

KIRKLAND M&A UPDATE

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Delaware Chancery Court Issues Important Decision Addressing Director Reduction Bylaws, the Definition of “Stockholder of Record,” and Vote Buying

A recent Delaware Chancery Court decision addresses director reduction bylaws, expands the definition of “stockholders of record” to include DTC participants and sets forth principles for analyzing whether a transaction involves illegal vote buying, some of which had not been previously articulated by the Delaware Courts.

On February 9, 2010, the Delaware Chancery Court rendered an important decision in the case of *Kurz v. Holbrook*.¹ In an opinion by Vice Chancellor J. Travis Laster, the Court held that:

- 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;
- Banks, brokers and others who hold shares through The Depository Trust Company (“DTC”) and, more specifically, through DTC’s nominee, Cede & Co. (“Cede”), are “stockholders of record” for purposes of determining who can vote on matters that come before stockholders; and
- Vote buying is problematic if it involves the use of corporate resources, has a disenfranchising effect, involves fraud or “informational disparities” or creates a misalignment between voting and economic interests.

The case is on appeal to the Delaware Supreme Court.

Background

This case arose out of a contest for control of EMAK Worldwide, Inc., (“EMAK” or the “Company”), a Delaware corporation that was traded in the pink sheets at the time the corporate control contest arose. EMAK had a seven-person board of directors consisting, at the time, of six directors and one vacancy. One faction (the “Kurz faction”) undertook a consent solicitation to remove two directors from the board and fill the three vacancies with their own candidates. As Donald Kurz was already on the board, this would give them a majority of the board seats. The other faction (the “Crown faction”) held primarily preferred stock that (i) voted on an as-converted basis with the common stock and represented 27.6% of the Company’s voting power and (ii) gave Crown the right to appoint two directors but did not vote in the election of directors and thus could not be voted to remove directors. Accordingly, the Crown faction sought to take control of the board through the adoption of two bylaws, one that reduced the board size from seven directors to three and a second that provided that if the number of directors exceeds three, the EMAK CEO shall call a special meeting of stockholders to elect the third director, who will take office as the “singular successor to his multiple predecessors.”

In order to obtain enough consents in favor of its consent solicitation, Kurz entered into a purchase agreement with a former EMAK employee, Peter Boutros, to acquire 150,000 shares owned by Boutros (the “Boutros shares”) and obtain a proxy to vote the shares. The Boutros shares were, however, restricted shares and the agreement governing the shares prohibited their sale, transfer, pledge, hypothecation, assignment or other disposition (but not a contract to sell the shares) until March 3, 2011. Consequently, the agreement pursuant to which Kurz purchased the shares (the “Boutros purchase agreement”) provided for the sale and transfer of the Boutros shares to Kurz only when Boutros was legally entitled to do so.

Surprisingly, both the Kurz faction and the Crown faction obtained a sufficient number of consents for the passage of their respective proposals. However, the inspector of elections invalidated all the consents that had been

executed in favor of the Kurz faction's proposals by a proxy holder on behalf of banks, brokers and others who maintain accounts at, and hold shares through, DTC and Cede ("DTC participants")—which consents were necessary for the approval of the proposals—because no party had obtained a DTC omnibus proxy with respect to the shares. The DTC omnibus proxy is the instrument by which DTC, which is the sole United States depository and clearing system for the execution and settlement of purchase and sale transactions of publicly traded equity securities of domestic corporations, transfers its voting power, as the record holder of a company's shares, to DTC participants.

The two factions raised numerous issues regarding the consent results, the most important of which were (i) the Kurz faction's challenge to the validity of Crown's bylaw amendments under Delaware law, (ii) the Kurz faction's challenge to the decision of the inspector of elections to invalidate the consents executed by a proxy holder on behalf of the DTC participants due to the lack of a DTC omnibus proxy, and (iii) the Crown faction's challenge to the proxy obtained by the Kurz faction with respect to the Boutros shares.

Key Holdings

Invalidity of bylaw amendments: The Court held that the bylaw amendments in question were invalid because they conflicted with the Delaware General Corporation Law (the "DGCL"). Specifically, the Court held that the amendments reducing the size of the board to fewer than the number of sitting directors conflicted with the "mandate" of DGCL Section 141(b) that "[e]ach director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal." The Court held that resignation, removal and death are the only legal means of removing a director from office prior to the expiration of the director's term (the Court noted that being alive is such an obviously basic requirement for service as a director that the absence of a reference to death in the statute was not necessary) and thus a director cannot be removed by shrinking the size of the board.

Expansion of "stockholder of record" definition to include DTC participants: The Court addressed the issue of whether only stockholders of record (i.e., those stockholders whose names appear on a company's stock ledger) should be entitled to vote on matters that come before stockholders, whether at an annual or special

meeting of stockholders, or by written consent. The Court focused on DGCL Section 219(c), which provides that "[t]he stock ledger shall be the only evidence as to who are the stockholders entitled by this section ... to vote in person or by proxy at any meeting of stockholders." The Court noted that under DGCL Section 228(a) the same stockholders who are entitled to vote at a stockholders meeting can also act by written consent.

After noting that a proxy holder can execute a written consent on behalf of a stockholder of record under DGCL Section 212(b), the Court cited with approval an earlier Chancery Court decision, *Olson v. Buffington*,² that had confronted a similar issue. Although the *Olson* Court held that a DTC omnibus proxy was required on the facts of that case, it indicated there may be exceptions to the general rule that consents must be executed by stockholders of record "where the consent is executed by a brokerage house and the record holder is a depository," and "the depository company [is] identified on the consent in order to provide the company a ready means of verifying the brokerage houses' holdings."

The Court then went on to hold that the "Cede breakdown," which is a list setting forth the names of the DTC participants who hold shares in a particular corporation and the number of shares held by each such entity, "should be part of the stock ledger for purposes of DGCL Section 219(c), and thus for determining who are the stockholders of record of the Company's shares. In reaching this conclusion, the Court noted, among other things, that (i) the federal proxy rules have long defined "record holder" to include banks, brokers and other entities that exercise fiduciary powers and hold securities of record in nominee name or as a participant in a clearing agency such as DTC (See Rule 14a-1(i) promulgated under the Securities Exchange Act of 1934 (the "Exchange Act")), and (ii) under DGCL Section 220, the statute that allows stockholders of a company to obtain a stockholders list, a requesting stockholder has long been entitled to the Cede breakdown.

Having concluded that the Cede breakdown is part of the stock ledger for purposes of Section 219(c), and thus that DTC participants are "stockholders of record" of the Company's shares, the Court was able to conclude that a DTC omnibus proxy was not necessary to convey voting authority from DTC (or Cede) to the DTC participants. Accordingly, even in the absence of the DTC omnibus proxy, the DTC partici-

pants had the legal authority to grant a proxy to Broadridge Financial Services, Inc. (“Broadridge”), the entity through which most large institutions vote their shares of U.S. public companies. Thus, the Court held that the consents that had been executed by Broadridge in favor of the Kurz faction’s director removal and appointment proposals had been validly executed and the proposals had been properly approved by EMAK stockholders.

Principles regarding vote buying. The Court rejected the Crown faction’s argument that the proxy obtained by the Kurz faction with respect to the Boutros shares involved illegal vote buying. Specifically, the Court found that even though Kurz would not take title to any of the Boutros shares until March 3, 2011, the Boutros purchase agreement “transferred full economic risk associated with the [Boutros shares] and that the voting rights appropriately followed the economic interest.”

In reaching this conclusion, the Court enunciated some “principles” applicable to an analysis of whether a particular transaction involves illegal vote buying, including the following:

- Vote buying is illegal if entered into for “deleterious purposes,” although the Court did not define this term;
- A transaction is more likely to be suspect if it involves the use of corporate resources (particularly the expenditure of corporate funds) than if it is merely a case of “third party vote buying;”
- Third party vote buying should “merit review only if it is disenfranchising, in the sense of actually determining the outcome of the vote” or “alter[ing] the voting pattern in a critical way;”
- Vote buying is likely to be illegal if it involves “fraud” and Delaware law “should be particularly sensitive to informational disparities;”
 - As an example, the Court stated that “disaggregated shareholders rationally de-value their votes when it appears they do not have control implications. A party seeking to aggregate votes into a meaningful block could take advantage of the rational pricing expectations of disaggregated stockholders who did not know such an effort was underway;” and
- Vote buying concerns may arise due to a “misalignment between the voting interest and the economic interest.”

Applying these principles to the facts before it, the

Court first noted that Kurz’s purchase of the Boutros shares was subject to a vote buying analysis because the transaction was disenfranchising as it was outcome-determinative of the corporate control contest. However, the Court found no evidence of fraud, informational disparities or misalignment of voting and economic interests and thus held that the purchase did not constitute illegal vote buying.

Conclusion

Kurz v. Holbrook is noteworthy for a number of reasons, including the following:

- The decision reflects the willingness of Vice Chancellor Laster, the Chancery Court’s newest judge, to address novel issues of law. Taken together with the Vice Chancellor’s December 22, 2009, decision in *Nacco Industries, Inc. v. Applica Incorporated*,³ in which the Court held that material misstatements or omissions in a Schedule 13D filed under the Exchange Act can be the basis for a fraud claim under Delaware law, it seems clear that he does not shy away from making new law.
- The decision expands the concept of the stock ledger to include the Cede breakdown and expands the definition of “stockholder of record” to include DTC participants, thereby effectively rendering the DTC omnibus proxy obsolete and irrelevant. In so doing, the decision may also call into question the need for a formal proxy under Delaware law in circumstances in which (i) it is understood by the relevant parties that one party has granted voting authority to another party and (ii) the lack of a proxy will not create confusion in counting the votes. In addition, as a result of the decision, DTC participants will presumably have all the rights of stockholders of record, including the right to receive notice of stockholders meetings.
- The decision makes it clear that a bylaw cannot reduce the size of a board to fewer than the number of sitting directors and that the term of a director can be terminated prior to its expiration only by the resignation, removal or death of the director. Although most practitioners probably presumed this was the case, this is the first Delaware decision to so hold.
- The decision sets forth some principles for analyzing whether a particular transaction involves illegal vote buying, some of which had not previously been clearly articulated by the Delaware courts. However, based on the decision, in the absence of

fraud it is unclear on what basis a Delaware court would find vote buying illegal. Perhaps one of the more important and troubling aspects of the decision is the suggestion that “informational disparities,” including failing to disclose to a seller that the buyer is purchasing the shares in question with a

view to gaining control of the company, could constitute illegal vote buying. This may effectively be creating a new disclosure requirement under Delaware law akin to the “investment intent” disclosure requirement under Section 13(d) and Schedule 13D of the Exchange Act.

1 C.A. No. 5019-VCL (Del. Ch., Feb. 9, 2010)

2 1985 WL 11575 (Del. Ch., July 17, 1985).

3 C.A. No. 2541- VCL (Del. Ch., Dec. 22, 2009).

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