

THE DELAWARE COURT OF CHANCERY INVALIDATES TERMS OF A STOCKHOLDER AGREEMENT AND SHEDS LIGHT ON HOW JOINT VENTURES AND GOVERNANCE SHOULD BE STRUCTURED

8 APRIL 2024 • ARTICLE



The Delaware Court of Chancery determined, in an opinion issued on February 23, 2024 in the case of *West Palm Beach Firefighters' Pension v. Moelis & Co.*,¹ that certain provisions contained in a stockholder agreement were invalid under Delaware's General Corporation Law ("DGCL") and its relevant public policy. The parties to the agreement were Moelis & Company (the "Corporation") and Ken Moelis ("Moelis"), the founder, CEO and chairman of the Corporation.

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KEY TAKEAWAYS:

- The court emphasized 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.
- The court invalidated certain provisions of the stockholder agreement that unlawfully constrained the board's discretion to manage the affairs of the corporation in violation of the DGCL, and therefore were invalid as they violated public policy.
- Many of the invalidated governance provisions would have been valid if included in the certificate of incorporation of the Corporation, instead of in the stockholder agreement.

- Parties to agreements that may be subject to similar challenges should consider amending those agreements to comply with the recent ruling, subject to fiduciary considerations.
- The ruling does not apply to similar governance provisions for limited liability companies or limited partnerships.
- As both Marshall Islands and Liberian corporation laws are based on the equivalent Delaware law, and adopt the relevant case law by reference, this opinion should be evaluated by parties that have, or will have, stockholder agreements relating to Marshall Islands or Liberian corporations.

BACKGROUND

The Corporation's stockholder agreement provided, among other things:

1. Moelis had pre-approval rights over 18 corporate actions;

2. Moelis could designate potential candidates to fill a majority of the board of directors;
3. the board of directors was required to recommend the individuals designated by Moelis;
4. the board of directors was required to nominate Moelis' designees as candidates for election;
5. the board of directors was required to recommend that stockholders vote in favor of Moelis' designees;
6. the Corporation was required to use its best efforts to set the size of the board of directors at not more than 11 seats;
7. the Corporation was required to use reasonable efforts to enable Moelis' designees to be elected and continue to serve;
8. the board of directors was required to fill any vacancy in a seat occupied by a Moelis designee with a new Moelis designee;
and
9. the board of directors was required to populate any committee with a number of Moelis' designees proportionate to the number of designees on the full board of directors.

The stockholders (other than Moelis) argued in the 2023 motion for summary judgment that these provisions violated Section 141(a) of the DGCL, which provides: "[t]he 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."² Those stockholders contended that the provisions were invalid because they violated the foundational principles of director decision making and primacy under the DGCL and effectively removed the duty of the directors "in a very substantial way" to use their own best judgment on matters of management. Furthermore, the restrictions in the stockholder agreement were not included in the Corporation's certificate of incorporation (which changes the default statutory governance mechanisms).

The Corporation maintained that corporations under DGCL have the authority to enter into contracts, including contracts that constrain board freedom of action, and that stockholder agreements fall under this authority.

LEGAL ANALYSIS

The court laid out a multi-prong test to first assess whether Section 141(a) claims pertain to the challenged provisions. In the ruling, the court determined that Section 141(a) applies if the challenged provision comprises part of the corporation's internal governance arrangement.³

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Upon finding that the provision regulates a corporation's internal affairs, the court would then apply the "*Abercrombie test*"⁴ which establishes 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

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The court found that many, but not all, of the challenged provisions failed the *Abercrombie* test and therefore determined that numerous provisions, including the pre-approval requirements, were facially invalid under DGCL. The court declared these provisions impermissibility constrained the board's ability to manage business and affairs of the Corporation, therefore deteriorated the foundation of the corporate form of independent authority of the board of directors. The court emphasized that the statute does not allow the board to delegate through contractual arrangements with stockholders.

As a result of those findings, the court invalidated the pre-approval requirements because, taken together, they forced the board of directors to obtain Moelis' prior written consent before taking almost any meaningful corporate action, and therefore Moelis controlled what the board could do. The court did not hold that individual pre-approval requirements are, by themselves, invalid, but it did not go so far as to state that such requirements were permissible; the court stated that the pre-approval requirements in the stockholder agreement at hand went "too far."⁶

The court highlighted that the "vast majority"⁷ of the provisions invalidated by its decision would have been valid under Delaware law if they had been included in the Corporation's certificate of incorporation, instead of the stockholder agreement. Furthermore, the court stated that the Corporation could have implemented several of the provisions by using its "blank check authority" to issue Moelis a single "golden share" of preferred stock carrying a set of voting rights and director appointment rights.⁸ Furthermore, because the decision derives from the DGCL, the analysis does not apply to other entity forms such as limited liability companies or limited partnerships.

APPLICABILITY TO MARSHALL ISLANDS AND LIBERIAN CORPORATIONS

Both Marshall Islands and Liberian corporation laws are based, in part, on the DGCL, and each regime generally adopts Delaware case law as its own. This case and its implications should therefore be evaluated by parties considering contractual provisions within Delaware, the Marshall Islands and Liberia. In addition, those with existing stockholder agreements relating to Delaware, Marshall Islands or Liberian corporations should review their provisions in light of this court decision.

FOOTNOTES

[1] West Palm Beach Firefighters' Pension Fund v. Moelis & Co., C.A. No. 2023-0309-JTL (Del. Ch. Feb. 23, 2024).

[2] 8 *Del. C.* § 141(a).

[3] Moelis, C.A. No. 2023-0309-JTL at 12.

[4] *Id.* at 5.

[5] *Id.*

[6] *Id.* at 9.

[7] *Id.* at 12.

[8] *Id.* at 6.

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