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IN THE COURTS

Frechter v. Zier: Delaware Court of Chancery Provides Guidance on Supermajority Voting Provisions

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In *Frechter v. Zier*, the Delaware Court of Chancery invalidated a bylaw that, on its own, purported to require a vote of two-thirds of the corporation's outstanding voting stock to remove directors.[1] The Court's opinion provides guidance as to the implementation of supermajority voting provisions under the Delaware General Corporation Law (DGCL), including when such provisions must appear in the certificate of incorporation and when they may appear solely in the bylaws.

Background

The facts underlying *Frechter* have roots in the Delaware Court of Chancery's 2015 ruling in *In re VAALCO Energy, Inc. Stockholder Litigation*.[2] In that case, the Court invalidated a provision of the defendant corporation's certificate of incorporation purporting to provide that directors elected on an annual basis by the corporation's stockholders generally could be removed only for cause.[3] The *VAALCO* Court held that, under Section 141(k) of the DGCL, directors may be removed with or without cause by stockholders entitled to vote thereon, except in cases where the board is divided into classes of directors serving staggered terms and where the certificate of incorporation provides for cumulative voting.[4] In defending the provision, the *VAALCO* defendants argued, unsuccessfully, that an order invalidating the company's for-cause removal provision would disrupt the market's settled expectations, and they filed with the Court a compendium naming 179 other Delaware corporations that had enacted or maintained in their certificate of incorporation or bylaws provisions similar to VAALCO Energy's for-cause provision.[5] The *VAALCO* ruling precipitated numerous inquiries from the plaintiffs' bar, which had ready access to the publicly-filed compendium, prompting many of the corporations on the list to review and consider whether to amend their certificate of incorporation and bylaws to assure compliance with Section 141(k).[6]

In January 2016, Nutrisystem, Inc., which had been listed in the *VAALCO* defendants' compendium, announced that its board of directors had amended the bylaws to eliminate the "for cause only" director removal provision. Before the amendment,

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stockholders of Nutrisystem were entitled to remove directors only for cause and only by the vote of two-thirds of the outstanding voting stock.[7] The amended bylaws provided that directors could be removed with or without cause, but still required the stockholders to obtain a vote of two-thirds of the outstanding voting stock to effect such removal (Supermajority Removal Bylaw).

A stockholder plaintiff filed suit challenging the Supermajority Removal Bylaw, alleging that the defendant directors, acting with entrenchment motivations, breached their duty of loyalty in adopting it. The plaintiff also sought a declaration that the Supermajority Removal Bylaw violated Section 141(k) of the DGCL.[8] The defendants moved to dismiss the claims; the plaintiff moved for summary judgment. At an oral argument at which the Court heard both motions, the plaintiff agreed not to pursue its breach of fiduciary claim if the Court ruled in its favor on the declaratory judgment count.

The Court's Analysis

After determining that it was appropriate to rule on the plaintiff's motion for summary judgment, as the facial validity of the bylaw was purely a matter of construction of the DGCL, the Court engaged in its statutory analysis. The Court noted that Section 141(k) permits the holders of a majority of the voting stock entitled to vote to remove directors and that, under Section 109 of the DGCL, the bylaws may contain any provision not inconsistent with law or the certificate of incorporation.[9] Despite remarking that the plaintiff had argued persuasively that the Supermajority Removal Bylaw was inconsistent with applicable law (namely, Section 141(k)), the Court gave due consideration to the defendants' argument that the bylaw was permitted under Section 216 of the DGCL.

Under Section 216, the defendants argued, a Delaware corporation may specify a vote of stockholders required for corporate action, subject only to the provisions of the DGCL "in respect of the vote that shall be *required* for a specified action."[10] While acknowledging that Section 141(k) specifies a vote of stockholders for the removal of directors, the defendants argued that the subsection merely

> sets the rules only for the circumstances under which stockholders *may* remove directors without cause, and does not address the percentage of the vote that is required to remove directors.[11]

Put differently, the defendants argued that Section 141(k), which uses the word "may" rather than "shall" or "must," is merely permissive.[12] According to the defendants, because Section 141(k) does not *require* a specific vote of stockholders, its expression of the voting standard for director removal is susceptible to variation under Section 216.

Rejecting the defendants' argument, the Court explained that, while Section 141(k) "provides that holders of a majority of stock may—not must—remove directors," where the power to remove directors is made subject to a supermajority vote, holders of a simple majority of the outstanding voting stock are precluded from exercising such power.[13] In that regard, the Court found that the Supermajority Removal Bylaw was inconsistent with the statute, as it would effectively render the stockholders' majority-removal power under Section 141(k) a "nullity."[14]

Observations and Implications

Although the Court's opinion in *Frechter* was focused on the facial validity of the Supermajority Removal Bylaw, it gives rise to several additional observations. First, the Court's opinion does not, nor should it be construed to, call into question the technical validity of supermajority provisions generally. Instead, the opinion should be read to provide guidance as to when, from a corporate power standpoint, supermajority provisions must appear in the certificate of incorporation and when they may be included solely in the bylaws. Section 102(b)(4) of the DGCL expressly provides that a certificate of incorporation may contain "[p]rovisions requiring

for any corporate action, the vote of a larger portion of the stock or of any class or series thereof… than is required by [the DGCL]."[15] While the Court did not engage in the specific analysis in its opinion, it is fair to say that Section 102(b)(4), which permits a *certificate of incorporation* to increase a minimum stockholder vote required by the DGCL, operates as what the Court of Chancery has, in other contexts, referred to as a "bylaw excluder."[16] That is, because Section 102(b)(4) specifically references a grant of authority that may be provided in the certificate of incorporation—in this case, increasing a statutorily required vote of stockholders—it excludes such grant of authority from being provided through the bylaws.[17]

Second, in light of the Court's analysis regarding whether Section 141(k)'s grant of authority to holders of a majority in voting power of the outstanding stock could be increased (so as to prevent the exercise of power by the holders of a majority in voting power of the outstanding stock), corporations and practitioners should be wary of bylaw provisions that purport to increase a vote of stockholders in a manner that would conflict with a grant of authority provided to the holders of a specified portion of the stock under the certificate of incorporation. For example, if the certificate of incorporation provides the holders of 25 percent of the outstanding voting stock the power to call special meetings of stockholders, a bylaw increasing the vote to a higher percentage (e.g., a majority of the outstanding voting power) may be found to conflict with the certificate of incorporation and, by virtue of Section 109(b), constitute a nullity.

Third, although not expressly addressed in the *Frechter* opinion, practitioners should be aware that, unless properly drafted, supermajority provisions included solely in the bylaws may be subject to elimination by a lesser vote of stockholders. In *Frankino v. Gleason*,[18] a stockholder holding 55 percent of the outstanding voting stock sought to regain control of the corporation's board of directors by expanding the size of the board and filling the newly-created directorships. The controller intended to do so by amending Article III of the bylaws, which dealt with the number of directors. Article IX of the bylaws, however, specified that Article III could not be amended except by the vote of 80 percent of the outstanding voting stock. But Article IX itself was not protected by a supermajority vote. Thus, the controller, acting by a simple majority vote, amended Article IX to eliminate the 80 percent vote imposed on Article III, and subsequently amended Article III to expand the size of the board. The controller then proceeded to fill the newly-created directorships. In the ensuing action to determine the validity of the director appointments, the *Frankino* Court held that the controller's two-step maneuver was valid.[19] Accordingly, corporations and practitioners should ensure that any supermajority voting provision that is included solely in the bylaws contains language specifying that any amendment to such provision, or the adoption of any bylaw inconsistent therewith, requires the same supermajority vote.

Finally, as indicated above, the *Frechter* Court was not required to, and accordingly did not, consider whether the adoption and use of the Supermajority Removal Bylaw was valid from an equitable standpoint. Nevertheless, corporations and practitioners should be aware that the validity of the board's adoption and use of an otherwise technically valid supermajority bylaw may be tested again on equitable grounds.[20] In *Chesapeake Corp. v. Shore*,[21] for example, the Court, applying the equitable tests under *Unocal*[22] and *Blasius*,[23] invalidated a bylaw amendment adopted by a board of directors in the midst of a control contest that would have required a supermajority vote for stockholder-initiated amendments to the bylaws, including any amendment to declassify the board.[24]

Conclusion

The Court of Chancery's opinion in *Frechter* provides useful guidance as to the manner in which supermajority provisions may be implemented validly, from a technical standpoint, under the DGCL. While the Court held that a supermajority voting bylaw would not be effective to increase a statutorily required vote, it did not invalidate or otherwise call

into question the use of supermajority voting bylaws generally. Subject to equitable considerations, the adoption and implementation of supermajority voting bylaws, in compliance with the DGCL and the certificate of incorporation, remains a valid method of structuring a corporation's internal affairs.

Notes

1. 2017 WL 345142 (Del. Ch. Jan. 24, 2017).
2. C.A. No. 11775–VCL (Del. Ch. Dec. 21, 2015) (TRANSCRIPT).
3. *Id.* at 3.
4. *Id.* at 3-4. Section 141(k) of the DGCL provides, in relevant part: "Any director or the entire board of directors 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, except as follows: (1) Unless the certificate of incorporation otherwise provides, in the case of a corporation whose board is classified as provided in subsection (d) of this section, stockholders may effect such removal only for cause; or (2) In the case of a corporation having cumulative voting, if less than the entire board is to be removed, no director may be removed without cause if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of the entire board of directors, or, if there be classes of directors, at an election of the class of directors of which such director is a part."
5. As to defendants' argument based on market expectations, the Court stated: "To the extent that this [ruling] upsets expectations at some give-or-take 175 public companies that may have some strange combination of provisions that attempts to achieve the same result, that is just a consequence of people not reading [Section 141(k)]. And I think defendants, quite appropriately, backed away from this argument today. Just as 'all the other kids are doing it' wasn't a good argument for your mother, and just as 'all the other drivers are speeding' still isn't a good argument for the highway patrolman, the idea that 175 other companies might have wacky provisions isn't a good argument for validating your provision." *VAALCO*, C.A. No. 11775–VCL, at at 11.
6. Che Odom and Michael Greene, "Delaware Ruling Spurs Rush to Change Board-Removal Clauses," *Corporate Law & Accountability Report*, Mar. 3, 2016.
7. 2017 WL 345142, at *1.
8. *Id.* at *2.
9. *Id.* Section 109(b) of the DGCL provides, in relevant part: "The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." 8 *Del. C.* § 109(b).
10. *Id.* § 216 (emphasis added).
11. 2017 WL 345142, at *3 (emphasis added).
12. *Id.*
13. *Id.*
14. *Id.* The Court further referenced the ruling in *VAALCO*, in which the Court stated: "'141(k) states affirmatively 'any director or the entire board of directors 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.' That is the rule.'"
15. 8 *Del. C.* § 102(b)(4).
16. *See Sinchareonkul v. Fahnemann*, 2015 WL 292314 (Del. Ch. Jan. 22, 2015). *Fahnemann* involved a challenge to the facial validity of a provision of the corporation's bylaws that purported to grant the chairman of the board a second "tie-breaking" vote on specified matters. The plaintiff alleged that, for such provision to be valid, it had to be included in the certificate of incorporation, as Section 141(d) of the DGCL permits the certificate of incorporation to provide differential voting rights to directors but is silent as to whether the bylaws may provide such rights. The *Fahnemann* Court stated: "The specific reference [in Section 141(d)] to the certificate of incorporation is 'a "bylaw excluder,"' in the sense that those words make clear that the specific grant of authority in that particular statute is one that can be varied only by charter and therefore indisputably not one that can be altered by a [Section] 109(b) bylaw." *Id.* at *8.

    Notably, while the DGCL may have certain "bylaw excluder" provisions, the converse is not true. Section 102(b)(1) of the DGCL provides, "[a]ny provision which is required or permitted by any section of [the DGCL] to be stated in the bylaws may instead be stated in the certificate of incorporation." 8 *Del. C.* § 102(b)(1). Thus, for example, Section 141(b) of the DGCL, which provides that "the

number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number," should be read as "the number of directors shall be fixed by, or in the manner provided in the [certificate of incorporation] or bylaws, unless the certificate of incorporation fixes the number." *Id.* § 141(b). Of course, in those cases where the certificate of incorporation includes such a provision, it will trump any inconsistent bylaw by the operation of Section 109(b). *Id.* § 109(b) (providing that "[t]he bylaws may contain any provision, not inconsistent with law or the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees").

17. *See* 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 7.24, at 7–61 (3d ed. 2016 Supp.) ("When a vote is specifically provided by the [DGCL], it may only be increased (other than in the case of Section 203) by a provision of the certificate of incorporation adopted pursuant to Section 102(b)(4), and not by the bylaws."). Note that Section 203(d) of the DGCL states: "No provision of a certificate of incorporation or bylaw shall require, for any vote of stockholders required by this section [203], a greater vote of stockholders than that specified in this section." 8 *Del. C.* § 203(d).
18. 1999 WL 1032773 (Del. Ch. Nov. 5, 1999).
19. *Id.* The *Frankino* Court drew a distinction to an earlier case in which the holders of a bare majority of the outstanding voting stock attempted to use a similar maneuver to amend a provision requiring a supermajority vote to amend specified provisions of a certificate of incorporation, noting that the earlier holding was ultimately codified in Section 242(b)(4) of the DGCL, 8 *Del. C.* § 242(b)(4), which provides, in relevant part, that "[w]henever the certificate of incorporation shall require for action … by the holders of any class or series of shares … the vote of a greater number or proportion than is required by any section of [the DGCL], the provision of the certificate of incorporation requiring such greater vote shall not be altered, amended or repealed except by such greater vote," and that no analogous provision of the DGCL applies to bylaws. *Frankino*, 1999 WL 1032773, at *4.
20. *See, e.g.*, *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, at 642 (Del. Ch. 2013) ("The complaint does not otherwise allege a statutory violation (as opposed to a breach of fiduciary duty) based on the fact that the Series E Charter specified unadjusted conversion prices for the Series A, B, and C Preferred. Corporate acts are "twice-tested," once for statutory compliance and again in equity. Assuming the adoption of the Series E Charter was otherwise valid, then the amendment process could be used to reset the economic rights of the Series A, B, and C Preferred, subject to the constraints of equity.").
21. 771 A.2d 293 (Del. Ch. 2000).
22. *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
23. *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).
24. *Chesapeake* 771 A.2d at 296. *Chesapeake* involved a contest for control between plaintiff Chesapeake Corporation and the defendant Shorewood Packaging Corporation. *Id.* The boards of each company evidently agreed that the two companies should be merged, but they apparently disagreed on the management of the surviving entity. *Id.* at 302. Following Chesapeake's unsolicited all-cash offer, Shorewood's board adopted a bylaw requiring a vote of two-thirds of the outstanding voting stock to amend the bylaws in order to prevent Chesapeake from declassifying the board, removing the incumbent directors and appointing new directors. *Id.* at 305. (Notably, Chesapeake's management controlled 24 percent of the outstanding stock.) Shorewood subsequently reduced the threshold to 60 percent from two-thirds, but Chesapeake continued its challenge. *Id* at 315. The *Chesapeake* Court held that the defendants had not met their burden under the *Unocal* and *Blasius* standards to sustain the supermajority voting bylaw. In sum, the Court found, among other things, that "the defendants faced only a modest threat of price inadequacy"; that "there was no legitimate threat of stockholder confusion" that the supermajority bylaw addressed; that the bylaw was effectively preclusive, as there was no "real-world evidence" that the supermajority vote could be obtained in light of management's position in the stock; and that the defendants "acted with the primary intent of changing the electoral rules so as to make it more difficult to unseat them." *Id.* at 296.