Vanderbilt Law Review

Volume 69
Issue 7 *En Banc*

Article 10

2016

Delaware Court Invalidates Commonly-Used Corporate Classified Board Provision as Contrary to Delaware Law

Robert S. Reder

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Recommended Citation
Robert S. Reder, Delaware Court Invalidates Commonly-Used Corporate Classified Board Provision as Contrary to Delaware Law, 69 *Vanderbilt Law Review* (2024)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol69/iss7/10

This Article is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

DELAWARE CORPORATE LAW BULLETIN

Delaware Court Invalidates Commonly-Used Corporate Classified Board Provision as Contrary to Delaware Law

*Robert S. Reder**
*Lauren Messonnier Meyers***

Finds that plain language of DGCL §141(k) protects stockholders' right to remove members of an unclassified board without cause.

INTRODUCTION 177
I. *IN RE VAALCO ENERGY, INC. STOCKHOLDER LITIGATION* . 179
 A. *Factual Background* 179
 B. *Litigation Ensues* 180
 C. *Vice Chancellor Laster's Analysis of the "Wacky" Provisions* 180
CONCLUSION 182

INTRODUCTION

Corporations seek to maintain highly valuable flexibility when structuring their charter documents under the Delaware General Corporate Law ("DGCL")—indeed, corporations have long flocked to this corporate haven to benefit from its hallmark trait of autonomy. However, if a Delaware corporation abuses this flexibility by adopting a charter provision that is "contrary to the laws of the State," that

provision is invalid.[1] Unfortunately, the plain language of the DGCL, at times, is not so clear.

For example, the DGCL allows a company to structure its board 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 (or "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 because it requires a potential hostile acquirer to win two consecutive annual election contests to win a majority position on the board and thereby gain the ability to disarm the corporation's other takeover defenses, primarily a stockholders' rights plan (i.e., a "poison pill"). Inasmuch as most acquirers are not willing to hold a hostile bid open for the 13-month interval that a corporation can, under the DGCL, impose between annual meetings, the classified board structure facilitates a "just say no" takeover defense.[2] By contrast, a corporation whose board is not classified must hold an annual election for its entire board, whose members serve only one year at a time.

While a corporation may choose either structure, assuming stockholders are in agreement, Section 141(k) of the DGCL ("DGCL § 141(k)") offers an important wrinkle when the classified board structure is selected: "Any director . . . 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 . . . in the case of a corporation whose board is classified . . . , stockholders may effect such removal *only for cause*."[3] While this provision may seem clear on its face—stockholders may remove members of a classified board only for cause—this provision was squarely challenged in *In re VAALCO Energy, Inc. Stockholder Litigation*, with implications for approximately 175 other Delaware public corporations.[4]

---

* Robert S. Reder, 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 Law School, J.D. Candidate, May 2016. I would like to thank Professor Reder as well as the *Vanderbilt Law Review* for the ability to participate in the *En Banc* series.

1. DGCL § 102(b)(1).

2. For a classic demonstration of the operation 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 Air Products & Chemicals, Inc. Air Products & Chemicals, Inc. v. Airgas, Inc., C.A. Nos. 5249, 5256 (Del. Ch. Feb. 15, 2011).

3. DGCL § 141(k)(1) (emphasis added).

4. C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015).

I. *IN RE VAALCO ENERGY, INC. STOCKHOLDER LITIGATION*

A. Factual Background

In 2008, VAALCO Energy, Inc. ("VAALCO")—a "Houston, Texas-based independent energy company principally engaged in the acquisition, exploration, development and production of crude oil and natural gas"—came under pressure from institutional investors to declassify its Board of Directors.[5] Like the boards of numerous other public corporations facing similar challenges, VAALCO's Board succumbed to the pressure and proposed that stockholders amend Article V, Section 2 of the certificate of incorporation (the "Declassification Amendment") at the 2010 annual meeting of stockholders to read:

> From and after the date of the 2010 annual meeting of stockholders, the Board of Directors shall not be classified and directors shall be elected at each annual meeting for a one-year term expiring at the next annual meeting.[6]

Notably, and consistent with DGCL § 141(k), Article V, Section 3 of VAALCO's certificate of incorporation provided that directors could be removed by stockholders only "for cause" (the "For Cause Removal Provision").[7] The Board did not propose to amend the For Cause Removal Provision as part of the Declassification Amendment. Thus, when stockholders overwhelmingly approved the Declassification Amendment, VAALCO was left with something of a hybrid—a declassified board whose members could be removed from office by stockholders only for cause. VAALCO's legal advisors did not invent this provision from whole cloth; rather, they employed language typically used by corporations undergoing board declassification.

Fast forward to September 2015, when VAALCO completed a twelve-month period during which the market value of its common stock declined by nearly 80%. A group of disappointed activist stockholders owning approximately 11% of the outstanding shares (the "Investor Group") began a consent solicitation to remove and replace four of VAALCO's seven directors *without cause*. In response, VAALCO claimed that, consistent with the For Cause Removal Provision, directors could not be removed by stockholders unless they cited sufficient cause.

---

5. Defendants' Opening Brief in Opposition to Plaintiffs' Motion for Summary Judgment and in Support of Defendants' Motion for Summary Judgment at 6, *In re VAALCO*, C.A. No. 11775-VCL [*hereinafter* "Defs' Br."]; VAALCO Energy, Inc., Annual Report (Form 10-K) (March 16, 2015).

6. Defs' Br., *supra* note 5, at 8.

7. *Id.* Article III, Section 2 of VAALCO's bylaws similarly limit stockholders to "for cause" removal of directors.

B. Litigation Ensues

The dispute between the Investor Group and the VAALCO Board landed in the Delaware Court of Chancery. The Investor Group asked Vice Chancellor J. Travis Laster to invalidate the For Cause Removal Provision as contrary to the mandatory provisions of DGCL § 141(k). This request was based on the Investor Group's contention that DGCL § 141(k) permits only a corporation with a classified board to limit stockholders to for cause removal of directors.

Vice Chancellor Laster analyzed DGCL §§ 141(d) and 141(k) to determine their statutory meanings, focusing on the issue whether the For Cause Removal Provision, which had been duly adopted by VAALCO stockholders in connection with the earlier establishment of the classified Board, became invalid when the Board was declassified. In resolving this issue, the Vice Chancellor tackled two questions: *First,* does DGCL § 141(k) explicitly mandate that stockholders may remove directors without cause *unless* the board is classified? And, *second,* does DGCL § 141(d) permit a classified board having only a single class?

C. Vice Chancellor Laster's Analysis of the "Wacky" Provisions

Vice Chancellor Laster concluded that the "plain language" of DGCL § 141 resolved the first question. According to the Vice Chancellor, 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—when a corporation has a classified board—was relevant to the issue before him. These are not default provisions that may be modified in a corporation's certificate of incorporation, but rather a "legislative statement of what Delaware law permits."[9] This analysis rendered the 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, the Vice Chancellor nevertheless found himself bound by the plain language of the statute.[11]

Vice Chancellor Laster considered VAALCO's argument in response to the second question to be its "strongest argument."[12] VAALCO contended that because DGCL § 141(d) seemingly permits a

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

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.* at 6.

corporation to have a classified board consisting of only one class,[13] a corporation which declassifies its board into a single class may retain limited director removal rights. The Vice Chancellor dismissed this argument in three takes:

- *First,* a "single-class classified board" is a "somewhat oxymoronic concept" representing a "pretty novel reading of 141(d)."[14] In the absence of "some really good reason for suddenly discovering something new about a section like 141, particularly when that interpretation . . . would cut against what . . . has been the standard analysis of 141(k)," the Vice Chancellor was not prepared to view the declassified VAALCO Board as a classified board consisting of a single class.[15]

- *Second,* the Vice Chancellor offered the opinion that DGCL § 141(d)'s formulation that boards may be "divided into 1, 2 or 3 classes" was intended to clarify that "special stock directors," also permitted by DGCL § 141(d), do not represent an additional class (or classes) of directors.[16] Rather, "they're just part of . . . [an unclassified] board along with everybody else.[17]

- *Third,* regardless of whether the DGCL permits a single-class classified board, in the case of VAALCO, this is not "what they did."[18] It might be "one thing if you went out to your stockholders and said 'We are declassifying, and we are declassifying from three classes into one class, and our newly re-classified one-class board will have all the attributes of a classified board under Delaware law and, therefore, will not allow removal except for cause.' "[19] However, the only matter that VAALCO stockholders voted on was an amendment of the certificate of incorporation to declassify the board. Under the "venerable principle of independent legal significance," the "route" chosen by VAALCO matters inasmuch as "we value formality" when it comes to questions of "statutory interpretation."[20] In other words, "the fact that you might theoretically have gone some heretofore

13. As noted above, under DGCL § 141(d), a board may be "divided into 1, 2 or 3 classes."
14. *In re VAALCO*, C.A. No. 11775-VCL, slip op. at 7.
15. *Id.* at 8.
16. *Id.*
17. *Id.* at 9.
18. *Id.* at 10.
19. *Id.*
20. *Id.*

> unforeseen path towards a single-class classified board for which directors would be removable only for cause doesn't mean that because you ended up with something that you'd like to say is the functional equivalent of that you get the benefit."[21]

Lastly, Vice Chancellor Laster had to address VAALCO's argument that a ruling in favor of the Investor Group "upsets expectations at some . . . 175 public companies that may have some strange combination of provisions that attempts to achieve the same result."[22] The Vice Chancellor quickly dismissed this concern, offering the admonishment that "wacky provisions" adopted as "a consequence of people not reading the statute" do not excuse corporations from following the plain language of the DGCL.[23]

On this basis, Vice Chancellor Laster granted the Investor Group's summary judgment motion and entered an order declaring the For Cause Removal Provision invalid.[24] Two days later, VAALCO settled the dispute by (among other actions) securing the resignations of two incumbent directors and agreeing to fill the vacancies with an Investor Group designee and an independent director to be mutually agreed upon by the VAALCO Board and the Investor Group.

CONCLUSION

In re VAALCO offers a note of caution to legal advisors who draft charter and bylaw provisions on behalf of their corporate clients. It is no coincidence that some 175 public Delaware corporations employ the same "wacky" declassified board structure limiting stockholders to for cause removal of directors as the one invalidated by Vice Chancellor Laster. Like VAALCO, many, if not most, of these companies were forced to declassify their boards by a combination of activist investors and corporate governance advocates. For better or worse, as one of your authors can testify from personal experience, corporate lawyers often follow the bromide "if it ain't broke, don't fix it" when it comes to drafting public company charter and bylaw provisions. As such, they

21. *Id.* at 10–11.

22. *Id.* at 11. To further minimize the impact of this argument, Vice Chancellor pointed out that the 175 companies with the "wacky provisions" represent "less than 5 percent" of all public companies. *Id.* at 11–12.

23. *Id.* at 11.

24. Although VAALCO's charter documents did not contain a "severability provision," the Vice Chancellor instructed that Delaware's "general default common law rule is that . . . provisions in a charter and bylaws . . . are severable." Thus, the other provisions of VAALCO's charter documents were not impacted by the Vice Chancellor's invalidation of the For Cause Removal Provision. *Id.* at 5–6.

are inclined to follow public company precedent on file with the SEC. VAALCO's Declassification Amendment certainly reflected the available precedent for declassifying corporate boards. However, now that these provisions are "broke" in light of Vice Chancellor Laster's *In re VAALCO* ruling, they need to be "fixed" and should no longer be perpetuated.[25]

25. *In re VAALCO* is somewhat reminiscent of the controversy over the interpretation of another classified board provision in *Airgas, Inc. v. Air Products & Chemicals, Inc.*, No. 649, 2010 (Del. Nov. 23, 2010). In that case, the Delaware Supreme Court reversed a Court of Chancery ruling supporting an interpretation of Airgas's classified board provision that would have created a serious problem for far more than 175 public companies. *Airgas* represented a pure case of contract interpretation, however, without any allegation that the provision in question (regardless of how interpreted) violated DGCL § 141.