

# Potential Fiduciary Implications Presented by Shareholder Agreements Post-DGCL Section 122(18)

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*Traditional shareholder agreements are used by shareholders to contract amongst one another and address how the shareholders will collectively exercise their shareholder-level rights. However, “new wave” shareholder agreements are between a corporation and a shareholder. Such agreements are highly popular in practice and often used to maintain a preferred shareholder’s control over corporate decision-making even after the shareholder’s voting power has been diluted. In February 2024, the provisions of a “new wave” shareholder agreement were invalidated by the Delaware Chancery Court in West Palm Beach Firefighter’s Pension Fund v. Moelis & Co., and the Delaware legislature promptly responded, adding Section 122(18) to Title 8 of the Delaware General Corporation Law in August 2024. Section 122(18) further advances Delaware’s commitment to contractarianism and provides broad authorization for “new wave” shareholder agreements. One of the most interesting questions raised by the amendment is whether a minority shareholder, otherwise lacking significant voting control or the ability to exercise the equivalent of majority voting control, may be deemed a controlling shareholder due to the contractual rights held under a Section 122(18) agreement. First, this Comment provides a background of the legal landscape leading to the addition of Section 122(18). Second, this Comment analyzes the potential fiduciary implications presented by Section 122(18) agreements for corporate directors and shareholders. Lastly, this Comment argues that a contracting shareholder should not be deemed a controlling shareholder nor owe corresponding fiduciary obligations because of contractual rights granted to the shareholder under a freely negotiated Section 122(18) agreement. The contractual rights bargained for by a shareholder under a Section 122(18) agreement exist independently from the shareholder’s fundamental shareholder-level rights as a stock owner, and as such, should not be considered when determining whether the shareholder is a controller.*

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## I. INTRODUCTION

Contractarianism advances “the thesis that corporate law is best understood as [a] network (or nexus) of interconnected contracts” and has recently gained heavy influence in corporate law.<sup>1</sup> The theory behind contractarianism is that there is a contractual relationship between the management and shareholders of a corporation.<sup>2</sup> Considering the contractual nature of this relationship, the basic idea of contractarianism is that “market forces are expected to create optimal corporate contracts, at the time a company initially goes public.”<sup>3</sup> Pre-initial public offering (IPO) shareholders undoubtedly hope the company’s shares will sell at high

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<sup>1</sup> Jens Frankenreiter & Eric L. Talley, *Sticky Charters? The Surprisingly Tepid Embrace of Officer-Protecting Waivers in Delaware* 3 (Eur. Corp. Governance Inst., Working Paper No. 762, 2024) (citing FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991)).

<sup>2</sup> Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. LAW 779, 782 (2006).

<sup>3</sup> *Id.* (citing EASTERBROOK & FISCHEL, *supra* note 1, at 1–39) (internal quotation marks omitted).

prices.<sup>4</sup> The price at which shares are sold at the IPO and on the secondary market depends on whether potential post-IPO shareholders (i.e., investors) can rely on the pre-IPO shareholders to enter corporate contracts regarding “effective corporate governance arrangements” that will provide immense value to all shareholders.<sup>5</sup> It thus follows that if post-IPO shareholders are confident that pre-IPO shareholders will enter into effective corporate governance arrangements, the corporation’s share price will reflect that confidence and sell at high prices.<sup>6</sup>

Delaware courts explicitly embrace contractarianism and the power of private ordering:

This jurisdiction respects the right of parties to freely contract and to be able to rely on the enforceability of their agreements; where Delaware’s law applies, with very limited exceptions, our courts will enforce the contractual scheme that the parties have arrived at through their own self-ordering, both in recognition of a right to self-order and to promote certainty of obligations and benefits. Upholding freedom of contract is a fundamental policy of this State.<sup>7</sup>

Moreover, “[s]ophisticated parties can and should make their own judgments about the risk they should bear, and Delaware courts are especially chary about relieving sophisticated business entities of the burden of freely negotiated contracts.”<sup>8</sup> The Delaware General Corporation Law (hereinafter DGCL) is intended to provide for flexibility so that directors and shareholders have wide discretion to engage in private ordering.<sup>9</sup>

Delaware’s commitment to contractarianism was most recently advanced by the 2024 Amendment to DGCL Title 8, Section 122(18).<sup>10</sup> Section 122(18) effectively overturned the

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<sup>4</sup> *See id.*

<sup>5</sup> *Id.*

<sup>6</sup> *See id.*

<sup>7</sup> *Ascension Ins. Holdings, LLC v. Underwood*, No. 9897–VCG, 2015 WL 356002, at \*4 (Del. Ch. Jan. 28, 2015) (citation omitted); *accord New Enter. Assocs. 14, L.P. v. Rich*, 295 A.3d 520, 565–66 (Del. Ch. 2023).

<sup>8</sup> *New Enter. Assocs.*, 295 A.3d at 566 (quoting *Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1061–62 (Del. Ch. 2006)) (internal quotation marks omitted).

<sup>9</sup> *Id.* at 567.

<sup>10</sup> Section 122(18) provides the following:

Every corporation created under this chapter shall have the power, whether or not so provided in the certificate of incorporation, to: . . . (18) Notwithstanding § 141(a) of this title, make contracts with 1 or more current or prospective stockholders (or 1 or more beneficial owners of stock), in its or their capacity as such, in exchange

controversial *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.*<sup>11</sup> (*Moelis II*) and allows corporations to contract with current or prospective shareholders regarding internal governance arrangements. The type of agreements authorized under Section 122(18) are a form of shareholder agreements, but since they differ from traditional shareholder agreements, Vice Chancellor Laster—the Delaware Chancery Court judge that issued the *Moelis II* opinion—described these agreements as “new wave” shareholder agreements,<sup>12</sup> which are highly popular in practice.<sup>13</sup>

Traditional shareholder agreements are contracts among shareholders, addressing how they will each exercise their shareholder-level rights.<sup>14</sup> However, “new wave” shareholder agreements are contracts between a corporation and one or more shareholders, outlining the rights, responsibilities, and obligations of the shareholders.<sup>15</sup> Shareholder agreements are consistent with

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for such minimum consideration as determined by the board of directors (which may include inducing stockholders or beneficial owners of stock to take, or refrain from taking, 1 or more actions); provided that no provision of such contract shall be enforceable against the corporation to the extent such contract provision is contrary to the certificate of incorporation or would be contrary to the laws of this State (other than § 115 of this title) if included in the certificate of incorporation. Without limiting the provisions that may be included in any such contracts, the corporation may agree to: (a) restrict or prohibit itself from taking actions specified in the contract, (b) require the approval or consent of 1 or more persons or bodies before the corporation may take actions specified in the contract (which persons or bodies may include the board of directors or 1 or more current or future directors, stockholders or beneficial owners of stock of the corporation), and (c) covenant that the corporation or 1 or more persons or bodies will take, or refrain from taking, actions specified in the contract (which persons or bodies may include the board of directors or 1 or more current or future directors, stockholders or beneficial owners of stock of the corporation) . . . .

DEL. CODE ANN. tit. 8, § 122(18) (2024). See *infra* Section II.B.

<sup>11</sup> 311 A.3d 809 (Del. Ch. 2024) [hereinafter *Moelis II*]. See *infra* Section II.A. *Moelis II* addresses the merits of the case. Defendant, Moelis & Co., sought summary judgment on the defenses of laches and ripeness, which the court addressed and rejected in a separate decision, *W. Palm Beach Firefighters' Pension Fund v. Moelis & Co.*, 310 A.3d 985, 1010 (Del. Ch. 2024) [hereinafter *Moelis I*].

<sup>12</sup> The terms “‘new wave’ shareholder agreements” and “Section 122(18) agreements” will be used interchangeably throughout this Comment.

<sup>13</sup> See *Moelis II*, 311 A.3d at 817.

<sup>14</sup> *Id.*; see generally DEL. CODE ANN. tit. 8, § 202(b) (2017). Examples of default shareholder-level rights include the right to sell shares, the right to vote in electing corporate directors, and the right to sue directors for fiduciary breaches.

<sup>15</sup> See *Moelis II*, 311 A.3d at 817 (describing these “new wave of stockholder agreements” as “the seemingly irresistible force of market practice.”). There are two avenues for regulating the internal governance of a corporation: (1) amending the certificate of incorporation (“charter”) or (2) entering into a shareholder agreement. For a discussion on why shareholder agreements, opposed to amendments to a corporation’s certificate of incorporation, are commonly used to regulate corporate internal governance, see Gabriel

the principle of freedom of contract,<sup>16</sup> and Section 122(18)'s broad authorization of agreements between a corporation and its shareholders is similarly consistent with advancing that principle.

"New wave" shareholder agreements often relate to the internal governance of a corporation and may be used to expand minority shareholders' rights. The agreements "typically grant[] rights to those shareholders who are party to the agreement that are above and beyond the rights that are inherent in the shares that they own, and are intended to ensure that those shareholders obtain the benefits of the additional rights that they bargained for."<sup>17</sup> For example, provisions may include but are not limited to topics covering the board of directors—including nomination, removal, vacancies, limitations on board power, and composition of committees—corporate opportunities, appointment and removal of officers, voting rights, information rights, and transfer restrictions.<sup>18</sup> Sometimes the agreements are "drafted to terminate upon the occurrence of any number of events."<sup>19</sup> Termination often occurs upon a corporation's IPO or when all of a corporation's outstanding shares are acquired by an outside party.<sup>20</sup>

A 2021 study analyzing companies that went public from 2013 to 2018 found that 55% of the companies had been or were party to a shareholder agreement, and 15% of those shareholder agreements survived the companies' IPOs.<sup>21</sup> A majority of shareholder agreements granted the contracting shareholder<sup>22</sup> board nomination rights, and many others granted extensive veto rights.<sup>23</sup> The use of shareholder agreements has become increasingly common when a company is preparing for an IPO "as a means of allowing favored stockholders to maintain control, even at levels where their stock ownership would not support a control

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Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 YALE J. ON REGUL. 1124, 1131–32 (2021).

<sup>16</sup> See The Corp. L. Comm. of the Ass'n of the Bar of the City of N.Y., *The Enforcement and Effectiveness of Typical Shareholders Agreement Provisions*, 65 BUS. LAW. 1153, 1155 (2010).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 1153.

<sup>19</sup> *Id.* at 1195–96.

<sup>20</sup> *Id.* at 1196.

<sup>21</sup> Rauterberg, *supra* note 15, at 1149.

<sup>22</sup> A "contracting shareholder" is referred to in this Comment as a shareholder who is party to a shareholder or Section 122(18) agreement.

<sup>23</sup> Rauterberg, *supra* note 15, at 1178 tbls.1 & 2 (85% of shareholder agreements granted board nomination rights, 72% required directors to support the shareholder's designees for the board, and many granted extensive veto rights including but not limited to mergers, material acquisitions, divestments, designation of the CEO, changing the board size, and new issuance of material equity).

finding.”<sup>24</sup> This allows preferred pre-IPO shareholders to maintain corporate decision-making power as their shares are diluted and their voting power diminishes.<sup>25</sup>

For some, this may be viewed as problematic. Corporate directors are elected by a corporation’s shareholders to exercise their independent business judgment and make decisions on behalf of the corporation. DGCL “Section 141(a) is the source of Delaware’s board-centric model of corporate governance”<sup>26</sup> and requires that the business and affairs of every corporation be managed by and under the direction of a board of directors unless otherwise provided in the corporation’s certificate of incorporation.<sup>27</sup> However, a board of directors may not actually be the corporate decision-maker if a preferred shareholder is granted extensive corporate decision-making power through a Section 122(18) agreement. Such an arrangement may trouble other minority shareholders because the contracting shareholder is not elected and may not face repercussions similarly faced by corporate directors, such as removal.

For others, “new wave” shareholder agreements are consistent with prevailing market practice and allow corporations to tailor their governance structure in a manner the corporation deems most efficient.<sup>28</sup> Section 122(18) signals a push further towards Delaware’s embracement of contractarianism. Although “new wave” shareholder agreements are now permissible under Section 122(18), case law on the recent amendment is nonexistent and its effect on Delaware law is largely unknown.<sup>29</sup> Section II will set the stage for this Comment’s discussion, providing an overview of the *Moelis II* decision and the Delaware legislature’s prompt response. Section III will discuss the significant amounts of control that shareholders may be granted through Section 122(18) agreements and demonstrate the low likelihood of fiduciary liability compared to controlling shareholders under current Delaware precedent. Section IV first provides recommendations to corporate directors on how to limit liability when causing a

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<sup>24</sup> *Moelis II*, 311 A.3d at 878 (citing Rauterberg, *supra* note 15, at 1148–54).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 816.

<sup>27</sup> See DEL. CODE ANN. tit. 8, § 141(a) (2020).

<sup>28</sup> See Amy Simmerman & Jason Schoenberg, *Significant Amendments to the DGCL Are Set to Become Effective*, HARVARD L. SCH. FORUM ON CORPORATE GOVERNANCE (Aug. 10, 2024), <https://perma.cc/U3WY-AM49>; Lawrence Hamermesh, *Letter in Support of the Proposed Amendments to § 122 DGCL*, HARVARD L. SCH. FORUM ON CORPORATE GOVERNANCE (June 11, 2024), <https://perma.cc/7RHV-ZS5M>.

<sup>29</sup> See *infra* Section III.

corporation to enter into a Section 122(18) agreement with a shareholder. Section IV then argues that shareholders party to Section 122(18) agreements should not be held to fiduciary obligations and doing so would be contrary to contractarianism, which Delaware law purports to embrace.

## II. LEGAL BACKGROUND

Delaware is often called the Corporate Capital of the World as the domicile of choice to 67.6% of Fortune 500 companies and nearly 400,000 corporations.<sup>30</sup> Delaware's Chancery Court is a court of equity, often hearing cases regarding corporate disputes, contractual rights, and fiduciary duties.<sup>31</sup> The DGCL is the bedrock of Delaware corporate law, renowned for its predictability and stability, guided by Delaware's rich case law and the Chancery Court.<sup>32</sup> The DGCL places emphasis on the right of a corporation to freely contract and tailor its corporate structure as the corporation sees fit.<sup>33</sup> This legal framework provides corporations with much desired flexibility, so long as such tailoring does not interfere with the DGCL or wander into certain restricted territory.<sup>34</sup> The 2024 amendments to DGCL Section 122(18) enhance corporate contract flexibility, yet case law on the recent amendment is nonexistent and its bounds are largely unknown.

### A. An Overview of *Moelis II*

In *Moelis II*, the Delaware Chancery Court invalidated a shareholder agreement between Moelis & Company (hereinafter Company) and Ken Moelis (hereinafter Moelis)—the founder, CEO, and Chairman of the Board.<sup>35</sup> Prior to the Company's IPO, the Company and Moelis entered into a shareholder agreement.<sup>36</sup> The shareholder agreement and its provisions were fully disclosed to the public when the Company initially went public and were unchallenged up until this case.<sup>37</sup> The plaintiff, a Company

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<sup>30</sup> DELAWARE DIVISION OF CORPORATIONS, 2023 ANNUAL REPORT (2023), <https://perma.cc/8BLX-K234>.

<sup>31</sup> DEL. CODE ANN. tit. 10, § 341 (1953). The terms "fiduciary duties" and "fiduciary obligations" will be used interchangeably throughout this Comment.

<sup>32</sup> *Delaware Corporate Law: Why Businesses Choose Delaware*, DELAWARE.GOV, <https://perma.cc/63QZ-VJFV> (last visited Nov. 1, 2024).

<sup>33</sup> See generally Frankenreiter & Talley, *supra* note 1.

<sup>34</sup> See *id.*

<sup>35</sup> *Moelis II*, 311 A.3d at 817.

<sup>36</sup> *Id.* at 817–18.

<sup>37</sup> Hamermesh, *supra* note 28.

shareholder, contended that the shareholder agreement provisions, *inter alia*, facially violated DGCL Section 141(a).<sup>38</sup>

The most notable disputed provisions of the shareholder agreement at issue in *Moelis II* are as follows. The agreement provided that the Company's board of directors (hereinafter Board) required Moelis' written consent before taking virtually any action (hereinafter Pre-Approval Requirements).<sup>39</sup> Other provisions ensured Moelis controlled the selection of Board members and that his designees controlled the Board, irrespective of whether Moelis held a majority of the Company's voting power (hereinafter Board Composition Provisions).<sup>40</sup> The Board Composition Provisions consisted of six separate provisions as follows: (1) the "Size Requirement" required the Board to maintain its size at no more than eleven seats; (2) the "Designation Right" entitled Moelis to "name a number of seats equal to a majority of those seats;" (3) the "Nomination Requirement" required the Board to nominate Moelis' designees as candidates; (4) the "Recommendation Requirement" required the Board to "recommend that stockholders vote in favor of Moelis' designees;" (5) the "Efforts Requirement" required the Company to "use reasonable efforts to enable Moelis' designees to be elected and continue to serve;" and (6) the "Vacancy Requirement" required the Board to fill any vacant seat previously occupied by Moelis' designee with a new Moelis designee.<sup>41</sup> Lastly, the shareholder agreement "force[d] the Board to populate any committee with a number of Moelis' designees proportionate to the number of designees on the full Board (hereinafter Committee Composition Provision)," so creating an independent committee would be impossible without Moelis' consent.<sup>42</sup>

Corporations are granted large amounts of flexibility in tailoring their affairs, but to the extent an agreement violates Section 141, it is invalid and unenforceable. After analyzing the above provisions, the court found that the Pre-Approval Requirements and the Recommendation, Vacancy, and Size Requirements of the Board Composition Provisions violated Section

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<sup>38</sup> *Moelis II*, 311 A.3d at 817–18. As discussed in Section I, DGCL Section 141(a) requires that the business and affairs of every corporation be managed by and under the direction of a board of directors unless otherwise provided in the corporation's certificate of incorporation. See DEL. CODE ANN. tit. 8, § 141(a) (2020).

<sup>39</sup> *Moelis II*, 311 A.3d at 818.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

141(a).<sup>43</sup> Additionally, the Committee Composition Provision violated both Sections 141(a) and (c).<sup>44</sup> The court extensively reviewed Section 141(a) decisions<sup>45</sup> and applied a two-part test to determine whether each of the challenged provisions violated Section 141(a): (1) whether the challenged provision is part of an internal governance arrangement as opposed to an external commercial contract that implements internal restrictions;<sup>46</sup> and (2) if so, the court applies the *Abercrombie*<sup>47</sup> test to determine whether the challenged provision improperly restricts the board in violation of section 141(a).<sup>48</sup> The *Abercrombie* test requires a court to determine “whether the provision has the effect of removing from the directors in a very substantial way their duty to use their own best judgment on management matters or tends to limit in a substantial way the freedom of director decisions on matters of management policy.”<sup>49</sup> Directors may not substantially contract away their duty to exercise their own best judgment in management of the corporation because “[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.”<sup>50</sup>

The court concluded that the Pre-Approval Requirements,<sup>51</sup> half of the Board Composition Provisions,<sup>52</sup> and the Committee Composition Provision<sup>53</sup> were part of an internal governance arrangement and failed the *Abercrombie* test in violation of Section 141(a) because the provisions, *inter alia*, constrained and improperly infringed upon the Board’s duties and powers. If the provisions of the agreement were to validly operate, they should have been included in the Company’s certificate of incorporation. But given the “irresistible force of market practice”<sup>54</sup> regarding similar

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<sup>43</sup> *Id.* at 821.

<sup>44</sup> *Moelis II*, 311 A.3d at 821; *see* DEL. CODE ANN. tit. 8, § 141 (2020) (empowering the board of directors to create committees and select members of the board to serve on such committees).

<sup>45</sup> *Moelis II*, 311 A.3d at 831–55.

<sup>46</sup> *Id.* at 856–60.

<sup>47</sup> *Abercrombie v. Davies*, 123 A.2d 893 (Del. Ch. 1956).

<sup>48</sup> *Moelis II*, 311 A.3d at 860–61.

<sup>49</sup> *Id.* at 860 (citing *Abercrombie*, 123 A.2d at 899) (internal quotation marks omitted).

<sup>50</sup> *Id.* at 845 (quoting *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1994)).

<sup>51</sup> *Id.* at 869.

<sup>52</sup> *Id.* at 870–76 (finding the Recommendation, Vacancy, and Size Requirements of the Board Composition Provisions facially invalid under Section 141(a)).

<sup>53</sup> *Moelis II*, 311 A.3d at 876–77.

<sup>54</sup> *Id.* at 816.

shareholder agreements, the court invited the Delaware General Assembly to provide guidance on the acceptable uses of shareholder agreements.<sup>55</sup> The Delaware Legislature promptly responded.

B. “What Happens When the Seemingly Irresistible Force of Market Practice Meets the Traditionally Immovable Object of Statutory Law?”<sup>56</sup> Market Practice Prevails

1. DGCL Section 122(18)—The Delaware Legislature’s Prompt Response to *Moelis II*

After *Moelis* was decided in February 2024, the Delaware General Assembly quickly reacted, passing Delaware Senate Bill 313 (S.B. 313).<sup>57</sup> Governor John Carney signed S.B. 313 on July 17, 2024, effectively overturning *Moelis II*.<sup>58</sup> The amendment added, *inter alia*, Section 122(18) to Title 8 of the DGCL, which took effect on August 1, 2024.<sup>59</sup> The new section further promotes corporate contract flexibility and declares shareholder agreements, similar to the one at issue in *Moelis II*, facially valid under Delaware law.

Section 122(18) provides that contracts between a corporation and one or more current or prospective shareholders may include, but are not limited to, provisions that (i) restrict specified corporate action, (ii) require the consent of one or more persons or bodies including current or future directors, shareholders, or beneficial owners of the corporation’s stock before the corporation may take specified action, and (iii) constitute an agreement that the corporation or one or more persons or bodies including current or future directors, shareholders, or beneficial owners of the corporation’s stock will take or refrain from taking specified action.<sup>60</sup> The purpose of Section 122(18) is to provide “bright-line authorization” for contractual provisions addressing the aforementioned matters such that the outcome in *Moelis II* would have been different.<sup>61</sup>

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<sup>55</sup> *Id.* at 881.

<sup>56</sup> *Id.* at 816.

<sup>57</sup> S.B. 313, 152nd Gen. Assemb., 2nd Reg. Sess. (Del. 2024) [hereinafter S.B. 313].

<sup>58</sup> Matthew DiRisio et al., *Delaware Passes Controversial Amendments to the Delaware General Corporation Law*, WINSTON & STRAWN LLP (July 31, 2024), <https://perma.cc/AX2W-7D89>.

<sup>59</sup> *Id.*

<sup>60</sup> DEL. CODE ANN. tit. 8, § 122(18) (2024).

<sup>61</sup> S.B. 313, *supra* note 57.

It is important to note that the main issue in *Moelis II* was whether the challenged provisions of the shareholder agreement were *facially* invalid.<sup>62</sup> A facial challenge requires the court to consider a provision as it appears in a specific agreement, and the plaintiffs in *Moelis II* were required to prove that the shareholder agreement provisions could not validly operate under Section 141(a).<sup>63</sup> Section 122(18) makes clear that similar shareholder agreement provisions are not *facially* or statutorily invalid under Section 141(a). But the provisions must not be in conflict with a corporation's certificate of incorporation or Delaware law. Section 122(18) appears to broadly authorize shareholder agreements that effectively give shareholders control of internal governance decisions. If shareholder agreement provisions, such as those at issue in *Moelis II*, are challenged as-applied, the court's analysis differs. For as-applied challenges, the court examines "the decision to exercise a contractual right in the specific setting when it was exercised . . . [considering] who did what, when, and how in the specific scenario at issue."<sup>64</sup> If shareholder-plaintiffs were to bring an as-applied challenge contesting provisions of a Section 122(18) agreement, it is unclear who the shareholder-plaintiffs may bring such action against and how fiduciary obligations may impact the case. Corporate directors are always bound by their fiduciary obligations, but it is unclear whether a contracting shareholder may also have fiduciary obligations depending on the degree of control held under a Section 122(18) agreement.

## 2. Response to DGCL Section 122(18) by Corporate Legal Scholars

The Delaware legislature's decision to amend the DGCL and how they chose to do it caused quite an uproar among corporate legal scholars with some providing applause and others expressing vehement opposition. One of the largest controversies surrounding Section 122(18) is that the amendment was passed before the Delaware Supreme Court was afforded an opportunity to review *Moelis II*. Opponents argue that the shareholder agreement provisions at issue in *Moelis II* were anything but ordinary and "warrant careful judicial review, not hasty legislative

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<sup>62</sup> *Moelis II*, 311 A.3d at 828.

<sup>63</sup> *Id.* at 860 (citing Del. Bd. of Med. Licensure & Discipline v. Grossinger, 224 A.3d 939, 956 (Del. 2020)).

<sup>64</sup> *Id.* (citing Del. Bd. of Med. Licensure & Discipline, 224 A.3d at 956).

action.”<sup>65</sup> Proponents of the amendment argue that Section 122(18) simply restores the status quo of market practice by affirming the legality of widely used shareholder agreements.<sup>66</sup>

Shareholder agreements have received increased attention since the addition of Section 122(18), and they will undoubtedly face heightened scrutiny moving forward. The impact of Section 122(18) on Delaware law is still largely unknown. One of the many uncertainties is whether a contracting shareholder with extensive contractual rights, providing authority over corporate decision-making, owes fiduciary duties to the corporation and its shareholders.

### III. DGCL SECTION 122(18): VAST POTENTIAL FOR CONTROL & AN UNKNOWN LIKELIHOOD OF LIABILITY

Most minority shareholders owe no fiduciary obligations. But some may be held to such obligations if deemed a controller.<sup>67</sup> Additionally, a control group may be found if a group of minority shareholders contract amongst themselves and agree to collectively exercise their shareholder-level rights.<sup>68</sup> Shareholders that typically would not owe fiduciary obligations assume fiduciary obligations akin to directors when the shareholder attains controller status or when a group of shareholders is deemed a control group.<sup>69</sup> First, this section distinguishes controllers and control groups from shareholders with contractual rights under Section 122(18) agreements. Second, this section provides an overview of fiduciary obligations relevant to this Comment’s discussion.

#### A. The Implications of Controllers’ and Control Groups’ Voting Powers Are Much Different from Contractual Rights Granted Under Section 122(18) Agreements

A controller is not merely a shareholder who controls more than 50% of a corporation’s voting power.<sup>70</sup> A shareholder may also be deemed a controller if a court finds “a combination of

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<sup>65</sup> See, e.g., Sarath Sanga, Gabriel Rauterberg & Eric Talley, *Letter in Opposition to the Proposed Amendment to the DGCL*, HARVARD L. SCH. FORUM ON CORPORATE GOVERNANCE (June 7, 2024), <https://perma.cc/AUT7-6B6Q>.

<sup>66</sup> See, e.g., Hamermesh, *supra* note 28. See *Moelis II*, 311 A.3d at 878 (noting that the Company is correct that many corporations have entered into similar agreements).

<sup>67</sup> See Note, *Controller Confusion: Realigning Controlling Stockholders and Controlled Boards*, 133 HAR. L. REV. 1706, 1708 (2020) [hereinafter *Controller Confusion*].

<sup>68</sup> Rauterberg, *supra* note 15 at 1168 (citing *Sheldon v. Pinto Tech. Ventures, L.P.*, 220 A.3d 245, 251 (Del. 2019)).

<sup>69</sup> See *Controller Confusion*, *supra* note 67, at 1710.

<sup>70</sup> *Id.* at 1708.

potent voting power and management control such that the stockholder could be deemed to have effective control of the board without actually owning a majority of stock.”<sup>71</sup> In assessing whether a shareholder has controller status, a court will typically look to whether the shareholder has a substantial degree of voting power or control over management such that the board of directors is unable to exercise its independent business judgment because if the directors fail to succumb to that shareholder’s wishes they face the threat of removal by that shareholder.<sup>72</sup> In the absence of a substantial degree of voting power, courts focus “on the *de facto* power of a significant (but less than majority) shareholder, which, when *coupled with other factors*, gives that shareholder the ability to dominate the corporate decision-making process.”<sup>73</sup> Once a shareholder attains controller status, the shareholder will owe fiduciary duties to the corporation akin to directors and be subject to liability for fiduciary breaches as directors would be. Shareholder agreements are typically irrelevant to the traditional controller inquiry because the shareholder—in his or her individual capacity—may have either 50% of a corporation’s voting power or possess a combination of potent voting power and control over management.<sup>74</sup>

However, through a traditional shareholder agreement, a group of shareholders may attain controller status if they collectively possess a large portion of a corporation’s voting power and agree to collectively exercise their shareholder-level rights. This group of shareholders is called a “control group.”<sup>75</sup> Traditional shareholder agreements are between individual shareholders and address how each shareholder will exercise his or her shareholder-level rights.<sup>76</sup> No one shareholder in the control group can be a controller in his or her individual capacity due to a lack of sufficient voting power. A control group is often found when shareholders enter agreements with one another to vote

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<sup>71</sup> *Id.*; *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 307 (Del. 2015).

<sup>72</sup> *See In re KKR Fin. Holdings LLC S’holder Litig.*, 101 A.3d 980, 994–95 (Del. Ch. 2014); *see also Controller Confusion*, *supra* note 67, at 1708–09.

<sup>73</sup> *In re Tesla Motors, Inc. S’holder Litig.*, No. 12711-VCS, 2018 WL 1560293, at \*14 (Del. Ch. 2018) (quoting *Superior Vision Servs., Inc. v. ReliaStar Life Ins. Co.*, No. 1668-N, 2006 WL 2521426, at \*4 (Del. Ch. Aug. 25, 2006)). In *Moelis I*, the court called *Superior Vision Servs.* into question because it “assert[s] that a fiduciary does not owe fiduciary duties when exercising contractual rights, even if the counterparty is the fiduciary’s beneficiary.” *Moelis I*, 310 A.3d at 1010; *Superior Vision Servs.*, 2006 WL 2521426, at \*5.

<sup>74</sup> *See generally, Controller Confusion*, *supra* note 67, at 1708; *Corwin*, 125 A.3d at 307.

<sup>75</sup> *Rauterberg*, *supra* note 15, at 1168 (citing *Sheldon*, 220 A.3d at 251 (Del. 2019)).

<sup>76</sup> *Moelis II*, 311 A.3d at 817; *see generally* DEL. CODE ANN. tit. 8, § 202(b) (2017).

collectively, such that they may exercise control over the board of directors.<sup>77</sup> Although no one shareholder in the control group alone has sufficient voting power to exercise control over the board of directors, the group collectively has such power. There is no bright line rule, but courts often look to whether the group exercises collective control and is “connected in some legally significant way—such as by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal.”<sup>78</sup> Once a control group is found, the shareholders comprising the control group owe fiduciary duties to the corporation and are subject to liability for fiduciary breaches.

While it is clear that a controller and the shareholders comprising a control group may be held to fiduciary duties and face liability for corresponding breaches, “[s]ubstantial uncertainty exists as to whether a stockholder could bring a viable fiduciary duty claim against [a contracting shareholder] for exercising [rights pursuant to a shareholder agreement] under Delaware precedent.”<sup>79</sup> This is because current precedent “refuses to consider contractual rights when assessing controller status.”<sup>80</sup> This was briefly discussed in *Moelis I*—an opinion issued before Section 122(18) was signed into law.<sup>81</sup> One may wonder—why will courts consider traditional shareholder agreements when assessing whether a group of shareholders is a control group but not consider “new wave” shareholder agreements when assessing whether a shareholder has attained controller status? To understand the answer to this question, it is important to understand the fundamental difference between traditional and “new wave” shareholder agreements.

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<sup>77</sup> Rauterberg, *supra* note 15, at 1168 (citing *Sheldon*, 220 A.3d at 251).

<sup>78</sup> *Sheldon*, 220 A.3d at 251.

<sup>79</sup> *Moelis I*, 310 A.3d at 1009–10.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.* (discussing whether contractual rights, granted through a shareholder agreement, could be considered in assessing Moelis’ status as a controller in a potential fiduciary breach action against Moelis for exercising his shareholder agreement rights) (citing *In re KKR*, 101 A.3d at 995, *aff’d sub nom. Corwin*, 125 A.3d 304). See Rauterberg, *supra* note 15, at 1171–72, n.160 (citing *Calesa Assocs., L.P. v. Am. Capital Ltd.*, No.10557-VCG, 2016 WL 770251, at \*10–11 (Del. Ch. Feb. 29, 2016) (noting that “actual control” over the board may not be demonstrated by the exercise of contractual rights alone)); *Thermopylae Cap. Partners, L.P. v. Simbole, Inc.*, No. 10619-VCG, 2016 WL 368170, at \*14 (Del. Ch. Jan. 29, 2016) (“a stockholder who—via majority stock ownership or through control of the board—operates the decision making machinery of the corporation, is a classic fiduciary; in controlling the company he controls the property of others—he controls the property of the non-controlling stockholders. Conversely, an individual who owns a contractual right, and who exploits that right—even in a way that forces a reaction by a corporation—is simply exercising his own property rights, not that of other, and is no fiduciary.”).

There is a corporate hierarchy in Delaware law—“the DGCL, the charter, and the bylaws establish the rights that stockholders possess.”<sup>82</sup> A shareholder’s stock is his or her personal property, and the shareholder may choose whether or not to freely exercise the rights associated with stock ownership.<sup>83</sup> “Three rights are viewed as fundamental: the rights to sell, vote, and sue.”<sup>84</sup> If two or more shareholders enter into a traditional shareholder agreement (i.e., shareholder-level agreement) that binds each shareholder as to how they will exercise those fundamental rights, the agreement is valid because it merely defines how the shareholders will collectively exercise or refuse to exercise their *pre-existing* rights.<sup>85</sup> Shareholders who enter into traditional shareholder agreements are not granted any additional rights—they “are bargaining over their private property.”<sup>86</sup> Thus, the fact that Delaware precedent refuses to consider contractual rights in assessing controller status is irrelevant in determining whether a traditional shareholder agreement creates a control group because a traditional shareholder agreement does not grant any additional rights that the shareholders did not previously possess.

Contrarily, “new wave” shareholder agreements are often used as a means of allowing favored shareholders to maintain corporate decision-making power after their shares and voting power have diminished.<sup>87</sup> The agreements do not address how a shareholder will exercise his or her pre-existing fundamental rights. Instead, “new wave” agreements—now authorized by Section 122(18)—may create new rights for the contracting shareholder that exist separate from his or her fundamental rights to sell, vote, and sue.<sup>88</sup> The extent of the rights that may be permissibly granted to a shareholder under Section 122(18) is largely unknown due to the novel nature of the amendment. But Section 122(18) provides three examples of permissible shareholder agreement provisions, and permissible provisions are not limited to those enumerated.<sup>89</sup> The statute provides that a corporation

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<sup>82</sup> *Moelis II*, 311 A.3d at 862 (citing *New Enter. Assocs.*, 295 A.3d at 573).

<sup>83</sup> *New Enter. Assocs.*, 295 A.3d at 570 (citing DEL. CODE ANN. tit. 8 § 159 (1983)).

<sup>84</sup> *Id.* (citation omitted).

<sup>85</sup> See e.g., DEL. CODE ANN. tit. 8 § 218(c) (2014) (authorizing “[a]n agreement between 2 or more stockholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as provided by the agreement, or as the parties may agree, or as determined in accordance with a procedure agreed upon by them.”).

<sup>86</sup> *New Enter. Assocs.*, 295 A.3d at 570.

<sup>87</sup> See *Moelis II*, 311 A.3d at 878 (citing Rauterberg, *supra* note 15, at 1148–54).

<sup>88</sup> See discussion *supra* Sections II.A–B.1.

<sup>89</sup> DEL. CODE ANN. tit. 8 § 122(18) (2024).

may grant extensive rights to a shareholder or group of shareholders by, for example, agreeing to “require the approval or consent of 1 or more persons or bodies before the corporation may take actions specified in the contract.”<sup>90</sup> Since a Section 122(18) agreement may grant additional rights to a shareholder, rather than simply specifying how a shareholder will exercise his or her pre-existing rights, it is of monumental importance that Delaware courts will not consider contractual rights when assessing controller status. Regardless of the amount of control shareholders may exercise over a corporation through Section 122(18) agreements, courts will not consider that control when assessing controller status because the shareholders’ control is merely the exercise of contractual rights.<sup>91</sup>

However, given the extensive rights that can be granted to a shareholder under Section 122(18) agreements, it is possible that a court might hold such shareholders to fiduciary obligations, notwithstanding the fact that the shareholder is simply exercising contractual rights. Prior to Section 122(18) being signed into law, New York University School of Law Professors Edward Rock and Marcel Kahan noted that, if enacted, Section 122(18) agreements “may render a counterparty a ‘controller’ with all of the accompanying fiduciary obligations but far fewer of the benefits.”<sup>92</sup> Additionally, Yale Law School Professor Jonathan Macey identified a recent trend in controversial Delaware Chancery Court decisions of providing increased protection to minority shareholders in an attempt to shield such shareholders from controllers, pointing to *Tornetta v. Musk*<sup>93</sup>—where Elon Musk’s pay package was immediately approved by an overwhelming majority of disinterested shareholders after being invalidated by the Delaware Chancery Court—and *Moelis II*.<sup>94</sup> In his discussion on *Moelis II*, Professor Macey notes that the shareholder agreement provisions, invalidated by the court, were fully disclosed at the Company’s IPO, so

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<sup>90</sup> *Id.* (providing that “persons or bodies may include the board of directors or 1 or more current or future directors, stockholders or beneficial owners of stock of the corporation”).

<sup>91</sup> See cases cited *supra* note 81.

<sup>92</sup> Edward Rock & Marcel Kahan, *Proposed DGCL § 122(18), Long-term Investors, and the Hallowing Out of DGCL § 141(a)*, HARVARD L. SCH. FORUM ON CORPORATE GOVERNANCE (May 21, 2024), <https://perma.cc/YC3C-DSKQ> (arguing that the amendment in response to *Moelis II* be postponed until the Delaware Supreme Court has an opportunity to address the issues).

<sup>93</sup> 310 A.3d 430 (Del. Ch. 2024).

<sup>94</sup> Jonathan R. Macey, *Delaware Law Mid-Century: Far from Perfect but Probably Not Leaving for Las Vegas* 5–8 (Dec. 4, 2024) (unpublished research paper) (on file with SSRN).

if shareholders thought they may be harmed by the agreement, they simply could have declined to invest.<sup>95</sup> Indeed, this is consistent with contractarianism.<sup>96</sup> Professor Macey argues that the Delaware courts are pushing unwanted and unnecessary “protections” onto minority shareholders.<sup>97</sup>

If Professors Rock, Kahan, and Macey are correct, it is probable that Delaware’s Chancery Court may hold certain minority shareholders with contractual rights under Section 122(18) agreements to fiduciary obligations, regardless of whether the shareholder is simply exercising contractual rights. This could raise concerns for shareholders entering into Section 122(18) agreements for two primary reasons. First, minority shareholders previously owing no fiduciary obligations to a corporation may be held to fiduciary standards akin to corporate directors, rendering them liable for monetary damages in the event of a fiduciary breach. Second, while a corporation’s charter may exempt directors from personal liability arising from duty of care breaches, controllers do not have that same liability exemption.<sup>98</sup>

To illustrate the possible dilemma, consider a variation of *Moelis II*. Suppose Moelis was seriously underperforming as CEO of the Company and the Board wished to replace him. Moelis could exercise his shareholder agreement rights and veto the Board’s decision to fire him as CEO and hire someone else. If plaintiffs alleged that Moelis breached fiduciary obligations as a controller, Moelis would argue that he owed no fiduciary obligations because he was simply enforcing contractual rights and did not own more than 50% of the Company.<sup>99</sup> If Moelis were to argue this successfully, he would face no liability for breaching fiduciary obligations because since he was not a controller, no duties were owed. Moelis could claim he was merely exercising his contractual rights under the shareholder agreement, and the board of directors that caused the Company to enter into the shareholder agreement could claim protection under the business judgment rule, leaving the plaintiffs with no remedy. In response to Section 122(18) agreements and considering the extensive control that a minority shareholder may exert over a board, it would not be

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<sup>95</sup> *Id.* at 7.

<sup>96</sup> See discussion *supra* Section I.

<sup>97</sup> Macey, *supra* note 94.

<sup>98</sup> See discussion *infra* Section III.B.1.

<sup>99</sup> See *Moelis I*, 310 A.3d at 1009–10. This is assuming that the shareholder party to the shareholder agreement would not owe fiduciary duties in another capacity as, for example, the CEO or a director or officer.

surprising if a court were to hold contracting shareholders to fiduciary standards to protect unsuspecting minority shareholders.<sup>100</sup>

## B. An Overview of Fiduciary Duties and Potential Obligations

The duties of care and loyalty are the core fiduciary duties always owed by corporate directors and are only owed by a shareholder if deemed a controller or part of a control group. The ordinary minority shareholder, on the other hand, owes no fiduciary obligations whatsoever. The purpose of the following two subsections is to provide a sufficient, but not comprehensive, overview of the core fiduciary duties of care and loyalty as a background for this Comment's discussion in Section IV.

### 1. The Duty of Loyalty

The duty of loyalty requires directors, officers, and controllers to refrain from putting their self-interest ahead of the interests of the corporation and its shareholders.<sup>101</sup> The duty to act in good faith falls under the duty of loyalty because "[t]o act loyally, a director or officer must act in good faith."<sup>102</sup> Fiduciary duty lines are often blurred between the classic understanding of the duty of loyalty and gross negligence (i.e., the duty of care).<sup>103</sup> The duty to act in good faith<sup>104</sup> is somewhat difficult to understand but generally requires that the corporate fiduciary not act in bad faith.<sup>105</sup> For instance, bad faith may be shown if the corporate fiduciary "intentionally acts with the purpose other than that of advancing the best interests of the corporation"<sup>106</sup> or with reckless disregard for the interests of the corporation and its shareholders.<sup>107</sup> "[A] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."<sup>108</sup>

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<sup>100</sup> See discussion *infra* Section IV.B.

<sup>101</sup> See *In re Columbia Pipeline Grp., Inc. Merger Litig.*, 299 A.3d 393, 453–54 (Del. Ch. 2023).

<sup>102</sup> *Id.* (citing *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).

<sup>103</sup> See *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 66–67 (Del. 2006).

<sup>104</sup> The terms "duty of good faith" and "duty to act in good faith" will be used interchangeably.

<sup>105</sup> See *Disney*, 906 A.2d at 66–67.

<sup>106</sup> *Id.* (citation omitted).

<sup>107</sup> *Id.* at n.111.

<sup>108</sup> *Stone*, 991 A.2d at 369–70 (citing *Guttman v. Huang*, 823 A.2d 492, 506 n. 34 (Del. Ch. 2003)) (internal quotation marks omitted).

Furthermore, in *Stone v. Ritter*,<sup>109</sup> the court held that directors may be liable for a *Caremark*<sup>110</sup> violation (i.e., failure to engage in proper oversight) if the directors either (a) “utterly fail to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operation thus disabling themselves from being informed of risks or problems requiring their attention.”<sup>111</sup> The directors must be aware that they were failing to discharge their fiduciary obligations to be liable under *Caremark*.<sup>112</sup> Contrary to the duty of care, corporations are expressly prohibited from including a provision in the charter eliminating director and officer personal liability for the duties of loyalty and good faith.<sup>113</sup>

## 2. The Duty of Care

Directors owe a duty of care to refrain from engaging in grossly negligent conduct and to inform themselves of all material information reasonably available to them prior to making a decision on behalf of the corporation.<sup>114</sup> While the duty of loyalty may give rise to liability for controlling shareholders, the duty of care poses a lesser threat of liability for two primary reasons. First, even though the existence of a general duty of care has been acknowledged by Delaware courts,<sup>115</sup> “there is not a single case in which a controlling shareholder was actually found liable for a mere violation of his general duty of care.”<sup>116</sup> Second, DGCL Section 102(b)(7) allows corporations to include a provision in their charter eliminating director or officer personal liability for duty of care breaches.<sup>117</sup> In 2020, over 95% of Delaware public corporations included an exculpation provision in their certificate of incorporation.<sup>118</sup>

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<sup>109</sup> 991 A.2d 362 (Del. 2006).

<sup>110</sup> *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

<sup>111</sup> *Stone*, 991 A.2d at 370.

<sup>112</sup> *Id.* (citing *Guttman*, 823 A.2d at 506).

<sup>113</sup> DEL. CODE ANN. tit. 8 § 102(b)(7)(i)–(ii) (2022).

<sup>114</sup> *See Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (Del. 1985).

<sup>115</sup> Jens Dammann, *The Controlling Shareholder's General Duty of Care: A Dogma That Should Be Abandoned*, 2015 U. ILL. L. REV. 479, 496.

<sup>116</sup> *Id.* (citing *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 619 (Del. Ch. 1999)).

<sup>117</sup> DEL. CODE ANN. tit. 8 § 102(b)(7) (2022). This was added to the DGCL following the infamous *Smith v. Van Gorkom* decision where the Delaware Supreme Court found the directors personally liable for breach of the duty of care. *See Van Gorkom*, 488 A.2d at 893.

<sup>118</sup> Frankenreiter & Talley, *supra* note 1, at 5 (citation omitted).

It would be difficult to facilitate a liability exemption for shareholders party to Section 122(18) agreements given that, under current Delaware precedent, no fiduciary duties are owed. Indemnification of the shareholder in the Section 122(18) agreement may lead to a court inferring that the contracting shareholder agreed to hold himself to fiduciary duties he may not have otherwise owed. The indemnity route may only be useful if Delaware courts begin to recognize fiduciary duties for contracting shareholders. Assuming the Delaware courts were to recognize fiduciary duties for such shareholders, the Delaware legislature could also amend Section 102(b)(7) and extend the duty of care personal liability opt out to contracting shareholders or controllers. However, as history has shown, even without eliminating contracting shareholders' personal liability for duty of care violations, it is unlikely that they would be found liable for such a violation.<sup>119</sup>

#### IV. WHEN MAY FIDUCIARY IMPLICATIONS ARISE AND WHEN SHOULD THEY NOT?

Section 122(18) raises concerns for two primary groups of people: (1) corporate directors who cause a corporation to enter into Section 122(18) agreements and (2) shareholders who contract into Section 122(18) agreements. Corporate directors are always bound by their fiduciary obligations, and although it is unclear under current precedent whether shareholders would be held to fiduciary obligations as a consequence of rights exercised under a Section 122(18) agreement, trends in the Delaware Chancery Court suggest the possibility that such shareholders may be held to fiduciary obligations—at least in some situations.<sup>120</sup> Subsection IV.A will discuss the likelihood of directors facing individual liability for causing a corporation to enter into a shareholder agreement. Subsection IV.B will discuss the likelihood of and argue against shareholders being held to fiduciary obligations by reason of contractual rights granted under Section 122(18) agreements.

##### A. Directors Ought to *Care(mark)* About the Implications of Section 122(18) Agreements

Corporate directors are always bound by their fiduciary duties, and directors may face liability for breaching their fiduciary

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<sup>119</sup> See Dammann, *supra* note 115.

<sup>120</sup> See discussion *supra* Section III.B.

duties by causing a corporation to enter into a Section 122(18) agreement. Indeed, S.B. 313's synopsis provides that Section 122(18) does not relieve corporate directors of their fiduciary duties "with respect to deciding to cause the corporation to enter into a [Section 122(18) agreement] . . . and with respect to deciding whether to perform, or cause the corporation to perform, or to breach, the contract."<sup>121</sup> Such liability may present itself in the form of a *Caremark* claim for failure to properly oversee a shareholder's decisions if the contracting shareholder has the power to make internal corporate decisions and such decisions are detrimental to the corporation. As discussed above, this is problematic for corporate directors because although a *Caremark* claim would appear to fall under the duty of *care*, a *Caremark* claim falls under the duty of *loyalty* and corporations cannot include a provision in their charter eliminating director personal liability for duty of loyalty breaches.<sup>122</sup>

Consider a scenario where a corporation's board of directors cause the corporation to enter into a Section 122(18) agreement with a shareholder and the provisions of the agreement, individually or collectively, permit the contracting shareholder to make business decisions on behalf of the corporation, thereby preventing the board of directors from freely exercising its independent business judgment. If the agreement has this effect and the contracting shareholder exercises his or her contractual rights in furtherance of his or her own self-interest and to the detriment of the corporation, it is possible that other minority shareholders may bring an action against the directors for entering into such an agreement on behalf of the corporation. However, the directors may not face liability in such a case because they "could rely on precedent suggesting that they could not breach their duties by complying with (i.e., not breaching) the Stockholders Agreement."<sup>123</sup> The board of directors' decision to enter into the agreement would also ultimately be protected by the business judgment rule unless the plaintiff-shareholders could show fraud,

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<sup>121</sup> S.B. 313, *supra* note 57.

<sup>122</sup> See *infra* Section III.B.1.

<sup>123</sup> *Moelis I*, 310 A.3d at 1010 (citations omitted). Alternatively, the directors could choose not to comply with the shareholder agreement and argue that performance of the contract would cause them to breach fiduciary duties. Section 122(18) raises a host of other complex issues regarding the enforceability of shareholder agreements when performance would cause directors to breach their fiduciary duties. These issues will not be discussed in this Comment. For further discussion, see Jim An, *Moelis*, § 122(18), and *Remedies in Contractual Breaches Prompted by Fiduciary Duty*, HARVARD L. SCH. FORUM ON CORPORATE GOVERNANCE (July 3, 2024), <https://perma.cc/993M-RS63>.

illegality, self-interest, or gross negligence on the part of directors.<sup>124</sup> Corporate directors should tread lightly when entering Section 122(18) agreements because an aggressive shareholder-plaintiff could bring a claim under *Caremark* for failure to properly oversee a shareholder's decisions if the contracting shareholder has the power to make internal corporate decisions and such decisions are detrimental to the corporation.<sup>125</sup> However, director liability under a *Caremark* claim would require that the contracting shareholder actually exercise his or her contractual rights in a way that causes harm to the corporation.

The plaintiffs in *Moelis II* did not challenge Moelis' decision to exercise a contractual right granted to him by the shareholder agreement. Rather, the plaintiffs argued that the provisions of the shareholder agreement *facially* violated Section 141(a).<sup>126</sup> As previously discussed,<sup>127</sup> as-applied challenges are quite different from facial challenges. The court in *Moelis II* did not have the opportunity to determine whether the shareholder agreement provisions at issue would survive an as-applied challenge because the court rendered its decision based on whether the contested provisions could "operate validly under Section 141(a)."<sup>128</sup> But Section 122(18) makes clear that the provisions at issue in *Moelis II* would survive a facial challenge if challenged today. The outcome of an as-applied challenge is not as clear.

An as-applied challenge in the context of Section 122(18) agreements requires that a contracting shareholder exercise rights granted to him or her in the agreement. In an as-applied challenge, "a court examines the decision to exercise a contract right in the specific setting when it was exercised," and "will focus on who did what, when, and how in the specific scenario at issue."<sup>129</sup> Without such action by a contracting shareholder, the corporate directors who caused the corporation to enter into the shareholder agreement will likely not be subject to liability under *Caremark*.

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<sup>124</sup> Plaintiff-shareholders may be limited to alleging fraud, illegality, or self-dealing as a means of bypassing the business judgment rule if the corporation eliminated director liability for gross negligence (i.e., duty of care violations) in the charter. *See generally* DEL. CODE ANN. tit. 8 § 102(b)(7) (2022).

<sup>125</sup> *See Stone*, 991 A.2d at 369–70.

<sup>126</sup> *See Moelis II*, 311 A.3d at 817–18.

<sup>127</sup> *See supra* Section II.B.1.

<sup>128</sup> *Moelis II*, 311 A.3d at 860 (citing *Del. Bd. of Med. Licensure & Discipline*, 224 A.3d at 956).

<sup>129</sup> *Id.*

But this does not lead to the conclusion that corporate directors who caused the corporation to enter into a shareholder agreement will always be free from liability. Corporate directors may be subject to future *Caremark* liability if the contracting shareholder has the right to make internal corporate decisions, exercises that right to the detriment of the corporation, and the directors fail to maintain proper oversight shareholder's decisions. If a board of directors decides to outsource internal corporate decisions to a shareholder, the directors should consider drafting the shareholder agreement such that they maintain a degree of oversight over outsourced decision-making power to avoid the possibility of *Caremark* liability.

#### B. Shareholders Party to Section 122(18) Agreements Should Not Be Held to Fiduciary Obligations

Under current Delaware precedent, courts will not consider contractual rights when assessing controller status.<sup>130</sup> In part, this is because “every contractual obligation of a corporation constrains the corporation’s freedom to operate to some degree.”<sup>131</sup> But considering the recent trend observed by Professor Macey<sup>132</sup> and that corporations can effectively outsource corporate decision-making power to shareholders through Section 122(18) agreements, courts may hold contracting shareholders to director- and officer-like fiduciary duties, depending on the degree of control exercised by the contracting shareholder. This section, however, argues that contracting shareholders should not be subject to fiduciary obligations solely due to their freely negotiated contractual rights.

To determine when a court may hold a contracting shareholder—with de minimis voting power such that he or she would not be deemed a controller—to fiduciary duties to protect unsuspecting minority shareholders, it is necessary to consider two scenarios regarding Section 122(18) agreements. First, consider a shareholder with de minimis voting power and the contractual right to nominate four directors to a ten-director board. The shareholder effectively has no control over the board or corporate decision-making because the shareholder merely has nomination rights. Second, consider a situation similar to *Moelis II*, where a shareholder has extensive pre-approval rights. The board can

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<sup>130</sup> See *Moelis I*, 310 A.3d at 1009–10.

<sup>131</sup> *In re KKR*, 101 A.3d at 994.

<sup>132</sup> See discussion *supra* Section III.A.

only manage the corporation to the extent permitted by the shareholder and “cannot approve, authorize, or even plan to take a covered action without [the shareholder’s] prior written approval.”<sup>133</sup> It was argued in *Moelis II* that the board still maintained control over the business and affairs of the corporation because the Pre-Approval Requirements were merely veto rights, representing Moelis’ passive control.<sup>134</sup> The court disagreed, noting that “[t]he power to review is the power to decide.”<sup>135</sup> So even if a shareholder merely has veto rights, the board of directors is still prohibited from freely exercising its independent business judgment.<sup>136</sup> Whether pre-approval or veto rights, one could argue that these types of provisions may provide a shareholder with extensive control such that the business and affairs of the corporation are managed under the direction of the shareholder, rather than the board of directors.

In the above hypotheticals, the former shareholder’s role is drastically different from the latter’s. Under no circumstance should the former shareholder be held to fiduciary duties because he has no control over corporate decision-making. In the latter scenario, the contracting shareholder arguably has a significant degree of control over the business affairs of the corporation. If a plaintiff alleges that a shareholder owning less than 50% of the corporation’s voting power is a controller, the plaintiff must allege facts demonstrating the shareholder “*exercises control* over the business affairs of the corporation.”<sup>137</sup> It is tempting to hold the latter shareholder to fiduciary obligations to ensure the protection of other unsuspecting, minority shareholders because otherwise a shareholder-plaintiff may have no recourse against the contracting shareholder under current precedent if he or she exercises his or her rights under a Section 122(18) agreement to the detriment of the corporation.

The voting power inquiry is ineffective when assessing controller status in the context of Section 122(18) agreements because the agreements are typically used to preserve a shareholder’s control *after* his or her voting power has been diluted.<sup>138</sup> “[I]n deciding whether a stockholder owes a fiduciary obligation

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<sup>133</sup> *Moelis II*, 311 A.3d at 820–21.

<sup>134</sup> *Id.*

<sup>135</sup> *Id.* (quoting Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 815 (2002)).

<sup>136</sup> *See id.*

<sup>137</sup> *Kahn v. Lynch Commc’n Sys., Inc.*, 638 A.2d 1110, 1113–14 (Del. 1994) (quoting *Invanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1334 (Del. 1987)).

<sup>138</sup> *See Rauterberg, supra* note 15, at 1131–32.

to the other stockholders of a corporation in which it owns only a minority interest, the focus of the inquiry is on whether the stockholder can exercise actual control over the corporation's board."<sup>139</sup> The inquiry focuses on whether the shareholder has coercive power to wield over the board's ability to make independent business decisions or whether the shareholder has sufficient voting power to retaliate against the directors by removal if they fail to adhere to the shareholder's will.<sup>140</sup> A substantial degree of voting power is typically necessary for a court to find controller status because without such voting power the shareholder likely does not have the power to remove directors if they fail to comply with the shareholder's wishes.<sup>141</sup> Since contracting shareholders likely have insufficient voting power to retaliate against directors by removal, it appears the traditional controller inquiry is unworkable in the context of Section 122(18) agreements where the contracting shareholder has de minimis voting power.

In *Superior Vision Services, Inc. v. ReliaStar Life Insurance Co.*, the Chancery Court stated the following:

... a significant shareholder, who exercises a duly-obtained contractual right that somehow limits or restricts the actions that a corporation otherwise would take, does not become, without more, a "controlling shareholder" for that particular purpose. There may be circumstances where the holding of contractual rights, coupled with a significant equity position and other factors, will support the finding that a particular shareholder is, indeed, a "controlling shareholder," especially if those contractual rights are used to induce or to coerce the board of directors to approve (or refrain from approving) certain actions.<sup>142</sup>

Section 122(18) agreements undoubtedly give contracting shareholders a "duly-obtained contractual right" that, depending on the provisions, may "restrict[] the actions that a corporation otherwise would take."<sup>143</sup> *Superior Vision Services* appears to suggest that such an agreement does not make the contracting shareholder a controller by merely exercising his or her contractual rights.

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<sup>139</sup> *In re KKR*, 101 A.3d at 995.

<sup>140</sup> *Id.* at 994–95.

<sup>141</sup> *Controller Confusion*, *supra* note 67, at 1708–09.

<sup>142</sup> *Superior Vision Servs.*, 2006 WL 2521426, at \*5.

<sup>143</sup> *See id.*

However, a contracting shareholder runs the risk of becoming a controller if he or she has contractual rights plus “a significant equity position and other factors.”<sup>144</sup> Consider *In re Tesla Motors*, where the Chancery Court held that if a shareholder lacks requisite voting power to be deemed a controller, the court will look to whether that shareholder with significant—but less than majority—voting power has the ability to dominate corporate decision making.<sup>145</sup> Although Elon Musk—Tesla’s largest shareholder—only held 22.1% of the company’s stock, Musk had the “ability to exercise the equivalent of majority voting control” due to his influence over shareholders, the company, and board members.<sup>146</sup> *In re Tesla* is one example of how an unquestionably minority shareholder, from a voting power perspective, may be deemed a controller when that shareholder has “a significant equity position and other factors.”<sup>147</sup> But Section 122(18) agreements do not provide the contracting shareholder with the “ability to exercise the equivalent of majority voting control.” Rather, Section 122(18) agreements may provide a shareholder with contractual rights that place limits on corporate decision-making. Such contractual rights exist independently from that shareholder’s voting power and influence over other shareholders, the company, or board members. Although a minority shareholder may have the ability to exercise contractual rights that place significant limits on corporate decision-making through a Section 122(18) agreement, that shareholder likely lacks the ability to exercise the equivalent of majority voting control “to induce or to coerce the board of directors to approve (or refrain from approving) certain actions.”<sup>148</sup>

Delaware’s commitment to contractarianism should be at its zenith when corporations and minority shareholders enter into Section 122(18) agreements, regardless of the degree of control exercised by the contracting shareholder. Corporate directors are always required to exercise their independent business judgment, and if a board of directors decides that entering into a Section

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<sup>144</sup> See *id.*

<sup>145</sup> See *In re Tesla Motors*, WL 1560293, at \*14.

<sup>146</sup> *Id.* at \*13–19.

<sup>147</sup> *Superior Vision Servs.*, 2006 WL 2521426, at \*5.

<sup>148</sup> *Id.* If a shareholder party to a Section 122(18) agreement owns a substantial share of a corporation’s voting power and can exercise the equivalent of majority voting control, the shareholder may be deemed a controller. But that shareholder’s status as a controller is independent from his or her contractual rights granted under a Section 122(18) agreement. *Id.* at \*5. This Comment only argues that a shareholder party to a Section 122(18) agreement should not be deemed a controller when the shareholder can exercise contractual rights and lacks the ability to exercise the equivalent of majority voting control.

122(18) agreement with a preferred shareholder prior to the corporation's IPO is in the best interest of the corporation and the most efficient manner to effectively allocate corporate decision-making power, that decision should be respected absent fraud, illegality, or self-interest. Additionally, the contracting shareholder should be permitted to exercise his or her bargained for Section 122(18) contractual rights without unnecessary judicial intervention. Section 122(18) agreements are exemplary of sophisticated parties making their own independent judgment about the risk they will bear, "and Delaware courts [should be] especially chary about relieving sophisticated [parties] of the burden of freely negotiated contracts."<sup>149</sup> If minority shareholders feel that a corporation does not provide them with adequate protection, they can simply decline to invest and divert their funds to corporations with broader protections. Consequently, shareholders should not be held to fiduciary obligations solely as a consequence of contractual rights exercised under freely negotiated Section 122(18) agreements.

## V. CONCLUSION

All parties entering into Section 122(18) agreements should be wary of the murky waters and tread lightly when drafting such agreements. Corporate directors should beware of losing control over the decision-making process because if they do, they could face *Caremark* liability if the contracting shareholder takes action detrimental to the corporation. To avoid *Caremark* liability, the directors should maintain some degree of oversight with regard to the contracting shareholder's decision-making power. Shareholders entering into Section 122(18) agreements should also beware of potential fiduciary implications because if found to be a controller they may face personal liability and monetary damages. However, such shareholders should not be deemed controllers because they lack controller characteristics and merely hold freely negotiated contractual rights.

Section 122(18) reinforces Delaware's commitment to freedom of contract. It is unclear how the courts will approach fiduciary obligations with regard to Section 122(18) agreements, but when the issue arises, the Delaware courts should follow their current precedent and refuse to consider contractual rights when assessing controller status. If Delaware hopes to maintain its

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<sup>149</sup> See *New Enter. Assocs.*, 295 A.3d at 566 (quoting *Abry Partners*, A.2d at 1061–62) (internal quotation marks omitted).

status as Corporate Capital of the World, it should continue to allow corporations to structure their affairs as they see fit, without undue interference from the courts. If corporate directors, in exercising their independent business judgment, decide that outsourcing corporate decision-making power to a shareholder is in the best interests of the corporation, they should be permitted to do so.

Keep in mind the basic idea of contractarianism—"market forces are expected to create optimal corporate contracts, at the time a company initially goes public."<sup>150</sup> If the overwhelming majority of potential investors do not invest in a corporation because they believe that the corporation will not provide them with adequate protections, contractarian theory tells us that those market forces will have significant impacts on the board of directors' decisions regarding effective corporate governance arrangements. The goal of every corporation pre-IPO is to demand the highest share price at the IPO and on the secondary market. If investors are hesitant to invest due to inadequate protections, a corporation will likely respond accordingly and implement corporate governance arrangements that provide more protection for minority shareholders. Moreover, if investors are made aware of a corporation's limitations due to a Section 122(18) agreement when they choose to invest, they are investing with the understanding that the business and affairs of the corporation will be managed by and under the direction of the board of directors, subject, of course, to the Section 122(18) agreement.

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<sup>150</sup> Klausner, *supra* note 2 (citing EASTERBROOK & FISCHER, *supra* note 1) (internal quotation marks omitted).