Del. Dispatch: How Moelis Upends Stockholder Agreements

By **Gail Weinstein, Philip Richter and Warren de Wied** (March 8, 2024)



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This article is part of a monthly column that delves into the most significant corporate law cases emerging from Delaware and offers practice points arising from recent court decisions. In this installment, we examine the Delaware Court of Chancery's decision in West Palm Beach Firefighters Pension Fund v. Moelis & Co.

In an important decision on Feb. 24, the Court of Chancery upended the standard practice of a corporation entering into a stockholder agreement with key stockholders, such as founders and pre-IPO investors, to provide extensive governance rights.

The court held that many of the rights granted by Moelis & Co. to Ken Moelis, the company's founder, CEO and chairman, violated Delaware General Corporation Law Section 141(a) on the basis that they divested control from the company's board of directors. These provisions, the court held, contravened Section 141(a)'s mandate that the business and affairs of a Delaware corporation be managed by the board, except to the extent otherwise provided in the DGCL or the company's charter.

Delaware corporations with existing stockholder agreements — and, potentially, other types of agreements that grant governance rights — should consider what steps to take in response to the decision, and those about to enter into such agreements should consider providing any governance rights in the company's charter.

Background

Moelis, after years of operating the company, a global boutique investment bank, very successfully as a private entity, decided to raise capital from the public markets. Just before the shares began trading publicly, Moelis and the company entered into the stockholder agreement, which, in a typical arrangement, ensures his control even after his equity ownership falls well below a majority of the outstanding shares.

Immediately after the company's initial public offering, Moelis owned 96.8% of the company's equity. Currently, his equity interest is about 6.5%, with rights to obtain additional shares that would bring it to 11.5%. Through his ownership of some super-voting shares, his voting power is about 40.4%.

The plaintiff-stockholder brought suit claiming that many provisions of the stockholder agreement violate DGCL Section 141(a) and are therefore invalid. Vice Chancellor J. Travis Laster granted the plaintiff summary judgment.

Key Points

The decision upends the common corporate practice of providing governance rights in stockholder agreements.

Under the court's analysis, it appears that many stockholder agreements with Delaware corporations may be invalid to the extent that they provide governance rights to stockholders, such as founders or pre-IPO investors, which arguably divest control from or unduly constrain the exercise of decision making by the company's board.

The court acknowledged that including governance provisions in stockholder agreements has become common practice, but stated that the decision "will not be overly disruptive, particularly when statutorily permissible alternatives exist." The court also emphasized that, in any event, the "seemingly irresistible force of market practice" must yield to "the traditionally immovable object of statutory law."

The court held that numerous provisions in the stockholder agreement violate Section 141(a).

With respect to the pre-approval requirements granted to Moelis, which covered board action under 18 different categories, the court found that, in combination, they prohibit board action in almost every area in which a board may act.

The court stated that, under these requirements, the board cannot take any of the specified actions unless Moelis gives his prior approval — "mak[ing] Moelis the gatekeeper to board action." The court said the result would be no different if the rights had been framed instead as veto rights, and it considered these rights "in combination" and expressly declined to state a view as to whether some lesser set of consent rights might pass muster under Section 141(a).

With respect to the board composition rights and the board committee rights granted to Moelis, the court held to be valid the stockholder's right to designate nominees for a majority of the board seats, as well as the requirements that the board facilitate these nominations and use reasonable best efforts with respect to the nominees' election and continued service on the board.

The court held to be invalid, however, the requirements that the board recommend the election of Moelis' designees, fill any board seat vacancies created by such designees with other Moelis designees, not change the board size, and populate board committees with Moelis designees in the same proportion as his designees on the board.

The court suggested alternative routes to validly providing substantially the same governance rights.

The court stated that the vast majority of the rights could have been provided at the time the company went public by including them in the charter or through issuance to Moelis of a so-called golden preferred share, which is a share of preferred stock that carries governance rights but no equity interest.

Even now, the court said, the company could pursue these routes to replicate the rights, noting that approval of the company's public stockholders for a charter amendment likely would not be obtainable as a practice matter, but that the company could issue a golden preferred share without stockholder approval as it has blank-check preferred stock

authorized.

We would note that the issuance of a golden preferred share, to replicate rights in an existing stockholder agreement that may violate Section 141(a), may raise significant fiduciary duty issues for the board of a private or public corporation — which, depending on the circumstances, if challenged in litigation, may be subject to judicial review under enhanced scrutiny or entire-fairness standards, rather than deferential business judgment review.

In addition, for a public corporation, the issuance of a golden share may raise issues under the voting policies of the exchange on which the company's shares are listed.

The complex issues surrounding a board's fiduciary duties and stock exchange voting rights policies in these circumstances may be manageable.

The decision implicates corporate agreements other than stockholder agreements.

The defendants argued that the DGCL expressly authorizes corporations to enter into contracts, and that, as all contracts inherently restrict board authority — for example, an exclusive supply agreement restricts the board from entering into any other supply agreement — it could not be that Section 141(a) prohibits corporations from entering into governance agreements.

The court determined, however, that the precedential Section 141(a) decisions — while never so stated explicitly — establish that Section 141(a) applies to "internal corporate governance contracts" and not to "external commercial contracts." The stockholder agreement, the court stated, is subject to Section 141(a), as it is clearly "part of an internal governance arrangement."

The court acknowledged what it called a line-drawing issue for agreements that contain both governance and commercial arrangements — including, for example, merger agreements, which, in addition to providing for a merger, restrict the target board's exercise of its fiduciary duties in connection with responding to a superior offer that may emerge.

The guidance the court offered with respect to such line-drawing is that Section 141(a) applies to provisions where "governance rights are the point" but not where "the bargain is the point and the governance rights protect the bargain." The court did not answer whether the fiduciary-out provisions of a merger agreement would be subject to the same analysis as in Moelis, and it expressly left open whether governance provisions in an activist settlement agreement would.

We note a likelihood of difficulty with such line-drawing, given the inclusion of both commercial and governance provisions in many corporate arrangements, as well as the flexibility of financial instruments to blur the lines between equity and debt.

Companies should consider potential steps in response to the decision.

We note that the decision may be appealed, and it is possible the Delaware Legislature will amend the DGCL to provide guidance as to what restrictions on corporate boards are permissible under Section 141(a), as the court requested in Moelis. Furthermore, future decisions in similar cases, several of which already are pending, may provide further guidance. At least pending these developments, litigation challenging existing stockholder agreements is likely.

Parties to stockholder agreements with Delaware corporations should consider whether governance rights provided in the agreements may violate Section 141(a) under the analysis in Moelis, whether to pursue replication of the rights through a charter amendment or golden preferred share, and attendant disclosure issues. Parties putting into place a governance arrangement de novo generally should do so in the corporation's charter or through the issuance of a golden share.

The decision furthers concerns about predictability under Delaware law.

Moelis is one of several recent Court of Chancery decisions that have surprised practitioners by holding that long-standing, common market practices violate Delaware law.

We note the Court of Chancery's Feb. 29 decision in Sjunde AP-Fonden v. Activision Blizzard, for example, issued a few days after Moelis, in which the court held that various mechanics that have been standard practice when negotiating and approving a merger agreement violate multiple sections of the DGCL. This decision, like Moelis, will have a significant impact on current corporate practice and may prompt a legislative response.

Practice Points

Review existing agreements.

Existing agreements between stockholders and a Delaware corporation that grant governance rights should be reviewed for possible noncompliance with Section 141(a) under the analysis set forth in Moelis. Pending further developments, how parties should now proceed will depend on a variety of factors particular to the specific facts and circumstances.

The available responses include the company doing nothing — at least pending further judicial or legislative guidance or pending being sued — or the company or the stockholder seeking to negotiate more limited rights that would comply with Section 141(a) or seeking to engage in discussions about replicating the existing rights in a charter amendment or through the issuance of a golden preferred share.

The alternative routes are more easily available to private corporations than public corporations, as a practical matter.

Alternative Entities, Such as LLCs

As Section 141(a) does not apply to alternative entities, an alternative entity can put into place any agreement it wants to, notwithstanding the Moelis decision.

A Private Corporation About to Go Public

In connection with an IPO, governance rights that go beyond what is permitted under Section 141(a) can be granted to stockholders — subject to IPO considerations — in the charter of the company that will become public or through issuance by that company of a golden preferred share. Consideration also could be given to providing control — instead or in addition — through the issuance of dual-class voting stock.

A Private Corporation (Not About to Go Public) or an Already Public Corporation

In either a private or public corporation context, the company can grant stockholder

governance rights that go beyond what is permitted under Section 141(a), or can validly replicate such rights that are in an existing stockholder agreement, either through an amendment to the company's charter such that the rights are set forth in the charter or through issuance of a golden preferred share carrying the rights.

However, both board and stockholder approval would be required to take either such action — except that stockholder approval would not be required to issue a golden preferred share if the company has blank-check preferred stock authorized. Importantly, board approval would be subject to the directors' fiduciary duties to the other stockholders, which, depending on the circumstances, if challenged in litigation, could be reviewable under enhanced scrutiny or entire fairness standards.

Key Differences Between the Private and Public Corporation Contexts

In the public corporation context, stockholder approval is likely to be very difficult to obtain as a practical matter — at least absent a sweetener to the stockholders.

In the private company context, by contrast, even if some stockholders may want something in exchange for agreeing to a grant or replication of governance rights to another stockholder, there likely will be fewer stockholders to deal with and they may be more inclined to be cooperative in the process than would be the case in a public company context.

As a practical matter, in the public corporation context, there is likely to be a greater risk of litigation challenging a grant or replication of governance rights.

In the public company context, the company will need to consider the voting rights policy of the exchange on which the company's shares are listed.

Boards may want to consider their fiduciary duties when replicating governance rights.

When determining whether to replicate for a stockholder the rights set forth in an existing stockholder agreement that may violate Section 141(a), a board, in satisfying its fiduciary duties to the other stockholders, might validly consider, for example, (1) any contractual obligation it has under a further assurances provision in the existing stockholder agreement, and/or (2) the benefits to the company, even at the current time, of ensuring the stockholder's continued, productive involvement with the company, particularly if, say, there are other contractual arrangements between the company and the stockholder, such as support agreements or agreements granting the company the right to use the stockholder's name only under specified circumstances.

What are other considerations in determining a response to the Moelis decision?

Stockholder's Need for the Rights

We note that a stockholder who has control without the stockholder agreement rights does not need those rights to control. Such a stockholder may therefore agree to the termination of a stockholder agreement or the revision of the agreement to provide more limited rights that would clearly be compliant with Section 141(a). Of course, the stockholder's control then would not be ensured in the future when the other bases for control, such as equity ownership, may no longer be present.

Similarly, a stockholder, whether a controller or not, may determine that the rights that it required and obtained at the IPO, or some other stage, may no longer be necessary, given factors such as the stockholder's current equity ownership and/or its relations with the board having been friendly.

Rights Already in the Charter

If any of the stockholder agreement rights are already also set forth in the charter, those rights may be sufficient such that the stockholder would agree to terminate the stockholder agreement. The disadvantage of the rights being only in the charter is that any amendments in the future would be subject to the approval of the stockholders, which may be difficult to obtain.

Specific Language in the Agreement

To the extent that rights in an existing agreement are expressly subject to the board's fiduciary duties — or, potentially, otherwise subject to the board's exercise of discretion and judgment — those rights may not violate Section 141(a).

Consider any ramifications for the company's disclosure.

To the extent that the agreement has been disclosed, depending on the circumstances, consideration should be given, for example, to disclosing that the agreement is being reviewed to determine compliance with Section 141(a), that the company is considering what actions to take in light of the Moelis decision, or that the company has determined to take certain action with respect to the agreement.

In any event, a board should establish a record, for example, through board minutes, reflecting that the board is considering what actions, if any, to take in light of the Moelis decision or what action that board has determined to take.

Consider any line-drawing issues.

Parties to merger agreements and activist settlement agreements, and other corporate arrangements under which governance rights are granted, must keep in mind the line-drawing issues presented under Moelis, and consider the possible applicability of Section 141(a) to provisions in the agreement.

Parties entering into such agreements should consider providing supplemental language to relevant provisions — such as, in a merger agreement, provisions that limit the target directors' discretion in fulfilling their fiduciary duties to terminate the agreement to accept a superior offer — in an effort to clarify that the parties' intention is not primarily governance-related but primarily to protect the commercial arrangement.

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