[Alerts and Updates]

2009 Amendments to the Delaware General Corporation Law Address Corporate Governance, Focus on Stockholder Rights

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Delaware recently enacted changes to its General Corporation Law (the "DGCL") that directly address significant issues of corporate governance. With the creation of Section 112 and Section 113, a Delaware corporation can adopt bylaw provisions that allow stockholders greater access to the corporation's proxy solicitation materials in order to nominate directors and to reimburse stockholders for proxy solicitation expenses in connection with director nominations.

Although many legal commentators have focused on new Sections 112 and 113, the amendments also include significant changes that address the problem of "empty voting" by allowing Delaware corporations to provide separate record dates for determining stockholders entitled to notice of and to vote at stockholder meetings, prohibit retroactive elimination of indemnification or advancement of expenses and permit judicial removal of directors in limited circumstances. The "corporate friendly" amendments will become effective August 1, 2009.

Access to Proxy Solicitation Materials (New Section 112)

Stockholder access to a corporation's proxy statement has long been an area of potential Securities and Exchange Commission ("SEC") rulemaking and stockholder concern. On April 6, 2009, SEC Chairman Mary Schapiro revealed that in May "the Commission will consider a proposal to ensure that a company's owners have a meaningful opportunity to nominate directors." Schapiro said that the SEC is reviewing 2003 and 2007 rulemaking initiatives and is "considering the potential impact of [] changes to Delaware's corporate law." It is unclear whether the SEC's proposal next month will include amendments to Rule 14a-8 to rescind the current exclusion of stockholder proposals relating to directors from corporate proxy statements, and how the proposal will address the Delaware legislation. If the SEC changes its current regulations, Delaware corporations that are subject to the SEC's proxy rules and wish to take advantage of Section 112, discussed below, may want to tailor proxy access bylaws to align with the SEC's amendments.

Section 112 makes clear that a corporation has the authority to provide stockholders access to its proxy materials through a bylaw provision. The section also allows the corporation to control stockholder access through any lawful procedures and conditions set forth in the bylaws and provides a non-exclusive list of permitted procedures and conditions, which includes:

- Requiring a minimum record or beneficial ownership or duration of ownership of shares of the company's stock by the nominating stockholder to avoid election contests instituted by stockholders having little or no economic interest in the corporation; the definition of beneficial ownership may include options or other rights;
- Requiring the nominating stockholder to submit specified information concerning the stockholder and the stockholder's nominees to be included in the proxy solicitation materials;
- Conditioning eligibility to require inclusion on the corporation's proxy solicitation materials upon the number or proportion of directors nominated by stockholders or whether the stockholder previously sought to require such inclusion;
- Precluding nominations by any person if such person, any nominee of such person, or any affiliate or associate of such person or nominee has acquired or publicly proposed to acquire shares constituting a specified percentage of the voting power of the corporation's outstanding voting stock within a specified period before the election of directors; and

- Requiring that the nominating stockholder undertake to indemnify the corporation in respect of any loss arising as a result of any false or misleading information or statement submitted by the nominating stockholder in connection with a nomination.

Among other things, by authorizing a corporation's bylaws to condition stockholder proxy access on whether a majority of board seats are contested or whether nominations relate to an acquisition of a percentage of the corporation's stock, Section 112 makes clear that a corporation may limit stockholder proxy access to "short slate" elections, or a slate for less than a majority of the corporation's board of directors, and otherwise may preclude changes of control through the corporation's proxy materials. In short, Section 112 authorizes a corporation to adopt a bylaw denying stockholder access to the proxy statement for stockholder nominations of a majority of the directors.[1]

Section 112 may encourage activist stockholders to seek adoption of bylaw provisions that grant stockholder access to proxy solicitation materials in order to nominate directors and thereby facilitate the ability of stockholders to engage in proxy contests. Given the possibility of these circumstances, a corporation's board may want to adopt a Section 112 bylaw proactively to allow for stockholder proxy access pursuant to procedures and conditions amenable to the corporation.

Proxy Expense Reimbursement (New Section 113)

New Section 113 essentially codifies the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan*,[2] in which the Court concluded that a stockholder bylaw amendment proposal that provides for reimbursement of the stockholder by a corporation for proxy expenses incurred by the stockholder is a valid subject for stockholder action because it is procedural in nature. Because the proposed bylaw in question did not contain a fiduciary out, the Court concluded that the proposed bylaw was invalid.

Section 113 permits the bylaws of a corporation to provide for reimbursement of reasonable expenses incurred by a stockholder in the solicitation of proxies for the stockholder's candidate(s) for election to the corporation's board of directors, subject to the conditions and procedures prescribed by the bylaws. Like Section 112, Section 113 provides a nonexclusive list of permitted procedures and conditions, including:

- 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[3];
- Limiting the amount of reimbursement based upon the proportion of votes cast in favor of the persons nominated by the stockholder or based upon the amount spent by the corporation soliciting proxies in connection with the election; and
- Imposing limits concerning elections of directors by cumulative voting.

These restrictions permit corporations to tailor their bylaws to their specific situation. Any bylaw adopted pursuant to Section 113 would not apply to elections for which the record date precedes its adoption.

Notably, the amendments do not expressly require that a bylaw adopted under Section 113 contain a fiduciary out. It is unclear whether the Delaware courts would read a fiduciary-out standard into such a bylaw or invalidate bylaws adopted pursuant to Section 113 if they do not contain a fiduciary out. Because it is unlikely that the Delaware courts would allow the abdication or diminution by a director of his or her fiduciary duties, corporations may want to utilize the flexibility in Section 113 to limit reimbursement to circumstances that are consistent with a director's performance of his or her fiduciary duties.

As with Section 112, when Section 113 becomes effective, many corporations may be faced with stockholder proposals of bylaw amendments that provide for reimbursement of proxy solicitation expenses. Corporations may want to amend their bylaws proactively to provide for reimbursement for proxy solicitations regarding director elections on conditions acceptable to the corporation.

Prohibition of Elimination of Indemnification or Advancement of Expenses (Section 145(f))

The amendments to Section 145(f) prohibit amending a provision of a corporation's certificate of incorporation or bylaws to eliminate or impair an indemnitee's right to indemnification or advancement of expenses after the occurrence of the act or omission that is the subject of the action for which indemnification or advancement is sought, unless the provision in effect at the time of the act or omission explicitly authorizes such elimination or impairment. These amendments reverse the rule articulated by the Court of Chancery in *Schoon v. Troy Corp*.[4] In *Schoon*, the court concluded that the right to advancement of legal expenses does not vest until a corporation's obligations are triggered by the filing of a pleading against the director and therefore can be cancelled by the corporation, even after the underlying cause of action accrues. This determination prompted many corporations to revise their governing documents or to enter into indemnification agreements with indemnitees to negate the result of *Schoon*, in order to attract and keep talented directors and officers and give directors and officers the security to make the decisions they deem best for the corporations, even if those decisions contain a certain degree of risk. The amendments to Section 145(f) eliminate these concerns, unless the charter provision specifically authorizes elimination or limitation of indemnification or advancement rights.

"Empty Voting" Amendments (Section 213(a))

Amendments to Section 213(a), which sets forth the process by which corporations may determine stockholders of record for purposes of stockholder meetings, allow corporations to address concerns about "empty voting," which occurs when stockholders have voting rights in a company but do not have a comparable economic ownership interest, which would motivate investors to make decisions in the best interests of the corporation. Empty voting typically occurs when a person acquires voting rights to a significant block of publicly traded stock, takes a short position that offsets the stockholder's economic interest in the company or contracts to sell its shares at some time after the record date. The amendments to Section 213(a) would allow corporations to fix a record date for voting that is separate from the record date for notice of a stockholder meeting,[5] giving a corporation greater flexibility to align stockholder voting and economic interests. The record date for *notice* to stockholders would remain between 10 days and 60 days prior to the meeting.[6] The record date for determining stockholders *entitled to vote* could be any date on or before the date of the meeting. By moving the record date to determine stockholders entitled to vote at a meeting closer to the meeting date, a board of directors can reduce the potential for voting by persons who no longer have an economic interest in the company. However, the practical application of Section 213(a) may pose logistical problems for public corporations, and public corporations wishing to take advantage of new Section 213(a) may want to determine record dates for voting after consulting with parties such as transfer agents, stock exchanges and proxy voting services. It remains unclear how mechanically all of this would work.

Judicial Removal of Directors (Section 225)

Section 225 of the DGCL governs contested elections of directors. The amendments to Section 225 add a new subsection (c), which authorizes the Court of Chancery to remove a director who has been convicted of a felony or found by a court to have committed a breach of the duty of loyalty in connection with his or her duties to the corporation following application by the corporation or derivatively in the right of the corporation by any stockholder or member of a nonstock corporation. Removal would be appropriate

if the Court of Chancery, in a proceeding subsequent to the one in which the underlying judgment of unsuitability of the subject director is made, determines that the director did not act in good faith in performing the acts underlying the conviction or judgment and that the removal of the director is necessary to avoid irreparable harm to the corporation. It is important to note that new Section 225(c) is narrower than Section 8.09 of the Model Business Corporation Act, which addresses judicial removal of directors and has been adopted in several states.

Officers, directors and general counsel of Delaware corporations need to review periodically their charter and bylaws to provide maximum flexibility and to address changes in law and practice. The current amendments to the DGCL emphasize such a need.

For Further Information

If you have any questions regarding this Alert or would like more information, please contact any member of the Corporate Practice Group or the attorney in the firm with whom you are regularly in contact.

Notes

1. It is unclear how Section 112 would apply to nominations to a staggered board of directors where a majority of directors is not elected in any one year. For example, assuming a staggered board of nine directors divided equally into three classes, only three directors are elected each year, and a majority of directors necessarily includes directors from more than one class. In this case, it is unclear how and when a majority would be determined with respect to a specific stockholder and whether the election or non-election of a stockholder's proposed candidates to one class would affect the number of directors that stockholder could nominate to the other two classes. Specifically, if a stockholder nominated three directors in the stockholder's first designated election year and all three were elected to the board, would that stockholder be limited to only one director nomination over the next two years? If only one of the stockholder's three nominees were elected to the board in year one, would the three nominations nonetheless limit the stockholder to only one director nomination over the next two years? Without further legislation, the Court of Chancery may be called upon to answer this type of question.
2. *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).
3. In other words, a corporation with a board consisting of eleven directors could craft a bylaw providing for full reimbursement of expenses incurred by a stockholder in connection with the solicitation of proxies for the election of five or fewer directors and denying reimbursement of expenses in connection with proposals for six or more directors. Presumably, the corporation could also structure reimbursement pursuant to a Section 113 bylaw as a ladder, permitting reimbursement of 100% of a stockholder's expenses related to his or her nomination of one or two directors, 75% for nominations of three or four directors, and so on. In this manner, Section 113 allows a corporation to control the nominating behaviors of its stockholders by tailoring proxy access broadly or narrowly and could be used to discourage stockholder solicitations.
4. *Schoon v. Troy Corp.*, 948 A.2d 1157 (Del. Ch. 2008).
5. The amendments to Section 213(a) require conforming changes to Sections 211, 219, 222, 228, 262 and 275 of the DGCL to include the concept of different record dates for notice and voting rights.
6. We note that revised Section 219, relating to the list of stockholders entitled to vote, puts an onus on a corporation to generate two separate lists of stockholders when the corporation sets a record date for determining stockholders entitled

to vote that is less than ten days before the date of a meeting of stockholders. Revised Section 219 provides that if the record date for determining stockholders entitled to vote is less than ten days before the date of the meeting, the corporation must make available a list of those stockholders entitled to vote as of the tenth day before the date of the meeting; this list would obviously constitute a "preliminary" list, because the list of stockholders as of the actual voting record date (*i.e.*, a voting record date that is less than ten days prior to the date of the meeting) would necessarily constitute the "final" list evidencing those stockholders eligible to vote at the meeting. The Synopsis to Section 219 makes clear that the amendment to Section 219 does not change the fact that the "final" list of stockholders must be made available at the meeting. Because the preliminary list will in most cases differ from the final list, a corporation that sets a voting record date less than ten days before the date of a meeting of stockholders will likely have to generate two separate stockholder lists in order to comply with revised Section 219.