



DELAWARE SUPREME COURT RULES ON CORPORATE GOVERNANCE ISSUES

RULING REVERSES IN PART THE CHANCERY COURT'S HOLDING IN *KURZ v. HOLBROOK*

On April 21, 2010, the Delaware Supreme Court issued an opinion affirming in part and reversing in part the Chancery Court's holding in *Kurz v. Holbrook*, C.A. No. 5019-VCL (Del.Ch. 2-9-2010). As we described in a [Client Alert](#) dated April 9, 2010, the lower court decision had established new precedent on several corporate governance issues. The Supreme Court's decision addresses for the first time the issue of whether seated directors can be removed through a bylaw amendment that seeks to reduce the size of the board. The opinion also deals with the right to vote shares that are held in street name, third party vote buying, and the potential to contract around stock transfer restrictions.

BACKGROUND

The case dealt with competing consent solicitations relating to control of the board of directors of EMAK Worldwide, Inc., a publicly traded Delaware corporation ("EMAK"), initiated by two opposing stockholder factions – Take Back EMAK, LLC ("TBE") and Crown EMAK Partners, LLC ("Crown").

At the time of the solicitations, EMAK had five seated directors and two vacancies on its board. TBE sought to remove two of the five EMAK directors without cause and elect three of its own designees. TBE secured consents for its proposal from brokers listed on the securities position listing maintained by The Depository Trust Company ("DTC"). TBE also obtained a consent from Donald A. Kurz ("Kurz") with respect to certain shares that he had the right to purchase at a future date from Peter Boutros ("Boutros"). The agreement between Boutros and Kurz transferred all the economic rights, but not record title, to the shares to Kurz because Boutros was not permitted to sell the shares outright due to certain transfer restrictions to which the shares were subject. Boutros had also granted to Kurz an irrevocable proxy entitling him to vote the shares.

Crown, which held shares of EMAK's preferred stock that entitled it to elect two directors (the "Crown Directors") to the EMAK board, but did not entitle it to vote in the election of other directors, sought to amend EMAK's bylaws to reduce the size of the board from seven to three directors and require that if the number of sitting directors exceeded three, a special meeting of the stockholders would be called to elect one director who would replace all directors other than the Crown Directors. Crown secured consents in favor of its proposed bylaw amendments from EMAK management and a large institutional holder.

EMAK's inspector of elections ruled in favor of Crown and against TBE, declaring the Crown solicitation in support of the bylaw amendment to be successful. The inspector of elections invalidated over one million votes obtained by TBE from DTC participant banks and brokers on the ground that the participants did not have proper voting authority because DTC had not provided its omnibus proxy. TBE's proposal was therefore found to lack sufficient support. TBE contested the decision of the EMAK inspector of elections, arguing that (i) the bylaw amendments proposed by Crown were invalid, and (ii)

the inspector improperly invalidated the banks' and brokers' consents obtained by TBE. Crown sought an order invalidating the TBE proposal on the basis that the votes attributable to the restricted shares purchased by Kurz from Boutros were the product of illegal vote buying and a violation of the transfer restrictions to which the shares were subject.

Please see our [Client Alert](#) dated April 9, 2010, for additional details about the facts of the case and the Chancery Court's opinion.

THE SUPREME COURT'S RULINGS

In *Crown EMAK Partners, LLC v. Kurz*, No. 64, 2010 (4-21-2010), the Supreme Court affirmed the Chancery Court's ruling that the bylaw amendments seeking to reduce the size of the board were void, noting that the legally proper sequence under Section 141(b) of the DGCL for accomplishing Crown's objective would be to (i) remove the challenged directors, (ii) reduce the number of directorships, and (iii) fill the vacancies. Crown's proposed amendment, by reducing the size of the board, would have removed sitting directors in a manner not permitted by this statute. The Supreme Court opinion did not, however, address Vice Chancellor Laster's dictum in the Chancery Court opinion regarding the impermissibility of bylaw provisions that impose a requirement that would disqualify a sitting director before the end of his or her term. The lack of Supreme Court guidance on this topic leaves open the question of whether, for example, a bylaw provision requiring a seated director to retire upon attaining a pre-determined age could be found to be impermissible under Section 141(b) of the DGCL.

The Supreme Court also affirmed the Chancery Court's ruling that Kurz did not engage in illegal vote buying, noting that "the Chancery Court correctly concluded that there was no improper vote buying because the economic interests and the voting interest of the shares remained aligned since both sets of interests were transferred from Boutros to Kurz by the purchase agreement." However, the Supreme Court reversed the Chancery Court's determination that the purchase agreement entered into by Boutros and Kurz did not violate the transfer restriction associated with the purchased shares. The Supreme Court concluded that "By reconnecting the voting rights to the economic ownership via the irrevocable proxy, the Purchase Agreement immediately conferred upon Kurz the functional equivalent of 'full ownership' . . .," which the Supreme Court determined left "nothing for Boutros to transfer to Kurz in the future, other than the bare legal title." The Supreme Court found that the purchase agreement between Boutros and Kurz was a violation of the transfer restrictions and therefore held that the agreement "did not operate as a legally valid sale or transfer of Boutros' shares, and that Kurz was not entitled to vote those shares."

Because the Supreme Court invalidated the votes attributable to the Boutros shares, it concluded that it was unnecessary to rule on the Chancery Court's determination that the DTC securities position listing should be treated as part of the stock ledger for purposes of Section 219(c) of the DGCL, thereby giving DTC's participant banks and brokers the right to vote shares held in street name in the absence of an omnibus proxy from DTC. The Chancery Court had noted that there is no clear legal authority governing the process of obtaining a DTC omnibus proxy and that DTC's securities position listing contains the same substantive information as a DTC omnibus proxy. The Supreme Court concluded that the statutory interpretation necessary to determine the scope of Section 219(c) was one that should be handled by the legislature, stating that "Any adjustment to the intricate scheme of which Section 219 is but a part should be accomplished by the General Assembly through a coordinated amendment process." In reaching this conclusion, the Supreme Court labeled the Chancery Court's interpretation of Section 219 "*obiter dictum* and without precedential effect."

CONCLUSION

Because the Supreme Court did not address Vice Chancellor Laster's dictum on the impermissibility of bylaw provisions that would prematurely end the term of a seated director, Delaware corporations should consider whether their bylaws contain director qualification provisions that may be rendered invalid if future court decisions follow Vice Chancellor Laster's dictum on that point.

Delaware corporations should also confirm that procedures are in place to ensure the delivery of a DTC omnibus proxy in connection with the voting of shares held in street name due to the fact that the banks and brokers included on the DTC securities position listing may not be considered stockholders of record for purposes of the company's official stockholder list and for voting purposes under Section 219(c) of the DGCL. Because DTC routinely delivers an omnibus proxy in connection with annual meetings, issues may arise infrequently in this area.

Finally, although the Supreme Court's ruling reinforced the protections associated with stock transfer restrictions, Delaware corporations should be explicit when drafting transfer restrictions in contracts and equity award agreements, and should ensure that such agreements properly identify the specific attributes of the stock that are subject to the restriction.

Please contact the Thompson & Knight attorney with whom you regularly work or Kenn Webb, a Partner in the Firm's Corporate and Securities Practice Group, to discuss any questions you have regarding the potential impact of the *Kurz v. Holbrook* and *Crown v. Kurz* decisions on your company's bylaws, proxy policies and practices, or stock transfer restriction agreements.

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