DELAWARE CORPORATE LAW BULLETIN

Doubling Down on "Plain Language": Delaware Court Extends *In re VAALCO Energy* by Invalidating Supermajority Vote Requirement for Director Removal

*Robert S. Reder**
*Stanley Onyeador***

Court finds that plain language of DGCL §141(k) unequivocally requires only a simple stockholder majority to remove members of an unclassified board of directors

* Professor of the Practice of Law at Vanderbilt University Law School, has been serving as a consulting attorney at Milbank, Tweed, Hadley & McCloy LLP in New York City since his retirement as a partner in April 2011.

** Vanderbilt University, J.D./M.B.A. Candidate, May 2017. Upon graduation, Stanley Onyeador will join the Corporate group at Cravath, Swaine & Moore in New York, New York. Thanks to Professor Reder and the *Law Review* for the opportunity to publish in this *En Banc* series.

INTRODUCTION

The Delaware General Corporation Law ("DGCL") allows corporations to structure their boards of directors to be either classified or unclassified. Under Section 141(d) of the DGCL ("DGCL 141(d)"), a board may be "divided into 1, 2 or 3 classes." Typically, a classified board (commonly referred to as a "staggered" board) is divided into three separate classes, with each class serving three year terms and only one class up for election in any year. The classified board is thought to be the most potent takeover defense available to a corporation with publicly traded stock because it requires a potential hostile acquirer to win two consecutive annual election contests to gain a majority position on the board with the ability to disarm the corporation's other takeover defenses—primarily its stockholders rights plan (a.k.a., the "poison pill"). Inasmuch as most acquirers are not willing to hold a hostile bid open for the thirteen-month interval that a corporation can, under the DGCL, impose between annual meetings, the classified board structure facilitates a "just say no" takeover defense.[1] By contrast, a corporation whose board is not classified must hold an election for its entire board annually, whose members serve only one year at a time.

Section 141(k) of the DGCL ("DGCL 141(k)") governs removal of directors from both classified and unclassified boards.[2] Under DGCL 141(k), directors of unclassified boards "may be removed, *with or without cause*, by the holders of a *majority* of the shares then entitled to vote at an election of directors . . . ."[3] However, "in the case of a corporation whose board is *classified* . . . , stockholders may effect such removal *only for cause*."[4] This establishes a very high bar to removal of classified directors.

Over the past two decades, public companies have come under intense pressure from institutional investors and corporate governance activists to declassify their classified boards. And a large percentage has succumbed to this pressure.[5] But the process of declassification has proven not to be routine, particularly in the area of director removal.

---

1. For a classic demonstration of the power of a "just say no" defense facilitated by a classified board structure, see the successful defense by Airgas, Inc. against a premium hostile takeover bid by its competitor in Air Products and Chemicals, Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011).

2. *See* DGCL § 141(k).

3. *Id.* (emphasis added).

4. *Id.* (emphasis added).

5. While 32.1% of S&P 500 companies had a classified board in 2011, that percentage dropped to only 10.9% in 2015. *Fewer Classified Boards Could Mean Higher Director Turnover*, EQUILAR (Mar. 7, 2016), http://www.equilar.com/blogs/84-fewer-classified-boards.html [https://perma.cc/6BVT-TPRZ].

For instance, may the declassifying corporation retain "for cause" removal as the only means by which stockholders can remove directors from their newly declassified boards? And further, may a supermajority vote of stockholders be required before a director may be removed, even without cause? The Delaware Court of Chancery ("Chancery Court") addressed the first of these issues in 2015 and the second more recently.

I. "FOR CAUSE" REMOVAL: *IN RE VAALCO ENERGY, INC. STOCKHOLDER LITIGATION*

As discussed in a previous post in the *En Banc* series, the Chancery Court tackled the first issue in March 2015 in *In re VAALCO Energy, Inc. Stockholder Litigation* ("*In re VAALCO*").[6] In that case, the VAALCO Energy board of directors attempted to retain "for cause" director removal when it submitted a proposal to declassify the board in response to pressure from institutional investors.[7]

Vice Chancellor J. Travis Laster concluded that the "plain language" of DGCL 141(d) requires that stockholders may remove directors either with *or* without cause, subject, "[f]or better or for worse," to only the two exceptions set forth in DGCL 141(k).[8] And only one of those exceptions—a corporation with a classified board—was relevant to the issue before him. The Vice Chancellor explained that the DGCL's director removal provisions are not default provisions that may be modified in a corporation's charter documents, but rather a "legislative statement of what Delaware law permits."[9] This analysis rendered VAALCO Energy's "for cause" removal provision "contrary to law" and, therefore, "invalid."[10] Though, in "theory," allowing a declassified board to retain for cause removal might not run afoul of Delaware corporate policy, Vice Chancellor Laster nevertheless found himself bound by the plain language of the statute.[11]

6. C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015). For a detailed analysis of *In re VAALCO*, see generally Robert S. Reder & Lauren Messonnier Meyers, *Delaware Court Invalidates Commonly-Used Corporate Classified Board Provision as Contrary to Delaware Law*, 69 VAND. L. REV. EN BANC 177 (2016).

7. *See* Reder & Meyers, *supra* note 6, at 178.

8. *In re VAALCO*, C.A. No. 11775-VCL at 4.

9. *Id.*

10. *Id.*

11. *Id.*

II. "SUPERMAJORITY" REMOVAL: *FRECHTER V. ZIER*

A. Factual Background

The second issue came before the Chancery Court for the first time in January 2017 in *Frechter v. Zier*.[12] Presumably in response to *In re VAALCO*, the unclassified Nutrisystem board of directors approved an amendment to the "Director Removal Provision" of Nutrisystem's Bylaws, which previously allowed "company stockholders to remove directors only for cause and upon the affirmative vote of two-thirds of all outstanding shares of Company stock."[13] The amendment struck the "for cause" requirement, consistent with *In re VAALCO*,[14] but retained the two-thirds vote requirement for stockholders to remove directors without cause ("*Supermajority Removal Provision*").

An unhappy Nutrisystem stockholder sued on behalf of all public stockholders, alleging a breach of "duty of loyalty" on the part of the board "by enacting an unlawful bylaw to entrench [the Board] in office" (Count I) and seeking a declaratory judgment that the Supermajority Removal Provision violated DGCL 141(k) (Count II).[15] While acknowledging a steep "presumption that the bylaws are valid," Vice Chancellor Sam Glasscock III nevertheless held that the Supermajority Removal Provision "cannot operate validly 'in any conceivable circumstance.' "[16]

B. The Vice Chancellor's Analysis

Vice Chancellor Glasscock's refreshingly terse analysis was largely textual. He began with section 109(b) of the DGCL ("DGCL 109(b)"), which states that " 'bylaws may contain *any* provision[] *not inconsistent with law*.' "[17] DGCL 109(b) effectively set the stage for rebutting the presumption of validity: the Supermajority Removal Provision is presumed valid *unless* it contains a provision inconsistent with law. With that foundation, the Vice Chancellor turned to DGCL 141(k), finding the Section unambiguous and holding the Supermajority

12. C.A. No. 12038–VCG, 2017 WL 345142 (Del. Ch. Jan. 24, 2017).

13. *Frechter*, 2017 WL 345142 at *1.

14. *See generally* Reder & Meyers, *supra* note 6.

15. Plaintiff ultimately stipulated to withdraw Count I if she won partial summary judgment on Count II. *Frechter*, 2017 WL 345142 at *1.

16. *Id.* at *2.

17. *Id.*

Removal Provision "inconsistent with Section 141(k)" when evaluated "[u]nder the plain language of the statute."[18]

The Vice Chancellor proceeded with a deeper analysis in countering the defendant directors' remaining argument. The directors summarily argued that because (1) DGCL 216 "permits corporations to adopt bylaws specifying the required vote for the transaction of the business of the corporation" (in this case, director removal), and (2) DGCL 141(k) " 'does not address the percentage of the vote that is required to remove directors,' " those provisions, read together, allow the Supermajority Removal Provision.[19] Put differently, the directors argued that DGCL 141(k) is "merely *permissive*" because it "provides only that a majority of stockholders *may* remove directors." This leaves "bylaws free to require a minority, a supermajority or even unanimity . . . for director removal."[20] To support this argument, the directors "point[ed] to seven different sections in the DGCL" that use "mandatory language" (e.g., "shall" or "must") to "establish the vote required for a certain action." Logically, the directors argued, the absence of mandatory language in DGCL 141(k) permits a supermajority vote requirement.[21]

Rejecting this argument— characterized by Vice Chancellor Glasscock as "an unnatural reading of Section 141(k)"—Vice Chancellor Glasscock returned to the text of DGCL 141(k) and the precedent established in *In re VAALCO*. First, he stated that "may" applies wholly to the removal *action* by a *majority* of stock, rather than to the *vote* required to do so.[22] He concluded that the directors' latter reading—that under DGCL 141(k) a majority may remove a director "*only if* the corporation's bylaws so permit"—"renders the 'majority' provision essentially meaningless, and leaves the statutory provision an effective nullity."[23] As such, the Supermajority Removal Provision impermissibly prohibited the holders of a majority of the shares from removing directors, contrary to DGCL 141(k).

Finally, Vice Chancellor Glasscock used *In re VAALCO* as an "instructive" nail in the coffin. Like Vice Chancellor Laster before him, who found that DGCL 141(k) "states affirmatively" that "directors 'may' be removed with or without cause," Vice Chancellor Glasscock noted the Section "also mandates that a *majority* of stockholders *may* remove

18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.* at *4 ("The section provides that holders of a majority of stock may—not must—remove directors; that is, if they so choose, the section confers that power.")
23. *Id.*

directors."[24] Thus, "Section 141(k) unambiguously confers on a majority the power to remove directors, and the contrary provision in the [Nutrisystem] bylaws is [therefore] unlawful."[25]

CONCLUSION

Between *In re VAALCO* and *Frechter v. Zier*, the Chancery Court has clearly established that DGCL 141(k) offers very little flexibility beyond the plain language of the statute. Going forward, stockholders of Delaware corporations with unclassified boards may remove directors without cause and by a simple majority of the outstanding shares. Delaware boards, although normally entitled to adopt and amend bylaws at their discretion, may not utilize that power to vary the removal requirements in their favor. In essence, a Delaware corporation that is forced, or agrees, to declassify its board also loses the protective removal provisions of DGCL 141(k).

While Delaware courts are often lauded for their apt discretion in circumstantially balancing the interests of stockholders, directors, and other corporate stakeholders, some DGCL sections leave no room for judicial discretion. For instance, DGCL § 262(h) famously bakes-in judicial discretion by inviting the court to account for "all relevant factors" when appraising the value of shares dissenting from a merger.[26] However, provisions like DGCL 141(k) are static and mandatory and predetermine a judicial victory for stockholders. Given how historically protective both the Delaware legislature and judiciary have been of the stockholder franchise, this should not be a surprising outcome.

24. *Id.*

25. *Id.*

26. For further discussion of judicial discretion associated with DGCL § 262, see Stanley Onyeador, *The Chancery Bank of Delaware: Appraisal Arbitrageurs Expose Need to Further Reform Defective Appraisal Statute*, 70 VAND. L. REV. 339, 366–72 (2017).