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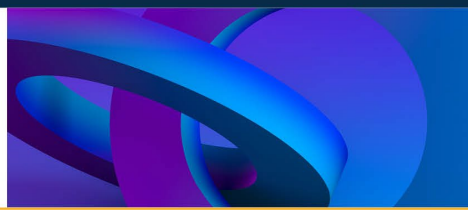

Proposed Amendments to the Delaware General Corporation Law: A Response to *Moelis* and *Activision*

A series of recent decisions from the Delaware Court of Chancery has muddied the waters for dealmakers and lawyers, raising questions about the legality of certain longstanding market practices relating to stockholders' agreements and the approval process for mergers. In deciding these recent cases, the court made clear that in construing the language of the Delaware General Corporation Law (DGCL), the court will apply a strict reading of the express language of the statute.

In response to the uncertainties caused by the court's recent decisions in *Moelis* and *Activision*, on March 28, the Council of the Corporation Law Section of the Delaware State Bar Association proposed certain amendments to the DGCL. These proposals are intended to conform the statute with customary market practice.

Implications to Stockholder Agreements

In *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.*,[1] the court cast a shadow over the enforceability of provisions in agreements between a corporation and its stockholders that provide such stockholders with veto powers or protective voting rights that could be viewed as impinging on the authority and discretion of the board to manage the corporation. These types of agreements are widely used, especially in private equity and venture capital deal structures. At issue in *Moelis* were certain "Pre-Approval Requirements" in the stockholders' agreement requiring the board to obtain the prior written consent of a founder stockholder (the founder) prior to taking virtually any meaningful corporate action, including, among others: (1) the issuance of common and preferred stock; (2) the appointment or removal of certain officers, such as the CEO, which was an office held by the founder; (3) entering into or amending any material contract; (4) adoption of a stockholder rights plan; and (5) any equity or debt commitment in an amount greater than $20 million.

Additionally, the court took issue with certain provisions in the stockholders' agreement that collectively ensured the founder's control over decisions by the board; such provisions include (1) a "Recommendation Requirement," which required the board to recommend for election those candidates that were named by the founder; (2) a "Vacancy Requirement," which allowed the founder to fill any board vacancy created by one of his departing designees with another designee of his choosing; and (3) a "Size Requirement," which improperly restricted the board's

[1] *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.*, No. 2023-0309-JTL (Del. Ch. February 23, 2024).

ability to increase the number of board seats beyond 11, thereby establishing that a majority of seats would continue to be represented by designees of the founder. Lastly, the court considered a provision that compelled the board to populate all board committees with a number of the founder's designees proportionate to the number of designees on the full board.

Ultimately, the court reasoned that the stockholders' agreement conferred upon the founder certain rights "so all-encompassing as to render the Board an advisory body"[2] in violation of Section 141(a) of the DGCL, which reads 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." Because the DGCL does not expressly permit such constraint to be accomplished through means of a stockholders' agreement, the court determined that such provisions effecting a constraint on the board's managerial discretion were facially invalid.

Rather, had such managerial power been vested in someone or something other than the board through an amendment to the corporation's certificate of incorporation, such amendment would have constituted a proper means of constraining the board's managerial discretion under the DGCL, as this would be consistent with the language of Section 141(a) permitting modification of such management of a corporation by the board through a provision in its certificate of incorporation. It is unclear whether a less comprehensive set of controls would have resulted in a different determination by the court.

The Proposal to Address *Moelis*: New Subsection 122(18)

In response to the *Moelis* decision, the council proposed adding a new Subsection 18 to Section 122 of the DGCL. For reference, Section 122 of the DGCL enumerates specific powers that a corporation may exercise and, in practice, primarily functions to negate any implication that a company lacks certain powers. New Section 122(18) of the DGCL would directly address the scope of a corporation's rights with respect to contracts entered into with current or prospective stockholders. Specifically, Section 122(18) of the DGCL would contain a nonexclusive list of provisions that can be included in such contracts to (1) restrict or otherwise prevent the corporation from taking certain actions, either absolutely or absent the consent of one or more persons or bodies, and (2) bind the corporation or one or more persons to take or refrain from taking certain actions. Therefore, if adopted, Section 122(18) of the DGCL would permit corporations to use stockholders' agreements to implement the types of protective voting provisions invalidated by the court in *Moelis*.

The application of new Section 122(18) of the DGCL would be limited as follows:

- Section 122(18) of the DGCL only applies to agreements between a corporation and its stockholders acting in their capacity as stockholders. Therefore, this section would not apply to contracts entered into by stockholders, who, for example, are also suppliers or creditors of the corporation.
- Section 122(18) of the DGCL only applies if a corporation enters into a contract with its stockholders or beneficial owners of its stock in exchange for minimum consideration. Such minimum consideration is to be determined by the board of directors and principally functions to treat those contracts involving bargained-for rights and benefits, such as the stockholders' agreement in *Moelis*, as different from governance arrangements, which are entered into without consideration. Examples of governance arrangements include a

[2] *Id.*

corporation's bylaws or stockholder rights plans. Thus, new Section 122(18) of the DGCL does not alter or otherwise conflict with existing case law regarding the facial validity of such governance arrangements.

- Finally, the proposed amendments introduce language establishing that the enumerated powers under Section 122 of the DGCL will only apply by default. As such, a corporation will only enjoy the enumerated powers conferred under Section 122 of the DGCL — including those powers under new Section 122(18) of the DGCL — in the absence of any provision in its certificate of incorporation that limits such powers.

Approval Process for Merger Transactions

In *AP-fonden v. Activision Blizzard*,[3] the court highlighted uncertainties with respect to mainstream practices and procedures underlying the approval process for mergers. The case involved a challenge to the merger of Microsoft Corp. and Activision Blizzard Inc. (the target company) by a stockholder of the target company, who claimed that the board had failed to comply with various procedural requirements under the DGCL. Significantly, the court emphasized the need to strictly observe the procedures prescribed by statute, stating, "Where market practice exceeds the generous bounds of private ordering afforded by the DGCL, then market practice needs to check itself."[4]

Specifically, the court determined that the target company's board had failed to approve an "essentially complete version" of the merger agreement, in violation of Section 251(b) of the DGCL, which requires the board to adopt a resolution approving an agreement of merger or consolidation and declaring its advisability. The court reasoned that a resolution by a company's board is meaningless if the essential terms of the merger agreement are subsequently altered and that a board cannot declare the advisability of a merger without first reviewing its essential terms. The court determined that the purchase price, disclosure letter, charter for the surviving company and dividend provision were essential and found their absence compelling. The court declined to "drill down" on whether the disclosure schedules were essential and acknowledged that "reasonable minds could reach different conclusions on this point."

The court further determined that certain key terms had been impermissibly delegated by the target company's board to an ad hoc board committee, in violation of Section 141(c)(2) of the DGCL, which provides that a committee lacks the authority to approve a merger or its terms. Additionally, the court found that the target company's board failed to provide adequate notice of the meeting to the stockholders of the target company to approve the merger in violation of Section 251(c) of the DGCL, which requires that notice of a stockholder meeting that is scheduled for the purpose of acting on a merger agreement contains either the merger agreement or a brief summary of the merger agreement. Although the court acknowledged that the target company's board delivered notice in a manner consistent with common practice — merely providing an agenda item for the meeting, along with a proxy statement containing both a comprehensive summary of the merger agreement and a copy of the merger agreement as an annex — the court held that notice given pursuant to such common practice is improper because the notice itself did not contain a brief summary of the merger agreement; only the proxy statement contained a summary of the merger agreement. Thus, the court construed the language in Section 251 of the DGCL literally, finding the proxy statement requirement distinct from, and in addition to, the notice requirement. As such, the court determined that the

[3] *AP-fonden v. Activision Blizzard*, C. A. 2022-1001-KSJM (Del. Ch. February 29, 2024).
[4] *Id.*

requirements of each must be independently fulfilled, even though they may, as was the case in *Activision*, be delivered to the stockholders together.

The Proposal to Address *Activision*: New and Amended Sections

The amendments proposed by the council, as summarized below, would allow for greater procedural flexibility under the DGCL to bring the law more in line with customary practice:

- **Section 147:** If adopted, Section 147 of the DGCL would permit a company's board of directors to approve any agreement, instrument or document requiring board approval under the DGCL — including merger agreements, which were at issue in *Activision* — provided that it is in its final or "substantially final" form. Although the proposed amendments do not expressly define the meaning of "substantially final," the synopsis of the proposed legislation states that substantially final form means that, at the time of the board's approval, all of the material terms are either (1) set forth in the agreement, instrument or document or (2) ascertainable through other information or materials presented to or otherwise known by the board of directors. If there is doubt as to whether the form is substantially final, new Section 147 of the DGCL would permit the board to adopt a resolution ratifying its approval of certain actions, such as approval of a merger transaction.
- **Section 232:** The proposed legislation includes amendments to Section 232 of the DGCL, which concerns the provision of notice to stockholders. In a direct response to the court's literal interpretation of the DGCL in *Activision*, the amendments recognize that any materials presented together with notice to stockholders — whether such materials are included with or appended or attached to such notice — would fulfill the requirements with respect to notice. As such, the amendments refute the notion advanced by the court in *Activision* that notice to the board must be fulfilled solely within the four corners of the notice and independent from and in addition to any other information provided to the board, including any proxy statements, even if such efforts are duplicative.
- **Section 268:** To address the court's determination that the merger agreement provided in the *Activision* case was not sufficiently complete, the council proposed a new Section 268(b) of the DGCL, which would provide that, unless otherwise expressly provided in the merger agreement, disclosure letters, disclosure schedules and similar documents do not constitute a part of the merger agreement. As such, under the statute's default rule, it would not be required that these materials be submitted to the board of directors and stockholders for approval.

Timing for Proposed Amendments

The council's proposed amendments address the uncertainties resulting from the court's rejection of widely accepted market practices because of a determination that such practices fail to strictly conform with the express language of applicable statutory requirements. Because the proposed amendments would both enhance clarity with respect to corporate actions and increase flexibility for corporations and stockholders, the amendments are likely to be received favorably by practitioners if adopted. Although these amendments would largely do away with the types of claims that were brought by the plaintiffs in *Moelis* and *Activision*, it is important to note that such amendments will not apply to or affect civil actions or proceedings, completed or pending, prior to August 1, the date that the amendments would become effective if adopted.

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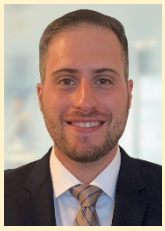

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