Stormy weather — Time to prepare for a potential proxy contest

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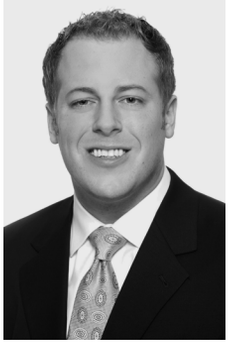
ABSTRACT

As a results of economic factors, as well as specific developments in Delaware law, the authors predict an increase in proxy contests and suggest a number of steps that issuers may consider taking to augment their preparedness for such a contest. Specifically, the authors suggest reviewing bylaws in light of the JANA Master Fund, Ltd v. CNET Networks, Inc and Levitt Corporation v. Office Depot, Inc decisions, and preemptively hiring a proxy solicitor.

Keywords: proxy contests, advance-notice by-laws



INTRODUCTION

The use of proxy contests to influence or change corporate control appears to be influenced by many factors, including macroeconomic conditions such as the availability of capital (in turn influenced by available liquidity).[1] Empirically, it has been reported that the number of proxy contests increased from 56 in 2005 to 108 in 2007, to 123 in 2008,[2] and the trend does not appear to be slowing.[3] Recent examples include the following.

- In December 2007, the Children's Investment Fund Management (UK) LLP and 3G Capital Partners LP nominated five persons for election to CSX Corporation's twelve-person board at the 2008 annual meeting.[4] After a hotly

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contested election and long court fight, four nominees were elected and eventually seated on the board.[5]
- In September 2008, Vishay Intertechnology Inc nominated three persons for election to International Rectifier Corporation's board of directors.[6]
- In January 2009, activist investor Carl Icahn announced his plan to nominate five directors to the board of Amylin Pharmaceuticals Inc.[7]

And some companies, such as National Fuel Gas Co. and Yahoo! Inc., have reached agreements to seat insurgents in response to the threat of a proxy contest:

- in January 2008, National Fuel Gas Co. nominated a candidate of New Mountain Vantage LP to its board in order to avoid New Mountain's threatened proxy fight;[8]
- similarly, in July 2008, Yahoo! Inc. agreed to appoint Carl Icahn and two additional nominees from his slate to its board in order to avoid Icahn's threatened proxy fight.[9]

Proxy contest activity has also led to several decisions by courts in Delaware that are likely to both encourage more contests and lead to the need for issuers to re-examine corporate by-laws. Those decisions — namely, *JANA Master Fund Ltd v CNET Networks Inc*,[10] *Levitt Corp v Office Depot Inc*[11] and *CA Inc v AFSCME Employees Pension Plan*[12] — have generally been perceived as favourable to the activist investor agenda. Outside of Delaware, the US Southern District of New York's decision in *CSX Corp v Children's Investment Fund Management (UK) LLP*[13] has led to a new focus on non-traditional ownership structures by activist investors, including the use of swaps as a way in which to accumulate significant voting positions in a company without actually purchasing the issuer's securities. This recent series of decisions, together with a widely noted lack of liquidity in the market to finance hostile tender offers, is likely to cause the number of activist stockholder proxy fights to increase rapidly. Likewise, new statutory law in Delaware is currently pending approval by the Legislature and, if adopted, will also likely to impact on the occurrence of proxy fights. As a result, now is the time for companies and their boards to take steps to ensure that they are best prepared to meet a proxy fight waged by activist investors. This paper summarises the recent case law, explains how the case law is brewing a 'perfect storm' for a significant rise in proxy fights and gives practical suggestions for how companies can prepare in advance for a proxy fight.

RECENT VICTORIES FOR ACTIVIST INVESTORS IN DELAWARE

Recently, both the Delaware Court of Chancery and the Delaware Supreme Court have decided cases that could be characterised as 'activist-friendly'. In two cases — *JANA* and *Levitt* — the Court of Chancery narrowly interpreted advance notice by-laws in favour of activist investors. In *CA*, the Delaware Supreme Court held, in part, that the by-law at issue, which required a corporation to reimburse an insurgent for the expenses of a successful proxy fight even where the contest is only to elect a 'short slate' — that is, where an activist seeks to elect less than a majority of the board — was a proper proposal for stockholder action. These three decisions, against the backdrop of a global liquidity crisis across all markets, but particularly those used to finance takeover activity, are a recipe for increased proxy contests.

A *JANA Master Fund Ltd v CNET Networks Inc*

In *JANA*, the plaintiff, an investment fund, owned with its affiliates approximately 11 per cent of the outstanding common stock of CNET.[14] JANA purchased its CNET stock in October 2007.[15] On 26th December, 2007, JANA notified the CNET board of its intention to seek to replace two CNET directors up for re-election, expand the size of the board from eight members to thirteen and nominate five individuals to fill the newly created positions.[16] Notably, JANA planned to finance its own proxy solicitation of other CNET stockholders, and sought access to CNET's stocklist materials under 8 Del C § 220.[17]

CNET refused JANA's § 220 demand on the ground that JANA's demand violated CNET's 'Notice Bylaw'.[18] The Notice Bylaw provided that any CNET stockholder, which had been the beneficial owner of at least US$1,000 of securities entitled to vote at an annual meeting for at least one year, '*may seek to transact other corporate business*' at the annual meeting.[19] It required, however, that such business be set forth in a written notice, mailed to CNET's secretary, and received no later than 120 calendar days in advance of the date on which the CNET proxy statement is released to stockholders.[20] The Notice Bylaw further stated that:

> such notice must also comply with any applicable federal securities laws establishing the circumstances under which the Corporation is required to include the proposal in its proxy statement or form of proxy.[21]

The Court of Chancery held that the Notice Bylaw led to:

> only one reasonable conclusion: the bylaw applies solely to proposals and nominations that are intended to be included in the *company's* proxy materials pursuant to Rule 14a-8 [of the federal securities laws].[22]

The Court based its holding on three related grounds. First, it stated that the notion that a stockholder '*may seek to transact other corporate business*' did not make sense outside of the context of Rule 14a-8.[23] The Court explained that what a stockholder may do under Rule 14a-8 is 'far different' from that which a stockholder may do on his own[24] — that is, while Rule 14a-8 places restrictions on a stockholder's ability to include a proposal on management's proxy, the securities laws do not allow management to prevent stockholders from presenting their own proposals and nominations.[25] Therefore, the Court found the term 'may seek' to envision situations in which a stockholder must obtain management's approval under Rule 14a-8.[26] Because JANA intended to finance its own proxy solicitation and consequently did not require management's approval under Rule 14a-8, the Court found that the Notice Bylaw did not apply to JANA's proposals.[27]

Secondly, the Court noted that the Notice Bylaw established its deadline for notice by reference to the date on which CNET would mail its own proxy materials.[28] The Court believed that the most reasonable explanation for such a deadline was that the by-law was designed to allow management time to include the stockholder proposal in the company's proxy materials.[29] In the Court's opinion, the deadline served as further evidence that the Notice Bylaw was designed to govern stockholder proposals under Rule 14a-8 rather than to operate as an advance notice by-law.[30]

Finally, the Court leaned heavily on the

final sentence of the Notice Bylaw, which provided that stockholder notice '*must also comply with any applicable federal securities laws establishing the circumstances under which the Corporation is required to include the proposal in its proxy statement or form of proxy*'.[31] The Court stated that '*applicable federal securities laws ... clearly refer to Rule 14a-8*',[32] concluding that: '*There is no reason for CNET to have grafted Rule 14a-8's burdensome requirements onto its Notice Bylaw if that bylaw applied outside the context of 14a-8 proposals*.'[33]

As a result, the Court found that JANA did not need to comply with the Notice Bylaw's advance-notice requirements.[34]

B *Levitt Corp v Office Depot Inc*

One month after *JANA* was decided, the Court of Chancery again interpreted a notice by-law narrowly, and in favour of an activist stockholder. In *Levitt Corp v Office Depot Inc*, a by-law of Office Depot Inc limited the business of an annual stockholders' meeting to:

(i) business proposed by the board; or
(ii) business proposed by a stockholder with advance notice.[35]

Levitt Corporation was engaged in a proxy contest seeking to place two nominees on the twelve-member Office Depot board of directors at Office Depot's annual meeting of stockholders, which was scheduled for 23rd April, 2008.[36] Levitt filed its proxy statement soliciting proxies in support of its two nominees with the US Securities and Exchange Commission (SEC) on 17th March, 2008, but did not, however, give advance notice to Office Depot of its intention to propose its nominees.[37]

The issue before the Court was the meaning and application of art II, s. 14, of Office Depot's by-laws, which provided, in relevant part:

> At an annual meeting of stockholders, only such business shall be conducted as shall have been properly brought before the meeting. To be properly brought before an annual meeting, business must be (i) specified in the notice of the meeting (or any supplement thereto) given by or at the direction of the Board of Directors, (ii) otherwise properly brought before the meeting by or at the direction of the Board of Directors or (iii) otherwise properly brought before the meeting by a stockholder of the corporation who was a stockholder of record at the time of giving of notice provided for in this Section, who is entitled to vote at the meeting and who complied with the notice procedures set forth in this Section.[38]

A separate provision of the by-laws required the stockholder notice to be delivered at least 120 calendar days before the date of the proxy statement for the previous year's annual meeting — in this case, 120 calendar days prior to 7th April, 2008.[39]

Office Depot announced the agenda for its stockholder meeting in a *Notice of Annual Meeting of Shareholders*, dated 14th March, 2008.[40] The first entry under an 'items of business' heading of the Notice read: '1. *To elect twelve (12) members of the Board of Directors for the term described in this Proxy Statement*.'[41]

In interpreting art II, s. 14, of Office Depot's by-laws, the Court held that the term 'business' included the nomination of directors.[42] This meant that Levitt had not complied with the notice requirement of the section.[43] The Court found, however, that Office Depot's notice of meeting, by listing the election of directors as an item of 'business' for the annual meeting, had satisfied the notice requirement of the section both as to the election of

directors and as to '*the subsidiary business of nominating directors for election*'.[44] Therefore, Office Depot could not prevent Levitt from nominating candidates for election to the Office Depot board.[45]

C *CA Inc v AFSCME Employees Pension Plan*

While *JANA* and *Levitt* reflect a willingness on the part of the Delaware courts to interpret narrowly by-laws designed to limit a stockholder's exercise of the corporate franchise, *CA Inc v AFSCME Employees Pension Plan* speaks to a different and far more practically important point — that is, who pays for a successful contest. CA suggests that certain stockholder-adopted by-laws may require a corporation to pay a dissident's proxy expenses for running a successful 'short slate'.

In *CA*, the Delaware Supreme Court answered questions of Delaware law that had been certified to it by the SEC.[46] The questions arose from a proposal that AFSCME Employees Pension Plan submitted on 13th March, 2008, for inclusion in CA Inc's proxy materials for its 2008 annual meeting.[47] The proposal sought stockholder approval of an amendment to CA's by-laws.[48] Specifically, the proposed by-law would require the CA board of directors to reimburse the 'reasonable' expenses — that is, not to exceed the amount expended by CA in connection with such election — incurred by a stockholder or group of stockholders running a short slate of director nominees for election if at least one nominee on the short slate is elected to the board of directors.[49]

On 18th April, 2008, CA requested a no-action letter from the Division of Corporation Finance of the SEC confirming that the Division would not recommend enforcement action if CA were to omit the proposal from the proxy.[50] In response, the SEC certified two questions of law to the Delaware Supreme Court:

(i) whether the proposal is a proper subject for action by stockholders as a matter of Delaware law; and
(ii) whether the proposal, if adopted, would cause CA to violate any Delaware law to which it is subject.[51]

The Supreme Court answered the first question in the affirmative,[52] noting that the General Corporation Law of the State of Delaware (DGCL) empowers both directors (as long as the certificate of incorporation so provides) and stockholders of a Delaware corporation to adopt, amend, or repeal the corporation's by-laws.[53] Because the DGCL also vests the board of directors with the authority to manage the business and affairs of the corporation, however, a conflict can arise.[54] While the Court refused to 'articulate with doctrinal exactitude a bright line' that would divide those by-laws that stockholders may permissibly adopt from those that would go too far in infringing upon the directors' right to manage the corporation,[55] it held that the proposal concerned the process for electing directors — '*a subject in which shareholders of Delaware corporations have a legitimate and protected interest*'.[56] Accordingly, the Court held that the proposal was a proper subject for stockholder action.[57]

The Supreme Court went on, however, to answer the second question — whether the proposal, if adopted, would cause CA to violate any Delaware law — in the affirmative.[58] The Court found that the proposal could require the board to reimburse dissident stockholders in circumstances under which a proper application of fiduciary principles would preclude them from doing so (such as when a proxy contest was undertaken for

'*personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation*').[59] Accordingly, the Supreme Court held that the proposed by-law, as written, would violate Delaware law if enacted by stockholders.[60] In doing so, however, the Court suggested, in a footnote, that, if drafted differently, the proposed CA by-law might not suffer from the same infirmity. Specifically, the Court stated: '[I]*n order for the Bylaw not to be "not inconsistent with law" . . . it would also need to contain a provision that reserves the directors' full power to discharge their fiduciary duties*.'[61] However, such a differently framed by-law was not, in fact, before the court.

D Pending legislative changes

In addition to case law developments, Legislation has been introduced in Delaware to add several important provisions to that state's General Corporation Law. The first, proposed new Section 112, would allow a corporation to provide in its by-laws that if the corporation solicits proxies with respect to an election of directors, the corporation may be required to include in its solicitation materials one or more individuals nominated by a stockholder in addition to the individuals nominated by the corporation. The new statute includes a series of permissible limitations on the right of access, but it is likely that, if passed, there will be attempts made by insurgents to require that the right of access be included in listed company by-laws.

The proposed Legislation also includes a new Section 113 to the Code, which, if adopted, would allow a corporation to include a provision in its by-laws requiring reimbursement of insurgent proxy contest expenses incurred in connection with the solicitation of an insurgent slate of directors, subject to certain limitations. As with proposed Section 112, if adopted, Section 113 by-laws are likely quickly to become 'hot button' issues with insurgents of all kinds.

It is worth noting for the benefit of the reader who is unfamiliar with the Delaware legislative process that the new Legislation has been drafted and approved by the Delaware Bar Association. Typically, corporate legislation which has survived this approval process is routinely approved by the Legislature.

E A recipe for more proxy fights

Despite its ultimate holding that the proposed by-law would violate Delaware law, *CA* could be viewed as a victory for insurgents. AFSCME had stated that the unavailability of reimbursement of expenses for a stockholder's election of a short slate leads to the scarcity of such proxy contests.[62] AFSCME noted that, practically, a dissident can only expect to be reimbursed upon electing a majority of directors.[63] The Supreme Court's conclusion — that the fact that the proposed by-law would require the expenditure of corporate funds did not, in and of itself, make the by-law an improper subject matter for stockholder action — leaves open the possibility for stockholder-adopted by-laws mandating that a corporation pay a dissident's successful proxy expenses. Combined with a lack of liquidity to finance hostile offers and the courts' continued chariness at anything that infringes on the stockholder franchise, which the *CA* Court noted was a 'protected' area,[64] as well as the pending legislation, the stage is now set for a potentially dramatic increase in proxy fights.

PREPARING NOW

While there is little that can be done to insulate a company from proxy fights

(except ensuring the consistent delivery of excellent stockholder returns), advance preparation is likely to help even the playing field when an insurgent attempts to seize the timing advantage by commencing an unexpected proxy fight. Two preparatory steps should include a thorough review of the company's by-laws to address recent advance-notice cases, and investment in developing more detailed stockholder profile information through the advance use of a proxy solicitation firm.

A Review by-laws

Firstly, and most importantly, a company should review its by-laws. Specifically, if an 'advance notice' by-law has been adopted, the company should determine whether that by-law contains provisions similar to those discussed in *JANA* and *Levitt*, and, if so, address the problems identified in each case by amending the by-law. Alternatively, in the absence of appropriate advance-notice by-laws, the company should consider adopting such a by-law. Absent a properly designed advance-notice by-law, issuers could see an insurgent attempt to seize an advantage by timing solicitations and nominations to the detriment of a fair opportunity for all stockholders to hear both sides' positions and become fully informed. Advance-notice by-laws, when properly constructed, eliminate this possibility and tend to promote a more robust flow of information from both sides of the contest.

But, as was made clear in *JANA* and *Levitt*, existing advance-notice by-laws might not be effective and are most definitely in need of review. For example, advance-notice by-laws should now make clear that they apply not only to situations permitted by Rule 14a-8 (in which a stockholder seeks to include a proposal in the company's proxy), but also to cases in which the stockholder is soliciting via its own proxy.[65] Moreover, as the *JANA* Court's decision was partly based on the fact that the by-law established its deadline for notice by reference to the date on which the issuer would mail its own proxy materials, an advance-notice deadline provision is best framed making no mention of a company's own proxy materials. Instead, a company can set the deadline for advance notice at a specific number of days before the annual meeting.

Likewise, to account for the ruling in *Levitt*, unless the company's advance-notice by-law expressly addresses the issue, the company's form of notice of a stockholder meeting should now contain an important 'limiting qualification' to give notice that the meeting is being held to consider and vote on *only* those nominees put forward by the *company*. The *Levitt* Court also raised questions concerning whether the use of the term 'election' was clear in the context.[66] Where a by-law uses the specific term 'election' or a more generic term, such as 'business', the by-law should explicitly explain that the 'election' of directors is not intended to include the 'nomination' of directors.

To the extent that the new legislation is passed, companies will want to carefully consider whether to avail themselves of new by-laws relating to the new statutes and, if so, how they will want to limit shareholder rights in those by-laws.

B The pre-emptive use of a proxy solicitor

Another way in which an issuer can prepare for a potential proxy contest is by hiring a competent proxy solicitor in advance of any insurgency. Although the proxy solicitor is a necessary party to any proxy contest, by hiring a proxy solicitor before word of a potential proxy challenge surfaces, the issuer can attempt to

enhance its information on its stockholder profile. If a proxy contest arises, the company will already have a record containing the names and contact information of many of its significant stockholders.

There are several advantages conferred by compiling a stockholder profile in advance. Firstly, the company will have a head start in soliciting votes should a proxy contest arise. More importantly, in the event that the company suspects an upcoming proxy challenge, the company can, subject to the requirements of the applicable federal securities laws, choose to reach out to large stockholders to gauge their concerns before a proxy fight ensues. Proxy solicitors are also abreast on trends in voting recommendations by proxy advisory firms such as RiskMetrics Group (formerly ISS (Institutional Shareholder Services))[67] and how best to position the issuer — in advance — to have the best chance to convince these proxy advisory firms to recommend a vote for management to its institutional clients.

C *CSX* By-Laws

Finally, at least one major New York firm has suggested that its clients consider adopting by-laws requiring any stockholder wishing to submit director nominations or put forward other proposals at an annual meeting to disclose, in advance of such meeting, derivative or swap contracts that may give the holder voting power or influence over significant blocks of stock without actual ownership.[68] This form of by-law arises as a result of the situation detailed at some length in the trial court's decision in *CSX Corp v Children's Investment Fund Management (UK) LLP*.[69] Whether or not the federal securities laws in fact cover disclosure of these types of arrangements — there is at least a *bona fide* question as to whether a state law created by-law may establish a new disclosure regime on non-controlling stockholders, who may or may not be fiduciaries under state law.[70] No Delaware case has directly addressed the enforceability of such by-laws. On the other hand, there are arguments in support thereof. Indeed, the Delaware corporate governance system is, at its core, a system of 'private ordering' and it is entirely possible that such by-laws will be upheld, if challenged. In any event, it may be preferable to avoid a rush to adopt them until the SEC or Congress has had an opportunity to address the subject.

CONCLUSION

Serious liquidity dislocations, coupled with several recent court decisions changing the landscape in proxy fights, make it highly likely that insurgencies waged by activist stockholders will increase — perhaps dramatically. Through reviewing existing by-laws, pre-emptively utilising proxy solicitors and opening dialogue with key stockholders, issuers can take solid steps toward preparing their companies to best confront potential insurgencies.

NOTE

While Richards, Layton & Finger was involved in some of the cases discussed herein, the opinions expressed in this paper are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.

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(2) SharkRepellent.net, 'Proxy fights, 2001-present', available online at https://www.sharkrepellent.net (accessed 30th January, 2009); see also Whitehouse, K. (2008) 'Hedge funds on track to set new record for activist campaigns', 14th February, available at: http://www.riskmetrics.com/press/articles/20080214-dj (noting the 'record levels' of proxy' contests in 2007, and predicting that the number of proxy contests waged by activist investors in 2008 would beat those record levels, notwithstanding unstable market conditions).
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(11) 2008 WL 1724244 (Del Ch, 14th April, 2008).
(12) 953 A.2d 227 (Del 2008).
(13) 562 F Supp 2d 511 (SDNY 2008), aff'd in part, No. 08-2899-cv (2d Cir, 15th September, 2008) (ORDER).
(14) JANA, 954 A.2d at 336.
(15) *Ibid* at 337.
(16) *Ibid*.
(17) *Ibid* at 337–338.
(18) *Ibid* at 337.
(19) *Ibid*. Interestingly, the Court's decision failed to comment upon the one-year ownership requirement, which the plaintiff in the case challenged as unreasonable.
(20) *Ibid* at 337–338 (emphasis added).
(21) *Ibid* at 338.
(22) *Ibid* at 339.
(23) *Ibid* at 340.
(24) *Ibid* at 342.
(25) *Ibid*.
(26) *Ibid* at 343.
(27) *Ibid*.
(28) *Ibid*.
(29) *Ibid*.
(30) *Ibid* at 344.
(31) *Ibid*.
(32) *Ibid* at 344–345.
(33) *Ibid* at 345.
(34) *Ibid* at 346.
(35) 2008 WL 1724244, at 2 (Del Ch, 14th April, 2008).
(36) *Ibid* at 1.
(37) *Ibid*.
(38) *Ibid*.
(39) See *ibid*.
(40) *Ibid* at 1.
(41) *Ibid*.
(42) *Ibid* at 6.
(43) See *ibid*.
(44) *Ibid* at 6.
(45) *Ibid* at 7.
(46) 953 A.2d 227, 229 (Del 2008). This was the first time that the SEC certified a question of law to the Delaware Supreme Court since Delaware's constitution was amended to allow for this procedure in 2007. *Ibid* at 229, n.1.
(47) *Ibid* at 229.

(48) *Ibid*.
(49) *Ibid*.
(50) *Ibid* at 230.
(51) *Ibid* at 231.
(52) *Ibid* at 237.
(53) *Ibid* at 231.
(54) See *ibid* at 231–2.
(55) *Ibid* at 234.
(56) *Ibid* at 237.
(57) *Ibid*.
(58) *Ibid* at 238.
(59) *Ibid* at 240.
(60) *Ibid*.
(61) *Ibid* at 237, n. 20.
(62) 'Bylaw is proper subject for action, but violates Delaware law, court rules' (2008) 23 Corp Couns Wkly 225.
(63) *Ibid*.
(64) CA, 953 A.2d, at 237.
(65) For example, a by-law provision may read as follows: '*Notwithstanding the foregoing provisions of this Section, a stockholder shall also comply with all applicable requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the rules and regulations thereunder with respect to the matters set forth in this Section; provided however, that any references in these By-Laws to the Exchange Act or the rules promulgated thereunder are not intended to and shall not limit any requirements applicable to nominations or proposals as to any other business to be considered pursuant to this Section, and compliance with [the advance notice provisions] of this Section shall be the exclusive means for a stockholder to make nominations or submit other business*.'
(66) *Levitt Corp v Office Depot Inc*, 2008 WL 1724244, at 7, n. 44. (Del Ch, 14th April, 2008).
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(70) See Jacobs, J. B., 'Paradigm shifts in American corporate governance law: A quarter century of experience', *Corporate Governance Advisor,* September–October 2007, at 1, 5: '*In that regard, a related (and in my view, provocative) question is whether institutional shareholders having actual or effective voting control, will be held to have acquired fiduciary duties if they seek to direct the exercise of the directors' business judgment by threatening to remove directors who disagree with their agenda. As with everything else in the legal world, we will not know the answer to that question unless — and until — we have a real case*.'