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Shareholder Activism: Investor Objectives, Strategies, and Key Considerations

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Active Shareholders and Shareholder Objectives

This practice note outlines the main types of activist campaigns and highlights the fundamental principles underlying the applicable rules and regulations. Activist campaigns and shareholder engagement programs are highly situational and fact-specific. Thus, generalizations are not particularly useful, but there are some commonalities to the types of campaigns and opportunities undertaken by activist investors. In addition, there is a broad range of shareholders who find themselves engaged in what can be identified as activist behavior, and there is an equally broad range of strategies that can be incorporated in an activist's playbook, or defenses that can be deployed by targeted companies.

Activist Shareholders, Occasional Activists, and Engaged Investors

Any shareholder who owns voting securities and is entitled to vote or act on a specific matter can exercise its franchise rights by submitting proposals or approaching the company with its concerns. Shareholders who do so more frequently than others are typified as activists. Among that group, pure-play activists are those whose general investment strategy revolves around increasing shareholder value through active participation in the management, governance, or direction of a company deemed to be underperforming, without necessarily assuming control of the company (in the way that a private equity firm would). These shareholders are usually large hedge funds (or a specific arm of a hedge fund tasked with an activist strategy) that hold a fairly concentrated portfolio of positions. At the other end of the spectrum are investment funds who are occasional activists, whose primary focus is not on activism, but who are occasionally driven to activism based on a potentially lucrative play. Similarly, partial activists are typically multi-strategy funds that invest opportunistically, but do not identify themselves as activists.

In between pure-play activists and occasional or partial activists are investors that have been labeled or self-identify as constructivists or "reluctivists" based on their preferred style of engagement with the company, or the frequency or ease with which they undertake a hostile campaign. Some consider short sellers to be activists because of their active approach to their investment. Those categorizations notwithstanding, any shareholder that takes an active approach to its investment is an activist of sorts and can benefit from understanding the various strategies of engagement and the context of shareholder involvement with its investments.

Both activists and targets companies range dramatically in size. Further, the size of the activist or the target company has generally not had an impact on the success of an activist engagement. Small activist funds, acting alone or in concert with other like-minded investors, have boasted some of the most significant victories, particularly relating to companies with smaller capitalizations. Notwithstanding that, activists have also had notable successes and tremendous impact on very large companies that, until recently, markets thought to be immune from shareholder pressure. Shareholders of all investment philosophies, including institutional investors, have become increasingly focused on the governance and quality of leadership at their portfolio companies. As part of monitoring their investments, institutional investors have engaged with those companies on a variety of issues and have profoundly influenced them with guidelines on corporate governance and shareholder engagement.

Shareholder Objectives

There are as many different objectives and value-unlocking ideas as there are activists and targets. Shareholders often target underperforming companies and run campaigns designed to reverse underperformance, but activists increasingly seek to implement value-unlocking alternatives to improve the valuation of a company beyond what the current strategies can achieve. A proxy contest occurs when shareholders believe poor decision-making and faulty strategic vision by the current leadership have served as the catalysts for underperformance and undervaluation. Activists will usually seek recourse by seeking a change in corporate control, promoting what they consider a more shareholder-friendly representation on the board of directors, or opposing a particular course of business or governance conduct (e.g., opposing an announced transaction or withholding votes from the election of current directors). Activist objectives can be broadly categorized as targeting three areas: (1) corporate strategy, (2) corporate actions, and (3) corporate governance.

Corporate Strategy

Changes that may influence or redirect a company's strategy—often in combination with seeking changes on the board to ensure proper oversight of a new strategy—include:

- Overhauling the current corporate strategy of operating within certain markets
- Completing extraordinary transactions, such as mergers or strategic acquisitions
- Abandoning stated plans to proceed with transactions or specific products and services
- Spinning off entire divisions

Corporate Actions

Prompting a company to take specific actions can serve to equalize the goals of shareholders with the goals of the company. It can take many forms, including:

- Improving capital allocation
- Implementing share repurchase (i.e., buyback) programs or declaring dividends
- Revisiting leverage levels and working capital
- For investment companies, seeking an evaluation of management fees and negotiation of arrangements to better reflect performance or market rates

In addition, operational activism is on the rise and normally involves an in-depth review of the potential for operational improvements through specific actions that a company can take, as well as minority representation for the activist on the board to ensure that the activist takes part in the deliberations and thought processes in revisiting operational plans.

Corporate Governance

Corporate governance improvements have a directly positive effect on the valuation of a company. Shareholders often seek corporate governance enhancements in the form of amendments to the charter, bylaws, or policies of a company either to bring it in line with industry or proxy advisor standards, or to account for a specific deficiency in governance procedures. Examples of such changes are:

- Fundamental changes to the board, including the number of directors, types of committees, board structure (e.g., declassifying a board), and splitting the chairperson and chief executive officer roles
- Changes to the rights granted to shareholders under the corporate documents, such as shareholder rights to act by written consent and request special meetings
- Adopting a majority voting policy for the election of directors
- Proxy access rights

- Changes to the capitalization structure of the company to eliminate a dual-class share structure that concentrates power in the hands of founders
- Weakening or dismantling obstructive takeover defenses such as shareholder rights plans (i.e., poison pills)

Executive compensation issues also loom large for shareholders but are often addressed by withdrawing support from a company proposal seeking ratification of executive compensation.

Anticipating Defensive Maneuvers

In running a campaign or in any other engagement with the company, shareholders must be mindful of the full range of defensive tactics that the company's leadership may use. A company can implement a number of defense mechanisms to thwart activist proposals and nominations. Those defenses can be broadly categorized as: (1) technical defenses, such as adopting a shareholder rights plan or eliminating shareholder rights, (2) preventive defenses, such as making board changes in anticipation of shareholder-promoted changes so that the board can retain control over the implementation, and (3) strategic defenses, such as engaging in acquisitions and divestitures.

Technical Defenses

A company can bolster its charter and bylaws in a way that makes exercising shareholder rights more difficult or eliminates rights altogether. Such technical defenses include:

- Creating a classified board (some states, like Maryland, allow boards to classify unilaterally)
- Blocking shareholders from filling vacancies on the board or being able to adjust the size of the board
- Eliminating shareholder rights to call special meetings or to act by written consent
- Requiring supermajority votes for certain matters
- Giving the board the option to issue blank check preferred shares without shareholder approval, which can be used to affect voting rights

Significantly, a company can put into effect a shareholder rights plan, which can be used to give shareholders the right to buy shares at a significant discount, thus diluting the voting interests of the activist shareholder. However, adopting such technical defenses can cause a board to slip into poor corporate governance and, as a result, lose the support of shareholders and proxy advisory firms, who do not view attempts to entrench a sitting group of directors favorably.

Preventive Defenses

Preventive defenses are changes that a board would typically make in response to a pending contest that, at least partially, implement the changes propagated by an activist. Such attempts to eliminate or minimize the need for such changes raise a number of new considerations for an activist. First, preventive defenses can often give a partial victory to an activist to the extent that a company is conceding the validity of the need for such changes. Companies can take operational or business actions that the activist has pushed for and identified as part of its platform; for example, in some cases, companies have sold a valuable intellectual property portfolio following an activist's prompting. More often, the changes are in the form of refreshing the board with candidates of the incumbents' choosing, effectively conceding that new governance is needed, but making sure that the change comes in a form that is palatable to the current directors. In such cases, the dynamics and calculus of the campaign change—both institutional advisors and institutional investors will expect more from a shareholder who is insisting that the change is either insufficient or undesirable. The result is often that the activist's engagement will continue under a new or reoriented strategy.

Strategic Defenses

Of course, a company can always initiate mergers and acquisitions or take on new debt to make itself less attractive to an activist, but it can also market itself to another investor or firm that it considers more favorable or friendly to its goals (such as soliciting a "white knight" that will rescue the company by making an acceptable counteroffer or counterproposal). In addition, a company can use media campaigns to control dialogue and influence shareholder and public perception.

Assembling a Robust Team of Advisors

In addition to engaging experienced legal counsel who can optimize a strategy and navigate the complex system of rules and regulations, shareholders can retain other types of advisors to consult on various areas of specialty, including proxy solicitation firms, investment bankers, investor relations teams, communications specialists, and increasingly often, industry consultants with deep knowledge of the market in which the company operates.

Shareholders use proxy solicitation firms to conduct a shareholder profile analysis, which can identify the shareholder base, estimate existing support for the proposed action, and solicit votes. In addition, proxy solicitors can coordinate meetings between a proponent and other shareholders, including road show presentations focused on the proponent's investment thesis; communicate with other shareholders on behalf of the proponent; advise on the voting rules and process; interact with intermediaries such as transfer agents and brokers; and consult on how to gain the recommendation of proxy advisory firms.

Investment banking teams are increasingly common in shareholder actions that require complex financial and tax analysis that can inform the value-proposition of the shareholder. Investment bankers can assist with modeling the effects of the proponent's actions and suggest alternative courses of action.

Shareholders often retain the services of investor relations and communications specialists to help develop a platform on how to communicate the shareholder's thesis, including strategies on how to engage other investors and the media. Such firms advise on the most effective messaging techniques.

Industry consultants have also become a common addition to an activist campaign team. Such advisors can be seasoned operators who can add insight into the competitive forces in the industry, and are sometimes former executives of the company with rich company-specific knowledge (to the extent no confidentiality restrictions are applicable).

Importantly, activists seek access to the highest caliber director nominees who are often widely recognized leaders in the industry in which the target company operates. Most often, director search firms can assist with access to highly qualified director candidates and industry consultants. Director investigative firms are helpful in performing background checks on nominees before an activist commits to adding them to the slate of candidates. These background checks can detect red flags and prepare the activist for any potential issues that may be unearthed in the context of a hostile campaign. Such investigative firms can also help to identify vulnerabilities or inaccuracies in the stated qualifications of incumbent directors that the activist opposes.

Campaign Types and Strategies

The following section sets forth the mechanics of some of the main activist campaign types. For the sake of brevity, some potential issues have been omitted, including: (1) short swing profit liability rules under Section 16 of the Exchange Act (15 USCS § 78p) for shareholders who may be deemed insiders (including as a result of owning more than 10%), (2) antitrust notifications that are triggered by large investments that activists sometimes make, and (3) antitakeover provisions in state statutes that may limit certain activities for activists with larger positions. For more information on these issues, see Antitrust and Regulatory Considerations in an M&A Deal, and State AntiTakeover Considerations in M&A Deals.

Proxy Contests at the Annual Meeting

Companies are generally required under the laws of their state of incorporation to hold an annual meeting at which shareholders can exercise the voting rights attached to their respective shares. Companies that have a fiscal year that ends on December 31 typically hold these meetings in April or May. Companies must give shareholders notice of the date, time, and place of the meeting, as well as notice of the record date. Shareholders of record (shareholders that own voting shares in their own name) as of the record date are entitled to vote at the annual meeting. Shareholders that beneficially own shares in "street name" must advise their brokers on how to vote their shares. The record date must generally be not less than 10 days prior to the date of the shareholder meeting, and not more than 60 days before. All meetings have a quorum requirement, which is the minimum number of shares entitled to vote that must be present for the meeting to proceed. Quorum is often set at a majority of shares entitled to vote in order to prevent a minority of shareholders from determining the outcome of a matter. In many states, if a company fails to hold an election of directors for some time after the anniversary of the prior year's meeting (that period differs in different states; in Delaware, it is 13 months), then the shareholders can turn to the courts to compel an election of directors.

The company's organizational documents set the voting standards for the election of directors. Typically, the voting standard in a contested election (one where there are more candidates than seats on the board) is a plurality of the votes cast. This means that the directors with the greatest number of votes will be elected to the board. Recently, as part of broad corporate governance reforms, more companies are adopting majority standards for uncontested elections. The majority standard requires that only candidates

who successfully gain the support of more than 50% of the votes cast will be elected to the board. In relatively rare cases, companies adopt a majority-voting standard that applies not only to uncontested but also to contested elections. While the majority standard in uncontested elections can be seen as a good corporate governance measure—since it allows the board to remove directors who do not have adequate shareholder support—this is not necessarily the case in the contested context. The majority standard presents a higher hurdle and may result in fewer directors passing that threshold, leaving the incumbent directors to fill the resulting vacancies with the candidates of their choice.

The Nomination Process

A proxy contest is a contested election of directors where a dissident or group of dissidents puts forth a competing slate of director candidates for election at an upcoming annual meeting. The election process starts with the nomination by shareholders of director candidates for election. While the right to submit such nominations is statutory and available in all states, the specific requirements for valid nominations are laid out in the company's organizational documents, usually in an advance notice bylaw. Typically, the advance notice bylaws provide when a nomination must be submitted to be considered timely and what information it must contain to be in proper form. Most often, the window for the submission of nominations ranges between 60 and 90 days before the anniversary of the prior year's annual meeting. There is usually an adjustment allowing a reset to 10 days following the public announcement of an annual meeting in those cases where the date is set much in advance or following (usually plus or minus 30 days) the anniversary of the prior year's meeting. Sometimes, as a defensive mechanism, a company will accelerate the nomination deadline by setting a date for the annual meeting that is outside of the 30day window in relation to the anniversary, in order to pressure activists for time and leave them stranded to quickly line up nominees and complete the nomination documentation.

The type of information that is generally required by companies includes:

- Biographical information about the nominees
- Beneficial ownership and transactional history of the nominating shareholder and the nominees
- Any agreements or arrangements between the nominee and the nominating shareholder
- All information with respect to the nominees and the nominating shareholder that is required to be disclosed in proxy materials under Schedule 14A in connection with the election of directors

In recent years, companies have often increased the scope of required information, making the process more burdensome and time-consuming for shareholders. There are numerous intricacies and strategic considerations with respect to the selection of the right size and composition of the nominee slate, the right to provide alternative nominees or make additional nominations or substitutions, and the appropriate responses to alleged deficiencies in nomination notices.

Business Proposals

In addition to or in lieu of submitting a nomination of directors, shareholders can also submit a business proposal to the company. Unlike proposals submitted under Rule 14a-8 (17 CFR 240.14a-8), these business proposals would not be included in the company's proxy statement. Instead, the activist will solicit proxies in favor of the proposal's approval through its own proxy statement and proxy card. The process of submitting a business proposal is similar to the nomination process.

Communications as Part of a Proxy Contest

The proxy rules require all written solicitation materials to be filed with the Securities and Exchange Commission (the SEC). Solicitation communications made prior to filing a definitive proxy statement are considered presolicitation materials. These materials are permitted under Rule 14a-12 (17 CFR 240.14a-12) but must be filed with the SEC on the same business day as their dissemination and must contain a clear and prominent legend identifying the participants in the solicitation and their share ownership and interest in the transaction. They must also advise shareholders where to obtain a full copy of the activist proxy statement. Generally, once a formal nomination has been submitted, any subsequent written statement, press release, letter, or presentation, is deemed to be pre-solicitation material. In some cases, even prior to the submission of a formal nomination, a statement that indicates the intent to nominate or solicit proxies or consents can constitute pre-solicitation material. The content of all solicitation materials should also comply with the generally applicable restrictions of Rule 14a-9 (described in more detail below).

Even though a shareholder can issue public pre-solicitation materials, the activist is not allowed to solicit proxies from shareholders until it has a definitive proxy statement on file with the SEC. In addition, in communicating with other shareholders, an activist must

also be cognizant of the Section 13(d) (15 USCS § 78m) rules and conduct all communications carefully so as not to inadvertently form a Section 13(d) group.

Proxy Statements, SEC Review, and Proxy Solicitations

Any dissident soliciting proxies in favor of the election of its competing slate must file a proxy statement with the SEC. The proxy statement must lay out certain required information regarding the participants in the solicitation, their ownership and transactions in the securities of the company, the biographical information and qualifications of their director candidates, and often, the platform for the contest and prior engagements with the company. The company will also have to go through the process of filing a preliminary proxy statement and undergo an SEC review before the proxy statement becomes definitive. This is because the company is on notice that the election is contested and, therefore, the company cannot directly file a definitive proxy as it would in the absence of a contest. The SEC reviews the preliminary proxy statements of both sides and the parties revise the proxy statements to address any comments; neither side can mail a definitive proxy statement to shareholders without giving the SEC at least 10 calendar days to review. In practice, SEC scrutiny tends to be higher in contested elections, so proxy statements in contested elections almost always receive comments from the SEC and both sides would likely go through a number of rounds of comments prior to receiving clearance. Once the SEC has completed its review, each side can file its definitive proxy statement and mail it to shareholders as of the record date, along with a proxy card that includes voting instructions. This process typically lasts two to three weeks.

Rule 14a-9 imposes limitations on the content of statements made in a proxy contest. Proxy materials may not contain false and misleading statements or omissions, should not impugn the character and reputation of the subject, nor contain predictions of the results of a contest. The obligation to comply with the proxy rules and to file all written solicitation materials continues after a definitive proxy statement and proxy card have been mailed to shareholders. These communications are deemed additional definitive materials and must also be filed with the SEC on the same business day on which they are disseminated. However, unlike pre-solicitation materials, definitive additional materials do not need a legend providing information about the participants, and unlike the proxy statement, the definitive additional materials do not need to be pre-cleared with the SEC. In practice, this means that some of the most aggressive rhetoric in a contest is published in these post proxy statement communications, most often in the form of so-called “fight letters” in which each party tries to convince unaligned shareholders to support their plans for the company.

Short Slates vs. Control Slates

An activist’s decision to run either a minority or majority slate involves both an assessment of the extent of the needed change and an understanding of the tactical implications under the proxy rules. Shareholders should be aware of an important opportunity when considering launching a proxy contest. Generally, a proxy card cannot confer authority to vote for any nominee unless that nominee has explicitly consented to being named in a proxy statement. This requirement is known as the bona fide nominee rule, and it effectively means that one party may not name the other party’s nominees on its proxy materials unless the other party’s nominees consent, which is rarely provided. However, under what is known as the short slate rule (Rule 14a-4(d))(17 CFR 240.14a-4), a shareholder who is nominating directors for less than a majority of the board seats can request proxies from shareholders to vote for some of the board’s nominees, or the nominees of another shareholder, on its proxy card. The short slate rule is designed to help a shareholder round out its slate, but limits the way in which a shareholder can present its ideal list of board candidates, if such list is composed of directors nominated by both the shareholder and board of directors.

That the company and the dissident will each have its own proxy card and the fact that the dissident may not be able to offer shareholders the opportunity to vote on all available director seats present certain tactical advantages to the company. The SEC has proposed amendments to these rules, including an amendment that would allow universal proxies, but such changes have not yet been ratified. Universal proxies, if approved, would allow all candidates, regardless of the proponent, and all proposals, whether recommended by the company or a dissident shareholder, to be included on the same proxy card, potentially easing the voting logistics for investors and evening the playing field in contested situations.

Special Meetings

Between annual meetings, the primary mechanisms that shareholders use to effect a change on a board of directors or to put forth business proposals for a shareholder vote are calling a special meeting or conducting a written consent solicitation (as discussed below). Because these mechanisms facilitate shareholders’ exercise of their franchise rights, proxy advisory firms consider them as reflecting good corporate governance standards and give them heavy weight in their ratings of companies. For the most part, such rights are set forth in a company’s organizational documents.

Who Can Call a Special Meeting?

Generally, consistent with the default rules in state corporate statutes, boards and certain executives can call special meetings. Shareholders, on the other hand, often must clear certain hurdles or meet ownership thresholds before they can request the calling of a special meeting. In Delaware, only the board of directors has a statutory right to call special meetings; a company's charter or bylaws can include a shareholder's right to request a special meeting. The special-meeting provisions may include ownership restrictions or other logistical requirements relating to the process of calling and scheduling the meeting. For example, some companies have provisions that allow a special meeting to be called only by investors representing at least 10% of the company's outstanding shares—others impose an even higher threshold. Companies can also make it burdensome for activists to request the calling of a special meeting by requesting detailed disclosures about the shareholders requesting the meeting, their proposals, and any nominees to be submitted in the shareholders' demand for the calling of a special meeting.

Proposals at a Special Meeting

The benefit of the right to call a special meeting is that there are helpful actions that can be taken at the special meeting. Most often, this means that shareholders have the right to remove directors without cause and may replace them through their right to fill the resulting vacancies. Notably, the directors of a company with classified boards in Delaware can be removed only with cause consistent with that state's corporate statute. On the other hand, for boards that are annually elected, the standard of removal is a majority of the shares outstanding and no cause is needed. Courts in Delaware have clarified that provisions in the organizational documents to the contrary cannot limit the shareholders' statutory right to remove annually elected directors without cause. In the alternative, shareholders can seek to expand the board to create new directorships and then fill the resulting vacancies at the special meeting. Determining whether the governance make-up of a particular company allows for this remove-and-replace strategy requires parsing through the interplay of the applicable state laws and the organizational documents of the company.

Activists must have a very clear purpose in calling for a special meeting, and companies require that purpose to be stated when submitting a meeting request. The majority of special meetings sought by activists revolve around attempts to make changes to the company's board of directors. These attempts include, but are not limited to, proposals to:

- Remove some or all of the current directors (to the extent that shareholders have the right to do so without cause)
- Expand the size of the board to create new directorships (this can be a two-step process to the extent that the right to set the size of the board is exclusively vested in the board and may involve a first step of amending the bylaws to give shareholders the right to set the size of the board and then a second proposal conditioned on the approval of the first to set the size of the board at a specified size)
- Elect new directors to fill vacancies resulting from the removal of directors or the creation of new directorships
- Change or amend unfavorable bylaws, including to vest in shareholders the right to expand the board, remove directors without cause, or to fill vacancies as to accomplish any of the above

It is important that a shareholder (or its counsel) verify which proposals may be properly put to a shareholder vote; this requires understanding which rights or limitations are available or imposed by the current organizational documents, but also if there is any flexibility to amend those documents. For example, in Delaware, shareholders may amend bylaws, but a charter provision restricting or taking away a shareholder right cannot be defeated by shareholders alone since the Delaware corporate statute requires board approval as well as shareholder ratification to amend or repeal charter provisions.

The activist must also verify the applicable voting threshold for the approval of each of its proposals. Typically, there is a higher voting threshold to remove and replace directors at a special meeting than to elect directors at an annual meeting. Often, a majority of the outstanding shares or a majority of the votes cast must support the proposals for them to pass. In contrast, while some companies have adopted a majority standard for the election of directors in uncontested elections at the annual meeting, the standard for director election is the much easier to achieve plurality standard. There is also a critical distinction between a standard of a majority of the votes cast and the much harder to achieve majority of the outstanding shares entitled to vote. When one takes into consideration that it is much more difficult to persuade shareholders to be present for quorum purposes and to vote at a special meeting, it is easy to see how obtaining the support of a sufficient number of the outstanding shares is a very high hurdle.

Mechanics of a Special Meeting

In addition to the potentially higher voting standard, another disadvantage of special meetings from the perspective of an activist is that the company controls the timing and process. For example, the board sets the record date for the meeting, which determines

which shareholders can vote on any of the proposals the shareholder is looking to put to a vote. While there are certain parameters for when the record date must fall (it usually cannot predate the date of the board resolution setting the record date and cannot be more than 10 days after it), it is within the prerogative of the board to set it. In addition, the board determines the time and place of the meeting and controls the agenda (other than including the properly submitted shareholder proposals).

Just as the annual meeting requires the presence of a quorum for any action taken at the meeting to be valid, so does a special meeting. A quorum is generally a majority of the outstanding shares. As discussed above, this burden of having more than 50% of the outstanding shares be present at the meeting is much harder to achieve at a special meeting than at an annual meeting. The activist must, as part of its campaign, persuade institutional investors, retail shareholders, and any other holders of the voting shares to be present and vote at the special meeting. Once the record and meeting dates for the special meeting are set, the process of soliciting shareholder support is very similar to the proxy solicitation process outlined above. The activist will file proxy solicitation materials soliciting proxies in favor of its proposals with the SEC and the company will typically file its own proxy materials in opposition, trying to persuade shareholders to vote against the activist's proposals.

Two-Step Special Meetings

As noted above, the organizational documents of a company may require a certain percentage of the shareholder base, for example 10% (but possibly as high as 50%), to request the calling of a special meeting. When this is the case, an activist holding less than the required ownership threshold can solicit consents from its fellow shareholders to join the activist in the submission of a request to call a special meeting on behalf of the group that together meets the ownership threshold. Once the activist has collected consents from a sufficient number of shareholders, it must submit a request to call a special meeting in accordance with the requirements of the company's organizational documents. This completes the first step. The second step requires filing proxy materials and conducting proxy solicitation to gain support for the approval of the activist's proposals at the special meeting. Because of the need to meet an ownership threshold, the activist must go through two separate processes—first, a consent solicitation to reach the ownership threshold and second, a special meeting solicitation for the approval of the activist's proposals. Each process requires filing solicitation materials with the SEC, undergoing SEC review, and then soliciting shareholders.

Consent Solicitations

As described above, companies will usually conduct shareholder business at formal shareholder meetings, via the official annual meeting, or at board-sanctioned special meetings. However, a consent solicitation is an alternative process to access the shareholder voting regime between annual meetings. Shareholders use consent solicitations in lieu of voting at a shareholder meeting for companies that permit shareholder actions by written consent. In Delaware, the default rule gives a right to shareholders to act by written consent unless the company expressly disallows shareholder action by written consent in its charter. Provisions in the bylaws prohibiting shareholder action by written consent are not consistent with the Delaware statute; therefore, the right to run a consent solicitation remains in those cases. Conversely, under California law, the presumption works against shareholders, who are required to garner unanimous consent—an almost impossible task—to field a consent solicitation. Such solicitations often seek to accomplish the same objectives as special meeting contests but are effected in a different way. To effect changes on the board through a consent solicitation, shareholders must obtain sufficient consents to remove directors without cause, or expand the size of the board to create new directorships and then fill the resulting vacancies with their selected candidates.

Consent solicitations have specific features. First, they generally have higher thresholds for approval than proxy contests. While most proposals at an annual meeting are taken on the basis of a majority of votes cast, consent solicitations are based on the total number of outstanding voting shares. In fact, many companies have provisions permitting action by written consent only if there is unanimous consent, making the consent solicitation process impractical. Second, an activist can control the timing of a consent solicitation to a greater degree. An activist may commence the process at any time, and while there are procedural hurdles, has more control over timing. This control has earned consent solicitations the reputation of having a "sudden death" component—once the requisite number of consents have been achieved there is nothing the company can do.

The Mechanics of Consent Solicitation

Consent solicitations are often a more streamlined process than the proxy contests that happen at annual and special meetings, and many activists prefer them to special meetings, which pose certain logistical challenges. Whereas special meetings often require shareholders to meet certain ownership thresholds and go through the process of requesting a special meeting before such a meeting can occur (effectively providing the company with advance notice of the activists' intent), consent solicitations are in lieu of the meeting.

Activists must file a consent solicitation statement with the SEC. A consent card similar to a proxy card will accompany the filing and will have to be returned after being signed by any consenting shareholder. Companies will typically file their own solicitation materials in the form of a consent revocation statement and will similarly undergo an SEC review. The delivery of the first consent (usually that of the activist) marks the record date for the consent solicitation, unless the board sets a different date. The organizational documents of many companies contain additional procedural requirements for the consent solicitation process.

One of the interesting challenges in a consent solicitation is that under certain state corporate statutes (including Delaware), a consent is only valid for 60 days. This means that an activist must carefully time the delivery of its consent card, which sets the record date and initiates the clearance of SEC review and the filing of a definitive consent solicitation (which marks the beginning of its solicitation of other shareholders), to make sure that the whole process can be completed within 60 days.

Withhold Campaigns

Most director elections are effected by a plurality vote, which is the default under most state corporate statutes (including Delaware). In a plurality vote, the nominees who receive the greatest number of votes are elected as directors. This means that in a standard, uncontested election, a single vote can elect a director, with "withhold" votes being the only way a shareholder can express dissent. In recent years, many companies have begun implementing a majority voting policy at the request of shareholders, which requires any director to receive at least a majority of votes cast in order to be elected. Director candidates who do not achieve a majority of votes must tender their resignation to the board, which the board may or may not accept. Generally, it is hard for a board to justify rejecting a resignation in this context, and some organizational documents require the board to publicly provide its rationale in the event that the resignation of a director who failed to obtain a majority is rejected. In addition to these thresholds, companies can also institute a cumulative voting policy (this is required for non-public companies under California corporate law), which gives shareholders a number of votes equal to the number of shares held by such shareholders, multiplied by the number of board seats that are up for election. Such votes may be cast for any nominee in any amount; the nominees with the highest number of votes are elected.

In a withhold campaign, the activist investor tries to convince shareholders to withhold votes from company supported directors. This strategy is also referred to as a "just vote no" campaign. In a majority vote regime, the directors who fail to obtain at least a majority of the votes will have to tender their resignations to the board. At the very least, in the face of a strong withhold vote, a company will suffer a public rebuke of its corporate vision.

Withhold Campaigns as a Vote of No-Confidence

On its face, a withhold campaign might not be as compelling as a full-fledged proxy contest since it lacks the activist-nominated replacement directors and corporate governance proposals that are normally hallmarks of an activist campaign. However, there are certain situations in which a withhold campaign can provide an effective tool in lieu of a traditional proxy contest. The most common circumstance in which a withhold campaign occurs is when the deadline to nominate directors has passed and the activist chooses to focus on shareholder dissatisfaction with the current board, even if no alternatives are immediately offered. If the company uses plurality voting, such shareholder actions send a powerful message to the board that they disapprove of the company's strategy despite its confirmation of the director. If the company uses a majority voting system, the shareholders can stop the company's director from being confirmed to the board, although the board can ignore the shareholder recommendation and either reinsert the director or simply replace him or her with a director that has similar tendencies. The board knows, however, that in doing so, it will incite a damaging public uproar.

Withhold Campaign Mechanics

An activist running a withhold campaign is not required to file its own solicitation statement with the SEC or mail its own proxy card seeking withhold votes on the company's proposals, although many activists make the filings and distribute a card anyway. The benefit is that the activist creates a platform to gather support through its own solicitation materials, giving its proxy solicitor visibility over the results as proxy cards from shareholders are received.

Withhold Campaigns for Efficiency Reasons

Even when the nominating deadline has not yet passed, some activists may still favor a withhold campaign over a full proxy contest for the following reasons:

- A withhold campaign generally requires a time commitment below what is needed for a proxy contest, thus giving the activist time to focus on other investments or contests.

- A withhold campaign may be cheaper than running a full-fledged proxy contest.
- Withhold campaigns can be logistically easier to manage, as they involve less moving parts.
- Because activists running withhold campaigns do not nominate replacement directors, the company cannot denigrate or criticize the activist's slate—this ensures that the conversation stays focused on criticizing the company's directors and vision for the future.

Exempt Solicitations

In addition to the standard proxy or consent solicitation, there are exempt solicitations that permit soliciting shareholders to operate under a different regime without the need to file full proxy materials and undergo SEC review. Exempt solicitations have a number of variations.

Non-solicitations

Rule 14a-1(l) (17 CFR 240.14a-1) sets forth both what is deemed a solicitation and circumstances under which a shareholder can make public statements that are not deemed a solicitation. Solicitation is defined as (1) any request for a proxy, whether or not accompanied by or included in a form of proxy, (2) any request to sign or not to sign, or to revoke, a proxy, or (3) the furnishing of a form of proxy or other communication to shareholders under circumstances reasonably calculated to result in the obtaining, withholding or revoking a proxy. What is not a solicitation is the public statement of how a shareholder intends to vote and the reasons for that decision. Differentiating between solicitation and non-solicitation communications requires careful analysis of the content and, sometimes, the timing of a communication.

"Just Vote No" Campaigns

Rule 14a-2 (17 CFR 240.14a-2) provides some alternative methods to avoid the full breadth of the proxy rules. Rule 14a-2(b)(1) exempts solicitations by persons who are not seeking authority to act on behalf of other shareholders as a proxy. This is the so-called "just vote no" campaign, or withhold campaign. This exemption is not available in certain circumstances, most pertinently to Schedule 13D filers unless they have disclaimed any intention or reservation of the right to engage in control transactions or a contested election of directors. Under Rule 14a-6 (17 CFR 240.14a-6), persons who use this exemption and own securities in excess of $5 million must file a notice of exempt solicitation with the SEC.

Ten or Fewer Campaigns and the Rule of 10

An alternative is the "ten or fewer" or "Rule of 10" exemption set forth in Rule 14a-2(b)(2), which is a limited solicitation of 10 or fewer shareholders. It is designed to allow a shareholder to gather support with a very limited outreach to few large shareholders and without incurring the significant expenses of preparing a proxy statement and running a full proxy contest. It is particularly effective in closely held companies, where soliciting a small number of shareholders can result in achieving the determinative vote. For the purposes of counting the 10

shareholders, one shareholder (in the context of Rule 14a-2(b)(2)) is interpreted to mean any single shareholder in the company, including one person who owns many shares, a hedge fund, or an asset manager. One drawback of running a ten or fewer campaign is that it may be harder for an activist to get a meeting with a large institutional investor or proxy advisory firm to plead its case.

Shareholder Proposals Under Rule 14a-8

Shareholders also have the option to submit proposals for a shareholder vote on the company's proxy. The SEC governs shareholder proposals under Rule 14a-8 (17 CFR 240.14a-8), which sets forth the guidelines and processes pertaining to the exercise of these rights.

The most common types of shareholder proposals are those related to corporate governance, environmental issues, human rights issues, and political spending disclosures. However, shareholders have also used Rule 14a-8

on numerous occasions to put forth proposals regarding strategic alternatives review, recommendations of spinoffs, and other corporate actions. Often, these proposals are precatory in nature because the shareholders do not have the power to enforce such actions. Nonetheless, they can be an effective tool to put pressure on boards.

To obtain the right to submit Rule 14a-8 proposals, shareholders must meet certain eligibility requirements and the content of their proposals must not give grounds for exclusion by the company, as laid out in Rule 14a-8:

1. The shareholder must have owned at least $2,000 worth or 1% of the company's shares (whichever is smaller) for one year prior to the proposal (the shareholder must provide corroborating documentation).

2. The shareholder must retain ownership of the shares through the date of the meeting.

3. The shareholder may only submit one proposal per meeting.

4. The proposal must be no more than 500 words.

In addition, the shareholder must submit the proposal at least 120 days prior to the anniversary date of the previous year's annual meeting.

No-Action Letters – The Battle Over Inclusion of Shareholder Proposals

If a shareholder proposal is compliant with Rule 14a-8, a company must include the proposal in its proxy materials unless it can show that the proposal is not compliant with the rule. If a company believes a submitted shareholder proposal to be noncompliant, the company will request a no-action letter from the SEC seeking approval for its assessment that the proposal is excludable. No-action letters reflect the SEC staff's views concerning the application of securities laws to a particular set of facts. In the Rule 14a-8 context, a no-action letter provides the company with guidance as to whether or not the staff would recommend that the SEC take enforcement action against the company were it to decline to include the proposal in its proxy materials.

A company can move to exclude a proposal if:

- The shareholder is requesting an illegal action (Rule 14a-8(i)(2)).

- The proposal is materially false or misleading (Rule 14a-8(i)(3)).

- The proposal centers on a personal grievance against the company and designed to further a personal interest not shared by other shareholders (Rule 14a-8(i)(4)).

- The proposal is not significantly related to the company's business (Rule 14a-8(i)(5)).

- The company lacks the authority to implement the proposal (Rule 14a-8(i)(6)).

- It directly conflicts with the company's own proposals (Rule 14a-8(i)(9)).

Thresholds for Resubmissions

Rule 14-8(i)(12) regulates the ability of shareholders to resubmit proposals that did not gain majority consent in the preceding years. The rules are simple: the first resubmission is permitted if the first proposal received at least 3% approval; the second resubmission is permitted if the first resubmission received at least 6% approval; and the third resubmission is permitted if the second resubmission garnered at least 10% approval. With limited exceptions, shareholders can continue to resubmit their proposals in perpetuity if they continue to hit specific minimum thresholds.

Proxy Access Bylaws

An alternative, company-specific method of nominating directors, outside of any statutory requirements, has gained momentum in recent years. Increasingly, companies are adding proxy access provisions to their bylaws, usually after having been prompted to do so by a shareholder proposal or the recommendations of investor organizations. However, shareholders may only exercise the rights granted under such bylaws if they meet high thresholds. The typical proxy access bylaw requires ownership (whether held individually, in the aggregate if part of a group, and sometimes loaned shares) of at least 3% of the outstanding voting shares of the company (sometimes 5%) for a period of at least three years. Shareholders who meet this threshold can nominate up to 20% (sometimes 25%) of the board, or two directors, whichever is greater. Although many companies have adopted proxy access bylaws, shareholders rarely invoke the rights granted under such provisions given the onerous requirements. When such rights are invoked, shareholders are limited by the fact that the rights cannot be used to seek to influence control of the company.

Shareholder Groups and Disclosure of Investment Intent

Beneficial Ownership Disclosure Requirements

Shareholder actions do not exist in a vacuum, and other considerations, such as beneficial ownership disclosure requirements, must be taken into account when accumulating a position and considering the effects of various tactics. Under Section 13(d) of Exchange Act (15 USCS §78m), a person (which included entities) who acquires beneficial ownership of more than 5% of any class of equity securities (which excludes non-voting securities) of a company that are registered under Section 12 of the Exchange Act must publicly file a detailed disclosure statement on Schedule 13D with the SEC within 10 days of such acquisition if that person is not a passive investor. A beneficial owner is any person who, directly or indirectly, through any contract, arrangement or otherwise, has or shares voting power (the power to vote or direct voting) or investment power (the power to dispose or direct disposition) over the securities. A non-passive person is also deemed to beneficially own any equity securities that it has the right to acquire at any time if such right to acquire is within their control (a passive person is only deemed to beneficially own what it has the right to acquire within 60 days). Accordingly, derivatives such as options, warrants, and other convertible securities may trigger a filing and would certainly need to be disclosed in any filing that is made. The purpose of the disclosure obligation is to notify the company, its other shareholders, and the market that the shareholder has begun accumulating a position in the voting securities of the company, which alerts the issuer to a party potentially looking to take or influence control of the issuer, increases the transparency of holdings in the marketplace and alerts investors of potential changes in control or the value of their investment. The alternative short-form Schedule 13G filing is not available to an investor that is active with respect to a particular company.

Forming a Section 13(d) Group

Shareholders sometimes work together to seek change at a company. A group is formed when two or more persons agree to act together for the purpose of acquiring, holding, voting, or disposing of the subject class of equity securities. For Section 13(d) purposes, if shareholders form a group, the group is deemed to be a person, and this means if the group's aggregate holdings exceed 5%, the group must make a Schedule 13D filing (which is typically done through a joint filing by the group members) disclosing the group's arrangement to act in concert.

Companies and regulators sometimes claim that investors formed a group earlier than the participants have disclosed. No formal agreement to form a group is needed, so long as there is a meeting of the minds to act in concert with respect to one of the enumerated group purposes. This means that an activist and its advisor must carefully weigh the facts and specifics of every communication with other shareholders to ensure that a Section 13(d) group is not inadvertently formed. It is important in this regard to take into consideration the fact that the SEC will determine whether a group was formed with the benefit of hindsight. While a particular communication may seem innocuous at the time, you have to consider how that communication may appear down the road.

Disclosing and Updating Investment Intent

While shareholders are required to make a number of important disclosures in a Schedule 13D, they are required to make the most relevant disclosures under Item 4 (Purpose of Transaction). Shareholders must state the purposes of the acquisition of securities and describe any plans or proposals that relate to or would result in any of the following:

- The acquisition or disposition of securities
- An extraordinary corporate transaction
- A sale or transfer of a material amount of assets
- Any change in the present board of directors or management (including to the number or term of directors or to fill any existing vacancies)
- Any material change in the present capitalization or dividend policy
- Any other material change in the business or corporate structure
- Changes in the organizing documents
- Causing a class of securities to be delisted
- A class of equity securities becoming eligible for termination of registration

- Any action similar to the preceding

A Schedule 13D filing also requires disclosure of:

- The filer's aggregate position in the securities being reported on
- The amount of funds used to purchase the securities being reported
- The filer's trading history during the prior sixty days
- Any contracts or arrangements the filer has with any other person with respect to any securities of the issuer (including debt securities)
- Copies of certain agreements related to the foregoing as exhibits to the filing

Schedule 13D filers must also "promptly" (usually within two business days) amend their filings to reflect material changes in their initial disclosure. Such material changes can include a development in the filer's engagement or intentions with respect to the company or a change in the aggregate ownership, with an increase or decrease in beneficial ownership of 1% or more being deemed under the Section 13(d) rules to be material. General best practices for determining whether a change is material and an amendment should be made include considering:

- The nature of the change
- The market's sensitivity to the specific change
- The impact on the market of any previous disclosure
- The timing of shareholder's ability to freely acquire or dispose of shares, or exercise the rights underlying the shares, for a specified period of time

Settlements and Other Negotiated Solutions

At any point in time, including before a campaign is ever launched and often in parallel to a contest, the activist and the company may engage in negotiations in an attempt to reach an amicable resolution. If constructive dialogue ensues and the parties reach a successful settlement, the resultant agreement will usually produce the appointment of an activist-backed board member, corporate governance enhancements demanded by the activist, and sometimes a corporate change, or at least commitment to review strategic courses or form a committee of the board empowered to do so. While an activist may carefully customize a settlement agreement to further their specific business objectives with respect to a specific target, there are certain commonalities to most settlement agreements. The following provisions appear in most settlement agreements in various forms:

- **Board composition changes and governance improvements.** These provisions implement all or some of the requests of the shareholder, such as giving the shareholder a number of board seats (possibly including replacement rights and committee membership) or committing to implement governance improvements such as declassification of the board or to form a committee to oversee new strategic directions.
- **Standstill restrictions.** These are restrictions on a shareholder's ability to freely acquire or dispose of shares, or exercise the rights underlying the shares, for a specified period of time.
- **Voting obligations.** These require a shareholder to vote in line with the recommendations of the board on some or all issues during the standstill period.
- **Non-disparagement.** In these provisions parties normally agree that they will not publicly criticize one other.
- **Ownership thresholds.** These provisions establish minimum and maximum share ownership thresholds that the shareholder must meet in order to maintain the terms of the agreement.
- **Confidentiality and non-disclosure.** These obligations are with respect to the terms of the settlement, information acquired in the course of the shareholder's negotiations with the company and information learned by the shareholder's affiliates.
- **Other terms.** These include termination dates, extension options, press release requirements, expense reimbursements, dispute resolution, and forum selection.

The Future of Shareholder Activism

Shareholder activism is undergoing a meaningful and consistent surge, as well as an evolution, as the strategies mature and players become more sophisticated and creative. Among the widely reported trends are the rising levels of bolder campaigns at larger targets, the growing number of international campaigns and greater acceptance for activism outside the United States, and the increasingly critical and more engaged role of institutional investors. Additional trends that are evident in practice are access to more sophisticated and knowledgeable consultants, the availability of director candidates of the highest caliber, increasingly creative and audacious strategies, and the deeper conviction to pursue them, often through litigation if necessary. We are witnessing an exciting evolution in the roles that shareholders play, and their interactions with boards and management have the potential to change corporate governance models and practices in significant and permanent ways.

Related Content

Practice Notes

- Shareholder Activism – Developments in the M&A
- Survey of the Regulatory Landscape for Contests for Control
- Antitrust and Regulatory Considerations in an M&A Deal
- State Anti-Takeover Considerations in M&A Deals

Forms

- Schedule 13D
- Joint Filing Agreement (Beneficial Ownership Under Section 13)
- Schedule 13G

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