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Delaware Chancery Court Invalidates Moelis Shareholder Agreement

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On February 23, 2024, a decision by Vice Chancellor J. Travis Laster in the Delaware Chancery Court invalidated parts of a shareholder agreement between Moelis & Company and its Chairman, Chief Executive Officer and founder, Ken Moelis ("Moelis"). The Court found that certain pre-approval rights, board composition requirements and board committee requirements in favor of Moelis and his controlled entities violated, and therefore were facially invalid under, Section 141 of the Delaware General Corporation Law (the "DGCL") because those requirements foreclosed the directors from managing the company in accordance with the statutory requirements of the DGCL.

Section 141(a) of the DGCL states that "the 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 Court found that the all-encompassing nature of Moelis' rights under the shareholder agreement impermissibly disempowered the board of directors and therefore violated the statute. We think that while the pre-approval rights and board and committee composition requirements Moelis had in place in the shareholder agreement were comprehensive, this decision could affect the ways companies, their insiders, and their investors think about and document shareholder rights.

Shareholder Rights

The rights that Moelis enjoyed under the shareholder agreement at issue are similar to what venture capital investors negotiate for in preferred stock financings. Preferred shareholders often negotiate for special voting rights, so-called "protective provisions" (i.e., corporate actions which require a subset of shareholder, often preferred shareholder, consent in order to be valid corporate acts), director designation rights, and preemptive rights (the right to participate in future financing rounds). The Court in the Moelis case found that the types of rights granted to Moelis in the shareholder agreement were overly broad to the effect of impeding the proper functioning of the board and, in the Court's words, "render[ing] the Board an advisory body." Therefore, those provisions of the shareholder agreement, discussed in detail below, were found to be facially invalid.

The Legal Test—*Abercrombie*

To understand the Court's decision, it is helpful to understand the legal test the Court applied. The opinion discussed a number of precedent cases, but the decision in *Abercrombie v. Davies*[1] from 1956 contains the basic two-part test.

Part one asks whether an agreement implicates the "internal governance" of a Delaware corporation. If the answer to that question is yes (and the answer will depend on the facts and circumstances of the case, as there is no bright line rule), then the Court must decide whether the functioning of the board of directors is improperly restricted. Here, in the Moelis case, the answer was yes, as the agreement in contention explicitly dealt with internal company governance. Further the Court in the Moelis case, quoting *Abercrombie*, explained that the Court must assess whether the provisions of the agreement at issue 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." After a lengthy discussion, the Court found that the Moelis shareholder agreement deprived the board of directors of a significant part of their authority to act as a board and manage the company with independent judgement, as required under DGCL Section 141(a).

Moelis' Rights Under the Shareholder Agreement and the Court's Legal Rationale

At the center of this case were 18 "Pre-Approval Requirements", a "Board Composition Requirement", and a "Committee Composition Provision." The Pre-Approval Requirements required Moelis' prior consent (as long as certain ownership thresholds were maintained) for the board of directors of the company to approve: (1) the incurrence of certain indebtedness, (2) the issuance of equity securities above a pre-determined ceiling, (3) the issuance of preferred stock, (4) certain investments over a pre-determined size, (5) entering into new lines of business, (6) adoption of a shareholder rights plan (i.e., a "poison pill"), (7) the removal or appointment of any officers subject to Section 16 of the Securities Exchange Act of 1934, (8) amendments to the certificate of incorporation or bylaws, (9) amendments to a partnership agreement, (10) any changes to the company's name, (11) the adoption of the annual budget, business plan or amendments thereto, (12) the payment of any dividends (subject to limited exceptions), (13) any merger agreement, sale of substantially all of the company's assets or any similar transaction, (14) the initiation of a bankruptcy event, (15) the entry into any material amendment of material contracts, (16) entering into a transaction that would be required to be disclosed under Regulation S-K of the Exchange Act, (17) the initiation or settlement of any material lawsuit, or (18) changes to the company's taxable year or fiscal year. Taken together (the Court did not opine as to whether any individual or subset of the Pre-Approval Requirements would have been valid, but considered them as a whole), the Court found that the Pre-Approval Requirements encompassed, in the Court's words "virtually everything the board can do" and that Moelis' consent was required before the board could take "virtually any meaningful action." As a result, the Pre-Approval Requirements were invalid under Section 141(a) of the DGCL.

The Board Composition Requirement included six provisions that gave Moelis the right to determine the size of the board of directors and select a majority of the directors. These six provisions: (1) required the size of the board to be set at no greater than 11 directors (the "Size Requirement"), (2) entitled Moelis to fill a majority of the seats (the "Designation Right"), (3) required the board to nominate Moelis' designees as candidates for election (the "Nomination Requirement"), (4) required the board to recommend that the shareholders vote in favor of Moelis' designees (the "Recommendation Requirement"), (5) required the company to use reasonable efforts to allow for the election of Moelis' designees (the "Efforts Requirement"), and (6) required the board to fill any vacancy in a seat occupied by a Moelis designee to be filled with a new Moelis designee (the "Vacancy Requirement"). The Court found that three of the six Board Composition Requirements (the Recommendation Requirement, the Vacancy Requirement, and the Size Requirement) were facially invalid under DGCL Section 141 because they improperly compelled the board to take action and improperly enabled Moelis to prevent the board from increasing its size. The Court determined that the remaining three requirements (the Designation

Right, the Nomination Requirement and the Efforts Requirement) are legitimate shareholder rights, and therefore were not facially invalid under DGCL Section 141, noting that they did not improperly bind the board to any particular course of action.

Finally, the Committee Composition Provision required the board of directors to populate any committee of the board with a number of Moelis' board designees proportionate to the number of Moelis designees on the full board. The Court ruled that this provision was also facially invalid under DGCL Section 141(c) because the requirement took away from the board its proper authority to determine the composition of committees.

Implications of the Moelis Case; Practice Pointers and Next Steps

The Moelis decision will require management, shareholders, and boards of directors to think about how shareholder rights are documented and the limitations of shareholder agreements. Investors in private companies will note that similar rights are often given to preferred shareholders. This decision does not invalidate all shareholder rights. Agreements between or among shareholders (e.g., an agreement among the shareholders to vote a certain way in connection with a merger or other major transaction, or for certain board designees) normally do not implicate internal corporate governance. From the Court's opinion in the Moelis case, "the DGCL…expressly authorizes stockholders to enter into agreements about how they will exercise their voting rights." It remains to be seen whether venture capital-style shareholder agreements will come under challenge because of this decision.

In the private company context, preferred stock protective provisions are most often included in a corporation's certificate of incorporation, or charter, and the Court's decision does not invalidate those provisions. In fact, the Court noted that most of the invalidated governance provisions from the Moelis shareholder agreement would have been permissible if they were contained in the company's charter, rather than a shareholder agreement. The rationale here is that the rights of the board at issue in this case derive from and are subject to the DGCL, plus any provisions of a company's charter document (such as a certificate of incorporation or certificate of designations). The company could have issued Moelis a "golden share" in its charter, which could have given Moelis similar voting and control rights. The Court's decision underscores that building in specific protective provisions in the charter, which most often give a class or series of stock special voting rights, is a stronger protection for shareholders than documenting the same rights in, and relying upon contractual rights in, a shareholder agreement.

Some investors may want to make cross-references to, and incorporate by reference, shareholder agreements in a company's charter. The Court does not go into detail as to whether incorporation by reference would have saved the Moelis shareholder agreement. If cross-references are utilized, references in the charter should be specifically tailored and include future amendments to those shareholder agreements. Parties should also analyze whether stakeholders are creating fiduciary duties for controlling shareholders if they receive management-level rights, which can place similar duties of loyalty or care onto such shareholders as if they were board members. In addition, shareholder agreements incorporated by reference may be subject to information rights claims by the company's shareholders under DGCL Section 220, which may require the company to provide shareholders with copies of any referenced shareholder agreements in the charter. While incorporating a shareholder agreement into the charter may give it more strength from a statutory position, it may be the case that the parties to a shareholder agreement would not want certain of the company's shareholders to have access to these agreements. This might make incorporation by reference into the charter less desirable.

In the shareholder activism context, the Moelis decision will impact settlement agreements, which are often referred to as "cooperation agreements." Specifically, the decision will impact provisions relating to limitations on the size of the board, the right of the activist to replace directors if its appointed directors resign, and a company's ability to recommend in favor of activist appointed directors.

There are other variables at play in this case and only time will tell as to the extent of its impact. For instance, we do not yet know if Moelis will appeal this case, and if so, the outcome. In addition, other cases in the Court's pipeline touch on similar issues, and may expand on the Moelis decision. The Court found Moelis' rights in the shareholder agreement to be so overly broad as to render the board of directors a mere advisory body, and hence the offending rights were impermissible under the DGCL. This decision was, and others like it will be, heavily dependent on the facts and circumstances of a particular case. Most private companies that raise outside money will not have the level of founder control found in the Moelis case, and even fewer will memorialize those rights in a shareholder agreement. Finally, it's important to note that this case dealt with DGCL Section 141 specifically, and therefore should not be read to drastically impact the governance regimes of limited liability companies or partnerships governed by Delaware law. However, this case and its aftermath will impact how companies, shareholders, and practitioners will think about corporate governance for Delaware corporations.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] *Abercrombie v. Davies*, 123 A.2d 893, 899 (Del. Ch. 1956), *rev'd on other grounds,* 130 A.2d 338 (Del. 1957)

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