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Proxy Solicitation and Contested Director Elections

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With the burgeoning trend of shareholders having more input into how corporations are run, lawyers must know the law about contested director elections. What have the Delaware courts been saying recently about this very hot topic?

Recent Delaware decisions have addressed the nuances and the fundamentals involving how directors are elected, such as who is entitled to vote—record holders versus beneficial owners and the meaning of "stockholder of record," the confusion about "vote buying" and the decoupling of the vote from the economic interest in the company, and other factors that complicate an already entangled web.

Section 225—Directors and Contested Elections

Section 225 of the Delaware General Corporation Law (DGCL) provides a summary procedure to contest the director election process in order to resolve promptly disputes about whether a director was properly elected. Under section 225, a stockholder, director, or officer can ask the Court of Chancery to determine the validity of an election, removal, resignation, or appointment of a director or officer. Recent opinions from the Delaware Court of Chancery and the Delaware Supreme Court demonstrate the complexity of the analysis.

Kurz v. Holbrook,989 A.2d 140 (Del. Ch. 2010), is a case that involved competing requests for relief under section 225 regarding control of the board of directors of EMAK Worldwide, Inc. (EMAK or the Company). The Delaware Court of Chancery, in an expedited challenge to a director election under section 225, addressed for the first time whether a bylaw amendment may reduce the size of the board of directors. The court also addressed the issue of vote buying and provided an in-depth discussion of the meaning of "shareholder of record." The Delaware Supreme Court, after an expedited appeal, reversed in part and affirmed in part. (Complete copies of all decisions referenced in this article are available at wwww.delawarelitigation.com)

Consent Solicitation and Exchange Transaction

On October 12, 2009, Take Back EMAK LLC (TBE) delivered a consent regarding the election of directors to EMAK (the TBE Consent Solicitation). Without board intervention, the record date for consents would have been October 12, the date the first solicitation was delivered. However, under section 2.13(c) of EMAK's bylaws, the board had the power to set a record date for the TBE Consent Solicitation and so during the board's October 19, 2009, meeting, the board set October 22 as the record date. Also at the October 19 meeting, the board approved a transaction pursuant to which Crown EMAK Partners, LLC (Crown) exchanged its Series AA Preferred for new Series B Preferred Stock (the Exchange Transaction). The Series AA Preferred had the right to elect two directors to the board plus a third director if the board expanded the number of its members to more than eight members. The Series AA Preferred did not vote in the election of directors; instead, they voted on an as-converted basis with the common stockholders on all other matters. The Series B Preferred, however, voted on an as-converted basis with the common stock on all matters, including the election of directors.

As a result of the Exchange Transaction, Crown's Series AA Preferred had the right to vote approximately 28 percent of the total voting power in an election of directors. With an October 22 record date instead of an October 12 record date, the EMAK board permitted Crown to convert its Series AA Preferred into new Series B Preferred (and thus allow Crown to vote almost 28 percent of the total voting power in the election of directors) for the TBE Consent Solicitation. On October 26, 2009, a lawsuit was filed challenging the Exchange Transaction and while EMAK initially solicited consents to ratify the Exchange Transaction, on December 3, 2009, EMAK and Crown rescinded the Exchange Transaction.

Three Concurrent Consent Solicitations

Prior to December 18, 2009, the EMAK board had six directors and one vacancy. On December 18, one of the six directors resigned, creating a second vacancy. On December 18, 2009, Crown delivered consents (the Crown Consents) to amend EMAK's bylaws to add two bylaws. One new bylaw (section 3.1) would reduce the size of the board to three directors. Because Crown had the right to appoint two directors under the terms of EMAK's Series AA Preferred Stock, reducing the board to three, if valid, would give Crown a board majority. Another new bylaw (section 3.1.1) provided that if the number of sitting directors exceeded three, then the EMAK CEO would call a special meeting of stockholders to elect the third director, who would take office as the singular successor to his multiple predecessors.

On December 20 and 21, TBE claimed to have delivered the TBE Consents, which were sufficient enough to remove two additional directors without cause and fill three of the vacancies with their nominees which, if the TBE Consents were valid, would give TBE a board majority.

Roles of Beneficial Holders in the Consent Solicitation Process

The court in *Kurz* provided a summary of the process of voting stock that is not registered in the name of the person who bought the stock:

The vast majority of publicly traded shares in the United States are registered on the companies' books not in the name of beneficial owners—i.e., those investors who paid for, and have the right to vote and dispose of, the shares—but rather in the name of "Cede & Co.," the name used by The Depository Trust Company (DTC). Shares registered in this manner are commonly referred to as being held in "street name . . ." DTC holds the shares on behalf of banks and brokers, which in turn hold on behalf of their clients (who are the underlying beneficial owners or other intermediaries)." (citation omitted).

DTC is generally understood to be the entity with the power under Delaware law to vote the shares that it holds on deposit for the banks and brokers who are members of DTC. Through the DTC omnibus proxy, DTC transfers its voting authority to the banks and brokers. The banks and brokers then transfer the voting authority to Broadridge, which votes the shares held at DTC by each bank and broker in proportion to the aggregate instructions received from the ultimate beneficial owners.

As of December 18, 2009, TBE was approximately 116,000 shares short of a majority when it discovered that Peter Boutrous, a former employee and a consultant of EMAK, owned 175,000 shares. TBE also learned that a restricted stock grant agreement governed 150,000 of Boutrous' shares. This agreement prohibited Boutrous from transferring, selling, pledging, or assigning his shares until March 2011. As a work-around, Boutrous, who originally wanted $2.25 per share when the stock was trading at $0.95 per share, entered into a purchase agreement with Kurz wherein Boutrous sold to plaintiff Kurz all shares that Boutrous owned and was entitled to sell, transfer, or assign as of that date and all rights to receive all other shares that Boutrous may be entitled to sell for $1.50 per share. As a result, the agreement purported to delay the transfer of actual title until after the restrictions had expired. Kurz believed that the purchase agreement provided him with the economic and voting rights but not legal title to the 150,000 shares so that he had a valid proxy to vote the 150,000 shares and execute a valid consent card. TBE thought that it had secured enough consents for a voting majority, but the inspector of elections thereafter invalidated consents representing more than one million shares of EMAK stock held in "street name" due to EMAK's failure to obtain a DTC omnibus proxy. Kurz filed suit challenging the validity of the Crown bylaw amendment and the vote-buying arrangement.

Court of Chancery Invalidates Bylaw Amendment

The Court of Chancery held that the bylaw amendments adopted through the Crown Consents were void because they conflicted with the DGCL, and noted that if a bylaw amendment reducing the size of the board could eliminate sitting directors, then directors would have the power to remove directors, which is not permitted under Delaware law. The court observed:

New [proposed bylaw] Section 3.1 would shrink the board to three directorships at a time when five directors are in office. There are two possible consequences for the suddenly surplus directors. One is that their terms would end. The other is that they would continue to serve, albeit without official seats, until their terms were ended by a statutorily recognized means. [B]oth possibilities conflict with the DGCL.

The notion that the terms of the extra directors would end conflicts with Section 141(b)'s mandate 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." Section 141(b) thus recognizes three procedural means by which the term of a sitting director can be brought to a close: (1) when the director's successor is elected and qualified, (2) if the director resigns, or (3) if the director is removed. Section 141(b) does not contemplate that a director's term could end through board shrinkage. A bylaw that seeks to achieve this result conflicts with Section 141(b) and is void.

DGCL section 141(k) supports the general rule that a director or the entire board may be removed with or without cause by a majority of the shareholders entitled to vote. Although directors may, in certain instances, fill vacancies on the board, directors cannot remove a fellow director. In holding that the bylaw amendment at issue was a violation of the DGCL, the court stated:

In light of the three procedural means for ending a director's term in Section 141(b), I do not believe a bylaw could impose a requirement that would disqualify a director and terminate his service. Section 141(b)'s recognition of the bylaws as a locus for director qualifications instead contemplates reasonable qualifications to be applied at the front end, before a director's term commences, when the director is "elected and qualified."

The court also ruled in favor of TBE with respect to the validity of the consents for shares held in "street name," rejecting the defendants' argument that the TBE Consents cannot be effective because of the absence of the DTC omnibus proxy. The court also redefined the phrase "stockholder of record" to include the DTC participating banks and brokers listed in the Cede breakdown for purposes of determining the stockholders who would be entitled to vote (or act by written consent). The court noted that this was consistent with other sections of the DGCL including sections 219(c) and 220(b) where the Cede breakdown is part of the corporation's stock ledger as well as under federal law where banks and brokers are viewed as the record holders of the shares held by the depositories.

Court Rejects Claim of Illegal Vote Buying

With respect to Crown's claim that TBE engaged in illegal vote buying, the court rejected that argument, instead finding that the purchase agreement between Kurz and Boutrous transferred to Kurz "the full economic risk associated with the Boutrous shares and the voting rights appropriately followed the economic interest." The court noted that the principle of vote buying is not per se illegal unless it is entered into for deleterious "purposes." The court found that the purchase agreement did not violate the restricted stock grant agreement and that Kurz did not engage in illegal vote buying.

Delaware Supreme Court Decision

On appeal, the Delaware Supreme Court, en bancon April 21, 2010, affirmed in part and reversed in part the Court of Chancery's decision in this case. *See Crown EMAK Partners, LLC v. Kurz*,2010 WL 1610487 (Del. Apr. 21, 2010). The Delaware Supreme Court agreed with the Court of Chancery to the extent that there was no improper vote-buying. However, the Supreme Court found that there was a violation of the restricted stock purchase agreement, which prohibited any "transfer, [sale], pledge or hypothecat[ion] of Boutrous' restricted shares." The Supreme Court determined that the purchase agreement included a provision that Boutrous agreed to sell all shares that he owned and was permitted to sell and that, by its very terms, the restricted stock purchase agreement prohibited what the purchase agreement purports to do. As a result, the Supreme Court held that the purchase agreement did not operate as a valid sale or transfer so that Kurz was not entitled to vote the 150,000 shares and, by extension, TBE did not have the right to vote the majority of the shares.

With respect to the issue of whether the TBE Consents were effective even though there was no DTC omnibus proxy, the Supreme Court, like the Court of Chancery, reviewed the requirements for written consents of shareholders in lieu of a meeting, pursuant to DGCL section 228, and both recognized the requirement that such consents be executed by a stockholder of record. Where the two courts diverged, however, was at the point that the Court of Chancery determined that a Cede breakdown is part of the stock ledger for purposes of section 219(c). The Supreme Court regarded this part of the Court of Chancery decision as *obiter dictum* and reasoned that in light of the purchased votes being invalidated, it was not necessary to address or decide the issue of whether the Cede breakdown was part of the stock ledger for section 219 purposes.

Finally, with respect to the validity of the bylaw amendment, the Supreme Court agreed with the Court of Chancery that a bylaw amendment that purports to reduce the size of the board as a means of eliminating sitting directors is in violation of DGCL section 109(b). Rather, the correct procedure would have been for the dissidents to follow a three-step process: first, remove the sitting directors by written consent; then reduce the size of the board; and then elect new directors.

Scope of Section 225 Summary Proceedings

Other recent decisions have addressed nuances of section 225 cases. In *Levinhar v. MDG Medical, Inc.*, No. 4301-VCS, 2009 WL 4263211 (Del. Ch. Nov. 24, 2009), the Delaware Court of Chancery explained the expansive scope of claims allowable in a summary proceeding pursuant to section 225 of the DGCL. Section 225 proceedings are summary in nature and are designed primarily to address the proper composition of a board. Typically, such actions address, for example, whether a particular director is a proper board member or was properly elected or removed. In this case, the penalty imposed by the court for not including related claims in a prior section 225 suit was to bar those claims in the present suit based on the doctrine of res judicata.

Section 225 Suits, "Related Claims," and Res Judicata

The court's opinion in this case "serves notice" to all who may have considered section 225 suits to be limited by the nature of such an action as a summary proceeding to the specific issue of proper board composition only. Whether or not one was laboring under that misconception, this opinion removes any doubt that failure to raise related issues creates the risk that those related issues may be barred by res judicata in later suits.

Alternative to "Related Claims"—Contemporaneous Companion Case

The court explained that an alternative to including related claims that are part of the same operative facts or the same transaction that forms the basis of the section 225 dispute is filing a contemporaneous companion case and then asking the court to consolidate the companion case with the section 225 case. The reasoning used by the court includes the following: "Although Section 225 actions are summary proceedings, claims that bear on the appropriate composition of the board of directors many be brought in connection with a Section 225 action." Moreover, the court added that ". . . it is common in Section 225 cases for this court to address the consequences that stockholder voting agreements have on the outcome of director elections or removal efforts."

New Election—Remedy for Improper Shareholder Meeting

In *Portnoy v. Cryo-Cell International, Inc.*,No 4301-VCS, 2007 WL 4263211 (Del. Ch. Jan. 15, 2007), the Court of Chancery addressed a challenge to the election of directors under DGCL section 225 based on claims that the management engaged in inequitable behavior to entrench themselves, both in proxy battles leading up to the annual meeting as well as shenanigans during the annual meeting itself.

The court analyzed closely the issue of "vote-buying" to the extent that expression is used to refer to agreements to vote for certain board members in exchange for consent to act in a certain manner, such as working to secure a board seat for a major shareholder. Such arrangements are not per se illegal in the corporate context but will be closely scrutinized for inequitable conduct that interferes with the shareholder franchise especially in connection with the election of directors.

The court did not reject a deal with management that provided for a major stockholder to be seated on the board (in exchange for supporting management), but the court did find objectionable another part of the deal—that was not disclosed to stockholders prior to the election for the slate of directors—that provided for a new board seat to be created in connection with an expanded board that would be filled by someone whose past raised questions that may have made stockholders hesitate before supporting him. The problem was, as the court explained, that the "electorate voted in ignorance of the actual board that would govern them in the event the Management Slate won." However, the court found it was a breach of the CEO's fiduciary duty to use corporate machinery to coerce and to threaten economic penalties with commercial partners who did not vote in favor of management.

The CEO announced during the annual meeting at 2:00 p.m. that she was taking a three-hour lunch break. (The meeting started at 11:00 a.m.) The court saw this as a transparent attempt to lobby for more votes for management—which ultimately prevailed by a razor-thin margin. The court determined that (what it called) the "lupper" break affected the election of the directors and the defendants could not carry their burden to show that the CEO's actions were "motivated by a good faith concern for the stockholders, and not by a desire to entrench [herself]."

The customized remedy that the court fashioned in this case was to order a prompt special meeting for the new election of directors—and to make the management slate pay for the costs of such a meeting. The court also ordered the removal of the new director who was elected at the tainted meeting. Moreover, the court declined to award attorneys' fees in part due to the apparent violation of a confidentiality agreement by the plaintiff.

Conclusion

There are several lessons that can be learned from the cases reviewed in this article. In *Kurz*, the Delaware Supreme Court described the correct procedure for dissidents to follow in order to properly reduce the size of an existing board of sitting directors: first, remove the sitting directors by written consent or other appropriate shareholder action; next, reduce the size of the board; and then elect new directors. In *Levinhar*, the Court of Chancery explains that in order to avoid potential res judicata bars, despite the summary nature of a section 225 proceeding, affiliated claims should be addressed either in the section 225 proceeding or in a contemporaneous companion case. In the *Portnoy* case, the court described as a remedy for an improperly conducted shareholder meeting where directors were elected an order to conduct a new meeting for the election of directors with the cost borne by the management slate that conducted the improper meeting.