Professional Perspective

Delaware Guidance on Approval of Charter Amendments

Nate Emeritz and Adrian Broderick,
Wilson Sonsini Goodrich & Rosati, P.C.

Bloomberg Law

Read Professional Perspectives | Become a Contributor

Reproduced with permission. Published December 2020. Copyright © 2020 The Bureau of National Affairs, Inc.
800.372.1033. For further use, please visit: bna.com/copyright-permission-request

Delaware Guidance on Approval of Charter Amendments

Editor's Note: The views expressed herein are those of the authors and do not necessarily reflect the views of the firm or its clients.

Contributed by Nate Emeritz and Adrian Broderick, Wilson Sonsini Goodrich & Rosati, P.C.

Corporations amend their certificate of incorporation all the time, including as part of a financing, merger, or other significant transaction. The amendment of a corporation's certificate of incorporation is a technical process—in terms of both drafting and determining the requisite consents required to adopt the amendments. In particular, Section 242 of the Delaware General Corporation Law (the DGCL), protective provisions in Delaware corporations' charters, and contractual consent rights in side agreements can require the corporation to first obtain approval from subsets of the stockholders. And the precise contours of those requirements can be critical to planning a charter amendment or resolving related litigation. Analogues to those provisions can also be found in the organizational documents of other entities, such as the operating agreement of a limited liability company (an LLC).

This article identifies guidance from recent Delaware cases regarding amendments of both corporate and LLC governing documents, as well as directors' obligations to validly effect a charter amendment.

Guidance from Cases Involving LLC Operating Agreements

The protective provisions found in LLC operating agreements often contain terms that are similar to those found in Section 242 of the DGCL and corporate protective provisions. It is, of course, important to keep in mind the difference between the statutes underlying various types of entities, as well as any differences in the precise terms of the provisions. But where an LLC's protective provision is construed by the court, it is worth considering how that might reflect the court's view of comparable language in the context of a corporation.

For instance, Section 242(b)(2) requires class-specific approval of a charter amendment if the change would "alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely." Delaware courts have long held that layering on a new class or series of stock does not trigger this statutory approval right, because such subordination does not change the terms of the existing class.

But, in practice, determining whether an amendment adversely affects a class can depend on the precise changes to the charter—and potentially an existing class—that are necessary to add the new class in a way that harmonizes new and existing provisions. This can also lead to difficult questions when planning a transaction that involves an amendment and determining which votes are necessary. Similarly, Section 242(b)(2) requires series-specific approval of a charter amendment if the change would "alter or change the powers, preferences, or special rights of 1 or more series of any class so as to affect them adversely, but shall not so affect the entire class."

Delaware practitioners have long debated whether this series-specific approval is intended to be triggered by an amendment that is facially neutral as to a class but could differently or disproportionately affect certain series in that class. Provisions in LLC operating agreements that bear similarity to these class- and series-specific vote requirements have recently been examined in Delaware cases.

Adverse Effect on a Right of an Existing Series

In August 2020, the Court of Chancery addressed whether creation of a senior series of security in an LLC would "have the effect of removing any rights expressly granted" to an existing series of unitholders. *DG BF LLC v. Ray*, No. 2020-0459-MTZ (Del. Ch. July 9 & 17, 2020) interlocutory appeal refused by 237 A.3d 70 (Del. 2020) (order). The parties disputed whether the existing series' senior liquidation preference had been effectively granted in perpetuity, such that layering on a more senior series would "remove" that "expressly granted" seniority—as required to trigger a consent right under the operating agreement. That consent right for "removal" of an "expressly granted" right may be analogized to arguments under Section 242(b)(2) regarding whether creation of a new class of stock "adversely affects" an existing class of stock.

 ©2020 The Bureau of National Affairs, Inc.

Vice Chancellor Morgan Zurn found that the existing series of LLC units had not been granted a right to maintain its senior liquidation preference in perpetuity, and thus layering a more senior series could not have the effect of removing such a right. The court explained, "In this context, the absence of clear language granting [existing series] the permanent right to be the senior series leads to the conclusion that no such right was expressly granted."

The court denied declaratory judgment that the existing series' consent had been required and permitted the financing to proceed. Although there are important textual differences, Vice Chancellor Zurn's decision may be squared with Delaware precedent that a position in the capital stack is typically not drafted as an immutable term of that class of stock.

The court also noted that other provisions in the American General Resources LLC agreement were viewed as more "expressly granted" and potentially protected by the consent right for removal of that right—e.g., a provision that the series "shall have the right to appoint" a manager, a provision that certain holders "will each have the right" to designate a representative at board meetings, and a provision that each board "committee shall include" a certain board member.

The court was not required to evaluate whether the amendment had changed any of these "expressly granted" rights, but the drafting of those provisions could be relevant to deal planners trying to understand whether amendment of existing provisions might fall within Section 242(b)(2). In addition, the LLC agreement included a more familiar protective provision over changes disproportionately adversely affecting the existing series, but the plaintiffs did not allege such a disproportionate effect so the issue was not in front of the court.

Disproportionate Effect on Certain Members

In another litigation, the Court of Chancery considered whether a capital call and amendments to an LLC agreement, when viewed together, were "disproportionally adverse to a member relative to other members or to a class of members relative to another class." *Agahi v. Kelly*, C.A. No. 2020-0655-JTL (Del. Ch. Aug. 31, 2020) (transcript).

A member of Benchmark Investments LLC alleged that the company's controlling member had caused a capital call and LLC agreement amendments that would increase the dilutive effect of capital calls and permit a forced sale of nonparticipants' equity. As in the context of series votes under Section 242(b)(2), there was a question in this case as to whether the amendments could be "disproportionately adverse" if they were "nominally member neutral."

The LLC agreement granted the controlling member broad authority to amend the agreement unilaterally unless the amendment would modify the rights or obligations of a member in a manner that is disproportionately adverse to the member relative to other members or is disproportionately adverse to a class or series of LLC units.

Vice Chancellor J. Travis Laster noted that, for purposes of the pending motions for a temporary restraining order and expedition, the standard of review was quite low and the capital call and both amendments would be considered together as a package. On that basis, the court concluded that it was colorable that the amendments were disproportionately adverse and granted the motions.

The court noted the possibility that "later in the case I will conclude that this languages [sic], as a matter of law or based on the evidence in the record if it's deemed ambiguous, does indeed only contemplate strict disproportionality in a legal sense such that you are amending the rights of a specific member or class of members differently than others."

The Vice Chancellor's explanation is worth keeping in mind for drafters and deal planners grappling with the concept of proportionality and litigation risk:

> I can't rule out at this stage that the people who drafted this agreement understood the basic fact that sometimes things that are nominally equal are, in fact, profoundly unequal given the manner in which they're applied. In other words, that something that is nominally equal could, in fact, be disproportionally adverse given the real-world scenario in which it's applied. I'm not offering any definitive ruling on that today. I'm simply saying that it is colorable that what's going on here is disproportionate and adverse to the noncontrolling members. And, indeed, from [the controller]'s standpoint, that's one of the selling points of this move. That's why it makes sense from his standpoint to put this package in. If this were something that was really uniform such that people could exercise these rights back against him, he wouldn't be doing it. So that's the first basis for a colorable claim.

 ©2020 The Bureau of National Affairs, Inc.

Null and Void Ab Initio for Failure to Obtain Approval

Finally, it is worth noting a Court of Chancery decision regarding the phrase "null and void ab initio," which is increasingly appearing in protective provisions. *Absalom Absalom Trust v. Saint Gervais LLC*, 2019 BL 238570 (Del. Ch. June 27, 2019). In that case, an LLC member attempted to transfer its interests to an affiliate without the board approval required by a transfer restriction. The transferee subsequently demanded books and records, and the company rejected the demand on the basis that the transferee was not a valid member. Then-Vice Chancellor (now Justice) Tamika Montgomery-Reeves held that, because the parties had specified that violations of the transfer provisions would result in the transfer being "null and void," the transfer was ineffective and the transferee was not a member with inspection rights—and that result would not be affected by principles of equity.

Guidance from Cases Involving Corporate Charters

In two other recent Delaware cases, the Court of Chancery addressed the stockholder approvals required for amendments to corporate certificates of incorporation. These cases involved both statutory and equitable issues, serving as a reminder that Delaware corporate law disputes are "twice tested" in law and in equity.

Amendment vs. Conversion by Merger

In a litigation last year, holders of a series of preferred stock asserted that their consent was required under a protective provision applicable if the company sought to "amend, alter or repeal" the charter "whether by merger, consolidation or otherwise, so as to materially and adversely affect" the rights of the preferred stock. *SBTS, LLC v. NRC Group Holdings Corp.*, C.A. No. 2019-0566-JTL (Del. Ch. Oct. 11, 2019) (transcript). In that case, NRC Group Holdings entered into a merger pursuant to which its common and preferred stock was converted into common stock of a parent company, but the NRC Group Holdings certificate of incorporation remained intact.

Vice Chancellor Laster held that, because the charter had not been amended, altered or repealed, the protective provision had not been triggered. In granting the company's motion for summary judgment, the court said, "I don't suggest that the plaintiff's interpretation is wildly incorrect. Should the Delaware Supreme Court choose to speak on this issue, it could well take a broader policy-based view." The decision reflects previous Delaware decisions regarding preferred stock protective provisions and "the role of conversion relative to the concept of amendment, alteration, or repeal."

Board Obligations Regarding Valid Amendment

Section 242 of the DGCL requires in most scenarios that the board of a stock corporation must approve a proposed charter amendment and submit it to stockholders for approval. But Delaware law also imposes on the board a fiduciary duty to act in good faith to ensure that a charter amendment is validly effected. Chancellor Andre Bouchard recently presided over litigation regarding whether broker non-votes had been miscounted and stockholder approval of a charter amendment was therefore called into question. *Drachman v. BioDelivery Sciences International, Inc.*, C.A. No. 2019-0728-AGB (Del. Ch. Apr. 14, 2020) (transcript). The BioDelivery board allegedly received a demand raising the problem for the board and the board "rejected the demand out of hand."

Under those circumstances, the court stated that "the manner in which the BioDelivery board responded to plaintiffs' demand implicates general fiduciary principles that are broader and, to be frank, potentially much more important to this company than the narrower question of whether Section 242 was violated in the first place with the original vote tabulations." At the motion to dismiss stage, the court noted that one reasonable inference from those allegations was that "the directors just did not care about complying with the legal requirements of Delaware law, which would support a reasonably conceivable claim of bad faith."

The BioDelivery board also asserted that claims had been mooted by its approval of resolutions ratifying the charter amendment under Section 204 of the DGCL. That ratification, however, had only been submitted to stockholders for approval at an upcoming meeting, and therefore had not yet effectively ratified or validated the charter amendment. Alternatively, the company had represented that it would "repeal" the charter amendment if the stockholders did not approve the ratification.

Chancellor Bouchard stated that the argument that the claims had been mooted "makes no sense to me whatsoever. Stockholder ratification is not a foregone conclusion until it actually has occurred, which includes surviving a potential challenge that a stockholder might bring under Section 204 even if a proposed vote to ratify were to pass."

 ©2020 The Bureau of National Affairs, Inc.

As to the company's offer to repeal the amendment if the ratification were unsuccessful, the court stated that "it's unclear to me how one would repeal something if it is invalid. In any event, until such an action actually has occurred, the amendments would continue to exist and plaintiffs' claims are not moot. Put in simple terms, one may have the best of intentions, but intentions are just intentions. They're not an actuality." The analysis in this opinion provides a framework for understanding the authority and responsibility related to approving, overseeing in good faith, and ratifying a charter amendment.

Conclusion

Questions as to the required approvals for charter amendments continue to require a careful, nuanced analysis of the existing stockholder rights and the precise language of the amendments. The scope of consent rights relating to disproportionate effects and how they are drafted can have meaningful impacts on the authority to amend in the future, and in general these decisions reflect the court's strict reading of such provisions.

 ©2020 The Bureau of National Affairs, Inc.