West Palm Beach Firefighters' Pension Fund v. Moelis & Co.: An Affirmation of Statutory Board Authority

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The Delaware Court of Chancery decided two cases recently that may have a significant impact on future corporate action, in each stressing the need for corporate actors to follow statutory requirements, even when in potential tension with market practice. In a decision that may cause controlled companies to revisit existing stockholders agreements, the Delaware Court of Chancery in *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.* found certain terms in Moelis & Co.'s stockholders agreement with its founder to be facially invalid. The Court acknowledged that it is common for private equity sponsors and other controlling stockholders to enter into agreements allowing holders to retain governance rights and exercise veto rights over certain corporate actions following an initial public offering but held that "[w]hen market practice meets a statute, the statute prevails. Market participants must conform their conduct to legal requirements, not the other way around."

In connection with the company's initial public offering in 2014, the company entered into a stockholder's agreement with Ken Moelis. Among other things, the stockholders' agreement granted certain rights to Mr. Moelis that the plaintiffs alleged were unenforceable under the Delaware General Corporation Law ("DGCL"), including (A) pre-approval requirements, which the Court highlighted required the company to obtain Mr. Moelis' consent "before taking eighteen different categories of actions", (B) board composition provisions, which granted to Mr. Moelis the right to designate a majority of the directors on the company board, and (C) committee composition requirements, which provided that each committee of the board would be majority comprised of Mr. Moelis' designees.

In its 131-page decision, the Court agreed with the plaintiffs' contention that the above mentioned provisions of the stockholders' agreement deprived the company's board of directors of a significant portion of its authority, in contravention of Section 141(a) of the DGCL, which provides, in relevant part, that "the business and affairs of every corporation organized . . . [in Delaware] shall be managed by or under the direction of a board of directors." Unlike external commercial contracts, the stockholders' agreement at issue and other internal corporate governance arrangements "that do not appear in the charter and deprive boards of a significant portion of their authority contravene Section 141(a)."

Based in part on prior Delaware decisions, the Court employed a two-part test.

First, the Court must determine whether the challenged provision is part of an external commercial agreement or one that seeks "to govern the corporation's internal affairs". If the former, a challenge based on a violation of Section 141(a) will likely be unsuccessful.

Second, if the provision involves an "internal governance arrangement," the Courts will apply the test espoused in *Abercrombie v. Davies*, which requires the Court to find that the governance restrictions at issue violate of DGCL Section 141(a) if such restrictions "have the effect of removing from the 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."

As to the first prong of the analysis, the Court identified a number of factors to distinguish between external commercial contracts and internal governance arrangements, including whether the agreement:

(i) has a statutory grounding in the DGCL (here, the Court noted that stockholders agreements specifically are grounded in DGCL Section 218);

(ii) is agreed to by intra-corporate actors (here, the Court highlighted that the only parties to the relevant agreement are the company, Mr. Moelis and certain other stockholders he controls);

(iii) seeks to specify how intra-corporate actors exercise corporate power, (here, the court noted the stockholders' agreement in question, prohibits actions that a director on the board could otherwise take and restricts voting in a particular way);

(iv) reflects "an underlying commercial exchange" or has a "commercial purpose" beyond mere governance rights (here, the Court distinguished supply agreements, credit agreements and other commercial arrangements from the stockholders agreement in question);

(v) provides for a remedy of damages tied to a commercial bargain, rather than an injunctive remedy enforcing governance rights; and

(vi) has an indefinite duration and/or cannot be readily terminated by the company.

After determining the stockholders agreement was clearly an internal governance arrangement, the Court reviewed the pre-approval requirements and held that the requirements force the board to obtain prior consent from Mr. Moelis "before taking virtually any meaningful action" and with such requirements in place, the board "is not really a board." The Court was not swayed by the defendants arguments that the restrictions at issue granted to Mr. Moelis only veto rights to block certain matters and not rights to approve actions.

As to the board and committee composition provisions, the Court found that certain aspects were also invalid, including, among others, the restrictions on board size and the obligation on the board to recommend candidates designated by Mr. Moelis without restriction. The Court noted that designation and

nomination rights, on the other hand, are not facially invalid restrictions under DGCL Section 141.

While not expressly endorsing other alternatives, the board discussed other structuring options that may have been less problematic, including incorporating the restrictive provisions into the company's certificate of incorporation or issuing to Mr. Moelis preferred stock carrying specific rights.

Looking forward, both public and private companies should consider this decision when evaluating existing and prospective agreements that may encroach on board action and determine whether such provisions of agreements should be incorporated into the company's certificate of incorporation.