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Delaware Companies with Non-Classified Boards

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The Delaware Court of Chancery, in a transcript ruling in *In re Vaalco Energy Shareholder Litigation* (Dec.21, 2015), held that directors of companies without a classified board (*i.e.*, boards that are elected annually) can be removed *without cause*, irrespective of provisions in the charter or bylaws purporting to permit removal of directors only for cause. Vice Chancellor Laster held that providing for removal of non-classified directors *only for cause* conflicts with a "plain reading" of Section 141(k) of the Delaware General Corporation Law (which provides that, unless the board is classified or the company has cumulative voting for directors, directors may be removed *with or without cause*).

As noted in the ruling, approximately 175 Delaware companies with non-classified boards have charter or bylaw provisions purporting to permit removal of directors only for cause. In most of these cases, the company had declassified the board as the result of recent shareholder efforts favoring declassification—and did not at that time make any change to the director removal provisions. While the result in *Vaalco* is consistent with prior Chancery Court decisions in which the court rejected board refusals to remove non-classified directors without cause, in *Vaalco*, the Vice Chancellor clearly stated his view that these charter or bylaw provisions are *invalid as a matter of Delaware law*—removing any issue as to whether the result could depend on the particular circumstances.

Key Points

- **Invalidity of provisions limiting removal of non-classified directors to cases involving cause.** Non-classified directors can be removed *with or without* cause, notwithstanding charter or bylaw provisions that purport to permit removal only for cause. Companies considering declassification, or planning to go public and determining what corporate governance structure to adopt, should take into consideration that, if the board is not classified, directors will be removable without cause. (Although companies with cumulative voting can provide for for-cause-only removal of non-classified directors, companies typically do not consider the adoption of cumulative voting to be a practical response, as cumulative voting facilitates the ability of a dissident stockholder with a small stake to elect one or more directors.)
- **A charter provision requiring a supermajority stockholder vote for removal of directors should not be invalid under *Vaalco*.** Many companies with non-classified

boards have charter or bylaw provisions that require a supermajority vote by shareholders for the removal of directors. Because DGCL § 141(k) provides for removal of directors by vote of *a majority* of the shares, commentators have suggested that the analysis in *Vaalco* may raise a question about the validity of these supermajority voting provisions. We note that DGCL § 102(b)(4) expressly provides that, with respect to any matter requiring shareholder approval, a higher voting threshold than that set forth in the statute may be included in a charter. Thus, at least with respect to *charter* provisions providing for supermajority shareholder votes, it appears that these provisions would *not* be invalidated. For a company that does not have a classified board or cumulative voting, and has charter and bylaw provisions permitting shareholders to call special meetings or act by consent, a supermajority vote requirement for the removal of directors (at least without cause) would provide a similar type of protection against removal of directors as a classified board would. We note, however, that shareholders and proxy advisory firms generally disfavor supermajority voting requirements for removal of directors.

- **Reminder of the court's inclination to defer to the plain reading of statutes and to reject significant restrictions on the shareholder franchise.** The Vice Chancellor expressly based the decision on "the plain language" of the Delaware statute, reflecting the court's general inclination (which was specifically noted by the court in the decision) not to take into account equitable considerations in the context of statutory interpretation. In addition, the decision is another example of the court's general reluctance to support significant restrictions on shareholder rights relating to the election of directors**.**

Background

In 2009, the Vaalco shareholders voted to declassify the board. Charter and bylaw provisions that permitted removal of directors only for cause (as expressly permitted by DGCL § 141(k) for companies with classified boards) were not changed when the company declassified. In 2015, after Vaalco's stock price had fallen almost 80% over the course of a year, a stockholder group owning 11% of the shares announced, in an initial Schedule 13D filed with the SEC, that they might seek changes in the company's board and management. The following day, the board adopted a number of defensive measures, including a shareholder rights plan. The shareholder group later announced commencement of a shareholder consent solicitation to remove and replace four of the company's seven directors. The company took the position that the consent solicitation could not proceed because the charter and bylaws provided that directors could be removed only for cause. Following the court's decision rejecting that position, Vaalco reached an agreement with the shareholder group pursuant to which certain board members would retire.

Practice Points

- **Effect on a company's defensive position.** Companies should review their defensive position, taking into consideration that, if there is a shareholder effort to remove one or more non-classified directors, under *Vaalco*, the directors would be removable *without cause*, notwithstanding charter or bylaw provisions purporting to limit removal to cases involving cause. It should be noted that shareholders' ability to remove directors without cause may not have a meaningful impact on companies that have a high percentage requirement for the calling of special shareholder meetings or a requirement for a supermajority shareholder vote for removal without cause. In addition, non-classified

directors are subject to annual election in any event, so the impact would be one of timing, with removal of directors possible under all circumstances at the upcoming annual meeting.

- **Companies should consider whether action should be taken, or disclosure made, with respect to:**
    - **Existing director removal provisions**. Companies with charter or bylaw provisions limiting removal of non-classified directors to cases involving cause should consider whether, based on *Vaalco* and relevant factors applicable to the company, (a) no action should be taken or (b) the company should seek to amend the provisions. It remains to be seen whether the plaintiffs' bar will seek to bring actions to force amendment of these provisions. Even if it does, however, a decision to amend is not self-evident and should be considered in the context of the complex tactical factors relating to a company's overall defensive position. Companies also should consider whether there may be circumstances under which a disclosure obligation relating to the provisions could arise.
    - **A shareholder proposal for declassification**. If a shareholder proposal for declassification is included in a company's proxy statement, in connection with describing the effects of declassification, the company should consider what disclosure is required about existing director removal provisions.
    - **Declassification of the board**. If a company determines to declassify, the company should review all of its charter and bylaw provisions (including those relating to removal of directors) to determine which, if any, should be amended at that time in connection with the declassification.
- **Companies may wish to consider including in the charter a supermajority stockholder vote requirement for director removal without cause.** If a company determines to declassify the board, or if a pre-IPO company selects a declassified board structure, the company may wish to consider including a supermajority stockholder vote requirement for director removal—at least for removal without cause. A supermajority vote requirement should be set forth *in the charter* (rather than the bylaws), so that the provision's validity is established under DGCL § 102(b)(4). This action should not be taken without taking into consideration that stockholders and proxy advisory firms generally disfavor supermajority vote requirements for removal of directors.
- **Severability issue relating to director removal provisions.** Companies with existing supermajority vote requirements for removal of directors should review their director removal provisions to determine whether a supermajority vote requirement is *part of* the for-cause requirement—that is, whether *the same* charter or bylaw provision states that removal requires *both* cause and a supermajority vote of shareholders. While the court could regard this type of provision as severable (leaving intact the supermajority vote requirement part of the provision notwithstanding the invalidity of the for-cause-only removal part of the provision), there may be more incentive in the case of this type of a provision for a company to take action to eliminate the for-cause requirement in order to remove any uncertainty as to enforceability of the supermajority vote requirement.
- **Other models for board classification.**
    - **One-class classified board.** A company that does not otherwise want a classified board, but that wishes to retain removal of directors only for cause—without relying only on a supermajority stockholder vote requirement for removal—could consider a classified board structure comprised only of one class instead of the usual three (thus maintaining a "classified board," but holding

annual elections of directors). There is some uncertainty as to whether the court would uphold the validity of a one-class classified board. We note, however, that the Delaware statute expressly provides that a board "may be divided into 1, 2, or 3 classes." Moreover, in *Vaalco*, the Vice Chancellor acknowledged the potential validity of a one-class classified board, although he declined to determine the issue because Vaalco, while asking the court to view it as a one-class classified board, had never taken any formal action to constitute itself as such.

- **Two-class classified board.** A company that does not otherwise want a classified board, but that wishes to retain removal of directors only for cause—without relying only on a supermajority stockholder vote requirement for removal—also could consider a structure with two classes, with a mechanism to ensure either (i) that the class up for election each year includes a majority of the directors or (ii) that the terms of all directors expire if the directors in the class up for election are not elected.
- **Other models.** Finally, companies that wish to retain the primary benefits of the traditional classified structure, while also seeking to address the primary concerns that shareholders have had with classification, may wish to consider other modifications to the classic structure—see the previous Fried Frank M&A Briefing, *A New Approach for Classified Boards: Can the Paradigm Be Changed—To Retain Value-Enhancement While Addressing Director Accountability?*, April 1, 2014 (available here).