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BLOG

Delaware Passes Controversial Amendments to the Delaware General Corporation Law

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OVERVIEW

An amendment to the Delaware General Corporation Law (the DGCL) in response to a recent court decision could significantly affect the traditional reservation of corporate governance powers for boards of directors under Section 141(a) of the DGCL.

On February 23, 2024, the Delaware Court of Chancery issued an opinion in *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.* (*Moelis*), which challenged the validity of provisions in a stockholders agreement that (1) required the prior written consent of the company's founder and majority stockholder (the Founder-Stockholder) in order for the company's board of directors (the Board) to take a range of actions, (2) allowed the Founder-Stockholder to select a majority of the Board's members, and (3) required that Board committees be comprised of a number of the Founder-Stockholder's designees proportionate to the overall composition of the company's Board. Plaintiff challenged the agreement under Section 141(a) of the DGCL on the grounds that it comprised an internal governance arrangement that purported to confer rights and obligations that (a) were not provided for in the company's certificate of incorporation and (b) improperly prevented the company's Board from carrying out its duties under Section 141(a).

Section 141(a) of the DGCL provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." The cornerstone of Delaware's board-centric governance system, Section 141(a) reserves to a Board the right to manage the company. In exercising that authority, directors owe fiduciary duties of care and loyalty to the corporation and its stockholders.

In an unexpected decision, the Delaware Court of Chancery found that certain provisions in the *Moelis* agreement violated Section 141(a) by delegating management rights traditionally held by corporate boards to the Founder-Stockholder, thus depriving the company's Board of a significant portion of the authority bestowed to it by the statute. Specifically, the court found that the agreement was facially invalid under Section 141(a) because it effectively precluded directors from exercising their best judgment and imposed substantive (as opposed to procedural) limitations on their discretion over management decisions.

The *Moelis* decision spawned immediate backlash, including criticism from those who have long believed that Delaware corporations should be free to enter contractual governance arrangements with their stockholders. Perhaps the most prominent criticism was that *Moelis* contradicted a longstanding (and theretofore generally accepted) corporate practice and thus "called into question … market practice, creating confusion and uncertainty for untold numbers of Delaware corporations and their executives, employees, investors and advisers."

AMENDMENTS TO THE DGCL

On March 28, 2024, about five weeks after the *Moelis* decision was published, the Council of the Corporation Law Section of the Delaware State Bar Association (DSBA) released proposed amendments to the DGCL that directly addressed the *Moelis* decision. The amendments added a new subsection (18) to Section 122 of the DGCL ("Specific powers") providing that, notwithstanding Section 141(a) of the DGCL, and whether or not provided for in a corporation's charter, a corporation may enter into contracts with current or prospective stockholders that delegate to stockholders those governance rights addressed in *Moelis*, including but not limited to consent rights (and thus veto rights) on corporate actions and management decisions.

The amendments were approved by a special committee within the DSBA 11 days later, on April 8, 2024, and then introduced to the Delaware General Assembly as Delaware Senate Bill 313 (S.B. 313) on May 23, 2024. The Assembly passed S.B. 313 on June 20, 2024, and the bill was signed into law by Governor Carney on July 17, 2024. The amendments to the DGCL will be effective on August 1, 2024.

RESPONSE TO THE AMENDMENTS

In his opinion in *Moelis*, Vice Chancellor Laster acknowledged that legislative intervention may be appropriate, noting that "[t]he expansive use of stockholder agreements suggests that greater statutory guidance may be beneficial." Proponents of S.B. 313 point to the court's invitation and say that the amendments will properly allow boards greater flexibility to achieve their goals without limiting directors' fiduciary duties or stockholders' ability to pursue claims for fiduciary breaches, which, in turn, is sufficient to curtail abuse.

Critics, on the other hand, believe that S.B. 313 was rushed and is likely to harm both stockholders and companies because it "provides bright-line authorization" to enter into the very stockholder agreements that, per the court's *Moelis* decision, would otherwise violate Delaware statutory law. Those critics point out that the new law both nullifies the *Moelis* decision before the Delaware Supreme Court has the opportunity to adjudicate the holding and effectively undercuts Section 141(a) by preemptively blessing the delegation of governance rights while imposing no meaningful restrictions. In one of many LinkedIn posts on the topic, Vice Chancellor Laster (posting in his personal capacity) posted his criticism of Section 122(18): "instead of a small renovation project tailored to the need to allow contract based vetoes in discrete areas, Section 122(18) blows up the edifice that was Section 141(a)."

In a letter to the Delaware State Bar Association, the Council of Institutional Investors (CII) wrote, "[t]he need for a more deliberative approach in this case is underscored by the fact that the proposed legislation appears to contain no limit in terms of how far a stockholder agreement can go in changing a company's corporate governance." Similarly, in a post for the Harvard Law School Forum on Corporate Governance, Professors Marcel Kahan and Edward Rock of New York University School of Law expressed concern that the amendments will undermine Section 141(a), described as the "heart of Delaware's 'board centric' governance system[,]" by "introduce[ing] a fundamental change into Delaware law without adequate examination."

Finally, a letter signed by corporate law professors at law schools across the country urged the Delaware Legislature to forgo S.B. 313 in favor of allowing the Delaware Supreme Court to review the *Moelis* decision, calling the amendments "hasty legislative action." The CII suggests that the "legislative rush" threatens "Delaware's preeminence in corporate law," which is "dependent on the law being almost entirely 'judge-made.'"

While S.B. 313 faced no objection in the Delaware Senate, it passed subject to some criticism in the House on June 20, 2024, with some representatives echoing the concerns of academics, including that S.B. 313 will threaten Delaware's dominance in corporate law and that the Delaware General Assembly is acting too quickly while the *Moelis* case is still pending and subject to appeal.

AN ALTERNATIVE PATHWAY

Had S.B. 313 not been enacted, a recent development in Delaware case law provided a possible alternative path around the obstacles posed by *Moelis*.

In *Wagner v. BRP Group*, decided on May 28, 2024, Vice Chancellor Laster addressed claims challenging a stockholder agreement that, like the *Moelis* agreement, required a particular stockholder's written approval before the Board could take action on specific internal matters. The challenged provisions required the stockholder's written approval before:

(1) making "any significant decision regarding any senior official" (the Officer Pre-Approval Requirement); (2) amending the certificate of incorporation (the Certificate Amendments Pre-Approval Requirement); and (3) entering into significant transactions (the Transaction Pre-Approval Requirement). Each provision was challenged under Section 141(a) on the same grounds asserted in *Moelis*—the rights and powers conferred in the agreement were not provided for in the company's charter and prevented the company's Board from carrying out its mandate under Section 141(a). The Officer Pre-Approval Requirement was also challenged under Section 142 (governing officers), and the Certificate Amendments Pre-Approval Requirement was also challenged under Section 242 (governing charter amendments).

While the court held that the Officer Pre-Approval Requirement and the Certificate Amendments Pre-Approval Requirement were facially invalid under Sections 142 and 242, respectively, it departed from *Moelis* in finding each provision valid under Section 141(a). The key differentiating factor in *BRP* was that, following the filing of the lawsuit, the stockholder and the company entered into a Consent and Defense Agreement (the Consent Agreement) that placed guardrails around the stockholder's consent rights. Specifically, with respect to the matters subject to the consent right, the Consent Agreement obligated the stockholder to grant consent if the matter was unanimously approved in good faith by a newly formed committee comprised of each independent director of the board.

The court found that this arrangement – which is all that distinguishes *Wagner* from *Moelis* – sufficiently freed the board to act in accordance with Section 141(a).

RECOMMENDATIONS

Beginning August 1, 2024, Delaware companies will be entitled by statute to enter into agreements vesting governance rights traditionally reserved to corporate boards in stockholders or "potential stockholders" without amending their charters. Time will tell whether the new law effects any significant change on corporate governance or litigation practices or, instead, maintains a practice that has long been the status quo. Either way, stockholders are likely to test the limits of new Section 122(18) given the broad nature of the language. Companies should prepare for this, including the increase in bylaw proposals that would have ordinarily violated Section 141(a) of the DGCL. See here for our previous post about one such bylaw proposal.

Additionally, given the scope of authority conferred by these types of stockholder agreements, boards that are contemplating them should consider – at least until the law becomes effective and perhaps going forward – some form of limitation along the lines of the consent agreement in *Wagner*, which would serve as a check on otherwise unrestricted authority over corporate management functions.

We will continue to monitor the impacts of Section 122(18) on corporate governance issues.

8 Min Read

Authors

Matthew DiRisio

James P. Smith III

Oriana Pietrangelo

Dominique S. Fry

Delilah Efimov

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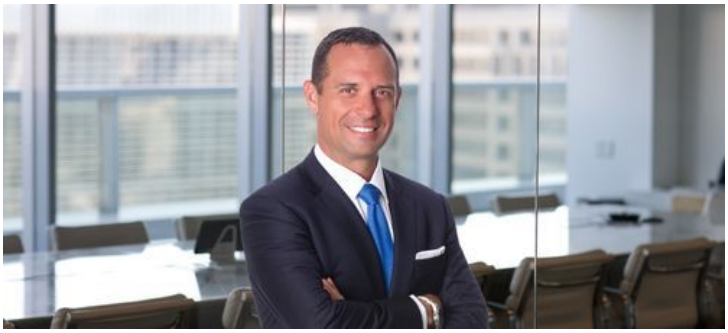

James P. Smith III

Oriana Pietrangelo

Dominique S. Fry

Delilah Efimov

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