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Corporate Alert: Delaware Decision Signals a New Focus on Vote Buying Claims and Redefines Law on Record Holders

A recent Delaware Court of Chancery opinion is a must read for corporate practitioners. In the context of determining the outcome of concurrent consent solicitations for control of EMAK Worldwide, Inc. ("EMAK"), the Delaware Court of Chancery recognized that third party vote buying—vote buying that does not involve the use of corporate resources—and certain voting manipulation techniques (such as empty voting) will be subject to equitable review under Delaware law. *Kurz v. Holbrook*, C.A. No. 5019-VCL (Del. Ch. Feb. 9, 2010). The court also reshaped Delaware law by holding that Depository Trust Company ("DTC") participant banks and brokers, rather than just DTC itself, are stockholders of record, effectively increasing the universe of corporations that could be subject to Delaware's interested stockholder statute (DGCL § 203) and decreasing the number of transactions for which appraisal rights will be available pursuant to DGCL § 262. In addition, the decision contains a number of practically significant developments including an interpretation of bylaws purporting to cut short the terms of sitting directors and an analysis of director qualification bylaws.

Take Back EMAK, LLC ("TBE") ran a consent solicitation to take control of EMAK's board by removing and replacing certain incumbent directors. Days before the TBE consent solicitation deadline, Kurz, a TBE member and EMAK director, learned that the solicitation was approximately 100,000 votes short. Kurz responded by purchasing the voting and economic rights of 150,000 EMAK shares for \$1.50 at a time when EMAK was trading at \$1. Although the court recognized that the purchase did not fit neatly within the traditional vote-buying rubric, in that the allegations did not concern the use of corporate resources to buy votes, the court nevertheless determined that third party vote buying could be deleterious to stockholder voting and, thus, under appropriate circumstances, should be subject to equitable review.

Importantly, the court specifically observed that the concept of vote buying is sufficiently broad to encompass voting manipulation techniques identified in recent scholarship, such as empty voting, and outlined certain principles that would govern its analysis of these techniques. Third party vote buying will only merit review if it disenfranchises stockholders by affecting the outcome of the vote, either by delivering the swing votes or critically altering the voting pattern. Third party vote buying must not be the product of fraud. Among the factors that the court will look at in its equitable review are the legitimizing conditions necessary for meaningful stockholder voting, including the absence of coercion, the presence of full information about material facts, and the alignment of economic interests and voting rights. Applying these principles to the facts at hand, the court found that Kurz's last minute purchase was subject to equitable review because it was potentially disenfranchising. In the end, the court concluded that there was no legal wrong because the record demonstrated that the seller knew his shares

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were the swing shares, the purchaser acquired *both* the voting and economic rights, and the purchaser did not have “any competing economic or personal interests that might create an overall negative economic ownership in EMAK.”

The second significant aspect of the *Holbrook* decision is its change in the definition of stockholders of record. This change was prompted by a technical misstep in the consent solicitation process. The TBE consent solicitation seemingly received the required number of consents, but the inspector of elections did not count consents by beneficial owners because no one ever obtained the DTC omnibus proxy, which authorizes DTC participant banks and brokers to vote in accordance with the instructions that they receive from the beneficial owners. Under pre-existing Delaware law, this misstep would have been fatal to the consent solicitation because only the holders of record on the corporation’s stock ledger are entitled to vote and, up until the decision, record holders were not defined to include DTC participant banks and brokers. The decision changed that by redefining Delaware’s interpretation of “stockholders of record” to include participant banks and brokers as record holders, thereby aligning Delaware law with federal securities law. Thus, no DTC omnibus proxy was required. The court reached this result by determining that the Cede breakdown—DTC’s list indicating how many shares of a corporation are held by each of its participant banks and brokers—is part of the corporation’s stock ledger for purposes of determining the stockholders entitled to vote under Section 219(c).

The change in the definition of record holders has practical significance. The applicability of Delaware’s antitakeover and appraisal statutes turn in critical part on whether either a corporation’s shares are listed on a national securities exchange or held of record by more than 2,000 stockholders. 8 *Del. C.* § 203(b)(4); *id.* § 262(b)(1). By increasing the number of record holders, the Court of Chancery has effectively increased the number of corporations subject to § 203 and decreased the number of transactions for which appraisal rights will be available under § 262.

Finally, the *Holbrook* decision is notable for its invalidation of bylaw amendments purporting to cut short the terms of sitting directors and its discussion of the permissible reach of director qualification bylaws. It is simply a must read for any corporate practitioner.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. If you have any questions or wish to discuss your particular situation, please call Stephen P. Lamb (302-655-4411), Frances Mi (212-373-3185), John P. DiTomo (302-655-4412) or Jeffrey M. Gorris (302-655-4413).