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Delaware Court of Chancery Invalidates Consent Rights and Certain Designation-Related Rights in a Stockholder Agreement

The decision raises questions as to the validity of certain stockholder consent and designation-related rights found in many public and private company stockholder agreements.

On February 23, 2024, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery issued a long-awaited opinion[1] ruling on the validity of pre-approval requirements and board- and committee-related designation rights included in the stockholder agreement between a public company and its founder that was entered into before the company went public.

The decision calls into question the enforceability of certain stockholder consent and designation-related rights that have long been considered market-standard and are found in many stockholder agreements for both public and private companies. This alert summarizes the provisions that were challenged in the case and the Court's decision. The decision left many questions unanswered, and we encourage you to reach out to any of your Gibson Dunn contacts to discuss the implications of this decision and any next steps.

I. Challenged Provisions

The challenged provisions in the case fall into two primary categories: (i) pre-approval requirements (commonly referred to as "consent" or "veto" rights[2]) and (ii) board and committee composition provisions (so-called "designation" provisions). The plaintiff challenged the facial validity of these provisions in the company's stockholder agreement on the basis that they violate Section 141(a) of the Delaware General Corporation Law (DGCL), which provides that "the business and affairs of every corporation organized … [in Delaware] shall be managed by or under the direction of a board of directors, except as may be otherwise provided … [under the DGCL] or in its certificate of incorporation." The plaintiff also argued that the committee composition-related rights further violate Section 141(c) of the DGCL, which provides that company boards are tasked with forming committees.[3] Specifically, the plaintiff challenged[4] the following provisions (the Challenged Provisions) in the company's stockholder agreement that give the founder certain rights for as long as a specified condition[5] is satisfied:

- Pre-Approval Requirements: Require the founder's[6] advance approval of 18 different categories of actions that encompass, in the words of the Court, "virtually everything the [b]oard can do."[7]

- Board Composition Provisions: Include six provisions that give the founder the right to determine the size of the company's board and select a majority of the directors who serve on it.

    - *Size Requirement*: The company's board is obligated to maintain its size at no more than 11 seats.

  - *Designation Right*: The founder is entitled to name a number of designees equal to a majority of those seats.
  - *Nomination Requirement*: The company's board must nominate the founder's designees as candidates for election.
  - *Recommendation Requirement*: The company's board must recommend that stockholders vote in favor of the founder's designees.
  - *Efforts Requirement*: The company must use reasonable efforts to enable the founder's designees to be elected and continue to serve.
  - *Vacancy Requirement*: The company's board must fill any vacancy in a seat occupied by a founder designee with a new founder designee.

- Committee Composition Provision: Requires the company's board to populate any committee with a number of founder designees proportionate to the number of founder designees on the full board.

II. Decision

The Court first determined that Section 141 of the DGCL applies because the company's stockholder agreement was an "internal corporate governance arrangement." The Court stated that "[i]nternal corporate governance arrangements that do not appear in the charter and deprive boards of a significant portion of their authority contravene Section 141(a)."[8] The Court emphasized that "Section 141(a) is the source of Delaware's board-centric model of corporate governance,"[9] and that "[t]he presence of a stockholder who controls the corporation does not alter the board-centric framework."[10] Further, the Court was unsympathetic to arguments that the arrangements reflect widely accepted "market practice," noting that "[w]hen market practice meets a statute, the statute prevails."[11]

The Court then held that the Pre-Approval Requirements, as well as three of the six Board Composition Provisions (the Recommendation Requirement, the Vacancy Requirement and the Size Requirement), all violate Section 141(a) of the DGCL. In the Court's view:

- The Recommendation Requirement: improperly compels the company's board to recommend the founder's designees for election.
- The Vacancy Requirement: improperly compels the company's board to fill a vacancy created by a departing founder designee with another founder designee.
- The Size Requirement: improperly enables the founder to prevent the Board from increasing the number of board seats beyond 11.[12]

The Court also determined that the Committee Composition Provision violates both Section 141(a) and Section 141(c) of the DGCL because "[d]etermining the composition of committees falls within the [b]oard's authority" and cannot be determined by stockholders.[13]

The Court upheld the Designation Right, the Nomination Requirement and the Efforts Requirement noting that these provisions simply allowed the founder to identify director candidates, aligned with his stockholder right to nominate candidates, and provided for the facilitation of certain processes without binding the board to any particular course of action.[14] The Court noted that challenges could, however, be brought to these provisions as applied.

III. Next Steps

Both public and private companies should keep their boards abreast of these developments, particularly if they are subject to stockholder agreements that may need to be reviewed or revisited in light of the Court's decision. Equally, stockholders relying on similar provisions in stockholder agreements as the founder in this case should consider implementing alternative strategies before such protections are challenged. Gibson Dunn is here to help.

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[1] See *West Palm Beach Firefighters' Pension Fund* v. *Moelis & Company*, case number 2023-0309, in the Court of Chancery of the State of Delaware (the "Opinion").

[2] Although one could argue that "consent" and "veto" rights may imply a different sequence of events, the Delaware Court of Chancery deemed the distinction to be meaningless.

[3] Specifically, Section 141(c)(2) of the DGCL provides that "[t]he board of directors may designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation. The board may designate 1 or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee."

[4] In addition to the company's arguments on the merits, the company sought summary judgment on both laches (contending that the plaintiff waited too long to sue) and ripeness (contending that the plaintiff sued too early). The Delaware Court of Chancery issued a separate decision rejecting those defenses. *W. Palm Beach Firefighters Pension Fund* v. *Moelis & Co.* (Timing Decision), 2024 WL 550750 (Del. Ch. Feb. 12, 2024).

[5] Under the company's stockholder agreement, the specified condition was deemed to be satisfied for so long as the founder (i) maintains direct or indirect ownership of an aggregate of at least 4,458,445 shares of Class A shares and equivalent Class A shares … ; (ii) maintains directly or indirectly beneficial ownership of at least five percent (5%) of the issued and outstanding Class A shares … ; (iii) has not been convicted of a criminal violation of a material U.S. federal or state securities law that constitutes a felony or a felony involving moral turpitude; (iv) is not deceased; and (v) has not had his employment agreement terminated in accordance with its terms because of a breach of his covenant to devote his primary business time and effort to the business and affairs of the company and its subsidiaries or because he suffered an "incapacity" (as defined in the company's stockholder agreement). In addition, the founder is entitled to fewer rights once the ownership threshold falls below a certain level. However, the Court did not address those provisions as they are not currently in effect.

[6] Technically, the company's stockholder agreement granted rights to an entity owned by the founder but because the founder controls such entity, the Court determined that he controls how the rights are exercised as well.

[7] Opinion at 4.

[8] Opinion at 2.

[9] Opinion at 1.

[10] Opinion at 2.

[11] Opinion at 132.

[12] Opinion at 11.

[13] *Id*.

[14] Opinion at 12.

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Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, the authors, or any leader or member of the firm's Capital Markets, Emerging Companies, Mergers and Acquisitions, Private Equity, Securities Litigation or Securities Regulation and Corporate Governance practice groups:

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