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The Permissible Scope of Bylaws: *CA, Inc. v. AFSCME Employees Pension Plan*

By Marc Weingarten and William F. Cassin

THERE ARE SURPRISINGLY few actions that stockholders, including activist stockholders, can take directly to influence corporate governance at the company they own.¹ Most significantly, they lack the power to amend the company's charter on their own initiative, as charter amendments must first be declared advisable by the board in order to be considered by the stockholders.² Their most powerful right, of course, is to elect directors, though even this right may be substantially circumscribed through staggered-board provisions and the elimination of the right to take action by consent or to call a special meeting, as well as the application of advance notification bylaws. One of the stockholders' few other powerful rights is to adopt or amend bylaw provisions. Section 109(a) of the Delaware General Corporation Law (the "DGCL") in effect provides that "both the board and the stockholders, independently and concurrently, possess the power to adopt, amend and repeal the bylaws."³ However, even this power is not absolute. It is subject to Section 141(a) of the DGCL, which provides that:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.

Presumably, therefore, a bylaw provision that "took management out of the board" could not be adopted by the stockholders.

On July 17, 2008, the Delaware Supreme Court issued a decision in *CA, Inc. v. AFSCME Employees Pension Plan*, No. 329, 2008 (Del. Supr. July 17, 2008) squarely addressing the permissible scope of a bylaw provision in view of these two statutory provisions.

The case arose in the context of an effort by CA, Inc. ("CA" or the "Company") to exclude a stockholder proposal submitted by the AFSCME Employees Pension Plan ("AFSCME") under Rule 14a-8 of the Securities Exchange Act of 1934 (the "Exchange Act") for inclusion in CA's 2008 proxy materials. The proposed bylaw amendment would require reimbursement by the corporation of reasonable expenses incurred by a stockholder in connection with the successful nomination of a candidate to the board of directors in a contested election.⁴

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- 1 This article presumes the application of Delaware corporate law.
- 2 DGCL § 242(b).
- 3 *CA, Inc. v. AFSCME Employees Pension Plan*, No. 329, 2008 (Del. Supr. July 17, 2008).
- 4 As discussed below, while the expenses incurred by incumbent directors are usually paid by the company, outside stockholders must bear their own expenses, which can be considerable, in connection with nominating directors.

The opinion, written to answer two distinct questions posed by the Securities and Exchange Commission (the “SEC”) to the Delaware Supreme Court, supported the Company’s exclusion of AFSCME’s proposed bylaw and could therefore be viewed as a defeat for both AFSCME and stockholder rights in general. However, the court’s fairly expansive holding as to the scope of permissible bylaw provisions, as well as its clear articulation of the rather narrow deficiency of the AFSCME bylaw, actually represents a significant affirmation of stockholder rights and, we believe, opens the door to creative bylaw proposals from stockholders.

Background to the Decision and the Current Law Regarding Proxy Solicitation Expense Reimbursement

As noted above, the *CA, Inc.* case arose out of a proposed bylaw amendment submitted by AFSCME for inclusion in CA’s 2008 proxy materials pursuant to Rule 14a-8 of the Exchange Act. This rule provides a stockholder owning a relatively small amount of a company’s securities with an opportunity to have its proposal included in a company’s proxy materials alongside those of management for presentation to a vote at the annual meeting of stockholders. The rule generally requires the company to include the proposal unless the stockholder has not complied with the rule’s procedural requirements or the proposal falls within one of 13 categories specifically enumerated in the rule.⁵ If a company believes a proposal falls within one of these categories, it may inform the SEC of its desire to exclude the proposal and request a no-action letter stating that the SEC will not recommend an enforcement action against the company based on the proposed exclusion. The SEC then reviews the request and the proposal and either issues the requested no-action letter or states that it declines to do so.⁶ Companies receiving their requested no-action letters will typically exclude the proposal from their proxy materials, while companies failing to receive the letter will include the stockholder proposal.

AFSCME’s proposed bylaw, if voted on and passed by CA stockholders, would have required the Company’s board of directors to reimburse a stockholder or a stockholder group soliciting proxies in support of a short slate of director nominees (i.e., a slate of directors comprising less than a majority of the board) for its reasonable costs incurred in the solicitation, so long as at least one nominee on the short slate was successfully elected to the board. As most stockholders interested in effecting change at the board level are well aware, the almost universal rule of proxy solicitations is that expenses incurred by a corporation’s board of directors to solicit proxies for the election of the company’s nominees are paid by the corporation; such expenses are viewed much like the expenses of preparing and distributing the corporation’s annual report—as just one of the many costs associated with running a company. The practical result, however, is that a proxy solicitation conducted by an incumbent board is essentially free to the incumbent board and to the candidates nominated by the board—and remains so whether these candidates win or lose their election. In contrast, a proxy solicitation conducted by a “dissident” stockholder must be paid for by the stockholder, and, in general, the stockholder has no right to reimbursement for the cost of such solicitation, even if the stockholder’s candidate is elected.⁷ And if the

stockholder fails to win election for any of its candidates, there is virtually no chance of reimbursement.

The economic burden placed on stockholders undertaking a proxy solicitation operates as a significant disincentive to stockholders contemplating seeking board representation, and clearly favors incumbent boards. AFSCME’s proposed bylaw, by mandating reimbursement to successful candidates, would have mitigated the financial disincentive faced by stockholders to some extent, arguably leveling the playing field somewhat between incumbents and dissident slates.

CA’s Grounds for Exclusion and the Questions Posed to the Delaware Supreme Court

In its request for a no-action letter, CA sought to exclude the AFSCME proposal from its proxy materials on two principal grounds:⁸ (i) the AFSCME proposal was not a proper subject for action by stockholders of a Delaware corporation, and (ii) AFSCME’s proposed bylaw, if adopted, would cause CA to violate Delaware law. Not surprisingly, AFSCME disagreed with CA’s view. Both AFSCME and CA’s Delaware counsel submitted opinions to the SEC supporting their respective positions, and in the face of these conflicting legal opinions, the SEC formally certified these issues to the Delaware Supreme Court for guidance.

Is the Question of Proxy-Expense Reimbursement a Proper Subject for Stockholder Action?

The Delaware Supreme Court first addressed the question of whether the AFSCME proposal was a proper subject for stockholder action. The court discussed the interplay between Sections 109(a) and 141(a), and concluded that while stockholders are entitled to adopt bylaws, their power to do so is not “coextensive” with that of the board of directors, but is limited by the board’s prerogatives under Section 141(a). In other words, there are areas of corporate power that exclusively pertain to the board, and stockholders are prohibited from infringing on board power in these

- 5 The categories include, among others, (i) if the proposal is not a proper subject for stockholder action under the laws of the jurisdiction in which the company is incorporated; (ii) if the proposal would cause the company to violate any state, federal or foreign law to which it is subject; (iii) if the proposal relates to a personal grievance against the company; and (iv) if the proposal deals with a matter relating to the company’s ordinary business operations.
- 6 During the 2006–07 proxy season, the SEC responded to approximately 360 Rule 14a-8 no-action requests, according to the SEC.
- 7 While a newly elected member or members of a board are free to request reimbursement for the expenses incurred by the stockholder responsible for his or her election, under the law of most jurisdictions, including Delaware, the majority is equally free to reject the request. If a stockholder successfully nominates and elects a majority of the board of directors, the stockholder may be able to recoup its expenses, assuming such reimbursement is approved by the new majority of the board, but reimbursement may also be subject to approval by stockholders.
- 8 As noted above, both of the grounds cited by CA are among those listed in Rule 14a-8 as permissible grounds for excluding a stockholder proposal.

areas. However, the court rejected CA's argument that any bylaw that infringes on the power of the board of directors automatically falls outside of the scope of permissible bylaws.

The court then turned to the two central questions of the case: Where is the line between permissible stockholder action and improper intrusion on the board's power to manage the corporation, and on which side of this line does the question of proxy solicitation expense reimbursement, as embodied by AFSCME's proposed bylaw, fall? While it explicitly declined to provide a bright line answer to the first question, the court stated that "[i]t is well established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive decisions but rather to define the processes and procedures by which those decisions are made." Having determined that the proper focus of its inquiry is whether the AFSCME bylaw was process-related, the court analyzed the proposed bylaw and concluded that while it calls for an expenditure of money, it nevertheless "has the intent and effect of regulating the process for electing directors" and, accordingly, that it is a proper subject for stockholder action.

Would the AFSCME Bylaw Proposal Cause CA to Violate Delaware Law?

The Delaware Supreme Court then turned to the second question posed to it by the SEC: whether AFSCME's proposed bylaw, if adopted, would cause CA to violate Delaware law. The court held that it would. In reaching its conclusion, the court focused on the mandatory nature of AFSCME's proposed bylaw, which would require reimbursement of election expenses incurred by outside stockholders in *all* instances of a successful election. Because it mandated reimbursement in all cases, the court reasoned, there could be situations in which compliance with AFSCME's proposed bylaw would cause a board to breach its fiduciary duties. Reimbursement could be improper, reasoned the court, in situations where the proxy contest for which reimbursement was sought was "motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation." As a result, the AFSCME-proposed bylaw would violate the well-established prohibition against contractual arrangements that preclude a board from fully discharging its fiduciary duties. For these reasons, the court held that the bylaw, if enacted by stockholders, would violate Delaware law, thereby providing the grounds on which CA could permissibly exclude it from its 2008 proxy materials.

Implications of the CA Decision

From a stockholder-rights perspective, the CA decision has a number of positive implications.

The Delaware Supreme Court reaffirmed the principle that a bylaw should not mandate the board's substantive business decisions, but rather should define the process and procedures by which these decisions are made. However, the court also held that "whether or not a bylaw is process related must necessarily be determined in light of its context and purpose." The court found that the context of the AFSCME proposed bylaw was the process for electing directors and, accordingly, that even though the bylaw mandated reimbursement by the board with the expenditure

of corporate funds, it was nevertheless a proper subject for stockholder action. Thus, a bylaw provision need not specify process exclusively; it simply must contextually *relate* to process. This holding opens the door to a wide array of potential bylaw provisions to be adopted at the initiative of stockholders.

While holding that the CA bylaw would have violated Delaware law, the state's high court specified the cure for its infirmity: the inclusion of a "fiduciary out." As indicated above, the court gave examples where the grant of reimbursement could violate fiduciary duties, such as where the dissident was motivated by personal or petty concerns, or sought to promote interests that did not further, or were adverse to, those of the corporation. While the latter seems somewhat expansive, the accompanying footnote indicates that such a circumstance may arise where a stockholder group affiliated with a competitor sought to elect candidates "committed" to using their director position to pass proprietary information to the competitor. Narrow grounds indeed, that would seem to disqualify not a single proxy contest within memory. And the court warned that, of course, "[a] decision by directors to deny reimbursement on fiduciary grounds would be judicially reviewable." While incumbent board members might well argue against a reimbursement request submitted by a newly elected dissident board member on the grounds that the dissident's agenda did not further the corporation's interests, the success of such an argument seems highly unlikely in view of the majority stockholder approval implicit in the election of the dissident to the board.

The aspect of the court's holding that defines the permissible scope of a bylaw may also be used by activist stockholders as a sword as well as a shield. It is not beyond boards to adopt bylaws seeking to restrict stockholder rights or powers, and the language of this decision should provide courts with the necessary ammunition to invalidate such provisions, even though board-approved.

The court noted in this decision that it has, in the past, upheld a bylaw requiring that board decisions be unanimous in order to be effective. A bylaw of this nature would be extremely powerful to an activist when coupled with the election of a minority slate, or even one director. The court also noted that it has, in the past, upheld the power of stockholders to abolish board-created committees. This raises some interesting questions. Could stockholders mandate the creation of a board committee? Possibly more significantly, could they identify which members of the board were to sit on the newly created committee?

The court declined to adopt a bright-line test dividing bylaws into those that stockholders may unilaterally adopt and those that they may not. This lack of predictability will, unfortunately, mean more litigation, with boards again utilizing the corporate treasury to fight dissidents who must finance their cause out of their own pockets. This very lack of predictability, however, also opens the door to stockholders willing to craft, with a view to the court's guidance, bylaw proposals that will withstand challenge. More case law undoubtedly will be forthcoming. ■

Stockholders' Rights to Demand Inspection of Corporate Books and Records: Recent Developments

By David E. Rosewater and Emily Vincent



IN A PREVIOUS ISSUE of this newsletter, we explored in detail some of the potentially powerful, but still somewhat infrequently used, rights of stockholders pursuant to Section 220 of the Delaware General Corporation Law (“Section 220”) to access many types of corporate records beyond the typical obtainment of a stockholder list or request for materials in connection with a derivative suit.¹ That article concluded by noting that “Section 220 will undoubtedly continue to develop as the most recent trend of investor activism exploits the boundaries of Section 220 and as the Delaware judiciary mediates the ensuing disputes.” That prediction has come true, and this article, in addition to summarizing some of the basics of Section 220 as a brief refresher, explores some of the more recent developments that have continued to define those boundaries.

Background on Section 220

Section 220 provides stockholders, under certain conditions, with the statutory right to inspect a “corporation’s stock ledger, a list of its stockholders, and its other books and records.” This right includes the right to make copies of demanded documents and can include the right to inspect the “books and records” of any subsidiary of the corporation. This statutory right “is an expansion of the common law right of [stockholders] to protect themselves by keeping abreast of how their agents [are] conducting corporate affairs.”² If all requirements are met, Section 220 can serve as a powerful tool for the activist investor.

To demand documents through Section 220, a stockholder must satisfy two general conditions set forth in the statute.

The first requirement is that the stockholder actually be a stockholder during the relevant time period. The second requirement, which often is the subject of disputes, is that the stockholder must establish a “proper purpose.” Under the statute, if the corporation refuses to provide the demanded documents (or fails to reply to the demand within five business days from the date the demand was made), and the stockholder has satisfied all requirements, the stockholder may apply to the Chancery Court for an order compelling disclosure.

Establishing a proper purpose is “[t]he paramount factor in determining whether a stockholder is entitled to inspection of corporate books and records.”³ Section 220(b)(2)(b)(2) defines a “proper purpose” as “a purpose reasonably related to such person’s interest as a stockholder.” A stockholder seeking to utilize Section 220 to access documents carries the burden of demonstrating a proper purpose by a preponderance of evidence.⁴ Examples of proper purposes, as recognized by the Delaware Courts, are: clarifying an unexplained discrepancy in the corporation’s financial statements regarding assets,⁵ ascertaining the value of one’s stock⁶ and investigating the possibility of an improper transfer of assets out of the corporation.⁷ Central to these purposes is the goal of investigating possible mismanagement by the corporation’s board of directors and executives. However, Delaware courts have been careful to balance the right of stockholders to investigate possible corporate mismanagement under Section 220 against Delaware’s general policy of deferring to the board of director’s business judgment.⁸ Therefore, stockholders must show “some evidence of possible mismanagement as would warrant further investigation” in order to demand documents under Section 220.⁹

A stockholder must demonstrate “that the information [he or she] seeks is necessary and essential to satisfy its stated

- 1 Marc Weingarten & Joseph Glatt, “Demands to Inspect Corporate Books and Records,” *Activist Investing Developments* (Schulte Roth & Zabel LLP, New York, NY), Fall 2005.
- 2 *Melzer v. CNET Networks, Inc.*, 934 A.2d 912, 912 (Del. Ch. 2007) (hereinafter “*Melzer*”) (citing *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113, 116 (Del.2002)).
- 3 *CM & M Group, Inc. v. Carroll*, 453 A.2d 788, 792 (Del. 1982).
- 4 *Seinfeld v. Verizon Comms.*, 909 A.2d 117, 121 (Del. 2006) (hereinafter, “*Seinfeld*”).
- 5 *Dobler, C.A.* No. 18105, slip op. at 10 (Del. Ch. Oct. 19, 2001); *State ex rel. Miller v. Loft, Inc.*, 156 A. 170, 175 (Del. Super. Ct. 1931).
- 6 *CM & M Group* at 792.
- 7 *Dobler, C.A.* No. 18105, slip op. at 10 (Del. Ch. Oct. 19, 2001); *Avigdor v. Avbrco, Inc.*, C.A. No. 5688, slip op. at 2 (Del. Ch. Oct. 4, 1978).
- 8 *Seinfeld* at 120.
- 9 *Seinfeld* at 125 (quoting *Security First Corp. v. U.S. Die Casting Device Co.*, 687 A.2d at 568).

purpose.”¹⁰ This places a key limitation on what information a stockholder may access. Each document sought must be specifically identified and necessary to satisfy the purpose. Delaware Courts have repeatedly stated their policy against allowing Section 220 demands to become “fishing expeditions.”¹¹ If the Chancery Court finds that alternative and publicly available information would satisfy the purpose, it may refuse to order the corporation to allow stockholders to access the information.¹² Therefore, it is of paramount importance that the stockholder precisely define the purpose of his or her Section 220 document demand. It should be broad enough to justify access to the appropriate documents, but not so broad that it risks the Chancery Court characterizing the demand as a fishing expedition.

Recent Developments

I. Ownership Time Period Requirement

Recently, in connection with the requirement to be a stockholder in the relevant time period, Delaware Courts have grappled with the issue of whether a stockholder that purchases stock after alleged mismanagement can seek documents related to the alleged mismanagement. In *Polygon Global Opportunities Master Fund v. West Corp.*, the Delaware Chancery Court denied a stockholder’s request for an order compelling disclosure of documents pursuant to Section 220 because the stockholder had purchased stock after the alleged mismanagement was made public.¹³ In this case, the stockholder alleged that West Corporation’s directors breached their fiduciary duty in approving a squeeze-out merger. The court reasoned that because the stockholder had purchased the stock after the merger was announced, the stockholder’s purpose in seeking documents under Section 220 was “not reasonably related to [the investor’s] interest as a stockholder as it would not have standing to pursue a derivative action based on any potential breaches” and thus denied the application for an order compelling disclosure.

Were *Polygon* interpreted as a complete bar to obtaining information regarding events occurring prior to the demanding party becoming a stockholder, the implications of the holding would be very significant. However, in *Melzer v. CNET Networks, Inc.*, the Chancery Court signaled at least a partial retreat from *Polygon*’s strong stance on timing. In *Melzer*, CNET attempted to rely on the court’s rationale in *Polygon* in refusing to provide documents to a stockholder who was seeking to demonstrate demand futility with respect to various securities and state law claims related to CNET’s admitted back-dating of stock options. Despite the fact that the stockholder had purchased stock after the back-dating had occurred, the court refused to rule that *Polygon* foreclosed the stockholder’s access to documents. The court found that the stockholder was seeking the documents “to show that there was a ‘sustained or systematic failure of the board to exercise oversight’—a violation of the board’s duty of loyalty by way of bad faith,” which would have potentially permitted the plaintiffs to establish a derivative action they would have had standing to assert.¹⁴ In order to show such a “‘sustained or systematic oversight’ the [stockholders] might reasonably need to consult documents that predate their ownership” of the corporation’s stock. Accordingly, the court granted the stockholder’s request to order the corporation to allow it access to the documents.

Unfortunately, it is not yet clear whether the strict *Polygon* standard or the more flexible *Melzer* application of *Polygon* will ultimately control in a situation in which a stockholder seeks documents through Section 220 that predate his or her ownership of stock in a context where derivative litigation is

not the purpose of the demand.

II. Limitations on Receipt of Confidential Information

Section 220(c)(3) gives the Chancery Court the power, “in its discretion, [to] prescribe any limitations or conditions with reference to the inspection, or award such other or further relief as the Chancery Court may deem just and proper.” Of primary importance is the court’s concern that potential harms from disclosing confidential business materials not outweigh any potential benefits of disclosure.¹⁵ The court will normally condition an order compelling disclosure of confidential documents on a “reasonable confidentiality order.”¹⁶ In determining whether a document is confidential, the court will examine factors such as whether the documents discuss “non-public business and personnel matters,”¹⁷ whether they relate to “private communications among or deliberations of the Company’s board of directors,”¹⁸ and whether the documents’ appearance signals the company’s intention of keeping the documents confidential.¹⁹

However, the court has recognized situations in which a stockholder may avoid the restraints of such a confidentiality order. “Chief among these, of course, is the use of the information to bring a derivative suit in the case of corporate waste or mismanagement, or to bring a suit attacking some aspect of a company’s public disclosures.”²⁰ A stockholder may also be justified in releasing confidential information obtained through Section 220 if the stockholder can demonstrate that the confidentiality of the documents has been compromised.²¹ The court will also “entertain an application for relief from a Section 220 confidentiality agreement in the context of an active proxy solicitation.”²² Disclosure may also be allowed under other “exigent circumstances (e.g., an active election contest) in which time constraints will not allow a stockholder to draft and file a complaint and then deal with issue of confidentiality in the ordinary course.”²³

In the recent decision, *Pershing Square, L.P. v. Ceridian Corp.*, the Chancery Court identified some limitations on these exceptions, particularly indicating that Section 220 cannot be used solely to “find a legal mechanism by which

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10 *Pershing Square v. Ceridian Corp.*, 923 A.2d 810, 816 (Del. Ch. 2007) (citing *Polygon Global Opportunities Master Fund v. West Corp.*, 2006 Del. Ch. LEXIS 179, 2006 WL 2947486 (Del. Ch. Oct. 12, 2006) (hereinafter “*Polygon*”).

11 See, e.g., *Seinfeld* at 122.

12 *Polygon* at *9-10.

13 *Polygon* at *17-18.

14 *Melzer* at 919 (quoting *Stone v. Ritter*, 911 A.2d 362, 272 (Del. 2006).

15 See *Pershing Square v. Ceridian Corp.*, 923 A.2d 810, 823 (Del. Ch. 2007) (hereinafter “*Pershing*”).

16 *Pershing* at 820 note 32; *Disney v. The Walt Disney Co.*, 2005 Del. Ch. LEXIS 94, *3 (June 20, 2005) (hereinafter “*Disney*”).

17 *Pershing* at 821.

18 *Disney* at 448.

19 *Pershing* at 821.

20 *Disney v. The Walt Disney Corp.*, 2005 Del. Ch. LEXIS 94, *19 (June 20, 2005).

21 See *Pershing* at 821-23.

22 *Disney* at 449.

23 *Disney* at 450.

“Plans” to Sell Stock: SEC 13D Settlement with Kerkorian

By Barry McCarty

ON SEPT. 3, 2008, the SEC announced a cease-and-desist order settlement with Kirk Kerkorian regarding certain Schedule 13D violations.¹ Specifically, the SEC cited Mr. Kerkorian for failing to disclose his plan to sell 28 million shares (approximately 5%) of General Motors Corp. (“GM”) common stock in November 2006 as required by Item 4(a) of Schedule 13D. In addition, the SEC found that Mr. Kerkorian’s “boilerplate” statement in his 13D amendment that he might purchase additional shares in the future to be misleading and violative of Rule 12b-20. This case highlights problematic Schedule 13D disclosure issues confronting investors who consider selling down, or adding to, their position.

Kerkorian’s Investment in GM

By the fall of 2005, as a result of open market purchases and a tender offer, Mr. Kerkorian beneficially owned 56 million shares or 9.9% of GM common stock.

In February 2006, GM appointed Jerome York, a Kerkorian advisor, to the GM board. Mr. York recommended that GM explore an alliance with Nissan and Renault. However, after a preliminary study, the GM board determined in October 2006 not to pursue an alliance. Mr. York resigned from the GM board on Oct. 6, 2006.

On Nov. 16, 2006 Mr. Kerkorian and his advisors met and discussed the GM investment. A key advisor forecasted that GM’s stock price would fall after the second quarter of 2007. Based on this forecast, selling half of the GM stake was discussed. On Nov. 20, 2006, Mr. Kerkorian contacted a broker-dealer and offered to sell 28 million shares of GM stock. The broker-dealer was willing to purchase the shares, but only at a significant discount to the current market price. Mr. Kerkorian was not willing to sell at that price at that time. However, he did ask for a bid on 14 million shares. The new bid was higher and the sale of 14 million shares was executed on Nov. 20, 2006.

An amended Schedule 13D was filed on Nov. 22, 2006 disclosing the sale of 14 million shares. However, it did not disclose any plan to sell 28 million shares or that Mr. Kerkorian had proposed a sale of 28 million shares. Rather, the amended Item 4 disclosure stated that Mr. Kerkorian “may determine, based on market and general economic conditions, the business affairs and financial condition of General Motors, the market price of its shares and other factors deemed relevant by the Filing Persons, to acquire or dispose of additional shares.”

On Nov. 28, 2006 Mr. Kerkorian sold an additional 14 million shares of GM stock to a different broker-dealer. This additional sale reduced Mr. Kerkorian’s GM holdings to 4.95%. On Nov. 30, 2006 Mr. Kerkorian sold his remaining 28 million shares of GM common stock.

Schedule 13D and Rule 12b-20 Require Disclosure of Plans to Dispose of Securities

Item 4(a) of Schedule 13D requires the beneficial owner of more than 5% of a Section 12 registered equity security to “describe any plans or proposals which the reporting persons may have which relate to or would result in ...[t]he acquisition by any person of additional securities of the issuer, or the disposition of securities of the issuer...” Overlaying the specific Schedule 13D line item requirements is Rule 12b-20, which requires filers to disclose all material information.² In addition,

Section 13(d)(2) requires a prompt amendment to Schedule 13D when any material change occurs in the reporting person’s plans.

The SEC found that Mr. Kerkorian had formed a plan to dispose of 28 million shares of GM common stock on Nov. 20, 2006 and failed to disclose that plan in the amended Schedule 13D filed on Nov. 22, 2006.

The violation turns on whether Mr. Kerkorian had a disclosable plan to sell 28 million shares of GM stock. “Plan” is not defined in Section 13(d) or any related SEC rule. However, the Second Circuit has applied the following standard to analyze whether an Item 4 “plan” is disclosable:

Disclosure is to be made of all definite plans and there is no requirement to make predictions, for example, of future behavior; or to disclose tentative plans; or inchoate plans. It is sufficient to merely identify those matters not fully determined. Thus, unless a course of action is decided upon or intended, it need not be disclosed as a plan or proposal under Item 4. (citations omitted).

Azurite Corp. Ltd. v. Amster & Co., 52 F.3d 15 (2d Cir. 1995). In finding that Mr. Kerkorian had a plan to dispose of 28 million shares on Nov. 20, 2007, the SEC points to a series of actions, beginning with the Nov. 16 discussion whether to sell half (28 million shares) of the GM position; the Nov. 20 solicitation of a broker dealer to buy 28 million shares; the sale of 14 million shares on Nov. 20; and the sale of an additional 14 million shares on Nov. 28, 2006.

Unfortunately, the SEC does not include any substantive analysis regarding its “plan” conclusion. In addition, it is unclear what, if any, arguments were advanced by Mr. Kerkorian. The amount of shares to be sold, 28 million shares, was significant from a Section 13(d) perspective because it would allow Mr. Kerkorian to reduce his holding below 5% and exit the Schedule 13D reporting scheme.

Regardless, the decision is consistent with two similar SEC administrative cases which focus on objective evidence of a plan: *In re Kass*, Release No. 34-31046 (Aug. 17, 1992) and *In re Payson*, Release No. 34-50589 (Oct. 26, 2004). In *Kass* the Commission found that Mr. Kass had formed the intent to sell his group’s stock to a third party as of Sept. 6, 1990. The plan to sell was manifested by receipt of a proposed stock purchase agreement on Sept. 5, 1990, following extensive discussions and negotiations which had begun in June of 1990. Based on the finding that Mr. Kass had formed the intent to sell the stock by no later than Sept. 6, 1990, the SEC held that the amended 13Ds filed Sept. 6, 1990, and Sept. 14, 1990, were false and misleading and violated Section 13(d), Rule 13d-1 Rule 13d-2 and Rule 12b-20 due to (1) the omission

1 *In the Matter of Tracinda Corporation*, Release No. 34-58451, Administrative Proceeding File No. 3-13157 (Sept. 3, 2008). Mr. Kerkorian is the sole shareholder and director of Tracinda Corp.

2 Rule 12b-20 states: In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.

of the intent to sell the Group's stock and (2) the erroneous affirmative statement that the Group "had no present intention to do so."

Similarly, in *Payson* the SEC found that Dr. Payson had a plan to sell his Oxford stock in December 2000. It was noted that Dr. Payson began considering the sale of his Oxford stock holdings in August 2000. In December, Dr. Payson transferred his membership interests in various trusts and entities that controlled his Oxford stock holdings, resigned from both management and trustee positions in those entities, appointed new managers and trustees, and executed stock trading plans. All these actions were part of his plan to allow the sale of up to 1.1% of the Oxford shares he owned during the next open trading window. Dr. Payson's financial advisor tried to sell up to 1 million shares during the open trading window but was limited by market conditions to 590,000 shares. Based on the finding that Dr. Payson had formed the intent to sell a portion of his Oxford stock by December 2000, the SEC held that the 13D filed on Dec. 15, 2000 and the amended 13D filed on Dec. 29, 2000, violated Section 13(d), Rule 13d-1 and Rule 13d-2 by inaccurately and incompletely describing his plan to sell during the next open-trading window for Oxford corporate insiders. Therefore, in both *Payson* and *Kass*, the SEC used on objective evidence standard to determine whether there was an Item 4(a) plan to dispose of stock. It appears that the SEC applied the same "plan" standard to Mr. Kerkorian.

Books and Records

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[a stockholder] can publicly broadcast otherwise improperly obtained and confidential information." In that case, Pershing Square learned of the existence and contents of certain letters to Ceridian's board of directors, but it only learned of the letters as a result of a breach of fiduciary duty by a self-dealing executive officer. The court in *Pershing Square* also indicated that the determination of the ability to avoid confidentiality obligations and allow inspection and publishing of material would be subject to a balancing of the desire to permit open, candid communications among executives and directors without fear of disclosure versus the benefits of disclosure in the particular circumstances.²⁴ More helpful to stockholders, however, the court did clearly indicate that a "desire to investigate the 'suitability of a director'" is a proper purpose for a Section 220 demand.²⁵

III. Risk of Counter-Document Requests Through Discovery

In any action seeking an order to compel the disclosure of records under Section 220, the stockholder runs the risk that the Chancery Court will rule that the corporation has the right to discover documents in the possession of the stockholder if those documents are "reasonably calculated to lead to evidence" that would undermine the existence of a proper purpose. In *Meltzer v. CNET Networks, Inc.*,²⁶ the Chancery Court ordered the stockholders to provide to the corporation a letter in the stockholders' possession because the letter was reasonably calculated to lead to evidence that undermined the stockholders' claimed proper purpose under Section 220.²⁷ The corporation was also permitted to question the stockholders about their stated purpose.²⁸

Because the right to access documents in the hands of stockholders is based on discovery rules, this right is not triggered until application is made to the Chancery Court seeking an order compelling discovery. A corporation may have an incentive to force a stockholder seeking documents under Section 220 to seek an order if the corporation's board believes that the stockholder possesses documents that

The SEC also found that the amended Schedule 13D that Mr. Kerkorian's filed on Nov. 22, 2006, was materially misleading because it stated that he might purchase or sell more GM stock, when there was only a remote possibility that he would buy any GM stock at that time. The SEC found the disclosure to have violated Rule 12b-20, cited above.

Conclusion

The line between a tentative plan, or a desire, and a plan which is required to be disclosed, is fine indeed. Mr. Kerkorian would no doubt have argued that he desired to sell 28 million shares, but only at the right price, and that if he could not get the price he sought, then he would not have sold. And that had he held and the price dropped precipitously, that he might then have bought. One wonders what earlier disclosure he should have made in addition to the fact that he had sold 14 million shares: that he desired to sell 14 million more at a price he was satisfied to take, but that there was no assurance that in fact he would sell? Will there be a similar finding when an activist is in a consistent *buying* mode, hitting bids to add to a position? An action taken, with hindsight, should not inevitably lead to the conclusion that there was a disclosable plan to take that action far in advance of taking it. But activists must take note of this SEC action and pay careful attention when considering selling down, or adding to, a position. ■

would disprove a proper purpose.

In *Meltzer*, the corporation specifically identified a document in the possession of the stockholders. Delaware courts will not give corporations a blank check to discover *any* documents related to a proper purpose.²⁹ Doing so would be inconsistent with the Chancery Court's refusal to allow Section 220 to become a "fishing expedition." An activist investor seeking to utilize Section 220 runs the risk, after seeking an order compelling disclosure, that the corporation will demand records from the investor. However, the scope of what can be discovered from the stockholder should be limited; the corporation may need to know about a *specific* document that is "reasonably calculated to lead to evidence" of an invalid purpose.

Conclusion

Conflicts between stockholders and corporations over the past few years have given the Delaware judiciary multiple opportunities to further delineate the requirements of Section 220 demands. However, uncertainties still remain and the statutory landscape of Section 220 will undoubtedly continue to develop as "books and records" demands become more frequently used and the judiciary is presented with new structures and situations arising as a result of significant changes in the corporate world. ■

²⁴ *Pershing* at 823.

²⁵ *Pershing* at 818.

²⁶ *Meltzer v. CNET Networks*, 2007 Del. Ch. LEXIS 132 (Sept. 6, 2007) (hereinafter "*Meltzer*").

²⁷ *Meltzer* at *5.

²⁸ *Meltzer* at *5.

²⁹ See *Security First Corp. v. U.S. Die Casting and Dev. Co.*, 687 A.2d 563, 565 (Del. 1997).

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