

Delaware Double Whammy Casts Doubt on M&A Practices

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Delaware courts recently issued important decisions that impact M&A dealmakers and lawyers. In this post, we dive into two cases that serve as a reminder that Delaware grounds review of corporate actions in statutory requirements and not market practice, no matter how prevalent. In response, legislation to resolve the ambiguity created by these decisions has been approved by the influential Council of the Corporation Law Section of the Delaware State Bar Association and is expected to be introduced to the Delaware General Assembly for consideration during its 2024 regular session. Pending any legislative changes, these decisions and the rationale provided by the Delaware courts illustrate the value of grounding M&A processes in statutory requirements – and offer insights into how Delaware courts evaluate governance arrangements.

Case 1: Delaware invalidates common provisions in stockholder agreements

In *West Palm Beach Firefighters v. Moelis & Company* (Del. Ch.; 2/24), the Delaware Court of Chancery invalidated relatively commonplace terms in stockholder agreements that grant a stockholder influence over the company's actions. In the ruling, Vice Chancellor J. Travis Laster struck down a number of stockholder veto rights and held that certain board composition requirements were facially invalid as a matter of law, including the right to:

1. Restrict the size of the board of directors.
2. Require the board to recommend in favor of a stockholder nominee.
3. Require the board to fill any vacancy on the board with a stockholder nominee.
4. Require the board to include a stockholder nominated director on committees of the board.

While the ruling has broad implications for many current arrangements (particularly stockholder agreements for public companies), it did provide a path forward, noting that many of these provisions would have been valid if included the corporation's certificate of incorporation instead of the stockholder agreement.

Background

At the center of this case is investment bank Moelis & Company and the stockholder agreement that it entered into with its founder prior to its initial public offering. The stockholder agreement gave the founder a number of rights and protections, specifically:

- "Veto rights" over 18 corporate actions, including stock issuances, financings, dividend payments and senior officer appointments.
- A "board size requirement" that the board size not exceed 11 members.
- A "board designation right" to designate a majority of the board members.
- A "board nomination requirement" that the board nominate the founder's designees for election to the board.
- A "board recommendation requirement" that the board recommend that stockholders vote to elect the founder's designees to the board.
- A "board efforts requirement" that the company use reasonable best efforts to enable the founder's designees to be elected and continue to serve on the board.
- A "board vacancy requirement" that the board fill any vacancy in any seat previously held by a founder designee with a new founder designee.
- A "committee composition requirement" that the board populate any committee with a number of the founder's designees proportionate to their membership on the board.

Ruling and rationale

The court focused its analysis on §141 of the DGCL, which provides that "the 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 its charter." The court detailed a two-factor test for assessing governance arrangements:

1. Does the provision at issue constitute part of the corporation's internal governance arrangement?
2. Does the provision 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?

First, the court concluded that the stockholder agreement was a "prototypical" internal governance arrangement because it implicated matters governed by the DGCL, its parties are the corporation and its founder/majority stockholder, it contains provisions governing the authorization of the corporation's actions, it is not tied to any underlying commercial transaction, and it is indefinite and cannot be terminated by the corporation.

Second, the court reviewed the various rights in the stockholder agreement and found several of them facially invalid. (A summary of the rulings is listed in the table below.) The overarching theme of the decision is that rights in a stockholder agreement cannot restrict the board's ability to exercise statutorily required corporate action. The court noted that even the below facially valid provisions could be subject to challenge on a case-by-case basis, depending on the facts. The court further noted that some of the provisions deemed facially invalid would have survived challenge if included in the company's charter.

Right	Ruling	Rationale
Veto rights	Facially invalid (reviewed collectively, not individually)	Invalid because they require consent from founder before taking any meaningful action.
Board size requirement	Facially invalid	Invalid because it removed from directors the ability to determine board composition.
Board recommendation requirement	Facially invalid	Invalid because it removed from directors the ability to candidly communicate views on a candidate.
Board vacancy requirement	Facially invalid	Invalid because it removed from directors the ability to determine board composition.
Committee composition requirement	Facially invalid	Invalid because it removed from directors the ability to determine board composition.
Board designation requirement	Not facially invalid	Valid because ultimate corporate action is subject to stockholder independent review.
Board nomination requirement	Not facially invalid	Valid because ultimate corporate action is subject to stockholder independent review.
Board efforts requirement	Not facially invalid	Valid because ultimate corporate action is subject to stockholder independent review.

Takeaways and questions

Assessing potential solutions in current environment

The court noted that governance rights that would be impermissible in a stockholder agreement may be acceptable if included in the charter. Pending a legislative change, companies should review their existing governance arrangements and consider putting permissible stockholder rights that restrict board action in their charter, either directly or in a certificate of designations governing a series of preferred stock. The scope of issues (and feasibility of potential solutions) depends on the governance arrangements of a company.

Venture-backed private companies typically follow the charter approach and have protective voting rights as part of the rights, preferences and privileges of the preferred stock in the corporation's certificate of incorporation. The charter provision approach, however, may not work for corporations with a single class of common stock.

Public companies and companies contemplating an IPO are in a trickier situation. It has been common market practice for founders, private equity sponsors and other controlling stockholders to retain governance rights over a controlled company after an IPO, often through a stockholder agreement with the IPO issuer. The court suggested a "golden share" approach, meaning that a company could use its blank check authority to issue a "single golden share" of preferred stock and grant that preferred stock governance rights in its certificate of designations. A potential downside

to this approach is that the holders would lose any preferential rights upon converting to common stock in order to gain liquidity. Additionally, parties should analyze whether any management-level rights granted to preferred stockholders could result in such stockholders owing fiduciary duties to other stockholders. Companies may also consider adopting a dual-stock approach with voting rights tied to a certain group of stockholders. As discussed in this [blog post](#), that approach is also fraught with landmines, including issues when contemplating a future transfer or M&A transaction.

Applicability of ruling

The case only applies to corporations and does not extend, for example, to partnerships or limited liability companies. The case did not differentiate between listed and private companies. The risk profile for such companies may differ depending on the shareholder base and scope of stockholder agreements.

Are any preapproval rights acceptable?

The court analyzed the preapproval conditions collectively, and Moelis had a lot (18!) of preapproval rights. Future court decisions may provide guidance as to the validity of individual preapproval or consent requirements and it is possible that some individual requirements may be more readily defensible when not combined with other rights.

Market practice and disclosure not a defense

Widespread market practice is not a defense to activities that the courts view as contrary to Delaware law. Further, long-standing acceptance by the corporation and its stockholders (even for 15 years, in this case) doesn't offer any protection.

Proposed amendments

The Council has proposed an amendment to DGCL Section 122, which enumerates the express powers that a corporation may exercise, in response to the result in this case. The proposed amendment would provide specifically that a corporation may enter into governance agreements with stockholders and beneficial owners where the corporation agrees, among other things, to restrict itself from taking action under circumstances specified in the contract, to require contractually specified approvals before taking corporation action, and to covenant that it or one or more persons or bodies (which may include the board or one or more current or future directors, stockholders, or beneficial owners of stock) will take, or refrain from taking, contractually specified actions. If these amendments are passed, it may effectively negate the impact of this case.

Case 2: Delaware sets high bar for board approvals, stockholder notice for M&A deals

In *Sjunde AP-fonden v. Activision Blizzard, Inc.*, (Del. Ch.; 2/24), Chancellor Kathaleen St. J. McCormick denied a motion to dismiss a plaintiff's claims that the Activision Blizzard board of directors violated multiple provisions of the Delaware corporate law governing board and stockholder approval of merger agreements when it authorized the company's merger agreement with Microsoft and provided stockholders with notice and request for approval. The case is a stark reminder of the requirements for obtaining board and stockholder approvals – and a cautionary tale for relying on market practice.

Background

On October 13, 2023, Microsoft closed its acquisition of Activision Blizzard in a transaction valued at \$68.7 billion. An Activision Blizzard stockholder subsequently filed claims arguing that the board of directors did not comply with the technical requirements of DGCL Section 251(b) by approving a draft merger agreement that omitted certain information and by delegating authority to a subset of directors to finalize the agreement. The plaintiff also alleged that the Activision Blizzard board further violated DGCL Section 251(c), which states that the notice of the stockholders' meeting to approve the merger agreement must include either the merger agreement in its entirety or a brief summary of the merger agreement. The Activision Blizzard notice followed the common practice of including an agenda item for a stockholder vote to approve the merger agreement and attaching a proxy statement, which contained an extensive summary of the merger agreement and a copy of the merger agreement as an annex.

Ruling and rationale

There were three key components to the court's ruling.

“Essentially complete” requirement: The court held that the draft merger agreement presented to the board for

approval must be at least an “essentially complete version” of the merger agreement. The court did not provide comprehensive guidance on what “essentially complete” means, reasoning that, wherever the line was drawn, it had been crossed in this case because the draft did not include the dollar amount of the merger consideration (it was left blank in the draft) or the charter for the surviving corporation in the merger. The court explained that, at a minimum, “essentially complete” covers the terms and documents “specifically call out” by DGCL § 251(b). One of these items is a copy of the surviving company’s charter. However, several of the other items mandated by §251(b) are subject to interpretation, such as “the terms and conditions of the merger” and “such other details or provisions as are deemed desirable.” The court noted that the draft provided to the board also was missing the disclosure schedules and the amount of dividends that Activision could pay while the deal was pending, and the board during the meeting (as reflected in the minutes) delegated authority to an ad hoc committee of directors to resolve the dividend issue before the merger agreement was finalized. The court acknowledged that it is common practice to present the target board with an incomplete but “near-final” version of the merger agreement for approval, given the realities of negotiating and executing a complex transaction. But the court concluded that market norms do not supersede statutory terms.

No delegation of approval: The court also found that the Activision Blizzard board improperly delegated the approval of a key open term in the draft merger agreement to an ad hoc board committee (specifically, the dividend issue), in violation of Section 141(c)(2) of the DGCL, which provides that “a committee does not have any power with respect to approving an agreement of merger or its terms.” Because the plaintiff alleged that these key terms were lacking in the draft merger agreement presented to the full board for approval, the motion to dismiss was denied and the case was allowed to proceed.

Sufficient notice to stockholders: The court found that the notice of the special meeting of stockholders was defective because:

1. The merger agreement annexed to the proxy statement did not include a copy of the certificate of incorporation of the surviving corporation and therefore was not compliant with Section 251(b).
2. The notice did not contain a brief summary of the merger agreement, even though the notice was printed with the proxy statement that contained a summary of the merger agreement.

Takeaways and questions

The Chancery Court’s strict interpretation of statutory requirements means that parties to a merger agreement involving a Delaware target corporation should carefully consider the contents of materials provided to the parties’ boards and the notice of stockholder meeting to approve the merger.

Presenting ‘essentially complete’ materials

While the court did not provide exact guidance on what constitutes an “essentially complete” merger agreement, parties should ensure that the board of directors receives and approves a version of the merger agreement that contains all material terms (including the purchase price) and is provided with the charter of the surviving corporation. Given the lack of clarity as to whether disclosure schedules are an essential part of the merger agreement, parties may want to include as close to final as possible disclosure schedules in the materials provided to the board out of an abundance of caution.

Limits of delegation

The entire board of directors, and not a subset thereof, should approve or ratify any decisions made, or actions taken by, a committee of the board with respect to any material terms of a merger agreement.

Going, going back to the board

The delegation issues, and potentially the approval process issues, described in this case could have likely been avoided by holding a brief final meeting of the board immediately before execution of the final merger agreement.

Sufficient notice to stockholders

To reduce the risk that a court will find a merger-related stockholder meeting notice deficient, such notice should:

1. Include the detailed summary of the merger agreement from the proxy statement – and not rely on a reference to the proxy statement.
2. In addition to the final merger agreement, attach the proposed charter for the surviving corporation.

The damages question

For post-closing lawsuits, it remains to be seen what, if any, damages or other relief a stockholder could plausibly seek. In this case, it is unclear how the plaintiff could claim that Activision stockholders were harmed either by the merger (at a large premium) or by the board's alleged statutory violations in approving the transaction. Further, it is difficult to imagine how a plaintiff could claim that its efforts conferred some benefit on stockholders warranting an award of a monetary amount or fees – a claim Delaware courts recently have viewed with some skepticism.

Proposed amendments

In an attempt to resolve the various ambiguities created by this decision, the Council proposed amendments to the DGCL.

1. Approval of Final Form Agreement: The Council proposed a new Section 147 of the DGCL that provides, where the DGCL requires the board of directors to approve an agreement, document or other instrument, the board may approve the document in final form or substantially final form.
2. Ratification of Approval: The Council proposed a ratification approach, including in a new Section 147 of the DGCL that would provide, where the board has previously taken action to approve an agreement, document or other instrument that is required to be filed with the Delaware Secretary of State – or required to be referenced in a certificate so filed (e.g., a certificate of merger or certificate of amendment) – the board may ratify the agreement, document or other instrument before the instrument effecting the act becomes effective.
3. Clarity on Stockholders Notices: The Council proposed amendments to Section 232 of DGCL, which deals with notices to stockholders of meetings. The amendments would provide that any materials included with, or appended or attached to, a notice to stockholders would be deemed to be part of the notice for purposes of compliance with the DGCL's notice procedures.

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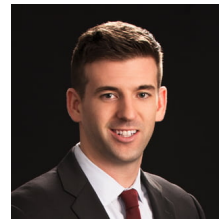
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