



## Client Alert

### Recent Amendments to the Delaware General Corporation Law and Case Law Developments Regarding Shareholder Proposals

On April 10, 2009, Delaware Governor Markell signed into law a series of amendments to the Delaware General Corporation Law (the "DGCL") in response to recent corporate governance developments and court cases. These amendments only apply to corporations incorporated in Delaware, but may be of interest to corporations incorporated elsewhere given the importance of Delaware and the fact that it is the first state to implement certain of these amendments. The amendments will become effective on August 1, 2009.

The first set of amendments will be of interest to boards of directors who are tracking the efforts of activist shareholders seeking to expand the ability of shareholders to nominate directors. The amendments permit a corporation to adopt bylaws (1) allowing stockholders to include in the company's proxy solicitation materials their own nominees for the board of directors and (2) allowing the corporation to reimburse stockholders for expenses incurred in soliciting proxies in connection with an election of directors. While these amendments are not mandatory, they are likely to further spur activist shareholders in the 2010 proxy season to seek access to corporate proxy statements or reimbursement in the manner now expressly permitted by the DGCL. As discussed below in more detail, these amendments come at a time when the Securities and Exchange Commission (the "SEC") has stated that it intends to implement a federal proxy statement access rule for shareholders before the next proxy season.

A different amendment to the DGCL provides some solace to directors that their rights to indemnification and advancement of expenses cannot be eliminated by amendment after the occurrence of an event giving rise to indemnification or advancement. Such elimination is only permitted if a corporation's certificate of incorporation or bylaws contain at the time of such event a provision expressly permitting elimination after the event.

A number of additional amendments are discussed below.

In addition, on April 14, 2009, the Delaware Court of Chancery handed down a decision in *Kistefos AS v. Trico Marine Services, Inc. et al*<sup>1</sup> that may provide shareholders with the ability to solicit proxies for, and present at a shareholder meeting, proposals that a company claims conflict with law or its governing document notwithstanding the company's objections. The court would then rule on the validity of the proposal if it was adopted by the required majority of shareholders. It remains to be seen whether this decision leads to an increase in the number of proposals sought to be made by shareholders through a separate proxy statement on matters that the company might previously have excluded based on conflict with law or its governing documents.

#### Provisions Regarding Stockholder Nominations for Directors

New Section 112 of the DGCL permits a corporation to adopt a bylaw allowing stockholders to include in a company's proxy solicitation materials their own director nominees. New Section 113 of the DGCL permits a corporation to adopt a bylaw requiring the corporation to reimburse stockholders for their expenses in soliciting proxies in connection with an election of directors.

This White & Case Alert provides a brief overview of some of the latest legislative, regulatory and judicial actions, policy statements and decisions that affect public and private companies.

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<sup>1</sup> Civil Action No. 4497-CC

These amendments do not in themselves require corporations to make any changes to their bylaws; however, they reflect the ongoing efforts of activist shareholders to lower the barriers and costs of proposing their own nominees for election to company boards. These amendments remove any doubt that shareholders who successfully seek to amend a corporation's bylaws can include such provisions without contravening the DGCL. (It should be noted, however, that this does not mean that such bylaw amendments would not be permitted under the laws of other states that have not yet adopted such provisions.)

### Background to the Amendments

**Rule 14a-8.** Access to company proxy statements continues to be a hot topic for shareholders. Even though matters regarding shareholder voting are generally governed by state law, Rule 14a-8 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), permits shareholders that meet specified ownership standards to submit to a public company limited types of proposals for inclusion in the company's proxy statement. Rule 14a-8(i) contains 13 bases upon which a company may exclude such proposals, which the company does by means of submitting a no-action letter to the SEC. Among other things, these bases permit exclusion of proposals that relate to elections of the company's directors. Because Rule 14a-8 does not allow shareholders to include nominees for a company's board of directors in the company's proxy statement, dissident shareholders must bear the cost of printing and mailing their own proxy statement if they wish to solicit votes for an alternate slate of directors.<sup>2</sup>

**SEC Action.** The SEC first raised the possibility of granting shareholders access to a company's proxy statement in 2003.<sup>3</sup> Its proposals were not adopted at that time. In June 2007, the SEC took the unusual step of publishing two separate rule

proposals because of a split in approach among SEC Commissioners. One proposal, which was subsequently adopted in December 2007, proposed amendments to Rule 14a-8(a)(i) to clarify that such rule not only permitted the exclusion of a proposal related to a nomination or election to a company's board of directors, but also permitted exclusion of a proposal related to a procedure for such nomination or election.<sup>4</sup> The second proposal contemplated significant changes to Rule 14a-8 that, among other things, would have permitted shareholders to include in company proxy materials proposals for bylaw amendments regarding procedures for nominating candidates to a company's board of directors. The first proposal and the second proposal effectively advocated opposing positions and were therefore mutually exclusive. Despite the SEC's decision not to adopt the second proposal, the SEC stated that it would reconsider the issue of proxy access in 2008;<sup>5</sup> however, the financial crisis initially overshadowed this intention. The new SEC Chairperson, Mary Schapiro, stated in March 2009 that a rulemaking proposal on shareholder access to corporate proxy materials will be on the SEC's agenda in May 2009.

**Reimbursement In Lieu of Access.** In July 2008, shareholders won a significant victory when the Delaware Supreme Court in *CA Inc. v. AFSCME Employees Pension Plan*<sup>6</sup> ruled that a company could be required to adopt a bylaw requiring the board to reimburse the reasonable costs of shareholders who seek to elect directors. However, with respect to the particular bylaw proposed by AFSCME, the court found that the bylaw violated Delaware law to the extent that it mandated reimbursement of expenses in situations where "a proper application of fiduciary principles" would require directors to not reimburse such expenses. Put differently, the

<sup>2</sup> The SEC's e-proxy rules may help dissident shareholders somewhat by lowering the costs of mounting a proxy battle, but the e-proxy rules still do not remove the need to mail a proxy notice to some or all shareholders. Therefore, there will still be some costs associated with a proxy battle even if solely conducted by e-proxy. Furthermore, initial indications are that retail shareholders are less likely to vote after receiving an e-proxy notice than if they receive a traditional proxy statement and proxy card. Therefore, e-proxy may not garner the incremental votes necessary to mount a serious challenge to an incumbent board.

<sup>3</sup> See "Proposed Rule: Security Holder Director Nominations," Release Nos. 34-48626; IC-26206, available at <http://www.sec.gov/rules/proposed/34-48626.htm>.

<sup>4</sup> See "Shareholder Proposals Relating to the Election of Directors," Release Nos. 34-56914; IC-28075, available at <http://www.sec.gov/rules/final/2007/34-56914.pdf>. The amendment followed the decision of the Court of Appeals for the Second Circuit in *AFSCME v. AIG*, 462 F.3d 121 (2d Cir. 2006), in which the Court held that AIG could not rely on Rule 14a-8(i)(8) to exclude a shareholder proposal seeking to amend the company's bylaws to establish a procedure under which the company would be required, in specified circumstances, to include shareholder nominees for director in the company's proxy materials.

<sup>5</sup> Remarks by SEC Chairman Christopher Cox, "SEC Speaks in 2008," Practising Law Institute, February 8, 2008, available at <http://www.sec.gov/news/speech/2008/spch020808cc.htm>.

<sup>6</sup> 953 A.2d 227 (Del. July 17, 2008).

court found that such a bylaw must be drafted to permit the board to exercise its fiduciary duties in deciding whether reimbursement is appropriate under the circumstances. Nevertheless, such a bylaw, if adopted, would address the costs incurred by dissident shareholders in launching their own proxy battle and would go a significant way towards mitigating the inability of shareholders to include their own slate of directors in the company's proxy statement.

**Pending SDNY Decision Regarding Access.** The most recent salvo in the battle for proxy access was fired by corporate law professor and governance scholar, Lucian Bebchuk. In February 2008, Bebchuk submitted a shareholder proposal seeking an amendment to the bylaws of Electronic Arts, Inc. ("EA"), which, if adopted, would have permitted any shareholder who continuously held stock with value of at least US\$2,000 for one year before submitting its proposal, or any shareholder who held at least five percent of EA's outstanding shares at the time of submission, to submit a proposal to amend EA's bylaws if the amendment was permitted pursuant to Delaware law. If adopted, the effect of Bebchuk's bylaw amendment would have been to permit shareholders to submit a proposal in a subsequent year to further amend EA's bylaws to permit shareholder access to the company's proxy statement. In April 2008, after EA sought to exclude the proposal, Bebchuk filed a complaint against EA in the United States District Court for the Southern District of New York seeking a declaratory judgment and requesting injunctive relief requiring EA to include the proposal in its 2008 proxy statement. In November 2008, the judge issued a one-page decision granting the company's motion to dismiss with no further explanation.<sup>7</sup> The judge did not write an extensive opinion knowing that the case would be taken up to the Court of Appeals for the Second Circuit, which it duly was.<sup>8</sup> A decision in this case is still pending.

**Recent Delaware Court Decision on Shareholder Proposals.** The Delaware Court of Chancery recently decided that a shareholder proposal that a company claimed conflicted

with its certificate of incorporation and with the DGCL could be presented by the shareholder at the company's annual meeting notwithstanding the company's claim that it could exclude the proposal on those grounds.<sup>9</sup> The Court stated that the company's legal position would be preserved and that the question of legality would become ripe for judicial review after the shareholder meeting if the required majority of shareholders adopted the shareholder proposal. The decision represents a novel compromise and may provide shareholders with proposals that could conflict with corporate documents or Delaware law with a tactical means to present the proposal over the company's objections even if it cannot be implemented until the Court decides on the merits at a later date. The fact that a shareholder would be permitted to present such a proposal at a shareholder meeting and that the vote on the proposal could, subject to a subsequent court decision, be binding on the company, will require companies to expend resources to persuade shareholders to vote against such proposals rather than simply excluding them.

To date, the vast majority of shareholder proposals of the type that could conflict with Delaware law or a company's constituent documents have been submitted under Rule 14a-8 and not through a separate shareholder proxy statement. There is no process under Rule 14a-8 to defer the determination of whether such proposals conflict with law. Separate shareholder proxy statements have been used predominantly to propose alternate director nominees. It remains to be seen whether this decision will lead to an increase in the number of proposals sought to be made by shareholders through a separate proxy statement on matters that the company might claim conflict with law or its governing documents. Such proposals could address, for example, governance (e.g. resolutions that may go beyond Delaware law in terms of how committees are formed, who may sit on them, etc.), oversight (imposing a higher standard than may otherwise be required under Delaware law) or conduct of business (seeking to prohibit certain business practices on environmental, moral or human rights grounds).

<sup>7</sup> *Bebchuk v. Electronic Arts, Inc.*, No. 08-cv-3716 (S.D.N.Y. Nov. 13, 2008).

<sup>8</sup> See our client alert, dated December 2008, titled "SDNY Decision Regarding Shareholder Access to Proxy Statements," available at [http://www.whitecase.com/alert\\_cmsecurities\\_sdny\\_decision\\_120908/](http://www.whitecase.com/alert_cmsecurities_sdny_decision_120908/).

<sup>9</sup> *Kistefos AS v. Trico Marine Services, Inc. et al*, Civil Action No. 4497-CC.

### New Section 112

New Section 112 permits a corporation to amend its bylaws to require the corporation to include in its proxy solicitation materials one or more individuals nominated by stockholders. Corporations are permitted to limit this ability through procedural requirements or additional conditions, including the following:

- **Ownership thresholds.** Corporations may require a minimum record or beneficial ownership or duration of ownership by the nominating stockholder, and define beneficial ownership to take into account options or other rights in respect of or related to such stock.
- **Information submission requirements.** Corporations may require that the nominating stockholder submit specified information concerning the stockholder and the stockholder's nominees, including information concerning ownership by such persons of shares of the corporation's capital stock, or options or other rights in respect of or related to such stock. It should be noted that this definition expressly permits the company to require disclosure of derivative or synthetic ownership provisions consistent with the bylaw amendments that many Delaware companies have recently adopted.
- **Limits on number or proportion of nominations and subsequent nominations.** Corporations may include a provision conditioning eligibility to require inclusion in the corporation's proxy solicitation materials upon the number or proportion of directors nominated by stockholders or whether the stockholder previously sought to require such inclusion.
- **Exclusion of stockholders owning or seeking a specified percentage of a corporation's shares.** Corporations may preclude nominations by any person if such person, any nominee of such person, or any affiliate or associate of such person or nominee, has acquired or publicly proposed to acquire shares constituting a specified percentage of the voting power of the corporation's outstanding voting stock within a specified period before the election of directors

- **Mandatory indemnification for false or misleading information or statement submitted by nominating stockholder.** Corporations may require that the nominating stockholder undertake to indemnify the corporation in respect of any loss arising as a result of any false or misleading information or statement submitted by the nominating stockholder in connection with a nomination.

In addition, Section 112 permits corporations to impose any other lawful conditions they deem necessary in establishing a framework for stockholder nominations to the board.

### New Section 113

New Section 113 overrides the limitation imposed in the CA, Inc. decision and permits a corporation to amend its bylaws to include mandatory reimbursement of expenses even in situations where fiduciary principles might preclude the board from permitting such reimbursement. New Section 113 does, however, allow corporations to place certain procedural requirements or additional conditions on reimbursements, including the following:

- **Conditioning reimbursement based on number or proportion of current and prior nominations.** Corporations may condition eligibility for reimbursement upon the number or proportion of persons nominated by the stockholder seeking reimbursement or whether such stockholder previously sought reimbursement for similar expenses;
- **Reimbursement limits.** Corporations may limit the amount of reimbursement based upon the proportion of votes cast in favor of one or more of the persons nominated by the stockholder seeking reimbursement, or upon the amount spent by the corporation in soliciting proxies in connection with the election; or
- **Limitations for cumulative voting elections.** Corporations may impose additional limitations concerning elections of directors by cumulative voting pursuant to Section 214 of the DGCL.

Bylaw amendments made pursuant to Section 113 will not apply to elections where the record date precedes such amendments.

As with Section 112, Section 113 permits corporations to impose any other lawful conditions deemed necessary in providing reimbursement of expenses to a stockholder for soliciting proxies in connection with electing directors to the board.

### Recommended Corporate Actions

There is no assurance as to whether the SEC will adopt a federal proxy access rule and, if it does so, the form such a rule might take. Nevertheless, the adoption of some sort of rule seems likely. The SEC will most likely take the approach of permitting shareholders to include in company proxy solicitation materials shareholder proposals seeking an amendment to the bylaws to permit proxy access (e.g., the approach currently on appeal to the Second Circuit by Professor Bebchuk). The SEC could simply mandate the inclusion of shareholder nominees in the company's proxy statement, but that approach would require the SEC to determine the appropriate thresholds and other ownership requirements for such nominations, and could result in conflicts with state laws.

Once the form and content of the SEC rules become more clear (or if Professor Bebchuk prevails in his appeal), boards of directors should consider on a case-by-case basis whether it is advisable to adopt on a preemptive basis a shareholder access bylaw. Many companies will likely wait to see if shareholders succeed in forcing the adoption of such amendments rather than adopting them voluntarily. Nevertheless, the voluntary adoption of a company-proposed shareholder access bylaw that incorporates conditions deemed appropriate by the board may be advisable for some companies in order to mitigate the risk of a less favorable shareholder access bylaw being forced on the company by shareholders. Such a company-proposed shareholder access bylaw could contain higher ownership thresholds, required holding periods and other limitations, such as a prohibition on acquisitions. The voluntary adoption of such a bylaw might also enable the company to exclude a competing shareholder proposal for proxy access under Rule 14a-8(i)(10) on the basis that the company has already substantially implemented the proposal.

Boards of directors should seek advice on these issues as further developments occur and as the 2010 proxy season approaches.

### New Restrictions on Narrowing of Indemnification and Advancement Rights of Officers, Directors, Employees and Agents

Section 145 of the DGCL provides the board of directors with broad discretion in establishing a corporation's policies with respect to the indemnification of and advancement of expenses for directors, officers, agents and other employees. Such policies may be contained in a corporation's certificate of incorporation or bylaws, and may be amended in accordance with the provisions of such documents. Although such provisions have been upheld frequently in Delaware courts, until last year Delaware case law was not clear on precisely when such rights to indemnification and the advancement of expenses become vested.

The Delaware courts addressed the issue directly last year in *Schoon v. Troy Corporation*,<sup>10</sup> where two directors—one current and one former—sought advancement of legal fees from Troy Corporation in connection with an action brought by Troy against the directors for breach of their fiduciary duties to Troy. Prior to the action, Troy had amended its bylaws to remove the word “former” from its definition of directors entitled to advancement. Troy argued that this would preclude the former director from being entitled to advancement of fees. In response, the former director argued that Troy could not unilaterally modify the bylaw provision because the advancement provision constituted a valid, binding contract and that the former director's rights in the advancement had vested when he first joined Troy as a director, prior to the amendment. The Chancery Court disagreed with the former director's assertion and upheld the bylaw amendment restricting the right to advancement of legal fees, finding that the director's right to advancement had not yet vested because it had not been triggered prior to the amendment. The Court clarified that such rights become “vested when the defendant's obligations [are] triggered. . . .”<sup>11</sup> The amendment was permissible because Troy had not yet sued the former director.

<sup>10</sup> 948 A.2d 1157 (Del. Ch. 2008).

<sup>11</sup> *Id.* at 1165.

In response to the *Schoon* decision, Section 145(f) of the DGCL has been amended to impose restrictions on a corporation's ability to modify the provisions in its bylaws granting indemnification and advancement rights to officers, directors, employees and/or agents. Although the court in *Schoon* noted that "indemnification and advancement are distinct types of legal rights," amended Section 145(f) addresses both types of provisions and in effect states that the right to indemnification or advancement vests upon "the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought." As a result, a right to indemnification or advancement of expenses cannot be eliminated or impaired after such rights have vested. Corporations can avoid this restriction, however, by amending their certificate of incorporation or bylaws to specifically permit elimination or impairment of such rights at any time. This would be effective so long as such language is in place at the time of the act or omission that gives rise to the right to indemnification or advancement of expenses.

#### Amendments to Facilitate E-Proxy

The current legislation also amends several other provisions of the DGCL to align the record dates under the DGCL with the e-proxy delivery system mandated under the Exchange Act. Amended Section 213(a) now allows corporations to separate the record date for determining the stockholders entitled to receive notice of a meeting from the record date for determining the stockholders entitled to vote at the meeting. Prior to these amendments, investors who purchased shares in

a corporation after the record date (for determining those entitled to vote) would not be entitled to vote at the stockholder meeting. Under Amended Section 213(a), corporations can separate the date for providing notice of the meeting from the date for determining those entitled to vote at the meeting, allowing the corporations to postpone the determination of those entitled to vote until the day of the meeting. The intention behind allowing corporations to move the record dates for determining eligibility to vote closer to the date of the meeting is to improve the link between ownership and voting rights.

The separation of the record dates is not mandated by the amendment, and corporations can continue to use the same date for both providing notice of the meeting and determining those entitled to vote at the meeting.

#### Amendments to Permit Judicial Removal of Certain Directors

New Section 225(c) of the DGCL allows the Delaware Court of Chancery, in a direct or derivative claim brought by or on behalf of a corporation, to remove from office directors who have been convicted of a felony in connection with their duties to the corporation or who have been deemed by a court of competent jurisdiction to have breached their duty of loyalty in connection with their duties. The court's ability to remove directors is limited to circumstances where: (i) the court determines that the directors did not act in good faith in performing the acts resulting in the prior conviction or judgment and (ii) judicial removal is necessary to avoid irreparable harm to the corporation.

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