

2009 Updates to Delaware General Corporation Law - Part 3: Improved Shareholder Access to Proxy Materials – Now, What Will the SEC Do?

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written by [Dean F. Hanley](#)

Delaware has added two new sections to the General Corporation Law, effective August 1, 2009. While the legislature appears to be concerned about improving shareholder access to proxy materials, the effect of these changes may not be clear for a while.

Some Background

The issue of shareholder nomination of directors of a public company is complex. In general, shareholders do not have the ability to nominate a person whose candidacy and biography will be included in the company's proxy materials. To achieve access to the shareholder constituency equal to that accorded to the company's candidates, a shareholder must wage an expensive proxy fight using the shareholder's own proxy materials. SEC Rule 14a-8 reinforces this dilemma, by authorizing public companies to exclude contested elections (i.e., shareholder nominations and the establishment of procedures for making such nominations) from the company's proxy statement.

The by-laws of most public companies typically contain advance notice provisions that require shareholders wishing to make nominations, or to bring up business, at a shareholder meeting to provide a considerable amount of information about their intentions, as well as information about nominees that is comparable to that required by SEC rules applicable to proxy statements.

The Delaware legislature has now offered a new framework for providing access to company proxy materials, by enacting sections 112 and 113 to the General Corporation Law. While these sections are new, it is by no means clear that prior to this amendment a Delaware corporation could not adopt by-laws such as those now explicitly authorized. This suggests that the change is partly one of emphasis, a step toward enhanced shareholder access to the election process.

Section 112 – Access to Proxy Solicitation Materials

Section 112 permits (but does not require) a Delaware corporation to adopt a by-law that specifies the circumstances under which shareholders would have access to the corporation's proxy materials. Although section 112 does not set forth the circumstances under which shareholder access must be granted, section 112 potentially limits the board's discretion, because the adopted by-laws may provide access if the particular conditions and procedures specified are satisfied.

As for the provisions in a section 112 by-law, the statute contains a non-exclusive list, including:

- Requiring a minimum level of beneficial ownership (which may be defined so as to include options and similar rights) by the nominating shareholder
- Requiring a minimum duration of ownership by the nominating shareholder
- Requiring the submission of specific details regarding the nominating shareholder and nominee(s) (not limited to the amount of ownership interest)
- Limiting the number or proportion of directors that may be nominated at a given time
- Precluding the nomination of shareholders and nominees who have acquired or proposed to acquire a specific percentage of voting power before the election
- Requiring indemnification of the corporation for any loss relating to false or misleading information submitted in connection with the nomination

This list suggests that section 112 is not intended to act as a vehicle for a total change of control within a corporation. The Delaware legislature may view section 112 as a tool by which corporations can balance the disruption caused by proxy contests with shareholder interest in effecting change.

Rumblings at the SEC

Boards will be placed in an interesting position. The SEC has previously made proposals that would have allowed a shareholder who owned 5% or more of a company's outstanding stock for a specified period to include nominees in the company's proxy materials, so long as the shareholder was not seeking to acquire control. As previously noted, however, existing SEC Rule 14a-8 bars the inclusion in company proxy statements of shareholder proposals to nominate a director or to adopt a procedure for such nomination.

The SEC's new Chair, Mary Shapiro, says that her agency is now readying new proposals on this subject. It is not yet clear whether those will follow the pattern of the original proposals, with perhaps a lower threshold of ownership, or whether instead the SEC will defer to state law and amend Rule 14a-8 so as to eliminate the prohibition on shareholder proposals that would establish nomination by-laws like those contemplated by new Delaware section 112.

Shareholder advocacy groups like Risk Metrics are likely to announce what types of procedures adopted under section 112 by-laws would be acceptable to such groups as fostering shareholder democracy. With that in mind, boards may decide to preemptively ward off such a shareholder by-law by enacting a "compromise" by-law that shareholders are unlikely to contest successfully.

On the other hand, some boards may ignore section 112 altogether, or may decide to set the bar high, using a section 112 by-law as more of a moat than a bridge.

Section 113 – Proxy Expense Reimbursement

New section 113 permits (but does not require) a corporation to adopt a by-law setting forth the circumstances under which shareholders may be reimbursed for proxy-related expenses by the corporation. This proposed legislation essentially codifies a recent holding of the Delaware Supreme Court in *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008). In *CA, Inc.*, the court held that a shareholder proposal to enact a by-law requiring reimbursement of proxy-related expenses was a valid action, but that there must be a “fiduciary out” available to the board in order for the by-law itself to be valid.

As with section 112, the legislature did not dictate which conditions or procedures must accompany the by-law granting reimbursement, but there are sample conditions and procedures as guidance, including:

- Limiting reimbursement based on the number or proportion of directors who were nominated
- Limiting reimbursement based on whether or not the shareholder has previously sought similar reimbursements
- Limiting the amount of reimbursement based on the proportion of votes cast in favor of the shareholder’s nominee(s) or on the amount spent by the corporation soliciting proxies
- Limiting reimbursement in elections by cumulative voting

Section 113 includes an explicit caveat precluding claims for reimbursement where the record date for the shareholder meeting precedes the enactment of a by-law pursuant to section 113.