

activist investing developments

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Proxy Contest Settlement Agreements: An Overview

By David E. Rosewater and Nicholas Tomasetti

ALTHOUGH INTENSE PROXY CONTESTS are what attract attention in activist situations, most potential contests are resolved in advance of a fight through settlement agreements. Settling a potential contest allows both the activist investor and the company to avoid significant drains on their resources—both time and money—while at the same time providing additional mutual benefits.

Such agreements typically have four basic components: (a) the actions to be taken by the company, (b) the standstill agreement of the activist, (c) the other agreements made by the activist for the benefit of the company, which can be further broken down into issues relating to securities purchases and issues related to corporate governance and (d) other material terms. This article explores these basic components, and also addresses some of the most common issues and considerations that arise in connection with such agreements.

Company Actions: Board Seats and Other Strategic or Governance Concessions

The goal of activist investors in a proxy contest is to enhance shareholder value by obtaining seats on the target company's board of directors and/or effecting changes in the company's policies. However, the mere grant of board seats in a settlement agreement leaves open certain issues that can significantly impact the effectiveness of those board seats for the activist's purposes or create loopholes for the company to disenfranchise the new directors in various ways, should they choose to do so.

Typical issues include the appointment of the new board members to various committees and how quickly the activist's selected appointees will take office after the settlement agreement is concluded. The issue of appointment to committees is obviously important because of the critical nature of the work done by a number of them, such as the audit, compensation and governance committees. Without a commitment on the part of the company to appoint the activist's candidates to the board's various committees, it is under no obligation to do so—and given that most settlements are for only a small minority of seats on the board, it may well choose to bypass those members for committee appointments. In fact, under state corporate law, it is often the case that a much wider range of board decisions can be delegated to board committees than is commonly done, if the board so chooses. Therefore, having the right to have a seat on future committees is necessary to avoid the possibility of being disenfranchised altogether on certain issues.

With respect to the timing of director appointments, it is common for the target company to seek to delay the appointment of the activist's nominees until at, or immediately following, the next annual meeting rather than concurrently with execution of the settlement agreement. Because the annual meeting may not occur for weeks, or even months, after the settlement, this can create a problem for activists, as much can be done or undone by the company during that period, without input from the new board members. Although a frequently offered reason for delayed appointments is that companies prefer not to embarrass existing board members by forcing them to resign to make room for activist nominees, this problem can be resolved by the company agreeing to expand the board temporarily to add an activist's nominees, and then returning it to the original size for the next annual meeting election.

Other issues to consider when a director is appointed in a settlement agreement include whether the activist investor has the right to appoint a replacement director in the event that their appointed director steps down or becomes incapable of continuing service, and under what circumstances, if any, the activist-appointed director will be required to resign entirely from the board.

There is a broad range of strategic alternatives and/or policy changes for activists to push for and which they choose to pursue is based on very fact-specific circumstances. Strategic alternatives that are often proposed include stock buybacks, leveraged recapitalizations, sale of all or part of the company, and special dividends. Policy changes can range from basic issues of corporate governance, such as forming a board committee to review certain practices, separation of the CEO and chairman roles, and revising standards for calling special meetings, to a more aggressive change such as agreeing to begin a search for a new chief executive officer. The settlement agreement will typically set forth the parameters of what, how and when changes or alternatives will be effectuated.

Standstill Duration

The duration of the "standstill" period (i.e., the period during which an activist agrees to refrain from certain activities with respect to influencing the control and/or policies of the issuer) varies by agreement. The first issue to be resolved is whether its termination will be event-driven or time-driven. For example, an event-driven termination would be where the standstill period lasts only so long as certain agreed-upon conditions are in effect, such as until the activist's nominees are no longer board members. However, a time-

driven termination (i.e., one with a definite expiration date) is often preferred by the activist because it allows the activist to consider its alternatives again at a discernible point in the future, for example, in the event that company performance has not, in the activist's view, sufficiently improved. Conversely, a standstill running for a potentially infinite period (e.g., for so long as an activist has directors appointed to the target's board) could diminish the influence of the activist with respect to shaping the company's policies and, by extension, its performance.

Assuming that the standstill period selected is one with a definite, non-event driven termination, the obvious question is the length. Activist investors in this situation generally keep an eye towards the future, namely, they want to keep the doors open for resurrecting the proxy contest at some point in the future in the event that the target company does not make prudent decisions and/or improve its performance. A typical time frame is one year, sometimes more, usually expiring shortly before the deadline for the giving of notice to bring director nominations prior to the company's next annual meeting (or, in the event of a two year period, the annual meeting that is scheduled to occur in two years). Thus, the duration language regarding the standstill period often tracks the requirements in a target company's advanced notice bylaws regarding the delivery by a stockholder of a notice of intent to nominate directors.

Standstill Types

Typically, there are two types of "standstill" provisions that can impact upon the activist investor: the share ownership standstill and the corporate governance standstill. Although a standstill agreement need not include both prohibitions, often both will be present. Share ownership standstill provisions will often prohibit the investor from acquiring any voting securities of the target company, with limited exceptions that are typically negotiated items and fact-specific, but which may permit the entry into swap agreements as well as the ability of the activist to acquire up to a certain percentage of the target company's stock (e.g., 10%).

Corporate governance standstill provisions are often more cumbersome than share ownership provisions insofar as there are more variables regarding what may or may not be included as "prohibited conduct." Such standstills can encompass such prohibited conduct as: seeking to control the management or policies of the target company, attempting to get additional board representation and submitting any proposals or participating in the solicitation of the company's proxies. Otherwise prohibited actions may sometimes be permitted in the event that the company

enters into certain "material transactions," such as a merger or asset sale in excess of a certain dollar amount. Often, activists will seek to ensure that the standstill provision does not prohibit its right to publicly criticize or oppose a transaction that could seriously alter the status of the business.

Additional prohibitions that often appear in corporate governance standstill provisions include publicly announcing or attempting to publicly affect a merger or related transaction involving the company and forming or joining in a "group." As stated above, the actual details of a corporate-governance standstill provision will depend on the facts and circumstances at hand.

Other Material Provisions

In addition to the duration of the agreement and the restrictions to be placed on both the company and the activist, there are other important provisions that routinely appear in such agreements. Key factors of any settlement agreement include restrictions on the sale or other transfer of the company's securities, non-disparagement clauses, remedies provisions and expense-reimbursement clauses.

Transfer restrictions generally prohibit the activist from transferring any of its securities without the prior written notice of the target company. This prohibition is often drafted to include certain exceptions, such as transfers to controlled affiliates, private transfers that would not result in a transferee holding more than a certain percentage of the target's stock, and with respect to certain tender offers or public repurchase offers.

A provision regarding remedies for breach of the agreement is another one that is often crafted with particularity. Properly drafted, it provides that, in the event of such a breach, either or both parties are entitled to the same remedies, whether at law, in equity or both.

Generally, the standstill agreement, by making concessions that both can live with, is an efficient way for both an activist investor and a target company to resolve a proxy fight in its early stages. As is the case with any agreement, compromise will play the most crucial role in the outcome of standstill agreement negotiations. Whether or not the overall terms are more or less favorable to one party will often depend simply on how much leverage that party has with respect to the proxy campaign. While this article covers the most common provisions in such agreements, they should be viewed largely as the backbone to an agreement, the details of which should be fleshed-out and negotiated based on the facts and circumstances at hand. ■

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