FUNDAMENTAL CORPORATE CHANGES: CHARTER AMENDMENTS

BY A. GILCHRIST SPARKS III *

The last topic, as I noted, in the fundamental corporate change area is that of charter amendments. I am assuming, in looking at the sophisticated nature of our audience, that the basic fundamentals are pretty well in hand as to how one goes about getting a charter amendment executed, filed, and effectuated here in Delaware.

There are three fundamental principles, though, that we will be coming back to and which form the necessary backdrop that you have to have in mind as we discuss this topic. They are found in the statute,[1] and they are:

1. The certificate of incorporation may be amended to include any provision which could lawfully have been included in the original certificate of incorporation. What can originally be included in the certificate of incorporation is found in section 102 of the Delaware General Corporation Law,[2] and that is any provision for management of the business or conduct of the affairs of the corporation and any provision creating, defining, limiting, and regulating the powers of the corporation, the directors and the stockholders, or any class of the stockholders, or the members of a non-stock corporation.

That is pretty broad. There is one proviso; that is that such provisions not be contrary to the laws of this state.[3]

2. In order to effect a charter amendment you must have a vote of stockholders, and the standard vote prescribed by the statute is the affirmative vote of a majority of the outstanding shares entitled to vote unless the amendment adversely affects the powers, preferences, or special rights of any class or series, increases or decreases the authorized shares of such a class, or increases or decreases the par value of the shares of such a class, in which event that class or series is entitled to a class vote.[4]

3. The third basic principle that one must keep in mind is that the certificate of incorporation may require a higher vote for the

* Member of the Delaware State and American Bar Associations. Partner, Morris, Nichols, Arsht & Tunnel, Wilmington, Delaware. B.A., 1966, Yale University; J.D., 1973, University of Pennsylvania.

1. DEL. CODE ANN. tit. 8, § 242 (1974).

2. DEL. CODE ANN. tit. 8, § 102 (1974).

3. DEL. CODE ANN. tit. 8, § 102(b)(1) (1974).

4. DEL. CODE ANN. tit. 8, § 242(c)(2) (1974).

amendment of a certificate of incorporation. That is found in section 102(b)(4) of the Corporation Law.[5]

In addition to that, there are two common law principles that must be kept in mind any time we discuss charter amendments. The first of these, set forth in the landmark Delaware case of *Schnell v. Chris-Craft*,[6] is that, notwithstanding that a transaction is authorized by statute, action cannot be taken which is inequitable. The second principle is that action taken by a majority stockholder will in all likelihood be scrutinized for entire fairness.

After preparing my remarks for today's session, I pulled out my copy of Professor Folk's book on the Delaware General Corporation Law,[7] which is only thirteen or fourteen years old now, and was amazed to read his comments on the judicial review of fairness of recapitalization by charter amendment. He said: "The scope of judicial review for fairness is very narrow. Several rules may even prevent the question from being adjudicated." [8] He goes on to say: "When the majority of stockholders speak for the corporation upon extraordinary occasions, as the directors do in the usual course of events, a like presumption of business judgment in favor of the bona fides of their decision should prevail." [9] Also: "The Courts will not inquire into the 'reasons for the amendment or the business necessity behind it,' although occasionally the Court will note 'in passing' the amendment's 'constructive intent' or even expressly examine its business purpose, typically when it requires whether 'fraud' taints the transaction." [10]

That was the law as Profesosr Folk saw it in 1972, and it is based on such cases as *Davis v. Louisville Gas & Electric Company*,[11] a chancery court decision in 1928, and the *Cole v. National Cash Register Tax Credit Association* [12] case in 1931.

In light of *Singer*,[13] I would doubt very seriously whether that is the law today.

With that I would like to move into some specific areas in which charter amendment issues are encountered. First, we consider the reverse stock split. Occasionally, we get questions as to whether a

5. DEL. CODE ANN. tit. 8, § 102(b)(4) (1974).
6. 285 A.2d 437 (Del. 1971).
7. E. FOLK, THE DELAWARE GENERAL CORPORATION LAW (1972).
8. *Id.* at 300.
9. *Id.* at 301.
10. *Id.*
11. 16 Del. Ch. 157, 142 A. 645 (1928).
12. 18 Del. Ch. 47, 156 A. 183 (1931).
13. Singer v. Magnavox Co., 367 A.2d 1349 (Del. Ch. 1976), *aff'd in part rev'd in part*, 380 A.2d 969 (Del. 1979).

reverse stock split requires a charter amendment. I am not aware of any Delaware decision on point, but I believe it is the general consensus that it does. If one is to try to find the language that supports this, I think you can look at the language in section 242(a),[14] which says that any change in outstanding stock requires a charter amendment. Obviously, by a reverse stock split, you are effecting a change in shares that are already issued.

The interesting aspect of reverse stock splits is that they may be utilized as a cash-out technique to eliminate minority stockholders. I am aware of only two or three instances where this has been done, and I am not aware of any litigated cases in recent years that have dealt with this technique. I think there may be some reasons for that which we will get to.

Section 155 [15] of the Delaware General Corporation Law requires that if you have a transaction which results in the creation of fractional interests you may pay "fair value" for fractional interests. Again, I am not aware of any Delaware case that interprets that term or that provision. One might ask whether that is the same standard as applied in the interested merger, and one might also ask whether, as in the *Singer* line of cases, for example, there would be a shift of the burden of proof to the defendant to prove the "fair value" paid for fractional shares in a reverse stock split.

I think where I would come out on that, although it is really just on the basis of last night's thinking, is that if the reverse stock split were imposed by a majority stockholder upon the minority with the effect of freezing out the minority, you are basically going to be under the *Singer* rules, with the burden of proving entire fairness being upon the majority. On the other hand, if it is a transaction which, for example, is designed to reduce the number of stockholders in a company which has a large number of small stockholders with attendant large costs, where there is no control shift involved and the vote on the amendment is not dictated by a majority stockholder, I would argue that the burden rests on a stockholder complaining about it to prove that the value paid for fractional shares was unfair, with the directors having the benefit of the business judgment rule.

If challenged, a majority stockholder which effects a reverse stock split will in all likelihood have to prove the entire fairness of and demonstrate a proper corporate purpose for the transaction. Again, there is an element of speculation. There are no cases dealing

14. DEL. CODE ANN. tit. 8, § 242(a) (1974).
15. DEL. CODE ANN. tit. 8, § 155 (1974).

with the question. On the other hand, the coercive element is clearly there. It is just an alternative technique or can be just an alternative technique for freezing out minorities, and it is hard to believe that the form of the transaction would result in a different rule than that of *Singer* being applied.

I think there may be two reasons why this technique has not become popular, although, as I said before, it has been used. One is that you do not have in the charter amendment area the safety valve of the appraisal process. I think it is notable that certainly in *Tanzer*[16] on remand, where the court enumerated the eight or nine points it considered in determining whether that particular merger was entirely fair, there was specific reference to the availability of appraisal rights.

As we know, at least where a merger is dictated by a majority stockholder, appraisal rights have been held not to be exclusive and not to bar a fairness inquiry.[17] On the other hand, it is certainly an element of fairness and if such rights exist, I think a court feels a little bit more comfortable in denying under particular facts a plaintiff's *Singer* claim.

The appraisal right will not be there under section 242.[18] Therefore, it seems to me that you start off with the idea that a somewhat more risky form of "going private" transaction than a merger is more likely to result in some sort of adverse judicial action.

MR. SCOTT: Gil [Sparks], could you voluntarily grant appraisal rights?

MR. SPARKS: There are proposed amendments to the Delaware General Corporation Law, which have been passed by the House and may get passed by the Senate in the fairly near future, which would specifically authorize corporations to volunteer to give appraisal rights with respect to charter amendments.[19]

I also think there is a perception of the nature of a reverse stock split which is a bit more harsh. It just seems a little more tricky

16. Tanzer v. International Gen. Indus., 402 A.2d 382 (Del. Ch. 1979).

17. Singer v. Magnavox Co., 367 A.2d 1349 (Del. Ch. 1976), *aff'd in part rev'd in part*, 380 A.2d 969 (Del. 1979).

18. DEL. CODE ANN. tit. 8, § 242 (1974).

19. Act of June 6, 1981, 16 Del. Laws, ch. 25, § 14(c) (to be codified in DEL. CODE ANN. tit. 8, § 262(c)):

> (c) Any corporation may provide in its certificate of incorporation that appraisal rights under this Section shall be available for the shares of any class or series of its stock as a result of an amendment to its certificate of incorporation, any merger or consolidation in which the corporation is a constituent corporation or the sale of all or substantially all of the assets of the corporation. In such event, the procedures of this Section, including those set forth in subsections (d) and (e), shall apply as nearly as is practicable.

in the real world. Let's take a person who has 999 shares. Of course, the way you do reverse stock split is to provide in a charter amendment that every 1,000 shares is converted into one share and everybody who does not have 1,000 shares gets cash for their fractional interest. If a person has 999 shares, he will get cash for it.

There is just something that strikes one as being a little bit manipulative about that. I see Irv Morris shaking his head affirmatively, so now I really know to tell my clients that plaintiffs' lawyers are going to really have their antenna up for that kind of transaction.

The next area is "recapitalizations," and if I had to do the outline over again, I would have probably used some other word because the first thing I am going to say is that "recapitalization" has been established by the Delaware case law to be a poor word to use.

Most of the recapitalization charter amendment law comes from a period that, frankly, was before the time I was born. I discuss these cases with my senior partner, Sam Arsht, from time to time and his eyes light up the way my generation's eyes light up when they discuss *Singer, Tanzer,* and some of the other recent merger cases. That is because back in the 1930's the big problem that corporations faced was no money and accumulated unpaid dividends on preferred stock. Prior to World War II, many of our corporations had economic problems, which make ours look pretty pale, so corporate lawyers in those days, rather than trying to figure out how to structure freeze-out mergers, spent their time trying to figure out how to take away accumulated unpaid dividends from preferred stockholders so their corporate clients could start to pay dividends on their common stock again and perhaps sell some new common stock and get their businesses back on track.

As a result, most of the charter amendment cases come from that pre-war era. It is fun to read them on the one hand; on the other hand, it reminds me a lot of trying to read *Singer* and *Tanzer* and *Weinberger v. UOP.*[20] You get some conflicting signals. While I am not going to go back and discuss those old cases, there have been some recent cases in the area and there are some principles that came from those old cases that we should focus on.

The types of things that these recapitalizations have frequently been used to accomplish are: to eliminate accumulated unpaid dividends; to take preferences away from preferred stockholders; and to turn preferred stockholders into common stockholders. These are

20. 409 A.2d 1262 (Del. Ch. 1979).

all techniques designed to simplify the capitalization base, generally at the expense of preferred stockholders.

The traditional protection against such changes on the part of preferred stockholders has been the class vote. Again, class voting is a pretty esoteric subject and one we could get into if we had days and days and everybody did not have a big lunch and people were not nodding, but instead of doing that—because I really do not think at this time in the afternoon I could afford to see my entire audience go to sleep—I would like to focus briefly on the major principles that our courts have reiterated time and time again. Then maybe we can tie it together a little bit with some of the other things that we have been hearing today.

It is clear from the decisions of our courts that contract principles are what govern the interpretation of preferred stock provisions. The main principle of contract interpretation that the courts talk about is considering the instrument in its entirety. I think the people who draft preferred stock provisions ought to know that there are a lot of Delaware lawyers who spend a great deal of time looking at the entire document and trying to conclude that the intent of the drafter was not what the drafter thought it was.

Anybody who is assigned the task of drafting preferred stock provisions just ought to think about that—about the fact that two or three or four or five years later there is going to be somebody pulling that dusty provision out of the file and asking, "Did this person really protect against a charter amendment effected as part of a merger when they said there won't be any charter amendments with adverse affect?" That is the kind of thing that Delaware lawyers are asked to look at.

I fortunately have not had to get too deeply into the business of drafting these provisions, but I have often thought it would be one of the more challenging tasks to try to draft an airtight set of preferred stock provisions protecting against almost every conceivable divesting of preferences. Very rarely do you see the perfect one.

The task of the drafter of preferred stock provisions is made all the more difficult by the fact that, to some extent, the way these preferred stock provisions have been interpreted by our Supreme Court turns standard contract interpretation principles a little bit on their head.

I think I remember that a standard rule of interpretation, at least in the consumer area, is that in case of ambiguous provisions you presume against the drafter so that the poor consumer out there does not get hurt by the small print. But that is not the rule in interpreting preferred stock provisions in Delaware. The rule is, as

expressed in *Ellingwood v. Wolf's Head Oil Refining Co.*[21] and repeated just recently in the *Wood v. Coastal States*[22] case, that nothing is to be presumed in favor of preferences attached to stock; when a corporate charter attempts to confer preferences upon any class of stock, the same should be expressed in clear language.

That principle came home to roost in the recent decision of both the Delaware Court of Chancery and the Delaware Supreme Court in *Wood v. Coastal States Gas Corp.*[23] That case involved primarily a determination of what the word "recapitalization" meant. The particular charter provision had required a class vote in the case of a "recapitalization" which is a term that was probably drawn by the drafter of the charter provision from the Internal Revenue Code. Unfortunately for the preferred stockholders in that case, the term "recapitalization" is not a term of art in Delaware corporation law, and so the court was required to analyze the contract as a whole to determine its meaning. After reading and generally discounting Internal Revenue Service cases, the court came to the conclusion that a spin-off of stock of a newly created subsidiary was not a "recapitalization."[24] True, it had effects upon the capital structure of the company, but it was not a recapitalization.

I think the lesson of that case to the drafter is that if he wanted to protect against a dividend of property or assets he should have clearly said so. Similarly, to go back to an earlier example, if you want to guard against a change of rights by way of charter amendment effected as part of a merger, the preferred stock provisions should clearly provide that if there is going to be a merger in which an amendment to the charter results, there must be a class vote. If you just say, "there shall be no amendment to the preferred stock preferences without a class vote," and thereafter a merger is proposed in which the preferred stock provisions are to be changed, some lawyer somewhere is going to be arguing that you did not protect against charter amendments effected as part of a merger, that the Delaware law has a concept of independent legal significance, and that when you said "amendment" you were probably thinking about statutory amendment.

It is an area that really puts a premium on the drafter's ability and knowledge of the law and you have to think about what words you are using and stay away from common words like "recapitaliza-

21. 38 A.2d 743 (Del. 1944).

22. Wood v. Coastal States Gas Corp., 401 A.2d 932 (Del. 1979).

23. *Id.*

24. *Id.* at 941.

tion" or "reorganization" which have no definite meaning. Instead, take a look at section 242 before you draft one of these provisions and try to hone in on exactly what it is you fear. Keep in mind the whole concept of independent legal significance in Delaware. If you want to stop a dissolution, require a class vote on a dissolution. If you want to stop a charter amendment by merger, make sure you say it.

There is one area that to me is not terribly clear in all of this, given these rather rigid interpretation rules that the supreme court has talked about since the '30s and right up until the more recent cases. I refer to language found in the recent opinion of the supreme court in *Judah v. Delaware Trust Co.*,[25] a 1977 case.

In that case the court says that the provisions of the certificate of incorporation generally govern the rights of preferred shareholders, the certificate of incorporation being interpreted in accordance with the law of contracts with only those rights which are embodied in the certificate granted to preferred shareholders. That is what we have just been talking about.

However, the court then goes on and says: "Additionally, the teachings of *Zahn v. Transamerica Corp.*[26] [a federal case applying Kentucky law] mandate that close judicial scrutiny be given the actions of management which serve to prejudice the interests of subordinate security holders." [27] And then the court goes on to say: "Where the majority shareholders stand to benefit at the direct expense of the minority shareholders by action of a board of directors they control, the backdrop provided by the fiduciary obligations owed by the directors to the minority requires that the proposed action be closely examined before being effectuated." [28]

I really do not know how to explain that language in the context it was used. It may just be a case of the supreme court having *Singer* on its mind. Maybe it is explainable by saying that if there is an ambiguity—and in this particular case the court found there was ambiguity in the preferred stock provisions—and if the board of directors is called upon to interpret that ambiguity in determining what action to take, and if that action could be deemed to be prejudicial to the minority, then fiduciary principles call for careful scrutiny by the court of the board's actions in interpreting the provisions. That is how I read it, but I think that language does give a little bit of

25. 378 A.2d 624 (Del. 1977).

26. 162 F.2d 36 (3d Cir. 1947).

27. 378 A.2d 624, 628 (Del. 1977).

28. *Id.* at 628.

a wedge to a plaintiff in this area to argue that the strict rules of control interpretation found in the other cases may be softened where a breach of fiduciary duty is alleged.

The next topic which I will touch on just briefly is defensive charter amendments. There are in your materials two recent cases: one unreported, *Seibert v. Gulton Industries,*[29] and the other *Telvest v. Olsen,*[30] which was a memorandum opinion and will also not be reported.

Those two cases point out what I think is the Delaware court's fundamental approach to the area of shark repellent or porcupine provisions in charter amendments. These, as the outline explains in some detail, have as many varieties as the flora and fauna. They run from some fairly simple things, as just requiring a super-majority vote in the case of mergers, to, on the other hand, some provisions that run on pages and pages and pages.

If there is one area in which the fertile legal drafting mind has had exercise in the past ten years it is this area. Some of these provisions are the most incredible things you can imagine and, frankly, I generally find myself falling asleep after about the thirty-third definition of "related person" and "affiliate" that lawyers have dreamed up. You almost throw up your hands and say, "what is this thing trying to do," but you know at the bottom line that what it is trying to do is prevent takeovers.

In *Seibert v. Gulton,* our supreme court did look at one of these provisions, a fairly simple one requiring a super-majority vote in interested mergers. What the court found was that these kinds of provisions are not contrary to the public policy or the laws of the State of Delaware. Significantly, though, *Seibert* involved a charter amendment which was submitted to stockholders at a time when there was no active contest for control of the company. The majority vote of the stockholders approving the amendment in that case was respected.

There is mention in the outline of the *Young v. Valhi*[31] case, which implicitly suggested that super-majority vote provisions for interested mergers are valid. In that case such a provision was enforced against a company which had acquired a majority position after the stockholders of the target company had put a super-majority provision into place.

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29. No. 5631 (Del. Ch. May 25, 1979), *aff'd without opinion,* 414 A.2d 822 (Del. 1980).

30. No. 5798 (Del. Ch. March 8, 1979).

31. 382 A.2d 1372 (Del. Ch. 1979).

The other side of the picture is presented by the *Telvest* case, in which the directors, facing an active threat by a raider, and without seeking stockholder approval, utilized an existing blank stock provision to create a new series of preferred stock which had an eighty percent vote requirement for an interested merger.

It was obviously a situation, at least as you read the court's opinion, in which action was taken by the directors in the heat of battle. I think in analyzing that decision and laying it against *Seibert* one can come to the conclusions that I have listed in the outline:

1. Defense charter amendments are generally conceded to be valid as a matter of statutory authority. I cited the fact that you can have super-majority vote provisions and the Delaware Supreme Court has held that such provisions are not, as a general matter, contrary to public policy.

2. Whether a court will uphold actions taken pursuant to such amendments will depend on the circumstances. Where a charter amendment is approved by stockholders prior to any real or perceived takeover threat, a court will be unlikely to interfere with its implementation, the theory there being, I think, that the stockholders have spoken and they have said, "this is something we think is good for our investment," and the courts are going to respect that, there being at that point really no basis for showing that that type of provision is not in the general interest of the stockholders.

However, as the balance tips towards the situation where the board of directors acts on its own and in the face of a threatened takeover, a court will examine that action closely to see whether it was indeed intended to protect the stockholders or whether the action constituted a manipulation of the corporate machinery to perpetuate control by management of the corporation.

That, of course, is right back to the old *Schnell v. Chris-Craft* case, which I mentioned at the beginning of my talk.

I would note in passing that there is some question in my mind and I believe in the minds of most members of the corporate Bar here in Delaware as to exactly what the *Telvest* case is trying to tell us with respect to the scope of blank stock powers. I do not think anybody quarrels with the application of the *Schnell* principle to this area. There is language in the *Telvest* case, however, which suggests that, as a general matter, a board of directors cannot adopt a blank stock provision which affects the voting rights of previously outstanding stock. Before the blank stock provision was effected, the stockholders of Telvest had the right to approve a merger by a majority vote. However, if effect were given to the requirement that

eighty percent of the preferred stock approve an interested merger, even if 100% of the common stockholders wanted the merger, it would not go through. The court seems to say that you cannot change outstanding stockholder voting rights that way by board action pursuant to blank stock provisions. I disagree with that as an abstract holding since once stockholders surrender to directors the right to create blank stock, in theory they have the power to create blank stock which does most anything, so long as it does not constitute manipulation of the corporate machinery for an improper purpose.

I regret that the opinion in *Telvest* can be read to go further and intrude into the theory behind blank stock. Perhaps, however, the court's statements with respect to the limits on blank stock powers should be read as reflecting a concern that the stockholders, when they passed the blank stock authorization (whether that was in the original charter or by amendment), were not thinking about the use of that blank stock power other than in a regular investment sense. I think you can read between the lines that what the court is saying is that if stockholders are going to approve these anti-takeover provisions and we are to give effect to that approval, at least the stockholders ought to know exactly what it is that the blank stock power is going to be used for. I think there is a little mischief in the *Telvest* case, but I think the principles in this area are shaking out pretty well.

I am going to turn the program over now to Don Scott for a final comment.