Declassified Board Requires Director Removal With or Without Cause

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The Delaware Court of Chancery's recent oral ruling in *In re Vaalco Energy Stockholder Litigation*, C.A. No. 11775-VCL, resulted in an order granting partial summary judgment invalidating certain provisions in Vaalco Energy Inc.'s certificate of incorporation and bylaws that prevented a director's removal without cause because Vaalco's organizational documents lacked a classified board or cumulative voting provision. The ruling has left more than 175 public Delaware corporations and countless private Delaware corporations with invalid provisions in their organizational documents.

In 2009, Vaalco's certificate of incorporation was amended to declassify its board of directors without modifying the provisions in its certificate of incorporation and bylaws that permitted the removal of directors only for cause. After the price of Vaalco's stock declined significantly during a one-year period, a group of stockholders that owned 11.1 percent of Vaalco's capital stock commenced a consent solicitation to remove without cause and replace four members of Vaalco's board of directors. Vaalco informed the group of stockholders that, pursuant to the plain language of the certificate of incorporation and bylaws, Vaalco's directors could not be removed without cause. Thereafter, two stockholders filed lawsuits against Vaalco to determine the validity of the only-for-cause director removal provisions in Vaalco's organizational documents.

The plaintiff-stockholders argued that the only-for-cause director removal provisions in Vaalco's organizational documents were unenforceable under Section 141(k) of the Delaware General Corporation Law, which expressly permits removal of directors with or without cause, unless the corporation's board of directors is classified or the corporation has cumulative voting.

Vaalco argued that Section 141(k) permits the removal of directors with or without cause without expressly precluding a corporation without a classified board and without cumulative voting from having an only-for-cause director removal provision in its certificate of incorporation or bylaws. In addition, Vaalco argued that the existence of similar provisions in the organizational documents of at least 175 Delaware corporations supported the validity of an only-for-cause director removal provision outside of the context of a classified board or cumulative voting. Lastly, Vaalco argued that, when read in connection with Section 141(d) of the DGCL, Section 141(k) permits the removal of directors only for cause when a corporation has created a single-class, classified board.

The Court of Chancery rejected the argument that Section 141(k)'s director removal provisions are permissive. The court held that Section 141(k) clearly provides only two exceptions to the stockholders' right to remove directors with or without cause: the existence of a classified board or cumulative voting.

Vaalco's argument that a significant number of public Delaware corporations have similar only-for-cause director removal provisions in their organizational documents also failed. The court noted that those corporations had simply failed to heed the statute and, in any event, "the idea that 175 other companies might have wacky provisions isn't a good argument for validating your provision."

Vaalco's most compelling argument was that having a single-class, classified board would, in theory, qualify Vaalco to have only-for-cause director removal provisions in its organizational documents. Importantly, however, Vaalco did not argue that its board had adopted a provision creating a single-class, classified board. As a result, this novel argument was not squarely before the court. In dicta, however, the court opined that a single-class, classified board would be oxymoronic and was not a persuasive interpretation of the statute. The court reasoned that although Section 141(d) contemplates that a board may be "divided into one, two or three classes," the language is intended to make clear that the right of holders of any class or series of stock to elect one or more directors does not grant that class or series a right to elect an additional class of directors (or, specifically, a fourth class of directors), but instead, to elect a director to an existing class.

Based on the foregoing, the court entered an order invalidating the only-for-cause director removal provisions in Vaalco's organizational documents.

The court's ruling is instructive. First, the board of directors of any corporation with an only-for-cause director removal provision and no classified board or cumulative voting provision in its organizational documents should consider amending the certificate of incorporation and bylaws, as applicable, of the corporation. A discontented stockholder seeking to remove the corporation's directors could attack the validity of the provision in the wake of the *Vaalco* ruling, resulting in potentially expensive litigation. Even the settlement of such a lawsuit could be costly, given that Delaware law recognizes the corporate benefit doctrine, which shifts legal fees to the corporation when a stockholder succeeds on a claim that benefits the corporation's stockholders. An alternative approach is to leave the provision unmodified and remove it only upon request of a stockholder, or when the certificate of incorporation or bylaws, as applicable, is being amended in any event. For certain corporations this alternative may be a less costly approach than amending an organizational document to remove a provision that may never come under scrutiny.

Second, Vice Chancellor J. Travis Laster's oral ruling in *Vaalco* indicates, by way of dicta, that the Court of Chancery may be suspicious of a single-class, classified board and, as a result, a provision implementing such a structure may not support an only-for-cause director removal provision. Corporations that do not have a classified board but desire to increase the difficulty of removing directors without adopting a classified board may consider the adoption of a supermajority voting provision. The board could adopt such a provision and then recommend it for adoption by the stockholders, or arguably it could unilaterally adopt such a provision in the bylaws of the corporation (assuming the certificate of incorporation empowers the board to amend the bylaws, as is generally the case) and simultaneously adopt a bylaw requiring a supermajority vote of the stockholders to amend the bylaws. A unilaterally adopted amendment to bylaws could be amended by the stockholders, subject to a reasonableness review by a court (assuming such actions are not taken in defense of a perceived threat or for entrenchment purposes, in which case the court may review the actions under *Unocal* or *Blasius*), or potentially subject to a challenge based on the possible interplay between Sections 216 and 102(b)(4) of the DGCL. Of course, the board of directors of a public company may be well advised to consider, among other things, corporate policy, strategic planning, stockholder interests and the potential reaction of proxy advisers, all of which should be given proper weight.

The overall effect of the *Vaalco* ruling on Delaware corporations is varied and subject to future rulings by the Delaware Supreme Court. On the one hand, the immediate effect will be minimal for the vast majority of Delaware corporations with organizational documents that comply with Section 141(k). On the other hand, as discussed above, the approximately 175 public corporations incorporated in Delaware that currently have an invalid only-for-cause provision in their organizational documents must, at a minimum, determine how best to proceed with the knowledge that such provision is, presently, presumably invalid. Aside from dealing with the invalid provision, it is not clear that the *Vaalco* ruling will have a strong substantive effect on the election of

directors of public companies, because the board of directors, regardless of the validity of an only-for-cause removal provision, must face re-election at each annual meeting. Privately held Delaware corporations with an invalid only-for-cause removal provision perhaps are most vulnerable to the recent ruling, given the relative ease with which stockholders of private corporations generally may schedule special meetings and act by written consent.

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