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Delaware Chancery Court Issues Two Stark Reminders: “When Market Practice Meets a Statute, the Statute Prevails”

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March 13, 2024 - The Delaware Chancery Court has issued two decisions insisting that market practice does not trump specific requirements of the Delaware General Corporation Law (the “DGCL”). The first decision declared invalid and unenforceable large portions of the governance rights contained in the “new-wave” public company stockholder agreement of Moelis & Company (“Moelis & Co.”). The second decision, which cited the first, declared invalid the approval by the board of directors and stockholders of Activision Blizzard, Inc. (“Activision”) of its merger with Microsoft Corporation (“Microsoft”).

New-Wave Stockholder Agreements: “The Seemingly Irresistible Force of Market Practice Meets the Traditionally Immovable Object of Statutory Law”

In an opinion delivered on February 23, 2024, Vice Chancellor J. Travis Laster granted summary judgment declaring invalid several of a controlling stockholder’s governance rights in what he described as Moelis & Co.’s “new-wave” stockholder agreement (the “Stockholder Agreement”) for violation of Section 141(a) of the DGCL.¹ The court defined a “new-wave” stockholder agreement as one that does not involve stockholders merely contracting among themselves to address how they will exercise their stockholder-level rights (as contemplated by Section 218(c) of the DGCL), but that in addition binds the corporation and contains veto rights and other restrictions on corporate action.

Moelis & Co. entered into the Stockholder Agreement with its eponymous founder, Ken Moelis, who was also its CEO and Chairman of the Board, and three of his affiliates (collectively, the “Founder”), one day before its shares began trading following its initial public offering in 2014. The Stockholder Agreement provided that as long as the Founder, among other things, owned at least five percent of the Company’s shares of Class A common stock (including certain securities convertible into Class A common stock):

- 1. Pre-Approval Requirements:** The board of directors of Moelis & Co. (the “Moelis Board”) had to obtain the Founder’s prior written consent before engaging in 18 different categories of transactions. These categories included some commonly negotiated in a “new-wave” stockholder agreement, such as the incurrence of indebtedness or the

issuance of equity above a certain threshold, and others that were more unusual, such as the removal or appointment of officers (*i.e.*, including Ken Moelis himself) or the adoption of the annual budget.

2. **Board Composition Provisions:** The Founder had the right to designate director candidates to fill a majority of the seats on the Moelis Board. The Moelis Board was obligated to (i) not increase its size beyond eleven directorships (the "Size Requirement"), (ii) nominate the Founder designees as candidates for election, (iii) recommend that stockholders vote in favor of the Founder designees (the "Recommendation Requirement"), (iv) use reasonable efforts to enable the Founder designees to be elected and continue to serve, (v) fill any vacancy in a seat occupied by a Founder designee with a new Founder designee (the "Vacancy Requirement"), and (vi) populate its committees with a number of Founder designees proportionate to their number on the full Moelis Board (the "Committee Requirement").

The court found the Pre-Approval Requirements to violate Section 141(a) of the DGCL, which provides that "[t]he business and affairs of every corporation . . . 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." In so finding, the court applied the "*Abercrombie Test*," which provides that governance restrictions violate Section 141(a) of the DGCL when they "have the effect of removing from 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. . . ." ² Without analyzing any individual consent right, the court found that "[t]aken together, the Pre-Approval Requirements force the [b]oard to obtain [the Founder's] prior written consent before taking virtually any meaningful action," ³ and were "so all-encompassing as to render the [b]oard an advisory body," thereby "removing from the directors in a very substantial way their duty to use their own best judgment on virtually every management matter." ⁴

The court clarified that its analysis only applies to "internal governance arrangements," not "external commercial agreements," such as credit- or supply agreements, which can restrict the freedom of director decisions in various ways. ⁵ It distinguished between the two by explaining that a governance arrangement had salient features that facilitated categorization: (i) it has statutory grounding in the DGCL, (ii) it is among intra-corporate actors, (iii) it specifies the terms on which intra-corporate actors can authorize the corporation's exercise of its corporate power, (iv) it does not readily reveal an underlying commercial exchange, (v) it has no commercial purpose, and (vi) the presumptive remedy for breach is equitable relief enforcing the right (and not damages tied to the commercial bargain).

The court also declared facially invalid and unenforceable (i) the Size Requirement, opining that the Moelis Board had authority to determine its size pursuant to Section 141(b) of the DGCL in conjunction with Moelis & Co.'s charter and bylaws, and that the Size Requirement removed "from the directors in a very substantial way their duty to use their own best judgment on a management matter, viz., the size of the [b]oard," ⁶ (ii) the Recommendation Requirement because it "improperly compels the [b]oard to support [the Founder's] candidates, whomever they might be," ⁷ which might involve a breach of the directors' duty of loyalty if they privately believed that electing a Founder candidate would not be in the best interest of Moelis & Co., (iii) the Vacancy Requirement, because it removed from the directors "in a very substantial way their duty to use their own best judgment on a management matter, viz., who should serve as a director," ⁸ and (iv) the Committee Requirement, because the composition of board committees fell within the board's authority pursuant to Sections 141(a) and (c) of the DGCL and the Committee Requirement removed from the directors "in a very substantial way their duty to use their own best judgment on a management matter, viz., who should serve on a committee." ⁹ The court upheld each of the other Board Composition Provisions on its face, noting they could be challenged as applied.

Merger Agreement Approvals – Market Practice Loses Out to Statutory Law Again

In an opinion delivered on February 29, 2024, and citing the *Moelis* case, Chancellor Kathaleen McCormick denied a motion to dismiss stockholder claims that Activision had violated multiple provisions of the DGCL governing, among other things, board and stockholder approval of merger agreements. ¹⁰

Activision's board of directors (the "Activision Board") had approved a draft merger agreement (the "Draft Merger Agreement") that did not include (i) the disclosure schedules, (ii) the certificate of incorporation of the surviving corporation (the "Survivor's Charter"), (iii) the amount of consideration, or (iv) the final provisions regarding amounts and timing of any dividends Activision would be permitted to pay between signing and closing (the "Missing Items"). After the merger agreement was signed, the merger was approved by the Activision stockholders and subsequently closed. Plaintiff claimed that the Activision Board, Microsoft, Microsoft's board of directors and the merger subsidiary had violated Sections 251 and 141 of the DGCL and asserted, among other things, a claim for conversion. ¹¹

The court found it reasonably conceivable that the defendants had violated the following provisions of the DGCL and thereby unlawfully converted plaintiff's stock into the right to receive the merger consideration:

1. **Section 251(b) of the DGCL**, which requires a board to adopt a resolution approving an agreement of merger compliant with that Section. The court did not decide whether or not Section 251(b) of the DGCL required the Activision Board to approve the final execution version of the merger agreement. However, it found that, at the very least, it had to approve an "essentially complete version," ¹² which had to include the Missing Items.
2. **Section 251(c) of the DGCL**, "which requires that a notice of the stockholder meeting set for the purpose of acting on a merger agreement contain either 'the agreement required by [Section 251(b)]' (option one) or 'a brief summary thereof' (option two)." ¹³ The court found that Activision had complied neither with option one, because the merger agreement attached to the proxy statement had failed to include the Survivor's Charter, which is an item mandated by Section 251(b)(3) of the DGCL, nor with option two, because while the merger agreement was summarized in the proxy statement, it was not summarized in the notice to stockholders. ¹⁴

Takeaways

- **The *Moelis* and *Activision* decisions highlight the importance of complying with the letter of the DGCL.** Both decisions affect ongoing corporate governance matters, which corporations should review with assistance of counsel to remediate where necessary and minimize litigation risk.
- **The *Moelis* case is most relevant for public companies.**
 - It does not apply to limited liability companies or other contractually created business organizations.
 - The case does not distinguish between public and private company stockholder agreements. However, practically there is little risk that governance provisions in an agreement among all stockholders of a private company become unenforceable if parties follow best practice to include a clause in such agreement obligating them to vote in favor of a charter amendment if necessary to give effect to those governance provisions.
- **While the *Moelis* case might be appealed, stockholders desiring to obtain extensive consent rights with respect to board decisions and/or board and committee representation rights should consider including these in the corporation's charter.**
 - The court noted that the Moelis Board could implement many of the challenged provisions by using its blank check authority to issue a "golden share" of preferred stock "carrying a set of voting rights and director appointment rights." ¹⁵
 - Another approach that has been taken by market participants is to reference and incorporate the stockholder agreement in the corporate charter. However, the court did not bless this practice, and Section 104 of the DGCL does not declare such stockholder agreements part of the certificate of incorporation, so that the validity of this approach is not assured.
- **The *Moelis* case affects the enforceability of activist settlement agreements, which commonly contain provisions resembling the Board Composition Provisions.**
 - While the court cautioned that "any Section 141(a) assessment of provisions in an activist settlement agreement must await an appropriate case," it indicated that, in reviewing such agreements, it would apply the same

standard it applied in this case, particularly where “the provisions purported to bind directors irrespective of future events.” ¹⁶

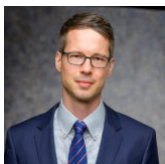
- Therefore, a board may be able to validly agree to appoint certain persons as directors, form certain committees and appoint those directors to those committees. However, provisions that require the board to recommend such persons to be elected by the stockholders at the next annual meeting, or to replace any such persons that resign with any future activist designee, seem more problematic.
- **The *Activision* decision reminds practitioners that a corporation’s board must approve, at the least, the “essentially complete version” of a merger agreement.**
 - The board must approve a merger agreement containing all six items required by Section 251(b) of the DGCL, including all essential economic terms and conditions.
 - Boards of corporations whose boards or stockholders approved mergers in violation of Section 251 of the DGCL should consult with counsel on how to remediate such failure. The court helpfully pointed to the ratification provisions in Sections 204 and 205 of the DGCL, but these are complex to navigate.

For more information about these cases, please contact [Alexander Rahn](#), [Chuck Samuelson](#), [Shahzeb Lari](#), [Gerold Niggemann](#), or [Michael Traube](#).

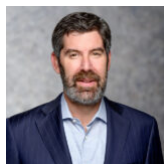
1. [See *W. Palm Beach Firefighters’ Pension Fund v. Moelis & Co.*, C.A. No. 2023-0309-JTL, 2024 WL 747180 \(Del. Ch. Feb. 23, 2024\).](#) ↵
2. [Abercrombie v. Davies](#), 123 A.2d 893, 899 (Del. Ch. 1956) (citation omitted), [vacated and remanded on other grounds](#), 130 A.2d 338 (Del. 1957). ↵
3. [W. Palm Beach Firefighters’ Pension Fund](#), supra, at *5. ↵
4. [Id.](#) at 46. ↵
5. [Id.](#) at 37. ↵
6. [Id.](#) at 50. ↵
7. [Id.](#) at 6. ↵
8. [Id.](#) at 49. ↵
9. [Id.](#) at 52. ↵
10. [Sjunde AP-fonden v. Activision Blizzard, Inc.](#), C.A. No. 2022-1001-KSJM, 2024 WL 863290 (Del. Ch. Feb. 29, 2024). ↵
11. [See id.](#) at 2. ↵
12. [Id.](#) at 7-8. ↵
13. [Id.](#) at 8 (brackets in original) (footnote omitted). ↵
14. [See id.](#) at 8-9. ↵
15. [W. Palm Beach Firefighters’ Pension Fund](#), supra, at *6-7 (footnote omitted). ↵
16. [Id.](#) at 54.

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