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SEC's Proposed Proxy Access Rules and the Promise of Inexpensive Director Nominations

By David E. Rosewater and Barry McCarty

On June 10, 2009, the U.S. Securities and Exchange Commission (the "SEC") published for public comment proposed rules¹ that will, for the first time, allow long-term shareholders to nominate up to 25% of the directors by placing them on the company's proxy. If adopted, Proposed Rule 14a-11 has the potential to significantly reduce the estimated \$368,000 expense that shareholders incur for sponsoring a director-election contest.² The SEC also proposed eliminating Rule 14a-8(i)(8)'s election exclusion, which currently prohibits shareholders from submitting bylaw amendments addressing director-nomination procedures. Further, the proposal includes proxy rule exemptions and guidance that would allow nominating shareholders or groups to remain eligible for Schedule 13G. All told, the SEC proposal is a strong step towards facilitating the right of shareholders to nominate directors.

Although the proposal has certain flaws, the SEC proxy access proposal, if adopted, stands to benefit all shareholders but especially institutional investors such as union-related pension funds, which tend to be simultaneously invested in many public companies. Their investments will, either individually or collectively with those of other institutional investors, likely satisfy the proposed requirements to nominate directors on the company proxy. The ability to nominate and potentially elect directors in this fashion will change the dynamic between institutional investors and

companies. Historically, management has been able to ignore institutional investors without fear of retribution because it controlled the board-selection process and SEC proxy rules limited shareholder options. However, the SEC's recent proxy-access proposal offers large institutional investors a reasonable opportunity to nominate and potentially elect directors with significantly reduced costs. The mere fact of their potential board presence should promote a dialogue between institutional investors and management at public companies.

The following is a summary of the key requirements of Proposed Rules 14a-11 and 14a-8(i)(8), two proxy exemptions and guidance regarding Schedule 13G eligibility.

I. Proposed Rule 14a-11 Would Allow Shareholders to Nominate Directors

Companies Subject to Rule 14a-11

Rule 14a-11, which would permit shareholders to place director nominees onto the company's proxy card, applies to any reporting company subject to Section 14(a) of the Exchange Act or any investment company³ registered under Section 8 of the Investment Company Act. Those companies

¹ "Facilitating Shareholder Director Nominations," SEC Release No. 33-9046 (June 10, 2009).
<http://www.sec.gov/rules/proposed/2009/33-9046.pdf>

² Automatic Data Processing, Inc., Comment Letter dated April 20, 2006 regarding Internet Availability of Proxy Materials, SEC Release No. 34-52926 (Dec. 8, 2005).
<http://www.sec.gov/rules/proposed/s71005/ccallan1565.pdf>

Due to limited public information, it is difficult to estimate the cost of proxy contests. The SEC does require companies and nominating shareholders to estimate the cost of a proxy contest. See Item 4 of Schedule 14A. The recent Target and CSX proxy contests cost nominating shareholders an estimated \$18 million. That amount was dwarfed by the estimated \$33 million spent by management to defend against the nominating shareholders. However, the SEC does not require disclosure of the actual cost of the proxy contest.

Schulte Roth & Zabel Comments on Proxy Access

Schulte Roth & Zabel submitted its comments on the proxy access proposal to the SEC on August 14, 2009. Our comments were supportive of the proposal, and included suggestions for improvements from the perspective of investor-shareholders. Our comments may be viewed on the SEC's website at <http://www.sec.gov/comments/s7-10-09/s71009-182.pdf>

³ Registered investment companies and their nominating shareholders or groups have slightly different requirements under Rule 14a-11 including the qualifying security ownership standard (net asset test), director independence and Schedule 14N disclosures.

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would be required to include shareholder-director nominee(s) in the company proxy *unless*:

- State law or company governing documents prohibit shareholder nominations;
- The nominee’s candidacy or election would violate state law, company governing documents, federal law or stock exchange rules;
- The nominating shareholder or nominating shareholder group (“group”) has not satisfied the security ownership level⁴ requirement, continuously held those securities for at least one year from the date the nomination notice was submitted to the company and represented its intent to hold those securities through the election date;
- The nominating shareholder or group failed to timely file Schedule 14N (which provides details regarding the nominating shareholder or group and nominees) and all other required disclosures, representations and certifications by the date established by state law or company governing documents regarding the submission of director nominations. In the event there is no state law or company governing document deadline, the Schedule 14N must be filed with both the company and SEC no later than 120 days prior to the date the prior year’s proxy statement was mailed to shareholders;
- The nominating shareholder or groups’ representations and certifications in Schedule 14N were false and misleading in any material respect; or
- The nominating shareholder or group exceeded the 25% board director nominee limit.

No state currently prohibits shareholder director nominations and companies generally do not prohibit such nominations in their governing documents. But state law also allows companies to adopt a wide variety of governance procedures including with respect to proxy access. Generally, state law allows companies to condition governance procedures in ways that severely

⁴ The security-ownership requirement is 1% of the voting securities of a company that has a market capitalization of \$700 million or more consistent with SEC large accelerated filer definition; 3% of the voting securities of a company that has a market capitalization between \$75 million and \$700 million consistent with the SEC accelerated filer definition; and 5% of the voting securities of a company that has a market capitalization under \$75 million consistent with SEC non-accelerated filer definition in Rule 12b-2.

restrict shareholder rights. Common corporate governance conditions that limit shareholder rights including advance notice provisions, stock ownership requirements based on duration and amount, and information disclosure requirements. Comverse Technology Inc., incorporated in New York, is the first public company to adopt a proxy access bylaw.⁵

Shareholder Eligibility Requirements Under Proposed Rule 14a-11

Where a reporting company or registered investment company is subject to Rule 14a-11, a nominating shareholder or group must meet certain eligibility requirements to utilize Rule 14a-11. For example, the shareholder or group must beneficially own at least 1%, 3% or 5% of the company’s securities entitled to vote on the election of directors. The securities ownership percentage requirement is a sliding scale (see box) based on (1) market capitalization on the date the nominating shareholder or group submits notice on Schedule 14N of its intent to include a nominee(s) in the registrant’s proxy materials pursuant to Rule 14a-11; and (2) the nominating shareholder or group must have continuously held the securities for more than one year and must state that it intends on holding the securities through the meeting date. See Rule 14a-11(a)(3).

Market Capitalization	Ownership Threshold to Nominate
\$700 million or more	1%
At least \$75 million, but less than \$700 million	3%
Below \$75 million	5%

Note the reference to a “Schedule 14N” in the preceding paragraph. This schedule is new, but similar to the existing Schedule 13G that must be filed by the beneficial owners of more than 5% of a Section 12 registered equity security. Schedule 14N also requires certain proxy contest disclosures detailed in Schedule 14A. All told, Schedule 14N has extensive disclosure requirements and its proper completion requires the understanding and application of five related rules: Rule 14a-18, Rule 14a-19, Rule 14n-1, Rule 14n-2 and Rule 14n-3.

⁵ Comverse’s proxy access bylaw requires a shareholder to own more than 5% of its voting securities continuously for two years prior to exercising right to nominate one director on the company proxy. Comverse conditioned access on timely notice and certain informational and liability requirements. Moreover, the bylaw provided that if the nominee failed to receive at least 25% of the votes at the meeting, the nominating shareholder would be precluded from using proxy access for a period of four years. See Comverse Technology, Inc., Form 8-K filed April 23, 2007: http://www.sec.gov/Archives/edgar/data/803014/000090951807000351/mm04-2307_8k.txt

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When and What a Shareholder Must File to Include Its Nominee in Proxy Materials

If a shareholder or group is seeking to compel the inclusion of director nominee(s) in the company proxy materials, the nominating shareholder or group must file a Schedule 14N with the company and the SEC at least 120 days⁶ prior to the date that proxy materials were mailed the prior year. See Rule 14a-11(a)(4), Rule 14a-11(c), Rule 14a-18, Rule 14a-19 and Rule 14n-1.

As expected, there is significant repetition between the rules and Schedule. However, part of the overlap is due to the distinction between a federal proxy rule nomination and state law or company-governing-document nominations. Specifically, Rule 14a-18 applies to federal proxy rule nominations pursuant to Rule 14a-11. Otherwise, nominations pursuant to state law or company governing documents are covered by Rule 14a-19. In either case, Rules 14a-18 and 14a-19 have **numerous similarities**, including:

- A requirement that Schedule 14N be filed by the date specified in the company's advance notice bylaw provision or, absent such requirement, no later than 120 days before the date the company mailed its proxy materials for the prior year's meeting.
 - A statement from the nominee that he or she consents to being named in the company's proxy statement and proxy and, if elected, will serve on the company's board of directors.
 - Disclosure about the nominee as would be provided in response to the disclosure requirements of Items 4(b), 5(b), 7(a), (b) and (c) of Schedule 14A.
 - Disclosure about the nominating shareholder or each member of the group as would be required in response to the disclosure requirements of Item 4(b) and 5(b) of Schedule 14A.
 - Legal proceedings disclosure regarding the nominating shareholder or each member of the group for the last five years consistent with Item 401(f) of Regulation S-K.
 - Instructions that detail look-through requirement to determine who must provide disclosure for items 4 and 5 above.
- Relationships between nominating shareholder or group and nominee and company and affiliates, including (1) direct or indirect material interests in any contract or agreement, (2) any material pending or threatened litigation, and (3) any other undisclosed material relationship.
 - Website address on which nominating shareholder or group may publish soliciting materials.

Compare Rule 14a-19(a) through (f) with Rule 14a-18(e) and (g) through (k).

Rule 14a-18, the federal proxy rule nomination procedure, is more demanding than Rule 14a-19, the state law or company governing document nomination procedure, because the former requires these **additional items**:

- A representation that, to the knowledge of the nominating shareholder or group, the nominee's candidacy or, if elected, board membership would not violate controlling state law, federal law or exchange rules.
- A representation that the nominating shareholder or group satisfies the conditions of Rule 14a-11(b).
- A representation that the nominee(s) meets the objective criteria for "independence" of the national securities exchange or national securities association rules applicable to the company.
- A representation that neither the nominee nor the nominating shareholder or any member of the group has an agreement with the company regarding the nomination.
- A statement that the nominating shareholder or group intends to continue to own the requisite shares through the date of the meeting of shareholders. Additionally, the nominating shareholder or group must provide a statement with respect to continued ownership after the election.
- Any statement in support of the shareholder nominee(s), which may not exceed 500 words, if the nominating shareholder or group elects to have such statement included in the company's proxy materials.

⁶ If neither state law nor company governing documents address notice requirement for director nominations, the default deadline is 120 days prior to the date the company mailed its proxy materials for the prior year's meeting. However, this deadline is an end point and leaves open the question of how early nominating stockholders may submit a Schedule 14N. The SEC has proposed a "race to the mailbox" test, which is a significant flaw.

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Compare Rule 14a-18(a) through (d), (f) and (l) with Rule 14a-19.

Item 6 of Schedule 14N requires nominating shareholders or groups to provide Rule 14a-18 disclosures, representations and statements. Similarly, Item 7 of Schedule 14N mandates that nominating shareholders or groups provide Rule 14a-19 disclosures, representations and statements.

Schedule 14N

Schedule 14N's cover page and its Items 1 through 3 disclosures are similar to what Schedule 13G requires,⁷ including core information such as the identity of the nominating shareholder or each member of the group and the amount and percent of securities owned by the nominating shareholder or each member of the group.

Beyond this core information, the major remaining requirements of Schedule 14N are the Item 5 statement of ownership and Item 8 certification. Item 5(a) requires the nominating shareholder(s) to document their ownership of the requisite amount of securities. If the shareholder(s) are record owners a simple confirming statement is required. Otherwise, bank or brokerage statements attesting to the shareholder(s)' ownership should be submitted with the schedule. If the shareholder has filed a Schedule 13D, Schedule 13G or Form 3, 4 or 5 those documents may be attached or incorporated by reference.

In addition, the shareholder must prove that he has continuously held the securities for more than one year. See Item 5(a) of Schedule 14N. Further, the shareholder(s) must provide a written statement that they intend to continue to own the requisite shares through the date of the meeting of shareholders and intent with respect to continued ownership after the election. See Item 5(b) of Schedule 14N.

Finally, Item 8 of Schedule 14N requires nominating shareholder(s) to certify no control intent. Specifically, the schedule requires the following verbiage:

By signing below I certify that, to the best of my knowledge and belief, the securities referred to

above are not held for the purpose of or the effect of changing control of the issuer of the securities or to gain more than a limited number of seats on the board.

Signatures and Item 8 certifications are required by each filing person or their authorized representative.

Exclusion Process Regarding Nomination Submissions

Rule 14a-11(f) sets forth the process by which eligibility issues relating to shareholder nominations will be determined. The process is similar to the existing Rule 14a-8 shareholder proposal process. Surprisingly, the SEC estimated that only 20% of the shareholder nominations would be challenged by companies,⁸ and that 90% of the shareholder nominations would be included in the company proxy materials.⁹ The following is required to challenge a nomination:

- Once a nominating shareholder has submitted its Schedule 14N to the company and SEC, the company has 14 calendar days to consider and challenge the nomination. See Rule 14a-11(f)(3).
- The company must provide the nominating shareholder(s) an explanation of the basis for determining that it may exclude the nominee(s). See Rule 14a-11(f)(4).
- The nominating shareholder has 14 calendar days after receipt of the exclusion notice to cure or correct any deficiencies identified by the company. See Rule 14a-11(f)(5).
- Generally, neither a nominee nor the members of the nominating shareholder group may be changed to remedy identified deficiency. See Rule 14a-11(f)(6). However, inadvertent excess nominees may be remedied. Companies seeking to exclude nominations must submit a notice to the SEC at least 80 calendar days prior to filing its definitive proxy materials. See Rule 14a-11(f)(7). The notice must: (1) identify the nominating shareholder or each group member, (2) identify the excluded nominee(s), (3) include an explanation of the basis for excluding the nominee(s) and (4), if applicable, include an opinion of

⁷ Rule 14n-1 requires nominating shareholder or groups to file Schedule 14N with the SEC and send a copy to the company. Rule 14n-2(a) requires the nominating shareholder or group to promptly amend Schedule 14N if the information contained or required has changed in any material respect. In addition, Rule 14n-2(b) requires nominating shareholder or groups to amend their Schedule 14N within 10 calendar days of the announcement of the final election results by the company to state their intent with regard to continued ownership of their shares. Rule 14n-3 requires the nominating shareholder or group to send a copy of the Schedule 14N to the company by registered or certified mail. Similarly, Rule 14n-3 requires the nominating shareholder to send three copies of the Schedule 14N to each national securities exchange where the securities are listed.

⁸ See SEC Proposing Release text at footnote 310.

⁹ See SEC Proposing Release text following footnote 306.

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counsel supporting state law claim as basis for exclusion. See Rule 14a-11(f)(8).

- The company has the burden of proof for any exclusion under Rule 14a-11. See Rule 14a-11(f)(9).
- The company must provide the nominating shareholder or group with a copy of its notice to exclude simultaneously with the SEC filing. See Rule 14a-11(f)(10).
- The nominating shareholder or group may submit a response to the company's notice to the SEC. Such response must be filed with the SEC no later than 14 calendar days after the nominating shareholder or group's receipt of the company notice. The shareholder or group must simultaneously provide the company with a copy of the response filed with the SEC. See Rule 14a-11(f)(11).
- The SEC staff may provide its views to the company and nominating shareholder or group. See Rule 14a-11(f)(12).
- Companies are required to provide notice to the nominating shareholder or group no later than 30 calendar days prior to the mailing of the definitive proxy materials whether the nominee(s) will be excluded. See Rule 14a-11(f)(13).

II. Proposed Amended Rule 14a-8(i)(8) Would Allow Shareholders to Propose Director-Nomination Bylaws

The SEC is proposing to amend Rule 14a-8(i)(8) to allow shareholders to propose director nomination bylaws or amendments to a company's governing documents that affect director nomination procedures. This amendment, if adopted, will reverse a long-standing SEC position allowing companies to exclude any shareholder proposal that implicated director elections.

As proposed, Rule 14a-8(i)(8) would only allow companies to exclude shareholder director nomination bylaw proposals that:

- Disqualify a nominee who is standing for election;
- Remove a director from office before his/her term expires;
- Question the competence, business judgment, or character of one or more nominees or directors;
- Nominate a specific individual for election to the board of directors, other than pursuant to Rule 14a-11, state law or company's governing documents; or

- Otherwise would affect the outcome of the upcoming election of directors.

The SEC's proposing release makes it clear that Rule 14a-8(i)(8) bylaws cannot conflict with Rule 14a-11 nominations or applicable state law. Therefore, shareholders may propose director-nomination procedures that are less stringent than Rule 14a-11 (e.g., a lower ownership threshold, shorter holding period or, possibly, a greater number of director nominees). However, the SEC indicated that director-nomination bylaws have limits, such as when they "result in an election contest between a company and shareholder nominees without the important protections provided by the disclosure and liability provisions otherwise provided for in the proxy rules." It is unclear whether the SEC will provide further guidance regarding the limits on nomination bylaws.

III. New Proxy Rule Exemptions for Nominating Shareholders

The proposing release includes two new proxy rule exemptions to facilitate shareholder nominations. One is designed to make it easier to form a shareholder group. The other liberalizes the solicitation process for the group seeking support for their nominees. Both require public filing with the SEC on the date of first use.

Proposed Rule 14a-2(b)(7), the exemption for group formation, has several substantive requirements and limitations. To qualify for the exemption that permits shareholders interested in forming a nominating group to approach other shareholders without violating the proxy rules, one must:

- Put in writing a shareholder's intent to form a Rule 14a-11 nominating group;
- Limit the written statement of each soliciting shareholder's intent to form a nominating shareholder group in order to nominate a director under Rule 14a-11;
- Identify, and a brief statement regarding, the potential nominee(s) or, where no nominee(s) have been identified, the characteristics of the intended nominee(s), if any;
- Disclose the percentage of securities that each soliciting shareholder beneficially owns or aggregate percentage owned by any group to which the shareholder belongs; and
- Disclose the means by which shareholders may contact the soliciting party.

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In addition, the written notice must be sent to the national securities exchanges where the securities are listed and registered. It is important, however, to note that if a nominating shareholder or group limits its solicitation to ten persons or less such solicitation is exempt from the proxy rules and need not comply with proposed Rule 14a-2(b)(7).

The exemption for nominee(s) supporting solicitations, Proposed Rule 14a-2(b)(8), also has substantive requirements and limitations. These include:

- The soliciting party does not, at any time during the solicitation, seek directly or indirectly, the power to act as proxy for a shareholder and does not furnish or request a form of revocation, abstention, consent or authorization;
- Each written communication includes the identity of each nominating shareholder and a description of his direct or indirect interests, by security holdings or otherwise;
- A prominent legend in clear, plain language advising shareholders that a shareholder nominee is or may be included in the company's proxy statement and to read the company's proxy statement when it becomes available because it includes important information. If the proxy statement is publicly available so state and encourage shareholders to read that document because it contains important information. The legend also must explain to shareholders that they can find the company's proxy statement and other relevant documents at no charge on the SEC website; and
- Any soliciting material published, sent or given to shareholders must be filed with the SEC on the date of first use and copies sent to each national securities exchange where the securities are listed and registered.

Certainly, both exemptions provide some relief to nominating shareholders' or groups' efforts to exercise the fundamental right to nominate and possibly elect director nominees.

IV. Nominating Shareholders Eligible for Schedule 13G

Even though Rule 14a-11's stock ownership requirements are generally below the Section 13(d) threshold of more than 5% of a Section 12 registered equity security, the SEC expects a certain number of nominating shareholders and groups to exceed 5%.¹⁰ Therefore, nominating

shareholders and groups that in aggregate exceed 5% would be required to file either a Schedule 13D or, if eligible, Schedule 13G.

Historically, the SEC considered the act of nominating directors evidence of a control intent. Therefore, shareholders who nominated directors were ineligible for Schedule 13G, which requires passive investment. The proposing release changes this historical SEC approach to control by allow nominating shareholders or groups to be eligible for Schedule 13G. This position is based on Rule 14a-11's certification of no control intent by the nominating shareholder or group over the issuer. This certification is similar to the Schedule 13G passive investor certification. In addition, Rule 14a-11 and Schedule 14N requires nominating shareholders to certify they are seeking "no more than a limited number of seats on the board."

It is important to note that nominating shareholders or groups may not be eligible for Schedule 13G if they pursue a nomination under state law or company governing documents. The SEC based this distinction on the possibility that nominating shareholders may not be required to limit the number of board nominees, certify a lack of intent to change control or gain more than a limited number of board seats as required by the Rule 14a-11.¹¹

In addition, if a nominating shareholder is elected pursuant to Rule 14a-11, he or she "would most likely be ineligible to continue filing on Schedule 13G because of [her] ability as a director to directly or indirectly influence the management and policies of the company."¹²

Conclusion

The SEC's proxy access proposal is a strong step towards facilitating the shareholder's right to nominate directors. Rule 14a-11 will allow certain long term shareholders to nominate up to 25% of the directors by way of the company proxy. This new rule should reduce the cost to shareholders of nominating a director. In addition, eliminating Rule 14a-8(i)(8)'s election exclusion, proxy rule exemptions and Schedule 13G guidance will encourage shareholders to exercise the shareholder franchise.

The proposal has flaws, but the SEC proposal certainly enhances the rights of shareholders. Once the rule is made final (assuming that it will be), we would expect to see a significant increase in the nomination of director candidates by shareholders.

¹⁰ See text preceding footnote 278, SEC Release No. 33-9046.

¹¹ See text following footnote 281 of SEC Release No. 33-9046.

¹² Footnote 281 of SEC Release No. 33-9046.

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Regardless, if adopted, the SEC proxy access proposal benefits all shareholders but especially institutional investors such as union-related pension funds. These large pension funds tend to be simultaneously invested in many public companies and have worked for decades to establish a dialogue with public companies and their management. Proxy access should make management more responsive to institutional investors who, individually or collectively, have the ability to nominate and elect directors.

To a lesser extent, proxy access will also benefit social-issue and activist investors. Social-issue investors generally promote issues, such as diversity or global warming and corporate policies fostering those issues rather than nominating directors. Typically, social-issue investors do not have as large an investment in a company as do the large pension funds. It is possible that social-issue investors may utilize proxy access in order to make it more difficult for companies and/or their fellow shareholders to ignore their concerns.

Activist investors, on the other hand, are generally motivated primarily by potential value, and proxy access may be useful in providing a less expensive avenue into the boardroom. However, certain aspects of proxy access are problematic for activists. For example, the “race-to-the-mailbox” test used in the rule to determine which shareholder or group is permitted to use the company’s proxy for their director nomination would create uncertainty in an activist’s approach to a particular company. In addition, the activist may want to nominate more directors than the 25% cap imposed by Rule 14a-11. Lastly, Rule 14a-11 limits the ability to solicit proxies and prohibits shareholders from seeking a change in control. Based on the foregoing, large pension funds could be expected to be the primary beneficiaries of SEC’s proxy access proposal. ■

SEC Enforcement: Enhanced 13(d) Scrutiny and Merger Arbitrage

By Eleazer Klein and Clara Zylberg

On July 21, 2009, the U.S. Securities and Exchange Commission (the “SEC”) announced that it had entered into a settlement with Perry Corp., a New York-based registered investment adviser to five private investment funds, in connection with the SEC’s claim that Perry failed to timely file a Schedule 13D disclosure statement pursuant to Section 13(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and Rule

13d-1 thereunder. In its order (the “Order”),¹³ the SEC accused Perry of failing to timely report its beneficial ownership of more than 5% of the shares of common stock of Mylan Inc. (f/k/a Mylan Laboratories Inc.). In general, beneficial owners¹⁴ of more than 5% of a voting equity security registered under Section 12 of the Exchange Act must report their beneficial ownership either on Schedule 13D or, if eligible, on a short-form Schedule 13G within 10 days after crossing the 5% threshold. Rule 13d-1(b), on which Perry relied, allows certain institutional investors to defer filing a Schedule 13G until 45 days after the end of a calendar year if they continue to own more than 5% as of the end of the year.

According to the Order, Perry engaged in “merger arbitrage,” a trading strategy by which Perry desired to profit from Mylan’s announced agreement to acquire King Pharmaceuticals Inc. by purchasing shares of King and selling short a corresponding number of shares of Mylan. As part of this strategy, the King shares would be exchanged for Mylan shares if the merger was consummated and Perry could use these Mylan shares to cover its short sales. As a result, Perry presumably would profit from the “risk arbitrage spread” created when the securities of an acquiring company (Mylan) trade at a higher price than the shares of the issuer it is attempting to purchase (King). This pre-merger spread typically reflects market uncertainty about the likelihood of the consummation of the transaction with the spread widening if there are indications that the merger will not be completed and narrowing as confidence grows that the merger will be completed.

The SEC alleged that Perry was concerned about losing its anticipated profits from the merger arbitrage because of opposition to the merger from an activist investor that became known after Perry’s initial risk-arbitrage trades. In reaction to this threat, Perry allegedly sought to purchase Mylan shares in order to obtain more voting rights to counter the activist investor’s opposition. The SEC accused Perry of purchasing these shares without any public disclosure through a Schedule 13D filing to increase its return on its merger arbitrage strategy, and of limiting its economic exposure to Mylan’s common stock by entering into swap agreements with certain banks to insulate itself from any decrease in the market price of Mylan common stock.

¹³ *In the Matter of Perry Corp.*, Release No. 34-60351, Administrative Proceeding File No. 3-13561 (July 21, 2009).

¹⁴ A beneficial owner of a security is defined in Rule 13d-3(a) of the Exchange Act as including “any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares” voting power and/or investment power with respect to such security. Voting power includes the power to vote, or to direct the voting of, a security, whereas investment power includes the power to dispose, or the power to direct the disposition, of a security.

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The Order stated that Perry was initially advised by outside counsel to defer reporting its beneficial ownership of Mylan shares in reliance on Rule 13d-1(b). Rule 13d-1(b) allows for deferred reporting only if the securities were acquired by a qualified institutional investor (i) in the “ordinary course of his business” and (ii) “not with the purpose nor with the effect of changing or influencing the control of the issuer.” According to the Order, Perry was not entitled to the extended filing deadline of a qualified institutional investor since Perry did not purchase the Mylan shares in the “ordinary course of his business.” This is the first time that the SEC has provided any significant insight into the “ordinary course of business” prong of Rule 13d-1(b). According to the Order, the SEC narrowly interprets “ordinary course of business” to mean routine business operations that are either for “passive investment” or “ordinary market making purposes.” As the following excerpt from the Order also makes clear, it is the SEC’s view that a qualified institutional investor could never satisfy the “ordinary course of business” requirement when purchasing shares in order to vote the shares in favor of a proposed transaction or to otherwise influence an issuer or the outcome of a transaction:

Irrespective of whether transactions of this type are routine for an institutional investor, reliance on Rule 13d-1(b)(1)(i) based on the “ordinary course of business” provision is inappropriate when transactions of the type executed by Perry are undertaken. The exception to the ordinary 10-day disclosure requirements of Section 13(d) for qualified institutional investors is available only where such investors are acquiring securities for passive investment or ordinary market making purposes as part of their routine business operations.

It is interesting to note that a literal reading of Rule 13d-1(b)(1)(i), which provides for acquisitions in the “ordinary course of *his* business” (emphasis ours), suggests that appropriate consideration should be given to the investment strategy of a particular investor. This suggests the possibility that the prong would be satisfied if the investor is in the business of buying shares solely for the purpose of influencing a shareholders vote. The SEC made clear in the Order, quoting from the legislative history of the provisions of Section 13(d), that its position is that “ordinary course of business” is to be determined “irrespective of whether transactions of this type are routine for an institutional investor” and that it requires either passive investment or ordinary market making activities.¹⁵

Also of interest in the Order is that the SEC did not determine that Perry was required to file a Schedule 13D because it had acquired the Mylan shares with the purpose or effect of changing or influencing control of the issuer, the second prong of the Rule 13d-1(b) test. Presumably, this was because Mylan was the acquiring entity in the proposed merger and would not have undergone a change of control had the merger gone through. Seemingly, the SEC did not want to argue that buying shares solely with the purpose of affecting the outcome of a vote to approve a merger transaction fails to satisfy the Rule 13d-1(b)(1)(i) requirement to not acquire the shares “with the purpose nor with the effect of changing or influencing the control of the issuer.” Ostensibly, the SEC would have needed to address difficult change of control issues for an acquiror in a merger. Therefore, in this case, it is difficult to conclude that an investor such as Perry would be a “passive investor,” the rule itself does not contain a pure “passive” standard. Instead, the SEC chose to introduce a passive intent requirement in the “ordinary course of business” prong. Of course, this prong of the rule does not actually state a passive intent requirement either and, as a result, the interpretation blurs the two prongs of the 13d-1(b) test and may be subject to challenge.

The basic concept that a risk arbitrageur is not a passive investor and cannot defer filing a Schedule 13G until 45 days after the end of a calendar year but instead must file a Schedule 13D within 10 days of crossing the 5% threshold, was previously articulated by the SEC in a no-action letter.¹⁶ In *Faith Colish*, the SEC stated that acquisitions of shares of target entities by professional risk arbitrageurs, when made after a public announcement of a tender offer or a proposed tender offer, are made in connection with a transaction which, if consummated, would have the effect of changing control of the issuer, and that such acquisitions thereby fail to satisfy the basic requirements of one of the prongs of Rule 13d-1(b). And, in fact, the Order in *Perry* states that when the activist investor announced an intention to launch a tender offer for Mylan shares, Perry did file a Schedule 13D within 10 days thereafter based on its voting rights in Mylan stock.

What is unclear after the *Perry* Order is whether the SEC’s focus on the “ordinary course of business” prong leaves the door open for an investor in similar circumstances to rely on Rule 13d-1(c) and file a short-form disclosure statement on form Schedule 13G within 10 days of crossing the 5% threshold, rather than filing a Schedule 13D. A Schedule 13G filed pursuant to the passive investor

¹⁵ The SEC does provide earlier in the Order that “Perry had never before engaged in a similar strategy to acquire voting rights to a security in order to vote those shares in a merger, without having

any economic interest in the shares,” but does not appear to rely on this in its analysis.

¹⁶ *Faith Colish*, SEC No-Action Letter (March 24, 1980).

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requirement of Rule 13d-1(c) is not subject to an “ordinary course of business” requirement, since the Rule only includes the requirement that the investor not have acquired the shares with the purpose or effect of changing or influencing the control of the issuer. In light of the SEC’s interpretation of “ordinary course of business,” it is unlikely that activities similar to those in the Order would be viewed by the SEC as being eligible for filing on Schedule 13G. If faced with these facts, it will be interesting to see if the SEC feels compelled to argue that passive intent also is inherent in the requirement not to acquire the shares with the purpose or effect of changing or influencing control of the issuer.¹⁷

Finally, it is important to note that this Order also impacts compliance with Section 16 of the Exchange Act. Rule 16a-1(a)(1) exempts certain qualified institutional investors who acquire more than 10% of equity voting securities registered under Section 12 of the Exchange Act from the coverage of Section 16 if they satisfy the “ordinary course of business” requirement as well as the requirement not to acquire the shares with the purpose or effect of changing or influencing control of the issuer. Therefore, if an investor is found not to have acquired shares in the ordinary course of business for purposes of Section 13, it not only will affect the investor’s eligibility to file a short-form disclosure statement on Schedule 13G by the extended deadline of 45 days after the end of a calendar year, but will also jeopardize the investor’s ability to rely on the exemption provided in Rule 16a-1(a)(1).

The activities at issue in this case were one of the earliest instances where concerns over so-called “empty voting” rights were raised. The term “empty voting” refers to situations where a person holding voting rights in connection with a shareholder vote has no economic stake in the shares being voted.¹⁸ The issue has been much discussed in academic literature and the press and this scrutiny may have contributed to the SEC’s decision to take this enforcement action.

The SEC determined in its Order that Perry was required to file a Schedule 13D within 10 days of acquiring 5% of the outstanding shares of Mylan, and that it failed to do so. Perry, for its part, without admitting or denying any of the SEC’s findings, agreed to a civil penalty of \$150,000, censure, and

a cease-and-desist order from any future violations of Rule 13(d).

The SEC’s actions in this proceeding demonstrate the agency’s continued monitoring of filing requirements under Section 13(d) and signal investor exposure to having their reporting determinations challenged by other investors with differing interests. Investors should be aware that engaging in risk arbitrage and related activities can have important consequences regarding their compliance with the disclosure requirements of Sections 13(d) and 16 of the Exchange Act and their ability to rely on the deferred filing of a short-form disclosure statement on Schedule 13G pursuant to Rule 13d-1(b). ■

‘Poison Puts’ and the Shareholder Franchise The Lessons of *San Antonio Fire v. Amylin*

By Marc Weingarten and Nicholas R. Tomasetti

An important consideration for an activist investor seeking board representation through a proxy contest is whether there exist restrictive provisions in any agreements to which the target company is a party. Prior to proceeding with a proxy contest, the activist investor must ascertain whether such third-party agreements contain “change-of-control” or similar provisions which, if triggered by the activist’s successful election of its slate, could have a negative impact on the company. The context in which this issue most often arises is with regard to so-called “golden parachute” provisions in key-person employment agreements and “change-of-control” events of default in debt instruments, such as a company’s credit facilities or indentures. If a change-of-control default would be triggered under such debt instruments, the result most often is that the debt instruments become immediately due. This issue typically arises only where an activist seeks to elect a majority slate, as a change in the majority of a board’s composition may trip such provisions. The triggering of default provisions in credit facilities and/or indentures can have material adverse effects on a company if refinancing is not readily available. The Delaware Chancery Court was recently faced with this issue in the case of *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc., et al.*, C.A. No. 4446-VCL (2009).

Background of the Litigation

The *Amylin* case arose in the context of two different activists nominating two independent short slates for seats on the twelve-person board of directors (the “Board”) of Amylin Pharmaceuticals, Inc. (“Amylin” or the “Company”). Icahn Partners LP

¹⁷ In the case of the Order, the SEC ruled that since Perry never filed a Schedule 13G pursuant to Rule 13d-1(c), it was legally precluded from claiming that it was still eligible to file on Schedule 13G instead of Schedule 13D.

¹⁸ For example, this can arise through borrowing shares with voting rights before a record date or through acquiring a large voting block of stock while swapping out the economic exposure to the shares.

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and affiliates ("Icahn"), holder of approximately 8.8% of Amylin's shares nominated a five-person slate, as did Eastbourne Capital Management, L.L.C. ("Eastbourne"), holder of approximately 12.5% of Amylin's shares. If both slates were to be successful, the practical result would be that the majority of the Board's composition would change.

Pursuant to the Company's indenture for its 3.00% convertible senior notes due 2014 (the "2007 Notes"), dated June 8, 2007 (the "Indenture"), the noteholders have the right to demand redemption of any or all of their notes at face value in the event of, among other things, a "Fundamental Change" as defined in the Indenture. A "Fundamental Change" will be deemed to have occurred if, at any time, the "Continuing Directors" do not constitute a majority of the Board. As defined in the Indenture, "Continuing Directors" are:

- (i) individuals who on the Issue Date constituted the Board of Directors and
- (ii) any new directors whose election to the Board of Directors or whose nomination for election by the stockholders of the Company was approved by at least a majority of the directors then still in office (or a duly constituted committee thereof) either who were directors on the Issue Date or whose election or nomination for election was previously so approved.

The issue became whether the activists' nominees, if elected, could be considered "Continuing Directors" or, alternatively, whether their election would trigger a default under the Indenture, thus making the 2007 Notes immediately due and payable. Litigation was ultimately filed by the San Antonio Fire & Police Pension Fund alleging breaches of the fiduciary duties of care and loyalty by the Board for, among other things, approving the "Fundamental Change" provision of the Indenture; and seeking, among other things, a declaration that the "Continuing Directors" provision was invalid.

The litigation was partially settled on April 13, 2009, with Amylin agreeing that, if the court determined it had the contractual right to do so, it would "approve" (as that term was used under the Indenture) the Icahn and Eastbourne nominees, and San Antonio Fire agreeing to discontinue the bulk of its claims against Amylin and the Board. At this stage in the litigation, Amylin, in an effort to resolve conclusively the issue of whether it had the right to approve such directors with respect to the Indenture, and in an attempt to resolve the impact the election of the activists' nominees would have

under the Company's credit facility,¹⁹ brought in as third-party defendants both the trustee under the Indenture and the administrator under Amylin's senior secured credit agreement.

Shortly thereafter, in early May 2009, Eastbourne and Icahn each announced that they had reduced their respective slates—to three nominees in the case of Eastbourne and two nominees in the case of Icahn. As the election of all of these nominees would not give rise to a change-of-control as defined in the Indenture, the Indenture trustee argued that the case was no longer ripe. The court, however, proceeded to a determination as to whether the Board had the power and the right under the Indenture to "approve" the stockholder nominees.

The Indenture trustee argued that a board cannot "approve" stockholders' nominees which the company publicly opposes and against whom it recommends its own competing slate. However the court found that a board could "approve" stockholders' nominees without endorsing them, reasoning in part that to find otherwise would sanction a provision with "an eviscerating effect on the stockholder franchise," forcing stockholders to vote for management's board nominees and thereby entrenching incumbent management. The court then turned to the question of whether the Amylin Board had in fact approved the stockholder nominees in accordance with its contractual duty of good faith and fair dealing, and held that it could do so if it "determines in good faith that the election of one or more of the dissident nominees would not be materially adverse to either the interests of the corporation or its stockholders." The court then stated that the record of the Board's deliberations was inadequate, and declared the issue "unripe" pending the outcome of the election and its aftermath.

'Poison Puts'

One of the most encouraging aspects of the opinion was its criticism of the "poison put" provisions so commonly found in indentures and debt documents. The inclusion of such provisions has long been the subject of "a wink and a nod" between the lenders and underwriters who include them as boilerplate and the issuers who are happy to have an entrenchment defense handed to them. The provision has become so routine that in Amylin's case, its existence was, unsurprisingly, neither brought to the attention of the Board nor

¹⁹ The change-of-control event of default in the credit agreement was clear that an individual whose nomination or assumption of office as a director resulted from an actual or threatened proxy solicitation by a person other than the Board could not be counted as a continuing director. The claims under the Credit Facility were then mooted when the bank lenders agreed to waive the change-of-control event of default, in exchange for a fee.

'Poison Puts' continued from previous page

discussed by it before it approved the Indenture and debt documents. Amylin's CEO and CFO both admitted that they had no idea of the existence of these provisions in Amylin's material contracts until they were raised in the proxy contest.

Yet the court indicated that its contractual interpretation was influenced by the fact that such provisions "can operate as improper entrenchment devices that coerce stockholders into voting only for persons approved by the incumbent board"; that they raise concerns relating to the board's fiduciary duties in agreeing to them (suggesting that the board should get "extraordinarily valuable economic benefits" not otherwise available to it in exchange for agreeing to their inclusion); and that they "might be unenforceable as against public policy". The court warned outside counsel to boards to "be especially mindful of the board's continuing duties to stockholders to protect their interests" and to highlight these provisions to their board clients to enable them to exercise their fully informed business judgment.

It will be interesting to see whether lending practices, and board deliberations and decisions, change as a result of this opinion. Boards may be hard-pressed to show that they obtained "extraordinarily valuable economic benefits" in trade for including the poison put. Lenders and underwriters may insist on the more restrictive, and entrenching, poison put provision found in Amylin's credit agreement rather than the "weaker" form in the Indenture. And board minutes will no doubt be dressed with the due consideration given by the board to its agreement to the poison put terms.

The Standard for Denial of Approval

Another interesting aspect of the decision is the standard adopted by the court for a board's decision on whether to "approve" stockholder nominees: it must determine in good faith that the election of "one or more" of the stockholder nominees would not be "materially adverse to the interest of the corporation or its stockholders." Could a board determine that the election of one or two would be okay but all five would be materially adverse, and then proceed to "approve" the nominees it least disfavored? It is curious that a board would determine whether the stockholder nominees' election would be adverse to the interest of stockholders when the stockholders would be voting on that very question in the proxy contest. And is a difference in view as to how to operate, or sell, a company enough to be "materially adverse"? The court gives no guidance as to the standards to be applied in making such a determination, and future courts will no doubt give substantial deference to the directors' judgment on the matter, even though they're making a self-interested, even "entrenching," decision.

Conclusion

The *Amylin* court, having determined that the controversy was not ripe for adjudication, indicated that the plaintiff or Amylin would be free after the annual meeting to replead its case that the stockholder nominees, if in fact elected, are Continuing Directors by virtue of Amylin's "approval." At Amylin's annual meeting, the stockholders elected ten directors proposed by management and one each proposed by Eastbourne and Icahn. The status of the stockholder-nominated directors as Continuing Directors therefore will only become relevant if there is an election contest again at Amylin next year as a result of which management-proposed directors cease to constitute a majority of the board. Meanwhile, Vice Chancellor Lamb, who decided the *Amylin* case, has stepped down from the Chancery Court bench. So we are left with the court's criticism, in dicta, of "poison put" practice in a case unlikely to be revived. ■

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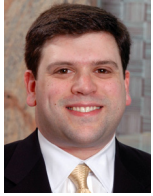
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