PHYSICS 101 MEETS DELAWARE CORPORATE LAW:

Irresistible Market Force vs. Immovable Object!

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Legislative backlash to a February 23, 2024, Delaware Court of Chancery decision that invalidated provisions of a stockholder agreement may have far-reaching consequences for corporations – and their lawyers – throughout the United States.

In the controversial opinion, West Palm Beach Firefighters' Pension Fund v. Moelis & Co., the Court of Chancery struck down parts of a stockholder agreement that heavily constrained the authority of the company's board of directors.[1] Critics of the decision contend that it flies in the face of long-established market practice, which permits corporations to contractually bind themselves via internal governance arrangements. In response to the outcry, the Delaware legislature enacted several consequential amendments to the Delaware General Corporation Law (the "DGCL") that authorize Delaware corporations to enter into agreements – without a charter amendment – granting governance rights typically handled directly by corporate boards and stockholders. These amendments were signed into law on July 17, 2024, and became effective on August 11, 2024. Because Delaware holds an influential position at the forefront of U.S. corporate law developments, businesspeople and legal practitioners across the country should stay alert to the possibility that other states will follow suit.

THE *MOELIS* CASE: IMMOVABLE OBJECT VERSUS IRRESISTIBLE FORCE

The global investment bank Moelis & Company (the "Company") and its founder, CEO, and Chairman, Ken Moelis, lie at the center of the case. One day before taking the company public, Moelis, three affiliated entities, and the Company entered into a stockholder agreement that granted "expansive rights" to Moelis. These rights included 18 "pre-approval requirements," which, taken as a whole, meant that the Company's board of directors could take effectively no action unless Moelis approved it himself. For example, without approval from Moelis, the board was prohibited from incurring debt in excess of $20 million, issuing any preferred stock, entering into a new line of business that required an investment of $20 million or more, appointing or removing certain Company officers, adopting the Company budget, or entering into a material contract (the "Pre-Approval Requirements").

In addition to the Pre-Approval Requirements, the stockholder agreement allowed Moelis to select a majority of the directors and prevented the board from adding more than 11 seats on the board. The stockholder agreement required the board to recommend that stockholders vote for the candidates Moelis nominated to run for board positions. Finally, the board was required to ensure that any committee was filled by a certain proportion of Moelis' designees. At the time of the lawsuit, Moelis owned less than a majority of the Company's outstanding voting power but was nonetheless able to exert significant control over the board of directors and the Company as a whole.

The plaintiff, another shareholder, argued that the stockholder agreement was an internal governance arrangement that violated DGCL § 141(a) and (c). Section 141(a) is a cornerstone of Delaware corporate law that requires every corporation to be managed by a board of directors. Section 141(c) allows the board to create committees and select committee members.

The plaintiff contended that the Pre-Approval Requirements and the other challenged provisions impermissibly limited the authority granted to the board by the statute. In defense of the stockholder agreement, the Company claimed that it had broad freedom to contract and that the challenged agreement was no different than an exclusive supply contract, which would also constrain the authority of a corporate board.

The Court was skeptical of the Company's arguments, writing that the challenged provisions of the stockholder agreement resembled "something a law professor dreamed up for students to use as a prototypical Section 141(a) violation."[2] Further, the Court distinguished contracts that bind the Company, like an exclusive supply contract, from contracts that are designed to bind the board itself.

The Court applied the "Abercrombie Test," from the landmark case of *Abercrombie v. Davies*, which states that governance restrictions violate DGCL § 141(a) when they prevent directors from using their best judgment to manage the corporation or substantially limit directors' freedom to make decisions about management policy.[3]

The Court also seriously considered the fact that internal governance arrangements are common market practice, framing the conflict at the heart of the case as one between the "traditionally immovable statutory object," Section 141(a), and a "seemingly irresistible force of market practice."[4] Ultimately, the Court wrote that although Delaware law "favors private ordering" and freedom of contract principles, the statute took precedence over market practice. As a result, the Court invalidated the Company's stockholder agreement.

A MODERNIZING SAVE OR RUSHED REACTION?

The *Moelis* decision generated significant pushback from businesspeople and practitioners who argued that Delaware corporate law should reflect prevailing market practice, not rely on rigid statutory construction. In the aftermath of the *Moelis* ruling, the Delaware State Bar Association drafted amendments to the DGCL to bring the law in line with market practice. The proposed amendments were quickly submitted to the Delaware Legislature, despite mounting criticism from supporters of Section 141(a) in its longstanding form. Significantly, Chancellor Kathaleen McCormick also waded into the debate, writing in *a private letter to the Delaware State Bar Association* that the expedited process of drafting the proposed amendments was "flawed."[5] She also called the proposal "the broadest set of substantive amendments since the 1960s" and cautioned that, although market practice is an important consideration, it is not the only or most important one. Instead, Chancellor McCormick suggested the most important consideration should be "whether the market is operating in a manner that is good for corporate law."[6]

Fifty law professors also submitted *a letter to the Harvard Law School Forum on Corporate Governance*, writing that the amendments were premature and that the proper course of action would be to allow the appellate process to proceed within the Delaware courts. More specifically, the academics argued that the courts should be trusted to weigh the "complex interplay between Delaware's commitment to contractual freedom and its equal commitment to protecting shareholders through an empowered and accountable board of directors."[7] They also wrote that the amendments went too far and "would allow corporate boards to unilaterally contract away their powers without any shareholder input."[8] The letter also argued that the stockholder agreement in *Moelis* was not as typical as the Company claimed. *A second letter from two other corporate law professors* went further, warning that "Delaware is on the verge of gutting DGCL § 141(a)'s iconic principle of board-centricity."[9]

NEW SECTION 122(18) AND THE FUTURE OF BOARD GOVERNANCE

Despite the controversy, the Delaware Legislature enacted and the Governor approved the proposed amendments, including new subsection (18) to Section 122, which explicitly permits corporate governance arrangements like the one found in *Moelis* regardless of Section 141(a)'s apparently clear support of the contrary position. Such arrangements are lawful, even for minimum consideration, if authorized by a board, and so long as the agreement does not otherwise violate the Company's charter or Delaware laws.

In the wake of this legislative remedy, the following provisions would likely be permitted in shareholder agreements: (i) restrictions or prohibitions on future corporate action specified in the agreement; (ii) provisions requiring the approval or consent of third parties before an action can be taken; and (iii) agreements requiring the corporation or the board/shareholders to take or refrain from taking a specific action. It should be noted, however, that the new amendments' legislative history indicates that subsection (18) was not intended to address the fiduciary duties of officers, directors and stockholders.

Time will tell whether, as Chancellor McCormick opined, the seemingly market-friendly amendments are "good for corporate law."[10] However, the Delaware Legislature's rush to enshrine market practice into law may be a sign that other jurisdictions will also refuse to "wait and see." Thus, businesspeople and practitioners should be aware that these "market practice" amendments may soon be arriving at a state capitol near you. Commercial litigators are also well advised to take note of these developments as these apparently salutary legislative fixes may foster more litigation.

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1 W. Palm Beach Firefighters' Pension Fund v. Moelis & Co., 311 A.3d 809 (Del. Ch. Ct. 2024).
2 Id. at 820.
3 Id. at 819 (Del. Ch. Ct. 2024) (quoting Abercrombie v. Davies, 130 A.2d 338 (Del. 1957)).
4 Id.
5 Jordan Howell, Top Delaware Judge Calls for More Debate Over Contentious Corporate Amendments, Delaware Call (May 29, 2024) *https://delawarecall.com/2024/05/29/top-delaware-judge-calls-for-more-debate-over-contentious-corporate-amendments/*.
6 Id.
7 Sarath Sanga, Letter in Opposition to the Proposed Amendment to the DGCL (June 7, 2024) *https://corpgov.law.harvard.edu/2024/06/07/letter-in-opposition-to-the-proposed-amendment-to-the-dgcl/#more-165603*.
8 Id.
9 Marcel Kahan & Edward B. Rock, Proposed DGCL § 122(18), Long Term Investors, and the Hollowing Out of DGCL § 141(a) *https://corpgov.law.harvard.edu/2024/05/21/proposed-dgcl-%C2%A7-12218-long-term-investors-and-the-hollowing-out-of-dgcl-%C2%A7-141a/*.
10 Howell, supra n. 5.