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Delaware Supreme Court Addresses Vote Buying and Synthetic Ownership

In an important decision for proxy and takeover contests, the Delaware Supreme Court last week addressed significant questions of corporate “vote-buying” and stock ownership. *Crown Emak Partners v. Kurz*, No. 64, 2010 (April 21, 2010). (See our [Memo of February 12, 2010](#).)

In the course of a corporate control contest, the incumbent directors amended the company’s by-laws to reduce the size of the board, thereby mooted the insurgents’ attempt to elect new directors. During the same period, the insurgents purchased from a former corporate employee the right to vote just enough shares to secure a bare majority, as well as the future economic interest in those shares. Because the former employee was contractually prohibited from selling his shares until 2011, however, the parties left “bare legal title” in his hands. After the inspector of elections invalidated pro-insurgent votes cast by holders of shares held in street name (for want of an appropriate “universal proxy”), the insurgents sued, challenging the validity of the by-law and the invalidation of their votes. The incumbents, in turn, alleged that the share purchase amounted to impermissible vote-buying. The Court of Chancery ruled for the insurgents, holding that street name holders – the banks and brokers who appear on the “Cede breakdown” – are “stockholders of record” for purposes of deciding who has the right to vote or act by written consent under Delaware law. Chancery also ruled that the share transaction was not impermissible vote-buying and that the by-law amendment was impermissible under Delaware law.

The Delaware Supreme Court upheld Chancery’s ruling that the by-law amendment purporting to reduce the size of the board to fewer than the number of sitting directors was impermissible but declined to decide whether the Cede breakdown is part of the stock ledger, stating that Chancery’s holding in that regard should be considered non-binding. Most significantly, the Court reaffirmed the principle that corporate voting rights and economic interests should travel together under Delaware law. Starting with the observation that “[f]or many years, Delaware decisions have expressed consistent concerns about transactions that create a misalignment between the voting interest and economic interest of shares,” the Court held that “Chancery correctly concluded that there was no improper vote buying, because the economic interests and the voting interests of the shares remained aligned, since both sets of interests were transferred.” In reaching this conclusion, the Court endorsed recent scholarship by Professors Henry Hu and Bernard Black on what they have called “empty voting,” and the danger to corporate policy presented by the “uncoupling” of voting interests and economic interests.

The Supreme Court’s decision draws welcome attention to the question of hidden – often purposely hidden – share ownership. As we have previously written, non-traditional derivative and synthetic investment devices permit stockholders to uncouple voting power and economic interest, often without regulation or even disclosure to the marketplace, and with potentially significant consequences to the many corporate law doctrines premised on the coincidence of economic and voting interests. Market participants sometimes “borrow” millions of shares at record dates to influence elections, without any corresponding interest in corporate performance. At the same time, hedge funds, corporate raiders and activist investors deploy structured forms of “synthetic” equity ownership – total return swaps, hedges and other contractual arrangements – often for the purpose of acquiring large stakes in publicly traded companies free from disclosure or other obligations.

Such practices have thus far evaded necessary regulation at the state and federal level in the U.S (even as numerous non-U.S. jurisdictions have taken steps to require disclosure of synthetic ownership positions, and to include such ownership for public reporting, takeover code and other purposes). We continue to urge the SEC to undertake comprehensive regulatory reform that addresses derivative arrangements in a clear and uniform manner, generally treating all such arrangements that are coupled with direct or indirect ownership of actual shares by counterparties as equivalent to actual ownership, and requiring appropriate disclosure of all such arrangements involving more than 5% economic equivalent ownership, whether long or short, and whether or not accompanied by underlying ownership positions. In the meantime, the Delaware Supreme Court’s decision is an important reminder that devices designed to transfer economic interest without actual ownership, or to transfer votes without economic interest, may also be subject to question under state law.

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