

UPDATE

JULY 2009

DELAWARE AMENDS CORPORATE LAW TO ALLOW INCREASED SHAREHOLDER ACTIVISM

On August 1, 2009, several amendments to the Delaware General Corporation Law will go into effect. The amendments allow Delaware corporations to change their bylaws to increase shareholders' access to proxy solicitation materials and provide shareholders with reimbursement for proxy expenses. While these amendments do not require corporations to modify their proxy solicitation procedures, corporations should expect shareholder requests for bylaw amendments. Furthermore, the SEC has also proposed new rules that would give shareholders the right, in certain circumstances, to nominate directors in company proxy statements. The Delaware amendments also (i) address the problem of "empty voting," (ii) prevent a corporation from revoking an indemnitee's right to indemnification in certain circumstances and (iii) authorize a judge to remove a director in narrow circumstances. The impetuses for the Delaware amendments were demands for increased shareholder influence and recent case law development. As a result of these amendments, corporations should review their bylaws to ensure compliance with the mandatory amendments and consider whether to take advantage of the permissive amendments.

I. Access to Proxy Solicitation Materials

As a result of the economic downturn, the call for increased shareholder influence has grown louder. Access to a corporation's proxy solicitation materials is an important and hotly contested mechanism for control of the board of directors. Under current Delaware law and SEC rules, shareholders face significant obstacles when attempting to nominate their candidates for the board of directors. Corporations are not required to include shareholders' nominations in their proxy statement. Therefore, shareholders seeking to elect their own candidate must incur enormous expenses in mailing out competing proxy materials. New Sections 112 and 113 seek to address these obstacles while also limiting the attendant cost and disruption of increased shareholder activism.

New Section 112 authorizes - but does not require - a Delaware corporation to adopt a bylaw providing that, if the corporation solicits proxies with respect to an election of directors, it must include shareholders' nominations. Importantly, the section also authorizes a Delaware corporation to place conditions on proxy access and includes the following non-exclusive list of allowable conditions:

- Excluding shareholders with nominal amounts of stock from nominating directors by requiring a minimum record or beneficial stock ownership and a certain duration of ownership;
- Requiring the nominating shareholder to submit specific information about the shareholder and the shareholder's nominees, including information concerning ownership by such persons;
- Restricting the number of nominees included in a proxy statement by conditioning eligibility to nominate directors on the number of candidates already nominated or whether the shareholder previously submitted a candidate;
- Precluding nominations by a shareholder if the shareholder, his nominee, or a person affiliated with the nominating shareholder or nominee, acquired or proposed to acquire a specified percentage of the voting power; and
- Requiring the nominating shareholder to indemnify the corporation for any loss arising as a result of any false or misleading information or statement submitted by the nominating shareholder.

In addition to Delaware's permissive amendment, the SEC has proposed a rule that would require registered corporations to include a specific number of shareholders' nominees in their proxy statement in certain circumstances. It is possible that the proposed SEC rule would preempt Delaware's newly enacted Section 112. The proposed SEC rule caps the amount of shareholder nominees to either one or the amount of nominees representing 25% of the board, whichever is greater. In order to nominate a candidate under the proposed rule, a shareholder must meet ownership thresholds and holding period requirements. The ownership thresholds vary depending on the size of the corporation. In order to be a candidate for election, a nominee must not violate

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applicable laws by becoming a member of the board and meet the objective criteria for “independence” in the applicable national securities exchange or national securities association. In order to allow this proposed rule to take effect, the SEC has also proposed amending Rule 14(a)(8), which currently allows a corporation to exclude shareholders’ proposals relating to election.

II. Reimbursement for Proxy Expenses

New Section 113 addresses another barrier to shareholders nominating their own directors: the prohibitive cost of mailing alternative proxy materials. It also codifies a recent Delaware Supreme Court opinion, holding that there must be a “fiduciary out” in a bylaw requiring reimbursement of proxy-related expenses. New Section 113 lowers this barrier by authorizing - but not requiring - a Delaware corporation to adopt a bylaw requiring the corporation to reimburse a shareholder for his expenses incurred in soliciting proxies in connection with an election of directors. Similar to Section 112, Section 113 also authorizes a Delaware corporation to place conditions on reimbursing shareholders and includes the following non-exclusive list of allowable conditions:

- Conditioning eligibility for reimbursement upon the number or proportion of persons nominated by the shareholder seeking reimbursement or whether the shareholder previously sought reimbursement;
- Limiting the amount of reimbursement based upon the proportion of votes cast in favor of the shareholders’ nominees;
- Limiting the amount of reimbursement based upon the amount spent by the corporation in soliciting proxies in connection with the election; and
- Limiting reimbursement in cumulative voting elections.

III. “Empty” Voting

Empty voting is a catch-all term for situations where shareholder voting rights have been decoupled from shareholder economic interests. When voting power and economic interests are aligned, shareholders tend to vote in a manner that increases the stock’s value. Empty voting occurs in a number of different, complex situations. For example, hedge funds and other sophisticated investors sometimes acquire additional votes by borrowing shares and then drive the price of the stock down to implement their short-selling strategy.

Under previous Delaware law, the record dates for determining shareholders entitled to vote at a meeting and entitled to notice of the meeting had to be the same. The relatively long period of time between the combined record date and the date of a stockholder meeting allowed investors to implement an empty voting strategy. In this long period, these investors could decouple their economic interests from their voting rights. New Section 213(a) attempts to address empty voting by permitting a board of directors to separate the record date for determining the shareholders entitled to vote at a meeting from the record date for determining those shareholders entitled to notice of the meeting. Therefore, a corporation can fix the record date for determining the shareholders entitled to vote at a meeting closer to the meeting and, in theory, create a shareholder base whose economic interests are still aligned with their voting rights.

IV. Preventing the Revocation of Indemnification

The Delaware Chancery Court recently handed down a decision upholding a bylaw amendment that revoked a former director’s right to indemnification after the relevant act had occurred. In doing so, the Court of Chancery held that a director’s right to indemnification vests when he is named in a lawsuit, not when the relevant act occurs or at the time of the bylaw’s amendment. New Section 145(f) overturns that decision by providing that a corporation may not amend its bylaws to eliminate an indemnitee’s right to indemnification after the occurrence of the act or omission that is the subject of the suit, unless the bylaw explicitly authorizes such elimination. In light of this amendment, corporations should review their bylaws relating to indemnification to ensure that they implement the desired indemnification policy.

V. Judicial Removal of Directors

New Section 225(c) permits the Delaware Court of Chancery to remove a director in specified limited circumstances. The Delaware legislature purposely drafted Section 225(c) very narrowly. The Court of Chancery can only order removal upon an application brought directly by the corporation or derivatively on behalf of the corporation. The Court of Chancery can exercise its removal powers when the director has been convicted of a felony in connection with the duties of such director or a judgment has been entered against the director for breaching his duty of loyalty. Finally, the corporation or shareholder bringing the action must also show that the director did not act in good faith and that judicial removal is necessary to avoid irreparable harm to the corporation.