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Corporate Alert: Delaware Supreme Court Narrows *Kurz v. Holbrook* Ruling

On April 21, 2010, the Delaware Supreme Court upheld in part and reversed in part the Delaware Court of Chancery decision *Kurz v. Holbrook*, discussed in our previous Corporate Alert (<http://www.paulweiss.com/files/upload/11Feb10Memo.pdf>).

Kurz v. Holbrook concerned an election contest between Take Back EMAK, LLC and Crown Emak Partners, LLC, both of which ran consent solicitations seeking to gain board control of EMAK Worldwide, Inc. The Court of Chancery opinion in *Holbrook* ruled on several issues of importance for corporate practitioners. First, the Court of Chancery ruled that third party vote buying and other vote manipulation techniques are subject to equitable review under Delaware law. Second, the Court of Chancery ruled that participant banks and brokers of Depository Trust Company, rather than just DTC itself, are stockholders of record for purposes of Delaware law, eliminating the need to obtain an omnibus proxy from DTC before consents executed by those participants can be given effect. Lastly, the Court of Chancery invalidated a bylaw amendment that attempted to cut short the terms of sitting directors.

Equitable Review of Third Party Vote Buying

The Supreme Court confirmed the Court of Chancery's opinion that third party vote buying merits judicial review when it disenfranchises stockholders by affecting the outcome of the vote. The Supreme Court also observed that for many years Delaware decisions have expressed concerns about transactions that result in a misalignment or disconnection between the voting and the economic interests of shares. However, the Supreme Court confirmed that the arrangement at issue in *Holbrook* was proper, because the transfer attempted to convey full economic and the voting interests in the shares.

Nevertheless, the Supreme Court invalidated the vote of those shares since the underlying transfer violated the terms of the governing restricted stock grant agreement. The Court of Chancery found that the transfer restrictions had been successfully contracted around. The Supreme Court disagreed, ruling that precisely because the buyer attempted to purchase both the full economic and voting rights, the transfer amounted to a violation of the restricted stock grant agreement.

Stockholders of Record

As a result of the Supreme Court's decision invalidating that transfer, it did not reach a decision on whether participant banks and brokers, rather than just DTC itself, are stockholders of record. Instead the Supreme Court ruled that the Court of Chancery's holding that DTC participant banks and brokers were part of a company's stock ledger was without any precedential effect, and further stated that the issue was a matter best left to the legislative process.

Amendment of Bylaws

The Supreme Court affirmed the Court of Chancery's decision that Crown's bylaw amendments were void as they were in conflict with the Delaware General Corporation Law. Crown held preferred stock that entitled it to appoint two directors, but the preferred stock could not otherwise vote in the election of directors and thus could not remove directors elected by the common stockholders. Given this, Crown sought passage of changes to the bylaws that would reduce the size of the board so that the directors it could appoint would be a majority of the board.

The DGCL explicitly addresses situations where the size of a board of directors is increased, but not where board size is decreased through a bylaw amendment. Thus, this was a case of first instance in Delaware. The Supreme Court affirmed the Court of Chancery's reasoning that removal of a director through a bylaw amendment violates the provision of the DGCL providing that a director "shall hold office until [a] successor is elected and qualified or until such director's earlier resignation or removal." Since the bylaw amendment at issue did not give rise to any of these circumstances, but nonetheless purported to terminate directors' terms of office, the amendment was invalid.

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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) or Frances Mi (212-373-3185).