Analysis of the 1998 Amendments to the Delaware General Corporation Law

Lewis S. Black, Jr., Esq.
and
Frederick H. Alexander, Esq.

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ANALYSIS OF THE 1998 AMENDMENTS TO THE DELAWARE GENERAL CORPORATION LAW

By Lewis S. Black, Jr. and Frederick H. Alexander
Morris, Nichols, Arsht & Tunnell
Wilmington, Delaware

INTRODUCTION

Effective on July 1, 1998, the Delaware General Corporation Law was amended for the ninth consecutive year. The Delaware legislature approved a single bill containing an unusually large number of changes to the statute, most of which were prompted by an effort to substitute gender neutral references for masculine pronouns wherever they appeared in the statute. Significant substantive changes were made in the sections governing the redemption of stock and the sections covering mergers. In addition, a number of changes were made to fine-tune or clarify provisions where practitioners had identified ambiguities in the statute.

This article describes the changes effected by the 1998 amendments [1] and supplements previous reports published by Aspen Law & Business and its predecessor, Prentice Hall Law & Business, describing amendments to the Delaware General Corporation Law. [2]

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1 The amendments addressing gender neutrality are self-explanatory and not discussed.

2 Arsht and Stapleton: Analysis of the New Delaware Corporation Law; Analysis of the 1967 Amendments to the Delaware Corporation Law; Analysis of the 1969 Amendments to the Delaware Corporation Law; Analysis of the 1970 Amendments to the Delaware Corporation Law; Arsht and Black: Analysis of the 1973 Amendments to the Delaware Corporation Law; Analysis of the 1974 Amendments to the Delaware Corporation Law; Analysis of the 1976 Amendments to the Delaware Corporation Law; Black and Sparks: Analysis of the 1981 Amendments to the Delaware Corporation Law; Analysis of the 1983 Amendments to the Delaware Corporation Law; Analysis of the 1984 Amendments to the Delaware Corporation Law; Analysis of the 1985 Amendments to the Delaware Corporation Law; Analysis of the 1986 Amendments to the Delaware Corporation Law; Analysis of the 1987 Amendments to the Delaware Corporation Law; Analysis of the 1988 Amendments to the Delaware General Corporation Law; Analysis of the 1990 Amendments to the Delaware General Corporation Law; Analysis of the 1991 Amendments to the Delaware General Corporation Law; Analysis of the 1992 Amendments to the Delaware General Corporation Law; Analysis of the 1993 Amendments to the Delaware General Corporation Law; Black & Alexander: Analysis of the 1994 Amendments to the Delaware Corporation Law (Prentice Hall, Inc., 1967, 1969, 1970, 1973, 1974, 1976, 1981, 1983, 1984, 1985, 1986, 1987, 1988, 1990, 1991, 1992, and 1993, Aspen Law & Business, 1994, 1995, 1996, and 1997, respectively).

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REGISTERED OFFICE AND REGISTERED AGENT

Registered agent in State; resident agent [§ 132].—Sections 131 and 132 of the General Corporation Law require that every Delaware corporation have a registered office and registered agent in the State for the purpose of accepting service of process, and certain other documents, such as demands for inspection of corporate records, specified in other sections of the statute. Section 132, in particular, permits the registered agent to be either the corporation itself, an individual resident in the State or another corporation. The 1998 amendments expand the class of entities that may serve as registered agents to include limited partnerships, limited liability companies and business trusts. This change recognizes the growing acceptance and use of so-called "alternative entities." It should be noted that either a domestic or foreign limited liability company or limited partnership may serve as a registered agent, but that only a Delaware business trust (and not a foreign business trust) may serve in that capacity.

STOCK AND DIVIDENDS

Classes and series of stock; redemption; rights [§ 151].—Section 151 of the General Corporation Law authorizes classes and series of stock with a broad range of powers, preferences and rights. The 1998 amendments further clarify the authority of corporations to create redeemable common stock. Prior to 1990, corporations generally could not authorize a redeemable class or series of stock unless that class or series had a liquidation or dividend preference; this limitation, however, was subject to certain exceptions in the case of regulated investment companies and corporations holding licenses or franchises that made redemption necessary. In 1990, Section 151(b) was amended to expand those exceptions and, more importantly, to eliminate the restriction on redeemable common stock generally. However, the drafters of the 1990 provisions were concerned that permitting all of the common stock of a corporation to be redeemable could, in unusual situations, leave a corporation with no stockholders with the power to elect directors. The 1990 amendments addressed this concern by providing that stock could be made redeemable only if, at the time of redemption, the corporation had outstanding shares of at least one class or series of stock with full voting powers that was not subject to redemption.

Many practitioners interpreted this language as requiring the existence at all times of a class or series of stock having full voting powers, none of the shares of which were subject to redemption. As a consequence, according to this view, a corporation's charter had to provide for more than one class of stock or two or more series within a class in order for the corporation to have any shares which could be redeemable. This was thought to be unduly restrictive in that the purpose of the limiting language included in the 1990 amendment could be achieved, *i.e.*, continuing stockholder control, without prohibiting the redemption of some, but not all, shares of a class or series. The 1998 amendments make it clear that shares of stock of any class or series may be made redeemable so long as, following any such redemption, the corporation has outstanding one or more shares of stock that

together have full voting powers. The shares of the class or series to which such shares belong may be redeemable generally. Hence, for example, a corporation may have a single class of redeemable common stock, all the shares of which are subject to redemption, so long as the corporation can not, in fact, redeem the last share of such class.

The 1998 amendments to Section 151(b) were not intended to address the issue whether holders of the same class or series of stock may be treated differently in any transaction or circumstance.

MEETING, ELECTIONS, VOTING AND NOTICE

Voting rights of members of non-stock corporations; quorum; proxies [§ 215].—Section 215 of the General Corporation Law addresses the voting rights of members of non-stock corporations. Section 215(c) sets forth default voting and quorum rules for meetings of members. In general, the provision states that unless otherwise provided in the statute or the corporate charter or by-laws, the presence of one-third of the members constitutes a quorum and the affirmative vote of a majority of the members present at a meeting and entitled to vote on the subject matter at hand constitutes the act of the members. The 1998 amendments change the latter rule by providing that in the case of the election of the governing body of the corporation, the members of the governing body shall be elected by plurality vote. This change makes Section 215(c) parallel Section 216 of the General Corporation Law (which governs the voting and quorum requirements for stock corporations). It should be emphasized that the rules set forth in Section 215(c) (and Section 216) are only default rules that apply in the absence of any specification by the drafters of the corporate charter and by-laws. Where the default rules apply, it is less likely that no new directors will be elected with the result that holdover directors will continue to manage the corporation's business and affairs.

Quorum and required vote for stock corporation [§ 216].—Section 216 governs the voting and quorum requirements for stockholder action on matters for which the vote is not specified in the General Corporation Law or in the corporation's charter or by-laws. In particular, Section 216 provides that the quorum requirement for action at a stockholders meeting, absent a charter or by-law provision, is a majority of the shares entitled to vote at the meeting; in addition, the statute states that, unless otherwise, stockholder action is taken by the affirmative vote of a majority of shares present and entitled to vote on the matter. Section 216 expressly prohibits the charter or by-laws from setting a quorum of less than one-third of the shares entitled to vote. In addition, the statute states that where the vote is by a separate class or classes, the quorum and voting requirements are based on the shares within such class or classes. Two clarifying changes were made to Section 216 by the 1998 amendments. First, the provision for class voting was expanded to include series voting so that the statute now provides that if a separate vote by a class or series is required, a quorum will consist of, unless otherwise provided, holders of a majority of the shares of stock of such class or classes or series and the vote required will be the affirmative vote of the majority of the shares of such

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class or series or classes or series present. In addition, the provision of Section 216 requiring that a quorum consist of no less than one-third of the shares entitled to vote at a meeting was amended to provide that, as to matters on which a class or series vote is required, the minimum quorum is one-third of the shares of such class or series or classes or series.

MERGER OR CONSOLIDATION

Merger or consolidation of domestic corporations [§ 251].—The changes to Section 251 of the General Corporation Law will, no doubt, generate the most interest on the part of corporate practitioners of any of the changes effected by the 1998 amendments. In general, the changes to Section 251 address the question whether the directors of a corporation may change their minds in the interval between board approval of a merger agreement and the time that stockholders vote on the agreement. The Delaware Supreme Court has held that a board of directors must recommend a merger to stockholders in order for it to be presented to stockholders at a meeting. *Smith v. Van Gorkom*, 488 A.2d 858, 873 and 887-88 (Del. 1985). One view has been that because directors owe fiduciary duties to stockholders, they must be able to change their minds prior to a stockholder vote and to recommend against a merger if they change their opinion as to its benefits. *See, e.g., Great Western Products Co-operative v. Great Western United Corporation,* 613 P.2d 873 (Colo. 1980). The opposing view holds that there is no fiduciary requirement that directors reserve the right to change their recommendation. *See, e.g., Jewel Companies, Inc. v. Pay Less Drug Stores Northwest, Inc.,* 741 F.2d 1555 (9th Cir. 1984). [3]

The 1998 amendments are intended to add some clarity to this area and to harmonize, at least in a procedural sense, the legal requirement that directors take some position on the merits of a proposed merger with the business reality that some merger partners will not enter into a merger agreement which is not binding save for the statutory requirement of stockholder approval. First, Section 251(b) has been amended to require a board determination, at the time of the adoption of a merger agreement, that the agreement is advisable. This requirement parallels the requirement set forth in Section 242(b)(1) that a charter amendment be declared advisable by the board of directors prior to its submission to

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3 Practitioners will recognize that subsumed in this debate are far more practical issues relating to the negotiation of merger agreements. Lawyers have tried to deal with these issues by developing "fiduciary outs," *i.e.*, provisions of merger agreements which permit directors to abnegate the agreement if their fiduciary duties so require. The term may be a misnomer both as written (it is really a euphemism for a "better offer" out) and as applied (directors may have no supervening fiduciary duty that precludes them from negotiating a binding merger agreement). See J. Johnston and F. Alexander, *Fiduciary Outs and Exclusive Merger Agreements—Delaware Law and Practice*, INSIGHTS, Feb. 1997, p. 15; A. Sparks, *Merger Agreements Under Delaware Law—When Can Directors Change Their Minds?*, 5 U. MIAMI L. REV. 815 (1997).

stockholders. Second, Section 251(c) has been amended by adding the following sentence, which specifically permits a board of directors to change its recommendation without withdrawing the merger agreement from stockholder consideration:

> The terms of the agreement may require that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it.

Accordingly, by including such a provision, the parties to an agreement may attempt to make it absolutely binding on the board of directors, so that subsequent changes in circumstances (including an offer by another acquiror to pay a greater price) will not permit the board of directors to withdraw the merger agreement from stockholder approval. Of course, such a provision does not bind the stockholders themselves, who are still free to vote such a binding merger agreement down. The effective date for the Act making the 1998 amendments to the General Corporation Law expressly provides that the change in the merger statute is effective for agreements of merger or consolidation entered into on or after July 1, 1998. Sections 252, 254, 257, 263 and 264 governing, respectively, mergers with foreign corporations, mergers with unincorporated associations, trusts and enterprises, mergers with non-stock corporations, mergers with limited partnerships and mergers with limited liability companies, were amended to conform to the changes to Section 251.

SUITS AGAINST CORPORATIONS, DIRECTORS, OFFICERS OR STOCKHOLDERS

Attachment of shares of stock or any option, right or interest therein; procedure; sale; title upon sale; proceeds [§ 324].—Section 324 both authorizes the attachment of shares, or the right to acquire shares, of stock of Delaware corporations for debt, and establishes a procedure for such attachments and judicial sales pursuant thereto. This statute expressly provides for the service of attachment process on a corporation, the notification to a debtor of an order of sale of the debtor's shares and the transfer of the shares upon a judicial sale.

The 1998 amendments to Section 324 are intended to enhance the utility of stock of a Delaware corporation as collateral by clarifying the procedure set forth in Section 324 and by making the attachment of a security represented by a certificate under the General Corporation Law consistent with the law governing attachment of a certificated security under Delaware law in general. First, the 1998 amendments make it clear that the application of Section 324 is limited to securities of a debtor identified on the books of the corporation. This clarification is consistent with the policy of the General Corporation Law that the obligations of a corporation with respect to its stock and rights in its stock should only extend to stock identified on the corporate books. Second, the 1998 amendments require the attachment of a certificated security under Section 324 to satisfy the requirements of new Section 8-112 of the Delaware Uniform Commercial

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Code, 6 Del. C. § 8-112. Section 8-112 requires actual seizure of a certificated security if it is held by the debtor. If the certificate has been surrendered to the issuer or is held by a secured party, attachment may be accomplished by serving legal process on the issuer or secured party, respectively. This procedure is designed to provide for an effective attachment of a certificated security by removing all possibility of the certificated security wrongfully finding its way into a transferee's hands. The 1998 amendments incorporate the procedure for effecting the attachment of a certificated security under Section 8-112 into the procedure set forth in Section 324. Finally, the 1998 amendments change the sentence order of the statute and make other minor modifications to further clarify the operation of Section 324.

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