CHANCERY COURT DECISION, INVALIDATING SUPERMAJORITY DIRECTOR REMOVAL BYLAW, HAS BROAD IMPLICATIONS FOR SUPERMAJORITY BYLAW PROVISIONS

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In *Frechter v. Zier*, C.A. No. 12038-VCG (Del. Ch. Jan. 24, 2017), the Delaware Court of Chancery held that a corporation's bylaw, requiring a supermajority stockholder vote for the removal of directors, was invalid. According to the Court, the supermajority bylaw was inconsistent with Section 141(k) of the General Corporation Law of the State of Delaware (the "DGCL"), which provides that, except with respect to corporations having a staggered board or cumulative voting, any director may be removed with or without cause by the holders of a majority of the outstanding voting power of the corporation. Unlike some other provisions of the DGCL, Section 141(k) does not expressly provide for a default rule that applies "unless otherwise provided in the certificate of incorporation or bylaws."[1] According to the Court, the majority rule set forth in Section 141(k) could not be altered by a bylaw provision.

The Court's decision calls into question *any* bylaw requiring a supermajority vote of stockholders if the DGCL otherwise provides for a specific voting threshold for stockholder action which is not expressly subject to modification by a bylaw provision. However, a certificate of incorporation provision, requiring a supermajority stockholder vote to take stockholder action, even where the DGCL provides a specific vote, should be valid under such circumstances.

FACTUAL BACKGROUND

On January 7, 2016, Nutrisystem, Inc. ("Nutrisystem") announced that its board had approved an amendment to Nutrisystem's bylaws which removed a previous requirement that directors could only be removed for cause. The amendment, however, did not remove the portion of the bylaw requiring the vote of 66 2/3% of the voting power of all of Nutrisystem's outstanding stock to remove directors (the "Removal Provision"). Specifically, the Removal Provision provided:

> Except as otherwise provided in the Certificate of Incorporation, no director may be removed from office by the stockholders of the Corporation except by the affirmative vote of the holders of not less than sixty-six and two-thirds percent (66 2/3%) of the voting power of all outstanding shares of stock of the Corporation entitled to vote generally in the election of directors, considered for this purpose as a single class.[2]

Plaintiff, a stockholder of Nutrisystem, subsequently filed a complaint alleging that Nutrisystem's board of directors had breached its fiduciary duties by adopting the Removal Provision to entrench its directors in office ("Count I"). The plaintiff also sought a declaratory judgment that the Removal Provision was inconsistent with Section 141(k) of the DGCL ("Count II"). Section 141(k) of the DGCL provides, in relevant part, that "[a]ny 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 . . . ."[3] Defendants moved to dismiss the plaintiff's complaint. Plaintiff moved for partial summary judgment as to Count II, stipulating that if the Court found in favor of plaintiff on Count II, plaintiff would withdraw Count I.

PARTIES' ARGUMENTS

As support for their argument that the Removal Provision was valid, defendants cited Section 216 of the DGCL, which allows corporations to adopt bylaws that provide the required vote for the transaction of business "[s]ubject to this chapter in respect of the vote that shall be required for a specified action . . . ."[4] Defendants contended that Section 141(k) merely "sets the rules [] 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."[5] Effectively, defendants argued that Section 141(k)'s majority standard is subject to any greater or lesser voting requirement set by the corporation in accordance with Section 216 of the DGCL. Defendants also argued that had the drafters of Section 141(k) intended to make its majority standard mandatory, they would have used the word "shall" or "must" as in seven other sections of the DGCL.

THE COURT'S HOLDING

The Court rejected defendants' argument and held that the Removal Provision was inconsistent with Section 141(k) of the DGCL because Section 141(k) explicitly provides for a majority stockholder vote for the removal of directors. In so holding, the Court explained that Section 141(k) is only permissive in the sense that stockholders *may* choose to remove directors, but they are not *required* to do so. The Court stated:

> Under the Removal Provision, however, a simple majority of Nutrisystem stockholders *may not* exercise such power; the bylaw is, unambiguously, inconsistent with the statute. Defendants' construction of Section 141(k), that a majority may—but only if the corporation's bylaws so permit—remove directors, renders the "majority" provision essentially meaningless, and leaves the statutory provision an effective nullity.[6]

Accordingly, the Court denied defendants' motion to dismiss and granted plaintiff's motion for partial summary judgment on Count II of his complaint. As stipulated, plaintiff withdrew Count I.

IMPLICATIONS

Given *Frechter*, corporations should review their bylaws to ensure that such bylaws do not contain any voting requirement for the removal of directors that would be inconsistent with the majority voting requirement as set forth in Section 141(k) of the DGCL. Any such provisions must be contained in the certificate of incorporation to be valid. This is because Section 102(b)(4) of the DGCL permits a corporation to place in its certificate of incorporation "[p]rovisions requiring for any corporate action, the vote of a larger portion of the stock or of any class or series thereof, or of any other securities having voting power . . . than is required by this chapter."[7] As noted by the Court, the DGCL does not contain a similar provision with respect to bylaws.[8]

This decision also has broader implications for *any* bylaw provision requiring supermajority stockholder votes to take action for which the DGCL provides a specific voting threshold. Post-*Frechter*, some examples of potentially problematic bylaw provisions include bylaws providing for a supermajority stockholder vote for the approval of mergers, significant asset sales and dissolutions, all of which explicitly require a simple majority vote of a corporation's stockholders under the DGCL.[9] Corporations should consider moving any such supermajority voting requirements from bylaws to the certificate of incorporation.

However, bylaw provisions imposing supermajority voting requirements for the amendment of the bylaws by stockholders are likely still valid following *Frechter*. Specifically, Section 109(a) of the DGCL, while granting the inalienable right to stockholders to amend the bylaws, does not specify a default voting standard for such action.[10] When read together with Section 216 of the DGCL, which permits a corporation to specify in its bylaws the required vote for corporate action "[s]ubject to this chapter in respect of the vote that shall be required for a specified action,"[11] Section 109(a) of the DGCL arguably permits bylaw provisions requiring supermajority stockholder votes for the amendment of the bylaws.[12]

Finally, as part of its analysis in *Frechter*, the Court addressed the precedential value of bench rulings when it pointed to the Court's recent bench ruling in *In re VAALCO Energy, Inc. Stockholder Litigation* as supporting its decision.[13] In a footnote, the Court stated that by referring to the bench ruling, the Court did "not mean to imply that bench decisions are part of the case-law of this Court, or encourage citation thereto."[15] The Court's remarks suggest that the precedential value of bench rulings should be considered by practitioners to be limited.

NOTES:

[1] See, e.g., 8 Del. C.§ 141(c)(3) (addressing the creation of subcommittees of the board of directors); 8 Del. C.§ 223(a)(1) (addressing the filling of board vacancies); 8 Del. C.§ 223(d) (same).

[2] Mem. Op.at 2–3 (quoting Compl. ¶ 25).

[3] 8 Del. C. § 141(k).

[4] 8 Del. C.§ 216.

[5] Mem. Op.at 6 (quoting Defs' Opening Br. 17, 19).

[6] Id.at 7–8.

[7] 8 Del. C.§ 102(b)(4).

[8] Specifically, the Court stated that Section 109(b) of the DGCL, which provides that "[t]he 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," "stands in contrast to Section 102(b)(4)" of the DGCL. 8 Del. C.§ 109(b); Mem. Op.at 5 n.19. The Court's decision suggests that certificate of incorporation provisions which require a larger vote than the majority vote provided by the DGCL may be valid.

[9] *See* 8 Del. C.§ 251(c) (specifying a majority voting requirement for stockholders approving a merger); 8 Del. C. § 271(a) (specifying a majority voting requirement for stockholders approving a sale of all or substantially all of the assets of a corporation); 8 Del. C.§ 275(b) (specifying a majority voting requirement for stockholders approving a dissolution of a corporation).

[10] *See* 8 Del. C.§ 109(a) (providing that "the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote" and, even if directors are granted the power in the corporation's certificate of incorporation to amend the bylaws, "[t]he fact that such power has been so conferred upon the directors . . . shall not divest the stockholders . . . of their power, nor limit their power to adopt, amend or repeal bylaws").

[11] 8 Del. C. § 216.

[12] *See, e.g.*, Centaur Partners, IV v. Nat'l Intergroup, Inc., 582 A.2d 923 (Del. 1990) (enforcing two similar 80% supermajority voting requirements found in a corporation's certificate of incorporation and bylaws to amend the section of the bylaws related to, among other things, the size of the board).

[13] C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015) (TRANSCRIPT) (finding that a provision in both a corporation's certificate of incorporation and bylaws, which required that removal of directors by stockholders be only for cause (where Section 141(k) of the DGCL mandates such removal to be with or without cause), was inconsistent with the plain language of Section 141(k) of the DGCL because the corporation did not have a staggered board or cumulative voting).

[14] *Mem. Op.* at 8 n.27.

