

Client Alert

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Nonvoting Common Stock: A Legal Overview

Dual-class stock structures have recently been the subject of significant commentary.¹ Much criticism has been levied at companies with high-vote/low-vote stock structures, but the conversation seemingly reached a boiling point after Snap Inc.'s recent initial public offering of nonvoting common shares. Without taking a position on the merits of dual-class stock structures, this article provides an overview of the legal issues associated with nonvoting common stock of Delaware corporations.²

Limited Right to Vote

The general rule in Delaware is that each share of capital stock is entitled to one vote,³ but the certificate of incorporation can provide that one or more classes or series of stock shall have limited or no voting rights.⁴ It is not uncommon for companies to issue preferred stock with limited or no voting rights, but nonvoting common stock is rare.

Unlike holders of voting shares, holders of nonvoting shares cannot vote on:

- the election or removal of directors;⁵
- the approval of extraordinary transactions, such as mergers,⁶ significant asset sales,⁷ or dissolution,⁸ but holders of nonvoting shares are entitled to vote on conversions⁹ and transfers, domestications, or continuances;¹⁰
- amendments to the certificate of incorporation, which is the legal document setting forth the terms of each class of stock, except that holders of nonvoting shares are entitled to vote on amendments that would (i) unless otherwise provided in the certificate of incorporation, "increase or decrease the aggregate number of authorized shares," (ii) "increase or decrease the par value

¹ A similar version of this client alert was published as *What's the Deal with Nonvoting Shares? An Overview of the Legal Differences Between Voting and Nonvoting Stock* in the October 2017 issue of *Insights*.

² This article addresses the general rules for nonvoting common stock. In some cases, corporations can modify these general rules by including specific provisions in their certificate of incorporation.

³ 8 Del. C. § 212(a).

⁴ 8 Del. C. § 151(a) ("Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, ... which classes or series may have such voting powers, full or limited, *or no voting powers*, ... as shall be stated and expressed in the certificate of incorporation...." (emphasis added)).

⁵ 8 Del. C. §§ 216(3), 141(k). Although holders of nonvoting shares cannot vote to elect or remove directors, Delaware law does allow "any stockholder" to petition the Court of Chancery to resolve the validity of any election, appointment, removal or resignation of a director or officer or the result of any stockholder vote. 8 Del. C. § 225(a).

⁶ 8 Del. C. § 251(c).

⁷ 8 Del. C. § 271(a).

⁸ 8 Del. C. § 275(b).

⁹ 8 Del. C. § 266(b) ("If all outstanding shares of stock of the corporation, *whether voting or nonvoting*, shall be voted for the adoption of the resolution, the conversion shall be authorized." (emphasis added)).

¹⁰ 8 Del. C. § 390(b) ("If all outstanding shares of stock of the corporation, *whether voting or nonvoting*, shall be voted for the adoption of the resolution, the corporation shall file with the Secretary of State a certificate of transfer if its existence as a corporation of this State is to cease or a certificate of transfer and domestic continuance if its existence as a corporation of this State is to continue...." (emphasis added)).

of the shares,” or (iii) adversely “alter or change the powers, preferences, or special rights of the shares;”¹¹

- converting the corporation into a public benefit corporation, whether through an amendment of its certificate of incorporation, merger, or consolidation;¹² and
- other corporate governance matters,¹³ including say-on-pay votes and bylaw amendments put to a stockholder vote.¹⁴

No Notice of Stockholders Meetings

Nonvoting stockholders are not entitled to notice of stockholders meetings, including annual meetings to elect directors, unless they are entitled to vote on at least one matter brought before the meeting (e.g., a conversion).¹⁵ The limited exceptions to this rule are that notice is required if the meeting is being held to vote on a merger¹⁶ or to obtain stockholder ratification of a defective corporate act.¹⁷

Other Annual Meeting Issues

The Corporation May Refuse to Permit Nonvoting Stockholders to Attend Annual Meetings

If nonvoting shares are not entitled to notice of or to vote at a stockholders meeting, then their presence is not counted in determining whether a quorum is present.¹⁸ Moreover, it would seem that those nonvoting stockholders also are not legally entitled to attend the meeting,¹⁹ although the Delaware Code does not address this issue specifically.

The Corporation May Choose Not to Hold Annual Meetings

Some corporations with nonvoting shares may be able to avoid holding annual meetings altogether. While Delaware law gives stockholders and directors the right to petition the Court of Chancery to order an annual meeting if one has not been held within the last 13 months,²⁰ no annual meeting is required if the directors are elected by unanimous written consent.²¹ Thus, a dual-class corporation with concentrated voting power whose voting stockholders elect directors by unanimous written consent is not

¹¹ 8 Del. C. § 242(b)(2). Note that the certificate of incorporation can override the first exception by expressly providing that the holders of voting stock are the only stockholders who will vote on an increase or decrease in the number of authorized shares of a class of stock. *Id.* Furthermore, if multiple series of the same class of stock are affected in the same manner, those series will vote together on the proposed amendment. *See id.* Thus, a particular series of nonvoting stock may not be entitled to a separate series-only vote to veto the amendment. Note, however, that many companies’ certificates of incorporation contain provisions that limit voting rights to holders of a certain class of stock (typically preferred stock) with respect to any amendment that would alter the rights and preferences of the outstanding shares of such class.

¹² 8 Del. C. § 363(a), (c). A nonvoting stockholder would be entitled to seek appraisal if the corporation became a public benefit corporation. *See* 8 Del. C. § 363(b).

¹³ *See* 8 Del. C. § 216(2).

¹⁴ 8 Del. C. § 109(a).

¹⁵ 8 Del. C. § 222(b)(4).

¹⁶ 8 Del. C. § 251(c) (“Due notice of the time, place and purpose of the meeting shall be mailed to each holder of stock, *whether voting or nonvoting...*” (emphasis added)).

¹⁷ 8 Del. C. § 204(d) (“If the ratification of a defective corporate act is required to be submitted to stockholders for approval ..., due notice of the time, place, if any, and purpose of the meeting shall be given ... to each holder of valid stock and putative stock, *whether voting or nonvoting...*” (emphasis added)).

¹⁸ 8 Del. C. § 216.

¹⁹ *See* R. FRANKLIN BALOTTI ET AL., MEETINGS OF STOCKHOLDERS § 8.3 at 8-6 (3d ed. Supp. 2016) (“[O]nly those who have the right to vote at the meeting have an enforceable right to attend the meeting.”).

²⁰ 8 Del. C. § 211(c).

²¹ 8 Del. C. § 211(b).

required to hold annual meetings under Delaware law.²² Stock exchange rules, however, may require the corporation to hold an annual meeting.²³

The Corporation May Choose Not to Distribute Proxy or Information Statements

Federal securities laws require corporations to distribute proxy or information statements prior to soliciting votes from their stockholders.²⁴ If a corporation has registered only nonvoting shares, however, federal law would not require that corporation to distribute a proxy or information statement.²⁵ As a result, the corporation could avoid making various disclosures typically required of public companies. The corporation, however, would have to include certain information in its Form 10-K that most public companies report in their proxy statement under Schedule 14A. In addition, stock exchange rules may require that any proxy statements or other communications sent to voting stockholders also be sent to nonvoting stockholders.²⁶

No Notice of Action Taken by Written Consent

Nonvoting stockholders are not entitled to notice that stockholder action has been taken by written consent in lieu of a stockholders meeting. Instead, Delaware law only requires that the notice be sent to non-consenting stockholders who would have been entitled to vote if the action had been taken at a meeting.²⁷

Notice of Ratification of Defective Acts

As noted above, nonvoting stockholders are entitled to notice of a stockholders meeting at which stockholders are requested to ratify a defective act, even if they are not entitled to vote on the ratification.²⁸ Notice also is required to be given to nonvoting stockholders if the board of directors ratifies an act that does not require stockholder approval or if stockholders ratify a defective act by written consent.²⁹

²² The statute does not specify that the “unanimous” written consent only pertains to the voting stockholders, but that is the natural conclusion because nonvoting stockholders would not be entitled to vote to elect directors if the corporation were to hold an annual meeting.

²³ See New York Stock Exchange Listed Company Manual, Rule 302.00 (“Listed companies are required to hold an annual shareholders’ meeting during each fiscal year.”); Nasdaq Listing Rule 5620(a) (“Each Company listing common stock or voting preferred stock, and their equivalents, shall hold an annual meeting of Shareholders no later than one year after the end of the Company’s fiscal year-end....”); see also Nasdaq Listing Rules FAQ No. 82 (“A company that lists only non-voting common stock on Nasdaq is required to hold an annual meeting.”).

²⁴ See generally 15 U.S.C. § 78n (governing the solicitation of proxies with respect to registered securities).

²⁵ See Rule 14c-2 of the Securities Exchange Act of 1934 (requiring the distribution of an information statement to all stockholders “of the class that is entitled to vote” on any matter to be acted upon at a stockholders meeting).

²⁶ Specifically, the New York Stock Exchange requires that “holders of shares of listed non-voting common stock,” although “not entitled to vote generally on matters submitted for shareholder action, ... must receive all communications, including proxy material, sent generally to the holders of the voting securities of the listed company.” New York Stock Exchange Listed Company Manual, Rule 313.00(B). Nasdaq does not appear to have a comparable rule.

²⁷ 8 Del. C. § 228(e).

²⁸ 8 Del. C. § 204(d).

²⁹ 8 Del. C. § 204(g) (“In respect of each defective corporate act ratified by the board of directors ..., prompt notice of the ratification shall be given to all holders of valid stock and putative stock, *whether voting or nonvoting...*” (emphasis added)). Notice is deemed given if a ratification is disclosed in a document filed publicly with the Securities and Exchange Commission. *Id.*

Inspection Rights

Voting and nonvoting stockholders have the same statutory right to inspect a corporation's books and records "for any proper purpose."³⁰ In addition, all stockholders have a statutory right to inspect the list of stockholders entitled to vote at a stockholders meeting "for any purpose germane to the meeting."³¹ The statutes do not limit the inspection rights to voting stockholders. Depending on the circumstances, however, a corporation might argue that a nonvoting stockholder does not have an inspection purpose that is "germane to the meeting."³²

Fiduciary Duties; Approval of Interested Transactions

Directors owe fiduciary duties to the corporation and its stockholders as a whole. Thus, directors owe the same fiduciary duties to voting and nonvoting stockholders, and nonvoting stockholders have standing to bring direct and derivative actions against directors and officers to the same extent as voting stockholders.³³

Under Delaware's interested directors statute, a contract or transaction with a director is not voidable solely due to the director's conflict of interest if there is proper disclosure "to the stockholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholders."³⁴ Although it could be drafted with greater clarity, the statute appears to provide that the only stockholders who can cleanse an interested transaction under the safe harbor are the voting stockholders.

Another interesting question is whether conditioning an interested transaction on, among other things, the approval of a majority of the outstanding nonvoting shares would cause a court to invoke the business judgment rule.³⁵ Although the holders of nonvoting shares would not be entitled to vote under state law, conditioning the transaction on their approval at the outset would help facilitate arms-length bargaining and provide for disinterested approval of the transaction.

³⁰ 8 Del. C. § 220(b) ("Any stockholder ... shall ... have the right during the usual hours for business to inspect for any proper purpose ... [t]he corporation's stock ledger, a list of its stockholders, and its other books and records...." (emphasis added)).

³¹ 8 Del. C. § 219(a) ("[A] complete list of the stockholders entitled to vote at the meeting ... shall be open to the examination of any stockholder for any purpose germane to the meeting for a period of at least 10 days prior to the meeting...." (emphasis added)).

³² A corporation could take the position that the only purpose "germane to the meeting" is voting, and that only a holder of voting stock can have that purpose. See generally *Magill v. N. Am. Refractories Co.*, 128 A.2d 233, 237 (Del. 1956) (explaining that the stockholder list is "designed to give [a stockholder] information, and this must mean information that he may intelligently make use of at the election," including for "communicating with his fellow stockholders to solicit their support in the voting" (emphasis added)).

³³ See 8 Del. C. § 327 ("In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains...." (emphasis added)).

³⁴ 8 Del. C. § 144(a)(2) (emphasis added).

³⁵ See, e.g., *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014) ("[B]usiness judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders."); *In re John Q. Hammons Hotels Inc. S'holder Litig.*, 2009 Del. Ch. LEXIS 174, at *41 (Oct. 2, 2009) ("[B]usiness judgment would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent special committee, and (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders."). See also James Moloney et al., *Non-Voting Shares and Judicial Scrutiny*, Insights, May 2017, at 10 (discussing the effect of nonvoting shares on the judicial standard of review).

No Right to Submit Stockholder Proposals

Under Rule 14a-8 of the Securities Exchange Act of 1934, stockholders may submit proposals for inclusion in a corporation's proxy statement. But Rule 14a-8 requires a stockholder to have owned at least \$2,000 in market value, or 1 percent, of a corporation's securities "entitled to be voted on the proposal at the meeting" for at least one year prior to submitting the proposal.³⁶ Thus, nonvoting stockholders cannot submit proposals under Rule 14a-8.

We are not aware of Delaware case law addressing whether a nonvoting stockholder can submit a proposal or nomination under state law if the stockholder is ineligible to vote on the matter. But given that nonvoting stockholders are not entitled to notice of or to vote at, and likely do not have an enforceable right to attend, a stockholders meeting, it seems unlikely that a court would find that nonvoting stockholders have an inherent right to present proposals at meetings. Of note, most public company bylaws specifically require that a stockholder must be eligible to vote at the meeting in order to submit a proposal or director nomination.

Excluded in Determining Whether Short-Form Mergers are Permitted

Under Delaware law, a stockholder who owns at least 90 percent of a corporation's voting shares can effect a "short-form" merger without prior action by the board of directors.³⁷ Because the short-form merger statutes are based on the percentage ownership of voting shares, nonvoting shares are irrelevant in determining whether a holder of voting shares can satisfy the 90 percent threshold even if nonvoting shares constitute a majority of a corporation's outstanding equity interests. At first glance, this may seem unremarkable because stockholders holding sufficient voting shares will always have the power to approve a merger. There are potentially significant implications, however, because Delaware courts have held that there is no duty to pay a "fair price" in a short-form merger, and, absent a disclosure violation, a minority stockholder's sole remedy is to seek appraisal of its shares.³⁸

Appraisal Rights

Nonvoting stockholders are entitled to appraisal rights in a merger to the same extent as voting stockholders.³⁹

Conclusion

As described above, there are significant differences between the rights of voting and nonvoting stockholders. As their name implies, nonvoting shares do not play a role in the voting process, except for a limited number of corporate actions that can fundamentally affect the shares. Nonvoting stockholders, however, are not entirely without governance rights. Outside of the voting process, they share several rights with voting stockholders, including certain notice rights and appraisal rights. There are also several areas of legal uncertainty as to nonvoting stockholders' ability to participate in corporate governance. In addition, stock exchange regulations may grant nonvoting stockholders of listed companies certain rights they would not otherwise have under state or federal law, such as requiring the corporation to hold annual meetings and distribute its proxy or information statement to all stockholders and not just voting stockholders. If more companies begin issuing nonvoting shares, we may see the Delaware corporation

³⁶ 17 C.F.R. 240.14a-8.

³⁷ See 8 Del. C. §§ 253(a), 267(a) (setting forth the requirements to complete a "short-form" merger).

³⁸ 8 Del. C. § 253(d); see also *Glassman v. Unocal Expl. Corp.*, 777 A.2d 242, 248 (Del. 2001) ("[A]bsent fraud or illegality, appraisal is the exclusive remedy available to a minority stockholder who objects to a short-form merger.")

³⁹ 8 Del. C. § 262(a) ("Any stockholder of a corporation of this State who [complies with the requirements of Section 262] shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock..."(emphasis added)); see also 8 Del. C. § 363(b) (granting appraisal rights to stockholders who have not "voted in favor of" an amendment of its certificate of incorporation or merger to become a public benefit corporation).

law, federal securities laws, and stock exchange rules and regulations adapt to provide greater clarity or perhaps expand the rights of nonvoting stockholders.

Summary of General Rights under Delaware Law for Voting and Nonvoting Stock

<u>Rights of Stockholders</u>	<u>Voting Stock</u>	<u>Nonvoting Stock</u>
Entitlement to vote on:		
• Election or removal of directors	Yes	No
• Mergers, consolidations, or sales of substantially all assets	Yes	No
• Conversion	Yes	Yes
• Transfer, domestication and continuance	Yes	Yes
• Dissolution	Yes	No
• Transition to/from a public benefit corporation	Yes	No
• Amendments to the certificate of incorporation	Yes	No, unless the amendment would: <ul style="list-style-type: none"> • change the par value of the stock; • alter the powers, preferences, or special rights of the stock in a way that would affect them adversely; or • unless the certificate of incorporation reserves this right to the voting shares, increase or decrease the aggregate number of authorized shares of the class
• Amendments to the bylaws	Yes	No
Notice of:		
• Action taken by written consent	Yes	No
• Annual meetings generally	Yes	No
• Special meetings generally	Yes	No
• Meetings (annual or special) to approve mergers, consolidations or conversions	Yes	Yes
• Meetings (annual or special) to approve dissolution or a sale of substantially all assets	Yes	No
• Ratification of defective acts	Yes	Yes
Inspection of books and records	Yes	Yes
Inspection of stockholder list	Yes	Yes
Owed fiduciary duties by directors	Yes	Yes
Appraisal rights	Yes	Yes

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