

Court of Chancery Affirms Director Primacy in Delaware Corporate Law

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The Court of Chancery recently affirmed the primacy of the board of directors in Delaware corporate law in a case that involved an attempt by the majority stockholder of a Delaware corporation to amend the corporation's bylaws so that he could appoint the chief executive officer directly.¹

Background

The case arose out of a long running dispute concerning the proper composition of the board of directors of Westech Capital Corp. The plaintiff in the case, John Gorman ("Gorman"), was a member of the board of directors and the beneficial owner of a majority of both the company's common stock and its series A preferred stock. Though he was the majority owner, under the terms of a voting agreement Gorman was restricted from appointing his own slate of directors. In addition, the company's bylaws provided that the company's chief executive officer would serve as a member of the corporation's board of directors.² The company's chief executive officer was Gary Salamone, one of three directors on a five person board who were allied against Gorman. On July 2, 2014, one of those three directors resigned leaving the four person board evenly split.

On July 7, 2014, Gorman executed a written consent purporting to amend the company's bylaws in a manner that would enable him, in his capacity as the majority stockholder, to remove Salamone as the company's chief executive officer and to appoint himself to that position. The action would enable Gorman to assume the chief executive officer board seat and to appoint a business associate to the vacancy created by Gorman's transition to the chief executive officer board position. The amended bylaw provided:

Section 6.2. Term of Office.... Any officer may be removed, with or without cause, at any time by the Board *or by the stockholders acting at an annual or special meeting or acting by written consent pursuant to Section 2.8 of these Bylaws. The Board shall, if necessary, immediately implement any such removal of an officer by the stockholders.... Any vacancy occurring in any elected office of the Corporation may be filled by the Board *except that any such vacancy occurring as a result of the removal of an officer by the stockholders shall be filled by the stockholders.**

¹ Gorman v. Salamone, C.A. No. 10183-VCN (Del. Ch. July 31, 2015)

² The voting agreement provided that that "if for any reason the CEO Director shall cease to serve as the Chief Executive Officer of the Company, each of the Stockholders shall promptly vote their respective Shares (i) to remove the former Chief Executive Officer from the Board if such person has not resigned as a member of the Board and (ii) to elect such person's replacement as Chief Executive Officer of the Company as the new CEO Director."

The issue before the Chancery Court was whether the amendment of the bylaws to remove Salamone from his position as chief executive officer and therefor from the company's board was valid.

Legal Analysis

The Chancery Court observed that while stockholders generally have a broad power to adopt and amend bylaws, the power is not unlimited. First, under Section 109 of the Delaware General Corporation Law ("DGCL"), a bylaw cannot conflict with the company's certificate of incorporation or the law. Second, under Delaware precedent, the stockholders' ability to amend bylaws is "limited by the board's management prerogatives under Section 141(a)."³

Section 141(a) provides that "[t]he business and affairs of every corporation...shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certification of incorporation."⁴ From this "statutory bedrock of director primacy" the Chancery Court concluded that, absent authorization by statute or language in the certificate of incorporation, both of which were missing in this case, stockholders "may not directly manage the business and affairs of the corporation". As a corollary, absent such specific authorization, the bylaws may not dictate how a board should decide substantive business decisions but simply define the process and procedures by which those decisions are made.

In this framework, the Chancery Court posited that whether Gorman's proposed bylaw amendment was valid depended on whether removal of an officer constitutes a substantive business decision and would allow stockholders to manage the company. It unhesitatingly answered this question in the affirmative since the amendment would eliminate the board's authority to determine who should conduct the company's daily business. "How a board without the power to control who serves as CEO could effectively establish a long-term corporate strategy is difficult to conceive."

The Chancery Court gave short shift to Gorman's argument that the amendment prescribed a procedure for election and removal of the company's officers and merely specified the mechanism for selecting and removing officers. The court reasoned that the amendment would permit stockholders to remove and replace officers without cause allowing them to make substantive business decisions for the company. Such action would compel board action, potentially in conflict with its fiduciary duties and would unduly constrain the board's ability to manage the company.⁵

The Chancery Court concluded that Delaware law does not allow stockholders to remove corporate officers directly through authority purportedly conferred by a bylaw. Such a bylaw would interfere with directors' management prerogatives and prevent them from discharging one of their most important functions. In the context of this case, it was clear the bylaw amendment was never intended to be process-related and was simply Gorman's attempt to usurp the board's authority in order to accomplish what he could not do by virtue of the voting agreement i.e. gain control over the company.

³ CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008).

⁴ According to the court, the board's responsibilities include the duty to establish or approve the long-term strategic, financial and organizational goals of the corporation, to approve formal or informal plans for the achievement of these goals, to monitor corporate performance, and to act, when in the good faith, informed judgment of the board it is appropriate to act.

⁵ A bylaw cannot mandate board action "in circumstances that a proper application of fiduciary principles could preclude." CA, Inc., 953 A.2d at 240.

Open Questions

The Chancery Court raised related questions concerning the scope of the stockholders' power to adopt bylaws relating to the appointment and removal of corporate officers. A bylaw that prescribed a method for the removal of officers by the board may be permissible if it specified a procedure but did not infringe on the directors' authority to exercise the removal power. In addition, there may be extraordinary circumstances that could require stockholders to intervene in the officer-designation process. Finally, a bylaw that granted stockholders the ability to elect directly individuals to vacant corporate office positions may be permissible. The court noted that, before the 1967 amendments, the DGCL explicitly authorized directors or stockholders to elect corporate officers but that there was now a split among commentators on the DGCL as to whether this was still permissible. However, none of these questions were presented by the motion pending and the Chancery Court did not address them.



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