, provisions that had required that the board:

- Not change the size of the board without the stockholder's consent.
- Recommend that stockholders vote for the stockholders' board nominees.
- If one of the stockholders' designees stopped being a director, fill that board vacancy with another designee of the stockholder.
- Cause each board committee to be comprised of a proportional number of the stockholders' designees.

The court upheld other provisions in the stockholder agreement, finding that they did not, on their face, unlawfully restrict the board's discretion or limit its ability to act as it determined to be in the best interests of all the stockholders. Surviving provisions that passed muster required the board to allow the stockholder to nominate candidates for a majority of the board seats and use reasonable efforts to cause those nominees to be elected and to continue to serve as directors.

The court took a different approach toward provisions regulating the rights and obligations of stockholders as stockholders, and so provisions allowing stockholders to nominate candidates for director and dealing ownership and transfer of the company's shares would generally be permissible. The opinion also noted that the invalid provisions could have been saved had they been included in the company's charter by a "golden share" of designated blank check preferred stock, a device that may become more popular following the opinion.

The court tried to distinguish impermissible arrangements primarily focused on the internal governance of a corporation from acceptable commercial contracts that could have an incidental impact on governance (e.g., a loan agreement or agreement with a supplier restricting dividends, changes in management or expansion to certain territories). While the court noted that in many situations this could be a difficult distinction to recognize, such as an investment agreement with a strategic supplier, the court provided a list of factors that would be relevant to making the distinction and for the rest relied on the wisdom of the Delaware judiciary to sort it out afterwards.

Boards that have approved arrangements similar to those invalidated in the *Moelis* case should pay close attention to the proposed legislative fix as it moves through the Delaware General Assembly. Venture capitalists, activists and other investors should also carefully consider their existing agreements and future protocols in light of this decision.

This case is a timely reminder of the primary responsibilities of the board. The buck stops with the directors, and they can't avoid their responsibilities even if a controlling shareholder pushes them to do so. It also provides an interesting illustration of the current dynamic between the Delaware judiciary and the business interests that are moving at almost unprecedented speeds to modify decisions with which they disagree. ■

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