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SHAREHOLDER ENGAGEMENT

Rethinking Board and Shareholder Engagement in 2008

*By Ira M. Millstein, Holly J. Gregory
and Rebecca C. Grapsas*

In 2008, we predict—and encourage—increased efforts by boards of directors to engage shareholders in less contentious, more cooperative interaction and communication. We also encourage shareholders to consider how they, in turn, might foster more constructive relationships with corporate boards, including through consideration of the appropriate limits of shareholder power.

Shareholder activism has provided strong stimulus for rebalancing corporate power in the past twenty years. Beginning in the late 1980's and early 1990's and accelerating to the present, we have seen a continuing rebalancing of corporate power in the US from management to the board of directors and the shareholders. To the extent that this shift has brought governance practices more into line with the theoretical accountability of management to the board and of the board to the shareholders, it is a shift that is in the nature of a correction. This rebalancing has been assisted by a host of legislative, regulatory, listing rule and voluntary “best

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practice” reforms, many of which are still of fairly recent vintage with the full effect not yet wholly known.

We caution, however, that the forces for change should abate once an appropriate balance is achieved, or a new imbalance will result. We are not yet at the point of a new imbalance but one could result if we don’t give the multitude of reforms a chance to settle into effect. Activist shareholders—and the proxy advisors they often rely on—need to respect that the corporation, by law, is “managed by or under the direction of” the board. Indeed, this legal empowerment of the board goes hand in hand with the limited liability that shareholders enjoy.

The fundamental role of shareholders in corporate governance is to assure that the board of directors is composed of persons capable of “managing and directing” in the best interests of the company and its shareholders. Boards should expect continuing pressure from shareholders for “rights” designed to provide this assurance. Boards are well-advised to be open to shareholder communications on topics that bear on board quality and attention to shareholder value, communications that are likely to improve mutual understanding and avoid needless confrontation.

Gone are the days when shareholders can broadly claim that boards are inactive, inattentive, and intractable or captives of management. The new reality is that boards are already engaged in an unprecedented level of dialogue with shareholders, and many show real interest in finding ways to further such communication. Certainly, boards and managements have come a long way in recognizing that shareholders have a very legitimate interest in how the company is governed. The *quidpro quo* on the shareholder side is to act as concerned and rational owners who make decisions based on knowledge of the nuances; who avoid rigid, box-ticking methods of judging good governance; who don’t abdicate to proxy advisors their responsibility to use judgment; and who avoid activism for activism’s sake.

We are optimistic that good will and common sense will prevail, and cooperative efforts and dialogue between shareholders and boards will aid in reaching consensus about the following issues, all bearing on board quality:

Board composition and independent leadership. Shareholders have a legitimate interest in the make-up and leadership of the board to which control of the corporation is delegated. Yet in many respects the board is better positioned to ensure that the right mix of experience, expertise and independence is at hand. Enhancing opportunities for significant long-term shareholders to provide their views to the nominating and governance committee about desirable characteristics, potential candidates and favored leadership structures should help broaden the committee’s perspectives. Efforts to understand shareholder views and to communicate the board’s own views on these issues are consistent with, and may even be viewed as necessary in light of, the widespread adoption of majority voting, strong shareholder sentiment in favor of proxy access, the move to electronic proxies that reduce the cost of contested elections, and the pending New York Stock Exchange rule that would bar brokers from voting without customer instructions in even uncontested director elections.

Corporate performance disclosures. Shareholders have a legitimate interest in understanding what they own and how it is performing. They expect disclosure to accurately reflect the performance and condition of the company. Boards may wish to consider their own role in overseeing how the company communicates material developments to shareholders. Is the board satisfied that it is providing management with appropriate guidance in this area or is this an issue that is largely left to management, investment relations and the lawyers? Also, as advocated by the Aspen Principles (June 2007), boards should consider whether there is benefit to be had in foregoing quarterly earnings guidance and the pressures for short-term focus that it may well bring.

Executive performance, compensation and succession. Shareholders have a legitimate interest in information about the performance and compensation of the senior executive officers and the board’s efforts to create an incentive culture designed to promote performance. They also have a legitimate interest in issues relating to management succession. Shareholders’ interests in these matters relate to their ability to make informed buy/sell/hold decisions as well as informed decisions in voting for the fiduciaries that represent them. Shareholders are not well-positioned to make these decisions themselves, and enabling second-guessing is not the

role of disclosure. Transparency of compensation and the processes followed to decide compensation (including any conflicts with respect to compensation consultants) should allow shareholders to make a judgment about whether compensation is principled, straightforward, and rational in relation to performance so that shareholders may make educated decisions in board elections and as relates to their investment. Improved communication and dialogue with significant long-term shareholders about executive compensation may provide compensation committees with a broader perspective and balance in relation to the views provided by management. It may also lessen the push for an advisory vote on executive compensation (say on pay).

Strategic direction. Shareholders have a legitimate interest in understanding the strategic direction of the company. Boards and managements have considerable interest in ensuring that their shareholder base—and especially significant long-term shareholders—can evaluate whether corporate direction is aligned with their investment priorities. Efforts to improve communication about strategy are particularly important in relation to (i) long-term strategies that involve disproportionately higher costs over the short-term, such as investments in R&D, and (ii) major transactions that require shareholder action.

Societal concerns, including climate change and other issues. Shareholders have legitimate interests in information about corporate policies and practices with respect to social and environmental issues such as climate change, sustainability, labor relations and political contributions. These issues, many of which do not fall neatly within a line item disclosure requirement, bear on the company's reputation as a good corporate citizen and consequently, the perceived integrity of management and the board.

Reaching out to shareholders in a concerted fashion will not appeal to every board. However, it is likely to be a prudent approach for companies seeking to avoid confrontation. Setting a positive and constructive tone in shareholder relations not only has the potential to elicit for the board useful insights about shareholder perspectives but also may encourage shareholders to focus on long-term performance and act as owners making rational investment decisions.

More broadly, it may be time for a dialogue on the limits of shareholder power. Where is the legitimate boundary? Long ago owners gave up rights to control the joint stock company in return for limited liability—and directors took on the fiduciary liability. If shareholders insist on ever-greater say in corporate decision-making, at what point do we need to rethink director liability? We may well miss the opportunity to achieve lasting balance in the corporate power structure if shareholders fail to recognize and respect that there are limits on the issues that are appropriate for shareholder initiatives—limits that are in keeping with both the duty of the board to direct and manage the affairs of the corporation and the limited liability that has been granted to shareholders.

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Who Gets a “Say on Pay”?

By Cynthia M. Krus and Lisa A. Morgan

Shareholder proposals calling for advisory votes on executive compensation, or “say on pay” proposals, were one of the most popular shareholder proposals made during the 2007 proxy season.¹ These non-binding proposals were included in the proxy materials of over 50 companies in 2007 and received a majority of votes cast at Motorola, Verizon Communications, Blockbuster, Clear Channel, Valero Energy, Ingersoll-Rand and Activision.² In addition, Aflac and Verizon Communications have agreed to hold an annual advisory vote on executive compensation beginning in 2008 and 2009, respectively, and Par Pharmaceuticals and RiskMetrics Group recently announced they will also hold an annual advisory vote. With more than 90 say on pay proposals already submitted to companies this proxy season, say on pay is quickly becoming one of the hottest topics in corporate governance.³

What is a “Say on Pay” Proposal?

A “say on pay” proposal is a non-binding proposal submitted by a shareholder to be included in a company’s proxy materials that calls for an annual shareholder advisory vote on a company’s executive compensation policies and practices. Such a vote would permit the shareholders to give the company an annual “thumbs up” or “thumbs down” vote on the company’s executive compensation policies and practices as set forth in the company’s proxy materials.

The recent push to require companies to provide shareholders with an advisory vote on executive compensation is the result of the relative success of a similar movement in the United Kingdom, Australia, the Netherlands, Norway and Sweden. The advisory vote initiative originated in the United Kingdom and became mandatory for all companies listed on the London Stock Exchange beginning in 2003. Since that time, there has been only one instance of a negative shareholder vote on pay, the result of an advisory vote at GlaxoSmithKline in 2003.⁴ One reason for the fact that there has been only one negative vote is that UK companies now

ensure that their pay package meet certain standards with several services before they put the package up for a vote by shareholders. In other words, their pay arrangements are essentially pre-cleared. A study of the 100 largest British companies reports that the annual advisory vote has checked rising executive pay slightly.⁵

To date, say on pay proposals submitted to US public companies have been structured in a variety of ways. The following say on pay proposal, submitted by several institutional and individual investors this proxy season, is an example of a type that many companies have encountered this proxy season:

RESOLVED, that shareholders of [Company Name] request the board of directors to adopt a policy that provides shareholders the opportunity at each annual shareholder meeting to vote on an advisory resolution, proposed by management, to ratify the compensation of the named executive officers (NEOs) set forth in the proxy statement’s Summary Compensation Table (the SCT) and the accompanying narrative disclosure of material factors provided to understand the SCT (but not the Compensation Discussion and Analysis). The proposal submitted to shareholders should make clear that the vote is non-binding and would not affect any compensation paid or awarded to any NEO.⁶

Although this proposal is the most widely disseminated this proxy season, companies may also encounter advisory votes requesting a vote on other portions of a company’s executive compensation disclosure this proxy season, including: (i) the Summary Compensation Table; (ii) the Compensation Discussion and Analysis (CD&A); and (iii) the CD&A and the Compensation Committee Report.

Last year, the Securities and Exchange Commission (the SEC) received several requests for no-action determinations from companies that intended to exclude say on pay proposals from their proxy materials in reliance on one of several bases for exclusion set forth in Rule 14a-8. The staff of the Division of Corporation Finance (the Staff) consistently denied no-action relief to companies, including, among others, Blockbuster, Verizon

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Communications and Wal-Mart Stores, where the say on pay proposal was substantially similar to the sample proposal set forth above.⁷ However, the Staff did permit companies to exclude say on pay proposals where the proposals sought advisory votes *solely* on the Compensation Committee Report in reliance on Rule 14a-8(i)(3).⁸ The grounds for exclusion in reliance on Rule 14a-8(i)(3) were based on the technicality that the proposals were materially misleading as a result of the fact that the information required to be disclosed in Compensation Committee Report had changed and the substantive information was now included in the CD&A.

Given the large number of say on pay proposals submitted to companies during this proxy season, it is likely the Staff has already received numerous letters requesting no-action determinations with respect to a variety of say on pay proposals. To date, the Staff has not issued any no-action letters regarding determinations under Rule 14a-8 with respect to say on pay proposals submitted to companies this proxy season.

Why Now?

The increase in the number of say on pay proposals over the past year can be attributed to the relative success of say on pay proposals during the 2007 proxy season as well as continued anger by shareholders over CEO pay levels, particularly “pay-for non-performance.” For example, the pay packages received by executive officers such as Robert Nardelli, the former chief executive officer of Home Depot, and Hank McKinnell, the former chief executive officer of Pfizer have been widely criticized. As a result of the increased scrutiny from shareholder activists and the media, executive compensation has also come to the attention of Congress as well as governmental agencies such as the SEC.

As part of its ongoing investigation into executive compensation practices of public companies, the Oversight and Government Reform Committee of the House of Representatives, chaired by Representative Henry Waxman, requested that Countrywide Financial, Citigroup and Merrill Lynch, three companies involved in the subprime mortgage crisis, each provide documentation relevant to the compensation of its chief executive officers.⁹ The Committee invited the chairs of the compensation committees at these companies to testify regarding the manner in which the

compensation and severance packages for these executives were determined and on what basis they were approved. This inquiry is part of an ongoing investigation by the Oversight and Government Reform Committee into the role played by compensation consultants at large public companies in setting executive compensation.

The increased popularity of say on pay proposals this proxy season can also be attributed to the SEC’s criticism of compliance with the SEC’s new executive compensation disclosure rules.¹⁰ The 2007 proxy season was the first proxy season in which the majority of companies were required to comply with the SEC’s new executive compensation disclosure rules. Following the conclusion of the 2007 proxy season, the SEC’s Division of Corporation Finance (the Division) issued a report regarding its initial review of the executive compensation and related disclosure of 350 public companies.¹¹ The Division commented, among other things, that the CD&A needs to focus on *how* and *why* a company arrives at specific executive compensation decisions and policies.¹²

The SEC has been very vocal about how dissatisfied it was with the executive compensation disclosure companies provided in their 2007 proxy materials. In a speech providing guidance on the SEC’s expectations for CD&As, John White, Director of the Division, noted that, “Far too often, meaningful analysis is missing—this is the biggest shortcoming of the first year disclosures. Stated simply—Where’s the analysis?”¹³ According to a recent article in the Wall Street Journal, the SEC is “unhappy with answers on executive pay.”¹⁴ Citing a general lack of analysis, the SEC announced that it has only completed its review of the executive compensation disclosure of 26 of the original 350 public companies selected for review during the 2007 proxy season.¹⁵

Who are the Proponents?

A variety of investors and shareholder activists, including, among others, the American Federation of State, County, and Municipal Employees, the New York City Employees’ Retirement System, the AFL-CIO, the Connecticut Retirement Plans and Trust Funds and Walden Asset Management, have submitted say on pay proposals at companies where they believe pay has been excessive or where they believe there has been a misalignment between pay and performance over the past several years.¹⁶ In fact, investors, shareholder activists and public

companies have also created a working group to focus on the advisory vote initiative.

In addition to investors and shareholder activists, Congress is also taking a leading role in the advisory vote initiative. Both the House and Senate received bills regarding amendments to the Securities Exchange Act of 1934 (the Exchange Act) to give shareholders an advisory vote on executive compensation. The House bill, HR 1257, the Shareholder Vote on Executive Compensation Act, amends the Exchange Act to give shareholders an advisory vote on executive compensation.¹⁷ This bill was sponsored by Democratic Representative Barney Frank and was introduced in the House on March 1, 2007. It requires companies to include a non-binding shareholder advisory vote both on executive pay plans and on any new golden parachute compensation in their annual proxy statements. The House bill passed on a 269 to 134 vote in the House on April 20, 2007. The Senate's companion bill to HR 1257, S. 1181, was introduced in the Senate on April 20, 2007 by Democratic Senator Barack Obama.¹⁸ Like HR 1257, this bill requires companies to include in their proxy statements a non-binding advisory shareholder vote on executive pay plans and new golden parachute compensation. At present, S. 1181 has been read twice and has been referred to the Committee on Banking, Housing, and Urban Affairs.

State legislatures have also jumped into the debate regarding say on pay. In the spring of 2007, North Dakota adopted a shareholder friendly corporate law.¹⁹ The new law provides for a governance structure for publicly-traded companies that gives shareholders greater rights than they currently have under other state laws. The law addresses several of the hot topics in corporate governance, including majority voting in director elections, advisory votes on executive compensation, separation of the roles of chairman of the board and chief executive officer, reimbursement for successful proxy contests and the ability for five percent shareholders who have held their shares for at least two years to include director nominees in the company's proxy statement.

What is the Benefit?

Proponents of say on pay proposals claim that implementing an advisory vote on executive compensation will incentivize public companies to think

about *how* and *why* they arrived at specific executive compensation decisions and, in turn, create better disclosure. In particular, some proponents argue that the potential for public censure regarding excessive executive compensation packages will lead directors to restrain excessive executive compensation in response to shareholder sentiment and more directly link pay with performance.

Other proponents claim that say on pay proposals will affect executive compensation levels in more indirect ways. For instance, say on pay proposals would promote dialogue with and feedback from shareholders. Also, these proposals would give shareholders a sense of empowerment without binding the company to anything. Furthermore, compensation committees might be able to use advisory votes to their advantage, as a way to provide cover for the committee and the board as a whole when negotiating compensation with managers.

Finally, opponents also point out that shareholders of companies listed on the New York Stock Exchange already get a say on pay because they must approve equity plans—and equity grants are the bulk of executive pay these days.

What is the Danger?

Opponents of say on pay proposals claim that an advisory vote on executive compensation will be ineffective, costly and confusing. They believe that say on pay proposals are ineffective because a simple “thumbs-up” or “thumbs-down” vote on executive compensation gives management little information about the specific components of executive compensation to which shareholders object. Opponents argue that such an advisory vote is unnecessary and confusing because shareholders are already receiving detailed information on executive compensation as a result of the SEC's new executive compensation disclosure rules.

Opponents also claim that an advisory vote will be costly because it will require companies to spend a significant amount of time engaged with various corporate governance activists and proxy advisory firms each year explaining their executive compensation practices and determinations in order to ensure that the advisory vote is in their favor. Finally, opponents fear that activist groups that support say on pay proposals might use advisory

votes as an inroads to promote their own social or political agendas that are not related to the company's economic growth.

What Happens Next?

Say on pay proposals have gained momentum and have emerged as one of the hottest corporate governance topics of the 2008 proxy season. With at least 90 say on pay proposals already submitted by over 70 institutional and individual investors this proxy season, compared to 44 such resolutions at this time last year, the majority of the largest public companies in the United States will likely encounter a say on pay proposal this proxy season. Even those companies that do not receive a proposal are likely to encounter increasing amounts of pressure to voluntarily put such an advisory vote before shareholders.

At this time, it is unclear what the 2008 proxy season will mean for the future of the advisory vote initiative. With the say on pay legislation stalled in the Senate, it appears that the future success of the advisory vote initiative is likely to be shaped by the efforts of the proponents of say on pay proposals, the decisions reached by the SEC under Rule 14a-8 and the actions of public companies. Proponents of say on pay proposals are hopeful that the advisory vote initiative will follow the same path as the majority voting initiative where many companies preempted shareholder activists and moved to voluntary adoption.

Notes

1. Shareholder proposals seeking advisory votes on executive compensation averaged 41.7 percent support at 41 meetings during the 2007 proxy season. See RiskMetrics Group, *2007 Postseason Report: A Closer Look at Accountability and Engagement*, (Oct. 16, 2008) http://www.riskmetrics.com/webcasts/2007proxy_season_review/ (last visited Feb. 5, 2008).
2. See LawyerLinks, LLC, "Say on Pay" Proposals, <http://content.lawyerlinks.com/> (last visited February 1, 2008); RiskMetrics Group, *2007 Postseason Report: A Closer Look at Accountability and Engagement*, (Oct. 2007) http://www.riskmetrics.com/webcasts/2007proxy_season_review/ (last visited Feb. 5, 2008).
3. See AFSCME press release, Institutional Investors Continue to Press Companies for Advisory Vote on Executive Compensation, <http://www.afscme.org/press/17494.cfm> (last visited Feb. 5, 2008).

4. L. Reed Walton, *Pay Vote Bill Clears House Panel*, Governance Weekly, http://www.issproxy.com/governance_weekly/2007/012.html (last visited Feb. 5, 2008).
5. L. Reed Walton, *Will Other Firms Follow Aflac?*, Institutional Shareholder Services Corporate Governance Blog, http://blog.issproxy.com/2007/02/will_other_firms_follow_aflacs.html (last visited Feb. 5, 2008).
6. See AFSCME press release, Institutional Investors Continue to Press Companies for Advisory Vote on Executive Compensation, <http://www.afscme.org/press/17494.cfm> (last visited Feb. 5, 2008).
7. See Wal-Mart Stores (pub. avail. Mar. 21, 2007); Blockbuster Inc. (pub. avail. Mar. 12, 2007); Verizon Communications, Inc. (pub. avail. Feb. 19, 2007). See also Jones Apparel Group, Inc. (pub. avail. Mar. 28, 2007); Affiliated Computer Services (pub. avail. Mar. 27, 2007); Northrup Grumman (pub. avail. Feb. 14, 2007).
8. See PG&E Corporation (pub. Avail. Jan. 30, 2007); Entergy Corp. (pub. avail. Feb. 14, 2007); Safeway Inc. (pub. avail. Feb. 14, 2007); Citigroup, Inc. (pub. avail. Jan. 31, 2007); Johnson & Johnson (pub. avail. Jan. 31, 2007).
9. See Committee on Oversight and Government Reform, *Oversight Committee to Examine Mortgage CEO Severance Packages*, <http://oversight.house.gov/story.asp?ID=1682> (last visited Feb. 5, 2008); See generally Committee on Oversight and Government Reform, <http://oversight.house.gov/story.asp?ID=1691> (last visited Feb. 5, 2008).
10. SEC Release No. 33-8732A, Executive Compensation and Related Person Disclosure, August 29, 2006.
11. See Staff Observations in Review of Executive Compensation and Related Person Disclosure, <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm> (last visited Feb. 5, 2008).
12. See also John W. White, Director of the Division of Corporation Finance, *Keeping the Promises of Leadership and Teamwork: The 2007 Proxy Season and Executive Compensation Disclosures*, Address at the 27th Annual Ray Garrett Jr. Corporate and Securities Law Institute (May 3, 2007), <http://www.sec.gov/news/speech/2007/spch050307jww.htm> (last visited Feb. 5, 2008).
13. John W. White, Director of the Division of Corporation Finance, *Where's the Analysis?*, Address at The 2nd Annual Proxy Disclosure Conference (Oct. 9, 2007), <http://www.sec.gov/news/speech/2007/spch100907jww.htm> (last visited Feb. 5, 2008).
14. Scannell, Kara and Lublin, Joann, *SEC Unhappy With Answers on Executive Pay* (Jan. 29, 2008), <http://online.wsj.com/article/SB120156732373223843.html>.
15. *Id.*
16. See AFSCME press release, *Institutional Investors Continue to Press Companies for Advisory Vote on Executive Compensation*, <http://www.afscme.org/press/17494.cfm> (last visited Feb. 5, 2008) (listing the names of approximately 70 institutional and individual investors that have submitted say on pay resolutions this proxy season).
17. H.R. 1257, 110th Cong. (2007).
18. S. 1181, 110th Cong. (2007).
19. N.D. Cent. Code. § 10-35 (2007).

The Governance of Ownership: A Practices Report

By Annalisa Barrett

Most people would agree that one set of governance practices is not appropriate for all companies. Indeed, the most effective governance structure for a given company depends on a variety of factors, including the size and ownership structure of the company. Comparisons between categories of company size and ownership structure can be an informative way to examine governance practices. A recent study conducted by The Corporate Library entitled “2007 Governance Practices Report” examines the governance practices currently in place at over 3,000 large US public companies and provides such comparisons. Chart one illustrates a few of the comparative findings from the report.

The companies in the study are broken down into three common categories of market capitalization for the analysis by company size: SmallCap, MidCap and LargeCap. For the analysis of ownership structure, the following categories are used:

Concentrated Ownership Models:

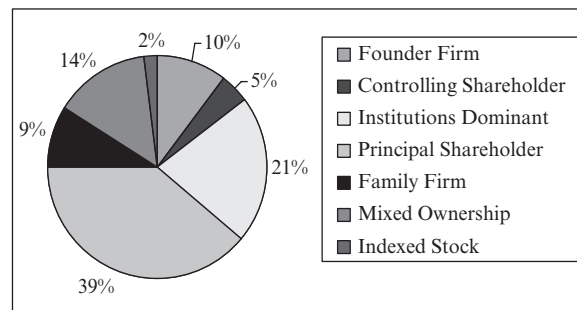
- **Principal Shareholder Firm**—A company where one or more shareholders own at least 10 percent of the outstanding shares.
- **Controlling Shareholder Firm**—A company where a single shareholder or shareholding block (but not a family or employee block) controls more than 50 percent of the outstanding shares.
- **Founder Firm**—A company where the CEO or Chair is both a founder and a principal shareholder.
- **Family Firm**—A company where family ties, most often going back a generation or two to a founder, play a key role in both ownership and board membership.

Annalisa Barrett is a Senior Research Associate of The Corporate Library. This article summarizes some of the findings from the “2007 Governance Practices Report,” a complete report is available to subscribers of The Corporate Library’s Board Analyst database or for purchase separately at www.thecorporatelibrary.com.

Dispersed Ownership Models:

- **Mixed Ownership**—Those companies which represent a balanced mix of individual and institutional owners.
- **Indexed Stock**—A company where no shareholder owns more than 1 percent to 1.5 percent of the outstanding shares.
- **Institutions Dominant**—A company where institutional owners, mainly pension or mutual funds, dominate the holdings, but no one institution controls more than 10 percent of the outstanding shares.

Chart 1: Ownership 2007



Source: The Corporate Library

Takeover Defenses

While takeover defenses can take many forms, involving varying degrees of complexity, the common theme is that they strengthen the board’s say over whether control of the company should be changed, and impair the shareholders’ ability to bring about such change against the board’s wishes. The classified board and the poison pill are comparisons of prevalence of two types of takeover defenses.

Classified Boards—A classified board—where directors are divided into classes and stand for re-election on a staggered schedule—acts as a takeover defense because a hostile bidder cannot change control of the board in a single election, but rather must wait through two elections.

SmallCap and MidCap companies are more likely to have classified boards than are LargeCap companies. In fact, 56 percent of the SmallCaps and 58 percent of the MidCaps studied have classified boards, while only 48 percent of the LargeCap companies have classified boards. This is consistent with other research conducted by *The Corporate Library* which found that larger companies seem to be leading the trend towards board declassification.

It is more common for companies with a Dispersed Ownership model to have a classified board. This is most likely the case because Concentrated Ownership, in and of itself, can function as a takeover defense. The study found that 58 percent of the Dispersed Ownership companies have classified boards, while 52 percent of the Concentrated Ownership companies have classified boards.

Poison Pills—A shareholder rights plan, or poison pill, increases the voting rights of shareholders—but not those of a hostile bidder—if the bidder acquires a threshold amount of the company’s stock. This practice dilutes the bidder’s holdings and makes it prohibitively expensive for the bidder to complete the acquisition.

When the prevalence of poison pills is analyzed among the three size categories, it is revealed that MidCap companies are most likely to have poison pills; 38 percent of the MidCap companies studied have poison pills. SmallCaps are least likely to have poison pills—only 31 percent of the SmallCaps studied currently have a poison pill in place. Thirty-five percent of the LargeCap companies studied have a poison pill.

Poison pills are more commonly found among Dispersed Ownership companies. The study found that 40 percent of Dispersed Ownership companies have poison pills in place, while only 30 percent of companies with Concentrated Ownership have poison pills.

The findings regarding the scarcity of poison pills, especially among SmallCap companies, must be analyzed taking into account the fact that any company where the charter authorizes “blank check preferred stock”—a class of preferred stock whose features can be set by the board without further shareholder involvement—has a “shadow pill,”¹ meaning that the board can adopt a pill quickly in response to a perceived threat. Put another way,

companies whose boards have adopted poison pills do not stand on dramatically different footing from companies without pills whose boards can adopt one on a moment’s notice. It is possible, then, that having adopted a pill serves as some sort of a signaling function.

Moreover, a company can appear more shareholder-friendly by redeeming its poison pill without actually impairing the board’s ability to adopt another pill in the future. Shareholder proposals on poison pills routinely receive majority support and boards fear “directors withhold” recommendations from the proxy advisory services if they do not implement majority-supported proposals. Because most pill proposals focus on pill redemption or require simply that the board seek shareholder approval before adopting another pill—not that the board adopt a formal governance policy promising to do so—redeeming the pill generally counts as implementation of the proposal.

Board Composition & Practices

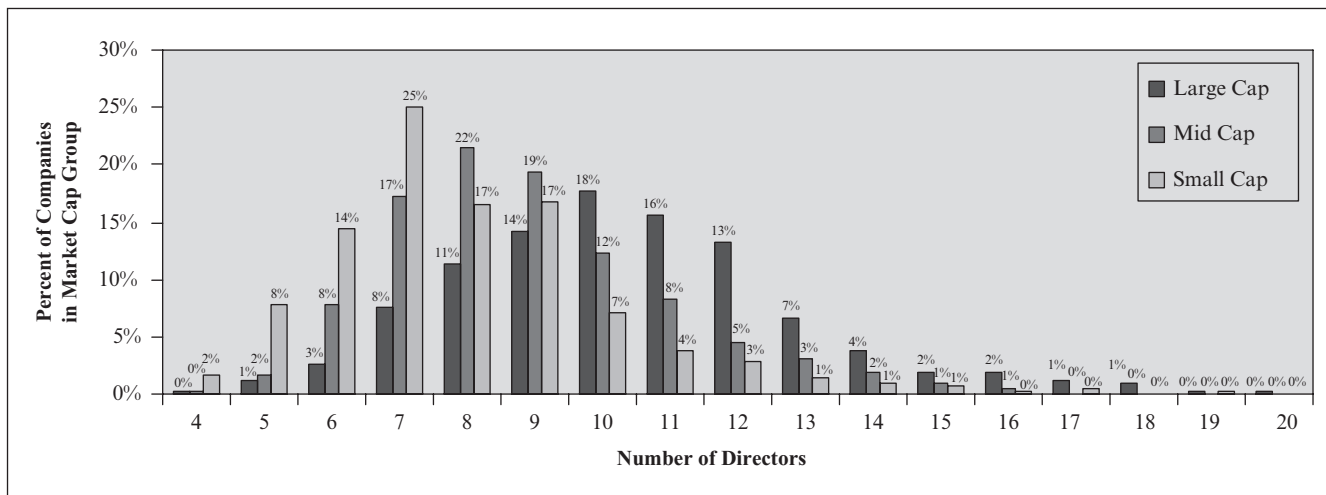
Board size, leadership and gender balance among board members are among the many aspects of board practices included in the study. As with other governance practices, there is no “right answer” applicable to all companies on these issues; however, there are patterns that emerge when comparing between size or ownership structure categories.

Board Size—Not surprisingly, the study finds that board size differs by company size, as shown in chart 2. It is much more common for a SmallCap company to have fewer than ten directors while LargeCap companies are more likely to have ten or more directors.

Gender Diversity—When it comes to gender balance among board members, companies with Concentrated Ownership are more likely to have no female directors serving on the board. At Concentrated Ownership companies, 46 percent of the boards are all male, while at Dispersed Ownership companies 34 percent of the companies have an all-male board.

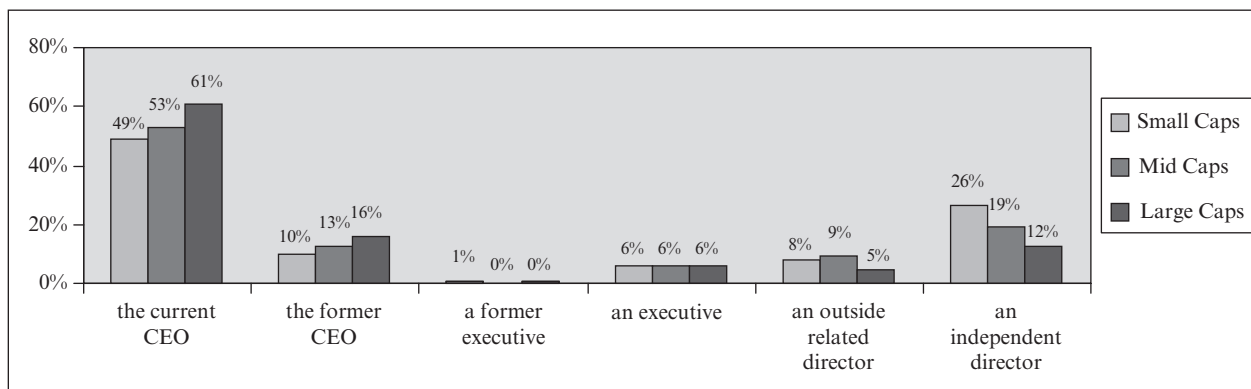
Separation of CEO and Chair—The focus on board independence in recent years has led many boards to separate the role of CEO and Chair of the Board and name an independent director

Chart 2: Board Size By Market Cap 2007



Source: The Corporate Library

Chart 3: Chairman of the Board's Relationship with the Company By Market Cap 2007

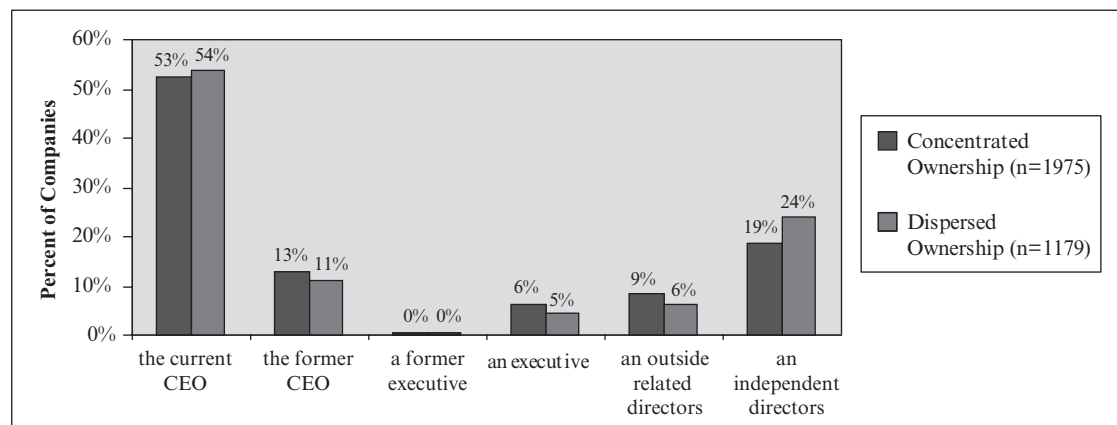


Source: The Corporate Library

to the role of Chair. Interestingly, it is less common for SmallCap companies to have the roles of CEO and Board Chair combined. In fact, less than half (49 percent) of the SmallCap companies studied have combined the two roles, while 53 percent of the MidCap companies and 61 percent of the LargeCap companies have combined the role. Additionally, it is more common for SmallCap companies to have a truly independent director in the role of Chair of the Board as shown in chart 3. Dispersed Ownership companies are more likely than Concentrated Ownership companies to have an independent director serving as Chair of the Board as illustrated in Chart 4.

The reasons for these company size trends are not clear. One explanation may be that SmallCap companies are more likely to have representatives from their financiers serving in board leadership roles who hire separate CEOs to manage day-to-day operations and strategy execution—leading to different people serving in the roles of CEO and Chair of the Board. Also, it has been argued that recruiting a CEO for a large US company is difficult without also offering the candidate the title of Board Chair as well. While this is a questionable rationale—in our opinion—for combining the two positions, it may help to explain the prevalence of LargeCap companies which have done so.

Chart 4: Chairman of the Board's Relationship with the Company By Ownership Structure 2007



Source: The Corporate Library

Lead Directors—Another trend in board leadership is the designation of a lead director, who is often tasked with serving as a liaison between the independent directors and the CEO and/or Chair of the Board. Specifically, this includes chairing the meetings of the independent directors, ensuring that the appropriate information is shared with the independent directors and that the voice of independent directors is heard when it comes to board meeting agenda and other issues. In the study, a board is designated as having a lead director if the company discloses the name of a single person who serves in this role. For example, companies which state that the chairs of the board committees rotate in the role of lead director were not included, nor were companies where a person is designated as a lead director due to service as the chair of a specific committee.

Companies with dispersed ownership are more likely to name a lead director. In fact, 35 percent of the Dispersed Ownership companies have named a lead director while only 31 percent of the Concentrated Ownership companies have one.

Executive Sessions—One of the most effective changes to board practices in the last decade has been the consistent use of executive sessions, where the independent members of the board meet

without any inside directors present. Interestingly, this practice is more common among companies with dispersed ownership; 85 percent of the Dispersed Ownership companies in the study reported holding executive sessions in their most recent proxy statement, while only 79 percent of the Concentrated Ownership companies did so.

Conclusion

Comparisons by company size and ownership structure provide meaningful insights into the governance practices currently in place at US companies. Other comparisons can also be useful, such as comparing trends over time and examining trends among companies with certain governance features (e.g., are companies lead directors more likely to hold executive sessions?). Many of these issues are addressed in the study described in this article. Of course, each analysis sparks ideas for new comparisons and further research.

Notes

1. Harvard Professor John C. Coates IV deserves credit for this concept. See, e.g., John C. Coates IV, "Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence," 79 Texas L. Rev. 271 (2000).

Federal vs. State Law: The SEC's New Ability to Certify Questions to the Delaware Supreme Court

By *J.W. Verret*

In the summer of 2007, the Delaware legislature amended the Delaware Constitution to permit the Securities and Exchange Commission to certify questions of law directly to the Delaware Supreme Court.¹ This ability to provide advisory opinions, if utilized by the SEC, is poised to enhance Delaware's dominance as the state of incorporation for publicly traded corporations. The SEC has not announced it has initiated any rule specifying an official procedure to certify questions of law to the Delaware Supreme Court. Thus, in the event of an internal controversy, one wonders whether a letter from the SEC General Counsel or Director of the Division of Corporation Finance would be sufficient, or whether it must be signed by a majority of the Commissioners. Nevertheless, barring such internal dissent, this development adds a fascinating chapter to the symbiotic, though at times rival, relationship between the SEC and Delaware as the primary sources of American Corporate Law.²

The primary mode through which Delaware corporation law interacts directly with the securities laws arises when shareholders attempt to place bylaws onto the corporate ballot. Under the DGCL, the bylaws of a corporation may contain any provision not in conflict with the DGCL, and may be adopted by the shareholders, or, if given the power to do so in the corporate charter, the board of directors.³ Rule 14a-8(i)(2) permits the exclusion of a stockholder proposal if it would, "if implemented, cause the company to violate any state, federal, or foreign law to which it is subject."⁴ Delaware law on the legality of proposed bylaws is, however, somewhat unclear when it comes to whether proposed bylaws are in conflict with the DGCL.⁵

It is uncertain, for instance, whether a bylaw proposal purporting to remove board authority to alter or amend that bylaw would be legal under Delaware law. Though unclear, directors may have the authority to unilaterally eliminate bylaws not otherwise

protected by the DGCL.⁶ Some commentators have argued that 109(a) requires at least some shareholder bylaws be protected from board amendment⁷, some argue that such a provision would be highly suspect.⁸ One recommendation is to simply require unanimous board approval of amendments to shareholder bylaws, in the hopes that at least one independent director might holdout.⁹

In any case involving the legitimacy of a bylaw, boards are also likely to make a more general argument in reliance on DGCL 141, which specifies that "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."¹⁰ Thus, they will argue that a bylaw at issue is in conflict with this general grant of authority to the board. One useful analysis is that the types of bylaws which would withstand such a challenge would be bolstered by four key characteristics: (i) a bylaw relates to fundamental changes in the structure of the corporation rather than day to day business decisions; (ii) it constrains board action rather than requiring affirmative action; (iii) it relates to procedural rather than substantive decisions; and (iv) it relates to a re-allocation of corporate governance relationships rather than business strategy.¹¹

The standard method to support an assertion of illegality for the purposes of 14a-8 was traditionally to secure an opinion from a Delaware corporate lawyer reasoning that a particular bylaw was not permitted and then seek exclusion by way of no-action relief from the SEC¹², but there was no facility for the SEC to communicate directly with the Delaware courts. In 2006, Professor Lucian Bebchuk, director of the Harvard Law School Center on Corporate Governance, submitted a bylaw proposal for inclusion on the proxy solicitation materials of Computer Associates, Inc. (CA) which sought to limit the board's ability to adopt a poison pill and required a unanimous vote of the board to amend the proposed bylaw. CA filed for no-action relief on the grounds that the proposed bylaw was illegal under state law, but Bebchuk challenged the assertion of illegality in the Delaware Court of Chancery¹³ and the SEC

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refused to comment on the no-action request due to the pending litigation.¹⁴ *Bebchuk's* suit sought a declaratory judgment that his proposed bylaw was legal in addition to an injunction prohibiting CA from excluding the proposed bylaw from its ballot. The Court ruled that the issue was unripe for adjudication, reasoning that only a bylaw passed by the shareholders reached the stage at which it became a justiciable controversy. This holding would make placing bylaws on the ballot nearly impossible, however, the target could exclude it claiming a state law violation under 14a-8 (despite the DGCL's murky jurisprudence on that matter) and the shareholders would be left with only the remedy of ex-post challenge in federal courts. In the risk-averse institutional investor community, such a remedy would be insufficient to permit bylaw challenges to succeed.

With this new ability to certify questions directly to the Delaware Supreme Court, the SEC would be hard pressed to claim an inability to rule on the legality of a 14a-8 exclusion. The SEC could certainly rule in favor of a challenging company and grant no-action relief without choosing to certify to Delaware. Nevertheless, a shareholder could then utilize his implied power under 14a-8¹⁵ to challenge the SEC ignoring its power to clear up the issue. That failure, combined with the fact that even the Court of Chancery in *Bebchuk v. CA* recognizes the uncertainty in the state law governing this area,¹⁶ would offer significant evidence for a federal court to rule against such an SEC no-action decision, especially since no-action findings are not considered agency rulemaking and thus not subject to *Chevron* deference.¹⁷

The types of bylaws that will be proposed are limited only by the creativity of the shareholders offering the proposals. The first, and likely most popular, type will relate to the process whereby the board of directors is elected. A recent addition to Section 216 of the DGCL, adopted in August of 2006, specifies that "A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors." Thus, the DGCL has blessed the legality of bylaws relating to elections, but that does not mean that all questions surrounding election bylaws have been resolved. For instance, what about a bylaw that, instead of specifying the number of votes necessary for success, specifies a method for counting (or excluding) supervoting shares from certain

decisions, or a method for excluding broker street votes, or changes to the record notice period?

Complicating this issue is another provision of 14a-8 permitting exclusion of bylaws that relate to an election.¹⁸ Governance gurus will be familiar with the SEC's most recent attempt at proxy access. The SEC considered two proposals: one which would specifically permit election bylaws being placed on the corporate proxy and another which would interpret 14a-8 to disallow placing such bylaws. Chairman Cox, the deciding vote on a four person panel, opted to support exclusion of election bylaws despite his initial support¹⁹ of proxy access (by election bylaw). Chairman Cox offered his decision as a temporary one, claiming that the prospect of litigation facing companies in light of uncertainty in interpretations of 14a-8 spoke in favor of a temporary resolution, but promises to look at the issue again in 2008.²⁰ The legitimacy of Cox's uncertainty objection is called into question, though, by his failure to certify a question concerning bylaw legality to the Delaware Supreme Court to resolve that aspect of the uncertainty.

Bylaws may also relate to the issue of poison pills, as in *Bebchuk v. CA*. Though the court in that case never actually ruled whether the proposed bylaw was legal, under Section 157 of the DGCL, the power to create and issue rights and to determine the duration for which rights may be issued and maintained is explicitly vested in the directors, not in stockholders or others.²¹ Thus it seems that poison pill bylaws are least likely to survive Delaware review. De-staggering of the board is another popular issue and a more open question when it comes to bylaws. As the form and subject matter of bylaw proposals veer off the beaten path of previous derivations, their legality becomes more uncertain.

The most interesting implication of the new Delaware certification is that it can permit the SEC to resolve pressure from Congress or interest groups by leaving open ended aspects to its rule-making in areas that may overlap with state law. For that matter, future rules proposals could make more use of state law carve-outs. For instance, the new independence definitions added to the NYSE listing standards in the wake of the Sarbanes-Oxley reforms have been much criticized, but imagine if the SEC had defined an opt-out cross referencing independence as defined under Delaware law. The SEC could then, in the event that Delaware case law was unclear, consult

the Delaware Supreme Court in advance of an enforcement proceeding it may later consider.

Going forward, the likelihood that the Delaware certification capability will have a significant effect on corporate law will depend on the SEC's willingness to certify questions, and the Delaware Supreme Court's willingness to accept the certification. In that event, and especially if the SEC revisits a bylaw oriented version of proxy access for elections, one should expect that election bylaws will be the first order on the agenda.

Notes

1. Del. Const. art. 4 §11(8) (2007).
2. Edward Rock & Marcel Kahan, Symbiotic Federalism and the Structure of Corporate Law, 58 Vand. L. Rev. 1573, *1616 (2005).
3. 8 Del. C. § 109(b) (2007).
4. 17 C.F.R. § 240.14a-8 (2007).
5. Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 Cardozo L. Rev. 511, 546 (1997).
6. See Gen. DataComm Indus. Inc. v. State of Wis. Inv. Board, 731 A.2d 818, 821 (Del. Ch. 1999) (noting, in the context of a motion for expedited proceedings, that "the question of whether a stockholder-approved bylaw can be repealed by a board of directors with such authority has not clearly been answered by a Delaware Court. However, the Supreme Court's decision in Centaur Partners and the views of a learned commentator (Professor Lawrence Hamermesh) suggest that the affirmative answer may be the correct one."); Am. Int'l Rent a Car, Inc. v. Cross, No. 7583, 1984 WL 8204, at *3 (Del. Ch. May 9, 1984) (Berger, V.C.) ("If a majority of American International's stockholders in fact disapproved of the Board's amendment of the bylaw, several recourses were, and continue to be, available to them. They could vote the incumbent directors out of office. Alternatively, they could cause a special meeting of the stockholders to be held for the purpose of amending the bylaws and, as part of the amendment, they could remove from the Board the power to further amend the provision in question.") (emphasis added).
7. Professors Coates and Faris consider the issue in some depth. John Coates & Bradley C. Faris, Second-Generation Shareholder Bylaws: Post Quickturn Alternatives 56 Bus. Law. 1323 (2001). In their view, the "best argument in response is that Section 109(a) of DGCL reserves to the shareholders the residual authority to adopt, amend, and repeal bylaws. If the shareholders' residual authority under Section 109(a) is to mean anything, the argument would go, it must mean that the shareholders may adopt a bylaw that is beyond board repeal." *Id.* at 1368. They also note possible ways to uphold a no-repeal provision, either by arguing that the repeal of the bylaw is a violation of fiduciary duty, or that it is a Blasius like disenfranchisement of the shareholders. *Id.* at 1369.
8. See Larry Hamermesh, Corporate Democracy and Stockholder-Adopted By-laws: Taking Back the Street?, 73 Tul. L. Rev. 409, 469-70 (1998) (arguing that a bylaw which purports to limit a director's ability to amend the bylaw is highly suspect under Delaware corporate law).
9. Coates & Faris, *supra*, at 1356.
10. 8 Del. C. § 141.
11. Professor Coffee also explores these four dimensions that seem to indicate whether a bylaw restricting the power of the board might be upheld. See John C. Coffee, Jr., The Bylaw Battlefield: Can Institutions Change the outcome of Corporate Control Contests?, 51 U. Miami L. Rev. 605 (1997).
12. *Bebchuk v. CA, Inc.*, 902 A.2d 737, 739 (Del. Ch., 2006).
13. *Id.*
14. *CA, Inc.*, SEC No-Action Letter, 2006 WL 1547985, at *1 (June 5, 2006).
15. See *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416 (D. Cir. 1992).
16. *Bebchuk*, 902 A.2d 742-44.
17. See *Roosevelt*, 958 F.2d at 427, (DC Cir. 1992).
18. Exchange Act Rule 14a-8, 17 C.F.R. § 240.14a-8 (2007).
19. Christopher Cox, Chairman, SEC, Opening Remarks at the SEC Open Meeting (July 25, 2007), available at: <http://www.sec.gov/news/speech/2007/spch072507cc.htm>.
20. Christopher Cox, Chairman, SEC, Opening Remarks at the SEC Open Meeting (Nov. 28, 2007), available at: <http://www.sec.gov/news/speech/2007/spch112807cc.htm>
21. 8 Del. C. § 157 (2007).

Statutory Prerogatives and the Appropriate Standard of Review: Section 203 Waivers and “Force the Vote” Clauses

By John J. Jenkins

Termination fees, shareholder lockups and other “deal protections” designed to protect pending transactions from interference have long been standard fare in mergers and acquisitions, but the Delaware courts have struggled to reach a consensus on the legal issues associated with these arrangements. During the late 1990s and the first part of this decade, the Delaware Chancery Court addressed deal protections no fewer than six times.¹ The cases were remarkably inconsistent, with judges disagreeing about whether board decisions in this area were subject to business judgment review,² or whether they should be regarded as defensive measures subject to heightened scrutiny.³

The Delaware Supreme Court sought to resolve the key legal issues associated with deal protections in 2003, with its decision in *Omnicare v. NCS Healthcare*.⁴ The deeply divided *Omnicare* court defined deal protections very broadly, and concluded that all such arrangements should be subject to heightened judicial scrutiny as defensive measures.⁵ The *Omnicare* court’s approach had the effect of subjecting to heightened scrutiny not only including contractual defensive measures (such as termination fees) entered into by the board, but also actions taken by the board pursuant to statutory grants of authority.⁶ In particular, the *Omnicare* court found that the board’s decision to waive Section 203 of the DGCL to permit the target’s controlling shareholders to enter into voting agreements supporting a negotiated transaction, and the board’s agreement to the inclusion of a force the vote clause in the merger agreement itself, were both defensive measures subject to *Unocal*.

With these decisions, the *Omnicare* court stood *Unocal* squarely on its head. A doctrine developed to govern board action in the face of statutory silence and amidst fears about entrenchment was applied to board actions that were taken under express statutory grants of authority and that facilitated shareholders’ efforts to dispose of their shares.

Furthermore, *Omnicare* applied *Unocal* scrutiny to board action that could scarcely be characterized as unilateral; in fact, it involved actions taken by the board in conjunction with the target’s controlling shareholders.

The *Omnicare* decision has been widely criticized among practitioners,⁷ and subsequent deal protection cases have narrowed, distinguished, and generally disdained it.⁸ With deal protection measures receiving renewed attention from the Delaware courts, this article argues that it is time to abandon the vestiges of *Omnicare* in favor of a different approach.⁹ While heightened scrutiny may be appropriate with respect to certain deal protections, that standard generally should not be applied to board actions that are premised upon an express grant of statutory authority. Instead, pre-*Omnicare* precedent and an appropriate concern for doctrinal integrity suggests that when the board is given a statutory prerogative, its decision concerning whether to exercise that prerogative should be entitled to the protection of the business judgment rule, even if it has the effect of helping to protect a negotiated merger.

This article specifically addresses two statutory grants of board authority that have come into play in the analysis of defensive measures: the power to waive application of the Delaware Takeover Statute,¹⁰ and the power to agree to so-called “force the vote” clauses.¹¹ This article concludes that the exercise of the board’s statutory authority generally should be evaluated under the more deferential business judgment rule standard of review, and that potential abuses of this authority can be addressed effectively through legal doctrines other than *Unocal*.

Business Judgment vs. Heightened Scrutiny.

The “business judgment rule” refers to Delaware’s long-standing presumption “that in making a business decision the directors of a corporation acted

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on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”¹² The most notable difference between the business judgment rule and the *Unocal* standard is in the identity of the party who bears the initial burden of proof. The business judgment rule places that burden on the plaintiff claiming a breach of fiduciary duty, while the *Unocal* standard places the initial burden on the board of directors.

The *Unocal* standard had its genesis in the Delaware Supreme Court’s 1985 decision in *Unocal v. Mesa Petroleum*,¹³ which addressed the standard of review applicable to defensive measures implemented by the board in response to an unsolicited takeover bid. The *Unocal* court was called upon to address the then novel issue of whether the board, which had no statutory role in tender offers, could interpose itself between a hostile bidder and the shareholders by unilaterally implementing defensive measures.¹⁴ The *Unocal* court sanctioned such intervention, but held that before it would defer to the board’s business judgment, the board would need to show that it had reasonably concluded that a hostile takeover presented a threat to corporate policy and effectiveness, and that the defensive measure was reasonable in relation to the threat posed.¹⁵ The *Unocal* court’s reason for subjecting decisions to adopt defensive measures to more scrutiny was its concern about the “omnipresent specter that a board may be acting primarily in its own interests” to preserve the directors’ positions with the corporation.¹⁶

Statutory Prerogatives and the Standard of Review

Why should the fact that the statute has given the board authority to act matter in determining the standard of review that should apply to board action? At the most basic level, the issue is doctrinal integrity. If *Unocal* provides a framework for reviewing board actions that may encroach on areas regarded as shareholder prerogatives under the default provisions of Delaware law, then why should this framework apply to areas where Delaware’s default provisions make the matter in question a board prerogative?

Suggesting that courts should draw a distinction in the level of scrutiny to apply based on how

statutory authority is divided between shareholders and directors under the Delaware General Corporation Law is not a novel idea, even in the age of *Unocal*. For example, consider Chancellor Allen’s 1989 decision in *In re TW Services, Inc. Shareholders Litigation*.¹⁷ The *TW Services* case arose out of a target board’s refusal to redeem a poison pill in the face of a hostile tender offer that had received strong shareholder support.¹⁸ The bidder’s offer was expressly conditioned upon, among other things, the target entering into a satisfactory merger agreement with the bidder.¹⁹

In seeking to compel redemption of the target company’s poison pill, the bidder contended that the ultimate question for the court to resolve was “whether in failing or refusing to redeem the poison pill...the defendant directors acted reasonably in relation to a threat that the SWT offer poses to the TW shareholders.”²⁰ In other words, the plaintiffs claimed that *Unocal* ought to apply to the board’s decision. Chancellor Allen disagreed. In doing so, he first noted that public tender offers were “functionally similar to merger transactions with respect to the critical question of control over the corporate enterprise.”²¹ But he went on to observe that while Section 251 of the Delaware General Corporation Law²² gives to the board the “critical role of initiating and recommending a merger”²³ to the board of directors, the board “traditionally has been accorded no statutory role whatsoever with respect to a tender offer.”²⁴

The statutory differences in the board’s role in these two transactions formed the basis for Chancellor Allen’s decision in *TW Services*. To Chancellor Allen, the different statutory treatment of the board’s role in a merger as compared to a tender offer provided the rationale for “the difference in judicial review of decisions not to pursue a merger and decisions to preclude a hostile tender offer...”²⁵ He indicated that a court called upon to review a board’s decision not to pursue a merger should ask itself the “questions that the business judgment form of review requires: did the board reach that decision in good faith pursuit of legitimate corporate purposes, and did it do so advisedly?”²⁶ If a plaintiff was unable to persuade the court that the answer to either question was “no,” then the court would not go on to exercise “even the restrained level of substantive review that *Unocal* contemplates.”²⁷

Applying these principles to the *TW Services* case, the Chancellor concluded that by deciding to condition its tender offer on the execution of a merger agreement, the bidder had implicated the board's statutory power under Section 251:

By conditioning the closing of its tender offer upon the execution of a merger agreement... [SWT] continues to call upon the board to act under Section 251. The exercise of the board's power under that Section is, where there is no interested merger involved, subject to a traditional business judgment review, not the proportionality review of Unocal.²⁸

While Chancellor Allen did not discuss the standard of review that should be applied to a board's Section 203 waiver decision, the importance he places on statutory division of authority strongly suggests that business judgment review is the appropriate standard. Indeed, the argument for business judgment review is even more compelling in the case of a Section 203 waiver than it is in the case of a merger. Section 203 confers power on the board to act unilaterally in granting a waiver.²⁹ In contrast, while the board has the prerogative to initiate and recommend a merger under Section 251, approval of the merger by the shareholders often is an indispensable part of the transaction.³⁰

Case Law on Section 203 Waivers

The standard of review for a board's decision to waive Section 203 has received substantive attention in two chancery court decisions. The better known of these cases is *In re Digex Shareholders Litigation*,³¹ which arose out of a proposed merger between WorldCom, Inc. (WorldCom) and Intermedia Communications, Inc. (Intermedia). Intermedia was Digex's controlling shareholder, and was experiencing financial difficulties.³² During the course of negotiations concerning a possible sale of Digex, Intermedia became interested in an alternative transaction involving the sale of Intermedia itself to WorldCom. During discussions with WorldCom about the proposed Intermedia transaction, Digex asked WorldCom to make a tender offer for the publicly-held Digex shares.³³ WorldCom refused, but expressed its desire to receive a waiver of Section 203 from the Digex board.³⁴ As a *quid pro quo* for that waiver, WorldCom was willing to agree to an amendment to Digex's certificate of incorporation that would require independent director

approval of any material transaction between Digex and WorldCom.³⁵

Digex's board was controlled by Intermedia, but did have three independent directors.³⁶ At its meeting on September 1, 2000, Digex's board learned that Intermedia's board had met earlier in the day, and had decided that, from Intermedia's perspective, a sale to WorldCom was preferable to a sale of its Digex subsidiary to another party.³⁷ Digex's financial advisor advised the board that the WorldCom deal was the worst alternative for Digex, and a special committee member proposed deferring a decision on the WorldCom deal for a brief period to allow Digex to solicit final offers from the three suitors that had proposed transactions.³⁸ The independent directors all voted in favor of this alternative, but were outvoted by the directors affiliated with Intermedia.³⁹ The independent directors voted against WorldCom's Section 203 waiver request, but were outvoted on that issue as well.⁴⁰

Chancellor Chandler concluded that since all four votes to waive Section 203 were cast by Intermedia affiliates, the board's action should be evaluated under the "entire fairness standard."⁴¹ In applying the entire fairness standard, the Chancellor noted that the Section 203 waiver decision was the only decision of any relevance to the WorldCom transaction that the Digex board had the power to make.⁴² He indicated that the "decision put before the Digex board was simply whether or not to grant WorldCom the Section 203 waiver. That is, was whatever Digex was being offered for this waiver worth the granting of the waiver and could Digex negotiate for more?"⁴³

Digex pointed out that in exchange for the Section 203 waiver, WorldCom agreed to the charter amendment requiring independent director approval of material transactions between the two companies.⁴⁴ Digex's board also noted the advantages arising out of replacing the financially troubled Intermedia with a financially sound controlling shareholder in support of its position that the price extracted from WorldCom for the waiver was fair.⁴⁵ But in light of the flaws in the negotiating process, and, in particular, the special committee's complete lack of involvement in that process, the Chancellor was not convinced that these factors were sufficient to demonstrate that the decision to grant the waiver was entirely fair.⁴⁶

In the end, the Chancellor concluded that the only party that stood to lose if the waiver was not granted expeditiously was Intermedia.⁴⁷ To the Chancellor, that meant that the ability to waive (or not waive) Section 203 provided Digex with leverage against Intermedia and WorldCom. The problem in this situation was that “[t]his leverage simply was not used—could not be used—because of the decision of the interested directors.”⁴⁸ Therefore, the Chancellor concluded that the plaintiffs had shown a reasonable probability of success on the merits with regard to the Section 203 claim.⁴⁹

On one level, *Digex* is not at all remarkable; this case clearly involved a deliberative process that was far from ideal, and actions by the controlling shareholder and its directors that, while understandable in light of Intermedia’s own interests, can best be described as the business equivalent of “leading with your chin.”⁵⁰ But there is potentially more involved in this decision than a court’s understandable response to overreaching by conflicted directors and a controlling shareholder. The court’s language clearly implies that it expected to see the board extract concessions in exchange for the waiver:

It may be that if the Digex special committee had approved the waiver after due consideration of the benefits to Digex, the court would have been satisfied. Yet, the court’s insistence on the use of leverage where leverage exists suggests that whenever a company is asked to grant a 203 waiver with respect to a control block, it must at least go through the steps of requesting something in exchange, even if the acquirer never proposed to buy the remaining shares.⁵¹

In light of these concerns, how can an argument for a more deferential standard of review be reconciled with the chancery court’s apparent willingness to scrutinize the board’s actions so closely in *Digex*?

The answer may be that, in some respects, there is less to *Digex* than meets the eye. *Digex* was a case reviewed under the entire fairness standard. That meant that the legal deck was, in an important sense, stacked against the board from the outset.⁵² In entire fairness cases, the burden is (at least initially) placed on the board to justify the fairness of the decision at issue.⁵³ This is a two pronged inquiry, with courts focusing on both fair dealing and fair price.⁵⁴ With the burden placed on the board to justify the result

produced by a badly flawed process, the outcome of that case hardly can seem surprising.⁵⁵

The court’s comments about directors’ duty to use the leverage provided by Section 203 must be evaluated in the context of its entire fairness review. Those comments arose in the course of Chancellor Chandler’s evaluation of the Digex board’s claims that the “price” received for the waiver was entirely fair—claims that these directors bore the burden of proving. WorldCom’s agreement to a protective charter amendment was a significant component of that price, according to Digex, and in light of the flaws in the process that culminated in that concession, the Chancellor was unwilling to conclude that the board had met its burden of persuasion under the entire fairness test. When the Chancellor’s comments are read in the context of what the board was required to demonstrate under the standard of review that the law obligated him to apply in this case, they seem less ominous.⁵⁶

Fuqua Industries

Interestingly, *Digex* was not the first case in which Chancellor Chandler was called upon to consider the standard of review to apply to a board’s decision to waive Section 203, and his decision in that earlier case provides the best argument for not reading more into *Digex* than that the factors traditionally invoked to overcome the business judgment presumption apply with equal force to decisions involving the exercise of the board’s statutory prerogatives.⁵⁷ In 1997, then Vice Chancellor Chandler addressed claims arising out of the validity of an agreement (the “Section 203 Agreement”) entered into by the board of directors of Fuqua Industries, Inc. (Fuqua) under the terms of which it agreed to, among other things, waive Section 203 with respect to Triton Group, Inc. (Triton), which at the time of the agreement owned just under 10 percent of Fuqua’s outstanding common stock.⁵⁸ While Triton had acquired some of its holdings on the open market, most of its holdings had been purchased from Fuqua’s Chief Executive Officer. The agreement prohibited Triton from entering into a business combination with Fuqua for three years from the date that it first became an interested shareholder unless it had first obtained the approval of a majority of Fuqua’s disinterested directors.⁵⁹ During that three-year period, Triton agreed that at least three members of the board

would be disinterested directors, and also agreed to vote its shares in favor of the board's nominees for Fuqua's directors.⁶⁰ Over a period of several months following the date of the waiver, Triton's ownership position in Fuqua increased to "just over twenty-five percent."⁶¹

The plaintiffs contended that the board's decision to enter into the Section 203 Agreement were all part of the defendants' scheme to entrench themselves until the CEO's planned retirement, "at which time, management would purchase [Fuqua] in a leveraged buyout."⁶² Triton's involvement allegedly arose out of management's realization that a buyout would be prohibitively expensive, and was recruited to serve as a "'friendly' stockholder who would allow the defendants to retain their positions."⁶³ The plaintiffs said that because the defendants' actions had the effect of "insuring effective control in the hands of Triton and thereby foreclosing any real opportunity for the [Fuqua] shareholders to receive an acquisition proposal",⁶⁴ the *Unocal* standard of review should apply to the board's decision to enter into the Section 203 Agreement.⁶⁵ The defendants countered that the allegations in the plaintiffs' complaint suggested that they "facilitated, rather than defended against, a change in control"⁶⁶ and that *Unocal* did not apply. The Chancellor agreed with the defendants, noting:

Plaintiff's allegations are not presented as preemptive acts designed to defend against a threat to control but as deliberate acts designed to entrench the directors and assist them in pursuit of either a management buyout or transfer of control to Triton. As such, the allegations do not trigger enhanced scrutiny and the burden of rebutting the presumption of the business judgment rule remains on the plaintiffs.⁶⁷

Turning specifically to the Section 203 Agreement, the Chancellor rejected contentions that the agreement was null and void because of alleged failures to conform the agreement to the board's resolution authorizing it or to subsequently ratify it.⁶⁸ In doing so, he noted that "the business judgment rule protects the Board's decision not to amend or formally ratify the Section 203 Agreement."⁶⁹ Since he found "no reason to presume that the Section 203 Agreement was not the result of a valid exercise of business judgment," he dismissed this aspect of the plaintiffs' complaint.⁷⁰

But resolution of this aspect of the plaintiffs' claim did not completely resolve the issues surrounding the Section 203 waiver. While the board's decision to enter into that agreement may have been entitled to the business judgment presumption, the plaintiffs also claimed that the aspects of the Section 203 Agreement requiring Triton and its affiliates to vote their shares in favor of management's nominees to the board "resulted in the creation of shares that may not be used to vote against the board's nominees."⁷¹ Chancellor Chandler held that properly supported allegations such as these created reasonable doubt concerning whether the actions were taken "solely or primarily to protect the board's tenure."⁷² Since actions motivated by such a desire could constitute entrenchment⁷³ and thus take the board's waiver decision outside of the ambit of the business judgment rule, he declined to dismiss the plaintiffs' entrenchment claim relating to the Section 203 Agreement.⁷⁴

Unocal is Not The Only Way to Address Entrenchment

The first thing about the *Fuqua Industries* case that is apparent is that the "quid pro quo" for the Section 203 waiver was quite similar to that involved in *Digex*: a guarantee that transactions between the acquiror and the target would be subjected to review by disinterested directors during the period in which those transactions would otherwise be subject to Section 203. In contrast to *Digex*, where the Chancellor asked skeptically whether this was the best the board could have gotten in exchange for the waiver, in *Fuqua Industries*, he said that the business judgment presumption applied to the board's decision to waive Section 203. That in itself seems to be a fairly compelling argument against reading too much into the Chancellor's *Digex* opinion. But it also illustrates another important, and sometimes overlooked, point: the mere fact that the business judgment presumption applies to a board's decision making does not amount to a "get out of jail free" card.

That is because *Unocal* is far from the only tool that courts have to address director conduct stemming from entrenchment motives. As *Fuqua Industries* suggests, well pleaded allegations of entrenchment may permit a plaintiff to overcome the business judgment presumption that applies to the board's exercise of a statutory prerogative.

Along the same lines, *Digex* suggests that current articulations of the entire fairness standard of review may be sufficient to address exercises of the board's statutory prerogatives that are tainted by conflicts of interest.

Other Defensive Measures Are Not Immune From Scrutiny

In the abstract, it is easy to say that the business judgment rule should apply to the board's decision to exercise a statutory prerogative such as a Section 203 waiver, but the more difficult situations are those in which the exercise of that prerogative guarantees that a transaction will be completed. That was the issue that concerned the *Omnicare* court and led it to warp the *Unocal* doctrine so significantly. But a similar issue was addressed in a more sophisticated manner by Vice Chancellor Strine in *ACE Limited v. Capital Re.*⁷⁵ In that case, the chancery court was confronted with a merger agreement protected by, among other things, a restrictive "no-shop" clause and voting agreements signed by the holders of 33.5 percent of the target's outstanding common stock.⁷⁶ The merger agreement also contained a provision allowing the target's board to terminate it in order to accept a superior proposal.⁷⁷ Vice Chancellor Strine indicated that a provision of the no-shop clause that the buyer said obligated the target's board receive a legal opinion before it could speak with other bidders was an improper abdication of the board's duty to decide for itself what its fiduciary duties require.⁷⁸ The court appeared to be particularly concerned about the interplay between the voting agreements and the no-shop clause's restrictions. If the no-shop clause was read as restrictively as the buyer wanted, the court believed that it vitiated the agreement's superior proposal out and, since the voting agreements terminated only if the board terminated the merger agreement, guaranteed that the merger would be approved.⁷⁹

Vice Chancellor Strine concluded that a board did not have unlimited authority to negotiate a merger agreement linked to voting agreements "ensuring consummation if the board does not terminate the agreement,"⁸⁰ regardless of whether the board no longer believed that the merger was a good deal. With formidable stockholder lock-ups in place, the board could not agree to "sit idly by and allow an unfavorable and preclusive transaction to occur that its own actions have brought about."⁸¹ The

Vice Chancellor went on to say that "it is important that [the board] negotiate with care and retain sufficient flexibility to ensure that the stockholders are not unfairly coerced into accepting a less than optimal exchange for their shares."⁸²

While Section 203 was not at issue in *ACE*, it has been suggested that the court's concerns about retaining the board's flexibility to terminate a merger agreement when the voting agreements guaranteed the deal's approval absent such termination "would appear to apply to the grant of a Section 203 waiver with respect to a lockup-arrangement with a significant stockholder,"⁸³ and that the case suggests that courts "will closely review 203 waivers in all contexts."⁸⁴

If *ACE* stands for that proposition, then unwinding *Omnicare* will accomplish little—*ACE* will put the courts right back in the business of putting Section 203 waivers under the *Unocal* microscope. However, if one looks closely at the *ACE* decision, it appears that the critical issue in that decision was the manner in which the voting agreements and the merger agreement were linked:

The parties could have unconditionally committed themselves to the deal, but they didn't. Instead, they agreed to vote for the transaction, but *only* if the board did not terminate the merger agreement. Their commitments were directly linked to the board's continued support of the deal, and only action by the board could release them from their obligations.⁸⁵

Thus, the shareholders were continuing to look to the board to exercise its fiduciary duties on their behalf. If the merger agreement's "superior proposal out" was rendered illusory by the no-shop clause agreed to by the board, then these shareholders had been misled into thinking that their fiduciaries would be able to discharge their responsibilities to them.⁸⁶

Viewed from that perspective, the fundamental problem with the deal protections at issue in *ACE* was the potentially misleading nature of the board's conduct—in other words, the board's presumed lack of candor in dealing with the shareholders who signed the voting agreements. Thus, the response to the concerns expressed in *ACE* is that under these circumstances, the business judgment rule would not apply to the board in any case, since it does

not shield fiduciaries from liability for failing to deal candidly with shareholders.⁸⁷ Since Delaware courts have long held that type of director misconduct is not protected by the business judgment rule, it appears that this is yet another area in which the abusive behavior about which the court is concerned can be addressed without the need to invoke *Unocal*.

Beyond that, however, there is no reason to conclude that because the board's decision to grant a Section 203 waiver or to agree to a force the vote clause will be evaluated under the business judgment rule, other deal protection measures will be inoculated against challenge under *Unocal*. Similarly, the fact that the board has exercised its statutory powers need not preclude a court from considering other contractual restrictions in light of the exercise of those powers. If other contractual provisions agreed to unilaterally by the board, when viewed in light of the board's decisions to exercise its statutory authority are appropriately regarded as being defensive in nature, there appears to be no reason to exempt those contractual arrangements from *Unocal* review. Ironically, that is a point of view that this article shares in common with the *Omnicare* court.⁸⁸

However, where this position parts company with *Omnicare* is when the only actions that might be regarded as objectionable under a *Unocal* standard of review are those taken by the board pursuant to the exercise of a statutory prerogative, whether taken unilaterally or in conjunction with shareholders' actions with respect to their own property. In those instances, *Unocal* would not be invoked, because there is simply no doctrinal basis for it to apply to actions of this type. In some situations, such as that involved in *Omnicare*, the combination of shareholder voting agreements, the board's waiver of Section 203, and its agreement to a force the vote clause may effectively make the outcome of the transaction a foregone conclusion; but that does not mean that courts should have a license to ignore established precedent and stand the *Unocal* doctrine on its head in order to apply it to these arrangements.

A Word About Revlon

For purposes of clarity, it should be noted that this article does not suggest that the business

judgment standard of review for the board's exercise of statutory prerogatives would extend to situations in which the board was subject to an obligation to act to maximize immediate shareholder value under the doctrine announced in *Revlon v. MacAndrews & Forbes*.⁸⁹ As has been cogently argued in recent years, there are generally compelling reasons to believe that it is inappropriate to view *Unocal* and *Revlon* as setting forth separate standards of director conduct. Instead, it is usually better to consider *Revlon's* requirements to be a particularized application of *Unocal's* reasonableness standard.⁹⁰ However, unlike *Unocal*, which focuses on defensive measures, in the limited circumstances in which *Revlon* applies, it encompasses the entire ambit of board actions, including decisions to enter into merger agreements involving a change in control.⁹¹ When *Revlon* duties apply, the board no longer faces "threats" to the corporate policy or effectiveness cognizable under *Unocal*. Instead, the board's role shifts from the "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."⁹² Because of the breadth of the doctrine in situations in which it applies, it seems inappropriate to conclude that the deference to statutory prerogatives will apply in situation where the board is subject to *Revlon* duties.

Force the Vote Clauses

While no case prior to *Omnicare* directly addressed the standard of review that should apply to a board's decision to agree to a force the vote clause, there appears to be no reason to differentiate between that decision and the decision to grant a waiver of Section 203. In both cases, the board is acting pursuant to a statutory grant of authority, and it seems likely that alternative legal doctrines provide ample protection against abuses of this authority without the need to invoke *Unocal*.⁹³

Conclusion

The Delaware judiciary's efforts to settle on a standard of review for deal protections that culminated in the *Omnicare* decision has left the law in this area in a state of disarray. That matters, because, as the *Omnicare* court noted,⁹⁴ these issues involve what former Delaware Supreme Court Chief Justice Norman Veasey has called "the

defining tension” in corporate governance—“the tension between deference to directors’ decisions and the scope of judicial review.”⁹⁵ Courts’ efforts to flesh out doctrinal limits in this area frequently are made more difficult by Delaware’s reluctance to address some of the key issues in its statute.⁹⁶

There can be no doubt that this statutory silence exists with respect to the board’s role in responding to unsolicited tender offers, but the irony of the deal protection cases is that the Delaware statute has quite a bit to say on the board’s authority in the context of negotiated mergers. The fundamental problem with Delaware’s deal protection cases stems from judicial efforts to resolve these cases entirely by reference to legal doctrines developed in the statutory vacuum surrounding unsolicited tender offers. Because the policy issues in board responses to unsolicited tender offers are frequently quite different than those surrounding decisions to protect a negotiated deal, these doctrines have not traveled well—and the situation has been made worse by courts’ failure to recognize that the statute has spoken on some of the important issues in this area.

Appropriate deference to the board’s statutory prerogatives will not fundamentally alter the deal protection landscape. It will not inoculate contractual defenses agreed to unilaterally by the board from characterization as deal protections subject to *Unocal*, nor will it affect the board’s obligations in situations in which *Revlon* applies. It will, however, address some of the most troubling aspects of the *Omnicare* decision, and will go a long way toward restoring the doctrinal integrity of the *Unocal* standard. In turn, that will provide substantial assistance to corporate dealmakers and their advisors in their efforts to comply with Delaware’s requirements.

Notes

1. *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, Nos. 17398, 17383, 17427, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sept. 27, 1999); *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999); *In re IXC Communications, Inc. Shareholders Litigation*, Nos. 17324, 17334, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999); *Wisconsin Investment Board v. Bartlett*, C.A. No. 17727, 2000 Del. Ch. LEXIS 42 (Del. Ch. Feb. 24, 2000); *McMillan v. Intercargo*, 762 A.2d 492 (Del. Ch. 2000); *In re Pennaco Energy, Inc. Shareholders Litigation*, 787 A.2d 691 (Del. Ch. 2001).

2. *See, e.g., State of Wisconsin Investment Board v. Bartlett*, 2000 Del. Ch. LEXIS 42, *30 (Del. Ch. February 24, 2000).

3. *See, e.g., ACE Limited v. Capital Re*, C.A. No. 17488 (Del. Ch. October 25, 1999).

4. *Omnicare v. NCS Healthcare*, 818 A.2d 914 (Del. 2003).

5. *Id.* at 930.

6. *Id.* at 934.

7. One was quoted as saying that the *Omnicare* decision was “idiotic, to use a technical term.” *Robert Kindler: American Dreamworks*, 4 *The M&A Journal* 2 at 13 (2003). Others expressed their hope that the decision ultimately would be “relegated to the dust bin of Delaware judicial left turns.” Robert A. Profusek and Lyle G. Ganske, *Lockups and Beyond in Omnicare v. NCS Healthcare*, *New York Law Journal*, May 30, 2003 at 4.

8. *See, e.g., Orman v. Cullman*, CA No. 18039 (Del. Ch. October 20, 2004); *In re Toys “R” Us, Inc. Shareholder Litigation*, Cons. C.A. 1212-N (Del. Ch. Jun. 24, 2005); *Unisuper Ltd. v. News Corporation*, C.A. No. 1699-N (Del. Ch. Dec. 20, 2005).

9. In 2007, the Delaware chancery court decided four cases directly addressing deal protection issues, *La. Mun. Police Employees Ret. Sys. V. Crawford*, C.A. Nos. 2633 & 2635, 2007 WL 58251 (Del. Ch. Feb. 23, 2007); *In re Neismart Technologies, Inc.*, C.A. No. 2562, 2007 WL 926213 (Del. Ch. Mar. 14, 2007); *In re Topps Shareholders Litig.*, C.A. Nos. 2786 & 2988, 2007 WL 1732586 (Del. Ch. June 14, 2007); *In re Lear Corp. Shareholder Litig.*, C.A. No. 2728, 2007 WL 1732588 (Del. Ch. June 15, 2007). For a discussion of these cases, *see*, J. Travis Laster & Steven M. Haas, *Judicial Scrutiny of Deal Protection Measures*, 11 *The M&A Lawyer* 7 at 8 (July/August 2007) (noting that these decisions have “put deal protection measures back in the spotlight.”)

10. 8 Del. Code §203 (2008). Section 203 of the Delaware General Corporation Law (the “DGCL”) limits a buyer’s ability to engage in certain types of “second step” transactions (such as squeeze-out mergers) for a period following the date that the buyer acquires more than 15% of the target corporation’s stock. Section 203 imposes a three-year moratorium on “business combinations” between certain Delaware corporations and an “interested stockholder” (in general, a stockholder owning 15% or more of a corporation’s outstanding voting stock). Section 203(a)(1) provides that the statute’s restrictions do not apply if prior to the time that a buyer crosses the 15% ownership threshold, “the board of directors of the corporation approved either the business combination or the transaction which resulted in the stockholder becoming an interested stockholder.” In other words, the statute contains an express grant of authority to the board of directors to waive application of the statute to a particular buyer.

11. 8 Del. Code §146 (2008). Section 146 of the Delaware General Corporation Law authorizes a corporation to “agree to submit a matter to a vote of its stockholders whether or not the board of directors determines at any time subsequent to approving such matter that such matter is no longer advisable and recommends that the stockholders reject or vote against the matter.” Provisions in merger agreements that take advantage of this statute and call for a transaction to be presented to shareholders regardless of whether or not the board continues to recommend it have come to be known as “force the vote” clauses.

12. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

13. *Unocal v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985). If the board satisfies these two requirements, its actions would be protected by the business judgment rule.

14. As Vice Chancellor Strine put it:

Any informed discussion of merger deal protection measures must acknowledge the default rules of the Delaware General Corporation Law. These rules permit stockholders to accept a tender offer and sell control of the company in the minimum number of days permitted under the federal securities laws... Put simply, statutory law itself provides no barrier to a tender offeror who wishes to deal directly with the stockholders of a Delaware corporation.

Vice Chancellor Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 Bus. Law. 919, 924 (2001).

15. *Unocal*. 493 A.2d at 955-956. If the board meets these two requirements, the business judgment rule attaches to its decision.

16. *Id.* at 954.

17. *In re TW Services Shareholders Litigation*, Fed. Sec. L. Rep (CCH) [1989 Transfer Binder] ¶94,334 (Del. Ch. 1989)

18. The TW Services tender offer had been launched by an affiliate of Coniston Partners, which owned slightly less than 20 percent of the company's outstanding shares prior to the offer. If the offer were completed, the acquiror would have owned approximately 88 percent of the outstanding shares. *Id.* at 92,174.

19. *Id.* at 92, 176.

20. *Id.* at 92,178.

21. *Id.* at 92, 181

22. 8 Del. C. §251 (2008)

23. *TW Services* at 92,181.

24. *Id.*

25. *Id.* at 92, 182.

26. *Id.*

27. *Id.*

28. *Id.* at 92, 182.

29. Section 203(a)(1) expressly provides that a corporation may not "engage in any business combination with any interested stockholder for a period of 3 years" unless prior to the time that an interested stockholder became such, "the board of directors of the corporation approved either the business combination or the transaction which resulted in the stockholder becoming an interested stockholder." 8 Del. C. §203(a)(1).

30. *See, e.g.*, 8 Del. C. §251(c), which generally requires a merger agreement to be adopted by a majority of the outstanding stock of the constituent corporations. This general requirement is subject to a number of important exceptions, the most notable of which is provided by Section 251(f). 8 Del. C. §251(f). Section 251(f) provides that no vote of the surviving corporation's shareholders is required in order to approve the deal if, the transaction does not involve the issuance of shares

in an amount exceeding 20% of the shares of common stock of the survivor outstanding before the deal, and if no changes are to be made to the outstanding stock or the certificate of incorporation.

31. *In re Digex Shareholder Litigation*, 789 A.2d 1176 (Del. Ch. 2000).

32. According to its annual report on Form 10-K for the year ended December 31, 1999, Intermedia realized revenues of \$712 million and losses from operations of \$317 million in 1998, and revenues of \$906 million and losses from operations of \$306 million in 1999. Intermedia Communications, Inc. Annual Report on Form 10-K for the year ended December 31, 1999, <http://www.sec.gov/Archives/edgar/data/885067/0000950144-00-003457-index.html>

33. *Digex*, 789 A.2d at 1185.

34. *Id.* at 1185. Without a waiver, Section 203's three-year moratorium on business combinations would have prevented WorldCom from engaging in a second-step merger to "squeeze out" the public shareholders of Digex.

35. *Id.* at 1185.

36. The Digex board had eight members, five of whom were also directors or officers of Intermedia and had significant ownership stakes in that company. The three remaining Digex directors were not affiliated with Intermedia. The Digex board saw the potential for a conflict between the interests of Digex and the interests of its controlling shareholder and, on July 26, 2000, appointed a special committee comprised of two independent directors.

37. *Id.* at 1187.

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.* at 1207.

42. *Id.* at 1210.

43. *Id.* at 1213. In light of the Digex board's limited role in the deal, the Chancellor was plainly troubled by the fact that, at the Digex board meeting, "there was absolutely no discussion whatsoever of the effect, purpose, or applicability of §203 to WorldCom". *Id.* at 1210.

44. *Id.* at 1211.

45. *Id.* at 1213.

46. *Id.* at 1214.

47. *Id.*

48. *Id.*

49. *Id.*

50. As one commentator aptly put it:

[Digex] involves one of those fortunately rare instances where the existence of conflicting interests between a parent and its controlled subsidiary is obvious and a special committee of disinterested directors is formed, but when the special committee does not approve what the majority holder wants, the interested

directors overrule the special committee. Courts do not take kindly to such cases.

Pat Vlahakis, *The Section 203 Waiver A New Delaware Hazard?* 3 *The M&A Journal* 4 at 4-5 (2001).

51. *Id.* at 5.

52. As one Delaware court has observed, “because the effect of the proper invocation of the business judgment rule is so powerful, and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of the litigation.” *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993).

53. *Weinberger v. UOP*, 457 A.2d 701, 710 (Del. 1983).

54. Chancellor Chandler summarized the entire fairness inquiry in his opinion in *Digex*:

Fair dealing concerns how the board action was initiated, structured, negotiated and timed. Fair dealing asks whether all of the directors were kept fully informed not only at the moment in time of the vote, but also during the relevant events leading up to the vote while negotiations were presumably occurring. Fair dealing also asks how, and for what reasons, the approvals of the various directors themselves were obtained. Fair price related to the economic and financial considerations of the proposed decisions, including any relevant factors that affect the intrinsic or inherent value of a company’s stock. The entire fairness test is not simply a bifurcated analysis of these two components...The Court shall examine these two aspects as well as any other relevant considerations in analyzing the entire fairness of the waiver as a whole.

Digex 789 A.2d 1207. [citations omitted].

55. The Chancellor expressed doubt, based on the record before him, that “the waiver vote could even pass the most deferential business judgment review.” *Id.* at 1211.

56. It seems fair to say that the Chancellor was concerned about the possibility of too much being read into this aspect of his opinion. For example, immediately after making the point about the board’s failure to use the leverage provided to it by Section 203, he concluded that “[i]n the unique circumstances here, this conduct by directors acting with a clear conflict of interest is difficult to justify and would not seem appropriate.” *Id.* at 1214. [emphasis added.] It is also worth noting that there is no conflict between Chancellor Chandler’s views in *Digex* and those expressed 11 years earlier by Chancellor Allen in *TW Services*. For that matter, the possibility of heightened scrutiny of actions taken pursuant to a board’s statutory prerogatives was specifically contemplated in *TW Services*. Chancellor Allen said that the business judgment standard of review should apply to a board’s exercise of its statutory prerogatives only “where there is no interested merger involved.” See note 28, *supra*. The transaction at issue *Digex* plainly did not satisfy that requirement.

57. Throughout this article, I have referred to the “business judgment rule” or the “business judgment standard of review,” and now I switch to the “business judgment presumption.” My equivocation mirrors that of the Delaware courts, which in their current formulation of the business judgment rule note that the rule has both a procedural aspect (establishing which party bears the burden of proof as to a particular matter) and

as a substantive aspect. Delaware’s current articulation of the dual function of the business judgment rule was summarized by the Delaware Supreme Court as follows:

The business judgment rule “operates as both a procedural guide for litigants and a substantive rule of law.” Procedurally, the initial burden is on the shareholder plaintiff to rebut the presumption of the business judgment rule. To meet that burden, the shareholder plaintiff must effectively provide evidence that the defendant board of directors, in reaching its challenged decision, breached any one of its “triad of fiduciary duties, loyalty, good faith or due care. Substantively, “if the shareholder plaintiff fails to meet that evidentiary burden, the business judgment rule attaches “ and operates to protect the individual director-defendants from personal liability for making the board decision at issue.

McMullin v. Beran, 765 A.2d 910, 916-917 (Del. 2000) [citations omitted.]

58. *In re Fuqua Industries, Inc. Shareholder Litigation*, C. A. No. 11974, 1997 Del. Ch. LEXIS 72 (Del. Ch. May 13, 1997)

59. *Id.* at *15.

60. *Id.*

61. *Id.* at *17.

62. *Id.* at *5.

63. *Id.* at *6.

64. *Id.* at *26.

65. *Id.*

66. *Id.*

67. *Id.* at *27.

68. *Id.* at *31-32.

69. *Id.* at *32.

70. *Id.*

71. *Id.* at *43

72. *Id.*

73. Directors who act with the intent of entrenching themselves in office breach the fiduciary duty of loyalty. See, e.g., *Uni-marts v. Stein*, 1996 Del. Ch. LEXIS 95 (Del. Ch. August 9, 1996). An entrenchment claim has two elements: “the first is proof of a corporate action that has the effect of protecting the tenure of corporate directors by one means or another; the second is proof that that action was motivated primarily or solely for the purpose of achieving that effect.” *Heineman v. Datapoint Corporation*, 1990 Del. Ch. LEXIS 162 *6 (Del. Ch. October 9, 1990)

74. *Fuqua*, 1997 Del. Ch. LEXIS 72 at *26.

75. *ACE Limited v. Capital Re*, note 1, *supra*.

76. When added to the approximately 12% ownership stake held by the buyer, these voting agreements meant that approximately 46% of the outstanding shares were “locked-up” in support of the merger. *ACE*, 747 A.2d at 98.

77. *Id.* at 97.

78. *Id.* at 106.

79. The Vice Chancellor noted that in light of the voting agreements, “the board’s inability to consider another offer in effect precludes the stockholders (including the 33.5 percent holders) from accepting another offer.” *Id.* at 107.

80. *Id.* at 108.

81. *Id.* at 108.

82. *Id.* at 109.

83. Pat Vlahakis, *The Section 203 Waiver A New Delaware Hazard?* 3 *The M&A Journal* 4, at 7-8 (2001).

84. *Id.*

85. John J. Jenkins, What’s the Big Deal? Delaware Looks at Boards, Stockholders and Protecting the Agreement, *Business Law Today*, Nov/Dec. 2000 32, 36.

86. As Vice Chancellor Strine observed, “in another sense, the [buyer’s interpretation of the no-shop] provision is much more pernicious in that it involves an abdication by the board of its duty to determine what its own fiduciary obligations require at precisely that time in the life of the company when the board’s own judgment is most important.” *ACE*, 747 A.2d at 106.

87. The business judgment rule does not protect against disclosure claims, because a decision about disclosure is not “a decision concerning the management of the business and affairs of the enterprise.” *In re Anderson, Clayton Shareholders Litig.*, 519 A.2d 669 (Del. Ch. 1986).

88. In *Omnicare*, the defendants argued that because the voting agreements did not involve unilateral board action, applicable precedent demonstrated that they were not subject to review under *Unocal*. The court did not disagree, but noted that, those prior decisions did not hold that “the operative effect of a voting agreement must be disregarded *per se* when a *Unocal* analysis is applied to a comprehensive and combined merger defense plan.” *Omnicare*, 818 A.2d at 934.

89. *Revlon v. MacAndrews & Forbes*, 506 A.2d 173 (Del. 1986), is likely to produce groans from the Delaware corporate bar.

90. See J. Travis Laster, *Exposing a False Dichotomy: The Implications of the No-Talk Cases for the Time/Revlon Double Standard*, 3 *Del. L. Rev.* 179, 221 (“directors always have an obligation to act on an informed basis to maximize stockholder value by maximizing the value of the corporation. *Revlon* and its progeny are unique only because they identify situations in which the directors must focus on a particular point in time for purposes of ascertaining competing values and analyzing alternatives.”)

91. See, e.g., *Paramount Communications v. QVC Networks*, 637 A.2d 34 (Del. 1993).

92. *Revlon*, 506 A.2d at 182.

93. In *Orman v. Cullman*, CA No. 18039 (Del. Ch. October 20, 2004), the chancery court applied a *Unocal* analysis to a force the vote clause contained in a merger agreement. However, it did so with a remarkably light touch, noting that the minority shareholders had the ability to turn down the transaction, it was inappropriate to strike down the merger agreement’s force the vote clause under *Unocal*, even though the majority shareholder had agreed to an 18-month “lock-out” provision prohibiting it from entering into another transaction. *Id.* at 15-23.

94. *Omnicare*, 818 A.2d at 927.

95. E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 *Bus. Law.* 393, 403 (1997).

96. William T. Allen, Jack B. Jacobs and Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 *U. Chi. L. Rev.* 1067, 1078 (“The DGCL gives the board of directors a central role in corporate decisionmaking, but it also requires stockholder assent for many fundamental transactions. Most importantly, the DGCL is silent on the most contentious question in the debate between the two schools: in what circumstances, and to what extent, are directors empowered to prevent stockholders from accepting a tender offer? The DGCL does not speak to this question, leaving the significance of that silence for vigorous debate.” [citations omitted.]

Insider Trading and “Big Boy” Letters

By David Becker and Shawn J. Chen

With the recent uptick in insider trading investigations being conducted by the SEC has also come an increased awareness of a previously obscure trading practice: the use of so-called “Big Boy” letters by sophisticated (generally institutional) investors.¹ Big Boy letters were originally designed to address the situation where a trader possesses material non-public information about a company that cannot be disclosed, but nonetheless wishes to trade in that company’s securities. The Big Boy letter allows the trader and his counterparty to acknowledge that information disparity and then, assuming the counterparty agrees to waive any claim of detrimental reliance, proceed with the trade.

While the exact language used in Big Boy letters may vary, the basic concept remains the same: The counterparty signing the letter represents that it is financially sophisticated and acknowledges that the trader has (or may have) material non-public information of which the counterparty is unaware. The counterparty states that it nonetheless wishes to proceed with the transaction—*i.e.*, “I’m a big boy”—and provides a blanket waiver of any potential cause of action under the securities laws or waives any factual claim of detrimental reliance on the non-disclosure, or both.

Afterwards, should the counterparty bring a private lawsuit for securities fraud, claiming to be the victim of insider trading, the trader can present the Big Boy letter to argue that (1) any such cause of action has been waived, (2) there was no reasonable reliance, or (3) there was no deception of the counterparty. Each of these arguments has met in the courts with differing success.

The first argument, though seemingly ironclad, is perhaps the least viable. In cases where the counterparty has signed a blanket waiver of all legal claims, that waiver might be deemed invalid under Section 29(a) of the Securities Exchange Act. That provision reads: “Any condition, stipulation, or provision binding any person to waive compliance

with any provision of [the Exchange Act] or of any rule or regulation thereunder . . . shall be void.” See 15 USC § 78cc(a). In other words, Section 29(a) prohibits the parties, as a matter of public policy, from relinquishing their rights under the federal securities laws. See *AES Corp. v. Dow Chemical Co.*, 325 F.3d 174, 181 (3d Cir. 2003).

More promising is the argument that, as a factual matter, a Big Boy letter critically undermines the counterparty’s ability to prove detrimental reliance. Since reasonable reliance by the plaintiff is an essential element of a private cause of action under Section 10(b), see *Basic Inc. v. Levinson*, 485 US 224, 243 (1988), a written representation of non-reliance as contained in a Big Boy letter would be compelling evidence for the defense. In *AES*, the Third Circuit focused on the element of “reasonable reliance” and held that non-reliance language in a merger agreement should be considered substantial evidence on that point and would, in some cases, justify summary judgment. *AES Corp.*, 325 F.3d at 181.

Lastly, there is the argument that the trader’s documented “quasi-disclosure”—that he possesses material non-public information that cannot be shared with the counterparty—shows that the counterparty had no reasonable expectation of information parity. In *McCormick v. Fund American Companies, Inc.*, 26 F.3d 869, 879-80 (9th Cir. 1994), and *Jensen v. Kimble*, 1 F.3d 1073, 1078 (10th Cir. 1993), the Ninth and Tenth Circuits adopted this argument and evaluated whether the alleged misconduct was even “manipulative or deceptive” in the first place. In both instances, the Court of Appeals assumed that there was a fiduciary duty to disclose, but held that, since the non-disclosing party had explicitly informed the counterparty of its failure to do so, those omissions could not be considered manipulative or deceptive. As the Court in *McCormick* summarized, “since the plaintiff ‘knew what he didn’t know,’ there was nothing misleading in the omission.” 26 F.3d at 880.²

The issues become thornier, however, in the context of an SEC enforcement action—and whether the same arguments prevail may turn on the particular legal theory applied. Unlike a private litigant,

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the SEC is not required to prove reliance or damages. *See, e.g., SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993) (citing cases). Therefore, the reliance argument under *AES* is unlikely to prevail.

With respect to the “lack of deception” argument, there seem to be two different possibilities. In cases brought under the “classical” theory of insider trading, the insider owes a fiduciary duty directly to his trading counterparty. Therefore, it may be possible to argue, under *McCormick* and *Jensen*, that the acknowledgments contained in a Big Boy letter are sufficient to satisfy the insider’s disclosure obligations and, thus, no deception has occurred.

In cases brought under the “misappropriation” theory, however, the alleged violation is premised on a deception against the source of the information, not against the trader’s counterparty. In other words, the trader owes a duty of trust or confidence to the source of his inside information, and he breaches that duty when he deceptively misuses that information to engage in a self-interested securities transaction. *See United States v. O’Hagan*, 521 US 642, 656 (1997) (stating that, under “misappropriation” theory, “the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information”). That deception would not seem to be redressed by a Big Boy letter signed by the trader’s counterparty.³

Not surprisingly, senior officials with the SEC staff have adopted that analysis and asserted that Big Boy letters are no defense to an SEC enforcement action.⁴ Yet following that logic would also mean that *any* trader in *any* misappropriation case—even one who provided complete disclosure of all non-public information to his or her counterparty—could theoretically be held liable based on the continued unremedied deception against the source of the information. The point is certainly debatable: it is unclear whether Section 10(b) can fairly be read to vindicate a federal interest in preventing sources of information from being deceived, where the trader obtains no informational

advantage in a private securities transaction as a result.

While the statements of individual staff members do not necessarily represent the views of the Commissioners or the official position of the SEC, these comments are noteworthy, since the staff has considerable discretion over the initiation and direction of enforcement investigations. It remains to be seen whether these comments are purely academic or presage a new direction for insider trading enforcement.

Notes

1. *See, e.g., SEC v. Barclays Bank PLC*, SEC Litigation Release No. 20132 (May 30, 2007), <http://www.sec.gov/litigation/litreleases/2007/lr20132.htm>. *See generally* Jenny Anderson, *Side Deals in a Gray Area*, N.Y. Times, May 22, 2007.

2. Both *McCormick* and *Jensen* involved allegations that the insider had breached his fiduciary duties to the plaintiff-counterparty. As discussed below, the legal analysis might be different in the context of a “misappropriation” case, where the insider is alleged to have breached his duty of trust or confidence to the source of the information, a third party not involved in the securities trade. *See* 15 U.S.C. § 78t-1(a) (granting private right of action to “contemporaneous traders” for claims based on “misappropriation” theory).

3. As the Supreme Court has noted, the proper “remedy” would be disclosure by the trader to his or her source, advising that the trader intends to breach his or her duty of trust or confidence and trade on the misappropriated information. *See O’Hagan*, 521 U.S. at 655. Scholars have commented on this peculiarity of U.S. securities law—that the faithless but “brazen” fiduciary could trade on inside information and technically not be liable for securities fraud (although other laws might still apply).

4. Rachel McTague, ‘Big Boy’ Letter Not a Defense to SEC Insider Trading Charge, *Official Says*, BNA Sec. L. Daily, Nov. 19, 2007, available at <http://pubs.bna.com/lip/BNA/sld.nsf/125731d8816a84d385256297005f336a1672fac662d8411bb852573960004f4f2?OpenDocument> (comments of Fredric Firestone, Associate Director, SEC); Rachel McTague, *In Insider Trading Case, Big Boy Letter Signatory Need Not Have Been Deceived, Official Says*, BNA Sec. L. Daily, Dec. 4, 2007, available at <http://pubs.bna.com/lip/BNA/sld.nsf/125731d8816a84d385256297005f336a128d852cb9ca4dc15852573a700024b22?OpenDocument> (comments of David Rosenfeld, Associate Regional Director, SEC).

Are Your Bylaws Ready for E-Proxy?

By John D. Tishler and Carrie H. Darling

Since 1995, the SEC has permitted electronic delivery of proxy materials provided that the stockholder has affirmatively consented in advance to electronic delivery. Following the SEC's interpretative guidance on this topic, many companies have attempted to solicit from their stockholders affirmative consents to electronic delivery. Common reasons include saving printing and mailing costs, reducing the environmental impact of paper delivery, and demonstrating technology savvy. The requirement for advance affirmative consent has however inherently limited the benefits which can be derived from electronic delivery.

In January 2007, the SEC adopted new rules to permit Internet delivery of proxy materials without advance affirmative consent. In July 2007, the SEC adopted further rules which combined the voluntary provisions of the January 2007 rules with a mandatory Internet availability requirement. The new rules, commonly referred to as the "e-proxy rules," apply to issuers, and to intermediaries who furnish proxy materials to beneficial owners of shares held in street name. The mandatory portion of the e-proxy rules became effective January 1, 2008 for large accelerated filers (other than registered investment companies), and will become effective January 1, 2009 for other issuers. Large accelerated filers, as well as other companies that wish to take advantage of the e-proxy rules this year, should make certain that the procedures they choose are in accordance with their bylaws. Our experience suggests that most companies will find that their bylaws do not affirmatively restrict their e-proxy choices, but many will nonetheless find that their bylaws can be improved to comport better with their actual corporate communication practices.

E-Proxy Framework

The e-proxy rules are structured via what the SEC calls a "notice and access model." The notice and

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access model allows companies a choice between two delivery methods:

Full Set Delivery—providing stockholders with a full set of paper copies of the proxy materials, posting the same on the issuer's web site, and including a Notice of Internet Availability of Proxy Materials with the paper copies.

Notice Only—posting proxy materials on the issuer's web site, and mailing only a Notice of Internet Availability of Proxy Materials. Under the notice only method, paper copies are not delivered unless a stockholder affirmatively requests paper copies.

Companies need not choose one method exclusively, and may use full set delivery for some stockholders, and notice only for others. Companies may also continue to use the SEC's existing guidance concerning delivery of proxy materials by electronic delivery with advance affirmative consent.

The e-proxy rules also facilitate electronic voting by permitting the notice to specify an electronic voting platform.¹

E-Proxy and Bylaws

The good news for most issuers is that complying with the mandatory portions of the e-proxy rules will not likely require changes to the bylaws. Most bylaws govern the manner of delivery of notices of stockholder meetings, and not the manner of delivery of proxy materials. Since both methods of notice and access compliance involve mailing a notice to stockholders, compliance with the notice provisions set forth in the bylaws will generally be satisfied in the same fashion as it has in the past.²

Even if a company decides to use e-proxy implementation to take advantage of the ability to secure advance affirmative consent for electronic only delivery, amendment of the bylaws is probably not required. In July 2000, amendments to the Delaware General Corporation Law (DGCL) facilitating electronic communications became

effective.³ These were commonly referred to as the “Technology Amendments.” The Technology Amendments allowed for electronic delivery of notices of stockholder meetings and any other notices required by the DGCL, a corporation’s certificate of incorporation or its bylaws, provided the stockholder has consented to such delivery. Section 232 of the DGCL states that notice of a stockholder meeting is effective if given by a form of electronic transmission consented to by the stockholder to whom the notice is given. This is similar to the SEC’s interpretive position on advance affirmative consent.⁴

The e-proxy rules also support (but do not require) use of electronic means of executing proxies. Section 212 of the DGCL, as amended by the Technology Amendments, permits a proxy to be given by telegram, cablegram or other form of electronic transmission provided that such transmission either sets forth or is submitted with information from which it can be determined that the proxy was authorized by the stockholder. Accordingly, electronic means of executing proxies may not require any amendment to a corporation’s bylaws.

The situation may be different for an annual report to stockholders. The DGCL does not require the delivery of an annual report to stockholders, and accordingly there are no provisions in the DGCL expressly authorizing delivery of such report by electronic transmission. Although there is no statutory requirement, many public companies do have bylaws that require delivery of an annual report to stockholders. These provisions were often included due to requirements imposed by the major stock exchanges for delivery of annual reports to stockholders. Both the NYSE and Nasdaq have recently amended their rules to permit annual report delivery to be satisfied through Internet posting.⁵ However, bylaw provisions corresponding to the old rules may still survive, and may require mailing of the annual report. Amendment of such a provision may be necessary in order to take advantage of the notice only method of delivery of proxy materials.⁶

Even where the Technology Amendments clearly permit a form of electronic transmission, there may be interpretive concerns with use of an electronic access method permitted by the e-proxy rules, where the bylaws expressly require a physical

means of delivery. While bylaws may be found void where they unreasonably limit a right given in the DGCL, a bylaw that places reasonable restrictions on a broader statutory right may be upheld. A company which chooses to take advantage of any of the voluntary flexibility permitted by e-proxy rules would be well-advised to make certain that its bylaws do not expressly prohibit the actions contemplated, or expressly require actions that are not performed in reliance on e-proxy flexibility. In such circumstances, it is not clear that the Technology Amendments will protect the validity of the corporate action. Inconsistencies may make it difficult to obtain an unqualified legal opinion as to the validity of certain corporate actions. Bylaws may generally be amended by board action, so correction of inconsistencies is not difficult.⁷

Moreover, the bylaws can be a useful roadmap for planning and conducting stockholder meetings. When they are kept current with statutory updates, the corporate secretary’s office may use them to plan for the proxy season and stockholder meetings without the need to reference separately the DGCL. Planning is more difficult and cumbersome, and procedural errors become more likely, when the bylaws are missing some of the requirements of the DGCL, are inconsistent with the DGCL, have provisions located under seemingly inapplicable section headings, or otherwise do not reflect the actual means by which a corporation is governing itself.

We therefore believe the SEC’s adoption of the e-proxy rules presents a good opportunity for companies to review all of their corporate governance communication practices, and ensure (1) such practices conform to all applicable laws and rules; and (2) that the bylaws conform to such practices. For example, many companies provide notices of board meetings by e-mail (which is permissible under the DGCL), but we frequently find that the enumerated means of giving notice stated in older bylaws do not include e-mail.

Examples of areas that may be reviewed, updated and improved in a communications review of bylaws include the following:

- All of the DGCL provisions relating to notices of stockholder meetings of stockholders can be relocated to a single section.

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- Provisions governing the electronic availability of stockholder lists may be provided, including express protection of the privacy of e-mail addresses.
 - Express language permitting a stockholder meeting without physical location may be added.
 - Express language permitting participation in stockholder meetings by remote communication may be added.
 - Express rules permitting ballot (as opposed to proxy) voting by electronic transmission may be added.

Various provisions stating the means of permissible communications, which may currently be internally inconsistent or not in full accordance with the definition of “electronic transmission” contained in the DGCL, can be harmonized and expanded to permit electronic communications in areas such as notices of board meetings, waivers of notice of or consent to board meetings, written consents in lieu of board meetings, notices of resignation by a director, and notices of resignation by an officer.

Conclusion

For most companies, e-proxy rules will not mandate an amendment to the bylaws. However, the e-proxy rules present an opportunity to take a fresh look at processes of corporate communications with stockholders and other corporate constituencies. It is not uncommon to find that bylaws, particularly older bylaws, no longer conform to the manner in which the company conducts itself or wishes to conduct itself. In the best case, the lack of conformity is an issue only of optics. In the worst case, it may call into question the validity of certain corporate actions, leading to unnecessary difficulty obtaining legal opinions, or even litigation challenging corporate decisions. For these reasons,

we recommend companies take the opportunity to review their bylaws with fresh eyes during the 2008 “e-proxy” season.

Notes

1. The issuer must establish and indicate in the notice a method of executing proxies. Permissible methods include an Internet voting platform, a toll-free telephone number, or a printable or downloadable proxy card from the issuer’s web site. If a telephone number is used, the number itself cannot be included on the notice card.
2. The e-proxy rules limit the content of the Notice of Internet Availability of Proxy Materials, but expressly permit information required to be included in a notice of a stockholders meeting under state law.
3. This article discusses only Delaware corporations. Many other state corporation codes have been updated to reflect electronic means of communications, and many of the areas of inquiry discussed in this article will also apply to bylaws of corporations organized in other jurisdictions. Of course, the laws of the particular state of incorporation need to be reviewed in accordance with any review of the bylaws.
4. The SEC’s interpretative releases permitting electronic delivery upon advance affirmative consent require evidence of actual delivery of a document. Such evidence is not required under Section 232 of the DGCL.
5. The NYSE and Nasdaq rules require a company that will rely on Internet posting to issue a press release stating that its annual report is available on the company’s website and including its website address. Consistent with the e-proxy rules, an NYSE or Nasdaq listed issuer must provide a hard copy free of charge upon request.
6. California corporations, as well as foreign corporations whose principal executive offices are located in California, or which regularly hold board meetings in California, may not be able to use the notice only method under current California law. California Corporations Code § 1501 requires such companies to delivery an annual report, and the permissible means of electronic delivery require advance consent as a precondition. Until Section 1501 is amended to conform to the e-proxy notice and access model, a corporation subject to Section 1501 should plan to use full set delivery for stockholders of record, and may also need to use full set delivery for street name holders.
7. A Form 8-K is required within four business days of any amendment to the bylaws. *See* Item 5.03.

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