

An M&A Lawyer's Guide to the DGCL Amendments

The recently approved amendments to the General Corporation Law of the State of Delaware (the "DGCL") have garnered significant public interest.¹ Much of that interest has focused on certain amendments relating to proxy access and proxy expense reimbursement. Although those particular amendments have received much of the attention, M&A counsel should be mindful of the impact of two other amendments on the negotiation of M&A transactions. One amendment addresses the problem of "empty voting" and permits a board of directors of a Delaware corporation to provide separate record dates for determining stockholders entitled to notice of and to vote at stockholder meetings, including meetings convened to vote on the approval and adoption of a merger agreement. Another amendment implicates the negotiation of indemnification and advancement rights of a target corporation's former officers and directors by expressly providing that pre-existing indemnification and advancement rights provided in a corporation's governing documents cannot be impaired by later amendments to those documents.

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"Empty Voting" Amendments

For M&A counsel, the most salient issue to be addressed in the 2009 amendments has its origins in the concern over the effects of "empty voting". Empty voting most commonly occurs when a stockholder: (i) sells its shares during the period of time after the record date, (ii) acquires voting rights to a significant block of publicly traded stock without acquiring a comparable economic interest in the company prior to the date of a stockholder meeting, or (iii) simultaneously takes a short position that offsets the stockholder's economic interest in the company. By divorcing voting power from economic interest, empty voting potentially disrupts the presumed tendency of stockholders to vote in a manner that maximizes their ownership interests in the company.

Hedge funds and other large stockholders that are successful in borrowing a significant number of shares and/or shorting the underlying stock may acquire enough voting power to swing a stockholder vote in their favor without having to take a comparable economic stake in the corporation. Under such circumstances, a significant number of shares could be voted in a manner that is inconsistent with the best interests of the corporation or its economic owners. For example, a hedge fund could borrow a large number of shares prior to the record date for the vote on a proposed merger, vote against the merger and sell the shares short, resulting in a profit derived from the knowledge that the proposed merger would be defeated.

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¹ The Governor of the State of Delaware has signed the amendments into law. The amendments will become effective on August 1, 2009.

One of the factors contributing to empty voting is the relatively long period of time between the record date and the date of a stockholder meeting. The amendments to Section 213(a) of the DGCL, which outline the process by which corporations may determine stockholders of record for purposes of stockholder meetings, provide a partial answer to this issue by permitting a board of directors to fix a record date for voting separate from the record date for notice of the stockholder meeting.² In this way, a board may fix a record date for voting, at the time it fixes the record date for notice, that is closer to the meeting date, and presumably more reflective of the stockholder base, than a record date that is as many as 60 days prior to the meeting date.

The need to provide for notice well ahead of a meeting frequently occurs in the case of votes to approve mergers and other similar matters requiring a longer solicitation period. This has sometimes led to difficulty in obtaining required majority votes in cases in which a large number of shares change hands following a record date because the holders of sold shares often fail to vote, and purchases in the public markets do not automatically carry with them associated authority to direct the voting of shares acquired after the record date. Revised Section 213(a) of the DGCL provides no limit on how close the voting record date may be to the meeting date. For public companies, this will need to be determined in consultation with non-Delaware actors such as transfer agents, stock exchanges and proxy voting services.³

For M&A counsel, the changes permitting the separation of the record dates for purposes of voting and notice are significant. In connection with an M&A transaction, counsel will need to consider whether a board of directors should set a record date for the vote on a merger, at the time it sets the record date for the notice, so that it occurs closer to the time of the meeting. In general, setting the record date closer to the time of the meeting should have a positive effect on the outcome of the vote, as the stockholders of record closer to the date of the vote should have an economic incentive to vote in favor of the merger. It is conceivable, however, that there could be particular circumstances in which a merger could be defeated as a result of a change in circumstance between the time of the notice of the meeting and the time of the vote.⁴ As a result, any decision to bifurcate the record dates should be done on a case-by-case basis depending on the particular circumstances.

² The changes in Section 213 necessitate conforming changes to a number of other sections to include the concept of different record dates for determining entitlement to notice and to exercise voting rights. These include Sections 211, 219, 222, 228, 262 and 275 of the DGCL.

³ The amendments to Section 213(a) of the DGCL also add language applying the separation of notice and voting record dates to adjourned meetings.

⁴ Not only late arriving offers from competing bidders, but also other late breaking news relating to the value of the target corporation (or other information) could lead to a rejection of a merger transaction. For example, a different result on a merger vote would have been likely in the merger involving Transkaryotic Therapies, Inc. See *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346 (Del. Ch. 2006) and *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 Del. Ch. LEXIS 57 (Del. Ch. Feb. 9, 2007). After the record date but prior to the vote on the merger, the target corporation learned of extraordinarily positive results for one of its pharmaceutical products. The merger was approved by a slim margin. If the record date for the vote occurred after the announcement of the late breaking news, the approval of the merger would have been placed in doubt.

Indemnification and Advancement Rights

The amendments also include a revision to Section 145(f) of the DGCL that adopts a default rule that is contrary to that articulated by the Court of Chancery in *Schoon v. Troy Corp.*⁵ In connection with M&A transactions, the revision is significant for purposes of negotiating indemnification and advancement rights of former officers and directors of target corporations.

In *Schoon*, the Court of Chancery held that a board of directors can amend a corporation's bylaws to eliminate indemnification or advancement rights for claims relating to actions taken prior to such amendment, provided that no claim has actually been made against the indemnitees before the amendment is adopted. In *Schoon*, William J. Bohnen ("Bohnen"), a former director of Troy Corporation ("Troy"), pursued claims for advancement in connection with defending threatened and pending fiduciary duty claims asserted by Troy. Bohnen was the director-nominee of Steel Investment Company ("Steel") from 1988 until February 2005, at which time Richard W. Schoon ("Schoon") replaced Bohnen. In September 2005, Steel and Schoon sued Troy for access to certain books and records under Section 220 of the DGCL. Shortly thereafter, in November 2005, Troy's board of directors amended the bylaws to remove the word "former" from its definition of the directors entitled to advancement.⁶ In early 2006, Troy initiated fiduciary duty claims against Bohnen and Schoon, alleging that the former and current directors provided proprietary information to Steel in contravention of their fiduciary obligations to Troy.

While the proceedings were pending, Bohnen and Schoon formally demanded advancement of their fees and expenses in defending the fiduciary duty claims. The Court of Chancery determined that, as a former director, Bohnen was not entitled to advancement under the amended bylaws. Bohnen argued that his rights in the pre-amendment bylaws, which granted former directors the right to advancement, vested before the adoption of the amendment.⁷ The Court of Chancery rejected this argument and found that the right to advancement vests upon the triggering of the corporation's obligations. Thus, even though the alleged breaches occurred before the bylaw amendments, because Bohnen was not named as a defendant until *after* the Troy board amended the bylaws (nor was there any evidence that Troy was even contemplating claims against him prior to the amendments), his rights under the pre-

⁵ 948 A.2d 1157 (Del. Ch. 2008).

⁶ *Id.* at 1161.

⁷ *Id.* at 1165. In support of his argument, Bohnen cited *Salaman v. National Media Corp.*, 1992 Del. Super. LEXIS 564 (Del. Super. Oct. 8, 1992), wherein the Superior Court granted advancement rights to a director for fees incurred in connection with defending a breach of fiduciary duty claim. In that case, after advancing the plaintiff a portion of his fees, the defendant corporation amended its bylaws to repeal the basis for the claimed right and then refused any further advancement. The *Salaman* Court rejected the corporation's argument that it could amend the bylaws to deny Salaman his preexisting right to advancement, holding that the corporation could not "unilaterally rescind a vested contract right upon which Salaman relied." *Id.* at *17. In the instant case, however, Bohnen "fail[ed] to acknowledge that the Court only upheld Salaman's right to advancement because he was named as a defendant *before* the bylaw was amended." *Schoon*, 948 A.2d at 1166 (emphasis added).

amendment bylaws had not been triggered.⁸

Schoon heightened the concerns with respect to the protection of the indemnification and advancement rights of a target corporation's officers and directors following the effective time of a merger. The amendment to Section 145(f) of the DGCL adopts a statutory rule that alleviates those concerns. Specifically, pursuant to revised Section 145(f) of the DGCL, a corporation cannot eliminate or impair an indemnitee's right to indemnification or advancement of expenses granted under a provision in the corporation's certificate of incorporation or bylaws through an amendment to such provision adopted after the occurrence of the act or omission to which the indemnification or advancement of expenses relates.

Such an amendment eliminating indemnification or advancement rights may be permitted, however, if the provision in the certificate of incorporation or bylaw in effect at the time of the act or omission includes language expressly authorizing such elimination or limitation. It remains important, therefore, for counsel in M&A transactions to carefully scrutinize the existing governing documents of the target corporation and to negotiate the relevant provisions of the merger agreement in light of the particular context.

Other Amendments

The other amendments to the DGCL, although significant and generating intense interest, are of less significance in the context of negotiated M&A transactions. Those amendments create new Sections 112 and 113 of the DGCL that expressly permit Delaware corporations to adopt bylaws implementing proxy access and requiring reimbursement of stockholder proxy expenses in certain circumstances, as well as a new provision permitting judicial removal of directors under specified circumstances.

Access to Proxy Solicitation Materials

The amendments create new Section 112 of the DGCL expressly authorizing a Delaware corporation to adopt a bylaw that grants stockholders the right to include within the corporation's proxy solicitation materials stockholders' nominees for the election of directors, subject to any lawful conditions the bylaws may impose. The subject of "proxy access" had been a significant one, and it promises to continue to be so in the current environment. At issue is whether companies may be required to include in company proxy materials nominees for director proposed by stockholders in addition to nominees proposed by the company. Activist investor groups have long argued that stockholders should be permitted to nominate directors without having to mount a costly proxy battle.

The Securities and Exchange Commission (the "SEC") will be revisiting the issue of proxy access in the near future, and it is possible that the SEC will

reverse its long-standing policy of permitting companies to exclude from its proxy materials stockholder proposals seeking the adoption of proxy access rules. If the SEC revises its position and permits proxy access stockholder proposals to be included in a company's proxy materials, Section 112 will facilitate the adoption and implementation of proxy access rules by Delaware corporations.

Section 112 of the DGCL removes any uncertainty regarding the ability of Delaware corporations to effect proxy access through adoption of a bylaw. In particular, the bylaws of a Delaware corporation may require that if the corporation solicits proxies with respect to an election of directors, the corporation may be required to include in its proxy materials one or more nominees submitted by stockholders, subject to certain limitations and conditions. The amendment clarifies that corporations may impose reasonable restrictions on the stockholders' right to access company proxy materials and identifies a non-exclusive list of restrictions that are deemed to be reasonable.⁹

The adoption of Section 112 of the DGCL thus would provide a more certain path for corporations and stockholders desiring to implement proxy access to balance the often disruptive nature of proxy contests with the desire to provide significant stockholders an avenue for effecting changes to the composition of the board of directors.

Proxy Reimbursement Bylaws

The other new election-related statute is Section 113 of the DGCL, which effectively codifies the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan*.¹⁰ In *CA, Inc.*, the Delaware Supreme Court answered certified questions of Delaware law from the SEC, as permitted under a recent amendment to the Constitution of the State of Delaware.¹¹ In an *en banc* opinion, the Delaware Supreme Court held that a proposed bylaw that would have required

⁹ One condition specified in Section 112 of the DGCL would permit the bylaws to establish minimum ownership requirements for stockholders to become eligible to include nominees in company proxy materials, measured both by amount and duration of ownership. The bylaws may establish this minimum ownership threshold by defining beneficial ownership to include ownership of options or other rights relating to stock, including derivative rights. Because Section 112 of the DGCL is intended to apply to stockholder nominations of short slates of directors and not as a vehicle for effecting changes of control through the corporation's own proxy materials, the new section also expressly permits the bylaws to condition eligibility for inclusion in the corporation's proxy materials to nominations for a limited number of seats that may be contested and to preclude entirely inclusion of nominations by persons who own or propose to acquire (such as through a tender offer) more than a specified percentage of the corporation's stock. The bylaws also may require the nominating stockholder to submit specified information such as information concerning the ownership of the corporation's stock by the stockholder and the stockholder's nominees. The bylaws also may condition eligibility to require inclusion of nominees in the corporation's proxy materials on the nominating stockholder's execution of an undertaking to indemnify the corporation for any loss resulting from any false or misleading information submitted by the stockholder and included in such proxy materials, or on "any other lawful condition."

¹⁰ 953 A.2d 227 (Del. 2008).

¹¹ Del. Const. Art. IV, Sec 11(8) (amended 2007) (authorizing the Delaware Supreme Court to hear and determine questions of law certified to it by (in addition to the tribunals already specified therein) the SEC).

CA, Inc. to reimburse the reasonable expenses of stockholders that were successful in short-slate director election contests was a proper subject for stockholder action, but as drafted, would violate Delaware common law by infringing upon the directors' ability to fully discharge their fiduciary duties. In particular, the Court found that, notwithstanding the fact that the proposed bylaw would specifically require and direct the board to expend corporate funds, the context of the bylaw at issue was largely procedural in nature. The Court reasoned that stockholders of Delaware corporations have the right to participate in the nomination process and thus, "the shareholders are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election."¹²

Nevertheless, the Court ultimately determined that the proposed bylaw was inconsistent with Delaware law because, if adopted, the bylaw would require the board of directors to expend corporate funds without regard to their fiduciary obligations. Importantly, the Court noted that the bylaw was unenforceable as drafted "because the bylaw contain[ed] no language or provision that would reserve to CA Inc.'s directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all."¹³ Justice Jacobs, writing for the Court, suggested that under at least one set of circumstances, the board of directors could be obligated to reimburse proponents that were successful, even if the proxy contest in question was driven by interests that conflicted with those of the corporation.¹⁴ Accordingly, the Court concluded that the fact that the proposed bylaw would require the board to expend corporate funds without regard to their fiduciary duties violated Delaware law and rendered the bylaw unenforceable as drafted.

Consistent with the Supreme Court's decision in *CA, Inc.*, new Section 113 of the DGCL would provide a statutory framework for the development of bylaw provisions that mandate reimbursement of reasonable expenses incurred by stockholders who achieve a defined level of success in a proxy contest. Specifically, Section 113(a) of the DGCL permits Delaware corporations to adopt a bylaw providing for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors, subject to such procedures or conditions as the bylaw may prescribe. Section 113 identifies a non-exclusive list of such conditions, including: (i) conditioning eligibility for reimbursement on the number or proportion of persons nominated by the stockholder; (ii) conditioning eligibility on whether the stockholder previously sought reimbursement for similar expenses; (iii) limiting the amount of reimbursement (which may be based upon the proportion of votes cast in favor of such nominee or the amount expended by the corporation in soliciting proxies); (iv) limiting elections of directors by cumulative voting; or (v) any other lawful condition. The restrictions thus permit corporations to limit the reimbursement to "short-slate" contests, to define what level of "success" must be achieved in order to qualify for reimbursement, and otherwise to tailor their

¹² 953 A.2d at 237.

¹³ *Id.* at 240.

¹⁴ *Id.*

bylaws to their specific situation.¹⁵

Judicial Removal of Directors

Section 225 of the DGCL, which affords directors, stockholders and corporations the right to a judicial determination of entitlement to office or the outcome of a stockholder vote, will be amended to add a new subsection (c) authorizing the Court of Chancery to remove a director in certain narrow circumstances upon the application of a corporation or derivatively by a stockholder on behalf of a corporation. The new subsection (c) 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 if the Court of Chancery 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. New Section 225(c) of the DGCL is purposely drafted very narrowly, and expressly requires that an action thereunder be brought “subsequent” to the one in which the underlying judgment is made. This amendment is similar to, though more circumscribed than, the judicial removal of directors provision in the Model Business Corporation Act,¹⁶ which has been enacted by several states.

Conclusion

When the amendments become effective on August 1, 2009, M&A counsel negotiating merger transactions should carefully consider, in the context of the particular M&A transaction at issue, the impact of the amendments relating to “empty voting” and indemnification and advancement rights of former officers and directors of a target corporation. The other amendments, although of less significance in the context of the negotiation of M&A transactions, are important and demonstrate Delaware's preference for enabling legislation (as opposed to statutory mandates) and maintaining maximum flexibility for Delaware corporations.

¹⁵ Section 113 of the DGCL does not, however, include an express requirement that any proxy reimbursement bylaw contain a fiduciary out. It remains to be seen whether, notwithstanding the express statutory authority for a proxy reimbursement bylaw provided by Section 113 of the DGCL, Delaware courts will read a fiduciary out requirement into such a bylaw.

¹⁶ Model Business Corporation Act, § 8.09.