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Delaware Supreme Court Rejects Bylaw Amendment Curtailing Term of Staggered Board of Directors

In a recent appellate decision entitled *Airgas, Inc. v. Air Products and Chemicals, Inc.* 2010 WL 4734305 (*Del Supr* 2010), the Delaware Supreme Court on November 23, 2010 reversed the decision of the Delaware Court of Chancery and held that a bylaw shortening the term of Airgas's Directors by eight months constituted a "de facto removal" that was inconsistent with Airgas's charter. Although the Delaware Supreme Court's decision resolved the ambiguity in the Airgas bylaws in a way that was consistent with Airgas' position, it is nevertheless advisable for corporations to ensure that their corporate organizational documents contain unambiguous language as to the length of the term of Directors on a staggered Board of Directors and the date of annual meetings.

Background

This case arises from a heated takeover contest between Airgas and one of its stockholders, Air Products. Air Products has made several proposals to acquire Airgas, none of which have been accepted by the Airgas Board of Directors. Airgas has a staggered nine member Board of Directors, with three Directors being elected at each annual stockholder meeting. At the September 15, 2010 annual meeting of Airgas, Air Products succeeded in electing three of its supporters to the Airgas Board. Air Products also proposed three amendments to the Airgas bylaws all of which were adopted at the September 15 annual meeting by a majority of votes cast (although not a majority of shares entitled to vote). The bylaw amendment at the center of this dispute advanced Airgas's annual meetings from August, which is within a month of when Airgas had always held its annual meeting, to January. This would cause the next annual meeting to occur in January 2011, four months after the previous meeting, and thus allow Air Products to hasten its takeover attempt by allowing it to elect another slate of three Directors at that time, giving it a majority of the Directors on the Board.

Airgas contended that this bylaw amendment was not validly adopted because it was not passed by a supermajority vote, as was required for any amendments that were inconsistent with Airgas's bylaw provisions relating to Director elections. Airgas argued that, since the amendment would shorten the term of any Director due for re-election at the 2011 annual meeting, the amendment was inconsistent with Article III of its bylaws. Article III covers the number of Directors, their election and terms in office and, in relevant part, states: "At each annual meeting of stockholders, the successors or the class of Directors whose term expires at the meeting shall be elected to hold office *for a term expiring at the annual meeting of stockholders held in the third year following the year of their election.*" [emphasis added] Airgas claimed that the bylaw amendment "impermissibly shortened" the terms of the Directors elected in 2008, and was inconsistent with Article III because those Directors



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up for re-election in 2011 would not be able to serve their full terms. Air Products, however, countered that the amendment only altered Article II of the Airgas bylaws, which relates to the annual meetings, and only required a simple majority vote to be adopted.

The Chancery Court's Decision

The Chancery Court rejected Airgas's argument and determined that the bylaw amendment proposed by Air Products was properly adopted at the September 15, 2010 annual meeting, did not conflict with Article III of Airgas's bylaws and was valid under Delaware law.

The Meaning of "Annual"

The Chancery Court focused on the ambiguous wording of the Article III provision quoted above determining the terms of Directors. Airgas argued that the provision called for Directors elected in 2008 to serve a term that would end at the annual meeting three full years after they were elected and that "annual meeting" meant that the meetings would be held one calendar year apart. Air Products, however, responded that, on its face, Article III stated that the term would expire at the annual meeting held in the third year after the election of the Directors, without mandating when in such third year the meeting should be held. The court noted that the wording of the Article III provision was open to several constructions that turned on the meanings of the words "annual" and "year" and that, in such a case, the court would look to the "common or ordinary meaning" of ambiguous terms. The court determined "annual" to mean "occurring or happening once a year." Thus, the court concluded that the annual meetings did not need to be separated by one year, so long as they occurred once per calendar year. Further, the court noted that Airgas did not include any definitions of "year" (such as calendar year or fiscal year) or "annual" in their governing documents that would indicate that they intended for the Directors to serve out a term of three full years, and that Airgas could have precisely provided appropriate language if it had such intentions. Since 2011 was the third year after the year of their election, the Directors elected in 2008, if up for re-election in January 2011, would serve their full term as mandated by the by-laws.

Validity Under Delaware Law

The court also held that the new annual meeting date in January was valid under Delaware law. The court noted that DGCL § 211 mandates that no more than 13 months could elapse between a corporation's annual meetings, but does not prescribe a minimum amount of time that must separate annual meetings. Since there is no statutory minimum duration between meetings, holding an annual meeting in January 2011, four months after the annual meeting on September 15, 2010, is valid under Delaware law.

The Supreme Court's Reversal

While the Delaware Supreme Court concurred that the language in Article III was facially ambiguous, it concluded that when a contract term had several reasonable interpretations, the consideration of extrinsic evidence was required to determine the drafting party's intent. In this case, the Supreme Court found that past precedents and common use of the language in question allowed them to definitively interpret the meaning of the Article III provision in dispute.

Delaware Precedent

The Supreme Court stated that the case law of the Court of Chancery and the US District Court for the District of Delaware (when applying Delaware law) had consistently interpreted similar staggered board provisions with three classes of Directors as providing that Directors on such boards each serve a three-year term.

Reliance on Industry Standard Practice

The Supreme Court also found that out of 89 *Fortune 500* corporations in Delaware with staggered boards, 58 used the same language in their bylaws as Article III of Airgas's bylaws. Of those 58 corporations, 83 percent (including Airgas) expressly represented in their proxy statements that their Directors would serve three-year terms. In addition, in corporations that had recently "de-staggered" their boards, 97 percent of corporations that used the same provision as Airgas represented in their proxy statements that Directors served three full-year terms. The Supreme Court concluded that this revealed an overwhelming practice that corporations with staggered boards that used language similar to Article III in their bylaws intended for Directors to serve three-year terms. Moreover, the Supreme Court also looked to the ABA's *Public Company Organizational Documents: Model Forms and Commentary* for guidance. The Model Forms contained a provision for a staggered board using the identical language found in Article III, and the commentary to that provision explicitly stated that this language intended for Directors in staggered boards to be elected for three-year terms.

Chancery Court's Ruling "Impermissibly Shortens" the Terms of Directors

In evaluating the Chancery Court's decision regarding the Airgas bylaw amendment, the Supreme Court cited *Essential Enterprises v. Automatic Steel Products, Inc.*, wherein a bylaw was adopted under which Directors' terms could be cut short by a vote of the majority of stockholders. In *Essential Enterprises*, the Chancery Court determined that, "the 'full term' visualized by [DGCL § 141(d)] is a period of three years – not up to three years,"

and that a by-law curtailing Directors' terms would "frustrate the plan and purpose behind the provision for staggered terms." The Supreme Court disagreed with the Chancery Court (which distinguished *Essential Enterprises* from *Airgas*) and found that the bylaw amendment proposed by Air Products would so extremely shorten the term of Airgas's Directors that it constituted a "de facto" removal and was not validly enacted under the Airgas charter, which requires a 67 percent vote to remove Directors. Thus, the Supreme Court found that the controversial bylaw amendment was inconsistent with Airgas's charter and reversed the Chancery Court's holding.

The Supreme Court went on to state that the requirement of a three-year term did not necessarily mean that a Director had to serve for precisely 36 months to fulfill the requirement. Since it was clear to the court that the four months between the two annual meetings which would have resulted if Air Products's by-law amendment had been allowed to stand, "so extremely truncates" the Directors' term that it was a de facto removal, the court did not need to define precisely the number of days or months that would satisfy the three-year term requirement.

Takeaways

Both the Chancery Court and the Delaware Supreme Court agreed that the Airgas staggered Board provision, which uses a common formulation of the length of a Director's term of office, is ambiguous on its face. Therefore, the most important lesson from *Airgas* is that it is preferable that corporate charters and bylaws contain unambiguous language regarding the length of time between annual meetings and the length of Directors' terms, although overly rigid provisions are not advisable. Additionally, it is important for a public company to be consistent in scheduling its annual meetings and precise in describing the length of Directors' terms in proxy statements and other public filings

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