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## THE DELAWARE AND SEC PROXY ACCESS REGIMES

*Stockholder activists have long pushed for access to the corporation's proxy materials to propose board nominees. After several false starts at the federal level, the issue has reemerged, with states like Delaware adopting optional proxy access regimes and the SEC considering a mandatory regime. This article reviews some of the many factors that a corporation may consider when adopting a proxy access bylaw under Delaware law and compares the flexible bylaw provisions to the fixed analogues of the proposed mandatory federal regime.*

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The issue of “proxy access” – the right of stockholders to use the corporation’s proxy statement to solicit votes for their own board nominees – has long been the “holy grail” for stockholder activists and institutional investors.<sup>1</sup> In 2003, the Securities and Exchange

Commission (“SEC”) proposed a rule that would have mandated proxy access under limited circumstances,<sup>2</sup> but the proposal was met with strong opposition and was never adopted.<sup>3</sup> Given its limitations, it is unlikely that

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<sup>1</sup> Press Release, American Federation of State, County and Municipal Employees, McEntee Calls 2<sup>nd</sup> Circuit Ruling “Holy Grail” of Corporate Governance Reform (Sept. 7, 2006), <http://www.afscme.org/11224.cfm>; Karey Wutkowski, *SEC to Look Outside Ballot on Proxy Access*, REUTERS, Jan. 4, 2008, <http://www.reuters.com/article/reutersEdge/idUSN1741224720080104> (“Investor advocates have long considered access to the company’s ballot the ‘holy grail’ of shareholder rights ... .”); J.W. Verret, *Pandora’s Ballot Box, Or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1007, 1039 (2007)

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*footnote continued from previous column...*

(“... [P]resuming that shareholders will manage to achieve the holy grail of corporate ballot access through one of these two SEC venues ...”).

<sup>2</sup> Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003).

<sup>3</sup> Stephen Labaton, *S.E.C. Rebuffs Investors on Board Votes*, N.Y. TIMES, Feb. 8, 2005, <http://www.nytimes.com/2005/02/08/business/08proxy.html>.

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stockholder activists were swooning over the proposed rule: it was limited to stockholders owning more than five percent of the corporation's voting securities for at least two years, and it was triggered only after one of the board's nominees was subject to a substantial "withhold vote" in an uncontested election or where a stockholder proposal providing for a nomination right received at least fifty percent of the votes cast.<sup>4</sup> In the ensuing years, the SEC flirted with proxy access again,<sup>5</sup> but the issue by that time was in the shadow of newer corporate governance trends, such as calls for majority voting in the election of directors, as well as the elimination of staggered boards and rights plans.<sup>6</sup>

When the recent economic downturn began to take hold – and part of the blame for the financial crisis was placed on failings in corporate governance<sup>7</sup> – the issue of proxy access reemerged,<sup>8</sup> this time with far more

political support.<sup>9</sup> Showing itself to be responsive to developments in corporate governance, on the one hand, and mindful of Delaware's overarching approach to corporate law, on the other, the Delaware legislature approved amendments to the General Corporation Law of the State of Delaware ("DGCL"), effective August 1, 2009, to add new Section 112, which expressly enables corporations to adopt a proxy access regime through a bylaw but leaves the key details of implementing that regime in the hands of individual corporations.<sup>10</sup> Concurrent with the adoption of the proxy access statute, the Delaware legislature added new Section 113, which expressly authorizes a corporation to adopt a bylaw that would reimburse stockholders for expenses incurred in connection with a proxy solicitation.<sup>11</sup>

Shortly thereafter, the SEC announced that it would again propose a mandatory proxy access regime, which it did on June 18, 2009.<sup>12</sup> The SEC's approach – long on regulatory prescriptions, with little variance based on the corporation's unique profile – stands in marked contrast to Delaware's flexible approach to proxy access. Considering that (at the time of this writing) the proposed rule may not become final in time for the next proxy season, activist stockholders and institutional investors may pressure corporations to act before the SEC decides whether to proceed with its proxy access regime. While corporations may elect to delay adopting a voluntary proxy access regime until they have more information about what the SEC intends to do, boards of

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<sup>4</sup> Security Holder Director Nominations, 68 Fed. Reg. at 60,789, 60,794.

<sup>5</sup> Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act No. 27,913, 72 Fed. Reg. 43,466 (proposed Aug. 3, 2007) (proposing rule to include stockholder proposed bylaws relating to nomination of directors); Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,161, Investment Company Act No. 27,914, 72 Fed. Reg. 43,488 (proposed Aug. 3, 2007) (proposing rule to clarify that Rule 14a-8(i)(8) allows companies to exclude bylaw proposals relating to the election of directors).

<sup>6</sup> *Get Ready for a Red-Hot Season*, DIRECTORSHIP, Dec. 2006/Jan. 2007, at 1 ("The folks with their fingers on the pulse of big shareholder groups have already identified the top five areas of activity this year: majority voting, executive compensation, board declassification, poison pill elimination, and activist hedge funds.").

<sup>7</sup> See Shareholder Bill of Rights Act of 2009, S. 1074, 111<sup>th</sup> Cong. § 2 (2009) ("Congress finds that ... among the central causes of the financial and economic crises that the United States faces today has been a widespread failure of corporate governance.").

<sup>8</sup> Claudia H. Deutsch, *Say on Pay: A Whisper or a Shout for Shareholders?*, N.Y. TIMES, Apr. 6, 2008, <http://www.nytimes.com/2008/04/06/business/06say.html>.

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<sup>9</sup> Jeffrey McCracken & Kara Scannell, *Fight Brews as Proxy Access Nears*, WALL ST. J., Aug. 26, 2009, at C1 (discussing political support and opposition to proxy access); see also Martin L. Lipton et al., *Schumer's Shareholder Bill Misses the Mark*, WALL ST. J., May 12, 2009, at A15 (arguing against the Shareholder Bill of Rights *supra* note 7 which would, *inter alia*, grant proxy access).

<sup>10</sup> 77 Del. Laws c. 14, § 1, Apr. 10, 2009.

<sup>11</sup> 77 Del. Laws c. 14, § 2, Apr. 10, 2009.

<sup>12</sup> Facilitating Shareholder Director Nominations, Securities Act Release No. 9,046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765, 74 Fed. Reg. 29,024 (proposed June 18, 2009) (proposing new Rule 14a-11 consisting of a mandatory proxy access regime).

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directors and their advisors should nonetheless be prepared with a considered and measured response if the need should arise before the SEC has promulgated a final rule with respect to proxy access.

As with any opt-in scheme, the first decision a corporation must make is whether to adopt a proxy access bylaw at all. While the precise calculus will differ from corporation to corporation, there are some threshold issues that many boards may find helpful to consider. Some boards, for example, may see an advantage to seizing the initiative and adopting a bylaw before it is pressured by stockholders to adopt a potentially less appealing alternative. Other boards may determine that a proxy access regime would advance the corporation's interests by providing stockholders with a more active role in the election of directors. As an alternative, corporations could determine that a proxy access regime is inappropriate and that the best method of granting stockholders greater influence over the nomination process is to adopt a bylaw requiring the corporation to reimburse stockholders' costs and expenses in connection with a traditional proxy contest, as authorized by new Section 113 of the DGCL.

If the board decides to take the first step on proxy access, it can structure its bylaw in various ways under Section 112. The statute provides a non-exclusive list of terms and conditions that may be included in the bylaw – including minimum ownership requirements as well as disclosure requirements regarding the nominating stockholder and the nominees – and also provides that the corporation may include in the bylaw any other “lawful conditions” it deems necessary or appropriate.<sup>13</sup> The remainder of this article provides an overview of various factors boards may consider in determining which conditions would be appropriate for their particular corporation. This article contemplates a proposed proxy access bylaw that would work in concert with the corporation's existing advance notice bylaws. The proposed proxy access bylaw described in this article, with annotations describing the many ways in which the corporation may craft its own proxy access regime, may be obtained from the authors, whose e-mail addresses are listed above.

### ***Establishing an Ownership Threshold and Holding Period***

The first of Section 112's non-exclusive conditions is a minimum level and/or duration of stock ownership.<sup>14</sup>

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<sup>13</sup> 8 *Del. C.* § 112.

<sup>14</sup> 8 *Del. C.* § 112(1).

This allows the corporation to set a threshold of ownership, requiring the nominating stockholder (or nominating group, if the corporation elects to allow stockholders to pool their holdings) to have a certain amount of “skin in the game” before gaining access to the corporation's proxy statement. Under our proposed bylaw, either an individual stockholder or a group of stockholders that pool their interests may make a proposal, so long as the stockholder or group beneficially owns at least five percent of the corporation's common stock. This threshold is a default position that was selected to match the beneficial ownership reporting requirements under Regulations 13D-G promulgated under the Securities Exchange Act.<sup>15</sup> But the ownership threshold is by no means intended as a one-size-fits-all provision, and a corporation considering an ownership threshold may also want to take into account, among other things, its market capitalization and its existing stockholder base. For example, a higher threshold may be appropriate, all else being equal, at a small cap company versus a large cap company because of the difference in the investment required to reach various ownership thresholds in each setting. Equal percentages of stockholdings in two corporations with substantially different market capitalizations may signal different levels of commitment to the long-term success of each individual corporation. The SEC's proposed rule, which also provides for a minimum ownership threshold, appears to recognize that the ownership threshold required to gain access to the corporation's proxy statement should be based upon the corporation's market cap and, to that end, provides for three thresholds, one, three, and five percent, for large accelerated filers, accelerated filers, and non-accelerated filers, respectively.<sup>16</sup>

Under our form of proposed bylaw, only one stockholder or group – the one that meets the applicable threshold and has the greatest beneficial ownership of all stockholders or groups submitting nominations – may present a nomination or nominations thereunder for any one meeting. But a corporation has maximum flexibility under Delaware law to craft a bylaw that allocates nominations differently under its proxy access regime. Other models, for example, contemplate that any number of qualified stockholders or groups may submit nominations up to the available number of director seats open for election at the meeting. The SEC's proposed rule contemplates a system that allocates nominations

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<sup>15</sup> 17 C.F.R. § 240.13d-1 et seq. (2009).

<sup>16</sup> Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,035.

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based on the time at which nominations are received.<sup>17</sup> While the SEC's system provides an easily discernible method of determining which stockholders are entitled to submit nominations, there is no discernible substantive justification for a first-in-time, first-in-right system for the submission of nominations. The advantage of the provision in our proposed bylaw is that it also allows for an easily discernible means of determining which nominations must be included in the proxy statement, and it further ensures that only those stockholders with the greatest economic interest are able to use the process.

Our proposed bylaw would require nominating stockholders (and each member of any nominating group) to have beneficially owned their shares for a period of at least one year prior to submitting a nomination and to continuously hold those shares through the date of the meeting.<sup>18</sup> As with the threshold ownership requirement, this provision is designed to ensure that the nominating stockholder or stockholders are committed to the corporation. It is intended in part to prevent short-term investors from accumulating stock and making nominations that are intended solely to advance their personal goals (which may be antithetical to the interests of long-term investors).<sup>19</sup> But this provision may be excluded, or the period may be shortened or lengthened, depending on the corporation's profile, including, among other things, the composition of its stockholder base, the volume of trading in its shares, and various other factors.

### **Timing of Submission; Informational Requirements and Disclosure**

Section 112 also expressly permits a proxy access bylaw to require the submission of certain information regarding the nominating stockholder or stockholders and the proposed nominees at a specified date prior to

the meeting.<sup>20</sup> To ensure that the board will have adequate time to review stockholder nominations and related materials, our proposed bylaw would provide for a time frame that corresponds to the advance notice periods set forth in Rule 14a-8.<sup>21</sup> This generally requires nominations to be submitted not less than one hundred twenty calendar days before the date the corporation's proxy statement was released to stockholders in connection with the previous year's annual meeting. Under Delaware law, the corporation may, however, select any number of time frames for the submission of nominations, though practical and equitable considerations likely would prevent the corporation from setting a time frame that is too brief in duration, or too far in advance of or too close in time to the date of the meeting.

Under Section 112, the corporation may require a stockholder or group, in connection with its submission of a nominee under the proxy access bylaw, to provide disclosure relating to, among other things, its ownership position (including through derivatives and other instruments) as well as the ownership position of each member of the group,<sup>22</sup> any agreement, arrangement, or understanding with respect to the nomination between or among the nominating stockholder (and each member of a nominating group) and any others (including the nominee), and any information regarding the nominee that would be required to be disclosed in a proxy contest under the federal securities laws, as well as requiring each nominee's written consent to being named in the proxy statement as a nominee and to serving as a director if elected. Because this information is largely coextensive with the information required by many

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<sup>17</sup> *Id.* at 29,044.

<sup>18</sup> Proposed Rule 14a-11 contains a similar (albeit unchangeable) requirement that the stockholder must represent that it has held the relevant percentage of securities for one year and intends to hold the securities through the date of the relevant meeting. *Id.* at 29,045.

<sup>19</sup> As an example of the agility with which the Delaware legislature responds to emerging issues in corporate law, Section 112 also provides that the ownership thresholds and durations may take into account financial instruments that are more complex than plain vanilla common stock ownership (e.g., synthetic long or short positions held through total return swaps). 8 *Del. C.* § 112(1).

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<sup>20</sup> 8 *Del. C.* § 112(2).

<sup>21</sup> 17 C.F.R. § 240.14a-8 (2008). The SEC's proposed Rule 14a-11 provides for the same time frame, but contemplates that there would be a single time frame applicable to all subject corporations. Facilitating Shareholder Director Nominations, 74 *Fed. Reg.* at 29,045.

<sup>22</sup> The inclusion of derivative positions in the calculation of beneficial ownership has been challenged in other contexts. For example, in *Louisiana Municipal Police Employees' Retirement Sys. v. Laub*, C.A. No. 4161-CC, a case currently pending in the Delaware Court of Chancery, plaintiffs challenged the corporation's inclusion of derivatives for purposes of determining the triggering threshold under its rights agreement. But any such challenge to disclosure of that information in the present context should be unavailing, as Section 112 expressly authorizes a bylaw to require disclosure of that information. 8 *Del. C.* § 112(2).

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advance notice bylaws,<sup>23</sup> our proposed bylaw would incorporate these informational requirements by reference to the relevant provisions of the advance notice bylaw. But the corporation may modify or supplement these requirements if particular information with respect to board nominees or stockholders is important to it, as would be the case, for example, if the corporation's charter or bylaws provided for specific director qualifications.<sup>24</sup>

Our proposed bylaw also enables the nominating stockholder or group to furnish a nomination statement regarding its nominee(s) for inclusion in the proxy statement. Although there is no requirement under Section 112 that the corporation include such a statement, in light of the general principle that stockholders should be fully informed when voting, a corporation may well determine that it is appropriate to allow for a nomination statement. To keep the nomination statement focused, the proposed bylaw, borrowing a page from Rule 14a-8 and proposed Rule 14a-11, limits that statement to five hundred words per nominee.<sup>25</sup> But a corporation, if it determines that nomination statements should be permitted, may place other appropriate limitations on the length, nature, and scope of the statement (*e.g.*, limiting the statement to a description of the nominee's professional experience and qualifications). Because the nomination statement would be included in the corporation's proxy statement, the corporation should consider requiring the nominating stockholder to update that information if it becomes stale or to remedy any previously made statement that becomes false or misleading. Our proposed bylaw requires the nominating stockholder's information to be updated as of the record date for notice of the meeting within five business days of that record date. To ensure that the nominating stockholder has notice of that date, our proposed bylaw requires the corporation to publicly announce the notice record date on or prior to its occurrence.

## **Prevention of Abuse**

Section 112 also guards against potential abuse of the proxy access process by allowing the corporation to exclude the stockholder's nominees if the stockholder is effectively seeking to run a proxy contest for board control.<sup>26</sup> Specifically, Section 112 permits the bylaw to provide that inclusion of a nominee may be conditioned on limiting the number or proportion of directors to be nominated by the stockholder.<sup>27</sup> This provision apparently reflects a policy judgment on the part of the Delaware legislature that a corporation should be entitled to require stockholders seeking to gain majority control of the board to use the traditional means of soliciting proxies and convincing other stockholders that its vision for the future of the corporation is superior to that of the incumbents. In other words, the corporation need not subsidize an insurgent's run at the corporation. To this end, our proposed bylaw provides that the maximum number of stockholder-nominees that may be included in the corporation's proxy statement for any annual meeting shall be no more than twenty-five percent of the total number of directors up for election at that meeting (but not less than one). That number – which mirrors the mandatory number in proposed Rule 14a-11<sup>28</sup> – could be increased or reduced as the corporation sees fit, taking account of, among other things, whether the board is classified, whether there are change-of-control provisions in the corporation's credit or other agreements, or whether there are classes of stock with separate rights of election. In addition, our proposed bylaw includes a provision whereby the nominator essentially agrees to a standstill, subject to a specified cap, and agrees that it will not conduct a proxy solicitation in the current year.<sup>29</sup> These provisions are intended to prevent an insurgent from using the proxy access bylaw as a first step in a hostile acquisition. The provisions may be eliminated or altered depending on whether, among other things, the corporation has an existing rights plan in place or if the corporation is subject to Section 203 of the DGCL (and no

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<sup>23</sup> As a matter of practice, where a corporation is considering adopting a proxy access bylaw, it may consider making changes at that time to its advance notice regime – both to ensure that the informational requirements are up-to-date and to eliminate any potential conflicts between the two sets of procedures.

<sup>24</sup> Proposed Rule 14a-11 would require much of the same information, but would not enable corporations to alter the requirements. Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,045-47.

<sup>25</sup> 17 C.F.R. § 240.14a-8(d) (2008).

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<sup>26</sup> 8 *Del. C.* § 112(4).

<sup>27</sup> 8 *Del. C.* § 112(3).

<sup>28</sup> Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,043.

<sup>29</sup> Proposed Rule 14a-11 provides that a nominating stockholder must certify that it is not seeking a change in control. *Id.* at 29,038.

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stockholders are exempt from that statute's restrictions).<sup>30</sup>

In a similar vein, our proposed bylaw provides that nominations may be excluded if made by a stockholder (or the affiliates and associates thereof) who has proposed to accumulate a specified percentage of the shares before the election of directors, and it further provides that nominations may not be made thereunder if the corporation is in the midst of a traditional proxy contest. The proposed bylaw also provides that any stockholder presenting nominations under the corporation's advance notice bylaw (*i.e.*, any nomination for which the stockholder likely would solicit its own proxies) may not submit nominations under the proxy access bylaw (and vice-versa). These provisions may be particularly important to certain corporations (*e.g.*, those with significant debt that would accelerate upon a "change of control"), but may make little sense in the context of other corporations.

Section 112 allows corporations to include a provision conditioning eligibility on whether the stockholder previously sought to require inclusion of a nominee in the proxy statement through the proxy access

bylaw.<sup>31</sup> To this end, our proposed bylaw precludes nominations from being made by persons or groups whose nominees have failed to receive at least twenty-five percent of the votes eligible to be cast in elections at the corporation taking place in the previous three years. This provision is intended to ensure that those stockholders who have been proven not to be credible will not gain access to the corporation's proxy statement to present nominations. In one sense, this provision benefits all stockholders, in that it ensures that the proxy access regime will not be monopolized by a significant stockholder who in years past has presented nominees that other stockholders have not approved. If the corporation includes such a provision, it may adjust the threshold percentage (including the method of calculating that percentage) and time period as appropriate, depending on, among other things, the composition of its stockholder base. A corporation may even consider making this eligibility requirement depend on whether nominees of the nominator or group have consistently failed to garner significant support at other corporations and thus prevent proven gadflies from abusing the corporation's proxy access regime.

Section 112 provides that the implementing bylaw may require the nominating stockholder to indemnify the corporation against losses resulting from any false or misleading statements that are included in the corporation's proxy statement and attributable to the nominating stockholder.<sup>32</sup> This provision guards against abuse of the proxy access regime by holding stockholders financially accountable for their statements. As provided in our proposed bylaw, the corporation may enforce this obligation by requiring the nominating stockholder, as a condition to submitting a nomination, to furnish an indemnification agreement that is satisfactory to the board. To prevent some of these issues altogether, the board may consider, as our proposed bylaw contemplates, retaining the right to omit information that the board itself determines would be false or misleading.

Finally, Section 112 allows the proxy access bylaw to contain any other "lawful condition."<sup>33</sup> This provides the board with an enormous amount of flexibility to determine what requirements may be in the best interest of the corporation and its stockholders. In addition to the various conditions described above, our proposed bylaw includes a requirement that each nominating

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<sup>30</sup> Section 203 of the DGCL and rights plans have the effect of deterring accumulations of shares beyond a specified threshold that are not met with prior board approval. Section 203 of the DGCL generally provides that any stockholder that becomes an "interested stockholder" (*i.e.*, obtains more than fifteen percent of the stock) without board approval is subject to restrictions on "business combinations" for a period of three years. 8 *Del. C.* § 203. Thus, a stockholder may be reluctant to become an "interested stockholder," as the stockholder would then be prohibited from, among other things, effecting a back-end merger, purchasing assets from the company, obtaining management fees from the company, or entering into any kind of commercial transaction with the company for three years, even on an arms-length basis, without obtaining a supermajority vote of the unaffiliated stockholders. *Id.* Likewise, under a customary rights plan, any person that becomes an "Acquiring Person" (*i.e.*, obtains more than a specified percentage, typically fifteen percent, of the outstanding stock) would trigger the rights under the plan. This would give rise to all stockholders, other than the Acquiring Person, becoming entitled to purchase shares of the corporation at a discount or to receive additional shares upon an exchange of the rights, which would potentially dilute the Acquiring Person's stake significantly. As a result, most stockholders are exceedingly reluctant to accumulate shares in excess of the plan's threshold. Thus, where a corporation is subject to Section 203 or has a rights plan in place, it may find the standstill provision in the proxy access bylaw unnecessary.

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<sup>31</sup> 8 *Del. C.* § 112(3).

<sup>32</sup> 8 *Del. C.* § 112(5).

<sup>33</sup> 8 *Del. C.* § 112(6).

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stockholder cause its nominees to submit an irrevocable resignation that is conditioned on a determination by the disinterested directors that the information provided by the nominating stockholder was false or misleading, or that the nominating stockholder breached any obligation under the bylaw. This is but one of the many potential terms and conditions that a corporation may include in a proxy access bylaw adopted under Section 112. As we attempted to demonstrate, the variations among the

possible proxy access bylaws that a corporation could adopt – if it takes the initiative to adopt a proxy access regime at all – are multitudinous and may be carefully tailored to match the specific profile of a particular corporation. That said, the corporation’s ability to design its proxy access regime may be severely circumscribed, or eliminated entirely, if a supervening law, rule, or regulation at the federal level overrides this state-law solution. ■