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Delaware Court of Chancery Redefines the “Stock Ledger”
and Addresses Vote Buying and Board Contraction By-laws

In a recent decision involving dueling consent solicitations, the Delaware Court of Chancery cast welcome light on the “foggy” mechanics of proxy solicitations and offered guidance on “vote-buying” in corporate control contests. Kurz v. Holbrook, C.A. No. 5019-VCL (February 9, 2010).

The case involved a contest for control of EMAK Worldwide, a “deregistered, poorly-performing microcap corporation” with one large preferred stockholder and an otherwise “diffuse” stockholder body. An insurgent slate sought to remove two directors and elect replacements, thereby taking control of the company. The incumbent group sought to amend EMAK’s by-laws to reduce the size of the board, thereby effectuating the dismissal of certain sitting directors, mooted the insurgents’ attempt to elect new directors, and ensuring a majority position for the large preferred stockholder. After a hard-fought contest, the incumbent’s by-law provisions obtained a close majority of consents. A few days later, however, the insurgent slate secured a majority of consents as well, but only after insurgents purchased 150,000 shares needed to provide a bare 50.89% majority. But the inspector of elections then disallowed some 1,000,000 shares held in “street name” because they were not accompanied by a DTC “universal proxy,” thus maintaining the incumbent group majority. The insurgents sued, challenging both the validity of the by-law and the invalidation of their “street name” votes.

The court ruled in favor of the insurgents. Marking a clear and considered revision of established law, Vice Chancellor Laster held that “street name” holders — banks and brokers who appear on the DTC participant listing (or “Cede breakdown”) — are “stockholders of record” for purposes of determining which shareholders have the right to vote or act by written consent. Although dispensing with the need for a DTC “universal proxy” in this case, the Vice Chancellor took care to reaffirm the traditional distinction between record holders and beneficial holders. It remains Delaware law that only record holders can vote, but in ascertaining who those record holders are, companies must now look behind Cede & Co. to the participating banks and brokers on the Cede breakdown on the record date. As the decision demonstrates, the new rule may be decisive in a close consent solicitation contest, even if its impact in the average case may not be noticeable to those not directly involved in the plumbing of the voting system. And the decision indicates that Chancery will consider revising even long-standing rules that risk to disenfranchise stockholders. In all events, the scholarly opinion provides fascinating reading for those interested in the historical evolution and working of our arcane proxy system.

In another matter of first impression, the court invalidated the by-law amendment that purported to reduce the size of the board to fewer than the number of sitting directors, ruling that it is impermissible under the Delaware statute to “metaphorically pull[] [directors’] seats out from under them.” In similar vein, the court noted that a bylaw purporting to impose a requirement that would disqualify a sitting director and thereby terminate his service would be invalid under Delaware law.

The decision also rejected the incumbents’ claim that the insurgents had engaged in improper “vote buying.” Dismissing the view that Delaware law has no restrictions on vote buying by third parties, the Vice Chancellor expressed that Delaware law should not hesitate to provide a remedy where the decoupling of economic ownership of shares from their voting rights proves deleterious, particularly where there is fraud or disparity of information. But where, as in this case, the party buying the votes assumes the economic risks of ownership, the court will perceive no “legal wrong” just because the buyer is primarily interested in securing swing votes needed to win an election. The decision thus underscores the potential for creative campaigning, and the need for careful planning, in the context of a contested election for corporate control.

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