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Dealing with Dissidents: Vote-Buying and Management Slates

It has become increasingly common for incumbent boards to settle proxy contests by agreeing to include on the company's slate one or more of the nominees on the dissident's slate. A recent Delaware decision provides guidance to boards and their advisors regarding when agreements relating to board service raise vote-buying concerns.

by John Mark Zeberkiewicz and Blake Rohrbacher

Vote-buying generally refers to an arrangement under which a stockholder agrees to vote its shares as directed by another in exchange for consideration personal to the stockholder.[1] In one important vote-buying opinion, the Delaware Court of Chancery held that "[b]ecause vote-buying is so easily susceptible of abuse it must be viewed as a voidable transaction subject to a test for intrinsic fairness."[2]

The seemingly broad definition of vote-buying, along with the harsh standard of review involved in the entire-fairness analysis,[3] has caused significant concern among boards and their advisors, particularly in the context of proxy fights, where agreements to vote in exchange for support or concessions are not infrequently sought and obtained.[4] Viewed through the lens of "vote-buying," these arrangements could be subject to the "intrinsic fairness" test, even if the board determines that entering into the arrangement is in the best interests of the corporation and its stockholders. Incumbent boards have long sought to settle proxy contests before the stockholders' meeting by agreeing to include on the company's slate one or more of the nominees on the dissident slate.[5] With no explicit direction from the courts on this topic, incumbent boards (and their advisers) have for years been hoping that the general principles behind the vote-buying cases do not apply to such arrangements.

The Delaware Court of Chancery recently issued a decision[6] providing guidance to boards and their advisors regarding when arrangements relating to board service may trigger entire-fairness scrutiny. The Court's opinion in *Portnoy v. Cryo-Cell* suggests that, while a board's misuse of corporate assets to secure votes may constitute "vote-buying" subject to scrutiny under the entire-fairness test, a board's agreement to nominate a dissident stockholder (or its designees) to the board will not alone trigger entire-fairness scrutiny, if the details of the arrangement are fully disclosed to the stockholders before the election.[7]

Vote-Buying from *Schreiber* to *Hewlett-Packard*

Until *Portnoy* was decided, Delaware's two major modern vote-buying cases were the 1982 *Schreiber*

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case[8] and the 2002 *Hewlett-Packard* case.[9] Before *Schreiber*, it was unclear whether vote-buying was void *per se*.[10] *Schreiber* answered this question and provided a key test for analyzing vote-buying scenarios.[11]

In *Schreiber*, Texas International Airlines (TIA) was considering a stock-for-stock merger that may not have gone through without the vote of a substantial stockholder, Jet Capital Corporation. Though it recognized that the transaction was beneficial to TIA's other stockholders, Jet Capital threatened to block the merger because of the adverse tax consequences it would suffer as a result of the merger's effect on its outstanding TIA warrants.[12] To induce Jet Capital to support the merger, TIA explored the possibility of loaning money to Jet Capital, at a rate far more favorable than Jet Capital could have otherwise secured, thereby allowing Jet Capital to exercise the warrants.[13] Because Jet Capital and TIA shared some directors, TIA formed an independent committee to negotiate the loan to Jet Capital.[14] TIA then put the loan proposal in front of its stockholders, who approved the transaction under a majority-of-the-minority provision.[15]

The plaintiff attacked this transaction as vote-buying, claiming that TIA bought off Jet Capital's opposition to the merger with the low-interest loan.[16] The Court agreed that it was vote-buying, defining that term as "simply a voting agreement supported by consideration personal to the stockholder, whereby the stockholder divorces his discretionary voting power and votes as directed by the offeror."[17] But the Court held that not all vote-buying is void *per se*, noting that these were "peculiar" facts in that a majority of the disinterested stockholders had approved the loan transaction after full disclosure and the transaction was "purportedly for the best interests of all [TIA] stockholders."[18]

The Court held, however, that "[b]ecause vote-buying is so easily susceptible of abuse it must be viewed as a voidable transaction subject to a test for intrinsic fairness."[19] Finding no fraud in the fact that no warrant holder other than Jet Capital received a loan from TIA, and finding that TIA's decision was based on the stockholders' best interests, the Court ultimately held that the loan transaction "was not void *per se* because the object and purpose of the agreement was not to defraud or disenfranchise the other stockholders but rather was for the purpose of furthering the interest of all [TIA] stockholders."[20] The Court also held that the loan transaction, while still voidable, had been ratified "by a majority of the independent stockholders, after a full disclosure of all germane facts with complete candor," precluding any further judicial inquiry.[21]

Other vote-buying cases appeared between *Schreiber* and *Hewlett-Packard*, but those added relatively little to the vote-buying analysis.[22] *Hewlett-Packard*,[23] on the other hand, clarified the principles involved in the vote-buying analysis, finding that a corporation's misuse of corporate assets to entice a stockholder to vote in a particular manner could constitute "vote-buying," even in the absence of a formal agreement. At issue in the case—at the motion-to-dismiss stage—were efforts by the Hewlett-Packard Company (HP) to garner approval for a merger between HP and Compaq Computer Corporation. Before the merger vote, the proxy committee of Deutsche Asset Management (Deutsche Bank) "determined to vote its shares against the proposed merger" and submitted proxies to that effect.[24] Around the same time, "HP closed a new multi-billion dollar credit facility to which Deutsche Bank had been added as a co-arranger."[25] Deutsche Bank became concerned that its no vote would cause HP to "end the ongoing, and desired future, business dealings between HP and Deutsche Bank."[26] On the morning of the special meeting, Deutsche Bank and HP management held a telephone conference, after which Deutsche Bank switched its votes—nearly 17 million votes—to vote in favor of the merger.[27]

The Court noted the distinction between stockholders and management in the vote-buying analysis. It first stated that stockholders "are free to do whatever they want with their votes, including selling them to the highest bidder."[28] The Court then stated that "[m]anagement, on the other hand, may not use corporate assets to buy votes in a hotly contested proxy contest about an extraordinary transaction that would significantly transform the corporation, unless it can be demonstrated . . . that management's vote-buying activity does not have

a deleterious effect on the corporate franchise."[29] Accordingly, the *Hewlett-Packard* Court held that a plaintiff need only show "facts from which it is reasonable to infer that in exchange for 'consideration personal to the stockholder,' a stockholder has agreed to vote, or has in fact voted, his shares as directed by another."[30]

In its analysis of the vote-buying claim, the Court noted that Deutsche Bank's vote was bought with corporate assets because the "future business" that served as consideration "would necessarily have to be paid for with corporate funds."[31] Finding "a reasonable inference" that Deutsche Bank switched its vote as a result of HP's enticement, the Court then went on to hold that the plaintiff's allegations regarding the arrangement stated an "improper use of corporate assets by a board to interfere with the shareholder franchise."[32] The Court described the protective measures taken by the board in *Schreiber*—an independent special committee, independent counsel's determination that the loan agreement would be in stockholders' best interests, submission to the stockholders for a vote on the loan agreement, and majority-of-the-minority approval—and noted that, without such measures, courts "should closely scrutinize transactions in which a board uses corporate assets to procure a voting agreement."[33]

Portnoy v. Cryo-Cell

The *Portnoy* case involved a small public company, Cryo-Cell International, which faced the possibility of a proxy fight with a slate led by Andrew Filipowski, the indirect owner of 6 percent of Cryo-Cell's stock.[34] After a meeting with Filipowski, Cryo-Cell's board invited Filipowski to join management's slate.[35] The board vetted Filipowski's credentials and eventually "approved the expansion of the board and Filipowski's inclusion on the Management Slate, subject to the negotiation of a suitable standstill and voting agreement with Filipowski."[36] Filipowski and Cryo-Cell entered into a voting agreement, which was filed with the SEC. That agreement provided that, in exchange for Filipowski's agreement to vote the shares he controlled in favor of the management slate, "Cryo-Cell would expand the board by one seat, effective at the date of the 2007 annual meeting, and that it would include Filipowski as the nominee for that seat on the Management Slate."[37]

The Court found that Cryo-Cell also had agreed to give Filipowski's colleague, Matthew Roszak, a seat on the board.[38] That is, the Court found that Cryo-Cell's CEO had "promised Filipowski that if the Management Slate won, the incumbent board majority would use its powers under the Company's bylaws to expand the Cryo-Cell board from six members to seven and to fill the new seat with Filipowski's designee, Roszak."[39] This agreement, the Court found, had not been disclosed to the stockholders.[40]

The plaintiff challenged these arrangements as improper vote-buying. The Court's analysis was split. Though the Court acknowledged that the Filipowski voting agreement "fit[] comfortably, as a linguistic matter, within the traditional definition of so-called vote buying," it found for the defendants.[41] On the other hand, the Court held that the Roszak deal "was improper and inequitably tainted the election process."[42]

Interestingly, though *Portnoy* discussed *Schreiber*, setting forth a two-pronged analysis under that case,[43] it did not explicitly rely on *Schreiber* or *Hewlett-Packard* to analyze the vote-buying claims regarding Filipowski and Roszak.[44] Regarding the Filipowski voting agreement, for example, the Court held that "a mere offer of a position on a management slate should not be considered a vote-buying arrangement subject to a test of entire fairness, and for that reason, I see no reason to condemn the addition of Filipowski to the Management Slate."[45]

The Court held that the Filipowski agreement did not disenfranchise the Cryo-Cell stockholders because it was disclosed to them.[46] That is, because Filipowski was added only to the management slate, subject to the stockholders' votes, the stockholders could not have been injured by the arrangement he made with the incumbent directors. The Court then held that such arrangements should not, as a general matter, be made subject to entire-fairness review, calling them "useful compromises that result in the addition of fresh blood to management slates, new candidates who will tend to represent actual owners of equity and might therefore be more independent

of management and more useful representatives of the interests of stockholders generally."[47] Again, because the stockholders would make the ultimate choice, the Court held that the Filipowski agreement was not the sort that merited an entire-fairness review: "Given that the electorate's own opportunity to decide for itself whether Filipowski should serve, I think it unwise, as a matter of our common law, to apply the intrinsic fairness test to this situation."[48]

The Court saw the Roszak situation somewhat differently. The Court first focused on the difference between a position on the management slate and a position on the board itself, calling the Roszak arrangement a "promise that would not be . . . subject to prior approval by the electorate."[49] Nevertheless, the Court did not rely on that fact. Though conscious of the argument "that incumbents should not be adding new candidates only on the condition that those who suggest them agree to vote for the management slate at the next election," the Court recognized that permitting such agreements would allow, and probably incent, boards to "add new representation at the instance of vocal stockholders and avoid a high-stakes fight for control."[50]

It was not necessarily the "vote-buying" aspect of the claim that eventually led the Court to find the Roszak arrangement improper. Instead, the Court's primary concern with the Roszak arrangement was that "it was a very material event that was not disclosed to the Cryo-Cell stockholders."[51] The Court held that the stockholders did not know that the CEO "had promised that the board would use its fiduciary powers to expand the board to seven members and seat another person designated by Filipowski."[52] The Court therefore held that the "Cryo-Cell electorate voted in ignorance of the actual board that would govern them in the event the Management Slate won."[53]

Dealing with Dissident Stockholders

The *Portnoy* Court was well aware of the realities of voting coalitions.[54] Similarly, the Court noted the "complicated calculus made by incumbent boards considering whether to add to the management slate candidates proposed by a large blockholder whose velvety suggestions were cloaking an unmistakably clenched fist," but recommended that such decisions were properly left to the board—so long as the stockholders were made aware of the arrangement.[55] That is, "[w]hen stockholders can decide for themselves whether to seat a candidate who obtained a place on a management slate by way of such bargaining," the courts will not get involved in second-guessing the arrangement.[56] Even with the Roszak arrangement, where Roszak would not have been elected by the stockholders, disclosure would have made the stockholders aware that their votes constituted a vote for the slate *plus* the soon-to-be-appointed Roszak.

Portnoy therefore provides guidelines for corporations and their counsel to navigate these types of settlement arrangements. If an incumbent board wishes to defuse a dissident stockholder's threat to mount a proxy challenge, or to convince a dissident to abandon the contest altogether, the board may reach agreement regarding board service so long as the agreement is fair,[57] the agreement is fully disclosed to the stockholders,[58] and the board does not coerce votes with corporate assets.[59]

Conclusion

The Delaware courts traditionally have viewed "vote-buying" arrangements with circumspection. As a result, although it has not been uncommon for boards of directors facing a proxy contest to negotiate with dissident stockholders to find a mutually agreeable resolution—often nominating a dissident's nominees to management's slate—it was unclear, until *Portnoy*, whether these arrangements could be challenged or voided for running afoul of the prohibitions on "vote-buying." The Delaware Court of Chancery's opinion in *Portnoy* suggests that these arrangements will not be subject to entire-fairness scrutiny, if the board fully discloses the details of the arrangements and does not misuse corporate assets or otherwise act inequitably.

NOTES

1. *See Hewlett v. Hewlett-Packard Co.*, 2002 WL 549137, at *4 (Del. Ch. Apr. 8, 2002); *Schreiber v. Carney*, 447 A.2d 17, 23 (Del. Ch. 1982). This article is concerned with "vote-buying" arrangements between the corporation and its stockholders. It does not address voting agreements

among stockholders entered into pursuant to Section 218(c) of the General Corporation Law of the State of Delaware, 8 *Del. C.* § 218(c), nor does it address agreements under which voting rights with respect to stock are divorced from the equitable ownership of the stock. The Court in *Hewlett-Packard* recognized this distinction, stating: "Shareholders are free to do whatever they want with their votes, including selling them to the highest bidder," so long as corporate assets are not exchanged for votes. *Hewlett-Packard*, 2002 WL 549137, at *4. *But see Commonwealth Assocs. v. Providence Health Care, Inc.*, 641 A.2d 155, 158 (Del. Ch. 1993) (expressing doubt that, "in a post record-date sale of corporate stock, a negotiated provision in which a beneficial owner/seller specifically retained the 'dangling' right to vote as of the record date, would be a legal, valid and enforceable provision, unless the seller maintained an interest sufficient to support the granting of an irrevocable proxy with respect to the shares").

2. *Schreiber*, 447 A.2d at 26.

3. *See Mills Acq. Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1988) (recognizing that, because "the standard of entire fairness [is] so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation" (internal quotation marks omitted)).

4. Indeed, this practice is on the rise. *See* Phred Dvorak & Joann S. Lublin, "Boards Give Up Taming Act: Activist Investors Take Seats Increasingly Without Fight," *Wall St. J*., Apr. 7, 2008, at C1.

5. For example, the boards of directors of Motorola, WCI Communities, Inc., and Nabi Biopharmaceuticals agreed to nominate directors designated by a dissident stockholder to head off a proxy contest. *See* Sara Silver, "Motorola Reaches Truce with Icahn," *Wall. St. J*., Apr. 8, 2008, at B3; WCI Communities, Inc., Proxy Statement (Form 14-A) (Aug. 21, 2007); Nabi Biopharmaceuticals, Current Report (Form 8-K) (Nov. 15, 2006); *see also* Ronald J. Gilson & Reinier Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors," 43 *Stan. L. Rev*. 863, 872 (1991) (discussing Texaco's agreement to give stockholder CalPERS a board seat in exchange for support in a proxy fight against Carl Icahn in the 1980s). Even if not successful, incumbent boards often offer board seats to avoid proxy fights. *See, e.g.*, Donna Kardos, "Jana Says It Rejects CNET Offer," *Wall St. J*., Apr. 2, 2008, at B8 ("The hedge fund, which is seeking to elect seven new members to CNET's eight-person board, also disclosed it rejected a CNET offer of one board seat.").

6. *Portnoy v. Cryo-Cell Int'l, Inc.*, 940 A.2d 43 (Del. Ch. 2008).

7. *Id.* at 68.

8. *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982).

9. *Hewlett v. Hewlett-Packard Co.*, 2002 WL 549137 (Del. Ch. Apr. 8, 2002).

10. *Schreiber*, 447 A.2d at 23.

11. *Id.* at 24.

12. *Id.* at 19.

13. *Id.* at 20.

14. *Id*.

15. *Id*.

16. *Id.* at 22.

17. *Id.* at 23.

18. *Id*.

19. *Id.* at 26.

20. *Id*.

21. *Id*.

22. *See, e.g.*, *In re IXC Commc'ns, Inc. S'holders Litig.*, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999); *Henley Group, Inc. v. Santa Fe S. Pac. Corp.*, 1988 WL 23945 (Del. Ch. Mar. 11, 1988, revised Apr. 12, 1988); *Weinberger v. Bankston*, 1987 WL 20182 (Del. Ch. Nov. 19, 1987); *Kass v. E. Air Lines, Inc.*, 1986 WL 13008 (Del. Ch. Nov. 14, 1986), *appeal refused*, 518 A.2d 983 (Del. 1986)

23. *Hewlett v. Hewlett-Packard Co.*, 2002 WL 549137 (Del. Ch. Apr. 8, 2002).

24. *Id.* at *3.

25. *Id*.

26. *Id*.

27. *Id*.

28. *Id.* at *4.

29. *Id*.

30. *Id*.

31. *Id.* at *5 n.12.

32. *Id.* at *5–6. The Court also stated that the plaintiffs would bear, at trial, the "significant burden" of showing that Deutsche Bank was induced into switching its vote by HP management "and that the switch of those votes was not made by Deutsche Bank for independent business reasons." *Id.* at *7. The Court found, in its post-trial opinion, that the plaintiff did not meet its burden. *Hewlett v. Hewlett-Packard Co.*, 2002 WL 818091, at *12 (Del. Ch. Apr. 30, 2002); *see also id.* at *13–15.

33. *Hewlett-Packard*, 2002 WL 549137, at *7 ("This is not to say that all of the protective measures taken in *Schreiber* must be present before the Court will validate vote-buying by management using company assets. Each case must be evaluated on its own merits to determine whether or not the legitimacy of the shareholder franchise has been undercut in an unacceptable way.").

34. *Portnoy v. Cryo-Cell Int'l, Inc.*, 940 A.2d 43, 48 (Del. Ch. 2008). Another slate of dissident directors led by David Portnoy did engage in a proxy contest with management, the results of which led to the lawsuit at issue in the case.

35. *Id.* at 51.

36. *Id.* at 53.

37. *Id*.

38. *Id.* at 63.

39. *Id.* at 71.

40. *Id.* at 72.

41. *Id.* at 66.

42. *Id.* at 72.

43. *Id.* at 67–68 (holding that *Schreiber* sets forth the following two-pronged analysis: (1) "if the plaintiff can show that the 'object or purpose

[of the vote buying was] to defraud or in some way disenfranchise the other stockholders,' the arrangement would be 'illegal per se'" and (2) "'because vote-buying is so easily susceptible of abuse it must be viewed as a voidable transaction subject to a test for intrinsic fairness'" (alteration in original)).

44. Notably, the Court cited *Hewlett-Packard* only in its analysis of a third vote-buying claim. *See id.* at 74 nn.174–175, 177 and at 75 nn.178–179. In that claim, the Court addressed Portnoy's complaint that Cryo-Cell—in an effort to secure the support of one of its significant stockholders, Saneron CCEL Therapeutics Inc. (Saneron)—indicated that it would discontinue its cooperation with Saneron if Saneron failed to support management's slate and promised to provide Saneron with its long-sought but never theretofore granted removal of a restrictive legend on its shares if it voted as management desired. *Id.* at 56–59. In addressing the plaintiff's claims regarding Saneron's vote, the Court found that the CEO breached her fiduciary duties "by intentionally using corporate assets to coerce Saneron in the exercise of its voting rights." *Id.* at 74.

The Court distinguished the analysis of these claims from the analysis of the Filipowski and Roszak claims. *Id.* at 73 (stating that the transactions underlying the Saneron claims "are much less problematically dealt within the *Schreiber* framework than properly disclosed agreements that involve give-and-take about the shape of a board slate").

45. *Id.* at 70.

46. *See id.* at 68.

47. *Id.*

48. *Id.*

49. *Id.* at 71.

50. *Id.* at 71–72.

51. *Id.* at 72.

52. *Id.*

53. *Id.* at 73.

54. *Id.* at 67 ("[V]oting agreements with respect to corporate stock are actually contemplated by our statutory corporate law [*citing* 8 *Del. C.* § 218]. Often such agreements have the intended effect of forming a voting coalition between stockholders that involves the requirement that the contracting parties vote to elect each other to the board." (footnote omitted)).

55. *Id.* at 69.

56. *Id.*

57. That is, "purposely inequitable conduct in the accumulation of voting power will not be tolerated." *Id.* at 67; *see also Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988) (stating that, in the case of "board acts done for the primary purpose of impeding the exercise of stockholder voting power," the board would bear the "heavy burden of demonstrating a compelling justification for such action").

58. *Portnoy*, 940 A.2d at 73 (stating that "an agreement of this kind that was made and disclosed in advance of an election is subject to the important fairness check of the stockholder vote itself").

59. *See id.* at 70 (noting that "there is not a hint that Filipowski sought to receive financial payments from Cryo-Cell in the form of contracts or consulting fees or other such arrangements").

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