Katten
Katten Muchin Rosenman LLP

ClientAdvisory

March 10, 2009

Numerous Proposed 2009 Amendments to the Delaware General Corporation Law Reflect Heightened Focus on Governance Issues

Lawmakers in the state of Delaware may soon be addressing issues that have become part of the increasingly vigorous debate about stockholder input in corporate governance. The Delaware State Bar Association is currently considering various proposed amendments to the Delaware General Corporation Law (DGCL), which, if and when submitted to the Delaware General Assembly for approval, could become Delaware law in a matter of months (presumably after this year's proxy season, at least for calendar year companies). The proposed amendments to the DGCL, if approved, would:

- permit bylaw provisions that require corporations to allow stockholders greater access to the corporation's proxy solicitations in order to nominate directors;
- permit bylaw provisions that require corporations to reimburse stockholders for proxy solicitation expenses in connection with director nominations;
- generally prohibit charter or bylaw amendments that eliminate indemnification or the advancement of expenses after the acts or omissions that gave rise to the need for indemnification or the advancement of expenses have occurred;
- separate the record date for determining the stockholders entitled to be given notice of a stockholders' meeting from the record date for determining the stockholders entitled to vote at such meeting; and
- allow, in limited circumstances, the judicial removal of a corporation's directors.

The following sets forth some of the reasons for the proposed amendments, explains the proposed amendments in more detail and describes what some of the effects of such amendments might be.

New Section 112; Stockholder Access to Proxy Solicitation Materials

The Securities and Exchange Commission (SEC) proposed a new rule in 2003, and again in 2007, which would have enabled certain stockholders with significant holdings to have their director nominees included in a corporation's proxy solicitation materials after certain conditions had been met. Although the proposed rules were never adopted, stockholder proxy access remains a much discussed and debated issue, and, in fact, the newly appointed SEC Chair Mary Schapiro recently told Congress, "it is time for a thoughtful approach to proxy access for significant, long-term shareholders."[1]

Under current Delaware law, a board of directors has no obligation to include stockholder nominees in the corporation's proxy solicitation materials. If a stockholder wants to nominate and seek election of its own candidate(s) to sit on the corporation's board, it would have to incur significant costs to produce separate proxy solicitation materials and distribute them to the corporation's other stockholders. Many activist investors and other stockholder groups are today demanding a method to facilitate the election of persons who they believe will, in certain cases, better represent stockholder interests than incumbent directors and other board-chosen candidates.

---

1 Although the SEC has indicated it will revisit the proxy access matter as soon as this year, it may be distracted by more pressing problems involving the economic downturn, credit crisis and market volatility. However, we believe that the activity in Delaware should be viewed as potentially facilitating any future SEC requirements on proxy access and that attention should remain fixed on the SEC for future guidance on the issue.

If approved, Section 112 of the DGCL would allow a Delaware corporation to adopt a bylaw requiring any proxy solicitation materials circulated by the corporation regarding the election of directors to include nominees submitted by stockholders in addition to the slate of nominees put forth by the corporation through its board of directors. Section 112 would not statutorily require stockholder access to proxy solicitations but, rather, would allow a bylaw amendment to provide for such access without overstepping the general principle, in Delaware, that the board of directors is charged with the management and affairs of the corporation. To the extent such a bylaw is adopted, the requirement to include stockholder candidates in the corporation's proxy could be made subject to procedures and conditions such as those discussed below or any other lawful condition.

To avoid a situation in which a stockholder holding a nominal economic interest in the corporation could include a candidate on the corporation's proxy, the bylaw provision could require a certain threshold level or duration of stock ownership by the nominating stockholder before that stockholder's candidate would be included in the proxy. The corporation could also provide that stockholder proxy access be limited to a specified number of directors or specified percentage of the board. In other words, the corporation could limit stockholder proxy access to only a "short slate" election (i.e., an election where less than a majority of the director seats is contested, which will always be the case where the corporation has a staggered board) and prohibit access in connection with a "full slate" contest. Additionally, the corporation could restrict nominations by a stockholder that has acquired or publicly proposed to acquire shares constituting a specified percentage of the voting power of the corporation's voting stock within a specified period before the election of directors. Under Delaware law, stockholders have the power, which may not be divested, to amend a corporation's bylaws.[2] As a new Section 112 would allow provisions regarding stockholder proxy access to be included in the bylaws, it may be likely that many corporations will be faced with stockholder proposals of bylaw amendments within the scope of the new section. If confronted with such stockholder proposal, the corporation could choose to fight it through the proxy process or to agree to a stockholder access bylaw amendment, possibly including changes negotiated with the proponent of the proposal, to avoid a stockholder vote on the issue. Given that these circumstances may be likely to occur, a corporation's board may want to consider whether to proactively amend the corporation's bylaws to allow stockholder access on conditions acceptable to the corporation, without the duress of dealing with a stockholder proposal. In considering such an approach, the board should understand that RiskMetrics Group, as well other proxy advisory firms, may establish positions with respect to acceptable bylaw provisions and, in this regard, the board should consider structuring the amendments such that these advisory firms would recommend against further stockholder proposals in this area.

New Section 113; Reimbursement in Connection with Proxy Solicitations

As noted above, soliciting proxies can be an expensive and time-consuming process for a stockholder, particularly if the stockholder is not able to piggyback on the corporation's proxy materials. In *CA, Inc. v. AFSCME Employees Pension Plan,*[3] the Delaware Supreme Court heard two certified questions of law from the SEC (marking the first use of a law allowing that court to answer such questions). At issue was whether a stockholder proposal to amend the corporation's bylaws to require stockholder reimbursement for proxy solicitation expenses related to a short slate election, without giving any "fiduciary out" (described below) to the board of directors, was valid under Delaware law. The Supreme Court held that a stockholder bylaw amendment proposal that, in general, provides for a stockholder's reimbursement by a corporation for proxy expenses relating to a short slate election is a valid proposal and not at odds with the board's right to manage the business and affairs of the corporation. However, the court stated that the proposal in question was not valid because it did not provide to the board the flexibility necessary to fully discharge its fiduciary duties to the corporation and its stockholders should the board have believed the expenses should not have been properly expended by the corporation (a fiduciary out).

Section 113 of the DGCL, if approved, would allow a corporation to adopt a bylaw, even one such as the proposed bylaw discussed in *CA, Inc.* which did not include a fiduciary out, that provides for reimbursement of a stockholder by the corporation for stockholder expenses relating to proxy solicitations in connection with an election of directors. Although the proposed amendment is silent with respect to directors' fiduciary out, it is conceivable that a Delaware court could read a fiduciary out into a bylaw enacted pursuant to a new Section 113; however, there is nothing in the current draft of Section 113 that indicates this would be the case.

---

2 DGCL Section 109(a).

3 953 A.2d 227 (Del. 2008).

The reimbursement right that could be included in a corporation's bylaws, pursuant to a new Section 113, could be made subject to certain procedures and conditions including: (1) conditioning the eligibility for proxy expense reimbursement on the number or proportion of nominees sought to be elected by the stockholder, such that reimbursement could only be available for short slate elections; (2) limiting the amount of the reimbursement sought based on the relative success of the stockholder's nominees in the election or the amount incurred by the corporation in soliciting proxies for the same election; (3) limiting reimbursement for elections by cumulative voting; or (4) any other lawful condition. Further, to prevent stockholders from claims of reimbursement for an election in which reimbursement would not have been available prior to such election date, Section 113, if adopted, would prohibit the application of any bylaw requiring reimbursement to any election for which the record date of the election precedes the adoption of the bylaw.

As with Section 112, if Section 113 is approved, to avoid undesirable stockholder proposals, it may be beneficial for corporate directors to consider whether to anticipatorily amend the bylaws setting forth the availability of reimbursement for proxy solicitations regarding director elections and the procedures and conditions tied to such reimbursement.

Amended Section 145(f); Prohibition on Retroactive Elimination of Indemnification or Advancement of Expenses

The Delaware Chancery Court, in *Schoon v. Troy Corp.*,[4] upheld a bylaw amendment that eliminated the corporation's commitment to advance expenses to a former director even though the corporation's bylaws, at the time of the director's alleged wrongdoing, required such advancement. In some circumstances, the indemnification of directors and officers of Delaware corporations is mandatory.[5] However, corporations often provide indemnification for officers and directors beyond what is required and may also offer to advance expenses related to legal proceedings. These indemnification and expense advancement provisions enable a corporation to attract and retain talent and encourage directors and officers to make decisions that they believe are in the best interests of the corporation, even if those decisions entail some degree of risk.

In *Schoon*, the court articulated that whether or not a corporation must indemnify or advance expenses to its decision makers does not depend on what the corporation's charter or bylaws states at the time of the alleged transgression, but rather what is set forth when the transgression is discovered and legal proceedings are commenced against the director or officer. The *Schoon* decision has been rightly criticized for being unfair to directors and officers by allowing a corporation, after the fact, to terminate indemnification and expense advancement provisions in charters and bylaws which have been relied upon.

The amendment to Section 145(f), if approved, would overturn *Schoon* by prohibiting amendments to a corporation's charter or bylaws that eliminate or impair rights to indemnification or advancement of expenses retroactive to the act or occurrence that gives rise to claims for indemnification or advancement. The corporation could only retain the ability to remove these director and officer protections after the time of the alleged wrongdoing if the charter or bylaw provisions in effect at the time of the alleged wrongdoing expressly allow it to do so. We find it hard to imagine that many corporations would deem it advisable to include such express allowances in their organizational documents.

Amended Section 213(a); Separation of Record Dates for Stockholders' Meetings

Public corporations, as well as state and federal regulators, have raised concerns about the phenomenon of "empty voting" (also sometimes referred to as "voting with a dead hand"). The empty voting problem occurs when stock voting rights have been de-coupled from the economic interests normally tied to shares of stock, which usually motivate investors to make decisions that they believe are in the best interests of the corporation. An example of how this problem could arise involves the use of a short-selling strategy by certain investors timed around a record date fixed by a corporation's board of directors to determine stockholders entitled to notice and to vote at a future meeting of the stockholders with respect to a business combination proposal or other significant strategic matter. To effect this strategy, the investor would borrow shares of the corporation's stock from another investor, thereby acquiring voting rights on the record date, sell the shares during the time period between the record date and the actual stockholders' meeting, vote at the meeting with the intention of effecting a

4 948 A.2d 1157 (Del. Ch. 2008).

5 DGCL Section 145(c).

vote outcome that causes a drop in the corporation's stock price, and finally purchase the stock at the now lower price in order to replace the stock that it borrowed and sold at a higher price prior to the meeting. Another type of empty voting may occur when a party assembles votes by getting voting stock temporarily into "friendly" hands on the record date so that the party effectively has more voting power than it normally would (e.g., management could secure more votes against a takeover proposal by engaging in a complex transaction that includes lending the corporation's treasury stock to another friendly party).

Based on our experience and on conversations with proxy solicitors, in most cases there is not a significant amount of stockholder turnover between the record date and the meeting date, and empty voting rarely affects the outcome of a vote. The proposed amendment to Section 213(a) would, however, enable a corporation to combat the empty voting situation where it does potentially exist. Specifically, the proposed amendment to Section 213(a), if adopted, would permit a corporation's board of directors to separate the record date for determining stockholders entitled to notice of a meeting from the record date for determining the stockholders entitled to vote at such meeting. Under current Delaware law, a corporation's board must set a record date for determining stockholders entitled to notice ***and*** to vote at a meeting between 10 and 60 days prior to such meeting. Because of various regulations, for instance SEC rules related to proxy solicitations, and practical considerations, directors may find the need to set a record date closer to the 60-day cutoff. Under a newly amended Section 212(a), the required record date for determining stockholders entitled to notice of a meeting would generally continue to be between 10 and 60 days prior to the meeting. However, the board would then have the discretion of fixing a separate record date for determining stockholders entitled to vote on any date before, or even the day of, the meeting of the stockholders. If the record date for determining who may vote is fixed on a date that is less than 10 days before the meeting date, then a proposed amendment to Section 219(a) of the DGCL would call for the stockholders' lists required by current Section 219 to reflect the stockholders entitled to vote as of the tenth day before the meeting date.

In theory, the amendment proposed for Section 213(a) would provide a means for Delaware corporations to ensure that the economics of ownership of their stock are more closely aligned with voting rights and to minimize the threat of empty voting. Nevertheless, from a practical standpoint, a corporation would have to be cognizant of other outside factors that could dictate when a record date to determine stockholders entitled to vote at a meeting should be set. For example, setting a later record date for voting could make it more difficult to obtain a quorum and the necessary votes to approve a matter. Also, the proxy mailing and vote processing services will need to be modified to address vote counting and notice requirements for separate record dates. From a logistical standpoint, there may still need to be a meaningful amount of time between the record date for determining voting and the meeting date in order to allow for the distribution of proxies, counting of votes, etc. We expect that the SEC would likely weigh in with proposed rule amendments and interpretive guidance concerning issues relating to the separation of record dates.

New Section 225(c); Judicial Removal of Corporate Directors

In general, the process of removing directors of Delaware corporations can be difficult. By stockholder vote, a director on a non-staggered board can be removed with or without cause and a director on a staggered board can be removed only for cause.[6] A stockholder vote to remove a director may be a futile exercise, though, particularly in cases where a bad director controls the vote or the proxy voting machinery. Although it may contravene the general principle that directors, who are elected by stockholders, should only be able to be removed by those same stockholders, some states have recently enacted statutory provisions allowing the judicial removal of directors as a means of relieving corporations of their "bad actor" decision makers when a stockholder vote would not achieve this result. At this time, however, Section 225 of the DGCL only permits the Delaware Court of Chancery to hear and determine the validity of any election, appointment, removal or resignation of any director.

The addition of Section 225(c) to the DGCL would provide the Court of Chancery with the ability, upon application by the corporation or in a stockholder derivative suit, to remove a director who has been convicted of a felony or been judged on the merits to have breached his or her duty of loyalty to the corporation. The court would only be able to order removal if it concludes that the director did not act in good faith when performing the actions that resulted in the felony conviction or judgment of the breach of the duty of loyalty and if the corporation or stockholder brought the action for judicial removal subsequent to the underlying criminal or civil proceeding.

6 DGCL Section 141(k)(1).

The proposed Section 225(c) is narrowly tailored, and a corporation or stockholder asking a Court of Chancery judge to remove a director would have to jump though multiple hoops and satisfy a considerable evidentiary burden before the desired outcome is achieved. As a state with substantial influence in setting best practices for corporate law, however, Delaware's enactment of Section 225(c) may signify a meaningful step toward greater deference to minority stockholder protections against clearly bad actor directors.

Summary

It is apparent that the 2009 proposed amendments to the DGCL, if approved, would have a significant impact on key aspects of Delaware corporate law. If and when they are adopted, Delaware corporations will have to react appropriately and plan a course to incorporate any changes into their corporate governance policies. At this point, however, it would be premature to consider adjusting governance documents or practices, as the proposed amendments could still be modified or rejected by the Delaware State Bar Association or the Delaware General Assembly.

For further information, please contact one of the attorneys listed below.

Chicago

Matthew S. Brown	312.902.5207	matthew.brown@kattenlaw.com
Mark Wood	312.902.5493	mark.wood@kattenlaw.com

Los Angeles

Mark A. Conley	310.788.4690	mark.conley@kattenlaw.com

New York

Robert L. Kohl	212.940.6380	robert.kohl@kattenlaw.com

Washington, D.C.

Frank Zarb	202.625.3613	frank.zarb@kattenlaw.com