Corporate Governance Issues Related to Strategic Investments in Public Companies

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Strategic investments in public companies have become an increasingly popular means for parties to form a strategic alliance. The investments reflect many of the same objectives that more traditional joint ventures offer, including risk sharing, a needed infusion of cash, access to specialized knowledge, a predicate to further arrangements and even operating synergies of one form or another. To the extent that a public company has more than...
one strategic investor, these structures can even be analogized to more formal joint ventures with the strategic investors using a public corporation as a vehicle. The public corporation may offer enhanced access to capital or establish a currency for acquisitions. In this type of arrangement, the public could be viewed as an additional party to the venture.

An issue of primary importance in structuring a strategic investment in a public corporation is providing for governance arrangements that both allow the corporation to function smoothly and effectively and allow the strategic partner to ensure that the resources it has committed will be used to further its business objectives. The strategic partners may not have entirely common business objectives because strategic partners often have a multiplicity of businesses and investments. These differences may lead to disputes, placing a premium on careful planning in advance as to the form and extent of each partner’s ability to influence the management and policies of the public corporation in the event of a dispute. When a strategic alliance is in the form of a corporation, governance arrangements as a means to achieve influence over a corporation vary from board representation to controls at the stockholder level to contractual consent rights. Board representation is sometimes coupled with supermajority voting requirements for certain actions by the board, which allow the directors designated by a strategic partner to block those actions. Similarly, stockholder controls include issuance of a separate class of stock with a class vote and charter provisions that require a supermajority vote, thereby enabling a strategic partner with a sufficient percentage to block action. In addition, the parties may avail themselves of the ability to veto major transactions through contractual provisions in a governance or similar agreement.

While legal issues with respect to the fiduciary duties of directors, managers and significant stockholders and the legality of certain contractual provisions arise in connection with the governance arrangements for any strategic alliance or joint venture, the use of a public corporation as a vehicle for a strategic investment introduces several factors that give rise to distinctive legal issues, particularly where the strategic investment is made in an already existing public company. The public corporation typically has a group of disaggregated investors who, under the leadership of the board, have a greater commonality of interests than a private partnership (or closed corporation) among a limited group of significant investors with varying

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1 In this article, the relevant legal issues are analyzed under Delaware law. In addressing stock exchange issues, the article focuses on the applicable rules of The New York Stock Exchange ("NYSE"). Strategic investments discussed in this article were made in Delaware corporations unless specifically noted.
strategic interests. Moreover, directors and controlling stockholders\(^2\) have a fiduciary duty to public stockholders to an extent that cannot be as easily mitigated as it can with a private partnership or closely held corporation.\(^3\) Accordingly, the inevitably conflicting goals of a strategic investor with the interests of public stockholders can raise special legal issues with respect to governance matters. In addition, unlike a private joint venture (or closed corporation), a public corporation must comply with the rules of the applicable exchange upon which the securities of the corporation are listed.\(^4\)

While the general topic of this article is strategic investments in public corporations, the focus is on investments made in preexisting public corporations. In contrast to strategic investments made in private joint ventures or close corporations that at some point become public corporations, strategic investments in preexisting public corporations present more difficult legal issues in designing governance arrangements because of the limits placed on altering the rights of preexisting public stockholders under applicable law and stock exchange rules. Designing the governance arrangements for a corporate joint venture before the public offering offers

\(^2\) A controlling stockholder includes a stockholder who owns more than 50% of the company's capital stock or otherwise has "a dominant position and actually control[s] the corporation's conduct." *In re W. Nat'l Corp. S'holders Litig.*, No. 15927, 2000 WL 710192, at *6 (Del. Ch. May 22, 2000).

\(^3\) See *US West, Inc. v. Time Warner Inc.*, No. 14555, 1996 WL 307445, at *22 (Del. Ch. June 6, 1996) (noting flexibility to contract with respect to fiduciary duties in limited partnership and even corporations, particularly close corporations, given the modern flexibility of corporate charters, while also noting there is little incentive for passive investors to contract away managers' fiduciary duties); see also 8 DEL. CODE § 350 ("A written agreement among the stockholders of a close corporation holding a majority of the outstanding stock entitled to vote . . . is not invalid, as between the parties to the agreement, on the ground that it so relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors. The effect of any such agreement shall be to relieve the directors and impose upon the stockholders who are parties to the agreement the liability for managerial acts or omissions which is imposed on directors . . . .").

\(^4\) When a strategic partner invests in an existing public corporation, the governance arrangements are often defined by a governance agreement or standstill agreement. See Steven A. Baronoff, Note, *The Standstill Agreement: A Case of Illegal Vote Selling and a Breach of Fiduciary Duty*, 93 YALE L.J. 1093, 1094-95 (1984) (explaining that standstill arrangements usually include an agreement to give the investor representation on the board and other agreements); Joseph W. Bartlett & Christopher B. Andrews, *The Standstill Agreement: Legal and Business Considerations Underlying a Corporate Peace Treaty*, 62 B.U. L. REV. 143, 144 (1982) (examining the basic framework of a typical standstill agreement). When there is more than one strategic investor, there is often a stockholders agreement among the investors accompanying the separate governance agreement typically entered into with the corporation. In addition, one should note that the legal relationship relating to strategic alliances involving investments in public corporations extends beyond governance arrangements to provisions regarding share transfers, registration rights, restrictions on additional purchases, preemptive rights and a number of other matters. These are beyond the scope of this article. In addition, this article does not focus on the issues presented by minority investments that are primarily financial (rather than strategic) or arise in response to a hostile attempt to achieve influence or control.
greater flexibility (and presents less difficult issues) under applicable law and stock exchange rules because each stockholder consents to the governance arrangements presented and is not thereby subject to any form of disenfranchisement. An alternative means of making a strategic investment in a public corporation that does combine some elements of an initial public offering is presented when a parent company takes its wholly owned subsidiary public by means of issuing such subsidiary's shares to acquire a public corporation. Under this structure, the parent company would typically become a significant stockholder of the newly formed public company, and the stockholders of the preexisting public corporation would become a stockholder of the newly combined entity.

Part II of this paper examines controls for a strategic partner of a public corporation through representation on the board and supermajority provisions for action by the board, Part III addresses stockholder controls over a public corporation through supermajority provisions for action by stockholders and the use of securities with a class vote on certain matters and Part IV considers control over corporate actions through contractual vetoes.

II. CONTROLS OVER THE BOARD OF DIRECTORS

A. Introduction

The obvious starting point for an analysis of governance arrangements used by strategic partners to protect their interests is representation on the board of directors. As a means to achieve influence, investors will seek to ensure that they have the power to designate certain members of the board of directors, subject to regulatory issues. This representation is typically proportionate to the investor's equity interest. In addition to board representation, the investor will often negotiate ancillary covenants to protect its right to board representation, such as a requirement of regular board

5 To be sure, even the governance arrangements for corporate joint ventures in anticipation of an eventual public offering can raise technical issues as noted in this article. Nonetheless, these issues can often be surmounted. The examples of strategic alliances in this article do not involve strategic investments in joint ventures that subsequently go public unless specifically noted.

6 For example, Liberty Media Corporation ("Liberty Media"), in connection with its investment in USA Networks, Inc. ("USA"), has the right to designate up to two directors of USA at any time that its representation on the board is not prohibited by FCC law and regulations (which it currently is). Form of Governance Agreement among HSN, Inc. (renamed USA Networks, Inc.), Universal Studios, Inc., Liberty Media Corporation and Barry Diller, dated as of October 19, 1997, § 2.02(f) [hereinafter USA Governance Agreement], page 171 of the Proxy Statement on Schedule 14A of HSN, Inc. filed on Jan. 13, 1998 [hereinafter USA Proxy Statement]; USA Proxy Statement at 34.
meetings and the right to be represented on committees of the board. Depending on the significance of the investor's investment, the strategic investor may also attempt to supplement its influence with supermajority voting provisions that would allow the designees of the investor to veto decisions, by virtue of the percentage of the entire board its designees represent, on major transactions or other corporate actions that could adversely affect the interests of that investor. Alternatively, the strategic investor may negotiate a requirement that certain decisions of the board necessitate the approval of the specific designees of the investor pursuant to the voting rights of a special class of stock or otherwise.

The Walt Disney Company ("Disney") negotiated board veto powers in connection with its proposed investment in Pinelands, Inc. ("Pinelands") in 1992. In that transaction, Pinelands agreed to acquire KCAL-TV, a Los Angeles television station owned by Disney, in exchange for the issuance to Disney of common and convertible preferred stock representing approximately 45% of the fully diluted capital stock of Pinelands. Disney was allowed to designate four of nine directors, although no more than two of those directors could be Disney employees. The four Disney designees had a potential veto right because the governance agreement required the affirmative vote of two-thirds of the nine Pinelands directors or of all the independent directors for acquisitions or other transactions relating to the television broadcast business involving consideration in excess of specified amounts and for transactions outside the television broadcast business in excess of a lower threshold.

When British Telecom USA Holdings, Inc. ("BT USA"), an affiliate of British Telecommunications plc ("BT"), invested in McCaw Cellular Communications, Inc. ("McCaw"), the parties used a variation of the supermajority board veto approach. BT USA invested approximately $1.5 billion in McCaw for shares of two classes of common stock representing

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7 See, e.g., Amended and Restated Investment Agreement between British Telecommunications plc and MCI Communications Corporation, dated as of January 31, 1994, § 9.7(d), (e) (granting British Telecommunications plc ("BT") the right to representation on board committees other than the nominating committee in proportion to its representation on the board, requiring board to hold at least six meetings per year and prohibiting MCI Communications Corporation ("MCI") from establishing an executive committee without BT's consent, among other provisions) [hereinafter BT/MCI Investment Agreement], Appendix I to Amendment No. 2 to the Proxy Statement on Schedule 14A filed by MCI Communications Corporation on February 4, 1994 [hereinafter MCI Proxy Statement]. For a brief description of this transaction, see infra note 53.

8 Governance Agreement between Pinelands, Inc. and The Walt Disney Company, dated as of March 30, 1992, § 2.01, Exhibit 2 to the Current Report on Form 8-K of Pinelands, Inc. filed on April 1, 1992.

9 Id. at § 2.05.
22% of the equity of the company. BT USA received the right to designate four of nineteen directors of McCaw and the right to challenge in good faith the nomination of the three independent directors.\footnote{Purchase Agreement between McCaw Cellular Communications, Inc. and British Telecom USA Holdings, Inc., dated January 19, 1989, § 9.3(a) [hereinafter McCaw Purchase Agreement], Exhibit 1 to the Current Report on Form 8-K of McCaw Cellular Communications, Inc. dated January 19, 1989.} In addition, BT USA negotiated several consent rights that prevented McCaw from taking certain actions unless either a majority of BT USA's board designees voted for a resolution on a matter and BT USA did not deliver a statement withholding its consent\footnote{The ability to withhold a consent may have been a means for BT USA designees to vote in favor of the resolution as fiduciaries but still prevent its passage by contract.} or an authorized representative of BT USA executed a written consent.\footnote{Id. at § 9.4. BT USA generally had the right to consent to (a) amendments to the charter or bylaws of McCaw that would adversely impair BT USA's rights under the purchase agreement or the stockholders agreement, (b) issuances of capital stock above certain thresholds in any fiscal year, (c) issuances of Class B common stock (one of the series of common stock received by BT USA), (d) issuances of preferred stock having disproportionately large voting rights or a class vote on any matter, (e) the conduct of businesses other than the telecommunications and related businesses and (f) sales or other dispositions of material assets, with specified exceptions. Id. These provisions were ultimately reflected in the certificate of incorporation of McCaw. See Restated Certificate of Incorporation of McCaw Cellular Communications, Inc. art. 5 (stating that actions of the board may be taken only in accordance with the applicable section of the purchase agreement with BT), Exhibit 3.1 to the Registration Statement on Form S-1 of McCaw Cellular Communications, Inc. filed on Jan. 9, 1990.} Thus, a majority of BT USA's board designees could veto an action by voting against a resolution on the matter.\footnote{BT USA's ability to influence McCaw's actions under these provisions was, however, limited because, among other reasons, BT USA's consent could not unreasonably be withheld, except with respect to charter and bylaw amendments. Under the purchase agreement, BT USA was deemed to have acted unreasonably if it took into consideration "any factors other than those involved in a good faith determination of the best interests of the Company," with specified exceptions. Id. See also Restated Certificate of Incorporation of NBC Internet, Inc. art. fifth, § 4 (granting the directors designated by the Class B common stock of NBC Internet, Inc. ("NBCi"), which was held by the National Broadcasting Company, Inc. ("NBC"), the right to veto (by majority vote of the Class B directors) certain changes of control of NBCi, certain sales of assets, certain issuances of equity securities and other matters, provided the Class B directors did not constitute a majority of the board of NBCi) [hereinafter NBCi Restated Certificate], Appendix D-1 to the Proxy Statement/Prospectus included in Amendment No. 5 to the Registration Statement on Form S-4 of NBC Internet, Inc. filed Nov. 1, 1999.}

Turner Broadcasting Systems, Inc. ("TBS") provided for class director veto provisions in connection with the convertible preferred stock it sold to investors in 1987, including affiliates of Time and TCI. Faced with high dividend payment requirements under the terms of the preferred stock it had issued in connection with its acquisition of MGM/UA Entertainment Co., TBS sought to redeem that preferred stock with the proceeds of the sale of two new classes of preferred stock in a private placement with twenty-eight investors, all of whom owned or were affiliates of owners of cable television...
systems. The Class C convertible preferred stock provided the investors with the right to elect seven of fifteen members of the board. In addition, the bylaws were amended to provide that the approval of twelve members of the board, including at least four directors designated by the Class C convertible preferred stock, was required for certain transactions. A majority of the Class C directors, therefore, could block those decisions.

B. Legal Issues

1. DESIGNATION OF DIRECTORS AND VOTING AGREEMENTS

An investor can ensure itself representation on the board by virtue of cumulative voting or a special class or series of stock that is entitled to elect a specified number of directors. Otherwise, a corporation or its board of directors cannot guarantee that a director will be elected to the board because the election of a director is within the power of the stockholders. Rather, under these circumstances, the typical agreement between the investor and the corporation provides an obligation for the board to nominate the designees of the investor. Even this obligation should as a strict legal matter be subject to the board’s fiduciary duty. Without this fiduciary flexibility,
the board could be viewed as having improperly surrendered a matter of important corporate policy. Nonetheless, some strategic partners may resist a fiduciary exception and insist on no exceptions to the obligation to appoint directors.

A related issue under Delaware law, which also arises under applicable exchange rules, is the propriety of a board's obtaining a voting agreement from a significant investor to facilitate or even ensure the board's own incumbency as a quid pro quo for the board's agreeing to nominate a specified number of designees of the significant investor. These types of arrangements are often used but do raise legal issues worth considering.

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exercise of its fiduciary responsibilities to the Company's stockholders, to recommend that the Company's stockholders elect such individual); see also Form of Stockholder Agreement between CheckFree Holdings Corporation and the applicable investor, § 2.1(a) (stating that the designee of the investor (Microsoft Corporation ("Microsoft") or First Data Corporation ("First Data"), as the case may be) to the board of CheckFree Holdings Corporation ("CheckFree") was "subject to the reasonable approval of a majority of the members of the Board," thus implicitly providing fiduciary latitude) [hereinafter CheckFree Stockholder Agreement], Exhibit 10(ff) to the Registration Statement on Form F-4 of CheckFree Holdings Corporation filed July 10, 2000. CheckFree is a Georgia corporation.

See Chapin v. Benwood Found., Inc., 402 A.2d 1205 (Del. Ch. 1979), aff'd 415 A.2d 1068 (Del. 1980) (finding an agreement among the trustees of a Delaware charitable corporation to fix the number of trustees within the range provided in the charter and to designate specific individuals in advance as successors to the existing trustees to be an undue delegation of the trustees' authority); Abercrombie v. Davies, 123 A.2d 893 (Del. Ch. 1956), rev'd on other grounds, 130 A.2d 338 (Del. 1957) (invalidating as an undue delegation of authority of directors the applicable portions of an agreement among stockholders to use best efforts to cause their designees to vote in the manner determined by seven of eight agents designated by the stockholders (and who were the same people as the designees) and to seek the removal of any designee that did not so vote on matters submitted to the board).

See infra text accompanying notes 45-49.

A board using a significant investor's voting power to ensure its incumbency should be distinguished from the significant investor simply obtaining proportionate representation, which can be analogized to cumulative voting.

See, e.g., Standstill Agreement between Koninklijke Luchtvaart Maatschappij N.V. and Northwest Airlines Corporation, dated as of Sept. 29, 1997, § 2.2 (requiring Koninklijke Luchtvaart Maatschappij N.V. ("KLM") during a standstill period to vote all the Northwest Airlines Corporation ("Northwest Airlines") voting securities it beneficially owned in favor of the election to the Northwest Airlines board of the persons recommended by the board) [hereinafter Northwest Airlines Standstill Agreement], Exhibit 10.7 to Quarterly Report on Form 10-Q of Northwest Airlines Corporation for the quarterly period ended Sept. 30, 1997; Investment Agreement between E.I. du Pont de Nemours & Company and Pioneer Hi-Bred International, Inc., dated as of August 6, 1997, § 6.2(a) (requiring E.I. du Pont de Nemours & Company ("Du Pont") during a standstill period generally to vote all the voting securities of Pioneer Hi-Bred International, Inc., an Iowa corporation ("Pioneer"), it beneficially owned in favor of, among other matters, the slate of nominees proposed by the Pioneer board, except that during any period in which there was in effect a valid court order or NYSE ruling that the voting agreement was invalid or unenforceable, the Pioneer board could request that Du Pont vote those securities in the same proportion as the votes cast by the other Pioneer stockholders) [hereinafter Pioneer Investment Agreement], Exhibit 10.1 to the Current Report on Form 8-K of Pioneer Hi-Bred International, Inc. dated Aug. 7, 1997. But see,
While suggestions that these types of arrangements amount to illegal vote selling are inappropriate and have not been followed, case commentary does exist suggesting that, under certain circumstances, these arrangements concern the courts. In some recent transactions, any legal issues presented by a voting agreement in favor of the board are avoided by providing that the investors are not required to vote in favor of the board in the event of a bona fide proxy contest. Furthermore, any legal issues with respect to these directed voting provisions would be substantially mitigated if approved by stockholders generally.

See, e.g., Exodus Stockholder Agreement, supra note 17, § 2.4 (providing that during the standstill period, GlobalCenter would vote on all matters submitted to a stockholder vote (other than a change of control), at its option, either in the manner recommended by the board of Exodus (including with respect to the management slate) or in the same proportion as the votes cast by disinterested stockholders).

See Lennane v. ASK Computer Sys., Inc., No. CIV.A.11744, 1990 WL 154150, at *5 (Del. Ch. Oct. 11, 1990) (in dicta, “If that Agreement means that the incumbent directors have in legal effect secured the power to direct the voting of 30% of the companies for themselves for the seven-year term of the Agreement, it is deeply troubling.”); Ivanhoe Partners v. Newmont Mining Corp., 533 A.2d 585, 608 (Del. Ch.), aff’d 535 A.2d 1334 (Del. 1987) (noting in dicta that a voting agreement went “too far” by binding a 49.9% holder to guarantee the incumbency of the board’s director nominees). In affirming the lower court’s decision in Ivanhoe on other grounds, however, the Delaware Supreme Court stated that the voting agreement in question did not violate fiduciary duties, noting that “[t]he voting provision only required Gold Fields to cast its votes for the nominees of the entire independent board [only 20% of members were insiders].” Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1346 (Del. 1987).

See, e.g., CheckFree Stockholder Agreement, supra note 17, § 2.1(f) (allowing Microsoft or First Data, as the case may be, if there were a bona fide proxy contest for the election of directors, to vote (at its election) either in favor of the management slate or in the same proportion as all votes cast by the disinterested stockholders); Form of Shareholder Agreement among ValueVision International, Inc. and G.E. Capital Equity Investments, Inc., § 2.1(h) (allowing G.E. Capital Equity Investments, Inc. (“G.E. Capital Equity”), a subsidiary of General Electric Capital Corporation and an affiliate of NBC, if there were a bona fide proxy contest for the election of directors, to vote the voting stock of ValueVision International, Inc. (“ValueVision”) it holds (at its election) either in favor of the management slate or in the same proportion as all votes cast by disinterested stockholders) [hereinafter ValueVision Shareholder Agreement], Exhibit 10.4 to the Current Report on Form 8-K of ValueVision International, Inc. dated Mar. 8, 1999 [hereinafter ValueVision Form 8-K]. ValueVision is a Minnesota corporation.

The Delaware Supreme Court has stated that enhanced scrutiny under Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), has application only when a board of directors unilaterally acts “in the absence of an informed stockholder vote ratifying the challenged action.” Stroud v. Grace, 606 A.2d 75, 82-83 (Del. 1992) (stating that the effect of stockholder approval or ratification, in the absence of fraud and assuming the proxy statement properly disclosed with complete candor all material facts surrounding the action taken, is to place on the person challenging the action the burden of proving a breach of fiduciary duties). In Unocal, the Delaware Supreme Court established that defensive measures taken by a board in reaction to a perceived threat (whether or not immediate) that touches upon issues of control are subject to enhanced judicial scrutiny, rather than the simple application of the business judgment rule. 1 R. Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of
Even in the absence of a stockholder vote, voting agreements in favor of the board should not be illegal per se but rather subject to a reasonableness review under Unocal. Certainly, the lower the percentage of the outstanding shares subject to a voting agreement in favor of the board, the easier to sustain under a Unocal reasonableness analysis. A reasonableness analysis under Unocal, however, would not generally be applicable to voting agreements executed in connection with issuances equal to or in excess of 20% because issuances of common stock representing at least 20% of the

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26 But see 8 Del. Code § 160(c) ("Shares of its own capital stock belonging to the corporation or to another corporation, if a majority of the shares entitled to vote in the election of directors of such other corporation is held, directly or indirectly, by the corporation, shall neither be entitled to vote nor be counted for quorum purposes."). To the extent that shares subject to a voting agreement entered into by a corporation could be viewed as shares belonging to that corporation, Section 160(c) issues could be raised. Cf. Jacobs v. Pabst Brewing Co., CA No. 82-449 (D. Del. July 21, 1982) (questioning whether shares of a corporation held indirectly by the corporation's 49%-owned subsidiary, which were the subject of a voting agreement giving the corporation the right to direct the voting of the shares, might well be found to "belong" to the corporation within the meaning of Section 160(c) and therefore be disenfranchised, notwithstanding the corporation's less-than-majority ownership of the subsidiary); Insituform of North America, Inc. v. Chandler, 534 A.2d 257, 270 n.12 (Del. Ch. 1987) ("Speaking very generally, § 160(c) prevents a corporation from voting its own stock. It is a provision designed to prevent those in control of a corporation from using corporate resources to perpetuate themselves in office."). The better view, however, should be that shares subject to a voting agreement in favor of a corporation's board should not be viewed as belonging to that corporation without additional indicia of economic or dispositive power.

27 There is obviously the possibility that voting agreements with the board could be subject to the Blasius standard requiring a "compelling justification" for a Board's actions. Blasius Industries, Inc. v. Altas Corp., 564 A.2d 651, 661 (Del. Ch. 1988). Blasius, however, applies "only where the 'primary purpose of the board's action [is] to interfere with or impede exercise of the shareholder franchise,' and the stockholders are not given a 'full and fair opportunity to vote.'" Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996) (quoting Stroud, 606 A.2d at 92). The courts recognize that Blasius is an onerous test and are reluctant to apply it. One would not expect Blasius to be applied where the primary purpose of a transaction is clearly strategic and the voting agreements are part of an overall arrangement to ensure that governance mechanisms are in place that allow the venture to function smoothly and effectively. The application of Blasius to a voting agreement integral to a strategic transaction in the absence of a contest for corporate control would be far afield from where the Blasius standard has been applied to date. But see State of Wisconsin Inv. Bd. v. Peerless Systems Corp., No. 17637, 2000 Del. Ch. LEXIS 170 (Del. Ch. Dec. 4, 2000) (applying Blasius standard to a situation in which the chairman of board, after closing the polls on two proposals that were approved, adjourned the stockholder meeting for 30 days when it became clear that there were insufficient votes to approve a proposal to increase the capital stock available for options). The Peerless court noted that "the facts [in that case] are quite different from the typical Blasius case that involves entrenchment or control issues in which a clear conflict exists between the board and the shareholders." Id. at *42.
outstanding common stock would require stockholder approval pursuant to applicable stock exchange rules.\textsuperscript{28} With respect to a voting agreement in favor of the board executed in connection with issuances of less than 20\% of the outstanding common stock, these should generally not be viewed as legally unreasonable because the public stockholders would retain the practical ability to remove the board.

2. STATUTORY ISSUES REGARDING SUPERMAJORITY PROVISIONS

The Delaware General Corporation Law expressly sanctions supermajority board voting provisions. Section 102(b)(4) states that a corporation's certificate of incorporation may contain "[p]rovisions requiring for any corporate action . . . the vote of . . . a larger number of the directors . . . than is required by this chapter."\textsuperscript{29} While not explicitly provided by statute, there is also authority for the proposition that these types of provisions can also be included in the bylaws.\textsuperscript{30} To the extent that a strategic investor seeks to condition board action on the vote of specified directors, however, the Delaware Court of Chancery stated in \textit{Carmody v. Toll Brothers, Inc.}\textsuperscript{31} that provisions creating voting distinctions among directors are invalid unless they are contained in the corporation's charter.\textsuperscript{32} The \textit{Toll Brothers} court quoted Section 141(d) of the Delaware General Corporation Law:

\begin{itemize}
\item \textbf{28} \textsc{New York Stock Exchange, Listed Company Manual} para. 312.03(c) (hereinafter \textsc{NYSE Manual}). Another factor to consider in evaluating the reasonableness of a voting agreement is whether the voting agreement is in favor of a board that is independent in its entirety. In addition, as noted \textit{infra} Part I.C, in a strategic alliance, as a matter of comity, there is an inherent reasonableness whereby a strategic investor whose designees have been nominated to a board's slate agree to vote for that slate.
\item \textsuperscript{29} 8 \textsc{Del. Code} § 102(b)(4).
\item \textsuperscript{30} See Frantz Mfg. Co. v. EAC Indus., No. 232, 1985, 1985 Del. LEXIS 598 (Del. Aug. 19, 1985) (permitting bylaw provision requiring unanimous vote of board). Because amendments to a corporation's charter require approval of both the board of directors and the stockholders, including such provisions in a corporation's charter rather than in its bylaws will also more readily ensure the integrity of the governance agreements over time. See 8 \textsc{Del. Code} § 109 (generally granting the stockholders of a corporation the authority to amend the bylaws).
\item \textsuperscript{31} 723 A.2d 1180 (Del. Ch. 1998) (invalidating on both statutory and fiduciary grounds a so-called "dead hand" rights plan that could not be redeemed except by the directors who had adopted the plan or their designated successors).
\item \textsuperscript{32} \textit{Id.} at 1190-91. \textit{But cf.} Phillips v. Insituform of North America, Inc., No. 9173, 1987 Del. Ch. LEXIS 474 (Del. Ch. Aug. 27, 1987) (bylaw adopted by the board that required affirmative vote of Class A directors held invalid under Section 109(b) of the Delaware General Corporation Law as inconsistent with charter, but neither court nor parties questioned statutory validity under Section 141(d)). A charter or bylaw provision requiring a unanimous (or supermajority) board vote would provide the designated directors with the same power as conditioning the vote on their approval but has the disadvantage of providing any other director or group of directors, as applicable, with the same power.
\end{itemize}
The certificate of incorporation may confer upon holders of any class or series of stock the right to elect one or more directors who shall serve for such term, and have such voting powers as shall be stated in the certificate of incorporation. The terms of office and voting powers of the directors elected in the manner so provided in the certificate of incorporation may be greater than or less than those of any other director or class of directors.33

3. FIDUCIARY RESPONSIBILITY OF DESIGNATED DIRECTORS

Once elected to a public corporation, a director designated by a strategic partner must maintain a delicate balance between his or her role (from the strategic partner's perspective) as the partner's representative on the board and his or her responsibilities under the law as a director with fiduciary obligations to all the stockholders of the corporation. The method of selection of a director has no bearing on the standards to which the director of a corporation will be held. "[T]he duty of designated directors is to the corporation and its stockholders, not to the particular designator."34 Thus, a director designated by a strategic partner must fulfill its duties of care and loyalty to the corporation of which it is a director, whether or not doing so would harm the strategic partner.35 Citing *Weinberger v. UOP, Inc.*,36 a leading treatise advises directors in situations where there is a conflict between the corporation and the designator to disclose the conflict they face and to abstain from participating in the decision.37 The *Weinberger* case is an extreme

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33 8 DEL. CODE § 141(d), quoted in Toll Brothers, 723 A.2d at 1191. The court also found that the "dead hand" pill violated Section 141(a) of the Delaware General Corporation Law by unduly restricting the ability of the directors to manage the affairs of the corporation. *Id.* at 1190-91; see also Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998), discussed infra text accompanying notes 91-93.
34 1 BALOTTI & FINKELSTEIN, supra note 25, § 4.38[B]. Even a director selected by a holder of a separate series or class of common stock has duties to all stockholders. Phillips, 1987 Del. Ch. LEXIS 474, at *30 ("[T]he law demands of directors ... fidelity to the corporation and all its shareholders and does not recognize a special duty on the part of directors elected by a special class to the class electing them."). This duty would, of course, also be applicable to a director who was designated by a strategic investor before a corporation went public. See 1 BALOTTI & FINKELSTEIN, supra note 25, § 4.38[C].
35 457 A.2d 701 (Del. 1983).
36 1 BALOTTI & FINKELSTEIN, supra note 25, § 4.38[B]. See Weinberger, 457 A.2d at 710-11 ("[I]ndividuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations, and in the absence of an
example of a conflict (and involves a parent/subsidiary relationship where fiduciary duties arose for a controlling stockholder) but is nonetheless a useful precedent to note.\textsuperscript{38}

The conflict issue is particularly critical with supermajority board approval provisions because their effectiveness as a protection for a strategic investor depends on a designee's voting in a manner consistent with the wishes of the investor. To be sure, as a practical matter, the business judgment rule provides a director wide latitude upon which to base a decision on the merits. Nonetheless, if a veto by a strategic partner's designees would be sufficient to prevent an action that makes good sense for the business but would not be advantageous to the strategic partner, the designees may be subject to legal pressure from management if they fail to

\footnotesize

independent negotiating structure . . . , or the directors' total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies."\textsuperscript{4}). In \textit{Weinberger}, The Signal Companies, Inc. ("Signal") had acquired 50.5\% of UOP, Inc. ("UOP") before the transaction that gave rise to the dispute litigated in that case and designated six of thirteen directors of UOP. In subsequent discussions with the president and chief executive officer of UOP of a cash tender offer by Signal for the remaining publicly held shares of UOP at $21 per share and the submission of this proposal for approval by UOP's board, none of the directors disclosed a Signal study recommending acquisition of the minority interest of UOP at up to $24 per share. The study had been written by two Signal officers who were also directors of UOP. The court noted that the directors designated by Signal owed a duty of loyalty to UOP and its other stockholders and found that the transaction did not meet the standard of "entire fairness" applicable in situations where parties have interests in both sides of a transaction. \textit{Id.} at 710. The court also noted that "the result . . . could have been entirely different if UOP had appointed an independent negotiating committee . . . to deal with Signal at arm's length." \textit{Id.} at 709 n.7. The principles expressed in \textit{Weinberger} must therefore inform not only the attitude of a strategic partner toward the directors it has designated but also the drafting of contractual provisions that relate to the conflicting roles of designated directors.

\textsuperscript{38} A related issue beyond the scope of this article is the extent to which a dual directorship can place the person designated by the strategic investor in a position where he or she must choose between conflicting duties, such as those arising from the disclosure of confidential information between the companies and the existence of corporate opportunities available to both companies. These are inherent in strategic investments generally, and a starting point for dealing with the problem is attention to the capacity in which information is acquired or in which opportunities are taken. A possible way to deal with corporate opportunity problems raised by the presence of a director on the boards of both the strategic investor and of the public company vehicle is for the parties to define carefully the scope of the directors' fiduciary duties with respect to corporate opportunities in the charter of the vehicle: "[T]here is no reason why corporate charters cannot contain provisions dealing with corporate opportunities or dealing with the ability of officers or directors to compete with the corporation. . . . The treatment of 'corporate' opportunities by a managing person or entity (or person controlling one) is a rather prominent candidate for explicit contracting . . . ." \textit{US West, Inc. v. Time Warner Inc.}, No. 14555, 1996 WL 307445, at *22-23 (Del. Ch. June 6, 1996); see, e.g., \textit{NBCi Restated Certificate, supra} note 13, art. thirteenth (certificate of incorporation contains provisions addressing allocation of corporate opportunities relating to NBC and NBCi).
act in accordance with the best interests of the venture. This pressure may be heightened by the absence of indemnification for directors in cases of breach of the duty of loyalty. Aware of this quandary, many parties structuring strategic alliances avoid board supermajority devices, preferring to rely on (or at least to supplement supermajority board provisions with) stockholder veto provisions contained in the charter or contractual consent rights.

C. Exchange Rules

For investments in existing public companies, the NYSE rules do not directly bear on the designation of directors by significant investors, but various rules could be deemed applicable. As noted above, arrangements by which a corporation agrees to designate nominees of a significant investor are often coupled with voting agreements on behalf of the significant investor, including an agreement to vote in favor of the board of director's nominees.

With respect to an investor designating a specific number of nominees, this could raise an issue under Paragraph 314, which states a concern with respect to special rights to a stockholder to the exclusion of the rest of the class. While the issue is not specifically addressed by the NYSE's rules, the designation of a specific number of designees should not be viewed as special rights so long as the representation is proportionate.
A voting agreement executed at the request of the board could also raise issues under Paragraph 308, which deals with the NYSE's concern with respect to defensive tactics.\textsuperscript{45} If a significant investor simply agreed to vote on all matters as the management directs, then this could raise entrenchment issues. Voting agreements with a significant investor often require the significant investor to vote in favor of all the board nominees.\textsuperscript{46} The rationale is that if the board agrees to place a director on the board, then a reasonable quid pro quo is for the investor to support the rest of the slate. With respect to all other matters, investors often have greater flexibility by virtue of a formulation that allows them either to vote as management directs or in proportion to other stockholders.\textsuperscript{47} Under such circumstances, the investor would not be able to use all its shares to vote against the wishes of management. While there is not a great deal of authority in this area, this

\textsuperscript{45} Paragraph 308 states that "[t]he Exchange has an ongoing concern as to the possible implications of certain so-called 'defensive tactics' which would in effect discriminate among shareholders. . . . As a matter of policy, the Exchange will refuse to list additional common stock of a company when restrictions exist such as voting trusts, irrevocable proxies, disproportionate voting power . . . or when unusual voting provisions are created which tend to nullify or restrict the voting of a class of stock . . . ." NYSE MANUAL, supra note 28, para. 308.00.

\textsuperscript{46} See, e.g., Northwest Airlines Standstill Agreement and Pioneer Investment Agreement, supra note 21. Sometimes the obligation to vote in favor of the board is not applicable in the event of a proxy contest. See supra note 24.

\textsuperscript{47} See, e.g., Stockholders Agreement between The Seagram Company Ltd. and Koninklijke Philips Electronics N.V., dated as of June 21, 1998, \S 2.3(b) (with respect to matters other than the election of directors, generally requiring Philips to vote, at its option, either proportionately on the same basis as other holders of voting shares or as recommended by the board); see also Exodus Stockholder Agreement, supra note 17, \S 2.4 (not requiring GlobalCenter to vote for the Exodus management slate of director nominees but requiring it, during the standstill period, to vote on all matters submitted to a stockholder vote (other than a change of control), at its option, either in the manner recommended by the Exodus board (including with respect to the management slate) or in the same proportion as the votes cast by disinterested stockholders). But see Northwest Airlines Standstill Agreement, supra note 21, \S 2.6 (permitting KLM to vote Northwest Airlines voting securities it beneficially owned "in its sole discretion," other than with respect to the election of directors); Pioneer Investment Agreement, supra note 21, \S 6.2(a) (generally allowing Du Pont to vote in its discretion the voting securities it held on matters other than the election of directors but requiring Du Pont, among other requirements, to vote in accordance with the direction of the Pioneer board on any non-Pioneer sponsored stockholder proposal and to vote in accordance with the direction of the Pioneer board on matters relating to stock option and other benefit plans, except that during any period in which there was in effect a valid court order or NYSE ruling that the voting agreement was invalid or unenforceable, the Pioneer board could request that Du Pont vote those securities in the same proportion as the votes cast by the other Pioneer stockholders).
compromise of not allowing directed votes except in connection with the
election of directors was sanctioned by the stock exchange in 1984 when
Carter Hawley Hale Stores, Inc. ("Carter Hawley Hale") issued a significant
block of shares of capital stock to General Cinema Corporation ("General
Cinema"). With respect to arrangements for which there is no clear
authority, the NYSE suggests "that companies consult with their Exchange
representatives while corporate planning is in an early stage to be certain that
Exchange voting rights policies are not violated."49

III. STOCKHOLDER CONTROLS

A. Supermajority Stockholder Vote Requirements

1. INTRODUCTION

As one means to avoid the fiduciary issues inherent in supermajority
board vote provisions, supermajority stockholder vote requirements have
been used in several recent transactions. The transaction among Sony
Pictures Entertainment Inc. ("Sony Pictures"). Universal Studios, Inc.
("Universal Studios") and Cineplex Odeon Corporation ("Cineplex
Odeon") that created Loews Cineplex Entertainment Corporation ("Loews
Cineplex") in 1998, and was conditioned on the charter of the new

48 Carter Hawley Hale issued convertible preferred stock to General Cinema as part of its
response to an attempted takeover of Carter Hawley Hale by The Limited, Inc. The Exchange objected
to the terms of the convertible preferred stock on the grounds that the terms were "violative of Exchange
policies, including its shareholder approval policy." Proxy Statement of Carter Hawley Hale Stores, Inc.,
dated June 21, 1984, at 36. Carter Hawley Hale ultimately agreed to submit the issue for approval by its
stockholders. Under the terms of its agreement with the NYSE, if the stockholders approved the
issuance, then the convertible preferred stock would, at the option of Carter Hawley Hale, be voted on
all matters other than the election of directors either in the same proportion as the votes cast by other
stockholders or at the discretion of General Cinema. Id. at 37. Whether or not the stockholders approved
the issuance, the NYSE agreed that the convertible preferred stock could be voted according to the
recommendation of a majority of the board on matters relating to the election of directors. Id.
49 NYSE MANUAL, supra note 28, para. 308.00.
50 In a stock-for-stock transaction pursuant to a plan of arrangement under Ontario law, Cineplex
Odeon, an Ontario company listed on the NYSE and the Toronto Stock Exchange with extensive film
exhibition operations in the United States and Canada, became a wholly owned subsidiary of LTM
Holdings, Inc. ("LTM"), a Delaware corporation with extensive film exhibition operations that prior to
the transaction was a wholly owned subsidiary of Sony Pictures. Pursuant to the transaction, the
stockholders of Cineplex Odeon received common stock of LTM, which went public in the transaction.
LTM was renamed Loews Cineplex in connection with the transaction. After giving effect to the
transaction, Sony Pictures was a 51% owner of Loews Cineplex. Universal Studios, which held
approximately 42% of Cineplex Odeon, was a 26% owner of Loews Cineplex, and the Claridge Group,
company being amended to include, among other negotiated provisions, a clause requiring the approval of at least 80% of the outstanding common shares for a merger or consolidation of the company, a sale of all or substantially all the company’s assets, or the adoption of a liquidation or dissolution proposal.\textsuperscript{51} The 80% veto did not apply if at least fourteen of sixteen board members approved the proposed significant event. If the significant event were a merger, consolidation, or sale of substantially all the assets, however, the approval of holders of 66 2/3% of the outstanding shares of common stock would still be required.\textsuperscript{52}

Similarly, in the investment by BT in MCI Communications Corporation (“MCI”) in 1993,\textsuperscript{53} as long as the Class A common stock issued to BT remained outstanding, redemption of the stockholder rights plan a group of individuals and trusts affiliated with the Charles R. Bronfman family, was a 10% owner of Loews Cineplex. The remaining approximately 13% of the equity of Loews Cineplex was held by former public stockholders of Cineplex Odeon. Sony Pictures contributed its subsidiary LTM to the venture, as well as certain other assets, and Universal Studios contributed cash and its equity interest in Cineplex Odeon. Information regarding this transaction, as well as the related documents discussed in this paper, can be found in the Management Information Circular and Proxy Statement/Prospectus included in the Registration Statement on Form S-4 filed by Loews Cineplex Entertainment Corporation on February 13, 1998 [hereinafter Loews Cineplex Form S-4].

\textsuperscript{51} \textit{Amended and Restated Master Agreement} among Sony Pictures Entertainment Inc., LTM Holdings, Inc. and Cineplex Odeon Corporation, dated as of Sept. 30, 1997, § 7.2(f), Annex D to the Loews Cineplex Form S-4, supra note 50; \textit{Form of Amended and Restated Certificate of Incorporation of LTM Holdings, Inc.}, art. V, [hereinafter Loews Cineplex Certificate of Incorporation], Annex H to the Loews Cineplex Form S-4, supra note 50.

\textsuperscript{52} \textit{Loews Cineplex Certificate of Incorporation}, supra note 51, art. V, para. 3. Assuming that the six directors designated by Sony Pictures and the three directors designated by Universal Studios voted in a manner consistent with the interests of Sony Pictures and Universal Studios, respectively, approval by fourteen of sixteen members of the board implied the consent of both Sony Pictures and Universal Studios. \textit{See Amended and Restated Stockholders Agreement} among LTM Holdings, Inc., Sony Pictures Entertainment Inc., Universal Studios, Inc., Charles Rosner Bronfman Family Trust and the other parties thereto, dated as of Sept. 30, 1997, § 2.1(a) [hereinafter \textit{Loews Cineplex Stockholders Agreement}], Annex G to the Loews Cineplex Form S-4, supra note 50. Accordingly, in cases in which the Sony Pictures designees and the Universal Studios designees to the board had already approved the transaction, the stockholder veto would, most likely, not be necessary. Part I discusses the fiduciary duty issues potentially raised by such clauses.

\textsuperscript{53} In the transaction, BT invested approximately $4.3 billion in MCI in return for an equity interest of approximately 20%. MCI planned to use the proceeds for a number of projects, including investments in distribution channels outside the United States. MCI also formed a separate joint venture with BT in which MCI would have an approximate 25% interest. The purpose of the joint venture was to build a worldwide telecommunications network, for which MCI would be the exclusive distributor of services in the Americas and BT would be the exclusive distributor in the rest of the world. The closing of the BT investment and the closing of the joint venture were mutually conditional. Information regarding the BT investment, as well as the related documents discussed in this paper, can be found in the MCI Proxy Statement, supra note 7.
required the approval of 75% of the voting securities of MCI, voting together as a single class.\textsuperscript{54} The veto remained in effect for four years after the closing of the transaction. Because the Class A common stock issued to BT represented approximately 20% of MCI's voting securities, BT would be in a very strong position to veto any attempt during that time to take control of MCI.\textsuperscript{55}

2. LEGAL ISSUES

Delaware law allows a corporation to require a supermajority vote of stockholders on matters it specifies in its certificate of incorporation.\textsuperscript{56} "In view of judicial endorsement of an 80 percent super-majority voting provision," states a leading Delaware treatise, "provisions not exceeding that level may safely be adopted without serious question regarding their validity."\textsuperscript{57}

As noted above, relying on board designees to block a course of action that requires a supermajority vote of the board can be problematic in light of the designees' fiduciary duty to all stockholders. In contrast, supermajority stockholder voting provisions do avoid this fiduciary issue because stockholders have a right to vote their shares in their own interest.\textsuperscript{58} Accordingly, the law is clear that a significant investor does not have a fiduciary duty to refrain from exercising a veto in order to benefit all stockholders.

Provisions requiring a supermajority stockholder vote for the redemption of a rights plan raise special issues in light of case law approving the validity

\textsuperscript{54} Composite Certificate of Incorporation of MCI Communications Corporation Marked to Show Changes Effected by the Charter Amendment § 4(d)(6) [hereinafter MCI Certificate of Incorporation]. Appendix II to MCI Proxy Statement, supra note 7; see infra text accompanying notes 59-61.

\textsuperscript{55} MCI Proxy Statement, supra note 7, at 63.

\textsuperscript{56} See 8 DEL. CODE § 102(b)(4). Section 102(b)(4) states that a corporation's charter may include "[p]rovisions requiring for any corporate action, the vote of a larger portion of the stock or of any class thereof, or of any other securities having voting power, . . . than is required by this chapter."

\textsuperscript{57} 1 BALOTTI AND FINKELSTEIN, supra note 25, § 7.24. The treatise also notes that the validity of unanimous stockholder vote requirements has not been decided by the Delaware courts. Id.

\textsuperscript{58} See Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987) ("Stockholders in Delaware corporations have a right to control and vote their own shares in their own interest. . . . It is not objectionable that their motives may be for personal profit, or determined by whim or caprice, so long as they violate no duty owed other shareholders."); Emerson Radio Corp. v. Int'l Jensen Inc., No. 15130, 1996 Del. Ch. LEXIS 100, at *54 (Del. Ch. Aug. 20, 1996), appeal refused, 683 A.2d 58 (Del. 1996) ("[E]ven a majority stockholder is entitled to vote its shares as it chooses, including to further its own financial interest."); Williams v. Geier, 671 A.2d at 1380-81 ("Stockholders (even a controlling stockholder bloc) may properly vote in their own economic interest, and majority stockholders are not to be disenfranchised because they may reap a benefit from corporate action which is regular on its face.").
of rights plans based upon their ability to be redeemed by the board. The legal issues are particularly acute where a single holder could block the redemption (or be close to having sufficient votes to block redemption, as was the case with BT with respect to the MCI rights plan). The issue should be substantially mitigated to the extent that the supermajority provision to redeem the rights plan had been approved by stockholders rather than simply incorporated in the rights plan. If such a supermajority provision were simply incorporated in a rights plan adopted by the board, the provision would be highly problematic under a Unocal analysis, if not illegal under Quickturn Design Sys. v. Shapiro and Carmody v. Toll Brothers.

As a related matter, the mere existence of veto rights in the absence of actual control should not otherwise trigger the fiduciary duties that would be applicable to a controlling stockholder. In In re Western National Corp. Shareholders Litigation, the court found that a 40% stockholder’s indication that it would vote against a proposed merger transaction did not constitute “actual control” of the subject company thereby triggering fiduciary duties to the other stockholders. In that case, Western National Corporation (“Western National”), which was 40%-owned by American General Corporation (“American General”), informed American General of a proposed merger with U.S. Life Insurance Corporation. Western National’s Chairman and CEO testified in a deposition that because American General was “a forty percent owner, nothing could be done without their approval... and [they] indicated they would not be in favor of having U.S. Life and Western National merge.” The court stated:

The fact that a large shareholder... takes steps to “veto” a business combination between the putative subsidiary corporation and a proposed merger partner... is not particularly probative of whether the large shareholder exercises actual control over the business and

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59 See supra text accompanying notes 53-55.
60 See Stroud v. Grace, 606 A.2d at 82-83, 92 (stating that neither Unocal nor Blasius applied in cases where charter and bylaw amendments in question were approved by the stockholders). But see Carmody v. Toll Bros., 723 A.2d 1180, 1189 n.28 (Del. Ch. 1998) (declining to address whether a provision limiting the power to redeem a rights plan to incumbent directors would be statutorily valid even if expressed in the certificate of incorporation).
61 See Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291-93 (Del. 1998) (invalidating provision that limited ability of newly elected board to redeem rights plan as violation of statutory authority of board of directors under Section 141(a) to manage the affairs of the corporation); Toll Brothers, 723 A.2d at 1189-92 (invalidating “dead hand” rights plan, as indicated supra note 31).
63 Id. at *8.
64 Id. at *7.
affairs of the corporation. . . . The standard for determining whether a large, though non-majority shareholder . . . exercises control over the corporation requires a judicial finding of actual control over the business and affairs of the corporation. Notwithstanding the explicit statutory grant of authority over the business and affairs of a Delaware corporation to its board of directors, certain events in the life of the corporation, such as a merger, require the affirmative participation of the corporation’s shareholders. The shareholders’ right to voice their view as to the advisability of a proposed merger, however, does not indicate that they exercise actual control over the corporation’s business and affairs.65

C. Class Voting Mechanisms

1. BACKGROUND

While strategic investors sometimes use supermajority stockholder voting provisions to place a check on corporate actions, they often rely on the issuance of a separate class of stock with distinct rights from those held by stockholders generally to provide an investor with veto rights or even affirmative governance rights, such as the power to designate certain directors. When compared with supermajority voting provisions, one of the advantages of providing veto powers to a specific holder is that it avoids granting a veto power to any other stockholders or group of stockholders

65 Id. at *8 (citing Section 251(c) of the Delaware General Corporation Law, which requires majority stockholder approval for a merger or consolidation). Because American General was a 40% owner, it could not independently veto a business combination, but its decision to oppose such a transaction would of course significantly affect the chances of approval. But see Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110 (Del. 1994). In Kahn, the Delaware Supreme Court upheld the Court of Chancery’s finding that Alcatel S.A. and its affiliates (“Alcatel”), which held 43.3% of the capital stock of Lynch Communication Systems, Inc. (“Lynch”), controlled Lynch. Particularly important in the Court of Chancery’s decision had been Alcatel’s actions at a meeting of Lynch’s board of directors, five of whose members were Alcatel designees. The Alcatel designees urged the nonrenewal of the compensation contracts for Lynch’s top managers, specifically noting Alcatel’s position as the largest stockholder, and voted against Lynch’s acquisition of Telco Systems, Inc. (“Telco”), presenting an alternate proposal involving an affiliate of Alcatel. One of the Alcatel directors was reported to have warned the board, “You must listen to us. We are 43 percent owner. You have to do what we tell you.” Id. at 1114. With respect to the proposed acquisition of Telco, Alcatel had the power ultimately to veto the transaction under a charter provision requiring 80% stockholder approval of a business combination. Id. at 1112. The analysis of the Delaware Supreme Court, however, was not limited to Alcatel’s veto of the Telco acquisition but extended to other indicia of control. Id. at 1115.
holding sufficient voting power to block action that requires a supermajority vote. Moreover, the difficulty of obtaining a supermajority vote at a meeting of stockholders is one of the reasons that companies are more comfortable giving a broader range of veto rights to a single holder than a supermajority provision that can be blocked by any significant investor or any other group of holders.

The issuance of a security with class voting rights has been used in a number of transactions. BT chose a different approach than relying on board vetoes, as it had in connection with its McCaw investment, when it subsequently insisted on newly created Class A common stock in connection with its $4.5 billion investment in MCI. The Class A common stock conferred the same number of votes per share as the common stock and voted with the common stock as a single class on most matters. However, the approval of the holders of a majority of the outstanding Class A common stock, voting as a separate class, was required for several actions. These actions include: a) business combinations proposed within four years after BT's investment, subject to certain exceptions, b) the adoption of a stockholder rights plan or the amendment of the stockholder rights plan proposed in connection with the transaction, c) the issuance of high-vote stock or stock with a separate class vote, d) the issuance of capital stock having voting power in excess of specified percentages, e) the issuance of voting securities to a person that beneficially owned more than 5% of MCI's voting securities, and f) the acquisition of assets or investments valued at more than 5% of MCI's market capitalization in a business other than the telecommunications and other specified businesses. In addition, the Class

66 Such separate classes of stock often provide for conversion into common stock under specified circumstances and have rights very similar to those attached to the common stock, except for the specific governance-related features negotiated by the strategic partner. When BT invested in MCI, for example, if the outstanding Class A common stock issued to BT, plus any outstanding Class A preferred stock, represented less than 10% of the voting securities of MCI, or if BT or MCI were to transfer its interest in the joint venture company to the other party, or a third party as specified in the investment agreement, or if certain other conversion events were to occur, then the Class A common stock would automatically be converted into common stock. MCI Certificate of Incorporation, supra note 54, § 4(b)(9). BT did not have an optional right to convert into common stock, in order to limit its influence on MCI to the rights set forth in the terms of the Class A Stock. In contrast, the investors in TBS in 1987 could convert their Class C convertible preferred stock at any time into shares of common stock. Proposed Article 5 of the Restated Articles of Incorporation § C(6)(c) [hereinafter TBS Restated Articles of Incorporation], Exhibit A to the TBS Proxy Statement, supra note 14.

67 MCI Certificate of Incorporation, supra note 54, § 4(b)(8). Similarly, the Class C convertible preferred stock that investors in TBS received in its 1987 capital restructuring entitled the holders to vote separately as a class to elect seven of fifteen directors. See supra text accompanying notes 14-16. In addition, approval of a majority of the outstanding shares of Class C convertible preferred stock was required before (a) any disposition of a substantial portion of the assets of TBS, (b) any merger or
A common stock voted separately as a class to elect a number of directors proportional, subject to limited exceptions, to the percentage of MCI's voting securities represented by the Class A common stock. 68

2. LEGAL AND STOCK EXCHANGE ISSUES

Although Delaware law clearly provides that different classes can have different voting rights, 69 the issuance of stock with class voting rights can

consolidation of TBS, (c) any issuance of capital stock that would increase the voting power of the aggregate capital stock more than 18% over the aggregate voting power on the issue date and (d) approval of any amendment to the charter or bylaws that would limit the voting rights of the common stock or the Class C convertible preferred stock in the manner specified, subject to limited exceptions in each case. TBS Restated Articles of Incorporation, supra note 66, § C(4)(g). Indeed, Time Warner used its veto power to vote against the efforts of Ted Turner, then CEO of TBS, to purchase CBS Inc. See Geraldine Fabrikant, How Ted Turner Plans to Play for a Network, N.Y. TIMES, Aug. 21, 1995, at D1 (noting that Mr. Turner needed board approval to spend more than $2 million and that Time Warner had been opposing Mr. Turner's efforts to acquire a television network. See also NBCi Restated Certificate, supra note 13, art. fourth, § A.11 (granting NBC, as holder of Class B common stock of NBCi, the right to veto certain amendments to the charter and bylaws (other than an amendment to the bylaws approved by the NBCi board), the issuance of Class B common stock to persons other than NBC and its affiliates, the adoption of a stockholder rights plan or other actions that could adversely affect in any material respect the rights of a Class B holder); Form of Certificate of Designation of Series F Cumulative Convertible Senior Preferred Stock § 3(b), Form of Certificate of Designation of Series C Cumulative Convertible Senior Preferred Stock § 3(b) and Form of Certificate of Designation of Series E Cumulative Convertible Exchangeable Senior Preferred Stock § 3(b) [granting each of the Series F preferred stock issued to British Airways Plc ("BA") and the Series C and E preferred stock (whose possible purchase by BA was also contemplated by an investment agreement with USAir Group, Inc. ("USAir") the right to approve by two-thirds majority vote of that class the merger or consolidation of USAir, the sale of substantially all of the assets of USAir, the voluntary liquidation of USAir and certain other actions, subject to limited exceptions], Appendices IV, V and VI to the Proxy Statement on Schedule 14A of USAir Group, Inc. dated Apr. 26, 1993; Form of Certificate of Designation of Series A Redeemable Convertible Preferred Stock § VII(d) (granting G.E. Capital Equity, so long as it holds a majority of the Series A redeemable convertible preferred stock of ValueVision, the right to approve, by majority vote of the class, transactions with certain restricted parties, issuances of capital stock in excess of specified thresholds, certain material acquisitions and dispositions, entry into other businesses, and certain other actions); Exhibit 10.5 to the ValueVision Form 8-K, supra note 24.

68 MCI Certificate of Incorporation, supra note 54, § 4(b)(7); see also BT/MCI Investment Agreement, supra note 7, § 9.7(c) (granting BT the right, in the event that the Class A common stock was no longer outstanding, the right to designate a number of nominees for election to the MCI board proportional, subject to limited exceptions, to the percentage of MCI's voting securities held by BT).

69 8 DEL. CODE § 151(a) (stating that the classes or series of stock issued by a corporation "may have such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof," as are set forth in the corporation's charter or in a resolution adopted by the corporation's board of directors pursuant to authority expressly given in the charter); Baker v. Providence and Worcester Co., 364 A.2d 838 (Del. Ch. 1976) ("[A] reading of § 151(a) leaves one with the firm conviction that 'classes' may be invested with differing voting rights . . . ."), rev'd on other grounds, 378 A.2d 121 (Del. 1977).
raise significant issues under applicable stock exchange rules. The NYSE, for example, has a firm policy of protecting stockholders from being disenfranchised with respect to their existing voting rights, which is expressed most clearly in Paragraphs 313 and 308 of the Listed Company Manual. The NYSE's voting rights policy states:

Voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Exchange Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock, or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer.\(^7\)

Further, Paragraph 308 of the Listed Company Manual states:

As a matter of policy, the Exchange will refuse to list additional common stock of a company ... when unusual voting provisions are created which tend to nullify or restrict the voting of a class of stock or the right to veto the action of another class are [sic] created.

The Exchange would also be concerned about the issuance of preferred stock which by its terms would vote separately as a class

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70 NYSE MANUAL, supra note 28, para. 313.00; see also NATIONAL ASSOCIATION OF SECURITIES DEALERS, MANUAL § 4351 (rule regarding voting rights); id. § IM-4351 (voting rights policy) [hereinafter NASD MANUAL]. See generally Rule 19c-4 Adopting Release, supra note 44 (announcing and providing justification for Rule 19c-4 under the Securities Exchange Act of 1934). Although Rule 19c-4 was vacated by the District of Columbia Circuit Court of Appeals in Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990), the NYSE's current voting policy expressly permits arrangements that would have been permitted under Rule 19c-4, and the NYSE has referred to the adopting release in its interpretations of its voting rights policy. NYSE MANUAL, supra note 28, para. 313.00 ("The Policy is more flexible than Rule 19c-4. Accordingly, the Exchange will continue to permit corporate actions or issuances by listed companies that would have been permitted under Rule 19c-4, as well as other actions or issuances that are not inconsistent with the new Policy."). The voting rights policies proposed by the NYSE and NASDAQ were approved by the SEC in 1994. See Self-Regulatory Organizations; American Stock Exchange, Inc., National Association of Securities Dealers, Inc., and New York Stock Exchange, Inc.; Order Granting Approval to Rule Changes Relating to the Exchanges' and Association's Rules Regarding Shareholder Voting Rights, Exchange Act Release 35121, Dec. 19, 1994, 59 Fed. Reg. 66,570, 66,571 (Dec. 27, 1994) [hereinafter Paragraph 313 Approval Release], available at http://www.lexis.com (Federal Legal, Federal Register).
from common stock on the approval of mergers and acquisitions, unless required by federal or state statute. 71

Accordingly, the issuance of a new class of stock with veto rights could present serious issues under applicable stock exchange rules because it would effectively reduce the rights of other stockholders to take corporate action. Importantly, a violation of the exchange policy is not avoidable by obtaining stockholder approval for the issuance of a class of stock that would otherwise violate the one share-one vote policy. 72 Similarly, the issuance of stock with special voting rights through exchange offers is disfavored. 73 A violation of the NYSE's voting rights policy could result in the loss of an issuer's exchange market or public trading market.

The NYSE's policy is, however, somewhat less equivocal than the quoted sections would suggest. Most significantly, the NYSE provides a specific exemption for issuances of stock with special voting rights in an initial public offering because purchasers buy the stock with full awareness of its voting power. 74 In addition, the NYSE grandfathered or exempted those companies that had a dual class voting structure when the rule was adopted, including, in general, the issuance of existing shares with special voting rights. 75 This

71 NYSE MANUAL, supra note 28, para. 308.00. See also Paragraph 314 of the Listed Company Manual, which is discussed infra Part III. NASDAQ has a rule similar to the one share-one vote rule expressed in Paragraph 313, see supra note 70, although NASDAQ does not specifically address defensive tactics as reflected in Paragraph 308 of the NYSE's Listed Company Manual.

72 See NEW YORK STOCK EXCHANGE, Para. 313.00 Interpretation No. 98-01, Mar. 19, 1998 (finding violation of Paragraph 313 in proposed transaction to allow convertibility of high-vote stock into low-vote stock, in spite of intent to submit proposal for approval by stockholders of the two classes, voting both as a single class and separately) [hereinafter NYSE Interpretation No. 98-01], at http://www.nyses.com/pdfs/para313.pdf; see also Rule 19c-4 Adopting Release, supra note 44, at 89,216 (stating that "the Commission does believe that...the shareholder voting process is not fully effective in preventing the adoption of disparate voting rights plans that disenfranchise shareholders").

73 In the Rule 19c-4 Adopting Release, the SEC stated the presumption that the issuance of stock with different voting rights through an exchange offer was impermissible under that rule. Rule 19c-4 Adopting Release, supra note 44, at 89,221. Explaining that in such exchange offers, stockholders were often offered lower voting stock with a higher dividend in exchange for their higher voting stock, the SEC noted, "The exchange offer is coercive because those shareholders wishing to hold the greater voting stock to defeat the plan would be taking a substantial risk that an insufficient number of outside shareholders will do likewise and majority voting control will shift to insiders." Id.; see also NYSE MANUAL, supra note 28, para. 313.00 (A) (including as example of violation of one share-one vote policy "the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer.").

74 Paragraph 313 Approval Release, supra note 70, at 66,571 ("[T]he issuance of disparate voting rights stock pursuant to an IPO is not a disenfranchising action because there are no existing public shareholders that are being affected by the transaction.").

75 NYSE MANUAL, supra note 28, para. 313.00, supp. material .10 ("The restriction against the
exemption would not generally extend, however, to any variation in the existing shares. The NYSE also provides exemptions to its voting rights policy for issuances by companies in financial distress, issuances by non-U.S. companies if the issuance were not prohibited by the company’s home country law, issuances of lower voting stock and issuances of lower voting stock specifically in the context of a bona fide merger or acquisition.

issuance of super voting stock is primarily intended to apply to the issuance of a new class of stock, and companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super voting stock without conflict with this Policy.”).

See, e.g., NYSE Interpretation No. 98-01, supra note 72 (finding violation of Paragraph 313 in proposed transaction to amend charter to modify the terms of existing high-vote stock to allow convertibility of high-vote stock into low-vote stock on the grounds that public stockholders could have incentives to convert into low-vote stock not shared by insiders holding high-vote stock). See also NYSE letter sent to all Listed Company Corporate Secretaries, April 24, 2000 ("[y]ou may observe that last year a NYSE-listed company with two listed classes of common stock, one voting and one non-voting, amended its certificate of incorporation to permit the voting stock to be converted into non-voting stock at the request of a holder. This event, which we consider to be inconsistent with the requirements of Section 313, resulted from a failure of communications between staff of the company and the Exchange.").

See NEW YORK STOCK EXCHANGE, Para. 313.00 Interpretation No. 96-03, June 7, 1996 (finding that preferred stock with a limited term issued to an investor in a company in financial distress entitling the investor to elect four of seven directors was permissible under Paragraph 313, even though the investor might hold as little as 32% of the company's equity), at http://www.nyse.com/pdfs/para313.pdf; NEW YORK STOCK EXCHANGE, Para. 313.00 Interpretation No. 96-05, Sept. 17, 1996 (finding that preferred stock with a limited term issued to an investor in a company in financial distress entitling the investor to elect a majority of the board, although the investor held a minority equity position, was permissible under Paragraph 313). In Interpretation No. 96-05, the NYSE quoted a provision of the SEC's release approving Paragraph 313: “[I]f a company is in financial distress, the company might issue preferred stock with heightened voting protection necessary to protect the interests of the preferred stock purchasers.” Paragraph 313 Approval Release, supra note 70, at 66,572.

NYSE MANUAL, supra note 28, para. 313.00, supp. material 40 (“The Exchange will accept any action or issuance relating to the voting rights structure of a non-U.S. company that is in compliance with the Exchange's requirements for domestic companies or that is not prohibited by the company's home country law.”).

Paragraph 313 Approval Release, supra note 70, at 66,571 (allowing issuances of lower voting stock "because shareholders purchasing a new issue of lower voting stock are fully aware of the limits on their voting power, both individually and collectively, at the time of purchase"). But see id. at 66,571-72 (stating that exchange offers of lower voting stock for higher voting stock would not be permitted and noting that exchanges would review issuances of lower voting stock to ensure compliance with Paragraph 313). Stock dividends of stock with voting rights not greater than existing stock would also often be permitted, although the SEC stated in the Rule 19c-4 Adopting Release, see supra note 44, at 89,220, that it would not establish a presumption regarding whether such stock dividends were permitted or disallowed, urging exchanges to review the individual circumstances of each transaction.

Paragraph 313 Approval Release, supra note 70, at 66,572 (stating that issuances of stock with voting rights not greater than existing stock would “be presumed to be accepted,” although combinations of companies with disparate voting rights and companies without disparate voting rights would be evaluated to verify that there was a “bona fide business purpose”); see also Rule 19c-4 Adopting Release, supra note 44, at 89,220 n.94 (noting, for example, that a merger of a large company with one class of stock
Finally, the SEC’s release adopting former Rule 19c-4 indicated some receptivity to the suggestion that the voting rights policy should be less strictly applied in circumstances in which a corporation’s insiders already have working control of the corporation, although a specific exception was not adopted and this has not been a meaningful factor in interpretive relief.81

Moreover, aside from specific exceptions, the NYSE states that its interpretations “will be flexible, recognizing that both the capital markets and the circumstances and needs of listed companies change over time.”82 NASDAQ has a similar rule.83 A particularly important factor in granting exceptions, which has particular relevance to strategic alliances, is whether the transaction in question has a strong economic and business justification and is not intended to disenfranchise shareholders.84 To the extent that a company is contemplating the issuance of a security with disparate voting rights that does not fit within an established exception, the safest course of action is to communicate with the NYSE when structuring the transaction and to request assurances that the NYSE views the applicable structure as compliant. Often the exigencies of time and desire for absolute

into a shell company with high-vote and low-vote stock “might disparately reduce the voting rights of existing shareholders”).

81 See Rule 19c-4 Adopting Release, supra note 44, at 89,227. In the Rule 19c-4 Adopting Release, the SEC noted that “where insiders have substantial control . . . minority shareholders still should have a right to be protected from further disenfranchisement” but that “the Rule’s protection will not necessarily benefit the minority shareholders.” Id. The SEC declined to establish an explicit exemption covering such situations of insider control, citing the difficulty of determining an appropriate percentage of control before Rule 19c-4 was in effect. Id.; see also NEW YORK STOCK EXCHANGE, Para. 313.00 Interpretation No. 96-01, May 9, 1996, at http://www.nyse.com/pdfs/para313.pdf (noting, in finding no violation of Paragraph 313 in recapitalization proposal pursuant to which existing common stock would be convertible into lower voting stock, that control persons already had “effective operating control” and that “while it is possible that the Control Persons’ voting power (which was capped at 49.9%) could increase from 43.5% to 49.9%, such a change would have no real practical significance for this particular Company.”). But see NEW YORK STOCK EXCHANGE, Para. 313.00 Interpretation No. 99-01 (proposed issuance of additional high-vote common stock to a stockholder with 56% voting power in exchange for lower voting stock not in compliance with voting rights policy because primarily for the purpose of entrenching control of existing controlling stockholder).

82 NYSE MANUAL, supra note 28, para. 313.00(A).

83 NASD MANUAL, supra note 70, § IM-4351 (voting rights policy) (“Nasdaq’s interpretations under the policy will be flexible, recognizing that both the capital markets and the circumstances and needs of Nasdaq issuers change over time.”). To the extent securities are listed by issuers that may appear to violate voting rights policies, one should note that the issuers may have informally cleared the arrangements with the NYSE or NASDAQ pursuant to unpublished rulings.

84 See Paragraph 313 Approval Release, supra note 70, at 66,574 (“There may be valid business or economic reasons for corporations to issue disparate voting rights stock. The Policy provides the [exchanges] with a voting rights standard which will provide issuers with a certain degree of flexibility in adopting corporate structures, so long as there is a reasonable business justification for so doing, and such transaction is not taken or proposed primarily with the intent to disenfranchise.”).
confidentiality do not allow for obtaining advance approval. In these cases, when parties anticipate the issue and condition the transaction on continued listing of the common shares on NYSE or NASDAQ after giving effect to the contemplated issues, there is sometimes a covenant to restructure the transaction to the maximum extent possible if the condition were not satisfied.\footnote{This was the approach the parties took in the BT/MCI transaction. See \textit{BT/MCI Investment Agreement, supra note 7, § 8.5} (agreeing, if condition of continuing designation as “NASDAQ National Market System security” could not be satisfied, “to consult in good faith with respect to alternative agreements that would provide each of the parties with the rights provided” under the documents negotiated). The parties consulted with NASDAQ after announcing the transaction, and NASDAQ ultimately decided that, based upon the specific facts and circumstances of BT’s investment, the veto rights were not violative of NASDAQ policy.}

C. Contractual Vetoes and Consent Rights

1. BACKGROUND

In lieu of consent rights incorporated in a security held by a single investor, strategic investors are sometimes able to negotiate for contractual consent rights to specific corporate actions as described below. As a technical matter, contractual consent rights bear the disadvantage of being able to be breached, whereas action cannot be taken in violation of the express terms of a security contained in the charter.\footnote{A breach can of course be dealt with by a remedy of specific performance, but that remedy cannot be guaranteed.} Nonetheless, contractual consent rights have the advantage of being able to provide consent rights without complicating the capital structure of the corporation by issuing new securities with a class vote. Moreover, they can be adopted without stockholder approval and — as is the case with a security with a class voting right — without extending the veto right to any other investor other than the strategic investor.

The Loews Cineplex transaction is an example of the granting of consent rights to the joint venture parties with respect to a limited number of significant actions. In that transaction, as long it beneficially owned at least a specified percentage (initially 17.86%) of the voting securities of Loews Cineplex, each of Sony Pictures and Universal Studios had the right to consent to certain actions, including: a) voluntary bankruptcy proceedings of Loews Cineplex or any significant subsidiary, b) acquisitions or dispositions exceeding certain value thresholds, c) entry into a line of business other than the exhibition of films, d) changes in the number of directors on the board,
e) issuances of voting securities above certain thresholds, f) the payment of cash or stock dividends or redemptions of capital stock above certain thresholds, g) the granting of consent rights to other holders of voting securities or the issuance of high-vote stock or stock with class voting powers and h) the adoption of a stockholder rights plan.87

Similarly, Anheuser-Busch, Incorporated ("Anheuser-Busch") negotiated a number of consent rights in connection with its 25% investment in Redhook Ale Brewery, Incorporated ("Redhook"),88 covering many of the same topics addressed in the Loews Cineplex transaction. For example, Redhook could not, without a written waiver from Anheuser-Busch: a) make acquisitions or investments representing more than 50% of the book value of Redhook's assets, b) make certain dispositions of assets, c) dispose of trademarks or trade names used for products to which at least 15% of consolidated revenues were attributable, d) issue or sell its capital stock, other than upon conversion of the Series B preferred stock received by Anheuser-Busch in the transaction or Redhook's convertible preferred stock, in connection with an IPO of not more than 25% of Redhook's outstanding common stock, in certain issuances not exceeding 20% of the outstanding common stock and in certain other instances, e) issue high-vote stock or stock with class voting powers, f) issue capital stock to any person whose gross revenues from the production or distribution of alcoholic beverages in North or South America exceeded specified amounts, g) give any person the right to designate more directors to Redhook's board than Anheuser-Busch was allowed to designate, h) engage in any material respect in a business other than producing and distributing beverages, i) consolidate or merge with another corporation, with certain exceptions, j) liquidate or dissolve itself, or
k) amend certain provisions of the charter and bylaws, including the provisions fixing the number of directors.\footnote{Investment Agreement between Redhook Ale Brewery, Incorporated and Anheuser-Busch, Incorporated, dated as of October 18, 1994, § 5.1, Exhibit 10.4 to the Registration Statement on Form S-1 of Redhook Ale Brewery, Incorporated filed June 30, 1995.}

2. **LEGAL ISSUES**

While there is limited legal authority with respect to these consent rights for public corporations under Delaware law, providing certain veto rights to protect the rights of a significant investor should not be problematic absent unreasonable or extreme restrictions on the board’s scope of authority. While veto powers at the extreme could improperly circumscribe the board’s ability to manage the corporation, boards routinely approve a variety of agreements that circumscribe their action, including debt covenants in connection with the issuance of debt or operating covenants in connection with a business combination agreement. As stated by the Delaware Supreme Court:

[B]usiness decisions are not an abdication of directorial authority merely because they limit a board’s freedom of future action. A board which has decided to manufacture bricks has less freedom to decide to make bottles. In a world of scarcity, a decision to do one thing will commit a board to a certain course of action and make it costly and difficult (indeed, sometimes impossible) to change course and do another. This is an inevitable fact of life and is not an abdication of directorial duty.\footnote{Grimes v. Donald, 673 A.2d 1207, 1214-15 (Del. 1996).}

Accordingly, to provide a minority investor with various protections for its investment, such as limitations on the issuance of equity to protect against dilution, seems consistent with recognizing that boards limit their flexibility in the ordinary course of business. Moreover, a restriction on the issuance of equity is analogous to debtholders negotiating for standard debt covenants to protect a company’s credit rating. To be sure, consent requirements could be so far reaching and comprehensive as to undermine the basic authority of a board to manage a corporation. For example, a contractual consent right with respect to the redemption of a rights plan by the board could implicate the same type of issues that were present in *Quickturn*. In *Quickturn*, the Delaware Supreme Court held that a “deferred redemption” provision in a stockholder rights plan\footnote{See supra note 61.} was invalid under Section 141(a) of the Delaware
General Corporation Law, which requires that any limitation on the board's authority be set out in the certificate of incorporation. The Court stated:

This Court has recently observed that "although the fiduciary duty of a Delaware director is unremitting, the exact course of conduct that must be charted to properly discharge that responsibility will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders." This Court has held that "to be the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable."

This language could also be problematic for consent rights that would limit a board's flexibility to proceed with a business combination that is otherwise in the best interests of the corporation. One should not, however, take this language so literally as to suggest that any consent right is problematic if it limits the fiduciary flexibility of a board. As pointed out earlier, entering into any contract limits the fiduciary flexibility of the board. The Delaware courts, however, appear to view contests for corporate control as singularly important, and most of the recent cases expressing concern as to limitations on the board's flexibility relate to contests for corporate control. There are no bright lines, but one would expect contractual veto rights relating to a contest for corporate control (which are not incorporated in the charter) to raise the most serious concerns under Section 141(a).

Aside from any statutory concerns under Section 141(a), fiduciary duty concerns may also be implicated if a board improperly disables itself from

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92 Id. at 1292; see 8 DEL. CODE § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

93 Quickturn, 721 A.2d at 1292 (citations omitted).

94 See, e.g., id. (negotiating possible sale of the corporation is an area of "fundamental importance to the stockholders"); Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1994) (referring to mergers, consolidations and sales of substantially all a corporation's assets as among the most fundamental corporate actions).

95 A less obvious but theoretical statutory issue for contractual vetoes is presented by Section 102(b)(4) of the Delaware General Corporation Law, which states that a corporation's charter may include "[p]rovisions requiring for any corporate action, the vote of a larger portion of the stock or of any class or series thereof . . . than is required by this chapter." With respect to those matters that require a stockholder vote under Delaware law, one could argue that a contractual veto that provides for an additional consent to the otherwise required statutory vote presents an issue under Section 102(b)(4) if not incorporated in the charter. Practitioners are generally not concerned with this issue and this may be due to the fact that they simply do not view a contractual consent as a vote under Section 102(b)(4). This is an issue on which the case law is not developed.
exercising its fiduciary duty. Stockholder approval, however, of an otherwise problematic contractual consent right would substantially mitigate any potential problem that such a provision is unreasonable under *Unocal*. In contrast, the type of restriction on a board’s ability to redeem a rights plan present in *Quickturn* was technically a statutory violation and therefore could not be cured by stockholder approval unless incorporated in the charter. As a practical matter, however, one could be skeptical as to whether the court would have been motivated to find a statutory violation if stockholder approval had been obtained (even if not incorporated in the charter).

3. **STOCK EXCHANGE ISSUES**

In drafting contractual consent rights for public corporations, strategic investors should also consider whether these types of provisions comply with stock exchange policies even though such rights are not incorporated in the terms of a security. Certain policies of the NYSE expressed in the Listed Company Manual that limit the use of class voting mechanisms could also restrict contractual provisions that achieve the same effect. As discussed in Part II, the NYSE’s voting policy states that “[v]oting rights of existing stockholders of publicly traded common stock registered under Section 12 of the Exchange Act cannot be disparately reduced or restricted through any corporate action or issuance.” Moreover, the NYSE has a specific concern with class voting rights in preferred stock. To the extent an exemption under the one share-one vote policy were not otherwise available, then a concern with respect to the issue could potentially be addressed by limiting the consent rights to those matters on which stockholders do not vote. For example, a sale of assets could be subject to a veto right to the extent that

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96 See the discussion of *Stroud v. Grace*, 606 A.2d at 82-83, *supra* note 25.

97 The validity of this type of provision even if incorporated in the charter was left open in *Toll Brothers*. *See supra* note 60.

98 Again, these concerns are not present with respect to contractual arrangements that are established before a company is taken public because purchasers of stock in a subsequent public offering will take the stock with the knowledge that those contractual arrangements could affect their voting power.

99 NYSE MANUAL, *supra* note 28, para. 313.00.

100 NYSE MANUAL, *supra* note 28, para. 308.00 (“The Exchange would also be concerned about the issuance of preferred stock which by its terms would vote separately as a class from the common stock on the approval of mergers and acquisitions, unless required by federal or state statute.”). In considering the application of the NYSE’s rules to contractual veto rights, one should note, however, that neither Rule 19c-4 nor the Exchange rules specifically address contractual consent rights.

101 Redhook was not a public company at the time it entered into the transaction with Anheuser-Busch and therefore was able to use the public offering exemption when it later went public.
such sale did not constitute a sale of substantial assets subject to a stockholder vote. If consent rights do not impinge on a stockholder vote, then they should not be viewed as violating the exchange's one share-one vote policy. Of course, this approach dilutes the scope of contractual vetoes if other veto rights with respect to matters voted on by the stockholders are not otherwise available.

The consent rights can also raise an issue under Paragraph 314 of the Listed Company Manual, which expresses the NYSE's concern with arrangements that grant special rights to a stockholder or group of stockholders to the exclusion of the rest of the class. Although the NYSE does not specifically cite consent rights as problematic, it highlights preemptive rights and put options available to a single stockholder as the types of provisions that would give it concern. While Paragraph 314 could potentially be problematic, the same exceptions that are applicable to the one share-one vote policy should be applicable to Paragraph 314. Finally, the NYSE has indicated, as has NASDAQ, that it will be flexible in regard to these matters, and exclusive arrangements in some form or another are relatively widespread as a means to induce prospective investors to provide capital or other consideration. One should note that to the extent that strategic investments for which documents are publicly available provide for consent rights that raise issues under NYSE (or NASDAQ) policies, the continued listing of the stock may have resulted from informal understandings with the issuer that are not publicly available. The NYSE (or NASDAQ) may have been persuaded on a confidential basis of the legitimate reasons for the transaction and that such transaction was not being taken primarily with the intent to disenfranchise.

IV. CONCLUSION

As strategic alliances have flourished, their popularity has extended to strategic investments in public corporations. The parties to a strategic investment in a public corporation have available to them various mechanisms to ensure appropriate influence or control between or among the parties. The basic governance structures to achieve decisive influence over corporate action are approval pursuant to a supermajority board vote, a supermajority stockholder vote (or a class vote of a security held by a single

102 Such a provision would also cure any issue under Section 102(b)(4) of the Delaware General Corporation Law, see supra note 95, because the contractual consent rights would simply fall away with respect to any matter subject to a stockholder vote under the corporation's charter or applicable law.

103 NYSE MANUAL, supra note 28, para. 314.00.

104 Id.
investor) or a contract (i.e., negative covenants). As a general rule, while supermajority board votes present the least protection due to the fiduciary responsibility of directors to represent all stockholders, supermajority stockholder votes (or class votes of a security held by a single investor) provide the most protection from a fiduciary perspective due to the right of a stockholder to vote, in its capacity as a stockholder, in its sole discretion. Although supermajority stockholder votes allow any stockholder or stockholders with the requisite minority ownership to block action, securities that vote separately as a class issued to a single holder raise concerns under exchange rules that are not present with simple supermajority stockholder votes. There is room for a degree of flexibility in the one share–one vote policy where there is reasonable justification for so doing and such transaction is not being taken with the intent to disenfranchise, although the limits of this flexibility are not well defined (even in connection with a strategic alliance). Contractual vetoes imposed upon a public corporation are effective from a business standpoint but the law (and exchange rules) relating to contractual vetoes is not well developed. Accordingly, contractual vetoes can present some legal uncertainty, particularly if they related to contests for corporate control and are not incorporated in the charter. In that connection, some of the same concerns applicable to securities voting as a class under exchange rules could well be applicable to contractual vetoes. As reflected in this article, each governance alternative presents different legal issues and has advantages and disadvantages based upon a number of factors, including the ability to obtain stockholder approval and the one share–one vote rule and other applicable stock exchange rules. Not surprisingly, strategic investments are structured in a variety of ways that reflect a careful juggling of these concerns. There is no “best” structure because the best result is factually driven based upon the particular circumstances.