HUNTON& WILLIAMS

MERGERS & ACQUISITIONS UPDATE

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Delaware Court Addresses Record Holders, Vote Buying and Bylaw Amendments

On February 9, 2010, the Delaware Court of Chancery issued an important decision in *Kurz v. Holbrook* that addresses several significant Delaware law issues. First, the court held that Depository Trust Company ("DTC") participant banks and brokers should be treated as record holders under Delaware law. Second, the court addressed the legalities of third-party "vote buying," making clear that Delaware courts will review any activity that threatens to disenfranchise stockholders generally. Third, the court invalidated a bylaw amendment that attempted to remove directors by reducing the size of the board.

Background

Kurz involved a consent solicitation for control of EMAK Worldwide, Inc. ("EMAK"). Take Back EMAK, LLC ("TBE"), an EMAK stockholder, solicited written consents to remove certain EMAK directors and to fill vacancies to obtain majority representation on the company's board of directors. In response, another EMAK stockholder, Crown EMAK Partners, LLC ("Crown"), solicited written consents to amend EMAK's bylaws to reduce the size of the board from five to three directors.[1]

Both consent solicitations were successful, but the inspector of elections invalidated TBE's consents for shares held in "street name" because no one obtained a DTC "omnibus proxy." The DTC omnibus proxy authorizes DTC's bank and broker participants to vote the shares held of record by DTC and establishes a chain of authority between DTC, as the record holder, and the banks or brokers, which then receive voting instructions from their customers, who are the beneficial owners. TBE brought suit challenging the Crown bylaw amendment and the inspector's determination, while the defendants sued TBE, challenging its purchase of "swing votes" that delivered a majority of consents to remove and replace the directors.

Validity of Consents

The court held that the "street name" consents solicited by TBE were valid despite the absence of the DTC omnibus proxy. It first explained that "DTC inevitably transfers voting authority to its participant member banks and brokers." Thus, specific evidence of proxy authority was not required. On an alternative basis, the court ruled that the DTC participant banks and brokers appearing on the DTC participant listing, known as the "Cede breakdown," should be considered "record holders" under Delaware law. As a result, the omnibus proxy was unnecessary because, for purposes of Section 219(c), a company's official stock ledger includes the persons named in the Cede breakdown.[2]

The court recognized that its decision was contrary to "[t]he established understanding among practitioners" that "DTC (through Cede) is the record holder and that everyone above DTC is a beneficial holder." But at the same time, it noted that Delaware courts have ordered the production of the Cede breakdown as part of the stock ledger when a stockholder requests a stockholder list under Section 220. The decision also conforms to federal law, which treats those banks and brokers as record holders. The court made clear, however, that its ruling only addressed the relationship between DTC and its participant banks and brokers and was not intended to affect the distinctions between record holders and beneficial owners, such as a typical broker-customer relationship.

The court's decision provides a detailed analysis of the complexities of the proxy voting system. From a corporate law perspective, the decision could affect the applicability of Delaware's anti-takeover and appraisal statutes, which turn, in part, on whether the company has more than 2,000 holders of record. Because *Kurz* increases the number

[1] As a preferred stockholder, Crown was entitled to nominate two of EMAK's directors but did not have the power to elect or remove the other members of EMAK's board. Thus, by reducing the number of authorized directorships to three, Crown would have secured majority representation on the board.

[2] Section 219(c) provides that "[t]he stock ledger shall be the only evidence as to who are the stockholders entitled by this section to examine the list required by this section or to vote in person or by proxy at any meeting of stockholders."

of record holders, it may cause more companies to be subject to the Section 203 anti-takeover statutes and decrease the number of transactions in which appraisal is available, though this is not likely to occur often.

Third-Party Vote Buying

The court held that TBE did not engage in improper vote buying when it purchased the voting and economic rights (but not actual ownership) to certain "swing" shares needed to pass its proposals. Vote buying has traditionally involved insiders' use of corporate funds and been subject to judicial scrutiny to guard against entrenchment motives. For example, in the 2008 decision of *Portnoy v. Cryo-Cell Int'l, Inc.*, the court reviewed allegations of vote buying by incumbent directors under the stringent entire fairness standard and ordered a new meeting. In contrast, vote buying by outsiders who use personal funds is an "underdeveloped area of [Delaware] law" and has received little attention.

The *Kurz* court held that Delaware courts will review insider and third-party vote buying that has the potential to disenfranchise stockholders, including attempts to manipulate a vote through derivative instruments. It identified several factors that it would consider in reviewing allegations of third-party vote buying, including whether (i) the buyer traded on inside information, (ii) the votes were procured by fraud or informational asymmetries or (iii) the vote buying "alters the voting pattern in a critical way," such as through "empty voting."[3] Based on those factors, the court ruled in favor of TBE. It found that, even though the shares were critical "swing votes," the seller was sophisticated and aware that his shares would likely affect the outcome of the consent solicitation. In addition, TBE had a "long" interest in EMAK and did not have any "competing economic or personal interests that might create an overall negative economic ownership in EMAK."

Bylaw Amendment

Finally, the court invalidated Crown's bylaw amendment to decrease the number of sitting directors. It held that a director's term can be shortened only by removal or the director's death or resignation. Thus, a bylaw that decreased the number of directorships prior to the end of the directors' terms at the company's next annual meeting was void. The court also noted that a bylaw that established director qualifications to disqualify a sitting director would be invalid for the same reasons.

The Court of Chancery's decision has been appealed to the Delaware Supreme Court.

If you have any questions about this update, please contact Gary Thompson at (804) 788-8787, Steven Haas at (804) 788-7217 or your Hunton & Williams LLP contact.

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[3] For more on empty voting and related issues, see this client alert.

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