Client Advisory

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Corporate

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Novel Action Raises Questions in Delaware on Stockholder Power to Directly Remove Officers

The 2009 proxy season has been particularly active and contentious. Among the battles being waged, a pending consent solicitation by a hedge fund stands out as a unique approach that may result in a new tactic for stockholders to circumvent a board of directors to directly depose management.

DellaCamera Capital's Move Against Enzon Pharmaceuticals

Claiming frustration with a lack of executive accountability, increased and risky expenditures on research and development, and poor stock performance, DellaCamera Capital Management LLC, a hedge fund that owns approximately 8.3% of the outstanding shares of Enzon Pharmaceuticals is soliciting stockholder consents to:

1. amend article V, section 5.2 of Enzon's bylaws to allow stockholders, by a majority vote, to remove the company's CEO and/or President;[1]
2. remove Jeffrey Buchalter, Enzon's current CEO and President, from those offices; and
3. amend the bylaws to provide that the board may only undo the change to section 5.2 by unanimous vote.

DellaCamera states that the proposed amendment would strengthen management accountability, improve corporate governance and ensure that the CEO and/or President are acting in the stockholders' best interests.

Enzon's Reaction

Not surprisingly, Enzon's board unanimously objected to DellaCamera's proposal and publicly responded that DellaCamera's consent solicitation is an unlawful, disruptive and unnecessary intrusion into the board's fundamental right to hire and fire executive officers. The Enzon board believes it is intimately familiar with the company's operations and in the best position to evaluate the performance of its officers, and the board has expressed its support for Mr. Buchalter. The Enzon board also has pointed out that the DellaCamera proposal does not recommend a replacement for Mr. Buchalter, and that a

[1] Section 5.2 of Enzon's bylaws currently states in pertinent part that "[a]ny officers elected or appointed by the Board may be removed by the Board with or without cause." The proposed amendment would add that "[a]ny officer holding the office of Chief Executive Officer and/or President may be removed by the Stockholders from such office(s) and any other officer's positions he or she holds with or without cause by the affirmative vote or consent of the holders of a majority of the Corporation's issued and outstanding shares of stock then entitled to vote."

If you have any questions regarding the issues discussed in this advisory, please contact one of the Katten Muchin Rosenman LLP attorneys listed below.

Matthew S. Brown
312.902.5207 / matthew.brown@kattenlaw.com

Brooks T. Giles
312.902.5386 / brooks.giles@kattenlaw.com

Jeffrey R. Patt
312.902.5604 / jeffrey.patt@kattenlaw.com

Herbert S. Wander
312.902.5267/ hwander@kattenlaw.com

Mark D. Wood
312.902.5493 / mark.wood@kattenlaw.com

search for a qualified replacement could take several months or longer, particularly in light of the unexpected uncertainty that the threat of removal by stockholders would present.

In addition to its public statements, Enzon initiated litigation in Delaware seeking an injunction against DellaCamera on the basis that the proposed amendment would violate principles of Delaware corporate law by taking authority away from the board to appoint and remove officers, thus undermining the board's ability to oversee the business of the corporation as required by Delaware General Corporation Law (DGCL) Section 141(a).[2]

DellaCamera's Defense

In response, DellaCamera has cited Section 142(b) of the DGCL, which provides that "[o]fficers shall be chosen in such manner and shall hold their offices for such terms as are prescribed by the bylaws or determined by the board of directors or other governing body."[3] Stockholders of course have the authority under Section 109 of the DGCL to adopt, amend or repeal any bylaw not inconsistent with law or the company's certificate of incorporation. Accordingly, DellaCamera asserts that, in light of Section 142(b) of the DGCL, stockholders may amend the bylaws to delegate to themselves the authority to remove officers.

DellaCamera has agreed, and the court has ordered, that the proposals, if approved by the stockholders in a timely manner,[4] will not be implemented until resolution of this litigation.

DellaCamera Might Be Right

It is generally viewed as the mandate of the board of directors to oversee management under Section 141(a) of the DGCL. Nonetheless, the plain language of Section 142 and its legislative history appear to support DellaCamera's argument. The minutes from the Delaware Corporation Law Study Committee discussing the 1969 amendments to Section 142 of the DGCL acknowledged the ability of stockholders to appoint and remove officers under that section.[5] A report prepared at that time by Professor Ernest Folk noted that, prior to the 1969 amendments, Section 142 allowed stockholders only to appoint and remove directors.[6]

The outcome of this case, and the Enzon consent solicitation, could have a meaningful impact on the balance of power between stockholders and directors. Stockholders could use this approach to circumvent the board by amending the bylaws, not only to allow them to remove officers, but also, taken to its logical extension, to appoint officers. These tactics could undermine the authority traditionally reserved for a corporation's board and, among other things, raise interesting legal and commercial issues regarding the consequences of such stockholder actions. For example, if stockholders could appoint officers, who would negotiate the compensation and other terms of their employment?

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[2] Section 141(a) of the DGCL states in part that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may otherwise be provided in this chapter or in its certificate of incorporation."

[3] In contrast, Section 8.40(b) of the Model Business Corporation Act (4th Edition) provides that the board of directors may elect individuals to fill one or more offices of the corporation and permits the bylaws or board of directors to delegate to an officer the authority to appoint one or more other officers. Thirty states have adopted the Model Business Corporation Act in whole or in part.

[4] For DellaCamera's proposals to be approved, a majority of stockholders will have to consent to the proposals within the 60-day period required by Section 228(c) of the DGCL. The 60-day period will run from the date of the earliest written consent.

[5] Delaware Corporation Law Revision Committee, Minutes of the 9th Meeting, at 3-4 (1965), available at http://law.widener.edu/LawLibrary/Research/OnlineResources/DelawareResources/DelawareCorporationLawRevisionCommittee.aspx.

[6] Professor Folk went on to recommend that stockholders should only have the authority to remove officers appointed by them. The minutes from the Ninth Meeting of the Delaware Corporation Law Revision Committee indicate that the committee rejected this proposed amendment on the basis that a corporation's bylaws should govern the scope of this authority.

Lessons Learned

Regardless of the outcome of the Enzon/DellaCamera battle, this is a helpful reminder of the importance of periodically reviewing a corporation's bylaws, with the assistance of legal counsel. As part of such review, a Delaware corporation's board of directors should confirm, among other things, that the bylaws explicitly delegate to the board the sole authority to appoint and remove officers. Depending on the circumstances, the board also may want to evaluate with its advisors whether it would be feasible to garner stockholder support for amending the certificate of incorporation to provide greater certainty that the board will retain the authority to appoint and remove officers. This likely would be accomplished most effectively by amending the certificate of incorporation to explicitly recognize the board's sole authority over these matters, since any subsequent amendment to this provision would require both board and stockholder action.[7]

It is fair to assume that in many cases it might be difficult to count on stockholder support for this type of charter amendment, other than prior to an initial public offering or other circumstance in which there is a concentration of stock ownership. However, to the extent that they take a long-term perspective on their investments and value management continuity, institutional investors in more widely held corporations might be persuaded that the right to meddle in the oversight of management is not something they bargained for, nor is it a right that they would envision exercising. Accordingly, these investors might find compelling commercial arguments such as those asserted by Enzon with respect to the disruption and uncertainty posed by the prospect of stockholders interceding on management decisions as well as the possible chilling effect this would have on a corporation's ability to attract and retain qualified executive officers.

In addition, this contest underscores the disadvantages a public company may face if it allows stockholders to take action by written consent—a right which can be denied in a Delaware corporation's certificate of incorporation. Although this same issue could have been submitted as a proposal for consideration at an Enzon stockholders meeting, in that case, the matter presumably would have unfolded according to a more familiar pattern that may have allowed the board more control over the timing and a better opportunity to respond to this challenge to its authority in a thoughtful and deliberate manner.

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[7] Another approach might be to amend the certificate of incorporation to require a supermajority vote of the stockholders to amend the bylaw provision delegating this authority to the board. Unlike moving this authority to the certificate of incorporation, a supermajority requirement to amend the related bylaw provision would not preclude stockholders from modifying the bylaws without board action. However, it would require a greater mandate for such an extraordinary override of the authority traditionally delegated to the board of directors.