April 21, 2009

# CORPORATE ALERT

## AMENDMENTS TO DELAWARE GENERAL CORPORATION LAW TO HAVE MAJOR IMPACT ON PUBLIC COMPANIES

The governor of Delaware recently signed into law amendments to the Delaware General Corporation Law (DGCL) that will take effect August 1, 2009. Several of these amendments will have a major effect on public companies incorporated in Delaware. Among other things, the amendments—

- allow Delaware corporations to adopt bylaws that give stockholders the right to include in the corporation's proxy materials stockholders' nominees for election of directors
- allow Delaware corporations to adopt bylaws that require reimbursement of proxy solicitation expenses incurred by stockholders in election contests
- allow the board of directors to set separate dates for those entitled to notice of a stockholder meeting versus those entitled to vote at the meeting
- limit the ability of a corporation to eliminate retroactively director and officer rights to indemnification and advancement of expenses
- permit judicial removal of directors in certain circumstances.

Each of these proposed amendments is discussed separately below.

## STOCKHOLDER ACCESS TO CORPORATION'S PROXY MATERIALS

A new Section 112 will be added to the DGCL that will authorize (but not require) a Delaware corporation to adopt bylaw provisions that give stockholders the right to include in the corporation's proxy solicitation materials (including the proxy card) stockholders' nominees for the election of directors, subject to such lawful procedures and conditions as the bylaws may impose. By clearly creating a mechanism for stockholder access to management's proxy solicitation materials, Delaware has taken a step forward in the fight for stockholder proxy access. SEC Chairman Mary Shapiro recently announced[1] that, in May, the SEC will consider a proposal regarding proxy access. In crafting that proposal, Chairman Shapiro stated that SEC staff will be looking at the changes to Delaware law and also the proposals the SEC made in 2003 and 2007. Those proposals would have allowed a stockholder who owned 5 percent or more of a corporation's outstanding stock and had held such stock for a certain period of time[2] to include such stockholder's nominees in the corporation's proxy statement, provided the stockholder was not seeking

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[1] Address by SEC Chairman Mary Shapiro to Council of Institutional Investors (April 6, 2009).
[2] The SEC's 2003 proposal required a stockholder to hold the stock for a period of at least two years and the 2007 proposal required a holding period of at least one year. See SEC Release No. 34-48626 "Security Holder Director Nominations" (October 14, 2003) and SEC Release No. 34-96160 "Shareholder Proposals" (July 27, 2007).

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control of the corporation. Chairman Shapiro emphasized that the SEC will be viewing these issues with "fresh eyes"and that any proposal should "ensure that a corporation's owners have a meaningful opportunity to nominate directors." In light of Chairman Shapiro's comments and the criticism leveled at the high thresholds for proxy access included in the SEC's earlier proposals, it would not be surprising if the SEC sets the bar lower in any proposal it introduces in May. Alternatively, in lieu of establishing a minimum ownership threshold that a stockholder must satisfy for inclusion of nominees in the corporation's proxy materials, the SEC may simply defer to state law by amending Rule 14a-8 to allow stockholders to propose bylaws that establish the conditions for proxy access. The new Delaware statute would clearly accommodate the latter approach. If the SEC sets its own standards for stockholder access, then there could be a conflict between federal and state law if a corporation, in reliance on the new Delaware statute, adopts bylaws that are more restrictive. Even if the SEC fails to take any action on the issue, stockholders could still introduce proxy access bylaws outside of Rule 14a-8 and wage or threaten to wage independent proxy fights for their adoption.

Section 112 includes a nonexclusive list of procedures and conditions that can be included in a bylaw, including provisions—

- establishing minimum ownership requirements, including duration of ownership, for nominating stockholders
- defining beneficial ownership to include options or other rights
- requiring specified information about the nominating stockholder and the nominees
- conditioning eligibility to submit nominations upon the number or proportion of directors nominated by stockholders or whether the stockholder previously sought to require that nominees be included in the corporation's proxy materials
- precluding nominations by any persons or their affiliates who have acquired or proposed to acquire shares in excess of a specified percentage of the outstanding shares.

The list of lawful conditions makes clear that a corporation can limit proxy access to a specified number or percentage of directors and can also impose ownership caps for stockholders seeking access to the corporation's proxy materials. Consequently, bylaws can be crafted in ways that preclude proxy access by those seeking to acquire control of the corporation.

Depending on the SEC's ultimate actions concerning proxy access, it is likely that starting this fall many public companies will face stockholder bylaw proposals to allow for proxy access. RiskMetrics and other proxy advisory firms are also likely to establish guidelines for proxy access bylaws that they will support.

## PROXY EXPENSE REIMBURSEMENT

New Section 113 of the DGCL will permit (but not require) corporations to adopt bylaw provisions requiring the corporation to reimburse stockholders who solicited proxies for the election of directors, subject to such lawful procedures and conditions as the bylaws may impose. This new provision is in response to the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan*,[3] in which the Delaware Supreme Court held, in response to a question certified from the SEC, that a stockholder-proposed bylaw that would have required reimbursement of proxy solicitation expenses in a successful short slate election was a proper matter for a stockholder-proposed bylaw, but that, as proposed, the bylaw was invalid because it required mandatory reimbursement of expenses without regard to directors' fiduciary duties.

New Section 113 allows corporations to adopt bylaw provisions that would require reimbursement of stockholders for proxy solicitation expenses in connection with an election of directors, subject to such lawful procedures and conditions as the bylaws may impose. The statute does not expressly require a "fiduciary out," and it remains to be seen whether Delaware courts will impose a fiduciary out requirement on a bylaw adopted under the new statute.

Section 113 includes a nonexclusive list of procedures and conditions that can be included in a bylaw, including provisions—

[3] *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).



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- conditioning eligibility for reimbursement upon the number or proportion of persons nominated by the stockholder or whether such stockholder previously sought reimbursement for similar expenses
- limiting the amount of reimbursement based upon the proportion of votes cast in favor of the stockholder's nominees or upon the amount spent by the corporation soliciting proxies in connection with the election
- imposing limits concerning elections of directors by cumulative voting.

Consequently, bylaws can be crafted that, among other things, limit reimbursement to situations in which stockholders are proposing only a short slate, rather than a majority of the seats up for election, and that specify the level of success that must be achieved for a stockholder to be entitled to reimbursement.

## SEPARATE RECORD DATES FOR NOTICE AND VOTING

Amended Section 213(a) of the DGCL will allow a board of directors to set different record dates for determining those stockholders entitled to *notice* of a meeting versus those entitled to *vote* at the meeting. Under the amended statute, the board may, at the time it sets the record date for notice, also set a record date for voting purposes for any date after the notice record date up to and including the date of the meeting. If the board does not set a separate record date for those stockholders entitled to vote, then the record date for determining those stockholders entitled to notice will also serve as the record date for determining those entitled to vote. As under the prior law, the record date for determining those stockholders entitled to notice must be between 10 and 60 days prior to the meeting.

Fixing a record date for voting that is closer to the meeting date can reduce the risk of "empty voting" where the persons voting no longer have an economic interest in the shares. Also, often in situations where a corporation is seeking approval for a merger or similar matter, the record date is set far in advance of the meeting to allow for an adequate solicitation period. This timing can sometimes make it difficult for a corporation to obtain the required majority vote where a large amount of shares changes hands after the record date, as stockholders who have transferred their shares no longer have an incentive to vote.

Although the statute allows the record date for determining stockholders entitled to vote to be set for any date up to and including the meeting date, as a practical matter, public companies will still need to set the record date for voting sufficiently in advance of the meeting to allow for the distribution of proxy materials and vote tabulation.

## RIGHTS TO INDEMNIFICATION AND ADVANCEMENT OF EXPENSES

Amended Section 145(f) of the DGCL will provide that a right to indemnification or advancement of expenses arising under a provision of a corporation's certificate of incorporation or bylaws cannot be eliminated or impaired by an amendment to such provision *after the occurrence of the act or omission* that is subject to the proceeding for which indemnification is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment. This amendment provides a default rule that effectively overturns the Delaware Court of Chancery's decision in *Schoon v. Troy Corp.*,[4] which held that a board of directors could amend a corporation's bylaws to eliminate rights to indemnification and advancement of expenses for actions taken prior to the amendment so long as the amendment occurred prior to the commencement of the underlying proceeding.

The amended statute eliminates the concerns raised in *Schoon* that caused many corporations to review and amend their certificate of incorporation or bylaws or to enter into separate indemnification agreements with directors and officers to clarify that indemnification and advancement rights are contractual and cannot be amended to the detriment of the director or officer. A corporation that wants to retain the ability to eliminate these indemnification and advancement rights after the time of the alleged act or omission may still do so under the amended Section 145(f), but only if expressly allowed in the applicable certificate of incorporation or bylaw.

Section 145(f), as amended, should give directors and officers comfort that they can rely on their existing indemnification and advancement of expenses protections without fear of losing such rights as a result of a subsequent amendment to the corporation's certificate of incorporation or bylaws.

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[4] *Schoon v. Troy Corp*., 948 A.2d 1157 (Del. Ch. 2008).



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## JUDICIAL REMOVAL OF DIRECTORS

New Section 225(c) of the DGCL will grant the Court of Chancery the power to remove a director if such director has been convicted of a felony in connection with the director's duties to the corporation, or if there has been a prior judgment on the merits that the director has breached his or her duty of loyalty to the corporation. The Court of Chancery may remove such director from office if the court determines, upon application by the corporation or derivatively in the right of the corporation by any stockholder or any member of a nonstock corporation, that the director did not act in good faith in performing the acts resulting in the prior conviction or judgment, and judicial removal is necessary to avoid irreparable harm to the corporation. Any action brought under new Section 225(c) must be subsequent to the one in which the underlying judgment is made.

Section 225 of the DGCL currently only allows the Court of Chancery to hear and determine the validity of any election, appointment, removal or resignation of a director. New Section 225(c) will provide the court with additional power to relieve corporations of bad directors, particularly if a stockholder vote will cause a delay or possibly not achieve the desired result. Although Section 225(c) is drafted narrowly and requires a corporation or its stockholders to overcome a substantial evidentiary burden of proving that the director did not act in good faith and that such removal is necessary to avoid irreparable harm to the corporation, it does nonetheless provide an additional protection for corporations and stockholders against directors who are clearly bad actors.

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