

LEGAL UPDATES

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Recent Amendments to the Delaware General Corporation Law and SEC Proposed Rules

Corporate governance issues concerning (i) access to proxy solicitation materials, (ii) proxy expense reimbursement, and (iii) director indemnification and advancement of expenses are again at the forefront of debate in the wake of recent amendments to the Delaware General Corporation Law (DGCL) that will take effect on August 1, 2009. The Securities and Exchange Commission (SEC) has also taken up the topic of stockholder access in its own proposed rule-making. If and how the two approaches are reconciled remains to be seen, but regardless of the outcome, it appears that the push to expand access rights is gaining momentum.

Stockholder Access to Proxy Solicitation Materials

Stockholder access to a corporation's proxy statement has been a recurring topic in the corporate governance debate for several years. Existing laws and rules permit corporations to exclude stockholder proposals for director nominees from their proxy materials. Stockholders who want their slate of director nominees included in an election have had to prepare and mail separate proxy materials on their own time and at their own expense¹. In 2003 and 2007, the SEC considered proposals that supported stockholder access to proxy materials, but no rules emerged. The recent amendments and proposed rules are changing this landscape.

DGCL Section 112

In its amendments to the statute governing Delaware corporations, the Delaware legislature introduced new Section 112, entitled "Access to Proxy Solicitation Materials." The section permits, but does not require, Delaware corporations to adopt a bylaw allowing stockholder access to a corporation's proxy materials for director elections. Section 112 also permits bylaws that

impose certain "lawful" prerequisites or conditions on stockholder access, including those that:

Impose minimum stock ownership requirements (type, quantity, and/or duration of ownership) on the nominating stockholder;

Require that the nominating stockholder provide information about himself or herself and about the nominee, including ownership information;

Limit the number or proportion of directors nominated by the sponsoring stockholder or the number of times the stockholder can nominate candidates;

Preclude nominees that have acquired or propose to acquire a specified percentage of the corporation's voting power within a certain time period before director elections; and

Require that the nominating stockholder agree to indemnify the corporation for any loss arising from any false or misleading information or statement submitted by the stockholder in connection with the nomination.

The practical implications of the new law suggest several things. First, the rule contemplates unprecedented access for stockholders to a company's proxy materials and consequently to representation on its board of directors. Second, the law permits conditions to be placed on proxy access, thereby recognizing that a stockholder's access rights can be appropriately limited. Finally, it signals again the need for companies to review their bylaws and consider whether modifications should be made to protect the interests of the corporation and to avoid unwanted shareholder activism.

SEC Proposed Rule 14a-11

On May 20, shortly after Delaware adopted its amendments, the SEC approved proposed Rule 14a-11, which, if adopted, will federalize stockholder proxy access and could raise conflicts with any proxy access provisions set forth in state law or in a corporation's governing documents. Specifically, the proposed rule allows stockholders to include their nominees for directors in the corporation's proxy solicitation materials after meeting certain eligibility requirements:

The stockholder must hold a certain level of ownership in the corporation that will be measured as a percentage of shares and varies based on the size of the corporation - for example, 1% of voting shares for large accelerated filers, 3% for accelerated filers, and 5% for non-accelerated filers;

The stockholder must have acquired and maintained the required level of ownership for at least one year before submitting a nomination;

The stockholder must provide notice of a director nominee to the corporation within 120 days before the proxy materials' release date;

The stockholder must sign a statement of intent to maintain the requisite level of ownership in the corporation through the annual meeting;

The stockholder must certify that the nomination is not for the purpose of changing control of the corporation or gaining more than a minority representation on the board;

The stockholder must represent that the nominee meets objective state law and stock exchange independence standards; and

The stockholder must not have a prior agreement with the corporation regarding the nomination.

Under the new rule, stockholders will be permitted to nominate up to 25% of a corporation's board of directors and will be required to file Schedule 14N disclosures with the SEC. In addition to new proposed Rule 14a-11, the SEC also proposed to amend Rule 14a-8(i)(8) to require that companies include stockholder proxy access proposals in their proxy materials.

Stockholder Proxy Expense Reimbursement

Another proxy-related amendment to Delaware law adds new Section 113, entitled "Proxy Expense Reimbursement." This section permits, but does not require, Delaware corporations to adopt a bylaw requiring the corporation to reimburse stockholders for expenses incurred in soliciting proxies for director elections.

Like Section 112, Section 113 permits bylaws that impose "lawful" conditions on the right to reimbursement, including those that:

Condition eligibility for reimbursement based on the number or proportion of persons nominated by the stockholder or whether the stockholder previously sought reimbursement for similar expenses;

Limit the amount of reimbursement based on the proportion of votes cast in favor of the stockholder's nominees, or the expense incurred by the corporation in soliciting the proxies;

Limit the election of directors by cumulative voting; and

Establish "any other lawful condition."

The new section codifies, in part, the Delaware Supreme Court's 2008 decision in *CA, Inc. v. AFSCME Employees Pension Plan*², in which the court held that a stockholder-proposed bylaw amendment requiring the corporation to reimburse the stockholder for proxy-related expenses

incurred was a valid proposal. However, the court further determined that the proposed bylaw must include a fiduciary out that allows directors to ultimately decide whether or not to award reimbursement on a case-by-case basis. Notably, new Section 113 does not expressly require the inclusion of a fiduciary out, and it is not clear whether Delaware courts will (i) invalidate bylaws adopted pursuant to Section 113 that lack a fiduciary out, (ii) consider the inclusion of conditions on eligibility for reimbursement sufficient in lieu of a fiduciary out, or (iii) use its ruling to read, on a case-by-case basis, a fiduciary out into any bylaw allowing for reimbursement.

Director Indemnification and Advancement of Expenses

The final area of corporate governance significantly impacted by amendments to the DGCL involves limits placed on a corporation's ability to change or eliminate director indemnification rights and advancement of expenses. Under amended Section 145(f), no right to indemnification or to advancement of expenses may be eliminated or impaired by an amendment after the occurrence of the event based upon which the indemnification or advance is sought, unless the granting language expressly permitted retroactive elimination or impairment. The amendment responds to a Delaware Chancery Court holding in *Schoon v. Troy Corp*³. In *Schoon*, the court denied advancement of a former director's litigation expenses where the corporation had amended its bylaws to eliminate its obligation to advance expenses after the director left the board although the action giving rise to the advancement claim occurred before the bylaw amendment. The law rejects that outcome by providing that in the absence of a contrary provision, directors are entitled to indemnification and advancement of expenses as provided in the certificate of incorporation or bylaws at the time the act or omission occurs, even if formal action triggering the right is not initiated until after a director leaves the board.

What This Means to You

Delaware corporations can expect to receive stockholder proposals relating to proxy access and proxy expense reimbursement beginning in the Spring 2010 proxy season. These corporations should consider ways to effectively address proxy access and other issues arising as a result of the DGCL amendments by reviewing their bylaws and considering changes to avoid problems next year.

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¹ See Rule 14a-8(i)(8) of the Securities Exchange Act of 1934, which states that a corporation may exclude a stockholder's proposal if it relates to the election of directors. 17 C.F.R. § 240.14a-8(i)(8).

² *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).

³ *Schoon v. Troy Corp*, 948 A.2d 1157 (Del. Ch. 2008).

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