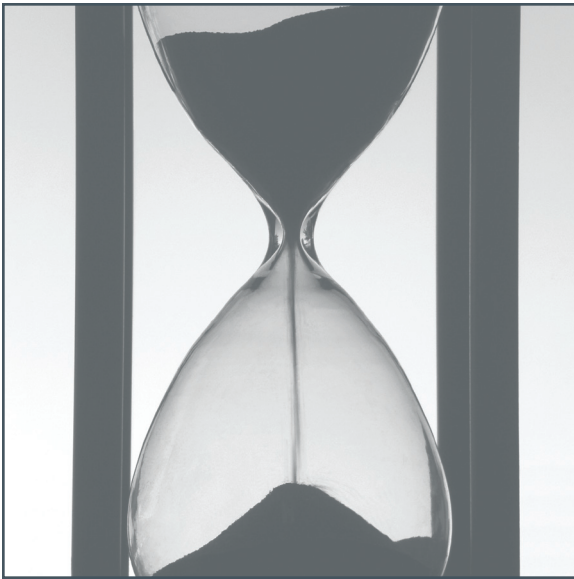


activist investing developments

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Second Generation Advance Notification Bylaws

By Marc Weingarten and Erin Magnor

IN THE SPRING 2005 ISSUE of *Activist Investing Developments*, we wrote about the special bylaw provisions regulating the ability of shareholders to nominate directors or place items on the agenda for consideration at a company's annual or special meeting or by consent, typically referred to as advance notification bylaws ("ANBs").¹ At the time, most ANBs were straightforward. They typically advanced the date by which a shareholder was obligated to notify the company to 60 or 90 days prior to the expected meeting date. These ANBs, or First Generation ANBs, also typically required the proponent shareholder to include in the notification the same basic information about the shareholder, and if applicable the nominees, as required by the proxy rules.

More recently, however, many companies, at the urging of counsel "defending" against activist investors, have adopted new forms of ANBs, or Second Generation ANBs, that demand far more extensive disclosure from, and in some cases purport to establish eligibility qualifications for, proponent shareholders. These ANBs have been

expanded to include not only longer advance notice requirements, but also requirements for the completion of company-drafted director nominee questionnaires, submission of broad undertakings by nominees to comply with company "policies," minimum size and/or duration of holding requirements, continuous disclosure of derivative positions, disclosure of otherwise confidential compensation information, and even information regarding shareholders with whom the proponent has merely had conversations regarding the company.

First Generation ANBs were upheld by the courts because they simply provided an orderly procedure for shareholder action that helped to give the company and the other shareholders adequate time to evaluate proposals. We believe that many of the Second Generation ANBs are designed not to elicit the relevant information a company reasonably needs to know months in advance of a proxy contest to ensure an orderly process, but rather to erect barriers in the path of shareholders seeking to exercise their rights in an attempt to disqualify them. We believe such provisions should, and will, be declared invalid when their legitimacy is challenged. Unfortunately, shareholders will be forced to bear the expense of challenging the validity of these provisions—which no doubt was part of the calculus when companies adopted them in the first place.

Advance Notice Periods

In our prior article, we noted that courts had determined that 90-day advance-notice requirements had become commonplace.² Since then, some companies have adopted ANBs requiring notice of 150, or even 180, days prior to the annual meeting (in some cases keyed off the mailing date of the prior year's proxy statement).

It is particularly ironic that these companies, whose common refrain rails against the disruption and distraction they suffer when subject to a proxy contest, lengthen the period during which the contest plays out when adopting such long advance requirements.

We believe that advance notice deadlines of 150 days, and certainly 180 days, are unreasonable and invalid, especially when imposed by companies without staggered boards. At 150 days, incumbent directors are barely more than halfway into their terms; shareholders should be given more time to evaluate their performance before being forced to determine whether to contest their reelection. Notification deadlines so far in advance permit the incumbent board members to operate during half their term free of accountability to the shareholders for their actions—and the temptation to delay taking controversial action until after the notification deadline has passed cannot be overlooked. There is no reasonable basis to argue that a company needs five or six months advance notice of an election contest. Evaluating the qualifications of nominees and the merits of their platforms simply does not take this much time. There is no reason that the concern for an "orderly procedure" that has led the courts to support First Generation ANBs cannot be fully satisfied by a 60- or 90-day notice requirement.

1 See Marc Weingarten, "Advance Notification Bylaws," *Activist Investing*, Spring 2005, http://www.srz.com/Weingarten_Activist_Investing_Developments_2005_Advanced_Notification_Bylaws/.

2 *Mentor Graphics Corp. v. Quickturn Design Systems*, 728 A.2d 25, 42-43 (Del.Ch. 1998).

Company-Drafted Questionnaires and Undertakings

Many companies have adopted Second Generation ANBs that require shareholder nominees to complete and submit company-prepared director questionnaires along with the nomination notification. The nominating shareholder is required to request a copy of the questionnaire from the corporate secretary, in effect pushing the advance notification deadline even further back by giving the company even earlier notice of a potential contest.

The questionnaire requirement is generally a pointless waste of time. ANBs already uniformly require a nominating shareholder to include in its notice all information with regard to itself and its nominees that would be required to be disclosed in a proxy statement, which includes information about the nominees' shareholdings, backgrounds and any relationships they may have with the company. The questionnaire generally will yield no additional relevant information. But so long as the company uses the same form for shareholder-proposed nominees as for its own candidates, without adding burdensome or troublesome questions targeted to frustrate shareholder nominations, the questionnaire requirement is merely an annoyance but not legally objectionable.

Many companies also now require, as a condition of eligibility, that shareholder-proposed director nominees agree to various undertakings. They may have to sign an agreement that they will not join in voting agreements, that they will not enter into undisclosed indemnification or compensation agreements, and that they will comply with all company policies and guidelines applicable to directors, which may include subjects such as corporate governance, conflicts of interest, confidentiality and stock ownership.

Clearly a nominee should only be required to agree to comply with specific, disclosed policies and guidelines, and not with whatever policies and guidelines may be adopted in the future. But even such a limited undertaking could create dilemmas for a proponent shareholder. A common company policy, for example, requires directors to keep company information confidential, which may present an issue for a nominee proposed by, and especially one who is affiliated with, activist investors. An activist that achieves the election of its nominee to the board often does so on the basis that the nominee's views will be more aligned with shareholder interests. The activist would like to be able to discuss company matters with that board member, at least to convey the activist's views on the company's conduct. The director will, of course, be required to act in accordance with his or her fiduciary duties and not on the instructions of the activist, and the activist, if privy to material non-public information about the company, would be restricted in trading (and typically would not want such information for that very reason). Discussions between the director and the activist would not make the information public, but might still violate company policy and, the company may argue, could even breach fiduciary duty. In a negotiated settlement, the company may be persuaded to permit this conduct but, at the initial stages, is not likely to agree to modify the undertaking. Company policies regarding trading by directors often raise another issue for activists: whether such policies apply to entities with which the director is affiliated.

But so long as the policies are reasonable and applied equally to all directors, the proponent shareholder and its nominees will be hard-pressed to object, and will have little choice but to sign.

Minimum Holding Periods and Levels of Ownership

Currently, under Rule 14a-8 of the Securities Exchange Act of 1934, in order to be eligible to submit a proposal to be included on a company proxy card, a shareholder must

have continuously held, for at least one year prior to the date the proposal is submitted, a minimum of \$2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal. Such a requirement is justified on the basis that the company is being put to expense and burden (albeit minimal), in including these proposals in its proxy materials, and should not have to do so for frivolous or harassing shareholders with de minimus or short-term holdings. Regardless of the merits of such rationale, it has no applicability where the shareholder utilizes its *own* proxy materials at its *own* expense. Any attempt to establish minimum holding periods or level-of-ownership requirements in ANBs as applicable outside the 14a-8 context should be an invalid and unenforceable limitation on shareholder rights.³ The adoption of such requirements as part of a federally mandated proxy-access regime similarly should have no bearing on shareholders seeking to take action utilizing their own proxy materials.

Disclosure of Derivative Positions

Another common trend in Second Generation ANBs is the adoption of requirements that the nominating shareholders disclose not only their beneficial ownership position but also any derivative positions, such as cash-settled swaps, that they may hold. Such holdings were not historically believed to confer beneficial ownership of any underlying counterparty-held shares, and so did not trigger the filing of a Schedule 13D when the shareholder held less than 5% in physical shares. As a result of the 2008 decision in *CSX Corporation v. The Children's Investment Fund (UK) LLP*⁴, corporate counsel have decried this supposed "loophole" in the 13D rules, and have urged companies to require swap disclosure in their ANBs. These ANBs now include laundry lists of security interests that the shareholder must disclose, including options, swaps, warrants and convertible securities, as well as broad catch-all phrases that seek to capture any economic interest that the company has not specifically named.

Such increased disclosure requirements should not be problematic for shareholder proponents, or objectionable. While such disclosures may provide a company with more information than it would have based on SEC filings alone, the overall consequence of companies learning more about the holdings of proponent shareholders should not significantly affect the ability of proponents to nominate directors or propose business for shareholder meetings.

However, one prominent defense-side law firm has suggested to its corporate clients that they adopt an ANB disclosure requirement for derivatives that we believe has been designed as a trap to disenfranchise shareholders and should therefore be invalidated. Specifically, the bylaw provision requires that, once a shareholder has obtained a certain percentage of economic interest in the company (the drafters suggest 7.5% or 10% as possible threshold amounts), combining long ownership with any derivative or synthetic interest, the shareholder must continuously inform the company of its "interest" level, even if the shareholder at that time has no intention whatsoever of taking governance

3 In a proxy contest last year by JANA Partners involving CNET Corporation (*Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335 (Del. Ch.), *aff'd*, 947 A.2d 1120 (Del. Supr. 2008)), JANA successfully sued to confirm that CNET's ANBs establishing minimum-holding-period and level-of-ownership requirements for shareholder nominations were intended to apply in the 14a-8 context and not otherwise. While the corporate defense bar seized on this opinion, as well as the opinion in *Levitt Corp. v. Office Depot, Inc.* (2008 WL 1724244 (Del. Ch. 2008)), as ominous shareholder-friendly developments in Delaware law, each represented no more than extraordinarily poorly drafted bylaw provisions interpreted to favor shareholder rights.

4 562 F. Supp. 2d 511 (S.D.N.Y. 2008).

action. If the shareholder does not comply with the provision, the company will disqualify the shareholder from later seeking to take action at a shareholder meeting.

This provision would require shareholders to review, in advance, the bylaws of every company in which they intend to purchase shares to determine whether they contain any custom-designed ownership-reporting requirement, since failure to do so may result in forfeiture of their rights to nominate directors or propose other corporate action should they later wish to exercise them. If this type of bylaw were valid, shareholders would be subject to a crazy quilt of reporting requirements with differing thresholds at different companies, and forced to comply at a time when they aren't even seeking to take governance action, to avoid forfeiting fundamental shareholder rights. Rather than relying on uniform SEC-mandated disclosure requirements, every company would be making up its own rules and reporting regimes to trap unwary investors. Such provisions should not be upheld.

Acting in Concert

In September 2008, another defense-side firm published sample ANBs for its clients that define the term "Proposing Person" to include any person with whom the proposing shareholder or beneficial owner is "Acting in Concert," and require proponent shareholders to disclose any such persons. These proposed bylaws provide that a person should be deemed to be Acting in Concert with another person if "such person knowingly acts (whether or not pursuant to an express agreement, arrangement or understanding) in concert with, or towards a common goal relating to the management, governance or control of the Corporation in parallel with, such other person where (a) each person is conscious of the other person's conduct or intent and this awareness is an element of their decision-making processes and (b) at least one additional factor suggests that such persons intend to act in concert or in parallel, which such additional factors may include, without limitation, exchanging information (whether publicly or privately), attending meetings, conducting discussions, or making or soliciting invitations to act in concert or in parallel....A person Acting in Concert with another person shall be deemed to be Acting in Concert with any third party who is also Acting in Concert with such other person."

The above "Acting in Concert" definition takes the federal securities law definition, which requires an agreement between the parties, and stretches it to cover mere consciousness of each other plus discussion. The plain intention of this provision is to force activist shareholders to disclose the identity of every other shareholder they've spoken to as a "concert party," or risk forfeiture of their shareholder rights. The provision is intended to chill protected and legitimate shareholder communication, encouraged by the SEC,⁵ and enables companies to disenfranchise shareholders by arguing that adequate disclosure has not been made. The bylaw does nothing to create a more orderly process for shareholder nominations, or serve any other legitimate purpose of the company. Discouraging shareholders from sharing their viewpoints on the management or governance of a company is not a legitimate purpose, and shareholders should have the right to discuss the actions of a company in which they are invested without having to disclose the participants in all such conversations to the company simply in order to be eligible to exercise shareholder rights.

Compensation Information

Several companies have adopted Second Generation ANBs requiring disclosure of compensation arrangements and "any other material relationships" between the nominating shareholder and its affiliates and concert-parties, on the one hand, and its nominees and their affiliates and concert-parties, on the other hand.

To the extent the shareholder has nominated a purportedly independent person to serve as a director, such a disclosure requirement at least would serve to confirm the nominee's independence from the nominating party. However, where the shareholder-nominee is admittedly affiliated with the nominating party (as when an activist hedge fund nominates a principal of the fund), such a requirement serves no legitimate corporate purpose. This information has never been required to be disclosed under the federal proxy rules, and is never disclosed by companies with respect to their outside directors. The proponent could offer to disclose the information in confidence to the company, on the off chance that the company had some legitimate need to know it, but, in one recent case, company counsel rejected such a proffer stating that it specifically intended to make the information public in its proxy materials. Such a response makes clear that the requirement was inserted for no corporate purpose other than to discourage an activist from nominating an affiliated party, or suffer public disclosure of private financial information. This matter is now the subject of litigation.⁶

Conclusion

Unlike First Generation ANBs, which simply require shareholders to submit proposals a reasonable time before the meeting and disclose only that information which is otherwise required by the proxy rules, Second Generation ANBs are being drafted with a different agenda in mind: controlling the ability of shareholders to nominate directors or to propose business. While some of these provisions serve legitimate purposes in promoting an orderly process, many are nothing more than thinly-veiled attempts to disqualify shareholder proponents. As eager defense-side counsel generate ever-more-ingenious provisions intended to strip shareholders of their fundamental rights, activists will be forced, at their own expense, to bring litigation to have these provisions declared invalid, while companies use the corporate treasury to defend them. Hopefully, the courts will send a message to these companies that shareholder rights are not to be gamed away. ■

5 See Exchange Act Release No. 31326, Regulation of Communications Among Shareholders (Oct. 16, 1992).

6 *Springbok Capital Onshore, LLC v. Tunney*, No. 4358 - VCL (Del. Ch. filed Feb. 11, 2009).

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