

KIRKLAND M&A UPDATE

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Delaware Supreme Court Issues Important Decision Regarding Vote Buying, Stock Transfer Restrictions, Definition of “Stock Ledger” and Director Reduction Bylaws

A recently issued decision by the Delaware Supreme Court in the Crown Emak Partners, LLC v. Kurz case both affirmed and reversed in part the earlier decision of the Delaware Chancery Court in Kurz v. Holbrook.

On April 21, 2010, the Delaware Supreme Court issued an important decision in the case of *Crown Emak Partners, LLC v. Kurz*.¹ The decision affirmed in part and reversed in part the much-discussed decision of the Delaware Chancery Court in *Kurz v. Holbrook*,² which was the subject of an earlier [M&A Update](#).

Summary of Relevant Facts

The case arose out of a contest for control of EMAK Worldwide, Inc. (the “Company”), a Delaware corporation traded in the pink sheets. One faction vying for control of the Company (the “Kurz faction”), held voting common stock in the Company and sought to gain control of the board of directors of the Company through a consent solicitation to remove two directors and fill all the vacancies on the board (including a pre-existing one) with its own candidates, which would give it control of the board. To obtain a sufficient number of votes in support of its proposals, the Kurz faction sought to purchase certain shares subject to a restriction on their sale, transfer or assignment by providing that title to the shares would be transferred only when the seller was “entitled or permitted” to do so.

The competing faction (the “Crown faction”) held preferred stock in the Company that had a contractual right to elect two directors and to vote generally on matters that came before stockholders except the election of other directors, and thus could not be voted to remove directors. Consequently, the Crown faction undertook a consent solicitation seeking stockholder approval of bylaws amendments that would reduce the number of directors to fewer than the number of sitting directors and establish a mechanism for a stockholder vote to replace the eliminated directors with one new director. The effect of these amendments would have been to give the Crown faction control of the board.

The voting results were complicated by the fact that the neither the Kurz faction nor the Company obtained a DTC omnibus proxy to vote the shares held through DTC in favor of the Kurz faction’s proposals, thus leading the inspector of elections overseeing the competing consent solicitations to invalidate those votes.

Chancery Court Rulings

The Chancery Court, in an opinion by Vice Chancellor Laster, held, among other things, that:

- The Crown faction’s proposed bylaw amendments were invalid because a bylaw cannot reduce the size of a board of directors to fewer than the number of sitting directors if doing so prematurely terminates the term of one or more sitting directors;
- The “Cede breakdown,” which sets forth the banks, brokers and others who hold shares through DTC and its nominee Cede & Co., and the number of shares held by each such entity, is part of the “stock ledger” as used in Section 219 of the Delaware General Corporation Law (the “DGCL”) for purposes of determining who can vote on matters that come before stockholders; and
- The Kurz faction’s purchase of the restricted shares did not constitute illegal vote buying because the faction acquired both the voting rights and economic interests in the shares, and the purchase did not violate the transfer restrictions applicable to the shares because legal title remained with the seller.

The Supreme Court's Rulings

The Delaware Supreme Court affirmed in part and reversed in part the Chancery Court's decision as follows:

Reversal of Chancery Court holding regarding transfer of certain restricted shares. The Supreme Court held that because the seller of the restricted shares transferred both the voting rights and economic ownership of the shares to the Kurz faction, the Kurz faction took "full ownership" of the shares in violation of the restricted stock agreement's prohibition on any sale, transfer or assignment of the shares. The Court stated: "Therefore, we hold that the [stock purchase agreement] did not operate as a legal and valid sale or transfer of [the sellers'] shares and that Kurz was not entitled to vote the shares." The logic underlying this holding seems questionable. There is no indication in the record at either the Chancery or Supreme Court level that the restricted stock agreement provided that any transfer in violation of its terms is null and void.³ Thus, although the transfer may have violated the terms of the restricted stock agreement, there is no reason to conclude that it did not vest ownership of the shares in Kurz, while giving rise to a breach of contract claim by the counterparty to the restricted stock agreement (the Company). Even if the transfer of the actual shares to Kurz was invalid, there is no reason to believe the accompanying proxy granting Kurz the right to vote the shares was also invalid, although a transfer of the voting rights of the shares without their economic ownership would presumably have necessitated a vote buying analysis by the Supreme Court. In any event, the decision stands for the proposition that a transfer of both the voting rights and economic ownership of stock constitutes a sale, transfer or assignment of the stock even if legal title to the stock remains with the seller.

Affirmance of Chancery Court's holding regarding vote buying. The Supreme Court affirmed the Chancery

Court's holding that Kurz' share purchase did not constitute illegal vote buying "because the economic interests and the voting interests of the shares remained aligned since both sets of interests were transferred from [the seller] to Kurz by the [stock purchase agreement]." However, the Supreme Court indicated that the Delaware courts will "closely scrutinize" situations where the voting rights and economic interests in shares have been separated "because [doing so] fails to serve the community of interest among all shareholders, since the 'bought' shareholder votes may not reflect rational, economic self-interest arguably common to all shareholders."⁴ Consequently, practitioners should keep in mind that any transaction that results in a separation of voting rights and economic interests may be subject to a judicial vote buying analysis.

Chancery Court's holding regarding the expanded definition of "stock ledger" rendered obiter dictum and of no precedential value. The Supreme Court stated that in light of its decision invalidating the transfer of the restricted shares to Kurz, which was outcome determinative with respect to the voting on the competing consent solicitations, it was unnecessary for the Court to decide the issue of whether the Cede breakdown is part of the stock ledger as used in Section 219 of the DGCL. The Court said any change to DGCL Section 219 should be the result of a "legislative cure." The Court stated that "[t]herefore, the Court of Chancery's interpretation of stock ledger in section 219 is *obiter dictum* and of no precedential value."

Affirmance of Chancery Court's holding invalidating the bylaw amendments. The Supreme Court affirmed the Chancery Court's holding that the bylaw amendments, which had the effect of reducing the size of the board to fewer than the number of sitting directors, were invalid because they conflicted with Section 141(b) of the DGCL, which provides that a director shall hold office until his successor is elected and qualified or until his earlier resignation or removal.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland author or your regular Kirkland contact.

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¹ No. 64, 2010, No. 85, 2010 (Del., April 21, 2010).

² C.A. No. 5019-VCL (Feb. 9, 2010).

³ In addition, the author's review of the Company's 2004 stock incentive plans did not reveal any provision stating that transfers in violation of the plans are null and void, although such a provision may be contained in the grant agreements themselves, which are not publicly available.

⁴ Quoting *In re IXC Communications, Inc. Shareholders Litigation*, 1999 WL 1009174, at 8 (Del. Ch., Oct. 27, 1999).

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