MORRIS, NICHOLS, ARSHT & TUNNELL

December 28, 2005

COURT OF CHANCERY REFUSES TO DISMISS CONTRACT CLAIM BASED ON BOARD POLICY

A recent decision of the Delaware Court of Chancery addressed the relationship between stockholders and directors of Delaware corporations in a novel manner. *Unisuper Ltd. v. News Corporation*, C.A. No. 1699-N, Del. Ch., Chandler, C. (Dec. 20, 2005). The case involved a claim that News Corporation breached a contract when it maintained a stockholder rights plan in violation of a previously announced board policy.

The board adopted a policy providing that any stockholder rights plan must, absent stockholder approval, expire after one year. Shortly after adopting the policy, the board adopted a rights plan, and, one year later, the board extended the rights plan without a stockholder vote.

The plaintiff stockholders claimed that the extension constituted, *inter alia*, a breach of contract. Although expressing some doubt as to whether the policy constituted a contract, the Court found that the plaintiffs had adequately alleged the existence of an enforceable agreement. Defendants, however, asserted that even if the policy were a contract, it was unenforceable as a matter of law. Specifically, defendants argued that such an agreement would violate Section 141(a) of the Delaware General Corporation Law, which vests directors with the power and duty to manage a corporation, unless the charter of the company provides otherwise. Defendants claimed that an agreement limiting board power to adopt a rights plan would violate that statute and constitute an unlawful delegation of the board's duties.

The Court first addressed that argument by noting that Section 141(a) does not preclude corporations from entering into binding contracts:

> *By definition, any contract a board could enter into binds the board and thereby limits its power. Section 141(a) does not say the board cannot enter into contracts. It simply describes who will manage the affairs of the corporation and it precludes a board of directors from ceding that power to outside groups or individuals.*

This is a correct restatement of an unremarkable proposition. *See Grimes v. Donald*, 673 A.2d 1207, 1214 (Del. 1996) ("[B]usiness decisions are not an abdication of directorial authority merely because they limit a board's freedom of future action."). Indeed, it is not uncommon for corporations to enter into contracts with lenders or investors that would prohibit the corporation from paying dividends without the approval of the lenders or investors. Such contracts prevent the board from adopting a rights plan without third-party approval since rights plans are implemented through dividends. *News Corporation* arguably involved this type of binding contract because the plaintiff stockholders alleged that investors relied on the rights plan policy to approve a reorganization that would, among other things, reincorporate the company in Delaware. Such contracts can be distinguished from true delegations, such as the rights plan invalidated in *Quickturn Design Systems v. Shapiro*, 721 A.2d 1281 (Del. 1998). The *Quickturn* rights plan, which delegated certain rights to "continuing directors," was unilaterally adopted by the board of directors and

did not constitute a contract with a true third party. *Cf. California Public Employees' Retirement System v. Coulter*, C.A. No. 19191, Del. Ch., Noble, V.C. (Apr. 21, 2005) (upholding contract containing continuing director provisions where contract was with true third parties).

In contrast, a pure delegation, or other attempt to allow non-directors to make decisions on behalf of the corporation, could constitute a violation of the board's fiduciary duties, even if the board's authority is delegated to a stockholder. *See, e.g., McMullin v. Beran*, 765 A.2d 910 (Del. 2000) (directors abdicated duty by permitting 80% stockholder to conduct sale of company). Given its finding as to the contract question, the Court in *News Corporation* did not need to address the delegation issue. Nevertheless, the Court made a number of observations concerning the delegation of power to stockholders:

> *Delaware's corporation law vests managerial power in the board of directors because it is not feasible for shareholders, the owners of the corporation, to exercise day-to-day power over the company's business and affairs. Nonetheless, when shareholders exercise their right to vote in order to assert control over the business and affairs of the corporation the board must give way. This is because the board's power—which is that of an agent's with regard to its principal—derives from the shareholders, who are the ultimate holders of power under Delaware law.*

This discussion came in response to defendants' argument that the delegation to stockholders represented by the policy constituted a breach of fiduciary duty because it abdicated to stockholders the decision whether to keep a rights plan in place. The Court found that a delegation to stockholders could not constitute a breach of duty because those duties were owed to the stockholders:

> *It makes no sense to argue that the News Corp. board somehow disabled its fiduciary duties to shareholders by agreeing to let the shareholders vote on whether to keep a poison pill in place. This argument is an attempt to use fiduciary duties in a way that misconceives the purpose of fiduciary duties. Fiduciary duties exist in order to fill the gaps in the contractual relationship between the shareholders and directors of the corporation. Fiduciary duties cannot be used to silence shareholders and prevent them from specifying what the corporate contract is to say. Shareholders should be permitted to fill a particular gap in the corporate contract if they wish to fill it. This point can be made by reference to principles of agency law: Agents frequently have to act in situations where they do not know exactly how their principal would like them to act. In such situations, the law says the agent must act in the best interests of the principal. Where the principal wishes to make known to the agent exactly which actions the principal wishes to be taken, the agent cannot refuse to listen on the grounds that this is not in the best interests of the principal.*
>
> *To the extent defendants argue that the board's fiduciary duties would be disabled after a hypothetical shareholder vote, this argument also misconceives the nature and purpose of fiduciary duties. Once the corporate contract is made explicit on a particular issue, the directors must act in*

accordance with the amended corporate contract. There is no more need for the gap-filling role performed by fiduciary duty analysis. Again, the same point can be made by reference to principles of agency law: Where the principal makes known to the agent exactly which actions the principal wishes to be taken, the agent must act in accordance with those instructions.

The idea that directors must treat a majority stockholder vote as a direction from a principal that frees them from the fiduciary obligation to manage the corporation in the best interests of the corporation and all its stockholders would represent a departure from prior law as articulated by the Delaware Supreme Court. *See, e.g., Adams v. Clearance Corp.*, 121 A.2d 302, 305-06 (Del. 1956) (stating that it is "well settled" that "directors may not delegate their duty to manage the corporate enterprise" and that "the general rule forbidding the directors to delegate managerial duties applies as well to a delegation of a single duty as to the delegation of several or of all duties"); *Lehrman v. Cohen*, 222 A.2d 800 (Del. 1966) (finding that the alleged stockholder delegation of certain powers and duties of the board to one director pursuant to a unanimously adopted, Section 141(a) charter amendment was valid and distinguishing cases finding improper delegation on the basis that such cases did not involve a Section 141(a) charter provision); *McMullin v. Beran, supra*; *Quickturn Design Systems v. Shapiro*, 721 A.2d at 1292 (invalidating provision within a rights plan eliminating the power of certain future boards to redeem the rights as "invalid under Section 141(a), which confers upon any newly elected board of directors *full* power to manage and direct the business and affairs of a Delaware corporation"); *see also Abercrombie v. Davies,* 123 A.2d 893, 899 (Del. Ch. 1956), *rev'd on other grounds*, 130 A.2d 338 (Del. 1957) (court "cannot give legal sanction to agreements which have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters"). The statement of the Court to the effect that this rule of non-delegation does not apply to delegations to stockholders is not supported by prior case law. Moreover, unlike directors, stockholders generally do not have fiduciary duties, and they are entitled to vote their shares in their own interest, even when they have interests that may diverge from those of other stockholders. These factors appear to call into question whether it is good policy to treat the vote of a majority of stockholders as if it were a direction by a principal.

In light of the weight of prior case law, practitioners should exercise caution in relying on the discussion of delegation principles contained in this decision.

If your address changes or if you do not wish to continue receiving these memos,
please send an e-mail to Newsletter@mnat.com or call 302-351-9241