Council of Institutional Investors®
The voice of corporate governance

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BY EMAIL

Dear President Harmon:

The Council of Institutional Investors (CII or the Council) writes to express its concerns with the Corporation Law Council's proposed amendments to the Delaware General Corporation Law (DGCL). Although our concerns relate to the substance of the legislative proposals, the more pressing concern is the pace at which legislation is being proposed to overturn a single trial court ruling that is not yet even final.[1] In our view, there is no need for a legislative rush to judgment as to whether the opinion in the *West Palm Beach Firefighters' Pension Fund v. Moelis & Company,* C.A. No. 2023-0309-JTL (Opinion) [2] was correct. The Opinion is subject to review by the Delaware Supreme Court, which may or may not agree with the Opinion.

We urge the Delaware State Bar Association (Association) to pause the process to permit a more complete consideration of the critical issues raised by the proposed legislation and their potential impact on long-term institutional investors. We note that the Delaware legislature is scheduled to adjourn next month, a schedule that would seem not to permit the sort of full analysis and debate that this proposed legislation requires, especially considering all the pending business that a legislative body must usually address prior to adjournment. There is no need for an immediate legislative "fix," particularly when there appears to be no consensus that there is a "problem" that needs fixing.

The background of this legislation is the Opinion by Vice Chancellor Laster in late February that upheld the facial validity of some provisions – but not others – in an agreement between Moelis & Company and its founder, who was also the controlling shareholder. The Opinion characterized that agreement as part of a "new wave" of agreements between companies and certain minority

[1] The Council of Institutional Investors (CII or Council) is a nonprofit, nonpartisan association of U.S. public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $5 trillion. CII members are major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families, including public pension funds with more than fifteen million participants – true "Main Street" investors through their pension funds. Our associate members include non-U.S. asset owners with about $4.8 trillion in assets, and a range of asset managers with approximately $55 trillion in assets under management. CII is a leading voice for effective corporate governance, strong shareowner rights and sensible financial regulations that foster fair, vibrant capital markets. CII promotes policies that enhance long-term value for U.S. institutional asset owners and their beneficiaries. For more information about the Council please visit our website at www.cii.org.

[2] *West Palm Beach Firefighters' Pension Fund v. Moelis & Company,* C.A. No. 2023-0309-JTL (Del. Ch. Feb. 23, 2024), *available at* https://law.justia.com/cases/delaware/court-of-chancery/2024/c-a-no-2023-0309-jtl-0.html.

shareholders or, as in the *Moelis* case, a controlling shareholder.[3] Such agreements do not "involve stockholders contracting among themselves about how they will exercise their stockholder rights,"[4] but instead "contain extensive veto rights and other restrictions on corporate action."[5]

The Opinion parsed specific provisions of the *Moelis* shareholder agreement under section 141(a) of the DGCL, the polestar of Delaware corporation law, which states the principle 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."[6] The Opinion applied existing law, asking whether the agreement related to purely "external commercial agreements,"[7] as opposed to an arrangement that sought to "govern the corporation's internal affairs"[8] – and in the latter instance, the question is whether a challenged provision '"[has] the effect of removing from [the] directors in a very substantial way their duty to use their own best judgment on management matters' or 'tends to limit in a substantial way the freedom of director decisions on matters of management policy . . . .'"[9]

Applying this methodology, the Vice Chancellor concluded that certain provisions were facially invalid because they required the board of directors to obtain the founder's approval before taking more than a dozen specific actions, including issuance of stock, the declaration of dividends and the approval of annual budgets. In addition, directors were required to urge stockholders to vote in favor of the founder's board nominees, to fill any vacancy caused by the departure of a founder's designee with another founder designee, to try to limit the size of the board to 11 seats or fewer, and to try to assure that board committees contain a proportionate number of the founder's designees.

What has been overlooked in the discussion of the proposed legislation is what the Opinion did *not* do. The Opinion concluded that certain other provisions were not facially invalid, *i.e.,* provisions requiring the board to allow the founder to nominate enough board candidates sufficient to create a majority, to nominate the founder's designees, and to make reasonable efforts to elect the founder's designees.

In other words, the Opinion did what judges of the Court of Chancery have been doing for many years: examine the challenged practice under the applicable statute and provide a careful, fully explained statement of the court's reasons for the ruling providing guidance to corporations and to investors alike, with additional guidance in future cases. Delaware's preeminence in corporate law

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[3] *Id.* at 3 & n.10 (providing examples of certain "new wave" agreements giving minority shareholders veto rights over important corporate decisions, such as whether to fire the CEO or effect a change of control, waive a director's obligation to present opportunities to the firm, and in some instances limit the ability of stockholders to sell their shares and citing Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 Yale J. Reg. 1124, 1148-54 (2021), *available at* https://openyls.law.yale.edu/bitstream/handle/20.500.13051/8341/08._Rauterberg_Article._Final._1124_1181.pdf?sequence=2&isAllowed=y).

[4] *West Palm Beach Firefighters' Pension Fund v. Moelis & Company,* C.A. No. 2023-0309-JTL at 3.

[5] *Id.*

[6] 8 Del. C. § 141(a) (2020), *available at* https://delcode.delaware.gov/title8/c001/sc04/index.html.

[7] *West Palm Beach Firefighters' Pension Fund v. Moelis & Company,* C.A. No. 2023-0309-JTL at 28.

[8] *Id*.

[9] *Id.* at 89-90.

against the ever-present threat of federal preemption is dependent on the law being almost entirely "judge-made."[10]

There is thus no need for a legislative rush to judgment as to whether the Vice Chancellor was correct. The Opinion is subject to review by the Delaware Supreme Court, which may or may not agree with the Opinion. Moreover, for those who believe that the Opinion was wrongly decided or consistent with marketplace practices, an appeal provides an opportunity to fully articulate those points as *amici curiae.*

A deliberative approach is needed here because the Opinion raises important questions that lie at the intersection of the board's ability to run the corporation and the right of shareholders to have a voice in the company they own. The Opinion rested on the bedrock principle articulating this balance, namely, the language of the aforementioned section 141(a) of the DGCL. Adherence to this principle gives a board the flexibility it needs to run the company, subject to governance principles that are set out for all to see.

The need for a more deliberative approach in this case is underscored by the fact that the proposed legislation appears to contain no limit in terms of how far a shareholder agreement can go in changing a company's corporate governance. A letter from Professor Rauterberg to the Association dated April 11, 2024, cites certain practices that are unlawful at present and asks if they would be permissible if new legislation were to be enacted, including:

- May a company enter into a contract with a controlling stockholder never to sue that shareholder for a breach of its fiduciary duties?
- May a company enter a contract never to take any material action without prior approval from a legal entity, such as an investment fund?[11]

More specifically, for CII and its members, we strongly believe that permitting stockholder agreements to contain the provisions at issue in the *Moelis* case would disadvantage long-term investors. One of the core principles of corporate governance is the principle of one share, one vote.[12] Currently, for a powerful founder to have full control rights -- of the sorts granted to Mr.

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[10] Marcel Kahan and Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 Vand. L. Rev. 1573, 1598 n.93 (2005), *available at* https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1639&context=faculty_scholarship.

[11] *See* Letter from Gabriel Rauterberg, Professor of Law, University of Michigan Law School to Executive Committee, Delaware State Bar Association 4 (April 11, 2024) (on file with CII) (noting that that if the proposed legislation were adopted it would be unclear whether the following actions would be unlawful: (1) "A corporation covenanting by contract with its controlling shareholder that it would never sue the controlling shareholder for a breach of its fiduciary duties"; and (2) "A corporation covenanting by contract that the board will never take any material actions without prior approval from a legal entity, such as an investment fund").

[12] CII, Policies on Corporate Governance 3.3 (last updated Mar. 6, 2023), *available at* https://www.cii.org/corp_gov_policies ("Voting Rights: Each share of common stock should have one vote [and]. [c]orporations should not have classes of common stock with disparate voting rights."); *see generally* Letter from Ken Bertsch, Executive Director, CII et al. to Henry E. Gallagher, Jr., Council Chair, Corporation Law Section of the Delaware State Bar Association 1 (Sept. 13, 2019) *available at* https://www.cii.org/files/issues_and_advocacy/correspondence/2019/September%2013%202019%20Final%20DGCL%20letter.pdf (CII requesting "that the Delaware State Bar Association propose to the Delaware General Assembly that

Moelis -- a company generally must put these provisions into the certificate of incorporation and go public with a multi-class capital structure. However, it appears that under the provisions of the proposed legislation, a company could instead go public with a single-class capital structure and then, after the company is already public, confer comprehensive control rights by contract *without any shareholder vote*. We believe many CII members and other long-term investors – whether they object to multi-class capital structures or not – would find very troubling this post-IPO transformation to a type of multi-class capital structure without a shareholder vote.

The fact that this and other potential implications of the proposed legislation exist and have not yet been publicly debated is a powerful indicator that we are not yet at a stage to be considering a legislative change that could have a significant impact on CII members and other shareholders. Prof. Rauterberg notes[13] that section 7.32 of the Model Business Corporation Act makes a wide variety of stockholder agreements enforceable but requires that the agreements be approved by all persons who are shareholders when the agreements are entered into.[14] A similar approach might not be the best policy for Delaware corporations and their shareholders, but it does point to the need for careful consideration about where exactly to draw the line before enacting legislation that could produce unintended – and undesirable – consequences.[15]

In making these points, we acknowledge the proverbial "elephant in the room," namely, the current campaign by Elon Musk to re-incorporate his companies in a "friendlier" state and his encouragement of other companies to do likewise. We are also aware of the criticism that the Opinion has upset certain practices that exist in the marketplace. The Council does not find these arguments to be persuasive.

A hallmark of DGCL is the careful and deliberate nature in which it is adopted and enforced, as well as the ways in which Delaware law balances boards' decision-making with accountability to shareholders'. That reputation could be seriously impaired by a perception that influential actors can easily change the law whenever a court has the temerity to rule against them.

In addition, we find ourselves in agreement with the observations of Professor Brian JM Quinn in his April 12, 2024, letter to you, which notes how "[t]ransaction planners will regularly push the

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Delaware General Corporation Law (DGCL) be amended to limit the authority of Delaware corporations listed on national securities exchanges to adopt multi-class common stock structures with differential voting rights.").

[13] *See* Letter from Gabriel Rauterberg, Professor of Law, University of Michigan Law School to Executive Committee, Delaware State Bar Association at 5 ("While unanimity may not be the right requirement, Delaware corporate law deserves thoughtful and systemic attention to the appropriate process by which governance can be changed.").

[14] *See* Model Bus. Corp. Act § 7.32(b)(1) (Am. Bar Ass'n 2003), https://www.lexisnexis.com/documents/pdf/20080618091347_large.pdf ("(b) An agreement authorized by this section shall be: (1) set forth (A) in the articles of incorporation or bylaws and approved by all persons who are shareholders at the time of the agreement or (B) in a written agreement that is signed by all persons who are shareholders at the time of the agreement and is made known to the corporation; . . . .").

[15] The Council does not oppose shareholder agreements *per se*. CII members have, however, adopted a policy (7.3h) that a director should not be considered independent if he or she is a party to a voting trust, agreement or proxy that gives his or her decision making power to management "except to the extent there is a fully disclosed and narrow voting arrangement such as those which are customary between venture capitalists and management regarding the venture capitalists' board seats." CII, Policies on Corporate Governance 7.3h.

envelope of statutory limits."[16] He cites examples of court rulings that challenged various practices, such as backdating of stock options,[17] which routinely occurred at the time they were challenged.[18] That development was unpopular in some quarters, but there was no rush for legislation to validate such backdating. It is difficult to see why this case should be any different.[19]

Thank you for your consideration of these points. Please do not hesitate to contact me if the Council can provide any additional information.

Very sincerely yours,

Jeffrey P. Mahoney
General Counsel

[16] Letter from Brian JM Quinn, Professor of Law, Boston College to Kate Harmon, Esq., President, Delaware State Bar Association 2 (Apr. 12, 2024) (on file with CII).
[17] *Cf.* CII, Policies on Corporate Governance 5.5d ("Stock Options . . . CII opposes option backdating and option repricing, whether achieved through amending exercise prices or cancelling and replacing outstanding options with lower exercise prices.").
[18] *See* Letter from Brian JM Quinn, Professor of Law, Boston College to Kate Harmon, Esq., President, Delaware State Bar Association at 2 ("Imagine what the world might look like, if, following protestations about how back-dating options as 'just market practice,' Delaware had amended Section 157 to permit boards of directors to back-date options, pushing the statute into accordance with market practice.").
[19] Prof. Quinn also cites the push from some quarters to overturn *Omnicare, Inc. v. NCS Healthcare,* 818 A.2d 914, 918 (Del. 2003), *available at* https://casetext.com/case/omnicare-v-ncs-healthcare-2, which held that directors who enter into fully locked-up merger agreements violate their fiduciary duties. *See id.* Despite dire predictions at the time, *Omnicare* remains on the books. Of course, pushing the envelope is not a new feature in corporate dealmaking. The textbook example from 50 years ago involved an effort by Sun Company to buy one-third of Becton Dickinson Co. stock not with a public tender offer but using a subsidiary to make a series of private transactions. The subsidiary was named "LHIW" – for "Let's Hope It Works." Tom Goldstein, *Business and the Law*, N.Y. Times (Dec. 1, 1978), *available at* https://www.nytimes.com/1978/12/01/archives/business-and-the-law-the-language-of-takeovers-those-saturday-night.html.