Harvard Roundtable on Shareholder Engagement

June 16–17, 2015

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Tab 1: The Debate About Activism

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Tuesday February 26, 2013

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton.

The activist-hedge-fund attack on Apple—in which one of the most successful, long-term-visionary companies of all time is being told by a money manager that Apple is doing things all wrong and should focus on short-term return of cash—is a clarion call for effective action to deal with the misuse of shareholder power. Institutional investors on average own more than 70% of the shares of the major public companies. Their voting power is being harnessed by a gaggle of activist hedge funds who troll through SEC filings looking for opportunities to demand a change in a company's strategy or portfolio that will create a short-term profit without regard to the impact on the company's long-term prospects. These self-seeking activists are aided and abetted by Harvard Law School Professor Lucian Bebchuk who leads a cohort of academics who have embraced the concept of "shareholder democracy" and close their eyes to the real-world effect of shareholder power, harnessed to activists seeking a quick profit, on a targeted company and the company's employees and other stakeholders. They ignore the fact that it is the stakeholders and investors with a long-term perspective who are the true beneficiaries of most of the funds managed by institutional investors. Although essentially ignored by Professor Bebchuk, there is growing recognition of the fiduciary duties of institutional investors not to seek short-term profits at the expense of the pensioners and employees who are the beneficiaries of the pension and welfare plans and the owners of shares in the managed funds. In a series of brilliant speeches and articles, the problem of short-termism has been laid bare by Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery, e.g., One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?, and is the subject of a continuing Aspen Institute program, Overcoming Short-Termism.

In his drive to enhance the shift of power over the management of companies from directors to shareholders, Professor Bebchuk has announced that he is pursuing empirical studies to prove

his thesis that shareholder demand for short-term performance enforced by activist hedge funds is good for the economy. We have been debating director-centric corporate governance versus shareholder-centric corporate governance for more than 25 years. Because they are inconvenient to his theories, Professor Bebchuk rejects the decades of my and my firm's experience in advising corporations and the other evidence of the detrimental effects of pressure for short-term performance. I believe that academics' self-selected stock market statistics are meaningless in evaluating the effects of short-termism. Our debates, which extend over all aspects of corporate governance, have of late focused on my effort to obtain early disclosure of block accumulations by activist hedge funds and my endorsement of an effort to require institutional shareholders to report their holdings two days, rather than 45 days, after each quarter. It is in the context of these efforts, opposed by the activists who benefit from lack of transparency, that Professor Bebchuk has announced his research project.

If Professor Bebchuk is truly interested in meaningful research to determine the impact of an activist attack (and the fear of an activist attack) on a company, he must first put forth a persuasive (or even just coherent) theory as to why the judgments as to corporate strategy and operations of short-term-focused professional money managers should take precedence over the judgments of directors and executives charged with maximizing the long-term success of business enterprises. There is nothing persuasive about his view, whether as theory or experience. Furthermore, he must take into account the following:

- 1. As to all companies that were members of the Fortune 500 during the period January 1, 2000 to December 31, 2012, what was the impact on the price of the shares of a company that missed the "street estimate" or "whisper number" for its earnings for a quarter and what adjustment did each of those companies make to its capital expenditures, investment in research and development and number of employees for the balance of the year of the miss and the following year.
- 2. For companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance and stock price performance relative to the benchmark, not just in the short period after announcement of the activist interest, but after a 24-month period.
- 3. Interviews with the CEOs of the Fortune 500 as to whether they agree or disagree with the following statements:
    - a) From the Aspen paper, "We believe that short-term objectives have eroded faith in corporations continuing to be the foundation of the American free enterprise system, which has been, in turn, the foundation of our economy. Restoring that faith critically requires restoring a long-term focus for boards,

managers, and most particularly, shareholders—if not voluntarily, then by appropriate regulation."

- b) From a 2002 interview with Daniel Vasella, CEO of Novartis in Fortune Magazine, "The practice by which CEOs offer guidance about their expected quarterly earnings performance, analysts set 'targets' based on that guidance, and then companies try to meet those targets within the penny is an old one. But in recent years the practice has been so enshrined in the culture of Wall Street that the men and women running public companies often think of little else. They become preoccupied with short-term 'success,' a mindset that can hamper or even destroy long-term performance for shareholders. I call this the tyranny of quarterly earnings."

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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The Myth that Insulating Boards Serves Long-Term Value

Posted by Lucian Bebchuk, Harvard Law School, on Monday April 22, 2013

Editor's Note: Lucian Bebchuk is Professor of Law, Economics, and Finance at Harvard Law School. This post is based on his article, The Myth that Insulating Boards Serves Long-Term Value, forthcoming this fall in the *Columbia Law Review,* available here.

In a new study, The Myth that Insulating Boards Serves Long-Term Value (forthcoming, *Columbia Law Review*, October 2013), I comprehensively analyze – and debunk – the view that insulating corporate boards serves long-term value.

Advocates of board insulation claim that shareholder interventions, and the fear of such interventions, lead companies to take myopic actions that are costly in the long term – and that insulating boards from such pressure therefore serves the long-term interests of companies and their shareholders. This claim is regularly invoked to support limits on the rights and involvement of shareholders and has had considerable influence. I show, however, that this claim has a shaky conceptual foundation and is not supported by the data.

In contrast to what insulation advocates commonly assume, short investment horizons and imperfect market pricing do not imply that board insulation will be value-increasing in the long term. I show that, even assuming such short horizons and imperfect pricing, shareholder activism, and the fear of shareholder intervention, will produce not only long-term costs but also some significant countervailing long-term benefits.

Furthermore, there is a good basis for concluding that, on balance, the negative long-term costs of board insulation exceeds its long-term benefits. To begin, the behavior of informed market participants reflects their beliefs that shareholder activism, and the arrangements facilitating it, are overall beneficial for the long-term interest of companies and their shareholders. Moreover, a review of the available empirical evidence provides no support for the claim that board insulation is overall beneficial in the long term; to the contrary, the body of evidence favors the view that shareholder engagement, and arrangements that facilitate it, serve the long-term interests of companies and their shareholders.

I conclude that, going forward, policy makers and institutional investors should reject arguments for board insulation in the name of long-term value.

Here is a more detailed account of the analysis in the article:

According to the board insulation view, inefficient capital markets and short investor horizons couple to produce a problem of "short-termism." Short-termism refers to companies taking actions that are profitable for the short term but value-decreasing in the long term, such as increasing near-term earnings by cutting research that would pay off later on. Activist investors with short investment horizons, it is argued, seek such actions and often succeed in pressuring companies to take them. Furthermore, it is argued, when corporate arrangements facilitate shareholders' ability to replace or influence directors, fear of activist intervention in the absence of satisfactory short-term results produces pressure on management to focus excessively on these results to the detriment of long-term value.

Insulation advocates contend that the long-term costs of short-termism, produced by both shareholder interventions and fears of such interventions, make it desirable to shield boards from shareholders. The long-term interests of companies and their shareholders are best served, these advocates argue, by insulating boards from shareholder pressure and enabling them to focus on enhancing long-term value.

The stakes in this debate are large. Arguments supporting the long-term benefits of board insulation have played a central role in corporate law policy debates for at least three decades. These arguments have been advanced by prominent legal academics, significant economics and business school professors, management thought leaders, influential business columnists, important organizations, a recent report commissioned by the British government, and noted corporate lawyers. Indeed, invoking the alleged long-term benefits of board insulation has been a standard and key argument in a wide range of significant corporate law debates, including those in support of takeover defenses, impediments to shareholders' ability to replace directors, and limitations on the rights of shareholders with short holding periods.

Furthermore, insulation advocates have been successful in influencing important public officials and policy makers. Chancellor Leo Strine and Justice Jack Jacobs, prominent figures in the Delaware judiciary, have expressed strong support for this view. Congress held hearings on the subject. William Donaldson, when he was chair of the SEC, accepted that short-termism is "a critical issue," and short-termism arguments persuaded the SEC to limit use of the proxy rule adopted in 2010 to shareholders that have held their shares for more than three years. Even

institutional investors, which are otherwise reluctant to support limiting shareholder rights, have shown significant willingness to accept the validity and significance of short-termism concerns.

The substantial impact of the claims made by insulation advocates may be at least partly due to the asserted gravity of the concerns they have expressed. Insulation advocates have argued that short-termism has “substantial corporate and societal costs,” “has created a national problem that needs to be fixed,” represents “a disease that infects American business and distorts management and boardroom judgment,” and has “eroded faith in corporations continuing to be the foundation of the American free enterprise system.” Indeed, insulation advocates have even viewed shareholder pressure as causes for the Enron and WorldCom scandals, the crash of 1987, and the excessive risk taking by financial firms in the run-up to the financial crisis of 2008–2009.

While insulation advocates have used strong rhetoric in expressing their concerns, they have failed to provide an adequate basis for their claims. These claims rely on critical and unsubstantiated premises, overlook the significant long-term costs of board insulation, and are not backed by evidence. Indeed, I show in this paper that an analysis of the long-term effects of board insulation, informed by the relevant theoretical and empirical literature, does not support such insulation.

To begin, insulation advocates often fail to acknowledge that they are advancing empirically contestable propositions whose validity cannot be derived from theory or intuition. Contrary to what insulation advocates commonly presume, even assuming the existence of inefficient capital markets and short investor horizons, it does not follow from these assumptions that the long-term effects of board insulation are overall positive. Under these assumptions, board insulation might produce some long-term benefits – but these benefits might still be outweighed by significant countervailing costs.

In particular, with inefficient market pricing and short investor horizons, it is theoretically possible that activists might in some cases seek actions that are not value-maximizing in the long term. The question remains, however, how often such situations do arise and, furthermore, whether the expected costs of such situations exceed the expected benefits from activists’ clear interest in seeking actions that are positive for both the short term and the long term.

Similarly, with inefficient market pricing and short investor horizons, fears of activist intervention and the arrangements facilitating it might theoretically lead some management teams to make distorted decisions with respect to long-term investments. However, the expected costs of such decisions have to be weighed against the expected long-term benefits of activist stockholder

interventions and the accountability and discipline they produce. Such accountability and discipline provide incentives to avoid shirking, empire building, and other departures from shareholder interests that are costly for both the short term and the long term.

Turning to examine the balance of costs and benefits associated with board insulation, I point out patterns of behavior that reflect a widespread and consistent view among sophisticated and well-informed market participants that activist interventions, and arrangements facilitating them, do not overall decrease value in the long term. The lack of investment products and services based on the prediction that companies targeted by activists underperform in the long term suggests the absence of any significant group of long-term investors that are willing to bet money on the validity of this underperformance claim. Similarly, the overwhelming opposition to insulation-increasing arrangements reflected in the voting decisions of institutional investors, including investors with long investment horizons, indicates that these investors do not subscribe to the view that such arrangements serve long-term value.

These patterns should give insulation advocates some pause. They should be reluctant to maintain that they know the interests of investors better than investors themselves unless they have significant empirical evidence to back up their views. Insulation advocates, however, have thus far failed to provide such evidence. They often failed to acknowledge the need for evidence or offered their experience as evidence.

Fortunately, empirical evidence that can shed light on the long-term effects of board insulation has been accumulating over the past decade. I provide a full review and analysis of the relevant empirical work by researchers, including work in which I have participated. As to activist interventions, existing empirical evidence – including a recent study by Alon Brav, Wei Jiang and I that analyzes the long-term effects of a large universe of activist interventions – provides no support for the view that such interventions are followed in the long term either by losses to the shareholders of targeted companies or by declines in the companies' operating performance of these companies. As to the fear of activist interventions, the body of existing empirical work again does not provide support for the view that stronger board insulation serves the long-term interest of companies and their shareholders.

To the contrary, the existing body of evidence favors the view that shareholders' ability to intervene and engage with companies provides long-term benefits to companies, shareholders, and the economy. This evidence indicates that activists target companies whose operating performance has been declining, and that their interventions are followed by improvements in operating performance that do not come at the expense of performance later on. Anticipating such improvements, market capitalization of targeted companies appreciates upon the

announcement of activist campaigns to levels that are not reversed in the long term. Furthermore, arrangements that insulate boards from shareholders and shareholder pressure have been consistently associated with lower firm value as well as with worse operating performance.

Given that available theory and evidence do not support the claims of insulation advocates, public officials and institutional investors should not be receptive to claims based on the asserted long-term benefits of board insulation. They should reject the use of such claims as the basis for rules, arrangements, and policies that limit the rights and powers of shareholders.

The study is available here.

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday May 7, 2014

Editor's Note: The following post is based on a recent *Columbia Law Review* article, earlier issued as a working paper of the Harvard Law School Program on Corporate Governance, by Leo Strine, Chief Justice of the Delaware Supreme Court and a Senior Fellow of the Program. The article, Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law, is available here. The article is a response essay to an earlier *Columbia Law Review* article by Professor Lucian Bebchuk, available here and discussed on the Forum here.

Leo Strine, Chief Justice of the Delaware Supreme Court Review and a Senior Fellow of the Harvard Law School Program on Corporate Governance, recently published in the *Columbia Law Review* a response essay to an essay by Professor Lucian Bebchuk published in the *Columbia Law Review* several months earlier. Professor Bebchuk's essay, The Myth that Insulating Boards Serves Long-Term Value, is available here and was featured on the Forum here. Chief Justice Strine's essay, titled Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law, is available here.

The abstract of Chief Justice Strine's essay summarizes it briefly as follows:

> In his essay, *The Myth That Insulating Boards Serves Long-Term Value*, Professor Lucian Bebchuk draws a stark dichotomy between so-called "insulation advocates" and proponents of shareholder-driven direct democracy. This Essay begins by rejecting this crude divide between "good" and "evil," and focuses instead on the practical realities surrounding increases in stockholder power in an era where there is a "separation of ownership from ownership." That separation arises because the direct stockholders of private companies are typically not end-user investors, but instead money managers, such as mutual funds or hedge funds, whose interests as agents are not necessarily aligned with

> the interests of long-term investors. These practical realities suggest that Bebchuk's crusade for ever more stockholder power may not actually be beneficial to ordinary investors, and that his contention—that further empowering stockholders with short-term investment horizons will not compromise long-term corporate value—is far from proven. This Essay concludes with some thoughts on improvements that could be made in the system that we have. These suggestions are not radical in either direction and they do not involve rolling back the rights of stockholders. Rather, these suggestions recognize that the fiduciaries who wield direct voting power over corporations should do so in a manner faithful to the best interests of those whose money they control, include proposals to require activist investors to bear some of the costs they impose and to disclose more information about their own incentives so that the electorate can evaluate their motives, and provide incentives that better align the interests of money managers and ordinary investors toward sustainable, sound long-term corporate growth. Taken as a whole, these suggestions would create a more rational accountability system by making all of the fiduciaries for ordinary investors focus more on what really matters for investors, citizens, and our society as a whole—the creation of durable wealth through fundamentally sound economic activity.

Chief Justice Strine provides a more detailed account of the analysis of his Essay in the introduction:

> "According to my dear friend and colleague, the distinguished Professor Lucian Bebchuk, everyone who has at any time questioned the extent to which public corporations should be direct democracies whose board of directors and managers must follow the immediate whim of a momentary majority of stockholders can be labeled and lumped together as an "insulation advocate," in order to create an intellectual straw man for him to burn down easily. Bebchuk is the sincere champion of one group of "agents" wielding power and authority over others' money—the money managers who control most of the investments belonging ultimately to ordinary Americans who are saving to pay for their retirements and for their children's education—against another group of "agents" that he believes is somehow more conflicted—the agents who actually manage corporations that make real products and deliver useful services (i.e. "productive corporations"). The fact that he is an advocate for the power of one group of privileged "haves" against another might lead a dispassionate observer to expect that Bebchuk would be cautious in drawing stark lines, on one side of which are

the good and faithful agents—the money managers—and on the other side are the suspect and presumptively faithless agents—the managers of productive corporations. In fact, such an unwitting observer might infer that someone passionate about constraining the agency costs of those who directly manage productive corporations would also be passionate about constraining the agency costs of the money managers who directly hold other people's money.

But Bebchuk is not an Adolf Berle who is concerned that all who wield economic and political power in a republican democracy are accountable for their responsible use of that power. That is not how Bebchuk approaches things. For him, there is only one set of agents who must be constrained—corporate managers—and the world will be made a better place when corporations become direct democracies subject to immediate influence on many levels from a stockholder majority comprised not of those whose money is ultimately at stake, but of the money manager agents who wield the end-users' money to buy and sell stocks for their benefit.

In this crude divide between good and evil, Professor Bebchuk is not alone. Arrayed against him and his fellow "money manager advocates" are scholars, corporate lawyers, and businesspersons who view stockholders as having little to no utility in helping corporations generate wealth and who seem to wish stockholders would simply go away. As with Bebchuk's fellow money manager advocates, there are differences among those who wish to constrain stockholder influence. In some cases, these skeptics go so far as to deny that boards of directors must, within the constraints of the law, make the best interests of stockholders the end goal of the governance of a for-profit corporation. Instead of accepting that a prerequisite to the application of the business judgment rule is that the directors have the same interest as the stockholders—i.e., in making the decision that will make the corporation the most profitable—these skeptics argue that the business judgment rule is really just a beard to give boards the cover they need to treat the stockholders' best interest as only one of many permissible ends, including the best interests of the communities in which the corporation operates, the corporation's consumers and workers, the environment, and society as a whole. In their minds, iconic cases like Dodge v. Ford and Revlon, which hold the opposite, are mere aberrations; really, the law is that boards can treat all constituencies equally in terms of the ends of management.

Inconvenient to this notion on two levels is an indisputable reality of American corporate law. That is the reality that if American corporate law makes all constituencies an end of corporate governance, American corporate lawmakers chose a decidedly unusual way to enable that equality. In American corporate law, only stockholders get to elect directors, vote on corporate transactions and charter amendments, and sue to enforce the corporation's compliance with the corporate law and the directors' compliance with their fiduciary duties. An unsubtle mind might believe that this statutory choice to give only stockholders these powers might have some bearing on the end those governing a for-profit corporation must pursue. But regardless of whether that is so as a matter of law, this allocation of power has a profound effect as a matter of fact on how directors govern for-profit corporations. When only one constituency has the power to displace the board, it is likely that the interests of that constituency will be given primacy.

More nuanced participants in the debate do not quibble with the notion that the end goal of for-profit corporations is the best interests of stockholders. But these participants argue that the best way to ensure that corporations generate wealth for diversified stockholders is to give the managers of corporations a strong hand to take risks and implement business strategies without constant disruption by shifting stock market sentiment. Those in this more measured place are troubled by the fact that traditional rights granted to stockholders may have a less desirable impact on the ability of corporations to generate wealth given important market developments, such as the realities that: Money manager intermediaries constitute a supermajority of those wielding actual stockholder rights rather than the long-term investors whose money is actually invested; activist investors are able to engage in hedging strategies that limit their exposure if their preferred strategies for the corporation do not turn out to be sound; putting together a momentary majority is easier today because of more concentrated ownership patterns and the Internet; and institutional investors have emerged who seem to be motivated by a desire for engagement for reasons unrelated to investment value. Even when the debate is narrowed to focus on the best interests of equity investors, these commentators worry that the demands of money managers and their advocates for additional rights will compromise the ability of corporations to pursue the most profitable courses of action for those whose money is ultimately at stake—the end-user investors saving to pay for college and retirement—because managers will be distracted and disrupted by constant mini-referendums and continual election seasons initiated by activist investors.

As may fit their shared experiences as Dungeons & Dragons aficionados, Bebchuk and his sparring partners share an affinity for exploring "myths" and engaging in rhetorical jousts where no real world blood is shed. One area of sharp disagreement between his money manager advocate team and the stronger insulation advocate team members is whether more wealth will be created for end-user investors by corporations if corporate managers are given more or less room to pursue strategies without fearing displacement of themselves or those strategies by stockholders. In this new essay, Bebchuk claims that there is no rational basis to believe that operating corporations under a direct democracy model will result in any reduction in the ability of corporations to generate profits in a durable manner. Even if the money managers who directly act as stockholders do not hold stock for more than the blink of an eye in real business terms, giving them more power for constant intervention is not worrisome because there is no empirical evidence that making corporate managers accountable to direct stockholder influence at all times, rather than periodically, reduces corporate value. In other words, Bebchuk argues that even if the activists proposing corporate action hold their shares for a few years at most and the electorate considering their proposals holds for months at a time, that does not necessarily mean that their incentives are distorted in any sense that might lead them to favor strategies that are inconsistent with the corporation's ability to create the most long-term, sustainable economic value for stockholders and to honor its obligations to creditors and society as a whole.

By contrast, Bebchuk's intellectual adversaries are skeptical that money managers, who buy and sell stocks rapidly in defiance of the core insight of the efficient capital market hypothesis (ECMH), are focused on whether strategies proposed by hedge funds are well-thought-out in terms of their effect on the corporation's capacity to comply with its legal duties and generate strong profits on a long-term basis. Many of them view it as likely that money managers—who do not intend to be around when the consequences of corporate policies proposed by activist hedge funds come to fruition—will give great weight to the short-term effect of policies, without adequately considering whether those policies create too little long-term investment or too much leverage and externality risk. For end-user investors who depend on their portfolio's ability to generate sustainable long-term growth, bubbles in equity prices that come at the expense of more durable and higher long-term growth are counterproductive. For society as a whole, further empowering money managers with short-term holding periods subjects Americans to lower long-term growth and job creation,

wreckage from corporate failures due to excessive risk taking and debt, and the collateral harm caused when corporations face strong incentives to cut regulatory corners to maximize short-term profits.

As I understand the primary purpose of Bebchuk's essay, it is to impose on the so-called insulation advocates the burden of proving that any limitation on the direct democracy model that money manager advocates favor is justified. Absent empirical proof that stockholder activism directed at corporations reduces stockholders' returns, insulation advocates should be mute and accept Bebchuk's view that corporations should be governed as direct democracies subject to the will of whatever majority happens to own their stocks at any particular time. Bebchuk marshals various empirical studies to support his contention that insulation advocates cannot meet the burden he puts before them. Although his essay is lengthy, his empirical claims are essentially two in nature and related. First, as to corporate governance rules of the road affecting how easy it is to replace a corporate board or effect a takeover—such as whether a corporation has a classified board—there is evidence that corporations without strong antitakeover defenses have higher values than similarly situated corporations with such defenses. In other words, Bebchuk contends that corporate managers who are more vulnerable to displacement by the market for corporate control deliver better returns. Second, and relatedly, Bebchuk argues that it has not been shown that long-term returns have been harmed because of the greater influence that reduced takeover defenses and increased electoral vulnerability for directors gives to activist investors such as hedge funds proposing that corporations change their business strategies. Because Bebchuk reductively focuses on equity returns, he blinds himself to any consideration of externality effects or the larger economic outcomes of the American economy for its citizens. Although he does not say so explicitly, one would suppose that he would argue, as others have, that what is good for equity holders as the so-called residual claimants is good for everyone else, and that if corporations can produce higher returns to equity, they will be better able to pay their other bills and honor their obligations to society.

I will not pretend to have had sufficient time nor training in statistical "social science" to evaluate whether Bebchuk's review of the empirical evidence is convincing. I must admit to having a healthy skepticism whenever the "law AMPERSAND" movement cranks up its machinery and tries to prove empirically a contestable proposition about a complicated question involving the governance

of a human community of any kind. I am particularly skeptical about claims that actions have no, this, or that effect in the long-term by reference to short-term period effects, justified by the argument that long-term effects cannot be measured because they are drowned out by “noise.” I cannot and will not claim that my respected friend Professor Bebchuk misstates the results of the studies he cites or that the one he himself conducted was done with anything but the greatest accuracy and rigor. I leave to others whose full-time job is writing academic articles to engage with the cited studies on those terms.

I do note that Bebchuk’s view—that there is no empirical reason to doubt that further moves toward the direct democracy model he favors will be good for long-term stockholder interests and those of society as a whole—is not universally shared. Respected scholars who are not fans of unconstrained corporate management believe that there are substantial reasons why a move to direct democracy might harm long-term corporate value. As they note, it is a solar system from the central claim of the ECMH—that it is unlikely that any person pursuing an active trading strategy is likely to outperform the market as a whole—to presuming that the stock market price of a particular company on a particular day represents a reliable estimate of the company’s future expected cash flows. They point to real world evidence that the companies most heavily engaged in and exposed to the risks of the financial practices that led to the financial crisis had received a premium in the stock market for doing so, despite the existence of public information suggesting that these practices were unsustainable in the long run and posed substantial risk. Bubble run-ups in the value of these companies’ stock might have provided value to stockholders engaged in rapid trading, but the companies’ stuck-in stockholders (such as those who were indexed) took the whole ride, which in some cases ended in a ravine. Furthermore, these scholars note that it is difficult to measure the system-wide costs of making corporate managers more directly accountable to changing market sentiments, but point out that such accountability could be dangerous to our economy’s long-term prospects for growth when a survey of corporate managers revealed that many of them would fail to pursue net present value positive capital investments if they feared that those projects would result in an inability to meet near-term earnings estimates. Some of Bebchuk’s debating adversaries even venture a more macro-level critique, wondering why proponents of direct democracy believe that the strong directional inertia in their favor should not be braked when a forest-level look at outcomes reveals: (i) much higher executive compensation and a growing disparity between CEO and

average worker pay; (ii) unimpressive returns to stockholders; (iii) stagnant economic growth; (iv) the need for huge government subsidies for corporations and industries that engaged in speculative and excessively risky conduct in pursuit of stockholder profit; and (v) sharp declines in the number of American public corporations. Put simply, they wonder what big-picture results for stockholders, or Americans more generally, have come from the sharp move in the last quarter century toward making corporations more responsive to stockholder pressure that might justify the efforts of Bebchuk and his allies to continue to push corporations even closer to the direct democracy model.

Interestingly, Bebchuk's debating adversaries have overlooked what might be seen as an admission on his part that increasing demands on corporations to manage to immediate stock market pressures might not be good for stockholders or society generally. Consistent with his distrust of agents who run actual corporations, Bebchuk has expressed concern about rewarding corporate managers for increasing the stock price without contractual protections requiring them to hold on to their equity for a long-term period. The reason: Bebchuk fears that if managers can benefit from short-term stock price increases without bearing the long-term risks that the policies causing those increases entail, they may propose and implement measures that sacrifice long-term, sustainable growth for short-term gain. In his own words: "Executives who are free to unload shares or options may have incentives to jack up short-term stock prices by running the firm in a way that improves short-term results at the expense of long-term value."

Likewise, although Bebchuk's career-long obsession has been advocating that corporate managers should be directly responsive to the immediate demands of the current stockholder majority, in recent writings he has expressed concern that paying corporate managers equity-based compensation could lead managers to implement excessively risky strategies that create a potential for bankruptcy and cause harm to creditors, employees, and society as a whole. The long-term stockholders who hold the stock when such risks come to fruition would, of course, suffer too.

It is likely that corporate managers, in contrast with activist investors such as hedge funds, are actually far more dependent on their employer firm's sustainable value and would thus be more, not less, immune to the temptation of forsaking long-term value for a short-term stock pop coming from an unduly risky

business strategy. But the logic that drives Bebchuk to worry about these temptations does not seem to trouble him when he is dealing with anyone claiming the title "stockholder," regardless of whether their investment horizons and portfolio likely make them far less invested in the corporation's long-term fate than a typical corporate manager. A dispassionate observer, however, might note that the analytical force of Bebchuk's analysis of the dangers of paying corporate managers in a way that breaks the link between short-term reward and accompanying long-term risk cannot be confined to that specific context. Ideology can be blinding, even apparently when one's secular faith involves the simple creed that those who own stocks are presumptively selfless while those who manage corporations are presumptively selfish and untrustworthy.

There is another oddment to Bebchuk's continuing push for direct democracy. For years, he and his allies pushed to make corporate directors more accountable directly to stockholders and to shift power within the boardroom to independent directors meeting stricter definitional standards. They were successful in this effort. Most boards are comprised not simply of a majority of independent directors, but almost exclusively of independent directors, with the CEO often being the only nonindependent director. Key board committees like compensation, audit, and nominating must be comprised solely of independent directors. But, rather than the increasing power of independent directors providing a relaxation of the need to move further toward a direct democracy model, Bebchuk and his fellow money manager advocates have instead proposed that these newly empowered independent directors be subject to the specific direction of stockholders on virtually every important aspect of management, including compensation, charter and bylaw changes, and change of control transactions. They also propose that these independent directors be removable from office not just when beaten at the polls by an actual human candidate, but also through a de facto recall vote in the form of a withhold campaign.

As, or more, important than the composition of boards, easy financing and the sharp reduction in the prevalence of antitakeover defenses have made the market for corporate control more vibrant as a disciplinary tool. Although Bebchuk will likely not admit the extent to which his world view helped to form a more open market for corporate control, that does not mean it is not a reality. With managers regularly subject to the type of discipline that Bebchuk and others thought would keep managers on their toes, the need for further ballot initiatives

is not evident. Of course, Bebchuk might note the decline in hostile takeovers. But the reason is telling: Serious bidders have no need to go hostile; they can get a fair opportunity to buy just by making an offer. The more expensive and risky route of hostility is not necessary, as most boards are happy to consider selling at a genuinely attractive price.

To the extent that Bebchuk claims that the empirical evidence regarding average increases in value at firms targeted by hedge fund activism supports deviating from board insulation at current levels, he must confront the possibility that increasing the leverage that hedge funds have against boards will generate less positive results. If, as Bebchuk and others posit, the market is now working well because hedge funds and the board each have clout and can debate their respective positions, leaving the solid center of the stockholder electorate to decide which is right and to encourage both hedge funds and boards to move toward policies that increase stockholder profitability in a durable way good for most investors, his contention that this relationship should be further tilted in favor of the insurgents itself requires more support. As a respected scholar notes, "[S]ince the mid-2000s . . . management has responded to shareholder demands as never before."

The need for fuller and more timely disclosure about the interests of activist investors who propose changes in the business plans of corporations but are not prepared to make a fully funded, all-shares offer to buy the corporation is arguably made more advisable because of these market developments. At the beginning of the takeover and merger boom that began in the early 1980s, scholars sharing Bebchuk's viewpoint that stockholders should get the final say on whether to accept a takeover bid argued that the optimal blend for stockholders was one where the traditional values of the business judgment rule gave managers room to innovate and take risks, with the takeover market acting as a protective check to ensure that stockholders could exit through a premium if a buyer believed it could do better in managing the assets than incumbent management. With easy access to financing available for buyers and the decline in structural takeover defenses, it has never been easier to make a full company offer and get it accepted. When a buyer purchases the entire company, it signals that it and its financing partners are willing to fully absorb the future risk of its business strategy. By contrast, when an activist argues that a corporation would be more valuable if it changed its business strategy, but is not prepared to buy the company or to even commit to hold its stock for any particular period of time,

there is good reason to make sure that the other stockholders have full information about the precise economic interests of that activist. With the sharp decline in structural takeover defenses, the plush access to deal financing, the prevalence of boards with supermajorities of independent directors, the increasing ease of running proxy contests and withhold campaigns due to increased institutional ownership, and the inexpensive nature of internet communication, the barriers to takeover bids, corporate governance and business strategy proposals, and changes to the board itself are lower than ever. Put simply, it is not clear that Bebchuk's findings do not support the conclusion that the current status quo, with all of its real world human blemishes, strikes, as a general matter, a reasonable balance between stockholder and management power. And Bebchuk's own articulation of the dynamic, which is shared by other distinguished scholars who may not agree with him on other particulars, suggests that modest policy moves that better enable the solid center of the investor community to more effectively evaluate activist proposals so that sound ones are more likely to become corporate policy and excessively risky ones are more likely to be rejected might even appeal to him.

I do not presume that there is any way to bridge the great divide between Bebchuk, on the one extreme, and those like Lynn Stout, on the other, as their positions are so starkly divergent. A far more modest goal might be in reach, though, suggested by the preceding discussion of disclosure regarding hedge fund activists' economic interests. That is, it may be possible to find some common ground between these dueling camps that might allow us to improve the corporate governance system we actually have, given the allocation of legal and market power that in fact exists. For example, it might be possible for all participants in the debate to acknowledge three things. First, stockholders have formidable power under our system of corporate governance. Second, the direct stockholders of productive corporations primarily consist of institutional investors who are themselves susceptible to conflicts of interests and other incentives that may lead them to act in ways that diverge from those whose capital they are controlling. Third, all fiduciaries within the accountability system for productive corporations should themselves be accountable for acting with fidelity to the best interests of the end-user investors whose money is ultimately at stake. If there is agreement on these mundane grounds, it might be possible to improve the system as it actually exists so that it works better for both investors and society more generally.

To the extent that Bebchuk accepts his sparring partners' contention that it is important that corporations be governed in a manner likely to create the most sustainable wealth for their investors and society, this means that both he and they should want a process of corporate accountability where there is adequate and effective representation of the interests of investors who have entrusted their capital to the market for the long term. To the extent that Bebchuk believes that stockholder input on key corporate issues is valuable, one would assume he believes that stockholder input should be based on a genuinely thoughtful deliberative process that involves careful consideration of what is in the interests of the ultimate investors for whom the stockholder is acting. In particular, if Bebchuk believes that any dangers posed by certain stockholders who have short-term investment horizons are checked because institutional investors representing long-term investors cast most of the votes, he should support ensuring that the representatives of long-term investors in fact think and vote in the manner faithful to their investors' unique interest in sustainable, durable wealth creation. Likewise, if Bebchuk believes that facilitating a reasoned debate between management and activist stockholders about important issues where the argument is settled by mainstream elements of the institutional investor community will produce good results for investors, one would also assume that he would not want those mainstream investors deluged with thousands of annual votes that are impossible to consider in a careful, cost-effective way.

Although it would be difficult to find much acknowledgement in his work, Bebchuk is likely to agree that innovative and competent management remains the key driver of returns for stockholders. Certainly his sparring partners would. Therefore, it might be that Bebchuk would recognize that it is counterproductive for investors to turn the corporate governance process into a constant Model U.N. where managers are repeatedly distracted by referenda on a variety of topics proposed by investors with trifling stakes. Giving managers some breathing space to do their primary job of developing and implementing profitable business plans would seem to be of great value to most ordinary investors. Likewise, Bebchuk and his sparring partners might agree that business strategies do not tend to be proven successful or not within the space of a year and that an effective system of accountability would be one where stockholders periodically have an enhanced opportunity to displace the board or change corporate policies such as compensation plans based on their assessment of several years of data regarding the company's performance and the consequences of the board's policies. In other words, if it was wise of our Founders to put in place a system

> where Abraham Lincoln would be subject to removal based on his performance in 1864, rather than every year, perhaps that sensible notion of holding vibrant elections after a rational time frame that takes into account the incumbent's performance over a period more relevant to the governance of a sophisticated entity is one that ought to be considered in determining how often to hold stockholder votes on issues like executive compensation and how often to enhance the chances of a proxy contest through subsidies like proxy access or reimbursement.
>
> In the pages that follow, I will venture some thoughts on improvements that could be made in the system that we have. As befits someone who embraces the incrementalist, pragmatic, liberal tradition of addressing the world as it actually is, these suggestions are not radical in either direction. They do not involve rolling back the rights of the stockholders of productive corporations. Rather, they involve accepting the reality that stockholders have strong rights and trying to create a system for use of those rights that is more beneficial to the creation of durable wealth for them and for society as a whole. Consistent with Bebchuk's concern that humans controlling others' money should be accountable for faithfully using that power, they do involve some modest requirements: that the fiduciaries who wield direct voting power over productive corporations do so in a manner faithful to the best interests of those whose money they control, and that stockholders who propose corporate actions that cost other stockholders money have a sufficient economic stake to justify the substantial costs imposed by ballot measures. Likewise, they recognize that activist stockholders who seek to act on the corporation and cause it to change its business strategy are taking action that affects all stockholders, and that the electorate should therefore have information about the activists' economic incentives in considering whether their proposals are in the best interests of the corporation.
>
> With that framework in mind, I hazard some specific thoughts about what a more sensible system of corporate accountability might involve."

Chief Justice Strine's response essay is available here.

The Harvard Law School Forum on Corporate Governance and Financial Regulation

The Long-Term Effects of Hedge Fund Activism

Posted by Lucian Bebchuk, Harvard Law School, Alon Brav, Duke University, and Wei Jiang, Columbia Business School, on Monday August 19, 2013

Editor's Note: Lucian Bebchuk is Professor of Law, Economics, and Finance at Harvard Law School. Alon Brav is Professor of Finance at Duke University. Wei Jiang, Professor of Finance at Columbia Business School. This post is based on their study, The Long-Term Effects of Hedge Fund Activism, available here. An op-ed about the article published in the *Wall Street Journal* summarizing the results of the study is available here.

We recently completed an empirical study, The Long-Term Effects of Hedge Fund Activism, that tests the empirical validity of a claim that has been playing a central role in debates on corporate governance – the claim that interventions by activist shareholders, and in particular activist hedge funds, have an adverse effect on the long-term interests of companies and their shareholders. While this "myopic activists" claim has been regularly invoked and has had considerable influence, its supporters have thus far failed to back it up with evidence. Our study presents a comprehensive empirical investigation of this claim. Our findings have important policy implications for ongoing policy debates on corporate governance and the rights and role of shareholders.

Below is a more detailed account of the analysis in our study:

Activist hedge funds have been playing an increasingly central role in the corporate governance landscape, and their activism has been strongly resisted by many issuers and their advisors. Opponents of such activism have been advancing the "myopic activists" claim — that activist hedge funds push for actions that are profitable in the short term but are detrimental to the long term interests of companies and their long-term shareholders.

The problem, it is claimed, results from the failure of short-term market prices to reflect the long term costs of actions sought by short-term activists. As a result, activists seeking a short term spike in a company's stock price have an incentive to seek actions that would increase short-term prices at the expense of long-term performance, such as cutting excessively investments in long-term projects or the reserve funds available for such investments.

The myopic activists claim has far been put forward by a wide range of prominent writers. Such concerns have been expressed by significant legal academics, noted economists and business school professors, prominent business columnists, important business organizations, and top corporate lawyers.

Furthermore, those claims have been successful in influencing important public officials and policy makers. For example, Chancellor Leo Strine and Justice Jack Jacobs, two prominent Delaware judges, have expressed strong concerns about short-sighted activism. And concerns about intervention by activists with short horizons persuaded the SEC to limit use of the proxy rule adopted in 2010 to shareholders that have held their shares for more than three years.

The policy stakes are high. Invoking the long-term costs of activism has become a standard move in arguments for limiting the role, rights, and involvement of shareholder activists. In particular, such arguments have been used to support, for example, takeover defenses, impediments to shareholders' ability to replace directors, limitations on the rights of shareholders with short holding periods.

The myopic activists claim is a factual proposition that can and should be empirically tested. However, those advancing the myopic activists claim have thus far failed to back their claims with any large sample empirical evidence. Some supporters of the claim seem to assume the validity of their claims, failing to acknowledge the empirically contestable nature of their claim and the need for evidence, while other supporters of the claim have offered their experience as evidence.

At the same time, financial economists have produced significant empirical work on hedge fund activism. There is evidence that Schedule 13D filings – public disclosures of the purchase of a significant stake by an activist – are accompanied by significant positive stock price reactions as well as subsequent improvements in operating performance. However, supporters of the myopic activist claims dismiss this evidence, taking the view that losses to shareholders and companies from activist interventions take place later on.

On their view, improved performance following activist interventions comes at the expense of sacrificing performance later on, and short-term positive stock reactions merely reflect inefficient market prices that are moved by the short-term changes and fail to reflect their long-term costs. Thus, one prominent supporter of the myopic activism claim claimed earlier this year that the important question is"[f]or companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance and stock price performance relative to the benchmark, not just in the short period after announcement of the activist interest, but after a 24-month period."

Data about companies' operating performance and stock returns years following activist intervention is publicly available and easily accessible. Nonetheless, supporters of the myopic activists view have failed to back their view with empirical evidence or even to test empirically the validity of their view. In our study, we seek to fill this void by providing the first comprehensive empirical investigation of the myopic activists claim.

Our study uses a dataset consisting of the full universe of approximately 2,000 interventions by activist hedge funds during the period 1994–2007. We identify for each activist effort the month (the intervention month) in which the activist initiative was first publicly disclosed (usually through the filing of a Schedule 13D). Using the data on operating performance and stock returns of public companies during the period 1991-2012, we track the operating performance and stock returns for companies during a long period – five years – following the intervention month. We also examine the three-year period that precedes activist interventions and that follows activists' departure.

Starting with operating performance, we find that operating performance improves following activist interventions and there is no evidence that the improved performance comes at the expense of performance later on. During the third, fourth, and fifth year following the start of an activist intervention, operating performance tends to be better, not worse, than during the pre-intervention period. Thus, during the long, five-year time window that we examine, the declines in operating performance asserted by supporters of the myopic activism claim are not found in the data. We also find that activists tend to target companies that are underperforming relative to industry peers at the time of the intervention, not well-performing ones.

We then turn to stock returns following the initial stock price spike that is well-known to accompany activist interventions. We first find that, consistent with the results obtained with respect to pre-intervention operating performance, targets of activists have negative abnormal returns during the three years preceding the intervention. We then proceed to examine whether, as supporters of the myopic activism claim believe, the initial stock price reflects inefficient market pricing that fails to reflect the long-term costs of the activist intervention and is thus followed by stock return underperformance in the long term.

In investigating the presence of negative abnormal returns during this period, we employ three standard methods used by financial economists for detecting stock return underperformance. In particular, the study examines: first, whether the returns to targeted companies were systematically lower than what would be expected given standard asset pricing models; second, whether the returns to targeted companies were lower than those of "matched" firms that are similar in terms of size and book to market; and, third, whether a portfolio based on taking

positions in activism targets and holding them for five years underperforms relative to its risk characteristics. Using each of these methods, we find no evidence of the asserted reversal of fortune during the five-year period following the intervention. The long-term underperformance asserted by supporters of the myopic activism claim, and the resulting losses to long-term shareholders resulting from activist interventions, are not found in the data.

We also analyze whether activists cash out their stakes before negative stock returns occur and impose losses on remaining long-term shareholders. Because activist hedge funds have been documented to deliver adequate returns to their own investors, such a pattern is a necessary condition for long-term shareholders being made worse off by activist interventions. We therefore examine whether targets of activist hedge funds experience negative abnormal returns in the three years after an activist discloses that its holdings fell below the 5% threshold that subjects investors to significant disclosure requirements. Again using the three standard methods for detecting the existence of abnormal stock returns, we find no evidence that long-term shareholders experience negative stock returns during the three years following the partial or full cashing out of an activist's stake.

We next turn to examine the two subsets of activist interventions that are most resisted and criticized – first, interventions that lower or constrain long-term investments by enhancing leverage, beefing up shareholder payouts, or reducing investments and, second, adversarial interventions employing hostile tactics. In both cases, interventions are followed by improvements in operating performance during the five-year period following the intervention, and no evidence is found for the adverse long-term effects asserted by opponents.

Finally, we examine whether activist interventions render targeted companies more vulnerable to economic shocks. In particular, we examine whether companies targeted by activist interventions during the years preceding the financial crisis were hit more in the subsequent crisis. We find no evidence that pre-crisis interventions by activists were associated with greater declines in operating performance or higher incidence of financial distress during the crisis.

Our findings that the data does not support the claims and empirical predictions of those holding the myopic activism view have significant implications for ongoing policy debates. Going forward, policymakers and institutional investors should not accept the validity of assertions that interventions by hedge funds are followed by long-term adverse consequences for companies and their long-term shareholders. The use of such claims as a basis for limiting shareholder rights and involvement should be rejected.

Our study is available here.

The Harvard Law School Forum on Corporate Governance and Financial Regulation

The Bebchuk Syllogism

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Monday August 26, 2013

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Steven A. Rosenblum, Eric S. Robinson, Karessa L. Cain, and Sabastian V. Niles. This post focuses on a recent study by Lucian Bebchuk, Alon Brav, and Wei Jiang, The Long-Term Effects of Hedge Fund Activism, available here, and discussed in a post by the authors here. An earlier post by Martin Lipton including a criticism of this study is available here. A related article by Lucian Bebchuk, The Myth that Insulating Boards Serves Long-Term Value, is discussed on the Forum here.

> *Empirical studies show that attacks on companies by activist hedge funds benefit, and do not have an adverse effect on, the targets over the five-year period following the attack.*
>
> *Only anecdotal evidence and claimed real-world experience show that attacks on companies by activist hedge funds have an adverse effect on the targets and other companies that adjust management strategy to avoid attacks.*
>
> *Empirical studies are better than anecdotal evidence and real-world experience.*
>
> *Therefore, attacks by activist hedge funds should not be restrained but should be encouraged.*

Harvard Law School Professor Lucian A. Bebchuk is now touting this syllogism and his obsession with shareholder-centric corporate governance in an article entitled, "The Long-Term Effects of Hedge Fund Activism" (previously discussed here). In evaluating Professor Bebchuk's article, it should be noted that:

There is heavy reliance in the article on Tobin's Q (*i.e.*, a ratio of market value to book value, with book value intended to serve as a proxy for replacement value) to measure the performance of the targets of activist attacks, and the article presents the data in a way that makes the statistical

analysis appear favorable to Professor Bebchuk's argument. The article highlights the average Q ratio for companies subject to activist attack in the following five years. Since averages can be skewed by extreme results (as the article acknowledges), focusing on the median outcome would be more appropriate. Indeed, the article presents median results, but does not reference in the text that the median Q ratio for each of the first four years following the attack year is lower than the median Q ratio in the year of the activist attack. Only in year five does the median Q ratio exceed the Q ratio in the attack year. While the article fails to disclose the average holding period of the activists in the study, it is undoubtedly less than five years. So it seems quite speculative, at best, to credit activists with improvements in Q ratios that first occur for the median company only in the fifth year after the attack.

Beyond the highly questionable conclusions Professor Bebchuk draws from his Tobin's Q statistics, there is also the fundamental question of whether Tobin's Q is a valid measure of a company's performance. A 2012 paper by Olin School of Business Professor Philip H. Dybvig, "Tobin's q Does Not Measure Firm Performance: Theory, Empirics, and Alternative Measures," points out that Tobin's Q is inflated by underinvestment, so a high Q is not evidence of better company performance. Companies that forego profitable investment opportunities—including as a result of pressure from activists to return capital to investors or defer investments in R&D and CapEx—can actually have higher Q ratios while reducing shareholder value that would have been generated by those investments. In addition, the use of book value as a proxy for replacement value introduces complications from different accounting decisions, including the timing of write-downs, depreciation methods, valuation of intangibles and similar decisions that can significantly distort a company's Q ratio. The other metric that Professor Bebchuk relies on in his article—return on assets (ROA)—is highly correlated with Tobin's Q (indeed, both ratios use the same denominator, and the numerators are substantially related), and thus his ROA statistics suffer from these same shortcomings and add little to the analysis.

Further undermining the validity of the empirical analysis, the article acknowledges but fails to control for the fact that 47% of the activist targets in the dataset cease to survive as independent companies throughout the measurement period. The study sheds no light on whether the shareholders of those companies would have realized greater value from other strategic alternatives that had a longer-term investment horizon, whether those companies were pressured to sell on account of the activist attack (as other empirical work has argued), or whether shareholder gains from activism are largely driven by the cases that result in sales of control.

Lastly, Professor Bebchuk concedes that his analytical methodology provides no evidence of causation, and thus simply misses the crux of the debate: whether activists can impair long-term value creation. Favorable results would arise under his approach whenever managements of the

target companies pursue value-enhancing strategies, even those that run counter to the activists' pressures or were being initiated even before the activist appeared. In addition, improving economic, market, industry and company-specific conditions would also contribute to favorable results independent of activist pressure. Professor Bebchuk also states that the targets in his dataset "tend to be companies whose operating performance was below industry peers or their own historical levels at the time of [activist] intervention"; if true, it is plausible that many companies improved from a historical or cyclical trough position in spite of—rather than as a result of—activist pressures.

These defects, among others, are sufficient in and of themselves to raise serious doubts about the conclusions that Professor Bebchuk draws from his empiricism. But there is a more fundamental flaw in Professor Bebchuk's syllogism: it rejects and denies the evidence, including anecdotal evidence and depth of real-world experience, that he acknowledges in the article comes from a "wide range of prominent writers… significant legal academics, noted economists and business school professors, prominent business columnists, important business organizations, and top corporate lawyers."

No empirical study, with imperfect proxies for value creation and flawed attempts to isolate the effects of activism over a long-term horizon influenced by varying economic, market and firm-specific conditions, is capable of measuring the damage done to American companies and the American economy by the short-term focus that dominates both investment strategy and business-management strategy today. There is no way to study the parallel universe that would exist, and the value that could be created for shareholders and other constituents, if these pressures and constraints were lifted and companies and their boards and managements were free to invest for the long term. The individuals who are directly responsible for the stewardship and management of our major public companies—while committed to serious engagement with their responsible, long-term shareholders—are nearly uniform in their desire to get out from under the short-term constraints imposed by hedge-fund activists and agree, as do many of their long-term shareholders, that doing so would improve the long-term performance of their companies and, ultimately, the country's economy.

Reflecting on Professor Bebchuk's article and failed syllogism, one is reminded of Mark Twain's saying, "There are three kinds of lies: lies, damned lies and statistics."

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Wachtell Keeps Running Away from the Evidence

Posted by Lucian Bebchuk, Harvard Law School, on Monday July 28, 2014

Editor's Note: Lucian Bebchuk is William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance, Harvard Law School. This post responds to a Wachtell Lipton memorandum by Martin Lipton and Steven A. Rosenblum, Do Activist Hedge Funds Really Create Long Term Value?, available on the Forum here. This memorandum criticizes a recently-issued empirical study by Lucian Bebchuk, Alon Brav, and Wei Jiang on the long-term effects of hedge fund activism. The empirical study is available here, and is discussed on the Forum here. Additional posts discussing the study, including critiques by Wachtell Lipton and responses by Professors Bebchuk, Brav, and Jiang, are available on the Forum here.

In a memorandum issued by the law firm of Wachtell, Lipton, Rosen & Katz (Wachtell) last week, Do Activist Hedge Funds Really Create Long Term Value?, the firm's founding partner Martin Lipton and another senior partner of the law firm criticize again my empirical study with Alon Brav and Wei Jiang, The Long-Term Effects of Hedge Fund Activism. The memorandum announces triumphantly that Wachtell is not alone in its opposition to our study and that two staff members from the Institute for Governance of Private and Public Organizations (IGOPP) in Montreal issued a white paper (available here) criticizing our study. Wachtell asserts that the IGOPP paper provides a "refutation" of our findings that is "academically rigorous." An examination of this paper, however, indicates that it is anything but academically rigorous, and that the Wachtell memo is yet another attempt by the law firm to run away from empirical evidence that is inconsistent with its long-standing claims.

Our study shows that the myopic activisms claim Wachtell has long advanced—the claim that that interventions by activist hedge funds are in the long term detrimental to the involved companies and their long-term shareholders—is not supported by the data. (The results of our study are summarized in a post on the Forum here and in a Wall Street Journal op-ed article available here.) Wachtell, which is well-known for developing the poison pill and other measures for insulating directors from removal, has repeatedly criticized our study. The memorandum issued last week is the fourth memorandum attacking our study that Wachtell issued; the three earlier memorandums Empiricism and Experience; Activism and Short-Termism; the Real World of

Business, The Bebchuk Syllogism, and Current Thoughts About Activism are available on the Forum here, here, and here.

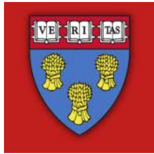
The white paper that Wachtell announced with excitement is authored by Yvan Allaire and François Dauphin, two IGOPP staff members. The paper raises several methodological criticisms that largely repeat ones that were made in Wachtell's first two memos. We already responded to these claims in detail in a post, Don't Run Away from the Evidence: A Reply to Wachtell Lipton, available on the Forum here, that explains why the criticisms raised by Wachtell (and now again by Allaire-Dauphin) do not undermine our findings and conclusions. Although we cite this post in our study, the Allaire-Dauphin paper fails to note our response or to engage with it.

Unexpectedly for an "academically rigorous" study, the Allaire-Dauphin study, like the Wachtell memos, expresses a preference reliance on the self-reported impressions of business leaders. In advancing the myopic activism claim, and in seeking legal changes that would further insulate directors from activists, Martin Lipton has been urging reliance "on the decades of my and my firm's experience in advising corporations," and asserting that, given the imperfections of empirical work, it would be better to use "anecdotal evidence and depth of real-world experience." In a keynote speech, he even quipped that his dismissal of our empirical findings is supported by the fact that "100 percent of my clients agree with me."

Taking a similar approach, the Allaire-Dauphin study stresses that "a wide range of observers with considerable financial experience and expertise take a dim view of 'activist hedge funds,' lambasting them for their greed-fuelled short-term stratagems," that this group of observers includes "famed lawyer Martin Lipton." Furthermore, Allaire and Dauphin fault Brav, Jiang, and myself for daring to "argue that these wise people, with loads of practical experience, have no 'scientific' basis for their collective judgment that activist interventions are detrimental."

Like the Wachtell memo, Allaire's and Dauphin's "academically rigorous" paper also expresses an opposition (unexpected from an "academically rigorous" paper) to relying on empirical evidence. In arguing that there are problems with our empirical methodology, the Allaire-Dauphin study, like the Wachtell memoranda, seeks not to facilitate an empirical examination that would address these problems but rather to convince readers that it would be best to give up on empirical work in this area. The paper asserts that "econometrics provides a crude tool kit" and that any regression model cannot "capture the nuances of every situation." Given the imperfections of empirical methods, the authors argue, "policymakers should weigh the experience and expertise of knowledgeable people rather more than tortured statistics."

In my view, this approach to the assessment of the myopic activism claim is misguided, not academically rigorous. This claim asserts propositions concerning the financial performance and stock returns of firms that can be directly tested using objective and publicly available financial data. Policymakers should not accept the validity of these propositions even though they do not show up in the data. I would welcome future empirical work that aims at improving upon ours in some methodological or other way. In the meantime, however, Wachtell should engage with the evidence, not use the "opinions of wise people with considerable experience" to run away from it. To be a constructive contributor to policy debates, Wachtell should stop asserting that the professed beliefs of its partners or clients should serve as the factual premises of policymaking.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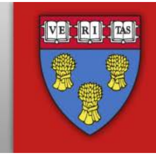

The Threat to the Economy and Society from Activism and Short-Termism Updated

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Tuesday January 27, 2015

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Sabastian V. Niles, and Sara J. Lewis. Earlier posts by Mr. Lipton on hedge fund activism are available here, here and here. Recent work from the Program on Corporate Governance about hedge fund activism includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here) and The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here). For five posts by Mr. Lipton criticizing the Bebchuk-Brav-Jiang paper, and for three posts by the authors replying to Mr. Lipton's criticism, see here.

Again in 2014, as in the two previous years, there has been an increase in the number and intensity of attacks by activist hedge funds. Indeed, 2014 could well be called the "year of the wolf pack."

With the increase in activist hedge fund attacks, particularly those aimed at achieving an immediate increase in the market value of the target by dismembering or overleveraging, there is a growing recognition of the adverse effect of these attacks on shareholders, employees, communities and the economy. Noted below are the most significant 2014 developments holding out a promise of turning the tide against activism and its proponents, including those in academia. **Already in 2015 there have been several significant developments that are worth adding, which are included in bold at the end.**

- Several institutional investors voiced concerns about activism this year, including Laurence Fink of BlackRock—first in March lamenting the cuts to capital expenditures and increased debt used to fuel dividends and share buybacks, which he views as having the potential to "jeopardize a company's ability to generate sustainable long-term returns," and then in December stating that "[s]trategies pursued by activist investors 'destroy jobs.'"

- Tim Armour of Capital Group criticized the recent wave of share buybacks, explaining that "[w]e think companies should be run for the long-term and do not think forced steps should be taken to maximize short-term profits at the expense of having thriving enterprise."
- William McNabb of Vanguard spoke out against the standard activist playbook of aggressively criticizing companies once problems emerge and endorsed a more low-key approach of engagement between directors and shareholders aimed to prevent problems before they happen.
- James Montier of GMO Capital presented compelling empirical evidence that, as Jack Welch once said, shareholder value maximization is "the dumbest idea in the world," and demonstrating that, ironically, it has not benefitted shareholders themselves.
- Even activists themselves began to acknowledge how outlandish some of their stunts are; Jeffrey Ubben of ValueAct, for example, who favors a more behind-the-scenes, constructive style of activism, likened certain recent actions by other activists to "greenmail," called certain activist tactics "corrupt" and accused one activist in particular of simply "entertaining himself."
- In December, the Conference Board released a must-read presentation entitled "Activists and Short Term Corporate Behavior" that compiles data demonstrating that capital investment by U.S. public companies has decreased (and is less than that of private companies), that short-term pressures are increasing and that hedge fund activism results not in the creation of value but in transfers of value from employees and bondholders to shareholders.
- William Galston's editorial in the *Wall Street Journal*, "'Shareholder Value' Is Hurting Workers: Financiers Fixated on the Short-Term Are Forcing CEOs into Decisions That Are Bad for the Country," as the title suggests, warned that activism is harming workers (pointing to the recent break-up of Timken as a prime example) and that if short-termism prevails, "we won't have the long-term investments in workers and innovation that we need to sustain a higher rate of growth."
- Dominic Barton, the global managing director of McKinsey, and Mark Wiseman, the president and CEO of the Canada Pension Plan Investment Board, joined to author an article in the *Harvard Business Review*, "Focusing Capital on the Long Term," which suggests practical steps that major asset owners such as pension funds, insurance firms and mutual funds can take to minimize the detrimental effects of increased pressure from financial markets and the resulting short-termism, which they believe has "far-reaching consequences, including slower GDP growth, higher unemployment, and lower return on investment for savers."

- A federal court in California found "serious questions" as to whether Valeant and Pershing Square violated the federal securities laws in connection with their joint hostile bid for Allergan and thereby, as a practical matter, put an end to this scheme until the issue is resolved.
- SEC Commissioner Daniel Gallagher and former Commissioner (and current Stanford Law Professor) Joseph Grundfest argued that the push for board declassification by Harvard Law School's Shareholder Rights Campaign, initiated by Professor Lucian Bebchuk, was not only based on shoddy scholarship, it actually violated federal securities law antifraud rules. (This paper was discussed on the Forum here.)
- SEC Commissioner Gallagher also called for much-needed reforms to Rule 14a-8 to "ensur[e] that activist investors don't crowd out everyday and long-term investors" by repeatedly bringing costly shareholder proposals (notwithstanding prior failures) that have little or no connection to company value.
- The SEC took a step toward limiting uncritical reliance on proxy advisory firms by issuing guidance indicating that, to fulfill their fiduciary duties to clients, investment advisers must establish and implement measures reasonably designed both to provide sufficient ongoing oversight of proxy advisory firms and to identify and address such firms' conflicts of interest **and errors in their voting recommendations**.
- Economics Professor William Lazonick argued that share buybacks can boost share prices in the short term but ultimately disrupt income equality, job stability and overall economic growth, and research by Barclays cited in a *Financial Times* article called "Buybacks: Money Well Spent?" provided empirical support showing that the "buyback bonanza" indeed contributed to slower growth, including lower earnings retention not reflected in price-to-book value.
- A paper by Dr. Yvan Allaire entitled "The Value of 'Just Say No,'" and also memos by our firm (here and here, the latter discussed on the Forum here), demonstrated that an ISS client note entitled "The IRR of No," which argued that companies that had "just said no" to hostile takeover bids incurred profoundly negative returns, suffered from critical methodological and analytical flaws that undermined its conclusions.
- Dr. Allaire also presented sophisticated **analyses** contained in **three** papers ("Activist Hedge Funds: Creators of Lasting Wealth? What Do the Empirical Studies Really Say?"; "Hedge Fund Activism and Their Long-Term Consequences; Unanswered Questions to Bebchuk, Brav and Jiang"; **and in 2015 "Still unanswered questions (and new ones) to Bebchuk, Brav and Jiang"**), consistent with our firm's earlier observations (discussed on the Forum here), offering a devastating critique of Professor Bebchuk's research claiming to show that attacks by activist hedge funds did not destroy long-term value.

- The argument made by Professor Bebchuk, together with Professor Robert Jackson, that poison pills were unconstitutional was similarly dismissed (some would say derided) as the grasping-at-straws argument that it was and one wholly inconsistent with existing case law. (This memorandum was discussed on the Forum here.)
- Delaware Supreme Court Chief Justice Leo Strine, Jr.'s *Columbia Law Review* article, "Can We Do Better By Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law," (discussed on the Forum here) persuasively argued against allowing investment funds to prevail over the carefully considered judgments of boards of directors and at the expense of the long-term interests of the ultimate beneficiaries whose assets such funds manage.
- In an article entitled "The Impact of Hedge Fund Activism: Evidence and Implications," Columbia Law School Professor John Coffee, Jr. rejected the so-called empirical evidence that Professor Bebchuk uses to "prove" that activist attacks are beneficial, and proposed various potential reforms and private ordering techniques (such as a "window-closing" poison pill) that could help mitigate activism's pernicious effects.
- In "How to Outsmart Activist Investors," Professors William George and Jay Lorsch of the Harvard Business School advised companies on how to fend off activist challenges, writing that they "remain unconvinced … that hedge fund activism is a positive trend for U.S. corporations and the economy."
- Leiden University Professor Pavlos Masouros, in his book entitled *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies*, convincingly outlined the chain of political, economic and legal events that led to the shift from a "retain and invest" corporate strategy to a "downsize and distribute" mentality, and the consequent stagnation in GDP growth.
- Cornell University Law School Professor Lynn Stout also published a book that challenges the ideology of shareholder value maximization, the title of which speaks for itself: *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*.
- Oxford University Professor Colin Mayer's *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It* set forth a new paradigm for thinking about corporations, in part to solve the "increasing[] difficult[y] for directors to do anything other than reflect what is perceived to be in the immediate interests of their most influential, frequently short-term shareholders."
- The Delaware Court of Chancery, in *Third Point LLC* v. *Ruprecht*, confirmed the legitimacy of the use of poison pills—not only in the face of an inadequate takeover offer—but also in response to an activist threat.

- **State Street Global Advisors issued an issuer engagement protocol that is intended to enable State Street to better understand issuers' business strategy, management and operations. Hopefully, this will result in State Street supporting issuers' long-term investment goals and mitigate exposure to activists' short-term demands.**
- **Vanguard reviewed their proxy voting and engagement efforts, emphasizing an approach to governance characterized by "quiet diplomacy focused on results," in which voting decisions are made based on "its own analysis, not the recommendations of third parties" and direct discussions with companies are prioritized to "permit a more nuanced and precise exchange of views than the blunt instrument of a shareholder vote."**
- **Two prominent former JP Morgan deal makers announced the formation of Hudson Executive Capital, which they described as a new type of activist hedge fund that will collaborate with companies and their boards. The announcement stated that Hudson will not conduct proxy fights or issue poison-pen letters. Their goal appears to be to have Hudson recognized as a traditional merchant bank and not an activist hedge fund.**
- **Well-known Yale School of Management Professor Jeffrey Sonnenfeld in an article in the January/February issue of *Chief Executive* said, "Vigilant CEOs have a right, and even a duty, to resist self-motivated activism that adds nothing. It's worth noting that it wasn't so very long ago that investors who resorted to such antics were called by the less salubrious term 'green mailers.'"**
- **Guhan Subramanian, a Professor at both Harvard Law School and Harvard Business School and a long-time protégé-colleague of Lucian Bebchuk, has written an article for the March issue of the *Harvard Business Review* advocating a new form of corporate governance that reflects a need to "return to first principles rather than meander toward 'best practices.'" His first principle is that "Boards Should Have the Right to Manage the Company for the Long Term." His other recommendations are (1) replacing quarterly earnings guidance with long-term goals, (2) accepting staggered boards if they can be overcome by a shareholder-approved takeover bid, (3) accepting exclusive forum bylaws, (4) instituting meaningful board evaluation but no director age or term limits, and (5) giving shareholders an "orderly" voice.**

We hope that the growing recognition of the analytical and methodological defects in the so-called empirical evidence put forward to justify activist hedge fund attacks by Professor Bebchuk and his cohorts and the growing recognition, not just in the business community, but in academia

as well, of the serious threat of activism and short-termism to employees, communities and the economy will result in further action by responsible institutional investors to deny support to activist hedge funds and will also result in legislative, regulatory and judicial actions to dampen their abuses and lessen substantially their impact.

Vice Chancellor Laster and the Long-Term Rule

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday March 11, 2015

Editor's Note: The following post comes to us from Covington & Burling LLP and is based on a Covington article by Jack Bodner, Leonard Chazen, and Donald Ross. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

Vice Chancellor Laster has been writing for several years about the fiduciary duties of directors who represent the interests of a particular block of stockholders. In his opinion in the *Trados* Shareholder Litigation he found that directors, elected by the venture capital investors who held Trados's preferred stock, had a conflict of interest in deciding on a sale of the corporation in which all the proceeds would be absorbed by the liquidation preference of the preferred and nothing would go to the common.[1] As a result of this finding, Vice Chancellor Laster applied the entire fairness standard of review to the Trados board's decision. He concluded that while the directors failed to follow a fair process, the transaction was fair because the common stock had no economic value before the sale and so it was fair for the common stock to receive nothing from the sale.[2] In a recent Business Lawyer article which he co-authored with Delaware practitioner John Mark Zeberkiewicz,[3] Vice Chancellor Laster extended his *Trados* conflict of interest analysis to other situations in which directors represent stockholder constituencies with short-term investment horizons, including directors elected by activist stockholders seeking immediate steps to increase the near term stock price of the corporation. He states that such directors can face a conflict of interest between their duties to the corporation and their duties to the activists.

In both his *Trados* opinion and the Business Lawyer article, as well as his opinion in the *Rural Metro* damages award decided in October 2014,[4] Vice Chancellor Laster took the position that directors owe a fiduciary duty to maximize stockholder value over the long-term (the "Long-Term

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[1] *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, (Del. Ch. 2013).

[2] In finding that the board failed to follow a fair process, he concluded that the directors "failed to consider the common stockholders, and sought to exit without recognizing the conflict of interest presented by the Merger,…." *Ibid.* 76.

[3] J. Travis Laster and John Mark Zeberkiewicz, "*The Rights and Duties of Blockholder Directors*," 70 Business Lawyer 33 (2014-2015).

[4] *In Re Rural/Metro Corporation S'Holders Litig.*, 102 A.3d 205, 253 (Del. Ch. 2014).

Rule”). This was a fundamental underpinning to his conclusion that directors who represent venture capital investors and activists with short-term investment horizons face a conflict of interest. As Vice Chancellor Laster and Mr. Zeberkiewicz (the “Authors”) stated in the Business Lawyer article, “the blockholder director’s duties to the corporation require that the director manage for the long term, while the blockholder director’s duties to the investor require that the director manage for an exit.”[5]

The notion that directors are required to maximize value over the long term and that directors who represent stockholders with short term investment horizons necessarily face a conflict of interest, if generally accepted, would represent a significant change in the law and would require a significant change in the procedural safeguards used by boards in discharging their fiduciary duties.

Today, the predominant view is that:

Directors have discretion to determine the time horizon over which they seek to maximize stockholder value, and

Absent special circumstances, a controlling stockholder (and by extension directors who represent such a stockholder on the board) do not have a conflict of interest in approving a transaction if such stockholder’s shares are treated proportionately with those of other stockholders in the transaction.

The Long-Term Rule

The Long-Term Rule can be viewed as a weapon to protect the other stockholders from directors who represent a particular faction in the stockholder base, such as the venture capitalists who were seeking a quick exit from their investment in *Trados*, and the stockholder activists with a short-term investment horizon discussed in the Business Lawyer article. The rationale that the Authors put forward for the Long-Term Rule, however, is based not on the interests and preferences of the corporation’s other stockholders, but on the intrinsic nature of the corporation and its equity capital. Critical to their analysis is that the existence of the typical corporation is perpetual and the capital provided by common and preferred stockholders is permanent. From these basic characteristics the Authors conclude that, “the directors’ fiduciary duties … require that they maximize the value of the corporation over the long term for the benefit of the providers of long-term (presumably permanent) capital.”[6]

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[5] *Op. Cit. 50*.
[6] *Op. Cit. 49*.

Notwithstanding these assertions, it is undeniable that the average holder of a corporation's common stock and preferred stock is not a permanent investor in the corporation. One of Chief Justice Strine's articles dealing with the time frame issue cites a statistic indicating that the average annual turnover in the shares of public companies is approximately 100%.[7] If we define a long-term holding period as five years or more, it seems likely that the holders of a large majority of the shares of most public corporations do not qualify as long-term investors. These stockholders have an interest in the pursuit of policies that permit them to exit their investment on advantageous terms that may very well be within five years or less. However, under the Long Term Rule directors could have an obligation to ignore this interest and manage the corporation exclusively to maximize its long-run profitability. It is hard to accept this position unless one takes the view that the directors' duties run not to the particular stockholders the corporation has when the directors are making their decisions, but to all the stockholders the corporation will have at that time and in the future. In addition, the Long-Term Rule applied in its strictest form may require directors to take actions that alienate a substantial portion of the stockholder base, leading to the election of a new board with a weaker commitment to the goal of maximizing long-term value.

Vice Chancellor Laster has cited various authorities in support of the Long-Term Rule which, among other things, suggest that Chancellor Allen, former Chancellor on the Delaware Chancery Court, was a believer in this approach. However, the Delaware Supreme Court has never endorsed this view. Its leading position on the issue remains the opinion in *Paramount v. Time*, in which it stated:

> "While we affirm the result reached by the Chancellor [William T. Allen], we think it unwise to place undue emphasis upon long-term versus short-term corporate strategy. Two key predicates underpin our analysis. First Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation, *8 Del. Ch. § 141(a)*. This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of "long term" versus "short term" value is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon. Second, absent a limited set of circumstances defined under *Revlon*, a board of directors, while always required to act in an informed manner,

[7] Leo E. Strine, Jr., "*One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*" 66, Business Lawyer, footnotes 30 and 32 (2010).

> is not under a per se duty to maximize shareholder value in the short term, even in the context of a takeover."[8]

While the *Paramount* opinion has its ambiguities, it clearly rejected the idea that directors must choose the long-term as the exclusive time frame for maximizing stockholder value.

In the Business Lawyer article the Authors invoke the harm that may be caused by short-term activist investors, citing articles by Chief Justice Strine and Martin Lipton expressing their concern. It is notable, however, that in his extensive writings on the time frame question Chief Justice Strine's focus is on the duties of investment managers whom he would require to pursue their clients' long-term investment goals, rather than attempting to redefine the fiduciary duties of corporate directors.[9]

Conflict of Interest

The Authors treat a blockholder director's conflict of interest as a logical corollary of the Long-Term Rule. "The blockholder director's duties to the corporation require that the director manage for the long term, while the blockholder director's duties to the investor require that the director manage for an exit."[10] If a court does not adopt the Long-Term Rule, it is questionable that controlling stockholders with a short-term investment horizon, or directors representing other stockholders with a short-term investment horizon, have an inherent conflict of interest. While it may be argued that short-term investors have a conflict of interest because they have a shorter investment horizon than some other stockholders, there is no single investment horizon that is broadly representative of stockholders generally, and existing case law supports the view that a short-term investment horizon does not alone create a conflict of interest in approving a transaction in which all shares are treated the same.

This point is illustrated by Chief Justice (then Chancellor) Strine's opinion in the *Synthes, Inc. Shareholder Litigation*.[11] There, Chancellor Strine rejected a challenge to the sale of a large corporation, which was based on the premise that the aged controlling stockholder who engineered the sale had a conflict of interest because of his need for liquidity. The court in *Synthes* found that when a stockholder who is also a fiduciary affords its minority stockholders pro rata treatment with itself, there is no disadvantage to the minority stockholders. However, Chancellor Strine added that there could be very narrow circumstances in which a stockholder's immediate need for liquidity could constitute a disabling conflict of interest irrespective of pro rata

[8] *Paramount Communications Inc. v. Time Inc.,* 571 A.2d 1140, 1150 (Del. 1989).
[9] Leo E. Strine, Jr., *Can we Do Better By Ordinary Investors? A Pragmatic Reaction To the Dueling Ideological Mythologists of Corporate Law*, 114 Columbia Law Review 449 (2014).
[10] *Op. Cit. 50.*
[11] Delaware Civil Action No. 6452 (2012).

treatment if such stockholder forced the sale of an entity at below fair market value.[12] Chancellor Strine's refusal to see an inherent conflict of interest in the situation of a controlling stockholder seeking liquidity may be a further indication that he does not accept the Long-Term Rule, although he has repeatedly demonstrated his concern over the ill effects of short-termism among corporate stockholders.

Effect of Adopting the Long-Term Rule

The adoption of the Long-Term Rule could have numerous far-reaching effects, but three in particular stand out.

First, there would likely be a change in the process by which boards, with the assistance of their bankers, value a target corporation for purposes of deciding whether to approve a proposed acquisition of the corporation. Today, bankers typically utilize three principal financial analyses of which only one—discounted cash flow analysis—is primarily a measure of long-term value. The other two—comparable transactions and comparable companies analyses—use a target corporation's current or near-term operating metrics for purposes of determining such corporation's implied value. Under the Long-Term Rule, there would be pressure on boards to focus primarily on the discounted cash flow analysis, and boards could face criticism for approving transactions with a value that did not exceed, or fall high in the range of, the corporation's implied value based on a discounted cash flow analysis. However, deriving a corporation's implied value based on a discounted cash flow is also arguably the least reliable measure of value, given the inherent uncertainty of long term projections on which a discounted cash flow analysis in based. A primary focus on a corporation's discounted cash flow may lead to result-driven analyses that are, in fact, less effective at policing the acquisition process than the present system that often gives equal or sometimes greater weight to comparable transactions and comparable companies analyses.

Second, adoption of the Long Term Rule could make activists and even hostile bidders wary of nominating board candidates who, because of a business relationship with the activists or bidder, might be deemed to have a conflict of interest. Should such candidates be elected to the board, they could be marginalized when the board considers the activists' proposals due to the perceived conflict of interest. For example, the conflict of interest could lead a board to establish a committee of independent directors to consider the activist's proposals, which committee would likely exclude board members who have a business relationship with the activist stockholder. In fact, even without widespread adoption of the Long-Term Rule, Vice Chancellor Laster's judicial opinions and other writings may cause activists to nominate only board candidates who could

[12] *Id. 1035-1037*.

"pass" the independence test. Some may consider that a desirable result, but the absence of directors who truly represent the stockholders who nominated them would prevent the board from functioning as a forum in which such stockholders and management can seek to resolve their differences.

Third, it would eliminate the flexibility provided by the opinion of the Delaware Supreme Court in *Paramount v. Time* which allows a board of directors to set a course of action which, in light of the particular circumstances of a corporation, it views as being in the best interests of the corporation and all of its stockholders. At present, boards of directors may develop a business strategy which pursues both short term and long term objectives. This more balanced approach may also align with the wishes of a substantial portion of the stockholder base.

In a letter sent last year to the CEOs of the public corporations in the S&P 500 index, Lawrence Fink, Chairman and CEO of BlackRock, one of the largest investment managers, wrote:

"Many commentators lament the short-term demands of the capital markets. We share those concerns, and believe it is part of our collective role as actors in the global capital markets to challenge that trend. …We do recognize the balance that must be achieved to drive near-term performance while simultaneously making those investments—in innovation and product enhancements, capital and plant and equipment, employee development, and internal controls and technology—that will sustain growth."[13]

A board of directors that wants to follow this approach needs the flexibility of the law as stated in *Paramount v. Time* rather than the approach mandated by the Long-Term Rule.

An Alternative Approach to Short-Termism

We do not believe the courts need to adopt the Long-Term Rule in order to address abusive short-termism. The Authors themselves identify an alternative means of dealing with this problem when they discuss the obligation of directors elected by a block of stockholders to promote the interests of all stockholders, not just those who elected them.[14] If, as in *Trados*, directors disregard the interests of the corporation or other stockholders in order solely to achieve the goals of the stockholders they represent, the courts could find a breach of the directors' fiduciary duty to act in the interests of all stockholders, without having to decide the time frame in which the board should seek to maximize stockholder value.

[13] These statements were quoted with approval by Martin Lipton in his article, Current Thoughts About Activism, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Aug 8, 2013, 9:15 A.M.).
[14] *Op. Cit. 49.*

An important practical question in applying this principle is under what circumstances would directors or the stockholders who elected them have a sufficient conflict of interest for the courts to depart from the business judgment rule in deciding whether the directors are violating their obligation to act on behalf of all stockholders. Recent cases, particularly Chancellor Strine's opinion in *Synthes*, suggest that the courts are still wrestling with this issue.[15] Should a court find that directors were acting to promote the narrow interests of a particular stockholder or stockholder block, which were in conflict with the interests of stockholders generally, it would be appropriate to find a conflict of interest and apply the entire fairness standard of review to determine whether there had been a violation of the duty of loyalty, with its serious consequences for the culpable directors. If, on the other hand, directors consider both the long-term and short-term objectives of a corporation because they are trying to do what is best for the corporation and balance the interests of different stockholder groups, including their varying time frames for exiting their investments, it seems inappropriate to find a violation of the duty of loyalty or any of the directors' other fiduciary duties.

[15] This approach could make use of the principle enunciated by the Delaware Supreme Court in *Getty Oil Co. v. Skelly Oil Co.*, 237 A.2d 883, 887 (Del. 1970) recently cited by Chancellor Strine *In re Synthes S'holder Litig.* 50A.3d 1022, 1039 fn. 81 (Del. Ch. 2012) that, "A basic ground for judicial interference with business judgment on the complaint of the minority interests is an advantage obtained by the dominant group to the disadvantage of the corporation or its minority owners."

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March 31, 2015

Over the past several years at BlackRock, we have engaged extensively with companies, clients, regulators and others on the importance of taking a long-term approach to creating value. We have done so in response to the acute pressure, growing with every quarter, for companies to meet short-term financial goals at the expense of building long-term value. This pressure originates from a number of sources—the proliferation of activist shareholders seeking immediate returns, the ever-increasing velocity of capital, a media landscape defined by the 24/7 news cycle and a shrinking attention span, and public policy that fails to encourage truly long-term investment.

As I am sure you recognize, the effects of the short-termist phenomenon are troubling both to those seeking to save for long-term goals such as retirement and for our broader economy. In the face of these pressures, more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth.

In 2014, dividends and buybacks in the U.S. alone totaled more than $900 billion, according to Standard & Poor's—the highest level on record. With interest rates approaching zero, returning excessive amounts of capital to investors—who will enjoy comparatively meager benefits from it in this environment—sends a discouraging message about a company's ability to use its resources wisely and develop a coherent plan to create value over the long term.

There is nothing inherently wrong with returning capital to shareholders in a measured fashion, as part of a broader growth strategy—indeed, it can be a vital part of a responsible capital strategy. Nor are the demands of activists necessarily at odds with the interests of other shareholders; some activist investors take a long-term view and have pushed companies and their boards to make productive changes.

It is critical, however, to understand that corporate leaders' duty of care and loyalty is not to every investor or trader who owns their companies' shares at any moment in time, but to the company and its long-term owners. Successfully fulfilling that duty requires that corporate leaders engage with a company's long-term providers of capital; that they resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, that they clearly and effectively articulate their strategy for sustainable long-term growth. Corporate leaders and their companies who follow this model can expect our support.

We fully appreciate that the business ecosystem has evolved significantly and presents a daunting challenge for companies working to resist short-term market pressures. But a clear, effective articulation of long-term strategy and goals will help your company explain to shareholders the short-term accommodations that businesses invariably do need to make at times to adapt to a changing environment. Overall, companies' ability to resist short-term pressures—and attract long-term stakeholders—will rest on their ability to both develop and communicate their plans for future growth.

BLACKROCK

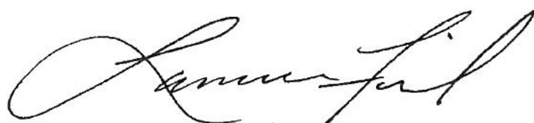
Companies should not have to fight this battle alone. We believe that government leaders around the world—with a concerted push from both investors and companies—must act to address public policy that fosters long-term behavior. We believe that U.S. tax policy, as it stands, incentivizes short-term behavior. For tax purposes, the U.S. currently defines a long-term investment as one held for one year. Since when was one year considered a long-term investment? A more effective structure would be to grant long-term treatment only after three years, and then to decrease the tax rate for each year of ownership beyond that, potentially dropping to zero after 10 years. This would create a profound incentive for more long-term holdings and could be designed to be revenue neutral. In short, tax reform that promotes long-term investment will benefit both the companies who rely on capital markets and the hundreds of millions of people saving for retirement.

Asset managers like BlackRock also have an important role to play, which is why we engage actively with companies on the key governance factors that in our experience support long-term, sustainable, financial performance. Chief among these is board leadership—in our view, the board is management's first line of defense against short-term pressures. Our starting point is to support management, particularly during periods where performance has deviated from the long-term trajectory. But this is more difficult to do where management has not articulated a clear long-term vision, strategic direction and credible metrics against which to assess performance. In such cases, we will take action to ensure that the owners' interests are effectively served.

To that end, we have revised our proxy voting guidelines this year to make clear our expectations of boards and set out when we may vote against directors, such as instances where we see evidence of board entrenchment or other signs of ineffective governance. But we also believe that engagement by firms such as ours should not be overly concentrated on proxy season or around earnings reports—rather, it should be consistent and sustained, and cover issues broader and deeper than board elections or earnings per share.

Throughout 2015, BlackRock will continue to focus on these issues, because we recognize that although much of the financial and business community is in agreement on the need for a more long-term atmosphere, more concrete steps must be taken to achieve it. We urge you to join us and with your fellow corporate leaders to invest in the future and thereby lay the foundation for stronger, more sustainable, and more stable economic growth.

Yours sincerely,



Laurence D. Fink
Chairman & CEO

Harvard
Business
Review

Profits Without Prosperity

FROM THE SEPTEMBER 2014 ISSUE

Five years after the official end of the Great Recession, corporate profits are high, and the stock market is booming. Yet most Americans are not sharing in the recovery. While the top 0.1% of income recipients—which include most of the highest-ranking corporate executives—reap almost all the income gains, good jobs keep disappearing, and new employment opportunities tend to be insecure and underpaid. Corporate profitability is not translating into widespread economic prosperity.

The allocation of corporate profits to stock buybacks deserves much of the blame. Consider the 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012. During that period those companies used 54% of their earnings—a total of $2.4 trillion—to buy back their own stock, almost all through purchases on the open market. Dividends absorbed an additional 37% of their earnings. That left very little for investments in productive capabilities or higher incomes for employees.

The buyback wave has gotten so big, in fact, that even shareholders—the presumed beneficiaries of all this corporate largesse—are getting worried. "It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies," Laurence Fink, the chairman and CEO of BlackRock, the world's largest asset manager, wrote in an open letter to corporate America in March. "Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks."

Why are such massive resources being devoted to stock repurchases? Corporate executives give several reasons, which I will discuss later. But none of them has close to the explanatory power of this simple truth: Stock-based instruments make up the majority of their pay, and in the short term buybacks drive up stock prices. In 2012 the 500 highest-paid executives named in proxy statements of U.S. public companies received, on average, $30.3 million each; 42% of their compensation came from stock options and 41% from stock awards. By increasing the demand for a company's shares, open-market buybacks automatically lift its stock price, even if only temporarily, and can enable the company to hit quarterly earnings per share (EPS) targets.

As a result, the very people we rely on to make investments in the productive capabilities that will increase our shared prosperity are instead devoting most of their companies' profits to uses that will increase their own prosperity—with unsurprising results. Even when adjusted for inflation, the compensation of top U.S. executives has doubled or tripled since the first half of the 1990s, when it was already widely viewed as excessive. Meanwhile, overall U.S. economic performance has faltered.

If the U.S. is to achieve growth that distributes income equitably and provides stable employment, government and business leaders must take steps to bring both stock buybacks and executive pay under control. The nation's economic health depends on it.

From Value Creation to Value Extraction

For three decades I've been studying how the resource allocation decisions of major U.S. corporations influence the relationship between *value creation* and *value extraction,* and how that relationship affects the U.S. economy. From the end of World War II until the late 1970s, a *retain-and-reinvest* approach to resource allocation prevailed at major U.S. corporations. They retained earnings and reinvested them in increasing their capabilities, first and foremost in the employees who helped make firms more competitive. They provided workers with higher incomes and greater job security, thus contributing to equitable, stable economic growth—what I call "sustainable prosperity."

This pattern began to break down in the late 1970s, giving way to a *downsize-and-distribute* regime of reducing costs and then distributing the freed-up cash to financial interests, particularly shareholders. By favoring value extraction over value creation, this approach has contributed to employment instability and income inequality.

As documented by the economists Thomas Piketty and Emmanuel Saez, the richest 0.1% of U.S. households collected a record 12.3% of all U.S. income in 2007, surpassing their 11.5% share in 1928, on the eve of the Great Depression. In the financial crisis of 2008–2009, their share fell sharply, but it has since rebounded, hitting 11.3% in 2012.

Since the late 1980s, the largest component of the income of the top 0.1% has been compensation, driven by stock-based pay. Meanwhile, the growth of workers' wages has been slow and sporadic, except during the internet boom of 1998–2000, the only time in the past 46 years when real wages rose by 2% or more for three years running. Since the late 1970s, average growth in real wages has increasingly lagged productivity growth. (See the exhibit "When Productivity and Wages Parted Ways.")

Not coincidentally, U.S. employment relations have undergone a transformation in the past three decades. Mass plant closings eliminated millions of unionized blue-collar jobs. The norm of a white-collar worker's spending his or her entire career with one company disappeared. And the seismic shift toward offshoring left all members of the U.S. labor force—even those with advanced education and substantial work experience—vulnerable to displacement.

To some extent these structural changes could be justified initially as necessary responses to changes in technology and competition. In the early 1980s permanent plant closings were triggered by the inroads superior Japanese manufacturers had made in consumer-durable and capital-goods industries. In the early 1990s one-company careers fell by the wayside in the IT sector because the open-systems architecture of the microelectronics revolution devalued the skills of older employees versed in proprietary technologies. And in the early 2000s the offshoring of more-routine tasks, such as writing unsophisticated software and manning customer call centers, sped up as a capable labor force emerged in low-wage developing economies

and communications costs plunged, allowing U.S. companies to focus their domestic employees on higher-value-added work.

These practices chipped away at the loyalty and dampened the spending power of American workers, and often gave away key competitive capabilities of U.S. companies. Attracted by the quick financial gains they produced, many executives ignored the long-term effects and kept pursuing them well past the time they could be justified.

A turning point was the wave of hostile takeovers that swept the country in the 1980s. Corporate raiders often claimed that the complacent leaders of the targeted companies were failing to maximize returns to shareholders. That criticism prompted boards of directors to try to align the interests of management and shareholders by making stock-based pay a much bigger component of executive compensation.

Given incentives to maximize shareholder value and meet Wall Street's expectations for ever higher quarterly EPS, top executives turned to massive stock repurchases, which helped them "manage" stock prices. The result: Trillions of dollars that could have been spent on innovation and job creation in the U.S. economy over the past three decades have instead been used to buy back shares for what is effectively stock-price manipulation.

Good Buybacks and Bad

Not all buybacks undermine shared prosperity. There are two major types: tender offers and open-market repurchases. With the former, a company contacts shareholders and offers to buy back their shares at a stipulated price by a certain near-term date, and then shareholders who find the price agreeable tender their shares to the company. Tender offers can be a way for executives who have substantial ownership stakes and care about a company's long-term competitiveness to take advantage of a low stock price and concentrate ownership in their own hands. This can, among other things, free them from Wall Street's pressure to maximize short-term profits and allow them to invest in the business. Henry Singleton was known for using tender offers in this way at Teledyne in the 1970s, and Warren Buffett for using them at GEICO in the 1980s. (GEICO became wholly owned by Buffett's holding company, Berkshire Hathaway, in 1996.) As Buffett has noted, this kind of tender offer should be made when the share price is below the intrinsic value of the productive capabilities of the company and the company is profitable enough to repurchase the shares without impeding its real investment plans.

But tender offers constitute only a small portion of modern buybacks. Most are now done on the open market, and my research shows that they often come at the expense of investment in productive capabilities and, consequently, aren't great for long-term shareholders.

Companies have been allowed to repurchase their shares on the open market with virtually no regulatory limits since 1982, when the SEC instituted Rule 10b-18 of the Securities Exchange Act. Under the rule, a corporation's board of directors can authorize senior executives to repurchase up to a certain dollar amount of stock over a specified or open-ended period of time, and the company must publicly announce the buyback program. After that, management can buy a large number of the company's shares on any given business day without fear that the SEC will charge it with stock-price manipulation—provided, among other

things, that the amount does not exceed a "safe harbor" of 25% of the previous four weeks' average daily trading volume. The SEC requires companies to report total quarterly repurchases but not daily ones, meaning that it cannot determine whether a company has breached the 25% limit without a special investigation.

Despite the escalation in buybacks over the past three decades, the SEC has only rarely launched proceedings against a company for using them to manipulate its stock price. And even within the 25% limit, companies can still make huge purchases: Exxon Mobil, by far the biggest stock repurchaser from 2003 to 2012, can buy back about $300 million worth of shares a day, and Apple up to $1.5 billion a day. In essence, Rule 10b-18 legalized stock market manipulation through open-market repurchases.

The rule was a major departure from the agency's original mandate, laid out in the Securities Exchange Act in 1934. The act was a reaction to a host of unscrupulous activities that had fueled speculation in the Roaring '20s, leading to the stock market crash of 1929 and the Great Depression. To prevent such shenanigans, the act gave the SEC broad powers to issue rules and regulations.

During the Reagan years, the SEC began to roll back those rules. The commission's chairman from 1981 to 1987 was John Shad, a former vice chairman of E.F. Hutton and the first Wall Street insider to lead the commission in 50 years. He believed that the deregulation of securities markets would channel savings into economic investments more efficiently and that the isolated cases of fraud and manipulation that might go undetected did not justify onerous disclosure requirements for companies. The SEC's adoption of Rule 10b-18 reflected that point of view.

Debunking the Justifications for Buybacks

Executives give three main justifications for open-market repurchases. Let's examine them one by one:

1. Buybacks are investments in our undervalued shares that signal our confidence in the company's future.

This makes some sense. But the reality is that over the past two decades major U.S. companies have tended to do buybacks in bull markets and cut back on them, often sharply, in bear markets. (See the exhibit "Where Did the Money from Productivity Increases Go?") They buy high and, if they sell at all, sell low. Research by the Academic-Industry Research Network, a nonprofit I cofounded and lead, shows that companies that do buybacks never resell the shares at higher prices.

Once in a while a company that bought high in a boom has been forced to sell low in a bust to alleviate financial distress. GE, for example, spent $3.2 billion on buybacks in the first three quarters of 2008, paying an average price of $31.84 per share. Then, in the last quarter, as the financial crisis brought about losses at GE Capital, the company did a $12 billion stock issue at an average share price of $22.25, in a failed attempt to protect its triple-A credit rating.

In general, when a company buys back shares at what turn out to be high prices, it eventually reduces the value of the stock held by continuing shareholders. "The *continuing* shareholder is penalized by repurchases

above intrinsic value," Warren Buffett wrote in his 1999 letter to Berkshire Hathaway shareholders. "Buying dollar bills for $1.10 is not good business for those who stick around."

2. Buybacks are necessary to offset the dilution of earnings per share when employees exercise stock options.

Calculations that I have done for high-tech companies with broad-based stock option programs reveal that the volume of open-market repurchases is generally a multiple of the volume of options that employees exercise. In any case, there's no logical economic rationale for doing repurchases to offset dilution from the exercise of employee stock options. Options are meant to motivate employees to work harder now to produce higher future returns for the company. Therefore, rather than using corporate cash to boost EPS immediately, executives should be willing to wait for the incentive to work. If the company generates higher earnings, employees can exercise their options at higher stock prices, and the company can allocate the increased earnings to investment in the next round of innovation.

3. Our company is mature and has run out of profitable investment opportunities; therefore, we should return its unneeded cash to shareholders.

Some people used to argue that buybacks were a more tax-efficient means of distributing money to shareholders than dividends. But that has not been the case since 2003, when the tax rates on long-term capital gains and qualified dividends were made the same. Much more important issues remain, however: What is the CEO's main role and his or her responsibility to shareholders?

Companies that have built up productive capabilities over long periods typically have huge organizational and financial advantages when they enter related markets. One of the chief functions of top executives is to discover new opportunities for those capabilities. When they opt to do large open-market repurchases instead, it raises the question of whether these executives are doing their jobs.

A related issue is the notion that the CEO's main obligation is to shareholders. It's based on a misconception of the shareholders' role in the modern corporation. The philosophical justification for giving them all excess corporate profits is that they are best positioned to allocate resources because they have the most interest in ensuring that capital generates the highest returns. This proposition is central to the "maximizing shareholder value" (MSV) arguments espoused over the years, most notably by Michael C. Jensen. The MSV school also posits that companies' so-called free cash flow should be distributed to shareholders because only they make investments without a guaranteed return—and hence bear risk.

But the MSV school ignores other participants in the economy who bear risk by investing without a guaranteed return. *Taxpayers* take on such risk through government agencies that invest in infrastructure and knowledge creation. And *workers* take it on by investing in the development of their capabilities at the firms that employ them. As risk bearers, taxpayers, whose dollars support business enterprises, and workers, whose efforts generate productivity improvements, have claims on profits that are at least as strong as the shareholders'.

The irony of MSV is that public-company shareholders typically never invest in the value-creating capabilities of the company at all. Rather, they invest in outstanding shares in the hope that the stock price will rise. And a prime way in which corporate executives fuel that hope is by doing buybacks to manipulate the market. The only money that Apple ever raised from public shareholders was $97 million at its IPO in 1980. Yet in recent years, hedge fund activists such as David Einhorn and Carl Icahn—who played absolutely no role in the company's success over the decades—have purchased large amounts of Apple stock and then pressured the company to announce some of the largest buyback programs in history.

The past decade's huge increase in repurchases, in addition to high levels of dividends, have come at a time when U.S. industrial companies face new competitive challenges. This raises questions about how much of corporate cash flow is really "free" to be distributed to shareholders. Many academics—for example, Gary P. Pisano and Willy C. Shih of Harvard Business School, in their 2009 HBR article "Restoring American Competitiveness" and their book Producing Prosperity—have warned that if U.S. companies don't start investing much more in research and manufacturing capabilities, they cannot expect to remain competitive in a range of advanced technology industries.

Retained earnings have always been the foundation for investments in innovation. Executives who subscribe to MSV are thus copping out of their responsibility to invest broadly and deeply in the productive capabilities their organizations need to continually innovate. MSV as commonly understood is a theory of value extraction, not value creation.

Executives Are Serving Their Own Interests

As I noted earlier, there is a simple, much more plausible explanation for the increase in open-market repurchases: the rise of stock-based pay. Combined with pressure from Wall Street, stock-based incentives make senior executives extremely motivated to do buybacks on a colossal and systemic scale.

Consider the 10 largest repurchasers, which spent a combined $859 billion on buybacks, an amount equal to 68% of their combined net income, from 2003 through 2012. (See the exhibit "The Top 10 Stock Repurchasers.") During the same decade, their CEOs received, on average, a total of $168 million each in compensation. On average, 34% of their compensation was in the form of stock options and 24% in stock awards. At these companies the next four highest-paid senior executives each received, on average, $77 million in compensation during the 10 years—27% of it in stock options and 29% in stock awards. Yet since 2003 only three of the 10 largest repurchasers—Exxon Mobil, IBM, and Procter & Gamble—have outperformed the S&P 500 Index.

Reforming the System

Buybacks have become an unhealthy corporate obsession. Shifting corporations back to a retain-and-reinvest regime that promotes stable and equitable growth will take bold action. Here are three proposals:

Put an end to open-market buybacks.

In a 2003 update to Rule 10b-18, the SEC explained: "It is not appropriate for the safe harbor to be available when the issuer has a heightened incentive to manipulate its share price." In practice, though, the stock-based pay of the executives who decide to do repurchases provides just this "heightened incentive." To correct this glaring problem, the SEC should rescind the safe harbor.

A good first step toward that goal would be an extensive SEC study of the possible damage that open-market repurchases have done to capital formation, industrial corporations, and the U.S. economy over the past three decades. For example, during that period the amount of stock taken out of the market has exceeded the amount issued in almost every year; from 2004 through 2013 this net withdrawal averaged $316 billion a year. In aggregate, the stock market is not functioning as a source of funds for corporate investment. As I've already noted, retained earnings have always provided the base for such investment. I believe that the practice of tying executive compensation to stock price is undermining the formation of physical and human capital.

Rein in stock-based pay.

Many studies have shown that large companies tend to use the same set of consultants to benchmark executive compensation, and that each consultant recommends that the client pay its CEO well above average. As a result, compensation inevitably ratchets up over time. The studies also show that even declines in stock price increase executive pay: When a company's stock price falls, the board stuffs even more options and stock awards into top executives' packages, claiming that it must ensure that they won't jump ship and will do whatever is necessary to get the stock price back up.

In 1991 the SEC began allowing top executives to keep the gains from immediately selling stock acquired from options. Previously, they had to hold the stock for six months or give up any "short-swing" gains. That decision has only served to reinforce top executives' overriding personal interest in boosting stock prices. And because corporations aren't required to disclose daily buyback activity, it gives executives the opportunity to trade, undetected, on inside information about when buybacks are being done. At the very least, the SEC should stop allowing executives to sell stock immediately after options are exercised. Such a rule could help launch a much-needed discussion of meaningful reform that goes beyond the 2010 Dodd-Frank Act's "Say on Pay"—an ineffectual law that gives shareholders the right to make nonbinding recommendations to the board on compensation issues.

But overall the use of stock-based pay should be severely limited. Incentive compensation should be subject to performance criteria that reflect investment in innovative capabilities, not stock performance.

Transform the boards that determine executive compensation.

Boards are currently dominated by other CEOs, who have a strong bias toward ratifying higher pay packages for their peers. When approving enormous distributions to shareholders and stock-based pay for top executives, these directors believe they're acting in the interests of shareholders.

That's a big part of the problem. The vast majority of shareholders are simply investors in outstanding shares who can easily sell their stock when they want to lock in gains or minimize losses. As I argued earlier, the people who truly invest in the productive capabilities of corporations are taxpayers and workers. Taxpayers have an interest in whether a corporation that uses government investments can generate profits that allow it to pay taxes, which constitute the taxpayers' returns on those investments. Workers have an interest in whether the company will be able to generate profits with which it can provide pay increases and stable career opportunities.

It's time for the U.S. corporate governance system to enter the 21st century: Taxpayers and workers should have seats on boards. Their representatives would have the insights and incentives to ensure that executives allocate resources to investments in capabilities most likely to generate innovations and value.

Courage in Washington

After the Harvard Law School dean Erwin Griswold published "Are Stock Options Getting out of Hand?" in this magazine in 1960, Senator Albert Gore launched a campaign that persuaded Congress to whittle away special tax advantages for executive stock options. After the Tax Reform Act of 1976, the compensation expert Graef Crystal declared that stock options that qualified for the capital-gains tax rate, "once the most popular of all executive compensation devices…have been given the last rites by Congress." It also happens that during the 1970s the share of all U.S. income that the top 0.1% of households got was at its lowest point in the past century.

The members of the U.S. Congress should show the courage and independence of their predecessors and go beyond "Say on Pay" to do something about excessive executive compensation. In addition, Congress should fix a broken tax regime that frequently rewards value extractors as if they were value creators and ignores the critical role of government investment in the infrastructure and knowledge that are so crucial to the competitiveness of U.S. business.

Instead, what we have now are corporations that lobby—often successfully—for federal subsidies for research, development, and exploration, while devoting far greater resources to stock buybacks. Here are three examples of such hypocrisy:

Alternative energy.

Exxon Mobil, while receiving about $600 million a year in U.S. government subsidies for oil exploration (according to the Center for American Progress), spends about $21 billion a year on buybacks. It spends virtually no money on alternative energy research.

Meanwhile, through the American Energy Innovation Council, top executives of Microsoft, GE, and other companies have lobbied the U.S. government to triple its investment in alternative energy research and subsidies, to $16 billion a year. Yet these companies had plenty of funds they could have invested in alternative energy on their own. Over the past decade Microsoft and GE, combined, have spent about that amount annually on buybacks.

Nanotechnology.

Intel executives have long lobbied the U.S. government to increase spending on nanotechnology research. In 2005, Intel's then-CEO, Craig R. Barrett, argued that "it will take a massive, coordinated U.S. research effort involving academia, industry, and state and federal governments to ensure that America continues to be the world leader in information technology." Yet from 2001, when the U.S. government launched the National Nanotechnology Initiative (NNI), through 2013 Intel's expenditures on buybacks were almost four times the total NNI budget.

Pharmaceutical drugs.

In response to complaints that U.S. drug prices are at least twice those in any other country, Pfizer and other U.S. pharmaceutical companies have argued that the profits from these high prices—enabled by a generous intellectual-property regime and lax price regulation—permit more R&D to be done in the United States than elsewhere. Yet from 2003 through 2012, Pfizer funneled an amount equal to 71% of its profits into buybacks, and an amount equal to 75% of its profits into dividends. In other words, it spent more on buybacks and dividends than it earned and tapped its capital reserves to help fund them. The reality is, Americans pay high drug prices so that major pharmaceutical companies can boost their stock prices and pad executive pay.Given the importance of the stock market and corporations to the economy and society, U.S. regulators must step in to check the behavior of those who are unable or unwilling to control themselves. "The mission of the U.S. Securities and Exchange Commission," the SEC's website explains, "is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." Yet, as we have seen, in its rulings on and monitoring of stock buybacks and executive pay over three decades, the SEC has taken a course of action contrary to those objectives. It has enabled the wealthiest 0.1% of society, including top executives, to capture the lion's share of the gains of U.S. productivity growth while the vast majority of Americans have been left behind. Rule 10b-18, in particular, has facilitated a rigged stock market that, by permitting the massive distribution of corporate cash to shareholders, has undermined capital formation, including human capital formation.

The corporate resource allocation process is America's source of economic security or insecurity, as the case may be. If Americans want an economy in which corporate profits result in shared prosperity, the buyback and executive compensation binges will have to end. As with any addiction, there will be withdrawal pains. But the best executives may actually get satisfaction out of being paid a reasonable salary for allocating resources in ways that sustain the enterprise, provide higher standards of living to the workers who make it succeed, and generate tax revenues for the governments that provide it with crucial inputs.

A version of this article appeared in the September 2014 issue of *Harvard Business Review*.

Harvard Business Review

Stock Buybacks Aren't Hurting Innovation

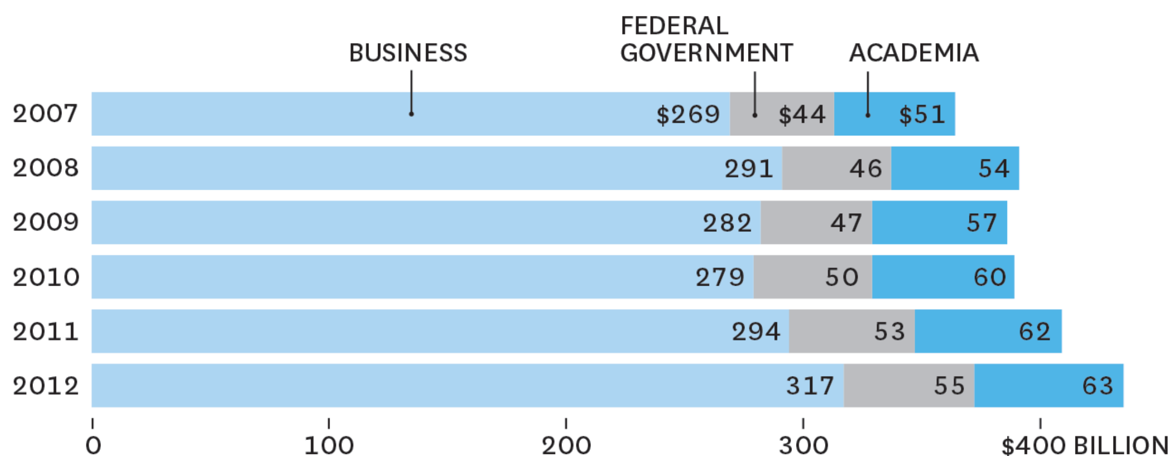
by Greg Satell
March 31, 2015

Companies are spending more money buying back their own stock than they ever have. These stock buybacks have come under criticism as a bad investment – the argument being that companies sitting on record amounts of cash ought to invest in innovation, salaries, or at least dividends, rather than pumping up their own stock price through buybacks.

But before we vilify stock buybacks, let's take a closer look at the charges against them.

Critics have pointed out that companies who spend money on stock buybacks a) are wasting money they could be plowing into R&D and innovation, and b) also hypocritically lobby for federal investment in research benefits them. Intel, for one, urged for greater public funding for nanotechnology research. Other top executives at the American Energy Innovation Council are pushing for more funding for alternative energy research. The list goes on. Shouldn't these companies be using the money they're spending on stock buybacks to fund that research themselves?

Not so fast. For one thing, it's not clear that the stock buyback trend is actually limiting corporate innovation spending. US business already are spending heavily on research and development – data from the National Science Foundation (NSF) even shows an uptick in US business investment in R&D.



Not only has business investment in R&D been outpacing economic growth in recent years (2012 is the most recent year available), but it's also outpacing longer term trends.

While R&D spending is an imperfect proxy for innovation investment, this data should give us pause when we hear claims that American innovation is in crisis because corporate investors are unwilling to invest in the future, or because activist investors demand short-term results.

The case of Apple is an instructive, if extreme, example. Last year, the company spent $56 billion on share repurchases. That exceeds its operating income of $52.5 billion by more than 7%. Surely, it seems that Apple is rewarding investors at the expense of its future.

But a closer look reveals that Apple has also been expanding investment on R&D at a compound rate of 28%, while simultaneously increasing its ratio of R&D to sales. What's more, the company still holds more than $170 billion in cash that it has very little idea what to do with.

We should also question the assumption that investor preference for quick returns limits managers' ability to invest in the future. In fact, private capital investment, an even larger ticket item than R&D, has also been increasing and is at historically high levels of GDP.

And it's not just short-term investors that like buybacks and dividends. Mark Mulholland, whose Matthew 25 Fund holds investments for an average of five years, argues that returning excess capital to investors is healthy, not just for share prices, but for the economy. He says, "a company shouldn't sit on cash, they should put money to work. If not in their own business then back to their investors so that it can be deployed elsewhere."

So it appears that the current surge in share buybacks may be a reasonable course of action: faced with a superabundance of capital, firms are both increasing investments and returning the excess to shareholders so that it can be invested elsewhere.

Moreover, we can't assume that these firms are lobbying for the federal government to invest in research that they could just as easily perform themselves. Firms are in business to make money and should therefore willing to make investments to make more of it. However, not all investments are equal. Some, like the development of specific technology for a new product, largely benefit one firm. Others, such as the discovery of DNA, the human genome project and clean energy, benefit society more broadly. The former tends to be conducted by corporations to develop products they expect will be profitable, and the latter tends to be more exploratory.

Even if corporations were willing to take on exploratory research, it's not clear the public should want them to. Because private research is proprietary, its fruits become the property of the organization. Public research, on the other hand, is published and shared widely. If we replace public sources of funding with private ones, we run two risks: first, that exploratory research would be effectively defunded, and second, that any important discoveries made will not become public property, but will remain in private, corporate hands.

The two different types of research are complementary. As Ed Lazowska, who co-chaired President Bush's Information Technology Advisory Committee, says, "In it's essence, innovation is combination. A private company is unlikely to come up with more than a few pieces of the puzzle. If the government doesn't invest, there will be nothing for these companies to engineer into products."

Let's return to the example of Intel, one of the companies that's used its cash to buy back it's own stock, even as it's lobbied for more federal funding for research that would benefit them. In a recent HBR article by William Lazonick, he writes that "Intel executives have long lobbied the U.S. government to increase spending on nanotechnology research" and then points out that Intel's share repurchases are four times the federal nanotechnology budget.

Fair enough, but Lazonick fails to mention that according to Intel's most recent 10-K filing, the company's annual research budget of $11.5 billion is *more than six times* that of the National Nanotechnology Initiative (NNI) budget of $1.5 billion. So clearly Intel's advocacy of broad based nanotechnology should not be considered a reticence to invest in the future.

I'm not arguing that hypocrisy and rent seeking in corporate lobbying doesn't exist and, in fact, Lazonick cites some other examples where it does seem to be taking place.

My point is that there is a fundamental difference between public and private investment. We don't advocate for corporate investments in all the public goods corporations rely on—the roads their trucks drive, the schools that educate their future employees, and so on. (Although we do expect corporations to pay their taxes, which of course help to fund those things.)

The fact that private firms benefit from public investment in research is not a bug, but a feature. Vannevar Bush, who was the chief architect of today's federal research programs, wrote that "there must be a stream of new scientific knowledge to turn the wheels of private and public enterprise."

He did not write these words offhand or as an aside, but in the founding document of our public research efforts, in which he argued strenuously that public support of basic research was essential to our national well-being and prosperity. He did so not to augment corporate programs, but to undertake efforts that they cannot.

And Bush's model clearly works. In fact, it is the envy of the world. It is not an accident that the iPhone was invented by a US company, virtually all of its basic technology has its roots in some federal program. Moreover, as Gary Pisano and Willy Shih point out in another HBR article, although data from the US funded Human Genome Project is available across the world, it is US companies that are reaping the benefits.

There is a lot to find fault with in corporate America today. Lobbying and rent seeking, elaborate tax dodging on a massive scale, outright fraud and other crimes are very real. However, insisting on private accountability is no excuse for shirking public duty.

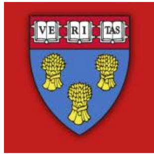
The real problem isn't that corporations are unwilling to think long term, but the rest of us. It's easy to point our fingers at highly paid executives and greedy investors for short-term thinking, but when it comes to our collective future, we are failing to live up to our basic responsibilities.

The American Society of Civil Engineers gives US infrastructure a grade of D+ and we hardly take notice. A bill for an infrastructure bank, written in 2007, languishes in Congress due to lack of political support. Senators gain cheap political points by attacking scientific research and we cheer them on. We make drastic cuts to funding for an Ebola vaccine and then panic when there's an outbreak.That's the real capitalist's dilemma.

It's much easier to demand lower taxes than to fix our crumbling roads, bridges and airports. It feels good to laugh at egghead scientists and their goofy research, but much harder to understand the significance of their work. I shudder to think of what political hay today's leaders would make of Einstein's notion of the relativity of time and space.

The truth is that you can only win the future if you invest in it. It is, in fact, America's postwar commitment to infrastructure and science that we have to thank for our current prosperity. So if we really care about innovation, we not only need to be forward looking in our private decisions, but our public ones as well.

Tab 2: Engagements in Connection with Activist Situations



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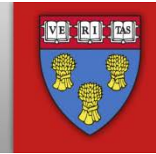


The Evolving Landscape of Shareholder Activism: Developments and Potential Actions

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Tuesday March 24, 2015

Editor's Note: The following post comes to us from Sullivan & Cromwell LLP, and is based on a Sullivan & Cromwell publication by Jay Clayton, Mitchell S. Eitel, Joseph B. Frumkin, and Glen T. Schleyer.

It is clear that shareholder activism continues to evolve, expand and increase in influence. There is a growing emphasis, in particular by large mutual funds and other institutional investors, on shareholder engagement and shareholder-friendly governance structures that, together with the increased activity of activist hedge funds and other "strategic" activist investors, make shareholder engagement and preparedness an essential focus for public companies and their boards.

Most recently, BlackRock Inc. and the Vanguard Group, the largest and third largest U.S. asset managers with more than $7 trillion in combined assets under management, have made public statements emphasizing that they are focused on corporate governance and board engagement. Vanguard recently sent a letter to many of its portfolio companies cautioning them not to confuse Vanguard's "predominantly passive management style" with a "passive attitude toward corporate governance." The letter goes on to emphasize numerous corporate governance principles and to highlight in detail (as discussed further below) the importance of direct shareholder-director interactions. BlackRock recently updated its voting policies to make clear that they are more than just guides to how BlackRock votes–they represent "our expectations of boards of directors." The new policies continue an emphasis on direct interaction between investors and directors.

These sorts of statements by large institutions are becoming more common—TIAA-CREF has sent letters to many issuers advocating the adoption of proxy access provisions, and a number of the largest institutions last year signed a letter sent to numerous companies in support of the shareholder engagement principles embodied in the Shareholder-Director Exchange (SDX) Protocol. These statements and advocacy efforts come amid continuing high level of shareholder activism at a wide range of large and small companies.

What all this means is that shareholder activism, in terms of corporate governance and shareholder relations, has become mainstream. What began as a targeted effort by a small number of governance activists, supported by some academics, clearly is now a broad movement that is redefining the relationship between public companies and their shareholders. We expect this evolution to continue and believe that companies and their boards of directors should recognize that historic shareholder relations models, as well as "traditional" approaches to responding to shareholder initiatives, may no longer be optimal.

Activism has been successful as an asset class, attracting over $200 billion in investor funds, much from pension funds and other institutional investors. There is an active debate about the long-term impact of activism, but there is no question that in recent years activists in many cases have achieved short-term excess positive returns, and that activist campaigns have regularly garnered the support of many traditionally more passive shareholders. As a result even the largest, most respected companies may be vulnerable.

Companies should take, and many are taking, these developments seriously. Both directors and executive officers are proactively considering possible activist initiatives and discussing them at board meetings. Companies are devoting greater effort to communications with shareholders and are beginning to arrange for direct communications between shareholders and outside directors; we expect this trend to continue. It appears that corporations and shareholders are feeling their way towards a new relationship with significantly more scope for engagement. This is a complex process that will take time and vary from company to company, and today we remain in transition.

Activists often benefit from underdeveloped lines of communication between corporations and their shareholders, particularly in times of crisis. Activists may also have benefited from a perceived general decrease in investor trust in the thoughtfulness and diligence of boards and managements following the financial crisis. Transitions are challenging, so what should a public company do to address the changing environment? Here are some observations:

- **1. There is no "one size fits all" approach to activism.** Corporations should recognize that every situation is different. Small differences in circumstances can lead to substantial differences in options available to optimize outcomes. Considerations may include, among others, size of equity capitalization, identity of shareholders, identity and track record of activist(s), nature and attractiveness of an activist proposal and the company's response to the proposal, total shareholder return of company in recent years, the media profile of the company and activist(s), and overall governance profile of company. The governance profile includes not only structural defenses, but also director tenure (which,

regardless of its merits, is becoming a more significant investor consideration), director expertise and compensation structures.

- **2. Study possible activist lines of attack, consider proactive communication with shareholders and be prepared to respond and preemptively address activist arguments.** It is essential that managements, boards and advisors thoughtfully consider possible activist lines of attack before the attack surfaces. They should evaluate whether any actions that might be advocated should be implemented and, if not, develop a clear explanation for why doing so is not advisable. This process should be rigorous and fact-based and should seek to anticipate activist counter-arguments to the company's position. The company should also consider proactively informing investors about its analysis of alternatives to create value, including previewing for investors why some superficially appealing actions are not advisable.

  Materials (talking points, communications to shareholder, other investor or analyst presentations, etc.) should be prepared in advance of any approach that explain in clear language why pre-identified activists ideas are not advisable. Although the amount of effort devoted to preparation of materials may vary from company to company, once an activist gets traction with shareholders, it can be difficult to turn things around, so preemption, and, if preemption is not possible, speed of response, is essential.

- **3. Prepare the Board of Directors.** Managements and advisors should keep the board apprised on possible activist avenues of attack, intended company responses and current trends in activism generally and tactics in particular. Many companies are doing this to some extent today, but the process should become a regular part of the annual board calendar and be integrated with board discussions on strategic planning and capital allocation. If an activist emerges, a high level of board involvement and cohesion will be essential and the mechanics for that should be established in advance.
- **4. Understand the consequences of the governance emphasis by institutional investors.** Index funds are the ultimate long term investors; they own the market and their obligation to their investors is to support an environment that creates the best chance to maximize, permanently, the overall value of public equities. Thus, index funds are showing a particular focus on how companies are governed.

  These fund managers have decided that one way to maximize value in an enduring way is to focus on the quality of corporate governance. The good news is that this gives public companies a path to obtaining the support of these funds, which control an ever increasing proportion of the votes at public companies. It also reduces the influence of proxy advisory firms. The bad news is that procuring this support, at this point, can

require significant adherence to a sort of “check the box” litany of governance initiatives, not all of which are appropriate or advisable for every company. But companies should focus carefully on these initiatives, and their relationships overall with these investors, because their support often will be decisive in any activist campaign. These fund managers will be inclined to support Boards and managements that they believe are properly selected for their experiences, expertise and independence, have demonstrated an openness to shareholder engagement, and demonstrated an appropriate level of oversight over corporate affairs, and, in the case of directors, of management and management compensation. This is also the basis on which increased director interaction with shareholders can be helpful to demonstrate the appropriate functioning of a particular board. We would expect over time the governance expectations will assume a less “check the box” and more nuanced approach, but for now they are relatively formalistic.

- **5. Consider appropriate structures for Board oversight of and involvement in shareholder engagement.** As noted above, the board should be kept apprised of shareholder outreach efforts, feedback from shareholders, and trends or developments regarding shareholder activism. The regularity and format of these postings will vary from company to company, as will the formality of board structures and processes for overseeing these areas. The Vanguard letter referred to above, although acknowledging that there is no one-size-fits-all engagement strategy, suggests that the creation of a “Shareholder Liaison Committee” as a possible means to facilitate board-shareholder communication. In addition, the SDX letter referred to above, which was signed by a number of large institutions, advocates the creation of a formal shareholder engagement policy.

  It is likely that many companies will determine that these sorts of formal measures are not necessary or appropriate. Even so, companies and boards should consider how best to effect the board’s oversight of shareholder engagement, and where appropriate contribute to that engagement. Some companies may determine that, while a stand-alone Shareholder Liaison Committee is not necessary in their particular circumstances, the mandate of their governance committee could be formally expanded to cover oversight of shareholder engagement. Even if no formal changes are made, a company should take steps to make sure that regular postings and presentations on shareholder engagement matters are included on the agendas for the board or relevant committees.

  As companies have expanded their shareholder engagement efforts, both within and outside of activist situations, a frequent topic of commentary has been the involvement of

directors in meeting directly with shareholders. Practice has varied significantly, depending largely on the predilections of particular directors and the expressed interest of key shareholders in these meetings. To date, most companies have made these decisions in an *ad hoc* manner, and until recently overall direct board-shareholder discussions have been relatively unusual, outside of a takeover or other crisis situation. It is clear that director-shareholder engagement will be a continuing and increasing area of focus for shareholders. The Vanguard Letter and SDX Protocol stand as clear indications that institutional investors will press for communications that include outside directors.

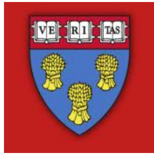
It seems unlikely that director meetings will ever be the primary means for shareholders to interact with companies—given the oversight function of the board, directors cannot be expected to have the details as to business matters that shareholders generally wish to discuss. However, it may become more common for directors to meet with large shareholders to discuss matters that are within the directors' purview, including governance structures, executive compensation and to hear the shareholders' views directly on other topics.

Even if a company has not received shareholder requests for meetings with directors, the company should anticipate that such requests will be coming sooner rather than later. The first step is to discuss the concept with the board. Ultimately, the level of director-shareholder engagement, if any, will turn on the comfort level that the board members have with particular directors engaging directly with shareholders on particular topics. Generally speaking, Regulation FD or confidentiality concerns should not be a bar to shareholder engagement, because these meetings would not normally involve the disclosure of non-public information. Of course, appropriate steps should be taken (including director training, accompaniment by legal personnel and/or limitation of topics discussed) to help avoid missteps.

- **6. Carefully review corporate by-laws.** Corporate by-laws can establish some useful—and equitable—rules for the sorts of corporate actions sometimes initiated by activists, including calling special meetings of shareholders and nominating candidates for director. Every public company should carefully review its by-laws with its advisors and consider whether changes are appropriate. By-law changes are an area that requires judgment, and clearly an area where one size does not fit all. A by-law change that would pass unnoticed at some companies may be seen as inflammatory at others. Shareholders are increasingly sensitive to board actions, such as by-law changes, affecting shareholder rights without prior shareholder consultation. Specific areas to consider include how far in advance shareholders must give notice of an intention to make a proposal or nominate a

director at an annual meeting, what disclosure is required of director nominees, whether there should be qualification requirements—such as an absence of third party compensation for director service—for directors, whether the by-laws should establish an exclusive forum for shareholder class actions and whether a board by-law change should preemptively address proxy access.

This period of transition may be challenging for companies and those that advise them. Activists seem to be achieving more success than would appear to be warranted by the strength of their ideas or proposals for change. At the same time, funds and other institutional investors are becoming more active in how they reach out to and interact with their portfolio companies. This current reality means companies need to ask themselves what they can do differently to change the existing dynamic so that the better substantive, value creating position prevails. In addition to the concrete steps outlined above, companies also should consider the increasing concentration in public company share ownership, the incentives affecting the interests of these owners, especially the index investors, the demonstrated ineffectiveness of focusing the substantive debate primarily on "short-termism" and the reasons for activist success. This is a complex analysis and, in many cases, action will be necessary, but undertaking that analysis and making appropriate adjustments will make it easier to prevent and, if prevention fails, prevail against, an activist challenge.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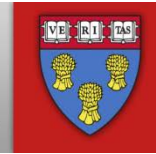


Dealing With Activist Hedge Funds

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Thursday November 6, 2014

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton and Sabastian V. Niles. Recent work from the Program on Corporate Governance about hedge fund activism includes: The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here); The Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forum here); and Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

This year has seen a continuance of the high and increasing level of activist campaigns experienced during the last 14 years, from 27 in 2000 to nearly 250 to date in 2014, in addition to numerous undisclosed behind-the-scenes situations. Today, regardless of industry, no company can consider itself immune from potential activism. Indeed, no company is too large, too popular or too successful, and even companies that are respected industry leaders and have outperformed peers can come under fire. Among the major companies that have been targeted are, Amgen, Apple, Microsoft, Sony, Hess, P&G, eBay, Transocean, ITW, DuPont, and PepsiCo. There are more than 100 hedge funds that have engaged in activism. Activist hedge funds have approximately $200 billion of assets under management. They have become an "asset class" that continues to attract investment from major traditional institutional investors. The additional capital and new partnerships between activists and institutional investors have encouraged increasingly aggressive activist attacks.

The major activist hedge funds are very experienced and sophisticated with professional analysts, traders, bankers and senior partners that rival the leading investment banks. They produce detailed analyses ("white papers") of a target's management, operations, capital structure and strategy designed to show that the changes they propose would quickly boost shareholder value. These white papers may also contain aggressive critiques of past decisions made by the target. Some activist attacks are designed to facilitate a takeover or to force a sale of

the target, such as the failed Icahn attack on Clorox. Prominent institutional investors and strategic acquirors have been working with activists both behind the scenes and by partnering in sponsoring an activist attack such as CalSTRS with Relational in attacking Timken, Ontario Teachers' Pension Fund with Pershing Square in attacking Canadian Pacific, and Valeant partnering with Pershing Square to force a takeover of Allergan.

Many major activist attacks involve a network of activist investors ("wolf pack") who support the lead activist hedge fund, but attempt to avoid the disclosure and other laws and regulations that would hinder or prevent the attack if they were, or were deemed to be, a group that is acting in concert. Not infrequently, at the fringe of the wolf pack are some of the leading institutional investors, not actively joining in the attack, but letting the leader of the pack know that it can count on them in a proxy fight. Major investment banks, law firms, proxy solicitors, and public relations advisors are now representing activist hedge funds and are eagerly soliciting their business.

Among the attack devices used by activists are:

- aggressively criticizing a company's announced initiatives and strategic actions and presenting the activist's own recommendations and business plan;
- proposing a precatory proxy resolution for specific actions prescribed by the activist or the creation of a special committee of independent directors to undertake a strategic review for the purpose of "maximizing shareholder value";
- conducting a proxy fight to get board representation at an annual or special meeting or through action by written consent (note that solicitation for a short slate is very often supported by ISS and, if supported, is often successful, in whole or in part, and ISS is increasingly showing support for "control" slates);
- orchestrating a "withhold the vote" campaign;
- seeking to force a sale by leaking or initiating rumors of an unsolicited approach, publicly calling for a sale, acting as an (unauthorized) intermediary with strategic acquirers and private equity funds, making their own "stalking horse" bid or partnering with a hostile acquirer to build secret, substantial stock positions in the target to facilitate a takeover;
- rallying institutional investors and sell-side research analysts to support the activist;
- using stock loans, options, derivatives and other devices to increase voting power beyond the activist's economic equity investment;
- using sophisticated public relations, social media and traditional media campaigns to advance the activist's arguments;
- hiring private investigators to establish dossiers on directors, management and key employees and otherwise conducting aggressive "diligence"; and
- litigating to obtain board records and materials and to block transactions.

Current SEC rules do not prevent an activist from secretly accumulating a more than 5% position before being required to make public disclosure and do not prevent activists and institutional investors from privately communicating and cooperating.

Prevention of, or response to, an activist attack is an art, not a science. There is no substitute for preparation. In addition to a program of advance engagement with investors, it is essential to be able to mount a defense quickly and to be flexible in responding to changing tactics. To forestall an attack, a company should continuously review its business portfolio and strategy and its governance and executive compensation issues sensibly and in light of its particular needs and circumstances. Companies must regularly adjust strategies and defenses to meet changing market conditions, business dynamics and legal developments.

This outline provides a checklist of matters to be considered in putting a company in the best possible position to prevent or respond to hedge fund activism.

Advance Preparation

Create Team to Deal with Hedge Fund Activism:

- A small group (2-5) of key officers plus lawyer, investment banker, proxy soliciting firm, and public relations firm
- Continuing contact and periodic meetings of the team are important
- A periodic fire drill with the team is the best way to maintain a state of preparedness; the team should be familiar with the hedge funds that have made activist approaches generally and be particularly focused on those that have approached other companies in the same industry and the tactics each fund has used
- Periodic updates of the company's board of directors

Shareholder Relations:

- The investor relations officer is critical in assessing exposure to an activist attack and in a proxy solicitation. The regard in which the investor relations officer is held by the institutional shareholders has been determinative in a number of proxy solicitations. Candid investor relations assessment of shareholder sentiment should be appropriately communicated to senior management, with periodic briefings provided to the board
- Review capital return policy (dividends and buybacks), broader capital allocation framework, analyst and investor presentations and other financial public relations matters (including disclosed metrics and guidance)

- Monitor peer group, sell-side analysts, proxy advisors like ISS, activist institutions like CalSTRs and TIAA-CREF, Internet commentary and media reports for opinions or facts that will attract the attention of attackers
- Be consistent with the company's basic strategic message
- Objectively assess input from shareholders—is the company receiving candid and direct feedback
- Proactively address reasons for any shortfall versus peer company benchmarks; anticipate key questions and challenges from analysts and activists, and be prepared with answers; build credibility with shareholders and analysts before activists surface and attempt to "educate" the sell-side
- Monitor changes in hedge fund and institutional shareholder holdings on a regular basis; understand the shareholder base, including, to the extent practical, relationships among holders, paying close attention to activist funds that commonly act together or with an institutional investor
- Maintain regular, close contact with major institutional investors; CEO, CFO and independent director participation is very important; regularly engage with portfolio managers as well as proxy-voting departments
- Monitor ISS, GL, CII, TIAA-CREF corporate governance policies; activists try to "piggy-back" on process issues to bolster the argument for management or business changes
- Monitor third-party governance ratings and reports for inaccuracies and/or flawed characterization
- Major institutional investors, including BlackRock, Fidelity, State Street and Vanguard have established significant proxy departments that make decisions independent of ISS and GL and warrant careful attention. It is important for a company to know the voting policies and guidelines of its major investors, who the key decision-makers and point-persons are and how best to reach them. It is possible to mount a strong defense against an activist attack that is supported by ISS and GL and gain the support of the major institutional shareholders
- Maintain up-to-date plans for contacts with media, regulatory agencies and political bodies and refresh relationships
- Monitor conference call participants, one-on-one requests and transcript downloads
- Continue regular temperature taking calls pre- and post-earnings and conferences and exercise caution and oversight with respect to large format or "group" investor meetings

Prepare the Board of Directors to Deal with the Activist Situation:

- Maintaining a unified board consensus on key strategic issues is essential to success; in large measure an attack by an activist hedge fund is an attempt to drive a wedge between the board and management by raising doubts about strategy and management performance and to create divisions on the board by advocating that a special committee be formed
- Keep the board informed of options and alternatives analyzed by management, and review with the board basic strategy, capital allocation and the portfolio of businesses in light of possible arguments for spinoffs, share buybacks, increased leverage, special dividends, sale of the company or other structural changes
- Schedule periodic presentations by the lawyer and the investment banker to familiarize directors with the current activist environment
- Directors must guard against subversion of the responsibilities of the full board by the activists or related parties and should refer all approaches to the CEO
- Boardroom debates over business strategy, direction and other matters should be open and vigorous but kept within the boardroom
- Avoid being put in play; recognize that psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a target
- A company should not wait until it is involved in a contested proxy solicitation to have its institutional shareholders meet its independent directors. A disciplined, thoughtful program for periodic meetings is advisable
- Scrutiny of board composition is increasing, and boards should self-assess regularly. In a contested proxy solicitation, institutional investors may particularly question the "independence" of directors who are older than 75 or who have served for more than 10 to 15 years

Monitor Trading, Volume and Other Indicia of Activity:

- Employ stock watch service and monitor Schedule 13F filings
- Monitor Schedule 13D and Schedule 13G and Hart-Scott-Rodino Act filings
- Monitor parallel trading and group activity (the activist "wolf pack")
- Monitor activity in options and derivatives, as well as corporate debt and other non-equity securities

The Activist White Paper

The activist may approach a company with an extensive high-quality analysis of the company's business that supports the activist's recommendations (demands) for:

- Return of capital to shareholders through share repurchase or a special dividend
- Sale or the spin-off of a division
- Change in business strategy
- Improvement of management performance (replace CEO)
- Change in executive compensation
- Change in cost structures
- Merger or sale of the company
- Change in governance: add new directors designated by the activist, separate the positions of CEO and Chair, declassify the board, remove poison pill and other shark repellants, and permit shareholders to call a special meeting (or lower thresholds for same) and act by written consent in lieu of a meeting

The white paper is used by the activist in private meetings with shareholders, sell-side analysts and the media and is ultimately designed for public consumption

Responding to an Activist Approach

Response to Non-Public Communication:

- Assemble team and determine initial strategy. Response is an art, not a science
- No duty to discuss or negotiate (no outright rejection, try to learn as much as possible by listening and keep in mind that it may be desirable to at some point negotiate with the activist and that developing a framework for private communication and non-public engagement may avoid escalation)
- No duty to disclose unless leak comes from within
- Response to any particular approach must be specially structured; team should confer to decide proper response
- Keep board advised (in some cases it may be advisable to arrange for the activist to present its white paper to the board or a committee or subset of the directors)
- No duty to respond, but failure to respond may have negative consequences
- Be prepared for public disclosure by activist
- Be prepared for the activist to try to engage directly with shareholders, sell-side analysts, business partners, employees and key corporate constituencies

Response to Public Communication:

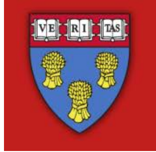
- Initially, no response other than “the board will consider and welcomes input from its shareholders”
- Assemble team; inform directors
- Call special board meeting to meet with team and consider the communication
- Determine board’s response and whether to meet with activist. Failure to meet may be viewed negatively by institutional investors. Meeting may result in activist using the meeting to mischaracterize the company’s position
- Avoid mixed messages and preserve the credibility of the board and management
- Gauge whether the best outcome is to agree upon board representation and/or strategic business or other change in order to avoid a proxy fight
- Be prepared and willing to defend vigorously
- Appreciate that the public dialogue is often asymmetrical; while activists can, often without consequence, make personal attacks and use aggressive language, the company cannot respond in this manner
- Remain focused on the business; activist approaches can be all-consuming, but continued strong performance of the business, though not an absolute defense, is one of the best defenses. When business challenges inevitably arise, acting in a manner that preserves and builds credibility with shareholders and rest of investment community is of paramount importance. Maintain the confidence and morale of employees, business partners and key constituencies
- The 2012 defeat by AOL of an activist short-slate proxy solicitation supported by ISS shows that investors can be persuaded to not blindly follow the recommendation of ISS. When presented with a well-articulated and compelling plan for the long-term success of a company, they are able to cut through the cacophony of short-sighted gains promised by activists touting short-term strategies. The AOL fight showed that when a company’s management and directors work together to clearly present a compelling long-term strategy for value creation, investors will listen
- The recent amendments, and then full withdrawal, by Carl Icahn of his attempt to force Apple into leveraging its balance sheet and paying out $150 billion to its shareholders, showed that investors can be convinced not to support an activist attack that is not in the long-term best interests of the company’s shareholders (Icahn later restated his support for continued buybacks). In this connection, it is noteworthy that on March 21, 2014, Larry Fink, Chairman and CEO of BlackRock, wrote to the CEOs of the S&P 500:

Many commentators lament the short-term demands of the capital markets. We share those concerns, and believe it is part of our collective role as actors in the global capital markets to challenge that trend. Corporate leaders can play their part by persuasively communicating their company's long-term strategy for growth. They must set the stage to attract the patient capital they seek: explaining to investors what drives real value, how and when far-sighted investments will deliver returns, and, perhaps most importantly, what metrics shareholders should use to assess their management team's success over time.

It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies. Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks. We certainly believe that returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company's ability to generate sustainable long-term returns.

We do recognize the balance that must be achieved to drive near-term performance while simultaneously making those investments—in innovation and product enhancements, capital and plant equipment, employee development, and internal controls and technology—that will sustain growth.

BlackRock's mission is to earn the trust of our clients by helping them meet their long-term investment goals. We see this mission as indistinguishable from also aiming to be a trusted, responsible shareholders with a longer term horizon. Much progress has been made on company-shareholder engagement and we will continue to play our part as a provider of patient capital in ensuring robust dialogue. We ask that you help us, and other shareholders, to understand the investments you are making to deliver the sustainable, long-term returns on which our clients depend and in which we seek to support you.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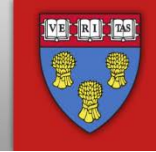

Wolf Pack Activism

Posted by R. Christopher Small, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Monday February 9, 2015

Editor's Note: The following post comes to us from Alon Brav, Professor of Finance at Duke University; Amil Dasgupta of the Department of Finance at the London School of Economics; and Richmond Mathews of the Department of Finance at the University of Maryland.

In our paper Wolf Pack Activism, which was recently made publicly available on SSRN, we provide a model analyzing a prominent and controversial governance tactic used by activist hedge funds. The tactic involves multiple hedge funds or other activist investors congregating around a target, with one acting as a "lead" activist and others as peripheral activists. This has been colorfully dubbed the "wolf pack" tactic by market observers. The use of wolf packs has intensified in recent years and has attracted a great deal of attention. Indeed, a recent post on this forum described 2014 as "the year of the wolf pack".

The formation of a wolf pack may enable activist hedge funds to gain the significant influence that they appear to wield in target firms with relatively small holdings: According to recent research, the median stake of activist hedge funds at the initiation of an activist campaign is only 6.3%. Yet, the process by which a wolf pack form appears to be subtle, for at least two reasons. First, wolf pack activity appears to be ostensibly *uncoordinated*—i.e., no formal coalition is formed—a fact that is usually attributed to an attempt by the funds to circumvent the requirement for group filing under Regulation 13D when governance activities are coalitional (e.g., Briggs 2006). Second, wolf packs appear to form dynamically: Writing in this forum in 2009, Nathan describes the process of wolf pack formation as follows: "The market's knowledge of the formation of a wolf pack (either through word of mouth or public announcement of a destabilization campaign by the lead wolf pack member) often leads to additional activist funds entering the fray against the target corporation, resulting in a rapid (and often outcome determinative) change in composition of the target's shareholder base seemingly overnight."

The subtle nature of wolf pack formation, combined with the prominence of this tactic, raises some questions of key importance to corporate governance: How can formally uncoordinated

dynamic wolf pack activity work? What role does the lead activist play? What is the role of the peripheral wolf pack members? How do leaders and followers influence each other?

Our model addresses these questions. We consider multiple activists of different sizes: One large and many small. There is one lead activist who is as large as several small activists taken together and is better informed than the small activists. Our model involves two key components. The first component is a static model of "engagement" by activist investors, which may be interpreted to include talking with target management, making public statements, sponsoring and voting on proxy proposals etc. Successful engagement naturally involves a collective action problem: Engagement can only succeed if there is enough pressure on management, given the underlying fundamentals of the firm. To capture this collective action problem, we build on methodology for analyzing asymmetric coordination problems in Corsetti, Dasgupta, Morris, and Shin (2004). The second component is a dynamic model of block-building which anticipates the subsequent engagement process. A key aspect of our analysis is that the ownership structure of the target firm (the total activist stake and the size-distribution of activists) is endogenous and determines the success of activism, given firm fundamentals.

We first show that the concentration of skill and capital matters: holding constant total activist ownership, the presence of a lead activist improves the coordination of wolf pack members in the engagement game, leading to a higher probability of successful activism. This occurs solely because the lead activist's presence *implicitly* helps the smaller activists to coordinate their efforts and become more aggressive at engaging the target, since in our model there is no overt communication among the activists and they all act simultaneously. An implication of this result is that, even when a significant number of shares are held by potential activists, the arrival of a "lead" activist who holds a larger block may be a necessary catalyst for a successful campaign, which is consistent with the activist strategies that are well documented in the empirical literature.

We next show the beneficial effect of the presence of small activists on a lead activist's decision to buy shares in the target. In particular, the larger is the wolf pack of small activists the lead activist can expect to exist at the time of the campaign, the more likely it is that buying a stake will be profitable given the activist's opportunity cost of tying up capital. Importantly, the expected wolf pack size consists of both small activists that already own stakes, and those that can be expected to purchase a stake after observing the lead activist's purchase decision.

We also examine the dynamics of optimal purchase decisions by small activists. We find that the acquisition of a position by the large activist (in effect, a 13D filing) precipitates the immediate entry of a significant additional number of small activists. While these activists know about the potential for activism at the firm before the lead activist buys in, other attractive uses of funds

keep them from committing capital to the firm before they are sure that a lead activist will emerge. Others with lower opportunity costs may be willing to buy in earlier, as the real (but smaller) chance of successful engagement in the absence of a lead activist provides sufficient potential returns. Thus, our model predicts that late entrants to activism will be those who have relatively higher opportunity costs of tying up capital. One potential way to interpret this is that more concentrated, smaller, and more "specialized" vehicles (such as other activist funds) may be more inclined to acquire a stake only after the filing of a 13D by a lead activist.

The full paper is available for download here.

The Deal Pipeline

Teaming up with CalSTRS helps activist funds get their way

by Ronald Orol | August 4, 2014

Startup activist Legion Partners Asset Management LLC revealed on July 17 that it had joined forces with the California State Teachers' Retirement System to launch an activist campaign to press retailer Perry Ellis International Inc. to consider strategic alternatives.

While Legion is new -- the firm started up in 2012 with seed money from the California pension fund -- the strategy is anything but new for CalSTRS, which has engaged with other governance-focused pension funds numerous times in recent years -- and with great success.

The strategy, known as co-investment, has evolved over time. CalSTRS, the second-largest pension fund in the U.S., with roughly $189 billion in assets under management, first launched its activist portfolio in 2004. Today, the fund allocates roughly $4.6 billion in assets to a variety of activist investors whose interests the pension fund says line up with its own.

The fund has allocated most of its activist capital to a group of high-profile funds including Relational Investors LLC, Trian Partners, Starboard Value LP, New Mountain Capital LLC and U.K.-based GO Investment Partners. For 2013, U.S. activist managers had a 43% return gross of fees, according to the latest figures compiled by the pension fund. For the three years ending Dec. 31, the return was 16.97%. Non-U.S. activists gave CalSTRS a 33% return for 2013 and 6.73% for the three years ending Dec. 31.

Relational, CalSTRS' first activist investment, now has a $1 billion capital commitment from the fund, followed by $300 million to Trian and $100 million to Starboard.

Besides investing in activist funds as it might in other kinds of alternatives, CalSTRS also sets up co-investment partnerships with Relational, Trian and now, Legion to target a particular company it wants to see make strategic or other changes.

Other funds, including California Public Employees' Retirement System and Ontario Teachers' Pension Plan Board have dabbled in being an active partner with funds, including Jana Partners and New Mountain but CalSTRS has struck out as a leader with the co-investment approach.

Legion recently received $50 million of a $200 million commitment. The startup activist can receive three more allocations in $50 million increments from CalSTRS if it meets certain targets for its assets under management through attracting further investors or increasing the value of existing investments.

"We can only make a co-investment with a manager that has a fund they are managing for us," says Philip Larrieu, investment officer at CalSTRS' corporate governance unit. "When we do the engagement we only do those with managers we've hired already. We understand their philosophy, they understand our interest, we have similar governance goals. The activist comes to us with a target company and we decide whether to participate," he adds.

Steve Wolosky, who heads the activism practice at Olshan Frome Wolosky LLP, notes that the pension fund and its leaders including Anne Sheehan, CalSTRS' director of governance, have terrific reputations among the institutional investor community. Sheehan was elected chairwoman of the Council of Institutional Investors -- a group that represents more than $3 trillion in assets -- and held that position in 2012 and 2013.

One of the things that happens when an activist walks into a boardroom with a CalSTRS representative by his or her side is that it robs management of one of the most common complaints about dissidents: that they are targeting the company for short-term gain.

"They remove the argument that is often made by companies and their advisers that the activist hedge funds are short-term investors. By having CalSTRS as a group co-investor provides not only credibility but also suggests that the investors are in it for the long haul," Damien Park, managing partner at Hedge Fund Solutions LLC said. "CalSTRS is one of the largest pension funds in the U.S. and they have a long history of supporting good corporate governance and investing with constructive activists that have a corporate governance bent to them."

However, Gary Lutin, chairman of the Shareholder Forum in New York, noted that not all institutional investors share the CalSTRS view, so their participation in a campaign can lose as well as win votes for their activist partner. "It is like a politician running for office and getting an endorsement," Lutin says. "Some people will consider it positive and others won't."

CalSTRS' Larrieu insisted that the combination adds credibility to a campaign because of the fund's long-term investment strategy. "When you are in an index you are in everything forever. So we are interested in the long-term sustainable performance of the stock and that's why we've hired activist managers," he said.

The pension fund official noted that the activist strategies are expensive and that CalSTRS receives "ancillary" benefits by hiring activist fund managers to employ them. After the activist succeeds, he said, it makes sense that they liquidate and move on. "We don't want to pay them to stick around in a company that they have already fixed; we want them to move on and fix another company," he said.

Among some of their recent campaigns, in 2012, CalSTRS joined with Relational in a successful campaign to press Timken Co., to separate its steel business from its bearings unit. Their nonbinding proposal to have the company split in two passed and the company subsequently executed a spinoff of its steel business. Relational's co-founder David Batchelder said CalSTRS brought a long-term track record as a Timken shareholder to the effort. "For those that believe the activist is short term, here is a true long-term third generation investor that will own the stock before and after the activist participating in the campaign," Batchelder said.

Batchelder argued that these side-by-side investments are typically the most successful because Relational only approaches CalSTRS to participate if it is a great opportunity. He added that in some cases Relational doesn't want to own a greater stake in the targeted corporation but would like to offer CalSTRS an opportunity to co-invest. "They come up only sporadically and the track record is good because we are careful about which campaigns to suggest to them," he said. "The work load for us is the same because we're already going to focus on the company but it adds to the investment overall which is always helpful."

Larrieu says he presented the CalSTRS' proposal at the Timken annual meeting while Relational hired a proxy solicitor and both funds engaged with the company's management. "It was a project where our interests aligned and our reputation as a long-term shareholder complimented Relational," Larrieu says. "Timken and Timken steel are both in the index: So we are in it for the long term."

Larrieu adds that with many of the co-investments, including with the Perry Ellis campaign, CalSTRS staff attend public and private meetings that involve the company's management, board, and other investors. "It takes days of work going to meetings, giving the same speech over and over," he says. Relational's Batchelder said that CalSTRS was extremely helpful in the Timken campaign. "They made the proposal, we solicited proxies in support of it and both of us met with management and they were at some of the meetings with shareholders."

In another notable 2012 campaign, CalSTRS teamed up with Trian, the governance-focused activist fund run by Nelson Peltz, to urge Ingersoll-Rand plc to improve some of its financial, operational and governance metrics and consider strategic alternatives including restructuring of some of its businesses. Trian later accepted one board seat for Peltz without the standstill restrictions Ingersoll-Rand originally demanded. Months later, the company announced a spin-off of its security unit and a hike in its dividend and share buyback plans.

In many cases CalSTRS has received the benefit of a company's stock price appreciation long after the activist fund has cashed out. Larrieu notes that CalSTRS entered into a co-investment with Relational in 2006 at Home Depot Inc. that resulted in a number of improvements. "Relational did make a profit on the investment but a year after they exited it was one of the best performing stock in the DJIA, and we received the benefit of that performance as well," he

says. In that case, CalSTRS had a $75 Million co-investment in addition to the .50% it owned in the index and via other managers.

Expectations may run high for the recent Legion-CalSTRS Perry Ellis effort. Lutin, of the Shareholder Forum, suggests that the backing of the pension fund will help distinguish the startup as a fund that many institutional investors will take seriously. "Public pension funds and proxy advisor firms will see them [Legion] as one of us, and at least give their proposals careful consideration," he said.

Harvard Law School Forum on Corporate Governance and Financial Regulation

Some Lessons from DuPont-Trian

Posted by Martin Lipton, on Thursday, April 30, 2015

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here) and The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here).

The ISS Report on the DuPont-Trian proxy contest calls attention to a number of important insights into ISS policies and practices and those of many of its institutional investor clients. Concomitantly, these policies illustrate the realities of the sharp increase in activist activity and the steps corporations can, and should, take to deal with the activist phenomena.

ISS and major institutional investors will be responsive to and support well-presented attacks on business strategy and operations by activist hedge funds on generally well managed major corporations, even those with an outstanding CEO and board of directors.

Trian Fund Management and its founder, Nelson Peltz, have clearly established credibility and acceptability. So too other well regarded funds like ValueAct. They have become respected members of the financial community.

An activist who attempts to work behind the scenes with a corporation to advise and achieve changes will have more credibility than one who surfaces with an attack.

In most cases a corporation will be well advised to meet with the activist and discuss the activist's criticisms and proposals, which are frequently presented in the form of a well-researched whitepaper. If the activist's recommendations are not unreasonable, careful consideration should be given to adopting some or all, thereby avoiding a public dispute. In situations where the activist seeks board representation to pursue its objectives, depending on the circumstances it may be the best course of action to consider agreeing to board representation on condition of an appropriate standstill agreement.

Major institutional investors like BlackRock and Vanguard want direct contact with the independent directors of corporations. Waiting to establish investor-director contact until under an activist attack is too late. Meaningful director evaluation has also become a key objective of institutional investors and a corporation is well advised to have it and talk to its investors about it. Regular board renewal and refreshment can be important evidence that meaningful director evaluation is occurring. In the DuPont situation, ISS did not accept DuPont's argument that the

addition of two “super star” directors to its board, after the attack started, obviated any reason to add Mr. Peltz and one of his nominees.

If a corporation disputes an activist’s counter whitepaper it needs to make a compelling case; failure to do so will result in ISS following its policy of generally supporting a dissident short slate. ISS’s question, “Have the dissidents made a compelling case that change is warranted?” becomes “Has the corporation made a compelling case that change is not warranted?” Note the not so subtle shift of the burden.

Finally, in some cases even winning a drawn out proxy battle can be more damaging to a corporation than a reasonable settlement with acceptable board representation.

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AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

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STRUCTURAL DEFENSES TO SHAREHOLDER ACTIVISM

Institutional investors and the influential shareholder advisory services have become persistently and famously critical of structural defenses that companies may implement to defend against hostile takeover bids and shareholder activism. Nonetheless, the rising tide of shareholder activism leads the authors to suggest that public companies should analyze their defenses against such challenges. In this article, they review the most important structural defensives available to companies from a legal and business perspective.

By Stephen M. Gill, Kai Haakon E. Liekefett, and Leonard Wood *

The surge of shareholder activism in recent years has featured highly experienced and well-capitalized activists. Activist investors, who acquire a small stake and then demand change under the threat of a proxy fight, have emerged as the most prevalent challengers to the incumbency and leadership of corporate directors. The recent collaboration of an activist hedge fund, Pershing Square, and a strategic bidder, Valeant Pharmaceuticals, in their unsolicited bid for Allergan has additionally raised the specter of a new wave of hostile takeover activity utilizing shareholder activism strategies.[1] Activism, as an investment strategy, enjoyed remarkable successes in recent years. Activist hedge funds returned around 16.6% to their investors in 2013 compared with an industry-wide average of 9.3%.[2] In turn, institutional investors are increasingly supporting activists, behind the scenes and sometimes openly, with funding and votes at the ballot box. Ten years ago, 36% of proxy contests initiated by activists resulted in settlements or victories for activists. This success rate

[1] In 2014, there have been only two hostile takeover bids for U.S. companies to date and there were only five hostile takeover bids in 2013. This is compared to 160 in 1988, when every board lived in fear of a hostile takeover fight. FACTSET MERGERS, https://www.factsetmergers.com (last visited Apr. 30, 2014); *see also* Steven M. Davidoff, *With Fewer Barbarians at the Gate, Companies Face a New Pressure*, DEALBOOK (Jul. 30, 2013, 1:49 PM), http://dealbook.nytimes.com/2013/07/30/with-fewer-barbarians-at-the-gate-companies-face-new-pressure.

[2] *Activists Trump Most Rival Hedge Funds with Double-Digit Returns*, REUTERS, Jan. 8, 2014, http://www.reuters.com/article/2014/01/08 (citing data from HEDGE FUND RESEARCH, https://www.hedgefundresearch.com). This firepower has in turn been used to target ever larger companies. In the past three years, activism against mid-cap companies with more than a $2 billion market cap increased approximately 230%. ACTIVIST INSIGHT, http://www.activistinsight.com. Activism against large-cap companies with more than a $10 billion market cap increased approximately 104%. *Id.*

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soared to 60% in 2013 and has been 77% for 2014 to date.[3] These successes have predictably attracted imitators. According to some calculations, there are currently at least 200 hedge funds employing activist strategies.[4] The sheer number of activist campaigns and proxy fights points to the continuing rise of shareholder activism: 2013 saw 219 reported campaigns, including 90 proxy fights,[5] and these are only the known cases. Many activist situations emerge, and are resolved, under the public's radar. In light of these developments, many observers are speaking of a "golden age" of activist investing.[6]

In this new era of shareholder activism, a public company should review not only its business plan, board composition, and investor relations, but also its structural defenses to shareholder activist campaigns. Companies pursuing an initial public offering (IPO) are particularly well advised to ensure that they go public with the best and most sophisticated defenses available, at least to the extent that the desired defensive measures do not jeopardize the marketing of the IPO. Powerful defenses against activism can be easily included in the charter of a company before it goes public, but it may be difficult to obtain the requisite stockholder approval for adding such defenses to the charter following an IPO. This is especially the case in today's climate, where institutional stockholders and proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis & Co. are encouraging companies to scale back their defenses. The proxy advisory services are persistently critical of corporate policies that could be viewed as interfering with the stockholder franchise.[7]

This article elaborates on the most important structural defenses available to public companies facing immediate or potential proxy contests or activism campaigns, and the discussion will focus on Delaware law. Not every defense will benefit every company when all considerations are weighed. Such considerations include the drawbacks of inviting criticism from institutional stockholders and proxy advisory services, the limiting effects and potentially costly consequences of running afoul of state law or the federal securities laws, and tax ramifications. Also, as a general matter, a board is well advised to implement structural defenses before an activist targets the company. Defensive measures adopted in response to a proxy contest or other activist efforts are likely to be subject to enhanced or even strict scrutiny by the Delaware courts and may receive a negative reaction from the proxy advisory firms, investors, and the media. While the analysis will be similar for companies in most other states, it is important to review the applicable state statutes and corporate law when analyzing the structural defenses of corporations incorporated outside Delaware.

1. MULTI-CLASS CAPITAL STRUCTURES

The best structural defense against shareholder activism is a controlling stockholder or another management-friendly stockholder with a large stake. Companies with these types of stockholders are not easily threatened by a proxy fight. As a result, activists typically stay away from these companies because activists lack the leverage of a proxy contest to push for change. A structure designed to ensure management-friendly control after an IPO is the "multi-class capital structure" (also known as "dual class capital structure").

While most IPO companies have a single class of common stock that provides the same voting and economic

[3] SHARKREPELLENT, https://www.sharkrepellent.net (last visited Apr. 30, 2014) [hereinafter SHARKREPELLENT].

[4] *Activist Investor Project: Top 200 Activist Hedge Funds*, NATIONAL INVESTOR RELATIONS INSTITUTE, http://www.niri.org/Other-Content/Top200HedgeFunds.aspx (last visited May 1, 2014).

[5] SHARKREPELLENT, *supra* note 3.

[6] John Carney, *Welcome to the Golden Age of Activist Investors*, CNBC (Aug. 14, 2013, 3:37 PM), http://www.cnbc.com/id/100963166; Nathan Vardi, *The Golden Age of Activist Investing*, FORBES (Aug. 6, 2013, 8:25 AM), http://www.forbes.com/sites/nathanvardi/2013/08/06/the-golden-age-of-activist-investing.

[7] For given defensive provisions, the annual percentages of IPO companies implementing any given provision is generally higher than the percentage of post-IPO companies nationwide that have the provision. *See 2013 M&A Report*, WILMERHALE, http://www.wilmerhale.com/2013MAreport [hereinafter WILMERHALE, *2013 M&A Report*]; *see also infra* notes 8, 23, 55, 63, 142.

rights to every stockholder (a "one share, one vote" model), more and more companies go public with a multi-class capital structure.[8] Under this structure, a few specified pre-IPO stockholders (typically the founders) receive shares of common stock that are entitled to multiple votes per share, while the public is issued a separate class of common stock that is entitled to only one vote per share.[9] Companies with multi-class capital structures are typically safe from shareholder activism because the holders of the high-vote class of common stock are able to retain voting control over the company, making a proxy contest a fruitless exercise.

Few public companies, however, have a multi-class capital structure in place.[10] Although it is possible to introduce such a structure post-IPO, this is in most circumstances not realistic. The rules of the New York Stock Exchange and NASDAQ allow for the issuance of super-voting stock at the IPO stage but not after the company goes public.[11] Also, a company requires stockholder approval to introduce the structure, and institutional stockholders generally vote against proposals to create a dual class capital structure. ISS recommends voting against any proposals to create a new class of common stock, except in certain limited circumstances.[12]

[8] In 2012, 13% of the IPO companies included a multi-class capital structure, as compared to 4% in 2007. *Id.*

[9] Most notably, Facebook, Google, LinkedIn, and Zynga went public with dual class capital structures.

[10] In 2012, 9% of the S&P 500 companies had a dual class capital structure. WILMERHALE, *2013 M&A* Report, *supra* note 7.

[11] NYSE, Listed Company Manual § 313.10 (2006) ("The restriction against the issuance of super-voting stock is primarily intended to apply to the issuance of a new class of stock, and companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super-voting stock without conflict with this Policy."); NASDAQ Stock Mkt., Inc., The Qualification, Listing and Delisting of Companies IM-5640 ("The restriction against the issuance of super-voting stock is primarily intended to apply to the issuance of a new class of stock, and Companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super-voting stock without conflict with this policy.").

[12] ISS, 2014 U.S. Proxy Voting Summary Guidelines 29 (Mar. 12, 2014) [hereinafter ISS Guidelines]. Also, ISS takes a multi-class capital structure into account as a negative factor when determining its recommendations for director elections. *Id.* at 11. The guidelines of Glass Lewis are silent on this subject. Glass Lewis & Co., Proxy Paper Guidelines: 2014 Proxy Season (2014) [hereinafter Glass Lewis Guidelines].

2. BLANK CHECK PREFERRED STOCK

Blank check preferred stock means that the board is expressly empowered to determine the terms and conditions of authorized and unissued preferred stock. The primary purpose of blank check preferred stock is to raise capital, but it can also serve as an anti-shareholder activism device. First, blank check preferred stock facilitates the creation of a poison pill.[13] Second, a board can use blank check preferred stock to create a new series of preferred stock that has special voting, conversion or control rights, and sell such stock to a management-friendly third party (a "white squire"). A significant block of shares in the hand of a stockholder who is not interested in acquiring control of the company can make it more difficult or even impossible for an insurgent to win a proxy contest.

To create blank check preferred stock, a corporation must provide for the blank check preferred stock in its charter by authorizing a maximum number of shares of preferred stock that the corporation may issue and by granting to the board of directors the express authority to determine the voting rights, designations, preferences, rights and qualifications, and limitations or restrictions of such preferred stock.[14] Generally, preferred stock is convertible into common stock, its holders vote on an "as converted" basis, and it becomes redeemable upon a change of control. Once issued, the specific powers, rights, and preferences of the preferred stock can be set out in a certificate of designation and filed with the Delaware Secretary of State as an amendment to the charter.[15]

More important, however, a board's decision to issue stock must be consistent with the directors' fiduciary duties. Delaware courts have established a battery of controlling principles and legal tests to regulate the use of

[13] *See infra* Section 15 (*Poison Pills*). While it is possible to create a poison pill using common stock, it is preferable to use preferred stock in order to avoid having to reserve for issuance (and thereby render unavailable for other uses) a substantial amount of the company's authorized and unissued shares of common stock. A modern poison pill is technically an issuance of warrants that initially represent the right to purchase 1/1000 of a share of preferred stock. Each 1/1000 of a share of preferred stock is usually designed to give a stockholder the same rights as one share of common stock. The purpose of using 1/1000 of a share of preferred stock instead of a full share is to minimize the number of authorized shares of preferred stock being used up. Blank check preferred stock allows the board to create such an equity security.

[14] 8 *Del. C.* §§ 151, 242(b).

[15] This is one of the rare instances in which the board of directors can effectively amend the charter without stockholder approval. 8 *Del. C.* § 151(a).

stock in the context of a prospective or pending proxy context. Depending on how and when a company issues stock, it will face different levels of judicial scrutiny. A company that issues stock with a sound business rationale before the advent of a contest for control is likely to be protected under the business judgment rule, which is generally deferential to the decisions of management.[16] Even if a company anticipates a proxy contest, it may still find protection under the business judgment rule if the court finds that the issuance of stock was designed more to enhance the company's business than to foil a would-be dissident at the ballot box.[17] On the other hand, if the company issues stock in the context of a takeover effort by an activist, the company could find its issuance reviewed in court under the *Unocal*[18] or *Revlon*[19] standards. If the company issues stock in a proxy context and appears to have done so for the "primary purpose" of thwarting the shareholder franchise, the company could face judicial review under either the *Unocal* or *Blasius*[20] standards. Finally, a company could find itself being reviewed under the demanding standard of entire fairness if a court has reason to believe that the issuance of stock occurred in a self-dealing context.[21] The takeaway is that although the analysis will always turn on the specific facts and circumstances, a company will usually be safer issuing stock before an activist emerges.

Most public companies have blank check preferred stock[22] and almost all IPO companies include this feature.[23] If a company is among the few that do not authorize the board to issue blank check preferred stock, stockholder approval is needed to change that policy.[24] In most circumstances, however, such approval may be difficult to obtain due to the impression created on stockholders. ISS and Glass Lewis generally recommend voting against the authorization of blank check preferred stock.[25]

[16] *Shamrock Holdings, Inc. v. Polaroid Corp.,* 559 A.2d 278, 285-86 (Del. Ch. 1989) (observing, for the purposes of extending business judgment protection, that the challenged transactions of the company had been "considered, reviewed and, in the case of the Preferred Stock issuance, negotiated, for several weeks, if not months, before [the dissident] announced the proxy contest").

[17] *Id.* (observing, for the purposes of extending business judgment protection, that although "[d]efendant directors were aware of the possibility of a proxy fight early . . . and . . . took that possibility into account[,] . . . . [the] directors were focusing more on ways to defeat [the dissident] in the market place than . . . at the polls").

[18] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Johnston v. Pedersen*, 28 A.3d 1079, 1089 (Del. Ch. 2011) ("When a board of directors takes action that affects the stockholder franchise, the board must justify its action under the enhanced scrutiny test."); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181 (Del. 1986) (stating that when a corporation exercises power to deal in its own stock "in an effort to forestall a hostile takeover, the board's actions are strictly held to the fiduciary standards outlined in *Unocal*" and that "[t]hese standards require the directors to determine the best interests of the corporation and its stockholders, and impose an enhanced duty to abjure any action that is motivated by considerations other than a good faith concern for such interests") (citing *Unocal*, 493 A.2d at 953-54); *cf. Williams v. Geier*, 671 A.2d 1368, 1377 (Del. 1996) ("*Unocal* analysis should be used only when a board unilaterally (*i.e.,* without stockholder approval) adopts defensive measures in reaction to a perceived threat.") (citing *Unocal*, 493 A.2d at 954-55).

[19] *Revlon*, 506 A.2d at 182 (holding that when a board of directors recognized that the company was for sale, the board's duties changed from the preservation of the company as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit).

[20] *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 652, 661 (Del. Ch. 1988); *cf. Williams*, 671 A.2d at 1376 ("[T]he application of the 'compelling justification' standard set forth in *Blasius* is appropriate only where the 'primary purpose' of the board's action [is] to interfere with or impede exercise of the shareholder franchise, and the stockholders are not given a 'full and fair opportunity to vote.'") (alteration in original) (quoting *Stroud v. Grace*, 606 A.2d 75, 92 (Del. 1992)) (internal quotation marks omitted); *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769, 776 (Del. Ch. 1967) (stating that where the objective sought in an issuance of stock was not merely the pursuit of a business purpose but also retention of control, the "control" effect of agreement cannot be considered "merely incidental to its primary business objective").

[21] *Keyser v. Curtis*, C.A. No. 7109-VCN, 2012 WL 3115453, at *12 (Del. Ch. July 31, 2012), *aff'd sub nom. Poliak v. Keyser*, 65 A.3d 617 (Del. 2013) (holding that an issuance of stock challenged on grounds of self-dealing was subject to entire fairness review).

[22] In 2013, approximately 94.93% of the S&P 500 companies had blank check preferred stock. *Takeover Defense Trend Analysis: 2013 Year End Snapshot*, SharkRepellent, https://www.sharkrepellent.net [hereinafter SharkRepellent, *2013 Year End Snapshot*].

[23] In 2012, 100% of the IPO companies included the provision in their governing documents, as compared to 78% in 2008. WilmerHale, *2013 M&A* Report, *supra* note 7.

[24] 8 *Del. C.* § 242(b).

[25] ISS Guidelines, *supra* note 12, at 30; Glass Lewis Guidelines, *supra* note 12, at 38, 41.

3. CHARTER AND BYLAW AMENDMENTS

Structural defenses are best secured through charter provisions because stockholders cannot unilaterally amend the charter of a Delaware corporation.[26] Under the Delaware General Corporation Law ("DGCL"), charter provisions can be adopted, amended, or repealed only through a combination of board and stockholder approval.[27] For this reason, it is difficult to add structural defenses to the charter following a company's IPO because it may prove challenging for a board to obtain the required stockholder approval. Therefore, a company's board will want at least to be able to adopt bylaws unilaterally as a next-best means for implementing desirable defenses.

Bylaw Amendments by the Board

Under Delaware law, stockholders possess a "sacrosanct" right to adopt, amend, or repeal bylaws.[28] Boards, however, can obtain a right to unilaterally adopt, amend, or repeal the bylaws only if that power is granted in the charter.[29]

The charters of most large public companies and almost all IPO companies include this feature. If, however, such a provision is not already in place, a company requires stockholder approval to add it to the charter. Obtaining stockholder approval would not be impossible in this context. While ISS recommends that stockholders "vote against proposals giving the board *exclusive authority* to amend the bylaws," it recommends voting in favor of proposals giving the board the ability to amend the bylaws *in addition* to stockholders.[30]

Bylaw Amendments by the Stockholders

Stockholders' power to unilaterally adopt bylaws is one of the few inalienable powers stockholders have to directly change the ground rules of a corporation's governance.[31] Stockholders are empowered, specifically, to adopt bylaws that shape the "process and procedures" by which corporate decisions are made.[32] As such, stockholder-initiated bylaw amendments have become a preferred tool for activists seeking to advance their agendas for changing corporate leadership. Activists have proposed bylaw amendments that increase the number of directorships and that grant stockholders the power to fill newly created directorships. Activists have also proposed bylaws giving stockholders, rather than sitting directors, the power to fill vacancies on the board created by stockholder-initiated removals. Such amendments can allow activist stockholders to remove incumbent directors and appoint their replacements in a single meeting.[33]

A corporation can constrain the ability of activists to affect corporate control by requiring a higher threshold of stockholder votes for adopting bylaws. Although the default rule is that stockholders have the ability to propose and adopt a bylaw by at least a vote of the majority of stockholder voting power,[34] the charter or bylaws can require a supermajority vote for adopting any subsequent bylaw amendment. If such a provision is provided in a

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[26] 8 *Del. C.* § 242(b)(1)-(2) (requiring that after a corporation has received payment for its stock, a charter amendment first be proposed by the board of directors and then approved by stockholders entitled to vote thereon). An amendment generally requires only the approval of a majority of outstanding stock entitled to vote thereon, but § 242(b)(4) provides that the certificate of incorporation may require a greater than majority stockholder vote.

[27] *Id.*

[28] 8 *Del. C.* § 109(a); *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 232 (Del. 2008).

[29] 8 *Del. C.* § 109(a).

[30] ISS Guidelines, *supra* note 12, at 23 (emphasis added). Since it is impossible for boards in Delaware companies to have "exclusive" authority to amend bylaws if it means divesting stockholders of their own power to amend bylaws, 8 *Del. C.* § 109(a), this recommendation can be read to mean that ISS is opposed to giving boards the power to amend bylaws without

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stockholder consent. The Glass Lewis Guidelines are silent on this subject.

[31] 8 *Del. C.* § 109(a).

[32] This power, although inalienable, is not unlimited in scope. Stockholder-adopted bylaws cannot usurp from directors the power to manage the business affairs of the corporation. *CA, Inc.*, 953 A.2d at 234-35 ("[A] proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather to define the process and procedures by which those decisions are made."); *see also Kurz v. Holbrook*, 989 A.2d 140, 157 (Del. Ch. 2010), *rev'd on other grounds*, *aff'd in part sub nom. Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377 (Del. 2010) (holding that a bylaw provision cannot impose a requirement that would disqualify a sitting director and terminate his service).

[33] The default rule is that directors make director appointments to fill vacancies on the board between elections. 8 *Del. C.* § 223(a); *see infra* Section 8 (*Removal of Directors*).

[34] 8 *Del. C.* § 109(a) provides stockholders with the power to amend the bylaws but does not provide a default voting standard; David A. Drexler, Lewis S. Black, Jr. & A. Gilchrist Sparks, III, Del. Corp. Law & Practice § 9.04 (2013).

company's charter, it cannot be altered, amended, or repealed except by the same supermajority vote.[35]

Although most IPO companies include a supermajority requirement for bylaw amendments in their organizational documents,[36] many public companies do not have this defense.[37] Where the company seeks to impose the supermajority requirement through an amendment to the bylaws as opposed to the charter, case law is not decisive as to whether that amendment can only be adopted by a vote of the same supermajority of stockholders that such amendment would impose on stockholders thereafter seeking to adopt subsequent bylaw amendments.[38] A supermajority bylaw adopted unilaterally by a board, in the face of an incipient challenge to incumbent leadership, could trigger "compelling justification" review and be struck down in court on the basis of equity.[39] From a legal standpoint, obtaining stockholder approval for a supermajority-requiring bylaw would perhaps pose less risk of being struck down on the basis of equity, although courts have yet to resolve the question whether the power to amend bylaws requires not only nothing less than, but also nothing more than, a majority of stockholder voting power.[40] From a practical standpoint, at any rate, obtaining stockholder approval for such a bylaw could be challenging due to the strongly negative views of institutional investors and proxy advisory services regarding supermajority requirements.[41]

4. ANNUAL DIRECTOR ELECTIONS VS. CLASSIFIED BOARDS

The Delaware default rule provides for all directors to be elected annually.[42] However, a company may also organize its directors into two or three "classes," with the directors of each class facing election every two or three years.[43] Such a "classified" or "staggered" board is among the strongest defenses to proxy contests for corporate control. Although implementation of the classified structure has declined significantly in the past decade,[44] it is still common for companies to include this feature in the governing documents at the IPO stage.[45] The chief advantage from an incumbent perspective is that an insurgent cannot take control of a board in a single proxy

[35] 8 *Del. C.* § 242(b)(4) ("Whenever the certificate of incorporation shall require for action . . . by the holders of any class or series of shares or by the members, or by the holders of any other securities having voting power the vote of a greater number or proportion than is required by any section of this title, the provision of the certificate of incorporation requiring such greater vote shall not be altered, amended, or repealed except by such greater vote.").

[36] In 2012, 71% of IPOs of Delaware corporations included this requirement, as compared to 44% in 2009. WILMERHALE, *2013 M&A Report*, *supra* note 7.

[37] In 2013, approximately 29.60% of the S&P 500 companies had this feature, down from approximately 67.62% in 2003. SHARKREPELLENT, *2013 Year End* Snapshot, *supra* note 22.

[38] Drexler et al., *supra* note 34, at § 9.04.

[39] *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000) (applying the "compelling justification" standard to strike down a board-adopted supermajority bylaw, where the board's "primary purpose" was to impair stockholders' ability to win a consent solicitation, on the basis that the company acted to "interfere with or impede . . . the shareholder franchise") (alteration in original) (quoting *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1995)) (internal quotation marks omitted) (citing *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 662-63 (Del. Ch. 1988)); *cf. Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971) (striking down a board-created bylaw advancing the stockholders meeting on the basis that authorized action under bylaws may not be permissible if the effect is to inequitably violate "established principles of corporate democracy"). In view of that principle, a board would be taking the greatest risk of having the bylaw struck down by adopting unilaterally the supermajority amendment. A board would take the second most risky action by proposing the amendment to stockholders and then soliciting only a majority stockholder vote (as opposed to a supermajority vote mirroring the same standard that would be subsequently imposed by the

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amendment). A board would take the least risk by proposing the amendment and then soliciting stockholder approval by the same supermajority that such amendment would subsequently impose on stockholders seeking to adopt bylaw amendments.

[40] 8 *Del. C.* § 109(a) provides stockholders with the power to unilaterally amend bylaws but does not explicitly state a voting standard. It is presently unclear if the majority voting generally imputed to stockholder power under § 109(a) constitutes both a floor and a ceiling for the exercise of such power.

[41] ISS Guidelines, *supra* note 12, at 28; Glass Lewis Guidelines, *supra* note 12, at 40. Also, ISS takes supermajority voting requirements into account as a negative factor when determining its recommendations for director elections. ISS Guidelines, *supra* note 12, at 11.

[42] 8 *Del. C.* § 211(b).

[43] *Id.* § 141(d).

[44] In 2013, only approximately 11% of the S&P 500 companies had a classified board, down from approximately 57.17% in 2003. SHARKREPELLENT, *2013 Year End* Snapshot, *supra* note 22.

[45] In 2012, 85% of IPOs of corporations included a classified board as part of company's governing rules, as compared to 50% in 2008. WILMERHALE, *2013 M&A Report*, *supra* note 7.

contest but needs successive victories in at least two annual elections to obtain control. It is widely believed that no activist or hostile bidder has ever won two consecutive elections to overcome a classified board.[46] A complimentary advantage of a classified board is that directors can only be removed "for cause."[47] This contrasts with default rules governing the annual election regime wherein directors may be removed by a majority vote of stockholders at any time "with *or without* cause."[48]

A classified board can be introduced through a charter provision, an initial bylaw, or a bylaw adopted by a vote of the stockholders.[49] As with other defensive measures, the classified board will be more secure if it is included in the charter. A classified board that is established pursuant to a bylaw, by contrast, can always be repealed if an activist subsequently pushes through a stockholder-adopted bylaw amendment to such effect.

Practically speaking, it is almost impossible to introduce a classified board following a company's IPO because this requires stockholder approval (even in the case of a bylaw amendment).[50] Institutional investors disapprove of classified boards on the theory that they deter unsolicited takeover offers, entrench management, and thereby harm the prospects for maximizing stockholder value.[51] Both ISS and Glass Lewis recommend that stockholders vote against proposals to classify the board and vote for proposals to repeal classified boards.[52]

[46] Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 928-29 (2002). *But see* Answering Brief on Appeal at 43-44 n.34, *Versata Enters., Inc. v. Selectica, Inc.*, No. 193,2010, 2010 WL 2464491 (Del. June 14, 2010) (pointing to six instances at micro-cap companies in which insurgents with less than 5% holdings had "some significant measure of success" against classified boards).

[47] That is, barring an additional charter provision to the contrary, 8 *Del. C.* § 141(k)(1).

[48] *Id.* § 141(k) (emphasis added); *see infra* Section 8 (*Removal of Directors*).

[49] 8 *Del. C.* § 141(d).

[50] *Id*.

[51] This opposition is strong in spite of the fact that companies with classified boards generally receive higher premiums in buyouts because bidders are forced to negotiate with the board.

[52] ISS Guidelines, *supra* note 12, at 17; Glass Lewis Guidelines, *supra* note 12, at 19. Also, ISS takes a classified board structure into account as a negative factor when determining its

5. STOCKHOLDER ACTION BY WRITTEN CONSENT

The default rule in Delaware is that any action that may be taken at a stockholder meeting may also be taken by written consent of the stockholders with the required vote.[53] Companies that allow stockholder action by written consent are particularly vulnerable to activism campaigns seeking to replace the board because stockholders can remove the incumbent directors at any time of the year and not only at the annual meeting.

Delaware law allows a company to opt out of this stockholder-friendly default rule through language in the charter providing that stockholders can act only at stockholder meetings.[54] And although many public companies and most IPO companies have elected to opt out of this rule, other companies have not.[55] However, as with many other defensive measures, it is difficult to adopt such a charter provision post-IPO because it requires stockholder approval. Proxy advisory services and institutional investors alike are opposed to restrictions on stockholder action by written consent.[56]

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recommendations for director elections. ISS Guidelines, *supra* note 12, at 11.

[53] 8 *Del. C.* § 228. *But see id.* § 211(b) ("Stockholders may, unless the certificate of incorporation otherwise provides, act by written consent to elect directors; provided, however, that if such consent is less than unanimous, such action by written consent may be in lieu of holding an annual meeting only if all of the directorships to which directors could be elected at an annual meeting held at the effective time of such action are vacant and are filled by such action."); *Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377, 401 (Del. 2010).

[54] 8 *Del. C.* § 228.

[55] In 2013, approximately 70.4% of the S&P 500 companies had a provision prohibiting stockholder action by written consent, and in 2003 approximately 73.77% of the S&P 500 had a similar provision. SHARKREPELLENT, *2013 Year End* Snapshot, *supra* note 22. Implementation of this provision has seen even higher levels at the IPO stage. In 2009, 70% of IPOs of corporations included the provision in the governing rules, and in 2012, 96% included the provision. WILMERHALE, *2013 M&A Report*, *supra* note 7.

[56] ISS recommends that stockholders generally vote against proposals to prohibit or restrict stockholders' ability to act by written consent. ISS Guidelines, *supra* note 12, at 27. Also, ISS takes the inability of stockholders to act by written consent into account as a negative factor when determining its recommendations for director elections. *Id.* at 11. While its

Even if eliminating stockholder action by written consent proves to be practically impossible, a company can still reduce its vulnerability to a consent solicitation by adopting procedural consent bylaws. The DGCL provides that if no record date is fixed by the board of directors, the record date for determining the stockholders entitled to consent is the first date on which a signed written consent is delivered to the company.[57] However, Delaware courts have upheld the right of companies to adopt a bylaw establishing the primary authority of the board to set a record date for determining stockholders entitled to act by written consent.[58] Furthermore, while there is no requirement under Delaware law for inspectors to be appointed for consent solicitations,[59] a company may adopt a bylaw that gives the company the right to appoint an inspector of elections for consent solicitations, thereby ensuring independent review of an insurgent's consents.[60] Proxy advisory services and institutional investors seem not to object to such procedural consent bylaws.

6. STOCKHOLDERS' RIGHT TO CALL SPECIAL MEETINGS

Delaware's default rule is that a board can call special meetings but stockholders are implicitly prohibited from doing the same.[61] However, a company's charter or bylaws may empower stockholders to call special meetings.[62] From the perspective of a company, a stockholder's right to call special meetings poses a significant concern because activists may call a special meeting between annual meetings, thereby making the company vulnerable to proxy contests at any time. In situations in which stockholders were empowered to call special meetings, activists have called special meetings for purposes that include the removal of directors and the filling of vacancies caused thereby, the creation of new directorships and the filling of newly created directorships, the repeal of bylaws that afford structural defenses to the incumbent board, and the adoption or amendment of bylaws to enhance the power of stockholders.

A significant number of public companies and almost all IPO companies prohibit stockholders from calling special meetings.[63] However, for those companies that have already granted stockholders the right to call special meetings, it is generally legal to re-establish, through the adoption of a charter provision or a bylaw, the prohibition on stockholder-called special meetings. A defensive provision in the charter or bylaws can either entirely prohibit the stockholder power or it can restrict the power to call a special meeting, short of a prohibition. A common limiting provision is to require that stockholders wishing to call a special meeting hold a given percentage of shares, such as 10%.[64] Companies can also adopt a bylaw that limits certain actions at a special meeting. For instance, many bylaws provide that a special meeting would not be required with respect to any matter within a certain time period (e.g., 12 months) after any annual or special meeting at which that matter was included on the agenda. Some bylaws also state that no special meeting may be held if the matter in question will be included on the agenda at an annual meeting to be held within a certain time period (e.g., 90 days) after the receipt by the company of the special meeting request.[65]

Institutional investors are typically opposed to new prohibitions and restrictions on stockholders' ability to call special meetings.[66] However, for companies that do not

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guidelines are silent on this subject, Glass Lewis typically also recommends voting against these kinds of proposals.

[57] 8 *Del. C.* § 213(b).

[58] *Empire of Carolina, Inc. v. Deltona Corp.*, 514 A.2d 1091 (Del. 1986); *Edelman v. Authorized Distrib. Network, Inc.*, No. Civ.A.1 1104, 1989 WL 133625 (Del. Ch. Nov. 3, 1989).

[59] 8 *Del. C.* § 231(a) (requiring corporations to appoint inspectors of elections only for all *meetings* of stockholders) (emphasis added).

[60] *Allen v. Prime Computer, Inc.*, 540 A.2d 417 (Del. 1988); *Datapoint Corp. v. Plaza Secs. Co.*, 496 A.2d 1031 (Del. 1985).

[61] 8 *Del. C.* §§ 211(a)(1), 211(d). Delaware is one of the few states that does not grant such power to stockholders by default. Other states allow that stockholders may call a meeting if they hold a minimum percentage that is generally between 10% and 25% of all entitled votes on any issue. 11 Fletcher Corporation Forms Annotated § 48:4 (5th ed. 2014).

[62] 8 *Del. C.* § 211(d).

[63] In 2013, approximately 43.55% of the S&P 500 companies prohibited stockholders from calling special meetings, from approximately 59.02% in 2003. SharkRepellent, *2013 Year End* Snapshot, *supra* note 22. Prohibition on stockholder-called special meetings has seen higher levels at the IPO stage. In 2012, 98% of the IPO companies included this prohibition, as compared to 65% in 2009. WilmerHale, *2013 M&A Report*, *supra* note 7.

[64] Fletcher, *supra* note 61.

[65] Typically, these provisions treat the election or removal of directors as the same matter with respect to all matters involving the election or removal of directors.

[66] ISS Guidelines, *supra* note 12, at 27. Also, ISS takes the inability of stockholders to call special meetings into account as a negative factor when determining its recommendations for director elections. *Id.* at 11. Although its guidelines are silent on this subject, Glass Lewis typically also recommends voting against these kinds of proposals.

already grant stockholders the ability to call special meetings, ISS deems it acceptable for stockholders to approve proposals that would empower stockholders to call special meetings on certain conditions, such as a minimum ownership threshold of 10% for the stockholders calling a meeting.[67]

7. ADVANCE NOTICE REQUIREMENTS

The default rule in Delaware is that stockholders can nominate director candidates and make other proposals at an annual meeting without prior notice or warning to the company.[68] From the company's perspective, the risk posed by this default rule is that the company may not have adequate time to evaluate the stockholders' nominees and proposals, and to consider their desirability or advisability. Generally, a company will want time to review the nominees and proposals, to negotiate a compromise or settlement, if possible, and to prepare for a proxy contest, if necessary. For these reasons, among others, Delaware courts generally permit a company's bylaws to require stockholders to furnish the company with advance notice of their intention to nominate directors or to present stockholder proposals.[69] However, the Delaware Court of Chancery warned that it is not averse to striking down advance notice bylaws that "unduly restrict the stockholder franchise or are applied inequitably."[70] Furthermore, Delaware courts will construe advance notice bylaws narrowly, against the company and in favor of the free exercise of stockholders' electoral rights.[71]

A typical advance notice bylaw requires delivery of a stockholder's notice to the company between 90 and 120 days in advance of a meeting. The notice is required to include disclosure related to the identity of the proxy-soliciting participants and specifics regarding their nominees and proposals. An advance notice bylaw will typically also require the proposing stockholder to be a record holder of the company's stock.[72]

In recent years, many companies have been able to adopt more extensive advance notice bylaws ("second-generation advance notice bylaws") without incurring negative judicial review in the courts.[73] These enhanced bylaws typically include requirements for the (i) completion of company-drafted director nominee questionnaires, (ii) submission of broad undertakings by nominees to comply with company policies (including a confidentiality policy that includes a confidentiality obligation for stockholder-designated directors[74]), (iii) minimum size and duration of holding requirements, (iv) continuous disclosure of derivative positions and, in the context of director elections, (v) disclosure of any arrangements related to the nomination or election (including voting agreements), and (vi) disclosure relating to the stockholder's nominees and director qualification requirements. Although enhanced notice requirements are unlikely to prevent a sophisticated activist from making valid nominations or proposals, such requirements nonetheless provide a company with vital information and adequate time to form a considered response. None of these second-generation advance notice bylaws have yet been tested in court.

One of the most recent second-generation bylaws addresses the undesirable consequences of so-called "golden leash" arrangements between activists and their director nominees providing that the nominees will receive additional incentive compensation from the activist. There is a concern that such golden leash arrangements can compromise the independence of the board. Therefore, some companies have adopted bylaws prohibiting such arrangements by requiring that all director nominees agree and represent to the company that they are not a party to any such agreement. ISS recently announced that it would recommend against anti-golden leash bylaws adopted by boards unilaterally but would consider such bylaws on a

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[67] *Id*. at 27-28.

[68] 8 Del. C. § 222(a); *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 344 (Del. Ch. 2008).

[69] *See, e.g.*, *Stroud v. Grace*, 606 A.2d 75, 95 (Del. 1992).

[70] *Jana Master Fund*, 954 A.2d at 344.

[71] *See, e.g.*, *id.*; *Harrah's Entm't, Inc. v. JCC Holding Co*., 802 A.2d 294, 310 (Del. Ch. 2002).

[72] This requirement forces an activist to first transfer some of its shares into record ownership, alerting the company that it may soon be the target of a proxy contest or other activism campaign.

[73] *See generally* John C. Coates IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 BUS. LAW 1323 (2001).

[74] *Kalisman v. Friedman*, C.A. No. 8447-VCL, 2013 WL 1668205 (Del. Ch. 2013) (holding that when a director serves as the designee of a stockholder on the board, the stockholder is generally entitled to the same information as the director). The existence of a pipeline of confidential information to an activist from its sponsored director could disrupt the effective functioning of the board in the event an activist is successful in having one of its candidates elected. Therefore, a company's confidentiality policy may provide that a director must not disclose confidential information to any stockholder that nominated the director. Alternatively, or in addition, the company could amend its advance notice bylaws to require all director nominees to agree in writing that they are not acting and will not act as the representative of any particular stockholder or group of stockholders while serving as a director.

case-by-case basis when put to a stockholder vote.[75] As a consequence, many companies have repealed their previously adopted anti-golden leash bylaws. However, there is reason to believe that ISS would not object to bylaws that require only full *disclosure* of golden leash arrangement (as opposed to a *prohibition*). There is benefit to this compromise because the disclosure of all golden leash arrangements would enable a company to make this a campaign topic in a proxy contest.[76]

Generally, advance notice bylaws have become commonplace both for existing public companies and IPO companies.[77] This feature is among the few defensive measures that ISS regards with some measure of approval.[78] By contrast, Glass Lewis unequivocally recommends that stockholders vote against any proposals that would require advance notice of stockholder proposals or director nominees.[79] Companies looking to adopt or improve existing advance notice provisions, however, should study carefully the precedents of other companies that drafted these bylaws, as well as limiting principles imposed on such bylaws by the courts. Moreover, it remains to be seen to what extent second-generation advance notice bylaws will be upheld by the Delaware courts.

8. REMOVAL OF DIRECTORS

The default rule in Delaware is that stockholders can remove any director, with or without cause, by a majority of shares entitled to vote at an election of directors.[80] This is assuming that all of the company's directors are elected annually in conformity with Delaware's default provisions. As previously noted, for companies that have adopted classified boards modeled upon the DGCL, a removal of this kind can only be accomplished "for cause," unless the charter otherwise provides.[81] Similarly, in a company with cumulative voting, no director can be removed without "cause" if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of directors.[82]

Definition of "Cause"

A company with a classified board or cumulative voting can enhance its defenses even further in this regard by adding provisions in the bylaws to define "cause." The DGCL does not provide a definition of "cause," which gives an activist room to argue, and possibly litigate, as to whether cause exists for director removal. Therefore, some companies have included a definition of "cause" in their bylaws.[83] While the definitions vary, many resemble the definitions of "cause" in employment agreements for senior officers of a public company. As a consequence, "cause" is commonly narrowly defined and is tied to either discrete

[75] ISS, Director Qualification/Compensation Bylaw FAQs (Jan. 13, 2014), http://www.issgovernance.com/files/directorqualificationcompensationbylaws.pdf.

[76] Elliott Management's nominees ultimately waived their incentive compensation in Elliot's proxy contest against Hess Corporation, admitting that the compensation plan had become a "distraction" in the campaign. William Alden, *Hedge Fund Rejects Proposal by Hess to End Proxy Fight*, DEALBOOK (May 13, 2013, 6:40 PM), http://dealbook.nytimes.com/2013/05/13/elliott-rejects-a-proposal-by-hess-to-end-proxy-fight.

[77] In 2012, approximately 95% of the S&P 500 had advance notice provisions. Implementation of this feature has seen even higher levels at the IPO stage. In 2012, 96% of the IPO companies included this feature, as compared to 85% in 2008. WILMERHALE, *2013 M&A Report*, *supra* note 7.

[78] ISS recommends that stockholders "[v]ote on a case-by-case basis on advance notice proposals, giving support to those proposals which allow shareholders to submit proposals/nominations as close to the meeting date as reasonably possible and within the broadest window possible, recognizing the need to allow sufficient notice for company, regulatory, and shareholder review." ISS advises further that stockholders "[i]n general, support additional efforts by companies to ensure full disclosure in regard to a proponent's economic and voting position in the company so long as the informational requirements are reasonable and aimed at providing shareholders with the necessary information to review such proposals." ISS Guidelines, *supra* note 12, at 23.

[79] Glass Lewis states: "We believe shareholders should be able to review and vote on all proposals and director nominees. Shareholders can always vote against proposals that appear with little prior notice. Shareholders, as owners of a business, are capable of identifying issues on which they have

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information and ignoring issues on which they have insufficient information." Glass Lewis Guidelines, *supra* note 12, at 38.

[80] 8 *Del. C.* § 141(k).

[81] *Id.* § 141(k)(1).

[82] *Id.* § 141(k)(2) ("In the case of a corporation having cumulative voting, if less than the entire board is to be removed, no director may be removed without cause if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of the entire board of directors, or, if there be classes of directors, at an election of the class of directors of which such director is a part.").

[83] It appears that no study to date has analyzed the data on how many public companies or IPO companies include this feature.

triggering events or objective criteria. Many bylaws limit the triggering events to the director's conviction of a serious felony involving moral turpitude or a violation of federal or state securities laws, the director's adjudication as legally incompetent by a court of competent jurisdiction and similar high thresholds. The board can typically introduce such a definition unilaterally by way of a bylaw amendment, which does not require stockholder approval. ISS and Glass Lewis have not yet taken a position on this kind of bylaw provision.

Voting Requirements

Delaware law allows a company's charter to set voting thresholds above the minimum thresholds imposed by the DGCL for achieving certain purposes.[84] Companies have set supermajority percentages at 66% and higher for votes to remove directors, without having those provisions overturned or even criticized by courts. The percentage of large companies implementing this provision has gone down over the past decade.[85] If this defense is not already in the charter, a company will most likely face difficulty convincing stockholders to adopt it. Both ISS and Glass Lewis recommend that stockholders vote against proposals to introduce supermajority vote requirements.[86]

Filling of Vacancies due to Removals

Finally, it is critical to determine the power to fill vacancies caused by director removals. If a company's governing documents do not prohibit stockholders from calling special meetings, stockholders could remove one or more — even all — directors from office between annual elections, possibly without cause. If stockholders are also empowered under the company's charter or bylaws to fill vacancies caused by removal, then the stockholders can fill the resulting vacancies with individuals whom stockholders nominate and elect.[87] Stockholders can accomplish the same ends through written consents between annual elections.[88] The DGCL's default rule is that the board can fill vacancies created by removal.[89] This rule can be altered in the charter or bylaws,[90] but most public companies do not deviate from the default rule.[91] Language in the charter confirming the default rule prevents stockholders from passing a bylaw to override it. In the absence of such a preventative charter provision, stockholders can pass a bylaw that transfers all or a share of vacancy-filling power to stockholders.[92] In the event a company's charter conveys this power to the stockholders, it will be difficult to obtain stockholder approval to return to the default rule. Institutional stockholders and proxy advisory services favor full stockholder control over the filling of vacancies.[93]

[84] *Id.* § 102(b)(4); *see also id.* § 216 (suggesting that bylaws may change the default majority rule for quorums and voting).

[85] In 2013, approximately 21.56% of the S&P 500 companies had this provision, down from approximately 32.79% in 2003. SharkRepellent, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies include this feature.

[86] ISS Guidelines, *supra* note 12, at 28-29; Glass Lewis Guidelines, *supra* note 12, at 40. Also, ISS takes supermajority voting requirements into account as a negative factor when determining its recommendation for director elections. ISS Guidelines, *supra* note 12, at 11.

[87] *Campbell v. Loew's, Inc.*, 134 A.2d 852, 855-56 (Del. Ch. 1957) (accepting as valid the effects of bylaws permitting stockholders to remove directors and to fill the vacancies thereby created, including at an authorized special meeting

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where such action is properly made an order of business, and further finding that acting on such bylaws did "not impinge upon the statutory right and duty of the board to manage the business of the corporation"). The courts, however, have placed limits on the ability of shareholders to pursue the same strategy by way of written consent between annual elections. *See infra* note 88.

[88] However, this cannot be accomplished with one-and-the-same consent, unless the consent removing directors and appointing their successors is unanimous (which is practically impossible in a public company). *Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377, 401 (Del. 2010) (holding that a stockholder's bylaw amendments regarding the election of directors were invalid, and further holding that a non-unanimous written consent, to operate in lieu of an annual meeting, must first remove all sitting directors and then fill the resulting vacancies); *Gentili v. L.O.M. Med. Intern., Inc.*, CIV.A. 7600-VCG, 2012 WL 3552685, at *2 n.28 (Del. Ch. 2012) (holding that the stockholders could not elect the "Challenged Directors" through their written consents in lieu of an annual meeting because the consents were not unanimous) (quoting *Crown EMAK Partners, LLC*, 992 A.2d. at 401).

[89] 8 *Del. C.* § 223(a)(1). This rule is applied to resignations in that resignations are treated as giving rise to a "vacancy." *Id.* § 223(a).

[90] *Id.* §§ 223(a), 109(a).

[91] In 2013, approximately 78.65% of the S&P 500 companies had the default rule, up slightly from approximately 75% in 2003. SharkRepellent, *2013 Year End* Snapshot, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies had the default rule.

[92] 8 *Del. C.* §§ 223(a), 109(a).

[93] ISS Guidelines, *supra* note 12, at 28-29; Glass Lewis Guidelines, *supra* note 12, at 40.

9. INCREASES IN THE SIZE OF THE BOARD

Another important consideration in reviewing a company's structural defenses is whether the board has the exclusive ability to set the number of directorships and the procedures for filling newly created directorships between scheduled elections.[94] If the power to fill newly created directorships does not rest exclusively with the board, an activist can persuade other stockholders to increase the board's size through a bylaw amendment and then elect the activist's own nominees to fill the newly created directorships.[95] A company seeking to prevent this activist strategy will want the board to possess the exclusive power to both set the number of directorships and fill newly created directorships.

While the DGCL includes a default minimum of one director,[96] it provides no default rule setting a maximum number of directorships, and it does not specify whether the board or stockholders set the number or by what procedure. Instead, Delaware law allows that the number of directorships and the method for changing that number can be established in the charter or the bylaws.[97] Post-incorporation, it is up to the company and its stockholders to determine whether the board, stockholders, or some combination of input from both groups will set the number of directorships.[98] A company seeking to place this power solely in the hands of directors will secure this objective best through a charter provision. Otherwise, the company can adopt a bylaw to this effect. As in most other cases, a charter provision trumps a bylaw provision; a bylaw provision can trump an earlier bylaw provision but not a charter provision.[99]

The DGCL's default rule on newly created directorships is that the board can fill such positions between scheduled elections.[100] Most public companies do not deviate from the default rule.[101] However, this default rule can be overridden by contrary text in the charter or bylaws. This means that a company seeking to lodge the power to fill newly elected directorships exclusively in the hands of directors is best served by adopting a charter provision to that effect. In contrast, a bylaw to this effect is subject to amendment by stockholders, who can adopt a bylaw affording stockholders the sole power to fill newly created directorships.[102]

A company could face an uphill climb in attempting to regain control previously granted to stockholders on these

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[94] Under the DGCL, the power to fill "newly created directorships" is distinct from the power to fill "vacancies" caused by removal and resignation. 8 *Del. C.* § 223(a) (referring to "[v]acancies *and* newly created directorships") (emphasis added); *DiEleuterio v. Cavaliers of Del., Inc.*, Civ.A. No. 8801, 13 Del. J. Corp. L. 273, 278-82 (Del. Ch. Feb. 9, 1987) (addressing the distinction in law and governing documents between vacancies and newly created directorships); *Campbell v. Loew's, Inc.*, 134 A.2d 852, 857 (Del. Ch. 1957). *But see Comac Partners, L.P. v. Ghaznavi*, 793 A.2d 372, 383 (Del. Ch. 2001) (holding that if a corporation's charter or bylaws address "vacancies" with the intent that such term comprise "newly created directorships," the court will honor the intent if it is explicit).

[95] This could happen at a special meeting as well as an annual meeting, provided no conflict arises in law or with other rules of the company. *See, e.g.*, *Richman v. DeVal Aerodynamics, Inc.*, 183 A.2d 569, 572 (Del. Ch. 1962) (holding that, in the absence of a contrary charter provision, stockholders could amend the bylaws to give stockholders the right to create additional directors and elect directors to fill the newly created directorships without first amending the charter). A bylaw, however, cannot *decrease* the number of board seats at the expense of a sitting director. *Kurz v. Holbrook*, 989 A.2d 140, 157-58 (Del. Ch. 2010), *aff'd in part*, *rev'd in part sub nom. Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377 (Del. 2010).

[96] 8 *Del. C.* § 141(b).

[97] *Id.*

[98] *Id.*; *Siegman v. Tri-Star Pictures, Inc.*, Civ.A. No. 9477, slip op. at 17 (Del. Ch. May 5, 1989, *rev'd* May 30, 1989), (holding that a certificate provision can vest exclusive power in a board to fill newly created directorships).

[99] The general rule is that a charter provision overrides a bylaw, such that a conflicting bylaw becomes a "nullity." *Burr v. Burr Corp.*, 291 A.2d 409, 410 (Del. Ch. 1972). There are, however, instances under Delaware law where a bylaw amendment, although adopted, cannot override a pre-existing bylaw. *See, e.g.*, 8 *Del. C.* § 216 ("A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.").

[100] 8 *Del. C.* § 223(a)(1).

[101] In 2013, approximately 78.65% of the S&P 500 companies had the default rule, up slightly from approximately 75% in 2003. SharkRepellent, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies have the default rule.

[102] *Grossman v. Liberty Leasing Co.*, 295 A.2d 749, 753-54 (Del. Ch. 1972) (observing that the power of directors to fill vacancies is an innovation in the law as compared to the older rule reserving such power to stockholders); *Campbell v. Loew's, Inc.*, 134 A.2d 852, 855-56 (Del. Ch. 1957) (observing the validity of a bylaw conferring power on stockholders to elect new directors when newly created directorships arise); Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of Corporations & Business Organizations § 4.5 (2014).

matters. There is also the added risk of attracting negative attention from institutional stockholders and proxy advisory services. Although ISS's position on the power to change board size is more moderate than it is for other defensive measures, ISS unqualifiedly supports full stockholder control over the filling of newly created directorships.[103]

10. VOTING STANDARDS FOR DIRECTOR ELECTIONS

The default voting standard in Delaware for director elections is the plurality standard, which can be changed in the charter or bylaws.[104] However, as a result of pressure applied by institutional investors and proxy advisory services in recent years,[105] most large public companies have amended their charters or bylaws to adopt either a majority (cast or present) standard or a so-called "plurality plus" policy.[106] By contrast, it is rare for public companies to have "cumulative voting."[107]

Plurality Voting

Under the plurality standard, a director candidate is elected to office by receiving the most affirmative votes of the shares present and entitled to vote, as opposed to other voting standards, which include a plurality of votes cast or a majority of votes of shares outstanding, shares present and entitled to vote, or eligible votes cast. In a plurality regime, one vote in favor of a director candidate secures a nominee's election in an uncontested election. In contested elections, a director candidate needs only to receive one more vote than a competing candidate to win the election and need not receive a majority of the votes either present or cast. Under the plurality system, stockholders cannot prevent the re-election of a given candidate simply by "withholding the votes," since a candidate will still win an election even if he receives more "withhold" votes than "for" votes.

Plurality Plus Policies and Majority Voting

Under the "plurality plus" approach (also known as "plurality plus resignation"), a board member who receives less than a majority of votes (cast or present) must submit his resignation to a committee of the board consisting of independent directors. The committee has the discretion to reject or accept the resignation. A tendered resignation puts pressure on the board to accept it, but a board's decision to refuse a resignation is unlikely to be reversed by Delaware courts.[108]

The majority standard comes in two forms. Under a full-fledged majority system in an uncontested election, an incumbent who receives less than a majority of the votes will hold the directorship into the next term by virtue of the DGCL's holdover rule.[109] The same would be the case in a contested election if neither the incumbent nor the challenger obtains a majority because only the incumbent is qualified to hold the seat by the holdover rule.[110] Beyond the full-fledged system, some companies have adopted the "majority plus resignation" system to address the conceivable — albeit lawful — legitimacy problem introduced by a failed candidate who continues to hold office on the basis of the holdover rule. Under this system, a candidate who has failed to secure election tenders a resignation, and the board is free to use its discretion to accept or reject the resignation. Such a policy seeks to ameliorate an ostensible legitimacy problem, but will not necessarily solve the problem from the perspective of the stockholders.

Companies with majority voting standards or "plurality plus" policies are more vulnerable to shareholder activism because those voting standards "give bite" to "withhold the vote" campaigns.[111] Even if directors remain in office by virtue of the holdover rule or a rejected post-election resignation, the lack of stockholder approval for the sitting

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[103] ISS Guidelines, *supra* note 12, at 17, 19. The Glass Lewis Guidelines are silent on this subject.

[104] 8 *Del. C.* §§ 215(c)(3), 216(3).

[105] Bo Becker & Guhan Subramanian, *Improving Director Elections*, 3 HARV. BUS. L. REV 1, 11 (2013). The motives of institutional investors to push companies to adopt a majority voting standard have been various. Generally, proponents of enhanced stockholder power in corporate governance argue that majority voting makes boards more accountable to stockholders. Critics of the plurality system have also observed that since withhold votes have no actual impact on director elections, plurality voting does not allow stockholders adequate opportunity to express disapproval. *Id.*

[106] In 2013, approximately 85.41% of the S&P 500 companies had majority voting and approximately 8.67% had plurality plus voting. SHARKREPELLENT, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies have included this feature.

[107] In 2013, approximately 95.56% of the S&P 500 companies did not have cumulative voting, slightly up from approximately 89.75% in 2003. SHARKREPELLENT, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies have included this feature.

[108] *City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc.*, 1 A.3d 281, 288-89 (Del. 2010).

[109] 8 *Del. C.* § 141(b) ("Each director shall hold office until such director's successor is elected and qualified, or until such director's earlier resignation or removal.").

[110] *Id.*

[111] Becker & Subramanian, *supra* note 105.

directors often results in tremendous pressure to effect change.[112] If a company seeking a heightened defensive posture finds itself strapped with a higher standard than plurality for director elections because of amendments made to the charter or bylaws in prior years, the company may wish to look for options to return the voting standard to the simple plurality or plurality plus standard. If the voting standard is set forth in the charter, a company can scale back the standard only with stockholder approval, which is unlikely to be obtained in the current climate. If the voting standard is set forth in the bylaws, the board of directors can return to the plurality standard by amending the bylaws unilaterally. This presumes the company is willing to weather the potential risks in investor relations and negative reviews of proxy advisory services.[113] However, if the higher voting standard was implemented by a bylaw amendment adopted by stockholders, that bylaw cannot be unilaterally amended by the board of directors.[114] In such case, only a stockholder-adopted bylaw amendment can scale back the standard for electing directors.[115]

Cumulative Voting

Finally, there is "cumulative voting." Delaware law allows a company to adopt a charter provision that grants to each stockholder the number of votes each stockholder possesses multiplied by the number of open directorships for which a candidate has been nominated.[116] Thus, a stockholder with one share, facing an election of nine candidates, receives nine votes and can apply all nine votes to support a single candidate. This method allows minority stockholders to pool their votes for one candidate and thereby improves their likelihood of obtaining minority representation on the board.

Activists can use cumulative voting to counterbalance the power of the majority of the stockholders. A company should be concerned that affording such disproportionate influence to a minority may lead to internally adversarial boards. A positive point about cumulative voting from an incumbent's perspective is that, as we noted, no director can be removed without "cause" if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of the board of directors.

Not surprisingly, relatively few companies have adopted cumulative voting.[117] If a company is among the few that already have a cumulative voting provision in its charter, the sole defensive option is to amend the charter.[118] However, obtaining the required stockholder vote will likely be an uphill battle since institutional investors and proxy advisory services enthusiastically support cumulative voting.[119]

11. DELAYS OF STOCKHOLDER MEETINGS

Both the company and the insurgent receive daily interim voting results in a proxy contest from Broadridge. If an activist were ahead in the vote count, a board might prefer to delay either the upcoming stockholder meeting or the closing of the polls in a meeting already in progress, even if a quorum is present. The purpose in either case would be to solicit additional proxies. The DGCL is sparse and indirect concerning the conduct of meetings and mechanisms for effecting delays of meetings and votes.[120]

[112] From the perspective of a company there are also other, less visible disadvantages. A so-called "failed election" might cause a loss of independent directors (and thus cause the company to run afoul of stock exchange rules) or violate the terms of the employment agreements of non-elected executives. It could also trigger the change-of-control provisions in debt instruments, thereby possibly requiring a refinancing. *See infra* Section 14 (*Change-of-Control Provisions in Debt Instruments*).

[113] ISS recommends that stockholders "generally vote for management proposals to adopt a majority of votes cast standard for directors in uncontested elections," and that they "vote against if no carve-out for plurality in contested elections is included." ISS also "strongly encourage[s]" companies to also adopt a resignation policy "to provide guidelines so that the company will promptly address the situation of a holdover director." ISS Guidelines, *supra* note 12, at 20-21; Glass Lewis Guidelines, *supra* note 12, at 21. Also, ISS takes the voting standard into account when determining its recommendations for director elections. ISS Guidelines, *supra* note 12, at 11.

[114] 8 *Del. C.* § 216.

[115] *Id.*

[116] *Id.* § 214.

[117] In 2013, approximately 95.56% of the S&P 500 companies did not have cumulative voting, up slightly from approximately 89.75% in 2003 SharkRepellent, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies did not have cumulative voting.

[118] 8 *Del. C.* § 214 (providing that cumulative voting is permitted only where the charter so provides).

[119] ISS recommends that stockholders "[g]enerally vote against proposals to eliminate cumulative voting," and that they "[g]enerally vote for shareholder proposals to restore or provide for cumulative voting" if certain other conditions are met. ISS Guidelines, *supra* note 12, at 18; *see also* Glass Lewis Guidelines, *supra* note 12, at 39.

[120] Most authorities validate adjournments and other delays by reference to 8 *Del. C.* § 222 ("Notice of Meetings and Adjourned Meetings"), which does not explicitly permit

Controlling law distinguishes between "adjournments" and "postponements."[121]

Adjournments

An "adjournment" occurs when a stockholder meeting is properly convened, but then is subsequently, before a vote is taken, rescheduled for a later time and date.[122] The DGCL recognizes that a stockholders meeting may be adjourned but does not provide the procedures for adjourning a meeting.[123] The default rule appears to be that in lieu of a chairperson-empowering provision in the charter or bylaws, once a meeting is formally convened and the presence of a quorum acknowledged, the power to adjourn belongs to the stockholders.[124] Delaware courts have accepted that a charter provision or bylaw can grant to the meeting's chairperson[125] the exclusive power to adjourn the meeting.[126]

As a practical matter, however, the courts will not allow chairpersons to exercise that power for just any reason. The Delaware courts have hedged the adjournment power of the chairperson by reference to the countervailing equitable doctrine of protecting the stockholder franchise as well as the full scope of duties subsumed under the heading of "fiduciary duties."[127] The core principle to emerge from a string of pertinent cases is that even where a company has adopted a chairperson-empowering provision in the charter or bylaws, the company should formulate as weighty a business rationale as possible for adjourning the meeting, and should do so "independently, with due care, in good faith, and in the honest belief" that the adjournment is "in the stockholders' best interests."[128] The company's rationale for adjourning a meeting can make the difference between encountering judicial review under the lenient business judgment standard or encountering a much more demanding level of scrutiny under some iteration of the *Blasius* standard of "compelling justification."[129] It is not

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adjournments and other delay tactics, but nonetheless envisions delays occurring.

[121] A possibly emergent third category is "recess." *See* Steven M. Davidoff, *Dynegy's Unusual Approach to Delay a Vote*, DEALBOOK (Nov. 18, 2010, 2:25 PM), http://dealbook.nytimes.com/2010/11/18/dynegys-unusual-approach-to-delay-a-vote. Under the "recess" option, the meeting is called to order, but then "recessed" until a later time. This is conceivably allowed under 8 *Del. C.* § 231 ("The date and time of the opening and the closing of the polls for each matter upon which the stockholders will vote at a meeting shall be announced at the meeting.").

[122] *See generally* 5 William Meade Fletcher, Cyclopedia of the Law of Private Corporations § 2015 (1976).

[123] 8 *Del. C.* §§ 213, 222(c).

[124] Drexler et al., *supra* note 34, at § 24.05 (citing *In re Dollinger Corp.*, 274 N.Y.S.2d 285, 287 (N.Y. Sup. Ct. 1966) ("It is the shareholders' meeting, the owners of the company, who have the right to make a decision on a question of adjournment, and not of the president who has only the duty of presiding.")); *Gunzburg v. Gunzburg*, 425 N.Y.S.2d 151, 152 (N.Y. App. Div. 1980); Fletcher, *supra* note 122.

[125] This discussion takes for granted that the acts of the board and the acts of a meeting's chairperson are one and the same. However, a threshold consideration is that for a board to be empowered to delay a vote (*i.e.*, to adjourn), the board must also be permitted to designate the chairperson of the meeting and to make that chairperson the instrument of the board as far as legally possible. In lieu of a charter or bylaw provision to such effect, stockholders can empower themselves through a bylaw to appoint the meeting chairperson. *Duffy v. Loft, Inc.*, 151 A. 223, 225-27 (Del. Ch. 1930), *aff'd*, 17 Del. Ch. 376

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(1930) (holding that as per the corporation's bylaws stockholders were entitled to elect a chairman to preside at an annual meeting, notwithstanding the presence of a high-ranking corporate officer).

[126] *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786, 809 (Del. Ch. 2007) ("[D]irectors can use the legal means at their disposal in order to pursue stockholder approval, means that often include tools like the ability to set and revise meeting dates or to adjourn a convened meeting."); *id.* at 811 n.78 ("So long as the directors are motivated by a good faith belief that the proposal is in the stockholders' best interests, taking a short adjournment to gather additional votes in a fair way seems like the kind of business judgment the adjournment tool was designed to facilitate."); *Gentili v. L.O.M. Med. Int'l., Inc.*, C.A. No. 7600-VCG, 2012 WL 3552685, at *1, *3 (Del. Ch. Aug. 17, 2012) (acknowledging without issue a bylaw provision empowering the meeting's chairman to adjourn a meeting at "his or her sole discretion").

[127] *Gentili*, 2012 WL 3552685, at *3; *In re MONY Group, Inc. S'holder Litig.*, 853 A.2d 661, 673-74 (Del. Ch. 2004); *Wis. Inv. Bd. v. Peerless Sys. Corp.*, No. Civ. 17637, 2000 WL 1805376, at *7-10, *12, *19 (Del. Ch. 2000).

[128] *Peerless*, 2000 WL 1805376, at *8.

[129] *Id.* at *9 (stating that the compelling justification standard of *Blasius* may be used to review an adjournment "only where the primary purpose of the board's action [is] to interfere with or impede exercise of the shareholder franchise, and the stockholders are not given a full and fair opportunity to vote") (alteration in original) (citations omitted) (quoting *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1996)) (internal quotation marks omitted); *id.* ("In the absence of a finding that the primary purpose of the board's action was to interfere with or

certain, however, that directors could rely on the mere fear of losing an election to justify an adjournment, particularly if the board already had ample time under its own advance notice bylaws to evaluate a dissident slate and to solicit proxies.

Nonetheless, a company is therefore well advised to have a chairperson-empowering provision in its charter or bylaws.[130] After all, it is better for a board to endow itself with the power and then decide whether to wield it, as opposed to not giving itself the power at all.[131] If a company does not have a chairperson-empowering provision, a board is best served by unilaterally amending the bylaws to that effect. A charter amendment would have a lower likelihood of success due to the difficulties of obtaining stockholder approval. ISS recommends generally to vote against proposals to provide management with the authority to adjourn absent "compelling reasons," such as for the purpose of sufficiently informing stockholders in advance of a vote in the event of material events.[132]

Postponements

A "postponement" occurs when a scheduled stockholder meeting is never convened and then a new meeting is scheduled and held, at a later time and date, in place of the originally scheduled meeting.[133] Unlike adjournments, Delaware law regards postponed meetings as new meetings. Consequently, postponed meetings require that a new meeting notice be sent to stockholders.[134] The board could also be required to set a new record date.[135] The postponement of an annual meeting may also result in the re-opening of the advance notice period for director nominations and stockholder proposals under a company's bylaws.[136]

The DGCL does not contain any express provisions concerning postponed meetings or the notice and record date requirements regarding such meetings. For this reason, Delaware courts have allowed boards to postpone or reschedule stockholder meetings "as they see fit," without express authorization in the company's organizational documents, "so long as they do not violate the limitations" posed by the DGCL.[137] In addition, courts look to a board's actions and statements for indicia of good faith, independent decision-making, a serious business rationale, directors' concern for the best interests of stockholders, and other manifestations of allegiance to fiduciary duties. A company's record in this regard could make the difference, as it does in the adjournment arena, between review under the business judgment rule or review under an iteration of the *Blasius* "compelling justification" standard.[138]

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impede exercise of the shareholder franchise, the business judgment rule presumption applies.") (citing *Geier*, 671 A.2d at 1376); *Mercier*, 929 A.2d at 811 n.78 ("So long as the directors are motivated by a good faith belief that the proposal is in the stockholders' best interests, taking a short adjournment to gather additional votes in a fair way seems like the kind of business judgment the adjournment tool was designed to facilitate.").

[130] It appears that no study to date has analyzed the data on how many public companies or IPO companies include this provision on their organization documents.

[131] A company can be encouraged in this regard by Justice Moore's observation that "every valid bylaw is always susceptible to potential misuse." Such potentiality, he held, does not constitute a sufficient reason for a court to strike down a bylaw or a necessary reason for a company to avoid adopting a bylaw. *Stroud v. Grace*, 606 A.2d 75, 96 (Del. 1992).

[132] ISS Guidelines, *supra* note 12, at 7. The Glass Lewis Guidelines are silent on this subject.

[133] Fletcher, *supra* note 122.

[134] 8 *Del. C.* § 222(b) (requiring that stockholders be given written notice of the annual meeting no fewer than 10 days and no more than 60 days before the meeting). A proxy statement would probably also need to clearly state that a proxy will stay in effect for a postponement. A postponement could also mean that a company must amend or supplement its proxy statement.

[135] The DGCL provides that the record date for the determination of shareholders entitled to notice of any stockholder meeting must not be more than 60 nor less than 10 days before the date of such meeting. 8 *Del. C.* § 213(a). That date is also the record date for determining the stockholders entitled to vote at such meeting unless the board determines, at the time it fixes the record date, that a later date on or before the date of the meeting will be the date for making such determination. *Id.*

[136] *Sherwood, et al. v. Ngon, et al.*, C.A. No. 7106-VCP, 2011 WL 6355209 (Del. Ch. Dec. 20, 2011).

[137] *Airgas, Inc. v. Air Prods. and Chems., Inc.*, Civ.A. No. 5817-CC, 2010 WL 3960599, at *12 (Del. Ch. 2010), *rev'd*, 8 A.3d 1182 (Del. 2010) ("Directors and stockholders are free to specify when the annual meeting shall occur, and they are free to change it as they see fit, so long as they do not violate the limitations that do appear in the [DGCL].") (citing 8 *Del. C.* § 211(c)).

[138] *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1207 (Del. Ch. 1987) ("The burden of persuasion . . . must be upon those seeking to postpone the annual meeting to show that the postponement is in the best interests of the stockholders.");

An important takeaway from the line of cases on postponements is that fear of losing a directors' election,[139] in isolation and without a more substantial business rationale, may not satisfy the courts as a valid reason for postponing a scheduled meeting.[140] An additional consideration could be a potential negative reaction from institutional investors and stockholder advisory services.[141]

12. FORUM FOR STOCKHOLDER LITIGATION

Activists often exert pressure on companies not only by threatening costly and time-consuming proxy fights, but also by threatening companies with expensive litigation. A company dealing with activists faces an increased likelihood of being pulled into costly and distracting lawsuits on all manner of issues, including derivative actions, fiduciary duty claims, claims under the DGCL, and other claims regarding the internal affairs of a Delaware corporation.

Companies may find that they are especially likely to benefit from adopting bylaws that require all stockholder lawsuits relating to the internal affairs of the corporation be exclusively brought in Delaware courts. These provisions are becoming more and more popular.[142] Also, in 2013, the Delaware Court of Chancery held that boards of Delaware corporations may validly adopt exclusive forum bylaws.[143] Exclusive forum bylaws are designed to prevent stockholders from forum shopping and engaging in multi-forum and duplicative litigation, thereby reducing litigation costs for a company and ensuring that claims are adjudicated in Delaware. The provisions do not eliminate any causes of action or prevent stockholders from bringing claims but are designed to consolidate litigation in a single jurisdiction. While there can be no guarantee that a non-Delaware court will enforce an exclusive forum bylaw, it enables a company to invoke the exclusive forum provisions in its motion to dismiss should a stockholder file suit in another jurisdiction.

As a practical matter, however, boards need to analyze their stockholders' views on exclusive forum provisions. Some institutional investors support exclusive forum bylaws; others object on the theory that such provisions deprive investors of an important right.[144] A problem, however, is that the proxy advisor firms generally oppose exclusive forum provisions, although ISS at least claims to advise stockholders to vote on a case-by-case basis if the company meets other governance standards.[145] Glass

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MAI Basic Four, Inc. v. Prime Computer, Inc., Civ.A. No. 10868, 1989 WL 63900 (Del. Ch. June 13, 1989); *see also Gries v. Eversharp, Inc*., 69 A.2d 922 (Del. 1949).

[139] A postponement in the face of a merger proposal, however, is easier to justify. *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786 (Del. Ch. 2007) (holding that the company had "compelling justification" to postpone the vote on a proposed merger); *In re MONY Group, Inc. S'holder Litig.*, 853 A.2d 661 (Del. Ch. 2004) (holding that a change to a later record date in the face of a court injunction requiring additional disclosure and favorable amendments made to the merger agreement was a business judgment and that, even with a higher standard of review applied, such as the *Unocal* standard, there was no evidence that the decision did not satisfy that standard); *MAI Basic Four*, 1989 WL 63900 (finding that directors had "sufficient reason" for delaying a scheduled meeting in the face of a hostile tender offer).

[140] *Aprahamian*, 531 A.2d at 1207 (observing that "[i]f the incumbent directors were truly sincere in their desire to make sure that the stockholders are fully informed before voting, they would have postponed the annual meeting at the time they put forth their new proposal on April 25 and not have waited until the evening before the meeting date," and finding that "the present record does not reveal that one proposed slate of directors is any better, or more sincerely interested in the welfare of the stockholders, than is the other"). The court also rejected postponement on the company's stated grounds that the directors needed additional time "to advise the stockholders about the relative qualifications of competing slates," once they already had ample time to do so.

[141] ISS recommends that stockholders "[v]ote for management proposals to change the date, time, or location of the annual meeting unless the proposed change is unreasonable." ISS Guidelines, *supra* note 12, at 7. The Glass Lewis Guidelines are silent on this subject.

[142] In 2012, approximately 5% of the Delaware corporations among the S&P 500 companies had an exclusive forum provision. As far as IPO companies are concerned, 38% of the Delaware corporations included such provision in governing rules in 2012 as compared to 13% in 2011. WilmerHale, *2013 M&A Report*, *supra* note 7.

[143] *Boilermakers Loc. 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).

[144] T. Rowe Price originally opposed exclusive forum provisions but has changed its view on the theory that "strike suits are effectively a tax on its investments." Claudia H. Allen, *Trends in Exclusive Forum Bylaws* 8, The Conference Board (Jan. 2012), http://www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V6N2-141.pdf&type=subsite.

[145] ISS Guidelines, *supra* note 12, at 24. ISS's case-by-case policy takes into account whether a company has been "materially harmed" by stockholder litigation outside its state of incorporation. As a practical matter, ISS has yet to identify a company it believes has suffered such harm. Note that these policies do not apply to board-adopted bylaws, but it is nonetheless important to take these positions into account. *See*

Lewis takes its opposition one step further by recommending against the election of the governance committee chair if, during the past year, the board adopted a forum selection clause without stockholder approval.[146]

13. DELAWARE'S ANTI-TAKEOVER STATUTE

Delaware's "business combination" anti-takeover statute is Section 203 of the DGCL. The statute restricts a stockholder that has acquired 15% or more of the outstanding shares, without approval of the board, from engaging in certain business combinations for a period of three years.[147] The provision is not triggered if a stockholder can acquire 85% of the stock in a single transaction.

As far as defenses against activism are concerned, the chief limitation of Section 203 is that the provision does not stop activists from increasing their holdings beyond 15% and simultaneously waging a contest to obtain corporate control. Therefore, Section 203 acts as a *de facto* poison pill only with respect to activists seeking to acquire the entire company. Most activists are content with a small stake in their target companies. Only a few activists (such as Carl Icahn and Elliott Management) have shown the willingness and the financial wherewithal to buy a target company outright. Section 203 is a useful defense if such an activist appears at a company's doorstep.

Section 203 is a defense afforded to Delaware corporations by default rule. Companies can opt out of it through a charter provision.[148] Few public companies or IPO companies elect to opt out of Section 203.[149] In the event a company wants to opt back into Section 203, it would require stockholder approval for the necessary charter amendment. The proxy advisory firms do not appear to have adopted an official position on this topic.[150]

14. CHANGE-OF-CONTROL PROVISIONS IN DEBT INSTRUMENTS

Change-of-control provisions in debt instruments provide a defense to shareholder activism that derives not from Delaware law but rather from contractual arrangements entered into by companies and their creditors. Many debt instruments include a change-of-control provision that triggers acceleration of the debt (typically in loan agreements) or a put right[151] (typically in bond indentures) in the event a majority of the board members are replaced with directors that were not nominated or approved by the incumbent board. These provisions are also known as "proxy put" or "poison put." [152]

In the past, companies often used these provisions in their proxy campaigns. They would warn stockholders in their proxy materials of dire financial consequences in the event that insurgents obtained control of the board. However, in 2013 the Delaware Court of Chancery held that directors have a fiduciary duty to approve an insurgent slate for the limited purpose of avoiding the triggering of a

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also Glass Lewis Guidelines, *supra* note 12, at 12; Allen, *supra* note 144.

[146] Glass Lewis Guidelines, *supra* note 12, at 37.

[147] Under the statute, a person deemed an "interested stockholder" may not engage in a business combination with the company for three years following the time such stockholder became an interested stockholder. 8 *Del. C.* § 203(a). An "interested stockholder" means any person, other than the company or its majority-owned subsidiaries, that owns at least 15% of the outstanding voting stock. Under the law, a business combination can be entered into if: (1) before the stockholder became an interested stockholder, the board approved the transaction or the business combination that resulted in the stockholder's becoming an interested stockholder; or (2) subsequent to the completion of the transaction that resulted in the stockholder's becoming an interested stockholder, such stockholder owned at least 85% of the company's voting stock; or (3) at the time of or after the stockholder became an interested stockholder, the board approved the business combination and stockholders authorized it at a meeting by the affirmative vote of at least 66 2/3% of the outstanding voting stock not owned by the interested stockholder.

[148] 8 *Del. C.* § 203(b)(1). A corporation may also opt out of Section 203 by a stockholder-adopted amendment of the charter or bylaws; however, the effectiveness of a bylaw amendment is deferred for 12 months. *Id.* § 203(b)(3).

[149] In 2012, approximately 95% of the Delaware corporations among the S&P 500 companies were subject to Section 203. As far as IPO companies are concerned, 79% of the Delaware corporations were subject to Section 203. WilmerHale, *2013 M&A Report*, *supra* note 7.

[150] Glass Lewis addresses Section 203 only in a different context. Glass Lewis Guidelines, *supra* note 12, at 36 ("Given the existence of state law protections for minority shareholders such as Section 203 of the Delaware Corporations Code, we believe it is in the best interests of shareholders to remove fair price provisions.").

[151] A typical put right allows the bondholder to sell the bond back to the company at a premium (commonly 101 cents on the dollar).

[152] It appears that no study to date has analyzed the data on how many public companies or IPO companies include change-of-control provisions in their debt instruments, but in the authors' experience most companies seem to include such provisions.

change-of-control provision unless the insurgents pose a "specific and substantial risk" to their corporation.[153] The court indicated its willingness to apply a heightened level of scrutiny in such cases given the potential encumbrances on the stockholder franchise in the absence of a strong showing of actual coercive harm.

The decision also emphasized that the courts are interested in seeing that a board push back against creditors when negotiating a change-of-control provision. Delaware courts expect to see evidence that a company seriously negotiated the change-of-control provision.[154]

15. POISON PILLS

The poison pill, the famous defense against hostile takeovers, can also be used against shareholder activists. Also known as a shareholder rights plan, the typical poison pill provides that if an insurgent stockholder acquires more than a certain percentage of a company's shares (commonly 10% or 15%) without board approval, all other stockholders will have the right to buy additional shares at a steep discount (typically 50%).[155] The triggering of a poison pill results in severe economic and voting dilution to the insurgent stockholder. The dilutive effect of the poison pill is such a powerful deterrent there is only one known case where a poison pill in its modern form was intentionally triggered.[156]

Delaware courts have generally upheld poison pills as a defense against hostile takeovers.[157] The pill has proven to be effective in this context because a hostile bidder cannot close a tender offer before the pill is redeemed. This forces the bidder to negotiate with the target's board or wage a costly and time-consuming proxy contest to gain control of the target's board. The Delaware Court of Chancery recently upheld a board's refusal to grant a limited waiver of a poison pill in the shareholder activism context, arguing that a board's concerns over "creeping accumulation of control" or "negative control" by activist investors are legally cognizable threats under the *Unocal* standard.[158]

[153] *Kallick v. SandRidge Energy, Inc*., 68 A.3d 242, 248-49 n.22-23, 260–61 (Del. Ch. 2013).

[154] *Id.*

[155] While it is possible to create a poison pill using common stock, it is preferable to use preferred stock. *See supra* Section 2 (*Blank Check Preferred Stock*).

[156] *Versata Enters. v. Selectica, Inc.*, 5 A.3d 586, 590 (Del. 2010).

[157] *Air Prods. &Chems. Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1354 (Del. 1985).

[158] *Third Point LLC v. William F. Ruprecht* (Del. Ch. 2014) (No. 9497).

However, even though the Delaware Court of Chancery upheld its use in this context, the effectiveness of a poison pill against shareholder activists is more limited.

The primary effect of a poison pill is to create a barrier to stock accumulations beyond a certain threshold. The problem is that most activists are perfectly content with less than 10%, the most common threshold for an activist-focused poison pill. In light of the significant support by institutional investors, activists can often wage effective proxy contests for director elections with small stakes and, as mentioned above, only a few activists have shown the willingness and the financial capability to take over a target company.

Another potential benefit of the poison pill is that it can impede the ability of activists to enter into informal arrangements with other activists (known as "wolfpacks"). If the language of the poison pill is drafted broadly enough, the stakes of members in would-be wolfpacks can be aggregated for purposes of determining whether the poison pill threshold has been crossed, thereby deterring activists. Although Delaware courts have not directly addressed the inclusion of "wolfpack language," the Court of Chancery has indicated that it will strike down impracticable and vague language, mitigating the deterrent effect of wolfpack language.[159] Similar legal uncertainty arises with another benefit of poison pills: many shareholder activists use derivatives to accumulate a position in the target company because one of the regulatory loopholes of the Schedule 13D regime is that certain derivatives are not picked up by the definition of "beneficial ownership."[160] Many poison pills try to deter activists from using derivatives by broadening the scope of "beneficial ownership" for purposes of determining whether the poison pill threshold has been crossed. Nonetheless, in practice there are numerous drafting issues associated with netting derivatives in poison pills. Although Delaware courts have suggested that reasonable derivatives language will be upheld, legal uncertainty in this area remains.[161]

Proxy advisory services and institutional investors have practically waged a war against the poison pill over the last decade and as a consequence, most companies have

[159] *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 339 (Del. Ch. Aug. 12, 2010).

[160] The best known example of this is "total return swaps," whereby an activist can create the equivalent in economic terms of ownership of a security without ever acquiring actual ownership of the security.

[161] *In Re Atmel Corp. S'holders Litig.*, C.A. No. 4161-CC, slip op. at 3 (Del. Ch. May 29, 2009).

removed their poison pills.[162] However, while ISS and Glass Lewis are generally opposed to poison pills and tend to issue voting recommendations against boards who adopt poison pills, they accept short-term poison pills with terms of 12 months or less in response to a specific threat.[163] As a consequence, today most companies keep their poison pill "on the shelf," meaning that they have a draft form stockholder rights plan that can be adopted quickly in the event of a threat. The problem with such a "shelf" plan is that it does not prevent stock accumulations until the poison pill is actually adopted. The adoption of a poison pill comes too late if an activist accumulates a significant stake before the company learns about the stake — that is, during the 10-day period for Schedule 13D filings or under the current Hart-Scott-Rodino Act threshold of $75.9 million. While stock watch services offer to alert a company of any unusual and substantial activity in its shares, the reliability of their intelligence seems to vary.

In any event, placing a poison pill on the shelf entails minimal risk for a company and enables the board to adopt it overnight when an activist emerges. However, a company should be aware that a poison pill has limited benefits and does not prevent a proxy contest.

CONCLUSION

Although all shareholder activists claim to want what is best for the company, companies should be prepared to fend off activists whose plans would harm the company. In the current market, no company — regardless of its size or success — can comfortably conclude that it is immune to shareholder activism. Advance preparation before an activist emerges is the best means to a good defense and any such advance preparation should include a thorough review of a company's structural defenses. Companies are well advised to implement structural defenses before the advent of a proxy contest or other shareholder activism campaign. Once an activist is on a company's doorstep, defensive measures undertaken by a board could be interpreted by a court as interfering with the stockholder franchise and may receive a negative reaction from proxy advisory firms, investors, and the media. ■

[162] Whereas 57% of the S&P 500 companies had poison pills at the end of 2003, only 7% had pills in place at the end of 2013. SHARKREPELLENT, *supra* note 3. As far as IPO companies are concerned, no company has gone public with a poison pill in force since 2008. In 2007, 8% of IPO companies had an active poison pill. WILMERHALE, *2013 M&A Report*, *supra* note 7.

[163] ISS Guidelines, *supra* note 12, at 11; Glass Lewis Guidelines, *supra* note 12, at 17.

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Rights Plans and Proxy Contests: Chancery Court Denies Activist's Motion to Enjoin Sotheby's Shareholder Meeting

Posted by Victor I. Lewkow, Cleary Gottlieb Steen & Hamilton LLP, on Monday May 5, 2014

Editor's Note: Victor Lewkow is a partner at Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb memorandum by Benet J. O'Reilly and Aaron J. Meyers, and is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

On May 2, 2014, the Delaware Chancery Court denied a motion to preliminarily enjoin Sotheby's annual stockholder meeting based on allegations by an activist stockholder, Third Point LLC, that the Sotheby's board of directors violated its fiduciary duties by adopting a rights plan (or "poison pill") and refusing to provide a waiver from its terms in order to obtain an advantage in an ongoing proxy contest. Applying the two-prong *Unocal* test, Vice Chancellor Parsons held that the plaintiffs failed to demonstrate a reasonable probability of success on the merits of their claims. Notably, the Chancery Court accepted that the threat of "negative control" (i.e., disproportionate influence over major corporate decisions) by a stockholder with less than 20% ownership and without any express veto rights may constitute a threat to corporate policy justifying responsive action by a board, including the adoption and retention of a right plan.

Background

Beginning in early 2013, Third Point and two other activist hedge funds established a position in Sotheby's stock, with Third Point ownership eventually reaching approximately 9.6% and the collective ownership of the three funds reaching approximately 19%. In August 2013, Sotheby's management met separately with Third Point and one of the other funds, Marcato, with the funds suggesting potential changes to Sotheby's strategy and leadership.

In October 2013, Third Point filed an amended Schedule 13D attaching a letter from Daniel Loeb, Third Point's CEO, to William Ruprecht, Sotheby's Chairman, President and CEO, raising concerns about Sotheby's and suggesting, among other things, that several new directors recruited by Mr. Loeb be added to Sotheby's board. Inferring the letter to be part of an "all out assault" intended to destabilize Sotheby's, the board adopted a two-tiered rights plan, triggered at

a 10% ownership level, but allowing any "passive" stockholder to acquire up to 20%. By its terms, the rights plan would expire in one year unless approved by a vote of Sotheby's stockholders and would not apply to a tender offer for all outstanding Sotheby's shares that remained open for at least 100 days.

In February 2014, Third Point and Sotheby's engaged in negotiations in an attempt to avoid a proxy contest in the lead up to Sotheby's annual meeting scheduled for May 6. Third Point sought, among other things, two seats on Sotheby's board and for the rights plan's trigger to be raised to 15%. Sotheby's offered Third Point a single board seat, subject to certain conditions including a standstill agreement capping Third Point's ownership at approximately 10%. The parties failed to reach agreement and, in March 2014, Third Point requested a waiver from the rights plan to allow it to purchase up to a 20% stake in Sotheby's. Sotheby's board was aware that the proxy contest was a "dead heat" and that an increase in Third Point's stake may have improved its likelihood of success. The board denied the request and Third Point filed suit, alleging that the board adopted and enforced the rights plan against Third Point for the primary purpose of inhibiting its ability to wage a successful proxy contest, without any compelling justification for doing so.

Applicable Legal Framework: *Unocal* and/or *Blasius*?

In evaluating the probability that Third Point's claims would succeed on their merits, the Chancery Court held that the board's compliance with its fiduciary duties as they relate to the rights plan must be assessed under the *Unocal* standard. The *Blasius* stringent "compelling justification" standard, though not mutually exclusive of the *Unocal* standard, could be applied only where "the primary purpose of the board's action is to interfere with or impede exercise of the shareholder franchise and the shareholders are not given a full and fair opportunity to vote effectively". Vice Chancellor Parsons noted that the plaintiffs had not cited any case in which *Blasius* was invoked to examine a rights plan, and suggested that the "reasonableness" prong of *Unocal* may adequately deal with any rights plan that adversely affects the shareholder franchise, making the application of *Blasius* unnecessary.

In any event, the Chancery Court concluded that the plaintiffs did not have a reasonable probability of demonstrating that the board adopted the rights plan for the *primary* purpose of interfering with any stockholder's franchise. In so concluding, the Chancery Court focused on the absence of any inference of entrenchment on the part of the board and the fact that the rights plan is neither coercive (since it does not impose any consequences on stockholders for voting their shares as they wish) nor preclusive (as the parties conceded that the proxy contest could be won by either side).

With respect to the board's refusal to grant Third Point's request to waive the 10% trigger, however, the Chancery Court described the question of the applicability of *Blasius* as "uncomfortably close", noting that the board's refusal came soon after it learned that Third Point's acquisition of an additional 10% stake likely would ensure Third Point's victory in the proxy contest. Vice Chancellor Parsons was "not unsympathetic" to the plaintiffs' position, but noted that in *Moran* the Delaware Supreme Court held that some incidental reduction of the stockholder franchise as a result of the adoption of a rights plan was acceptable so long as a proxy contest remained a viable option, and that subsequent case law had expanded the scope of threats justifying an incidental reduction of the franchise beyond the hostile takeover context. Nevertheless, the Vice Chancellor indicated that the plaintiffs' claims in this respect raised important policy concerns that deserved careful consideration under *Unocal*.

Application of the *Unocal* Standard

The Chancery Court applied the two-prong *Unocal* standard separately to its review of Sotheby's adoption of the rights plan and the board's subsequent denial of Third Point's request for a waiver from its 10% trigger, in each case concluding that Third Point had failed to demonstrate a reasonable probability that the board would not be able to demonstrate that it had satisfied the relevant test.

The "reasonableness" prong of the *Unocal* test requires the board to have had reasonable grounds for believing that a legally cognizable threat to Sotheby's corporate policy and effectiveness existed, both when Sotheby's adopted the rights plan and when it refused Third Point's waiver request. With respect to the initial adoption of the rights plan, the Chancery Court focused on the threat of "creeping control" by the activist hedge funds, who may form a "wolfpack" to jointly acquire large blocks of a target company's stock. As to the board's refusal to waive the rights plan's 10% trigger and allow Third Point to buy up to 20% of Sotheby's, the Chancery Court relied on the threat of "negative control": the possibility that Third Point, as a 20% stockholder, could exercise disproportionate influence over major corporate decisions, even without any explicit veto power. Earlier Delaware case law relating to negative control had involved *explicit* veto power obtained via contractual rights or by ownership of a stake sufficient to block actions requiring a supermajority vote. Nevertheless, on the basis of the aggressive and domineering manner in which Mr. Loeb conducted himself in relation to Sotheby's and that, at 20% ownership, Third Point would be Sotheby's largest single stockholder by far, the Chancery Court found that the board could have an objectively reasonable basis to believe Third Point could control important corporate actions, presenting a threat legally cognizable under *Unocal*.

The “proportionality” prong of the *Unocal* test requires the board to demonstrate that its defensive response was reasonable and proportional in relation to the threat posed. The Chancery Court considered that a 10% threshold would allow any activist stockholder to hold a substantial ownership position relative to that of Sotheby’s board (which collectively held less than 1%), that Third Point at just under 10% ownership was Sotheby’s largest single stockholder, and that a trigger level much higher than 10% would make it easier for a small group of activist investors to achieve control without paying a premium.

Lessons Learned

The Chancery Court’s opinion provides various important reminders for Delaware corporations, including:

- When considering whether to adopt, redeem, amend or waive any stockholder rights plan, directors should focus at all stages on the types of legally cognizable threats that will pass muster under the “reasonableness” prong of the *Unocal* test—the focus remains on threats to control of the company, including “creeping control” and “negative control”.
- An independent board, advised by competent outside financial and legal advisors, will be granted additional deference in its determination of the threats posed by an activist investor. The Vice Chancellor highlighted that the Sotheby’s board included only one member of management and ten of the eleven other directors were independent under NYSE standards, and that the average board tenure of 7.1 years was three years less than the average for the S&P 500.
- Another reminder that all written and electronic communications may be subject to discovery and subsequently revealed in litigation. The parties introduced numerous and candid emails among members of the board; among members of Sotheby’s financial advisors; and among the Third Point investment team—and the Chancery Court’s opinion even refers to personal emails exchanged between Sotheby’s CEO and his sister. The candid sharing of ideas among independent directors is critical to a healthy board debate, but is best reserved for a meeting or conversation. The likelihood of potentially embarrassing communications can be reduced by providing sufficient and regular opportunities for directors to engage in in-person discussions.
- More generally, a rights plan is of limited utility in connection with shareholder activism and therefore boards ought to continue to take into account the considerations and advice conveyed in our recent memorandum, Selected Issues for Boards in 2014 (discussed on the Forum here).

REUTERS

INSIGHT-Big fund firm blacklists directors who support poison pills

NEW YORK, April 29, 2015 | By Jessica Toonkel

A major funds company is putting directors on notice: if you adopt poison pill anti-takeover measures without shareholder approval, you will be blacklisted.

Since October, Dimensional Fund Advisors, the eighth largest U.S. mutual fund firm with $398 billion in assets, has been sending warning letters to companies whose stock it owns and who have adopted the measures without shareholder approval.

In the letters, the Austin, Texas-based money manager warns that it will vote against directors who approved those measures - not just at the company with the poison pills, but at every company they serve - unless they remove those pills or put them up for shareholder vote. The campaign, which hasn't been previously reported, will eventually target 250 companies.

DFA is worried that companies too often use the measures to deter acquirers and shareholder activists who could benefit shareholders, said Joseph Chi, the firm's co-head of portfolio management.

DFA appears to be the first major fund group to blacklist individual directors across its portfolios for such conduct. That may be a sign parts of the funds industry are taking a tougher line against boards who don't do what the funds want. Some of the largest U.S. fund managers have also recently been pressuring companies to make it easier for shareholders to nominate board candidates.

The measures DFA opposes can include pills which allow other shareholders the right to buy shares at a discount if one investor buys more than a certain amount of the company. Another example would be a pill that gives shareholders of a company being acquired the right to buy shares in the combined company after a takeover, again at a discount. These kinds of measures act as a disincentive to anyone seeking to buy a company by making it more difficult and by raising the costs of any deal.

While DFA has had the policy as part of its corporate governance stance since 2012, until now the firm has allowed exceptions primarily because companies said they were not aware of it,

Chi said. After sending the letters it is pursuing the policy more aggressively with individual directors, he said.

Chi declined to say how many directors DFA has voted against so far. He said 10 companies have agreed to remove their pills or let them expire since they received the letters, though he declined to identify them.

"It is a very strong stance by DFA," said Aeisha Mastagni, investment officer at the California State Teachers' Retirement System (CalSTRS), the second largest U.S. pension fund, which has also opposed poison pills but hasn't put such a target on individuals.

DFA is taking aim at companies with any type of poison pill that was brought in without shareholder approval. The one exception is if a measure is designed as a tax maneuver to protect tax benefits generated by net operating losses.

MANY IN CROSSHAIRS

The firm's tactic could impact scores of small and mid-sized firms in Dimensional portfolios that have poison pills in place, said Brandon Rees, deputy director of the Office of Investment of the labor union umbrella group AFL-CIO.

DFA owns shares in 170 of the 185 Russell 3000 companies with poison pills that DFA objects to, according to an analysis conducted by Lipper of ISS Quickscore data.

In the past year, at least one company, communications products company Sonus Networks, has removed its poison pill after DFA targeted one of its directors at another company where she served on the board. DFA had a 3 percent Sonus stake as of December 31, according to Thomson Reuters data.

In February 2014, DFA voted against Beatriz Infante on the board of Emulex Corp, a Costa Mesa, California-based network connectivity provider, where DFA is the third biggest shareholder. That was eight months after Sonus extended a poison pill that had been set to expire.

In September 2014, Sonus announced it was removing its poison pill a year ahead of schedule. There is no evidence that DFA's stance resulted in Sonus' decision to get rid of the pill early.

Chi declined to comment on specific companies it has targeted. A Sonus spokeswoman declined to comment. Infante did not return calls.

Companies that could be affected by DFA's stronger stance include Spartan Motors, a builder of specialty vehicles, where DFA is the third largest shareholder, and managed care provider Health Net Inc, where it is fifth biggest, according to Thomson Reuters data.

Both firms have active poison pills adopted without shareholder approval and directors that serve on multiple boards. For example, Hugh Sloan is chairman of Spartan and is on the board of Manulife Financial. Health Net director Mary Anne Citrino is on the board of retailer Dollar Tree Inc. Spokesmen for Health Net and Spartan said their directors were not available for comment.

Health Net's board will discuss DFA's letter at its next meeting, a spokesman said. The company's poison pill is set to expire in July 2016.

A spokesman for Spartan Motors said the company had not received the letter yet and declined to comment further.

Not everyone thinks DFA's personal arm twisting will intimidate directors.

"I can't imagine other investors will say 'I am going to vote against this director even though I like what they are doing at this company,'" said Jack Schuler, who is on the board of a number of publicly traded healthcare companies, none of which are being targeted by DFA.

'NO FLY' DIRECTORS

Investors on occasion target individual directors - sometimes referring to them as "no fly" directors - but it is unusual to see a company do it so systematically, said Patrick McGurn, special counsel for proxy adviser Institutional Shareholder Services.

At CalSTRS, Mastagni said she thinks DFA's tactic could backfire by inadvertently targeting those who are privately fighting against poor corporate governance measures like the poison pills. "They could be the ones in there asking the tough questions," she said. (Reporting By Jessica Toonkel; additional reporting by Ross Kerber in Boston and Nadia Damouni in New York; Editing by Linda Stern and Martin Howell)

DealB%k WITH FOUNDER ANDREW ROSS SORKIN

A Defense Against Hostile Takeovers Develops a Downside

By STEVEN DAVIDOFF SOLOMON NOVEMBER 25, 2014

A recent judicial decision may just upend the hidden world of companies and "poison puts," a world that frankly could use some clarity.

You are probably scratching your head, wondering what "poison puts" even are. Though rarely discussed, they are ubiquitous in debt.

Companies will borrow money and enter into a loan agreement with the lender or the bond trustee. Such agreements specify that if there is a change of control at the company, the debt must be bought back. This is the "put" part.

The "poison" is that the debt is often required to be bought back at a premium, or the company will be in a market where refinancing it is hard. In an extreme situation, the company may not be able to refinance its debt or have the cash to buy back the debt, leaving it effectively bankrupt.

Poison puts thus serve as one of the tools companies use to forestall shareholder activists and hostile takeovers. Companies that have debt with a poison put are more expensive to take over, or in some circumstances, impossible to be bought out because of the costs of the poison put.

Poison puts began as a well-intentioned way to protect debt holders.

In the 1988, RJR Nabisco was bought out by Kohlberg Kravis Roberts in a deal worth $25 billion, then the biggest leveraged buyout in history. K.K.R. borrowed billions to finance this acquisition.

In order to save money, K.K.R. did not refinance all of RJR Nabisco's debt. The firm instead kept the old debt outstanding, reducing its value by more than $1 billion. After the acquisition, RJR Nabisco was in greater debt and more likely to default.

The RJR Nabisco buyout was a turning point for the corporate debt world. After this, banks began to negotiate poison puts — and all sorts of other terms — to protect their investments

from such maneuvers. If you are going to lend a company bags of money, you probably want to know that its ownership will not change.

S&P Capital IQ reports that there are now more than 4,500 debt instruments outstanding with poison put features.

But like any good idea, it got a little out of hand. Companies realized that it might be costly for a potential acquirer to have to refinance all of their debt.

Casey's General Stores, for example, in 2010 negotiated a put in a provision in its debt that would have required it to pay approximately $2 a share to redeem the debt if the company was acquired. Casey's justified this feature because it claimed that it got a lower interest rate on the bond, not to fight off a hostile offer from the Canadian convenience store operator Couche-Tard. Right.

This kind of maneuvering has become even more commonplace now that shareholder activists have stepped on the scene. Companies began to negotiate poison puts that are activated not only if they are acquired, but also if a shareholder activist unseats a majority of a corporation's directors.

The ostensible justification of these provisions was to ensure that banks knew whom they were dealing with. Companies argued that the fact that it would deter a shareholder activist was beside the point, placing the blame on banks for demanding this provision. Although these features are common, courts have been struggling with how to deal with them. They have been weighing a need for banks to know whom they are doing business with against the fact that these provisions can entrench existing boards.

In a case involving Amylin Pharmaceuticals in 2009, Amylin had negotiated one of those poison put provisions that would be triggered if a majority of Amylin's directors were replaced, forcing Amylin to redeem its bonds. The only problem was that Amylin was about $100 million short of the cash to make such a redemption, if needed. The problem became real when Carl C. Icahn's firm, Icahn Partners, and Eastbourne Capital Management put up dueling slates to replace the entire Amylin board.

A Delaware court refused to find that the poison put provision was inappropriate because the directors had not been elected yet. (The hedge funds later each elected one director to the Amylin board). However, the court hinted that it might not view these provisions benignly, stating that "corporations and their counsel routinely negotiate contract terms that may, in some circumstances, impinge on the free exercise of the stockholder franchise."

This warning became a reality in a later decision when SandRidge Energy was sued by its shareholders over a poison put provision, which would be set off if SandRidge's directors were replaced without approval by the current board.

TPG-Axon Capital, a shareholder activist firm that had nominated directors to replace SandRidge's board, sued to get approval for its directors to be seated without forcing the company to refinance $4.3 billion in debt.

The court viewed the company's poison put skeptically as entrenching the directors. The ruling held that SandRidge's directors had a duty to approve TPG-Axon's directors under the company's debt in a way that would not to trigger the poison put.

The Amylin and SandRidge cases taught companies that poison puts in the face of hostile acquirers might be fine, but those that worked to entrench boards might not. A year later, when the Morgans Hotel Group board was unseated by OTK Associates, its departing board approved the transfer, so the debt was not triggered.

In the latest battle, involving Healthways, a health care firm, entered into a "dead hand" poison put that said that if the directors were replaced, the provision was triggered. The company did not negotiate an out if the previous directors approved, as happened with the SandRidge and Amylin cases. This is the "dead hand" because the poison put provision survives even if the directors are replaced with the company's blessing.

Shareholders sued the Healthways directors and their bank, SunTrust, for this poison put provision, claiming it chilled shareholders' ability to replace directors. A Delaware court agreed in a decision last month, stating that this type of poison put provision was a "Sword of Damocles." The court allowed the case to go forward to determine whether the company and bank "knowingly" pushed forward the onerous form of the poison put, noting that it is "something you ought to really think twice about."

With a bank potentially liable, poison puts linked to any director changes are likely to fade away. This makes sense. Although a bank may be concerned about the operation of a company, these director-centric poison puts seem to be more about entrenching existing board members.

Left unanswered is the scope of the poison put when the company is acquired. Courts have seemed to take a hands-off approach in such cases.

At least one study — dating to 1994 — found that poison puts unduly protected managers at the expense of stockholders.

Even so, there is much value in these provisions. Banks should be protected for lending millions, if not billions, regardless of who sits on a board.

But one has to wonder whether this is all a bit haphazard. Today, each company negotiates its own debt instrument with different terms for their poison put, if one exists. And there is no real sense for when these should be included and little transparency of the process by which companies agree to these provisions.

This year, the Canadian Bond Investors' Association put forth guidelines of what should and should not be done with poison puts.

That's the bond industry though. Instead it may make sense for the companies and their shareholders to agree on common principles for these bonds. It just may be that a poison put is acceptable, if it is a bit less poisonous.

Harvard Law School Forum on Corporate Governance and Financial Regulation

Anticipating Proxy Put Litigation

Posted by William Savitt, Wachtell, Lipton, Rosen & Katz, on Tuesday, June 2, 2015

Editor's note: William Savitt is a partner in the Litigation Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton firm memorandum by Mr. Savitt.

In recent months, a number of companies have received stockholder demands or faced stockholder litigation attacking "proxy put" provisions in credit agreements—that is, provisions that allow a lender to put outstanding debt to the corporate borrower for immediate payment upon a change in board control, creating potential financial risk for the company. These "proxy put" provisions are typically triggered when a majority of the board is displaced in a contested election. Many forms of credit agreement include a proxy put that allows an incumbent board to approve prospective directors for change-in-control purposes, even candidates sponsored by a dissident stockholder. Credit agreements of this kind can give rise to complex fiduciary duty litigation in the event a board declines to approve the members of a dissident slate in the face of a live proxy contest, but they do not appear vulnerable to facial attack under prevailing law.

The recent spate of challenges concerns a different form of credit agreement, one containing a so-called "dead-hand" proxy put. Credit agreements with this feature do not provide an incumbent board the discretion to approve a dissident slate and have been targeted by the stockholder plaintiffs' bar as presumptively illegal. Every public company with a dead-hand proxy put credit facility can expect to receive a stockholder challenge, whether in the form of a derivative lawsuit or a books-and-records demand, and sooner rather than later. Recent Delaware decisions indicate that such provisions are not per se invalid, and there is substantial reason to question the validity of a stockholder challenge based solely on the existence of a dead-hand put term. But irrespective of the ultimate merits, the mere receipt of a stockholder challenge gives rise to defense costs, pressure to seek an amendment to the credit agreement, and, more often than not, an obligation to pay plaintiffs' attorneys' fees. Accordingly, companies with dead-hand proxy put provisions in their credit agreements should consult with counsel and consider whether to seek to amend those provisions before the plaintiffs come calling.

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March 7, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934

Dear Ms. Murphy:

Wachtell, Lipton, Rosen & Katz[1] respectfully submits this petition[2] to the Securities and Exchange Commission (the "Commission") requesting that the Commission initiate a rulemaking project regarding the beneficial ownership reporting rules under Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act")—specifically, to propose amendments to shorten the reporting deadline and expand the definition of beneficial ownership under the reporting rules. We believe that the current reporting regime fails to fulfill its stated purposes, and outline in this letter a number of recommended amendments that we believe would be beneficial to investors, issuers and the market as a whole.

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[1] Wachtell, Lipton, Rosen & Katz is a New York based law firm that specializes in mergers and acquisitions, strategic investments, takeovers and takeover defense, corporate and securities law and corporate governance. We counsel both public and private acquirors and targets.

[2] Rule 192(a) of the Rules of Practice and Rules on Fair Fund and Disgorgement Plans of the Securities and Exchange Commission.

In particular, we believe that the current narrow definition of beneficial ownership and the ten-day reporting lag after the Section 13(d) ownership reporting threshold is crossed facilitate market manipulation and abusive tactics. It has become both simple and commonplace for aggressive investors to intentionally structure their acquisition strategies to exploit the gaps created by the current reporting regime, to their own short-term benefit and to the overall detriment of market transparency and investor confidence. Current tactics show that the very purposes for the Section 13(d) reporting requirement are being undermined.

There is no valid policy-based or pragmatic reason that purchasers of significant ownership stakes in public companies should be permitted to hide their actions from other shareholders, the investment community and the issuer; indeed, the need for transparency, fairness and equality of information in our financial markets has never been higher. Recent events have highlighted the potential extremes to which these acquisition tactics may be taken, and make clear the urgent need for meaningful, comprehensive reform, both to clearly prohibit these types of abuses and to conform with the current norm for developed markets throughout the world. The reporting regime in the United States must evolve if it is to continue to perform the vital function for which it was initially implemented.

Recent legislation has made clear that the Commission has the necessary authority to take these remedial steps, and that the time for decisive action has come.[3] Indeed, Section 766(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") highlights the need for prompt action by creating significant uncertainty as to the continued validity of long-standing interpretations of the reporting rules with respect to the treatment of derivatives. The Staff of the Commission has publicly indicated that it intends to act to resolve such uncertainties.[4] We applaud these statements, but urge the Commission to take this opportunity to undertake the comprehensive reform that is so sorely needed, rather than limiting its actions to a narrow rulemaking confined to the specific issues raised by Section 766(e) of the Dodd-Frank Act. Closing the ten-day window and requiring the proper reporting of derivative ownership are vital and pressing actions that should be a priority.

Historical Purpose of the Section 13(d) Reporting Rules

Since its adoption by Congress in 1968 as part of the Williams Act, the stated purpose of the beneficial ownership reporting regime has been to compel the release of information to the investing public with respect to the accumulation of substantial ownership of an issuer's voting securities.[5] In particular, Congress noted a troubling absence of disclosure regulations for accumulations outside of the context of proxy contests, despite the fact that policy reasons

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[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (hereafter "Dodd-Frank Act"); see in particular §§ 766(e) and 929R.

[4] See, *e.g.*, Joshua Gallu, *Secret Corporate Raids to Get Harder Under SEC Rule Change*, Bloomberg, Feb. 22, 2011; Yin Wilczek, *Shortening of Disclosure Period for Beneficial Owners*, Corp. Coun. Wkly., Feb. 16, 2011.

[5] See, *e.g.*, S. Rep. 90-550, at 1 (1967) ("There are, however, some areas still remaining where full disclosure is necessary for investor protection but not required by present law. One such area is the purchase of substantial or controlling blocks of the securities of publicly held companies").

dictate similar disclosure obligations in all circumstances.[6] Simply put, the purpose of the Section 13(d) disclosure rules has always been to "alert investors in securities markets to potential changes in corporate control and to provide them with an opportunity to evaluate the effect of these potential changes."[7]

This purpose is no longer being properly served. As the Commission has publicly observed for nearly three decades, the ten-day reporting lag leaves a substantial gap after the reporting threshold has been crossed during which the market is deprived of material information, and creates incentives for abusive tactics on the part of aggressive investors prior to making a filing.[8] Such investors may – and frequently do[9] – secretly continue to accumulate shares during this period, acquiring substantial influence and potential control over an issuer without other shareholders (or the issuer) having any information about the acquiror or its plans and purposes at the time stockholders sell their shares. This serves the interest of no one but the investor seeking to exploit this period of permissible silence to acquire shares at a discount to the market price that may result from its belated disclosures.

The Ten-Day Reporting Window

The pragmatic reasons which may have motivated the inclusion of a ten-day reporting lag in the Williams Act are simply obsolete. Changes in technology, acquisition mechanics and trading practices have given investors the ability to make these types of reports with very little advance preparation time. The impact of these advances and corresponding need for change in the Section 13(d) reporting timetable was noted as early as 1983[10] in the report of an advisory commission established by the Commission, and has only become more compelling with the passage of time. The advent of computerized trading has upended traditional timelines for the acquisition of shares, allowing massive volumes of shares to trade in a matter of seconds. The increasing use of derivatives has accelerated the ability of investors to accumulate economic ownership of shares, usually with substantial leverage. Furthermore, the markets rely on the expectation that material information will be disseminated promptly and widely, in no small part

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[6] See, e.g., S. Rep. 90-550, at 2 (1967) ("The failure to provide adequate disclosure to investors in connection with a cash takeover bid or other acquisitions which may cause a shift in control is in sharp contrast to the regulatory requirements applicable where one company offers to exchange its shares for another, or where a contest for control takes the form of a proxy fight").

[7] *Wellman* v. *Dickinson*, 682 F.2d 355, 365-66 (2d Cir. 1982), citing *GAF Corp*. v. *Milstein*, 453 F.2d 709, 717 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972).

[8] Advisory Committee on Tender Offers, SEC, Report of Recommendations (July 8, 1983), reprinted in Fed. Sec. L. Rep. (CCH) No. 1028 (Extra Edition) 22 ("The 10-day window between the acquisition of more than a 5% interest and the required filing of a Schedule 13D was found to present a substantial opportunity for abuse, as the acquiror 'dashes' to buy as many shares as possible between the time it crosses the 5% threshold and the required filing date.") (hereafter, "Tender Offer Advisory Committee Report"); *see also* Letter from Harold M. Williams, Chairman, SEC, to the Senate Banking Committee (Feb. 15, 1980) (hereafter, "Williams Letter"); Hearings Before the Subcomm. On Telecomm. And Fin. of the House Comm. on Energy and Commerce Concerning Pending Legislation Regarding Contests for Corporate Control, 100th Cong. 2 (1987) (statement of David S. Ruder, Chairman, SEC).

[9] See, *e.g.*, Andrew Ross Sorkin, Dealbook, *Big Investors Appear Out of Thin Air*, N.Y. Times (Nov. 1, 2010). For additional examples, see text accompanying footnotes 23-26.

[10] Tender Offer Advisory Committee Report at 1.

due to the impact of the internet and online information exchange. In today's world, ten days is an eternity.

These changes and trends have been explicitly recognized by the Commission in the context of other reporting rules, both through the implementation of additional disclosure requirements and the shortened timelines that have been adopted for other types of filings. In 2004, the deadline for filing Current Reports on Form 8-K, the primary mechanism by which issuers make ongoing disclosure to the Commission and the public, was shortened to four business days following the triggering event.[11] The Commission explicitly linked this change to the Sarbanes-Oxley mandate to provide investors with disclosure of material corporate events on a "rapid and current basis,"[12] in recognition of the fact that the previous fifteen-calendar-day deadline was too lengthy to accomplish this goal. This step followed an accelerated filing requirement imposed on officers, directors and 10% shareholders of corporate issuers with respect to reporting transactions in the issuer's securities, to the second business day following the triggering transaction.[13] In perhaps the most extreme example, following the enactment of Regulation FD in 2000, issuers are generally required to inform the market broadly of any material, non-public information *simultaneously* with its intentional disclosure to any outside party.[14] These examples illustrate a marked trend by the Commission toward more immediate disclosure of information material to investors, which should now be applied to the Section 13(d) reporting rules.

Lower reporting thresholds and shortened deadlines have been required for years in other developed financial markets, including the United Kingdom, Germany, Australia and Hong Kong. The U.S. should, at a minimum, offer investors an equivalent level of available information on as timely a basis as other markets, in order to maintain investor confidence in the integrity of the U.S. trading markets. For example, Australia requires disclosure of any position of 5% or more within two business days if any transaction affects or is likely to affect control or potential control of the issuer, or the acquisition or proposed acquisition of a substantial interest in the issuer.[15] The United Kingdom imposes a two-trading-day deadline for disclosure of acquisitions in excess of 3% of an issuer's securities.[16] Germany requires a report "immediately," but in no event later than four days after crossing the acquisition threshold.[17] Hong Kong securities laws require a report within three business days of the acquisition of a "notifiable interest" under the law.[18] No special policy or practicality concerns mandate that the

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[11] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release Nos. 33-8400, 34-49424; File No. S7-22-02 (Mar. 16, 2004).

[12] Id.

[13] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 34-46421, 35-27563, IC-25720; File No. S7-31-02 (Aug. 27, 2002).

[14] Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154, IC-24599; File No. S7-31-99 (August 15, 2000) (adopting Regulation FD).

[15] Australian Takeover Panels Guidance Note 20.

[16] Chapter 5 of the Financial Services Authority's Disclosure Rules and Transparency Rules.

[17] See Part 4 of the German Securities Trading Act.

[18] See Part XV of the Securities and Futures Ordinance.

U.S. retain its outdated, overly permissive reporting deadlines or definitions of beneficial ownership.

There are various options to be considered with respect to shortening the reporting deadline in order to re-align the Section 13(d) reporting rules with their intended purpose. We recommend that the Commission require that the initial Schedule 13D filing be made within one business day following the crossing of the five percent ownership threshold, using the same "prompt" disclosure standard that the Commission requires with respect to material amendments to existing Schedule 13D filings.[19] While some may argue that this deadline would impose an unreasonable deadline and reporting burden on investors, we disagree. The type of investor who acquires a 5% stake in a public company will almost always be a sophisticated, experienced investor, with the resources to submit the required filings promptly, particularly as these forms can be substantially prepared prior to crossing the 5% threshold.

Furthermore, to curtail the incentive towards abusive tactics currently inherent in the lag between crossing the ownership threshold and the reporting deadline, we recommend that acquirers be prohibited from acquiring beneficial ownership (under a broadened definition discussed below) of any additional equity securities of the issuer during the time between acquisition of a 5% ownership stake until two business days after the filing of the required Schedule 13D. This short "cooling-off period" would be similar to, but less restrictive than, the cooling-off period rules governing formerly passive investors switching from Schedule 13G filers to Schedule 13D filers, which prohibit such persons from voting, directing the voting of, or acquiring an additional beneficial ownership interest in, equity securities of the issuer from the time they develop a control intent until ten days after the filing of the required Schedule 13D.[20] As stated by the Commission in adopting the 1998 beneficial ownership reporting amendments, "[t]he cooling-off period will prevent further acquisitions or the voting of the subject securities until the market and investors have been given time to react to the information in the Schedule 13D filing."[21] The same policy concerns are at work here, and the recommended rule would be less onerous. The two business day cooling-off period would provide time for the investment community to review and assess the potential market impact of the initial Schedule 13D disclosures.

In enacting the Dodd-Frank Act, Congress specifically authorized the Commission to shorten the filing window: Congress modified Section 13(d)(1) of the Exchange Act to read "within ten days after such acquisition, *or within such shorter time as the Commission may establish by rule*."[22] This explicit grant of authority demonstrates Congress' recognition of the need for prompt corrective action, as exemplified by recent dramatic abuses of the ten-day window period.

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[19] 17 C.F.R. §240-13d-2(a).

[20] 17 C.F.R. §240-13d-1(e)(2).

[21] Amendments to Beneficial Ownership Reporting Requirements, Release No. 34-39538; File No. S7-16-96 (Jan. 12, 1998) at p. 10.

[22] Dodd-Frank Act §929R (emphasis added).

The recent acquisitions of J.C. Penney stock by Pershing Square Capital Management and Vornado Realty Trust vividly illustrate the extent to which savvy investors are able to exploit the gaps in the current Section 13(d) reporting rules – in this case, acquiring beneficial ownership of more than 25% of J.C. Penney's outstanding common stock before any public disclosure was made. Pershing Square first acquired 4.9% ownership through open market purchases, and then Pershing Square and Vornado rapidly acquired a total of approximately 27% ownership through open market purchases, forward purchases, call options and total return swaps during the ten-day window after crossing the 5% threshold in late September 2010 and prior to filing their initial Schedule 13D ten days later.[23] In the first full trading day after Pershing Square and Vornado filed their Schedule 13D reports, J.C. Penney's stock closed at $33.12, compared to the average closing price of $28.31 over the prior ten days while Pershing Square and Vornado were engaging in their aggressive accumulation program after crossing 5%, resulting in a substantial transfer of value to these two investors from the public shareholders who sold their shares during the ten-day window without knowledge of the investors' plans. In January 2011, representatives of each of Pershing Square and Vornado were appointed to J.C. Penney's board of directors, demonstrating the influence and control that these investors were able to obtain as a direct result of their secret share acquisitions during the ten-day window period.[24]

Pershing Square employed similar tactics in its recent acquisition of the stock of Fortune Brands. Pershing Square first acquired slightly less than 5% of Fortune Brands' common stock. During the ten-day period following its crossing of the 5% threshold in late September 2010, Pershing Square then acquired common stock and cash-settled total return swaps, ultimately accumulating ownership of 10.9% of Fortune Brands' common stock prior to filing its initial Schedule 13D on October 8, 2010.[25] In the first full trading day after Pershing Square filed its Schedule 13D report, Fortune Brands' common stock closed at $55.50, compared to the average closing price of $49.55 over the ten days prior to the filing while Pershing Square acquired ownership of an additional 6% of Fortune Brands' common stock. Just two months after the initial 13D filing, Fortune Brands announced plans to split up the company as had been reportedly pressed by Pershing Square, further illustrating the influence and control that can be secretly acquired during the ten-day window period.[26]

The prospect of possible closing of the ten-day window has already generated vocal opposition by the hedge fund activists who have gamed the window to their own advantage. One well-known activist has argued that the ten-day window period is needed to incentivize hedge funds to make sizable investments in companies seeking to force company actions that generate short-term profits arguably for the benefit of the issuer's shareholders.[27] However, the purpose

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[23] See, *e.g.*, Maxwell Murphy, Deal Journal, *How Bill Ackman Stalked J.C. Penney*, Wall St. J., October 8, 2010; Joann S. Lublin & Karen Talley, *Big Shoppers Bag 26% of J.C. Penney*, Wall St. J., October 9, 2010.

[24] Press Release, J.C. Penney Company, Inc., JCPenney Agrees to Name William Ackman and Steven Roth to Board of Directors (Jan. 24, 2011).

[25] See, *e.g.*, Matt Phillips, MarketBeat, *Ackman in Action*, Wall St. J. (Oct. 8, 2010).

[26] David Kesmodel, *Fortune Brands Plans to Split Up*, Wall St. J. (Dec. 8, 2010).

[27] See, *e.g.*, Joshua Gallu, *Secret Corporate Raids to Get Harder Under SEC Rule Change*, Bloomberg, February 22, 2011 (quoting William Ackman as saying that closing the ten-day window would decrease the number of activist

of the 13D window period was never to grant a license to hedge funds to make extraordinary profits by trading ahead of the undisclosed, market-moving information contained in their delayed 13D filings, nor to provide additional inducements to spur hedge fund activity. The activists' purported rationale for the window period is directly contrary to the overall purposes of the 13D reporting requirements – namely, to inform investors and the market promptly of potential acquisitions of control and influence so that investors have equal access to this material information before trading their shares. Indeed, the initial 10% reporting threshold in the Williams Act was amended to 5% in 1970 because of concerns that even 5% ownership conferred significant control rights and should require public disclosure.[28] The advent over the last four decades of computerized trading and extraordinary derivative opportunities to acquire substantial share positions has effectively neutralized the impact of the 1970 amendment, as investors have filed initial 13D forms reporting substantially over 10 percent ownership due to rapid acquisitions during the window period. The need for reform could not be clearer.

Derivatives and Beneficial Ownership

The concept of beneficial ownership, as used throughout the reporting rules and in the calculation of when the minimum ownership threshold has been reached, encompasses only those securities over which an investor (or group of investors) holds either "voting power" or "investment power," including the power to "dispose of, or to direct the disposition of," a security.[29] Other forms of ownership, including through derivatives, are currently explicitly counted for purposes of the 13(d) reporting rules only where they confer upon the holder the right to acquire beneficial ownership (*i.e.*, either voting power or investment power) over the underlying security within sixty days.[30] This paradigm fails to adequately address many ways in which modern investors may acquire economic exposure to a security, including through the purchase of non-traditional or cash-settled derivatives. Perhaps more importantly, it fails to recognize circumstances in which an investor may amass influence or control over both the voting and disposition of substantial blocks of securities, while maintaining the bare legal fiction that a third party holds such rights. We have extensively discussed elsewhere our concerns with this trend towards "empty voting," or otherwise decoupling the economic impact of security ownership from voting control,[31] and continue to believe that it poses a threat to the efficient

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investors challenging corporate management because "[i]f forced to disclose the position, the opportunity to buy at an attractive price disappears").

[28] See, *e.g.*, Staff of S. Comm. on Banking and Currency, Subcomm. on Securities, Report on Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions for Small Businessmen 1 (Comm. Print 1970) ("Ten percent of the stock of large corporations, indeed even 5 percent, can . . . have a significant impact on corporate control.").

[29] 17 C.F.R. § 240.13d-3(a).

[30] 17 C.F.R. §240-13d-3(d)(1).

[31] See, *e.g.*, Adam O. Emmerich and William Savitt, *Stealth and Ambush Equity Accumulation – Use of Synthetic Ownership Arrangements Continues to Pose Danger to Securities Markets and Public Companies* (2010), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.18056.10.pdf; Theodore N. Mirvis, Adam O. Emmerich and Adam M. Gogolak, *Beneficial Ownership of Equity Derivatives and Short Positions – A Modest Proposal to Bring the 13D Reporting System into the 21st Century* (2008) (hereafter "A Modest Proposal"), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.15395.08.pdf; Theodore N. Mirvis and Adam O. Emmerich, *De-Coupling of Economic and Voting Power in Public Companies – Equity Ownership*

operation of our public corporations and financial markets. In addition, we believe that recognition of the rise of this phenomenon by the Commission in the context of the beneficial ownership reporting rules is vital if such rules are to serve their intended purposes.

As a result of these developments, the current definition of beneficial ownership does not account for the realities of how derivatives and other synthetic instruments and ownership strategies are used today in complex trading strategies. To address this issue, the definition of beneficial ownership for Section 13 reporting purposes should encompass ownership of any derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of the subject security.[32] Derivative instruments should include, subject to certain exceptions, any instrument or right "with an exercise or conversion privilege or a settlement payment or mechanism at a price related to an equity security or similar instrument with a value derived in whole or in part from the value of an equity security, whether or not such instrument or right shall be subject to settlement in the underlying security or otherwise."[33] In addition, it should be made explicitly clear that the definition encompasses ownership of short positions in a security, as such positions have the same potential as long positions to influence the trading of the subject security.

Each of these types of derivative transactions permits an acquiror to exercise the type of market control in the relevant security, and potentially to exert the type of influence over the issuer, that the Section 13(d) reporting obligations are designed to address, yet are currently conducted outside of the disclosure regime. This deprives the market, and other investors, of valuable information that might influence their trading behavior if it were made accessible. Even in the absence of voting or dispositive power, participants in large hedging transactions gain influence in a number of ways. The shares subject to the hedge may be eliminated from the universe of voting shares entirely, depending on the terms of the transaction. In other situations, voting of the shares may be subject to counterparty influence or control, either directly or because the counterparty is motivated to vote the hedged shares in a way that will please the investor and induce them to continue to transact with such counterparty. Net short positions further create price pressure both through the influence of the short sales themselves, and also due to the need for their counterparties in such transactions to purchase shares to meet their potential obligations. Even those derivatives that are characterized as "cash-settled" may ultimately be settled in kind, creating further market pressure as the participants need to acquire shares for such settlement.

Derivatives are increasingly being employed to accumulate "empty voting" positions in an issuer's stock or to accumulate large stakes prior to making any Section 13(d) disclosures,

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Derivatives Create Unforeseen Dangers (2008), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.15268.08.pdf.

[32] See "A Modest Proposal" at 3. We note that we do not currently believe that equivalent changes are required or advisable with respect to the definition of "beneficial ownership" with respect to Section 16 of the Exchange Act and the rules promulgated thereunder, which we do not believe present the same risk of abuse as the Section 13 reporting rules.

[33] See "A Modest Proposal" at 3.

such as in the CSX proxy contest,[34] the Jana/CNET situation[35] and, more recently, J.C. Penney and Fortune Brands as described above. These illustrate the need for these reforms, but are only a fraction of the instances where the revised rules would have the impact of compelling much-needed material disclosure.

We do not believe that enacting these changes to the definition of beneficial ownership would create undue confusion or burden on reporting investors, a belief we base in large part on the fact that similar changes have been adopted in a number of other jurisdictions (including the United Kingdom,[36] Germany,[37] Switzerland,[38] Australia[39] and Hong Kong,[40] each of which use a broadened definition of beneficial ownership encompassing a range of derivative mechanisms). The shift to a broad, modernized definition of beneficial ownership in these jurisdictions and elsewhere both demonstrates that it is a workable construct and, we believe, compels the Commission to enact related reforms, lest the United States markets continue to remain more susceptible to manipulative maneuvers than other nations with similarly developed financial markets.

In addition to clarifying the Commission's authority to act, the Dodd-Frank Act creates added urgency for rulemaking with respect to Section 13 reporting. Section 766(e) of the Dodd-Frank Act, discussing security-based swaps,[41] arguably will reverse, and certainly creates confusion with respect to, currently settled rules and practice with respect to derivatives and beneficial ownership absent Commission action. Section 766(e) provides that ownership of security-based swaps constitutes ownership of the underlying security <u>only</u> to the extent that the Commission deems it so by rule.[42] In the absence of prompt action by the Commission in advance of this provision's July 2011 effective date, even the protections currently in place with respect to the treatment of derivatives for beneficial ownership purposes could be lost. This would be an unwarranted and harmful step in the wrong direction. It is imperative that the Commission act to prevent this occurrence, and take action to address the other significant gaps in the reporting rules discussed herein.

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[34] *CSX Corp.* v. *Children's Inv. Fund Mgmt. (UK) LLP, et al*, 562 F. Supp.2d 511 (S.D.N.Y. June 11, 2008), *affirmed without opinion* by *CSX Corp.* v. *Children's Inv. Fund. Mgmt. (UK) LLP, et al.,* .292 Fed. Appx. 133 (2d Cir. 2008).

[35] See, *e.g.*, Andrew Ross Sorkin, Dealbook, What is Jana Doing?, N.Y. Times (Feb. 7, 2008).

[36] See Chapter 5 of the Financial Services Authority's Disclosure Rules and Transparency Rules.

[37] See Part 4 of the German Securities Trading Act. A bill further expanding the universe of derivatives captured by German disclosure requirements (including, for example, cash-settled options) has passed the Bundestag (the lower house of German Parliament), and has been referred to the Bundesrat (the upper house) for an additional required approval. See *Gesetz zur Starkung des Anlegerschutzes und Verbesserung der Funktionsfahigkeit des Kapitalmarkts* (*Anlegerschutz-und Funktionsverbesserungsgesetz*) (Feb. 11, 2011), available at http://www.bundesrat.de/cln_161/nn_8694/SharedDocs/Drucksachen/2011/0101-200/101-11,templateId=raw,property=publicationFile.pdf/101-11.pdf).

[38] See Article 20 of the Federal Act on Stock Exchange and Securities Trading in Switzerland.

[39] See The Australian Takeover Panels Guidance Note 20.

[40] See Part XV of the Securities and Futures Ordinance.

[41] Dodd-Frank Act §766(e).

[42] Id.

Remedies

Even if our recommended amendments were to be adopted, the risk that the Section 13 reporting rules will continue to be disregarded or manipulated by sophisticated investors would remain high unless appropriate remedies are made available to issuers and investors. Currently, there is no clear path for an issuer facing flagrant reporting violations by an investor to obtain relief or protection for its stockholders. The CSX Corporation proxy contest provides a stark example of this state of affairs. After finding that an activist investor had intentionally used derivative instruments "as part of a plan or scheme to evade the reporting requirements of Section 13(d)" in connection with substantial share acquisitions in advance of a proxy contest[43], a federal court concluded that existing law did not permit it to enjoin the investor from voting its shares, despite a statement by the court that it would otherwise grant such relief.[44] The lack of an effective remedy even in such extreme situations will encourage certain investors to flout the rules, whether or not they are updated. We recommend that, in connection with the amendments described herein, the Commission undertake a study of enhanced remedies for violations of the Section 13 reporting rules.

Conclusion

Investor confidence in our financial markets depends in large part on the kind of transparency that the Section 13 reporting rules are designed to, and should, provide with respect to the acquisition of potential control positions in public companies. We firmly believe that closing the ten-day window and adapting the definition of beneficial ownership to fully address the reality of the way securities are currently traded is both workable and integral to the future proper functioning of the United States securities markets, and urge the Commission to undertake these reforms promptly.

Please feel free to contact Theodore N. Mirvis, Andrew R. Brownstein, Eric S. Robinson, Adam O. Emmerich, David M. Silk, Trevor S. Norwitz, David C. Karp or William Savitt at 212-403-1000 to discuss any of these matters in more detail.

Very truly yours,

Wachtell, Lipton, Rosen & Katz

cc: Meredith Cross
Michele Anderson

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[43] *CSX* at 548 (S.D.N.Y. 2008).

[44] Id. at 573-74.

The Harvard Law School Forum on Corporate Governance and Financial Regulation

Should the SEC Tighten its 13(d) Rules?

Posted by Lucian Bebchuk, Harvard Law School, and Robert J. Jackson, Jr., Columbia Law School, on Wednesday June 27, 2012

Editor's Note: Lucian Bebchuk is Professor of Law, Economics, and Finance at Harvard Law School. Robert J. Jackson, Jr. is Associate Professor of Law at Columbia Law School.

The upcoming issue of the *Harvard Business Law Review* will feature our article The Law and Economics of Blockholder Disclosure. The article is available here, and PowerPoint slides describing the paper's main points are available here.

The Securities and Exchange Commission is currently considering a rulemaking petition submitted by Wachtell, Lipton, Rosen & Katz (available here) that advocates tightening the rules under the Williams Act and, in particular, reducing the amount of time before the owner of 5% or more of a public company's stock must disclose that position from ten days to one day. Our article explains why the SEC should not view the proposed tightening as a merely "technical" change necessary to meet the objectives of the Williams Act or modernize the SEC's regulations. The drafters of the Williams Act made a conscious choice not to impose an inflexible 5% cap on pre-disclosure accumulations of stock to avoid deterring investors from accumulating large blocks of shares. We argue that the proposed changes to the SEC's rules require a policy analysis that should be carried out in the larger context of the optimal balance of power between incumbent directors and these blockholders.

We discuss the beneficial role that outside blockholders play in corporate governance, and the adverse effect that any tightening of the Williams Act's disclosure thresholds can be expected to have on such blockholders. We explain that there is currently no evidence that trading patterns and technologies have changed in ways that would make it desirable to tighten these disclosure thresholds. Furthermore, since the passage of the Williams Act, the rules governing the balance of power between incumbents and outside blockholders have already moved significantly in favor of the former—both in absolute terms and in comparison to other jurisdictions—rather than the latter.

Our analysis provides a framework for the comprehensive examination of the rules governing outside blockholders that the SEC should pursue. In the meantime, we argue, the SEC should not

adopt new rules that would tighten the disclosure rules that apply to blockholders. Existing research and available empirical evidence provide no basis for concluding that the proposed tightening would protect investors and promote efficiency. Indeed, there is a good basis for concern that such tightening would harm investors and undermine efficiency.

Below is a more detailed account of the analysis in our article:

Our article begins by explaining why policy analysis weighing the advantages and disadvantages of tightening these rules is needed before the SEC proceeds with the proposed tightening. It might be argued that more prompt disclosure is unambiguously desirable under principles of market transparency and was the clear objective of the Williams Act, which first established these rules by adding Section 13(d) to the Securities Exchange Act in 1968. Thus, at first glance one might conclude that the SEC should tighten the rules without consideration of the costs and benefits of doing so. Unlike ordinary disclosure rules that require insiders to provide information to investors, however, the Williams Act imposed an exception to the general rule that outside investors in public-company stock are entitled to remain anonymous. Moreover, tightening is not needed to achieve the objectives of the Williams Act: The drafters of the Act made a conscious choice not to impose a hard 5% limit on pre-disclosure accumulations of shares, instead striking a balance between the costs and benefits of disclosure to avoid excessive deterrence of the accumulation of these outside blocks. Thus, in deciding whether to tighten the rules in this area, the SEC should be guided by the general requirement that any costs associated with changes to its rules should be outweighed by benefits for investors rather than general intuitions about the desirability of transparency.

The second part of our article therefore proceeds to provide a framework for the policy analysis that the SEC should conduct. We begin by considering the costs of tightening the rules on blockholders. We begin by explaining that certain benefits of blockholders for corporate governance may be reduced or lost if these rules are tightened. We review the significant empirical evidence indicating that the accumulation and holding of outside blocks makes incumbent directors and managers more accountable, thereby reducing agency costs and managerial slack. Tightening the disclosure requirements for blockholders, we argue, can be expected to reduce the returns to blockholders and thereby reduce the incidence and size of outside blocks as well as blockholders' investments in monitoring and engagement—which, in turn, could result in increased agency costs and managerial slack.

The third part of our article considers the asserted benefits of tightening the rules that are described in the petition. We explain that there is no empirical evidence to support the petition's

contention that tightening these rules is needed to protect investors from the risk that outside blockholders will capture a control premium at the expense of other shareholders.

The final part of the article considers whether the proposed tightening is justified by changes in trading practices, changes in legal rules in the United States, or changes in legal rules in other jurisdictions that have occurred since the passage of Section 13(d). We first explain that there is no systematic empirical evidence supporting the suggestion that investors can now acquire large blocks of stock more quickly than they could when Section 13(d) was first enacted. We then show that changes in the legal landscape since that time, and particularly the emergence of the poison pill, have tilted the balance of power between incumbents and blockholders against the latter—and therefore counsel against tightening the rules in a way that would further disadvantage blockholders. We also explain why comparative analysis of the regulation of blockholders in other jurisdictions does not justify tightening the rules governing blockholders in the United States.

We conclude by recommending that the SEC pursue a comprehensive examination of the rules in this area along the lines we put forward. Such an examination should include an investigation of the empirical questions we identify. In the meantime, however, existing research and empirical evidence offer no basis for tightening the disclosure obligations of outside blockholders.

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Activist Hedge Funds Find Ways to Profit from M&A Transactions

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday June 4, 2014

Editor's Note: The following post comes to us from Spencer D. Klein, partner in the Corporate Department and co-chair of the global Mergers & Acquisitions Group at Morrison & Foerster LLP, and is based on a Morrison & Foerster publication by Mr. Klein, Enrico Granata, and Isaac Young; the complete publication, including footnotes, is available here.

Activist hedge funds continue to find ways to use public M&A transactions as a tool to generate returns for their investors. As a result, market participants need to consider potential activist strategies in determining how to structure, announce and execute their deals.

Activists have used three principal strategies to extract additional value from public M&A transactions. The first strategy involves directly challenging the announced deal in an effort to extract a higher price, defeat the merger and/or pursue an alternative transaction or stand-alone strategy. The second strategy involves attempting to use statutory appraisal rights to create value for the activist. And the third strategy involves making an unsolicited offer to acquire a target, either independently or in conjunction with a strategic acquirer, to put the target in play. In this article, we discuss examples of recent uses of these strategies by activist investors and point out some general implications of these examples for transaction planners.

Strategy One: Challenging an Announced Deal

One strategy that has been employed by activist hedge funds has been to acquire stock in a public merger target shortly after the transaction has been announced, announce opposition to the transaction and seek to encourage other stockholders to also oppose the transaction, support an alternative transaction proposed by the activist or pressure the acquirer to restructure the transaction and/or offer additional consideration to the stockholders of the target.

Two examples of public transactions in which activist opposition resulted in a change of deal terms are described below:

Dell/Carl Icahn. The most highly publicized recent use of this strategy was Carl Icahn's opposition to the buyout (the "Dell Transaction") of public stockholders of Dell, Inc. ("Dell") by Dell founder, CEO and 16% stockholder Michael Dell and private equity sponsor Silver Lake Partners (the "Silver Lake Group"). Shortly after the Dell Transaction was announced in February 2013, funds affiliated with Icahn announced that they had accumulated a substantial stake in Dell. Icahn and his affiliates joined together with institutional stockholder Southeastern Asset Management and waged a fight to defeat the transaction, in which Icahn engaged in a campaign of letters, press releases, interviews and social media posts attacking the announced transaction.

Icahn filed proxy solicitations opposing the transaction, nominated a slate of directors to replace Dell's Board and proposed no fewer than three alternative transactions. Notably, Icahn attacked both Michael Dell and the Board of Directors of Dell as part of his campaign. Icahn argued that Michael Dell was hurting Dell and showed little regard for the interests of Dell's other stockholders, pointing to the decline in Dell's stock price since Michael Dell was reappointed CEO in 2007. Icahn and Southeastern also accused the Board of Directors of Dell of painting a dark picture of Dell's prospects to "frighten stockholders into selling Dell to Michael Dell and Silver Lake" and threatened "years of litigation" against directors for breaches of fiduciary duty in connection with the transaction.

The Dell Transaction was ultimately approved by the stockholders of Dell and was consummated in October 2013 after the Silver Lake Group agreed to increase the consideration payable to stockholders not affiliated with the Silver Lake Group by $350 million.

MetroPCS Communication/John Paulson/Peter Schoenfeld. Another example of this strategy was John Paulson's and Peter Schoenfeld's campaign against T-Mobile USA's ("T-Mobile") acquisition of MetroPCS Communication ("MetroPCS") in a stock-for-stock merger (the "MetroPCS Transaction"). Paulson & Co., Inc. ("Paulson"), one of MetroPCS's largest stockholders, increased its stake in MetroPCS to 9.9% after the announcement of the transaction in late 2012. Together with P. Schoenfeld Asset Management ("PSAM"), which owned approximately 2% of the stock in MetroPCS, Paulson publicly opposed the MetroPCS Transaction.

Paulson and PSAM released a series of letters to public stockholders of MetroPCS and the Board of Directors of MetroPCS criticizing the amount of financial leverage that the combined company would bear through $15 billion in senior debt that would be owed to T-Mobile's parent company, Deutsche Telekom AG, and arguing that this debt would put the combined company at a disadvantage when competing against industry peers. In addition, PSAM released a white paper criticizing the MetroPCS Transaction terms as "grossly unfair to the [MetroPCS] shareholders"

and “unfairly favoring Deutsche Telekom” in its capacity as senior creditor and controlling stockholder of the combined entity, which PSAM called a “serious conflict of interest” and violation of “good corporate governance” norms. PSAM filed a proxy statement soliciting the proxies of MetroPCS stockholders to vote against the transaction and proposed that MetroPCS remain a stand-alone company.

After proxy advisory firms Institutional Shareholder Services and Glass Lewis & Co. recommended that stockholders of MetroPCS vote against the deal, MetroPCS and Deutsche Telekom agreed to revise the terms of the transaction to reduce the principal amount of debt to be issued by the combined company to Deutsche Telekom at closing by $3.8 billion, reduce the interest rate on this debt by 50 basis points and make certain other changes to the terms of the transaction. In response to these changes, Paulson and PSAM dropped their opposition and the MetroPCS Transaction was consummated in May 2013.

The following examples show the variety of tactics that have been used by activists to oppose an announced transaction:

- ***Publicly Criticizing the Transaction***. Activists will make arguments against the transaction publicly, repeatedly and in manners calculated to generate widespread attention. Icahn, Paulson and PSAM made public arguments against the relevant transactions by sending letters to the Board of Directors and stockholders of the target, issuing press releases and using websites and social media services like Twitter to oppose the announced transaction and argue that the announced transaction was unfair to the stockholders of the target.
- ***Soliciting Proxies Opposing the Transaction***. Activists may seek to solicit proxies from other investors to block the transaction or put pressure on the target’s Board. Icahn and PSAM each filed proxy statements with the SEC seeking to solicit proxies to vote against the transaction. Icahn also nominated slates of directors to replace the directors who supported the transaction.
- ***Lobbying Institutional Stockholders and Proxy Advisors***. Activists will often lobby large institutional stockholders of the target and proxy advisory firms like Institutional Shareholder Services to oppose the transaction. In the MetroPCS Transaction, the opposition of proxy advisory firms appeared to tip stockholder opinion against the transaction and force the transaction participants to modify the terms of the deal.
- ***Proposing Alternative Transaction(s)***. Activists may propose alternative transactions, such as recapitalization transactions or an alternative acquisition by the activist and its allies. Icahn and his allies proposed both of these alternative transactions, as well as a self-tender offer by Dell, in their campaign of opposition to the Dell Transaction.

- ***Attacking the Acquirer and the Target's Board and Management***. Activists may accuse the acquirer and the target's Board of Directors and management team of self-dealing, fecklessness and/or incompetency in connection with the transaction and, in the case of the target's Board of Directors and the management team, the management of the target more generally.

From an organizer's perspective, attacks by activist investors like Icahn and Paulson increase the risk that transactions will not be completed or that the transaction will need to be restructured. Attacks by activists can also be embarrassing to managers and directors and make them "gun-shy" about transactions. Further, even if the transaction is approved as announced, transaction participants face additional fees to legal and financial advisors and time and costs relating to responding to activist attacks and lobbying stockholders and proxy advisory services to support the transaction. These costs can detract from the resources that transaction participants can devote to closing the transaction and addressing post-closing matters.

Strategy Two: Obtain Appraisal of Shares in Target

A second strategy used by activist investors to extract value from public M&A transactions is to acquire shares in a public merger target with the intent to exercise statutory appraisal rights after the transaction closes.

Statutory appraisal rights are the rights of a dissenting stockholder to seek "fair value" for its stock in a merger target in lieu of accepting the price offered to stockholders of the target under a merger agreement. Generally speaking, the dissenting stockholder must typically vote against the merger or abstain from voting, and then initiate litigation in which the stockholder asks a court to determine the value of the stockholder's stock. However, the stockholder may purchase the stock of the target and perfect its claim for appraisal at any time prior to the date of the relevant stockholder meeting as long as certain technical requirements are met, allowing investors to "buy into" an appraisal claim after the transaction has been announced.

Broadly speaking, analysts have noted an increase in the number of appraisal actions in connection with public merger transactions. Appraisal claims having a value of $1.5 billion were brought in 2013, a 10-fold increase from 2004. Further, 23 appraisal claims were filed in Delaware in 2013, and, as of mid-March, 20 have already been filed in 2014.

Driving this increase in appraisal claims are potential returns to dissenting stockholders. In Delaware, the court in an appraisal proceeding must determine the value of the company on a going concern basis as of the date of the merger vote. Historical analyses of decisions by

Delaware courts have found that appraisal litigation often results in courts awarding dissenting stockholders a fair value for stock in excess of the merger price paid. In addition, Delaware statutes entitle the dissenting stockholder to statutory interest on the fair value of the stock equal to the Federal Reserve discount rate plus 5% and compounded quarterly, a rate that may be attractive to investors in the current low interest rate environment.

Below are some examples of the use of appraisal rights by hedge funds in connection with recent transactions:

Dole Food Co./Merion Investment Management. One recent, publicized instance in which an activist hedge fund sought appraisal rights in lieu of accepting the merger consideration was the 2013 buyout of Dole Food Co. ("Dole") by its CEO David Murdock (the "Dole Transaction"). In the Dole Transaction, Murdock purchased the 61.3% of the stock in Dole he did not own for $13.50 per share, an amount below the price that analysts ascribed to the company's stock. Only 50.9% of the company's public stockholders voted in favor of the merger. A few days before the merger vote on the Dole Transaction, hedge fund Merion Investment Management LP ("Merion") announced its ownership of 8.3% of the outstanding stock of Dole. Merion and other investors, which collectively owned 14 million shares of Dole, exercised their appraisal rights and sought valuation of their shares by Delaware courts in lieu of the $13.50 per share merger price.

Dell/Carl Icahn. In the Dell Transaction, Carl Icahn gave notice that he would seek appraisal of his stock in Dell. Icahn also issued press statements urging other stockholders to seek appraisal. Icahn ultimately decided not to seek appraisal for his stock in Dell; however, more than 100 other investors representing 47.5 million shares of Dell are reportedly seeking appraisal of their shares in lieu of accepting the $13.75 per share consideration ultimately offered to stockholders. Among the major investors seeking appraisal for their shares are T. Rowe Price Group Inc., as well as hedge funds Magnetar Capital and Loeb King Capital Management.

Appraisal demands can represent a significant challenge for transaction participants. A determination by a court that the fair value of stock exceeds the merger consideration and the high statutory interest will increase the total amount of consideration payable by the acquirer to target stockholders. Uncertainty as to the amount of consideration payable can complicate an acquirer's efforts to arrange financing for the acquisition. In addition, appraisal demands also impose costs on the acquirer in time and legal fees relating to the litigation.

Strategy Three: Initiate Transactions through Unsolicited Offers

A third strategy that activist hedge funds have used is making unsolicited acquisition proposals themselves for publicly traded companies in order to put the companies into play.

Historically, it was perceived that activist hedge funds were generally uninterested in actually taking over a public company. Rather, the activist's intention was to make an offer to purchase the target to put the target "in play" and then sell into an offer made by a strategic acquirer paying a higher price than the price offered by the activist. Such bids would fail if the intentions of the activist were transparent and the activist failed to convince the target or its stockholders to take its bid seriously.

An example of this approach was Carl Icahn's 2011 offer to acquire Clorox. Icahn purchased approximately 9.37% of the shares in Clorox during late 2010 and 2011. Icahn then made an offer to acquire the remaining shares of the company for $10.2 billion; however, the offer was subject to significant conditionality. At the same time, Icahn sent a letter to the CEO of Clorox "strongly suggesting" that Clorox "aggressively pursue a transaction with a strategic buyer, which should attract a higher price" because of the possible synergies with a strategic acquirer. Clorox rejected Icahn's offer as "inadequate and … unlikely to be completed." Icahn raised his offer to $10.7 billion but ultimately withdrew his offer and his efforts to initiate a sale, acknowledging that he could not persuade major Clorox stockholders to support his plan.

Icahn is notable for having put a number of companies in which he owned shares into play by announcing unsolicited offers. A 2011 analysis indicated that Icahn had made 15 prior unsolicited offers to buy companies during the period between 1996 and July 2011 and that none of these offers had resulted in an acquisition by Icahn.

On the other hand, a newer, more credible model of activist hedge fund-driven unsolicited offers may be emerging in connection with the proposed acquisition of pharmaceutical manufacturer Allergan, Inc. by activist investor William Ackman's Pershing Square Capital Management and acquisitive pharmaceutical company Valeant Pharmaceuticals International, Inc.

Pershing Square Capital and Valeant announced in April 2014 that they had created a jointly funded joint venture entity to acquire Allergan and that the joint venture entity had purchased stock, options and forward contracts giving it (and Pershing Square Capital and Valeant) beneficial ownership of 9.7% of the outstanding shares of Allergan. Then, in late April, Valeant publicly presented an offer to acquire Allergan for $45.7 billion in cash and Valeant stock in a merger that was not subject to a financing condition, stating that it was making the offer publicly after Allergan had rejected Valeant's private efforts to initiate negotiations for 18 months.

Allergan adopted a stockholder rights plan at the time Pershing Square Capital and Valeant's proposal was disclosed and formally rejected Pershing Square Capital and Valeant's proposal in mid-May without engaging in formal discussions. The co-bidders have indicated that they would

raise their offer to show their commitment to completing a transaction. They have also stated that they would seek to replace some or all of Allergan's directors.

Although the outcome of Pershing Square Capital and Valeant's joint bid for Allergan remains in doubt, it is becoming clear that, together, an activist hedge fund like Pershing Square Capital and a strategic acquirer like Valeant have certain advantages that each lack if pursuing an unsolicited bid on its own:

- ***Ability to Quickly Build an Initial Stake***. An activist hedge fund like Pershing Square Capital is able to build a position in the target company quickly before being required to disclose its position publicly and can use a variety of derivatives and other financial instruments to amass the position with a minimal initial outlay of capital. Because the core business of hedge funds is trading in securities, a hedge fund does not face the same financial and reputational costs in selling this "toehold" as a strategic acquirer would face if the bid fails.
- ***Higher Bids***. Synergies between a strategic acquirer's business and the target's business can allow the bidders to offer a higher valuation of the target and higher bids than an activist hedge fund could offer alone. Indeed, Pershing Square Capital and Valeant have touted the synergies between Allergan's and Valeant's respective businesses as reasons to support their joint bid for Allergan.
- ***Public Relations***. Activist hedge funds are well versed in techniques such as investor presentations, letters to management and threats of a proxy contest that can be used to pressure a reluctant target into accepting an unsolicited offer, while strategic acquirers may be less adept with these tools.
- ***Credibility***. The involvement of a strategic acquirer may make the offer more credible to target stockholders and to potential financing sources than an offer from the activist hedge fund alone.

The advantages that an activist/strategic joint bid brings to an unsolicited acquisition proposal are also relevant to participants in an announced transaction, who may face increased risk of "deal jumping" by activist/strategic teams of rival bidders. In particular, the speed with which an activist hedge fund can build a stake in a target means that the team can quickly acquire a toehold position from which the joint bidders can make a topping bid. At the same time, the presence of a strategic acquirer and the potential synergies with the target can increase the potential consideration that can be offered to public stockholders of the target. Higher deal prices make it easier for potential topping bidders to argue that the topping bid is a superior proposal to the existing transaction and that the target's Board of Directors is compelled by its fiduciary duties to terminate the existing transaction and accept the topping bid.

Nevertheless, it is unclear how many activist/strategic joint bids will be seen in the future. Arrangements such as those between Pershing Square Capital and Valeant are complex and potentially difficult to negotiate, and financing obtained from hedge funds would likely be more costly to strategic acquirers than financing obtained from conventional sources. In addition, some strategic acquirers may worry about reputational consequences stemming from association with activist hedge funds and may be reticent to allow an aggressive activist the benefit of information and access that would be required.

Conclusion

The following are some general lessons that transaction participants can take from the trends and examples discussed above:

Be Prepared for Activism and Appraisal Demands. Participants in high-profile transactions should assume that the transaction will draw meaningful interest from activist investors, although this interest may fall short of a full-fledged attack. Following the announcement of the transaction, the acquirer and the target should be prepared to work with their legal and financial advisors to monitor the market, respond to activist statements quickly and make the case for the business logic and fairness of the proposed transaction to the institutional investors, the proxy advisory services and the broader market.

Similarly, transaction participants should assume that there may be some number of demands for appraisal by stockholders. Accordingly, transaction participants should seek to account for appraisal demands in the pricing and terms of the transaction and allocation of legal resources for transaction-related litigation.

Monitor Strategic Acquirer Who May Team with Activists. Participants in transactions should also consider whether there are any potential strategic acquirers who might team with an activist hedge fund to make a topping bid and monitor the actions of these potential acquirers. Particular attention should be paid to any potential strategic acquirer who has expressed sustained interest in engaging in a transaction with the target in the past.

Structure the Transaction Carefully to Minimize the Leverage of Activist Investors. Participants in transactions should note that certain transaction structures may increase the leverage of activist investors.

For example, the merger agreement between Dell and the Silver Lake Group made the transaction subject to the condition that holders of a majority of the outstanding shares of Dell not affiliated with the Silver Lake Group vote to approve the merger. The majority-of-the-minority

voting condition gave leverage to Icahn and Southeastern, who collectively owned 12.8% of Dell's common stock, and could thus vote a disproportionately large portion of the unaffiliated stock of Dell against the Dell Transaction.

Transaction participants should weigh the utility of such structures against the risk that such structures may empower activists who are seeking to extract value from the transaction or force its abandonment.

Be Sensitive to Charges of Self-Dealing. Activist attacks and demands for appraisal rights may be particularly frequent and acute in take-private transactions such as the Dell Transaction and the Dole Transaction. Participants in such transactions should anticipate accusations of self-dealing by activists when pricing and structuring the transaction.

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Shareholder Activism in M&A— Checklists … and The Future

Shareholder activism is perhaps the most important M&A development of the past decade. The number of activists, the amount of capital they have at their disposal, the range of their targets, the scope of their activities and tactics, and the success of their efforts all continue to expand significantly. While they were initially derided as 1980s-style corporate raiders and excoriated for self-interested agendas at the expense of companies' long-term growth prospects, shareholder activists today are often admired for their tenacity and success in forcing change in corporate boardrooms and enhancing shareholder value.

Now a persistent force in corporate America, activists continue to seek new areas and creative methods of influence. Having initially focused on changing corporate governance and then on influencing business structure and strategy, activists now have emerged as significant players in the M&A arena. Corporate boards must be prepared to respond to possible activist challenges to planned M&A transactions, as well as possible M&A transactions instigated or proposed by activists themselves.

1. Shareholder Activism in M&A-- Preparation & Response

- **General advance planning**. To be ready for a possible future challenge of any type (whether or not M&A-related) from a shareholder activist, a board should:

  - **Ensure good general board process and practices.** As a general matter, the board and management should be engaged in a functioning process that is focused on the shareholders' best interests. In this regard, the directors and management should engage in a balanced dialogue about the company's business plan and strategic direction, analyzing benefits and risks, as well as possible alternatives. Information flow to the board-- with directors taking the time for review, questions and reflection, in an open board environment that promotes healthy skepticism and constructive criticism-- is the critical foundation for the exercise of business judgment.

  - **Know the company.** The board obviously must understand the company, its peer group and its industry, including emerging issues and strategic direction. The directors must understand the metrics of the company and must focus on any unusual or unexpected developments-- including for example, sudden changes (up or down) in operating or financial results or stock performance; potential compliance, accounting, reporting, litigation or contingent liability issues; employee hotline calls or social media attention; and so on.

  - **Know shareholders' concerns and ensure the effectiveness of the company's communications and public relations programs.** The perception and assessment of the company by its shareholders and the financial community generally are critical factors in the board's ability to achieve the best results for shareholders, as well as to anticipate and respond to challenges from activists. Effective outreach to and ongoing communication with the company's

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major shareholders (as well as the investment community at large) is critical. The company should know and understand the concerns of these constituencies, both generally and with respect to the company specifically. It is important that the company has a consistent, reasoned and compelling story to tell about its present and its future, and that it is effectively communicated at every opportunity.

- **Review potential vulnerabilities.** The board should be vigilant in reviewing its general business and strategy and should identify those areas that might be of particular concern to investors (whether because of historical problems or difficulties that have developed in an area; areas that have attracted attention at other companies or in the industry generally; or areas that are problematic due to factors unique to the company). The company should be proactive in identifying and addressing shortcomings and vulnerabilities, including substantive responses to ameliorate issues, as well as effective communications strategies to preempt or respond to investor dissatisfaction. The company should try to anticipate what areas of vulnerability it may have in terms of attracting an activist challenge-- such as, having real estate that could be monetized; holding a large amount of cash that could be returned to shareholders; owning underperforming or unrelated business units that could be sold or spun-off; or underperforming peer companies in terms of financial results or stock performance. Certain governance issues also attract activists' attention, including executive compensation that is higher than average or not sufficiently related to performance; lack of board turnover or expertise; related party transactions; and corporate governance that is not on par with best practices or is disfavored by activists. The board should have ready explanations for its decisions in these areas that may be likely to be questioned.

- **Monitor interest in the company and changes in the shareholder base.** It is important that the board be aware of the investment community's views about the company-- including shareholders, proxy advisory firms, analysts and activist groups. The board also should monitor activist challenges and proxy advisory concerns at other companies in its industry to develop sensitivity to the types of issues and events that are likely to attract the attention of activists. The board should understand the composition of the company's shareholder base and monitor changes on a regular basis. Special attention should be paid to activists, hedge funds and institutional investors, particularly those that are known to act together. The company and its advisors should be proactive in identifying and monitoring any rumors about the company.

- **Monitor activity in the company's stock and options.** It is critical that programs be in place to monitor activity in the company's stock and options. The programs should be designed to reveal at the earliest possible time a possible "secret" market accumulation of the company's stock or options or general buying by activists.

- **Assemble a team.** A small team that can effectively prepare for and respond to an activist challenge should be identified prior to any approach by an activist. The team should include senior officers of the company (including the General Counsel), as well as the company's outside legal counsel, investment banker, proxy solicitor and public relations firm. On an ongoing basis, the team should be responsible for, and know the results of, many of the action items listed above, and should keep the board informed as appropriate. The team should ensure that the board and management are instructed that any approach by or relating to possible activist interest in the company should be referred to a designated person (generally, the CEO or General Counsel). The team must be aware of the company's defensive posture-- that is,

whether it has a classified board; has an advance notice bylaw; is incorporated in Delaware or a state with more target-friendly provisions, such as Pennsylvania, Virginia or Ohio; and so on.

- **Advance planning with respect to an M&A transaction**. In addition to the foregoing, in the context of a proposed extraordinary transaction, a board should:

  - **Consider the vulnerabilities of the transaction.** The board should identify and be prepared to defend any aspects of the transaction that are likely to attract challenge. Of course, transactions that are "interested" (such as those involving a controlling shareholder, management participation, or conflicts of interest at the board or management levels) will be likely to attract challenges.

  - **Consider structuring the transaction to increase the likelihood of shareholder approval.** Most fundamentally, a pristine process, with a meaningful market check and effective minority shareholder protections, and a well functioning board with effective investment bankers and legal counsel, will increase the likelihood of obtaining required shareholder approval of a transaction. (For process guidelines for boards, bankers and controllers, *see here* our Memorandum, "Thoughts on the Most Recent Delaware Decisions: Part II – GUIDELINES for Controlling Shareholders, Special Committees and Investment Bankers".)

    Also, certain deal terms can affect a transaction's vulnerability to challenge. Crafting the deal terms involves a careful and nuanced analysis of the facts and circumstances. For example, conditioning a transaction on approval by the minority shareholders based on a majority of all *outstanding shares*-- rather than a majority of the *votes cast*-- can be an effective minority shareholder protection, but also can jeopardize the shareholder vote if shareholders are encouraged to seek appraisal rights or otherwise not to vote for the transaction (as every vote not voted "for" will in effect be counted as "against" in this scenario, making it difficult to obtain the required vote for the transaction). Another example is that conditioning a transaction on not more than a specified percentage of shares seeking appraisal rights may affect the likelihood of obtaining the required shareholder vote. (For a discussion of the effect of voting terms on activist Carl Icahn's challenge to the Dell management buyout and a discussion of appraisal rights conditions, *see here* our Memorandum, "Appraisal Arbitrage—A New Activist Weapon".)

  - **Consider the company's takeover defensive posture.** The board should consider all possible types of attacks by activists in response to a transaction, including a possible unsolicited bid for the company by activists or by bidders supported by activists. The board should consider the company's defensive readiness for such an attack.

  - **Redouble efforts in all other planning areas.** In the context of an extraordinary transaction, efforts with respect to each of the advance planning guidelines set forth above should be redoubled. Thus, for example, a team dedicated to responding to activist challenges should be in place and fully prepared to act; monitoring of activity in stock and options is critical (including while the transaction is being planned and considered); the company's communications and public relations programs with respect to the transaction must be well developed and implemented; and so forth.

- **Response to an activist's approach or public challenge.** Here, a checklist approach is inapposite. Once a company has been approached by an activist with respect to an M&A transaction, the

response will depend on a nuanced assessment of all the facts and circumstances at the time by the board, management and the company's outside advisors.

The critical factors and decisions will be:

- whether the activist has made a private approach or a public challenge-- however, the board should assume that even a private approach will have a high potential for becoming a public challenge; and
- whether, when and how to engage in discussions or negotiations with the activist.

The guiding principles must be:

- coordinating all action through the dedicated team;
- maintaining the company's credibility in the face of pressure (and, often, aggressive attacks) from the activist;
- communicating a compelling rationale for a transaction under attack and a consistent and effective message about the company's long-term strategy for value creation;
- continuing to focus on ensuring the company's strong performance and good reputation; and
- understanding that compromise, not "war", can be a sensible resolution of an activist encounter.

Automatic stonewalling of an activist is no longer the settled course. Depending on the circumstances, acknowledging the activist quickly and constructively may be the best way to proceed. Open communication can serve the company, the shareholders and the activist. The critical inquiry will include: What does the activist have to say? Are the ideas consistent with the objectives of investors in the company generally? What is the activist's history in terms of approach and result? In all events, the objective will be to develop a thoughtful balance in the reaction to an activist challenge-- trying to avoid "war" and its potential for significant distraction of the board and management from the real business of the company (with the attendant expense and unpleasantness); while not capitulating to ideas that are not in the company's interest. Negotiation and compromise should be evaluated as a possibility and, when feasible, may best serve the company.

Questions About the Future of Shareholder Activism in M&A

There is no doubt that the reach of activism is continuing to expand. Activists have more capital available to them, target larger and better performing companies, have had more success, and have targeted a wider array of corporate issues than in the past. Their geographic reach has extended beyond North America to Europe, and now to Latin America and beyond. (*See here* our Memorandum, "Shareholder Activism Spreads Globally".) Activists have *already* changed how corporations act and how deals get done. Announced transactions are often challenged by activists; deals being considered are structured to take into account the possibility of activist involvement; activists are instigating deals that otherwise would not have been considered; deals that might have been proposed may not be so as to avoid attracting activist attention. The *future* of shareholder activism in M&A will depend on a number of considerations.

- **What will activists have to do to remain relevant?** Although today's activists are in many ways a reincarnation of the corporate raiders of the 1980s, they have exerted much effort in portraying

themselves, unlike the raiders, as interested in enhancing value for *all* shareholders and not just in personal profiteering. While activists are criticized by some for having short-term self-interested motives, many activists claim to focus on long-term issues and hold their positions for extended periods of time. Most of the changes they advocate appear to affect all shareholders equally rather than being especially beneficial for the activist. Of course, there are numerous examples of activists acting in clearly or potentially self-interested ways. Will the activists as a group tend to become more focused or less focused on self-interest and short-term gain? Will more influential activists try to impose discipline on others in order to protect the value of the brand of activists generally against behavior that would negate a view that activists have all shareholders interests at heart? As activists expand to the M&A arena, will the greater potential for regulatory and insider trading violations, and the greater scrutiny by regulators, lead to the kinds of problems that contributed to the downfall of the corporate raiders a generation ago?

One trend seen within the last year is the move by activists at nine companies (more than in the six previous years combined) to cause the company to buy back the shares owned by the activist. Reminiscent of the "greenmail" extorted by corporate raiders in the 1980s, these stock buybacks are often combined with an agreement by the activist to resign its board positions, to not acquire more shares, or to vote its remaining shares in favor of the board's nominees for a period of time. Depending on the circumstances, a buyback of shares from an activist may be beneficial to shareholders generally. In fact, most of these buyouts have been at a slight discount to the market price of the stock (albeit a higher price than the activist could obtain if it sold a large stake into the market). However, at least one recent buyback was at a premium to market. Just as the blatant self-interest of "greenmail" led to an outcry by companies and investors against raiders-- and, ultimately, to laws restricting their tactics and making them virtually obsolete (including a 50% federal excise tax on certain greenmail gains)-- a move toward a more self-interested focus by activists may create a backlash against them that could lead to a reduction in their influence.

- **Will the power of proxy firms diminish?** Much of the power of activists, both generally and in M&A specifically, has been derived from the policies and influence of proxy firms. Proxy firms have been directing institutional investors how to vote their shares and most institutional investors have faithfully followed the recommendations. More recently, however, larger institutional investors have begun to analyze M&A (and other) situations on their own, with internal staff and external consultants, reaching their own conclusions about specific situations and not always following their proxy firm's lead. Moreover, there appears to be more of a divergence in the voting recommendations of the major proxy firms (that is, ISS and Glass Lewis) than there has been in the past. Finally, there has been some regulatory movement toward requiring greater oversight of proxy firms by the investment advisors that engage them, including in the area of disclosure of their conflicts of interest when making voting recommendations. All of these may lead to a reduction in the power of proxy firms to unify the response of institutional shareholders to activist campaigns.

- **Will a change in financial liquidity in the market reduce the influence of activists?** It remains to be seen what impact changes in the current very high level of transaction activity, exceptionally low interest rates, and exceptionally high level of financial liquidity will have on the activity and influence of activists. Specifically, to what extent will reductions in the availability of financing and increases in interest rates reduce the funds available to activists to take the number and size of positions that they currently take? Additionally, will increases in interest rates, and the availability to investors of other

investments with higher yields than are available currently, impact the ability of activists to generate the types of above market returns that have resulted in such significant investment in activist funds?

- **Will corporate America take action to try to establish a new paradigm of corporate governance that satisfies the underlying concerns that motivate shareholders to support activists?** The foundation for the rise of activists has been the inherent conflicts that arise in a corporate governance regime such as ours that separates ownership and management of companies. In considering corporate governance issues, will boards have the inclination and ability to move toward a new equilibrium among directors, managers and shareholders that will reestablish more of a commonality of interest among them in ensuring best practice governance that avoids entrenchment and facilitates responsiveness to shareholder interests? (As one example, in the context of consideration of the activist campaign to declassify boards, we have suggested compromise positions, as alternatives to the stark choice of retaining or eliminating traditional classified boards, that could be considered and would preserve the corporate benefits that classified boards offer while guarding against entrenchment and lack of responsiveness to shareholder concerns, including in a takeover situation. *See here* our Memorandum, "A New Approach for Classified Boards: Can the Paradigm Be Changed — to Retain Value-Enhancement While Addressing Director Accountability?")

The activist world continues to grow in size, reach and innovation. Activists challenge and initiate M&A transactions with increasing frequency and success. Many of the more established activists have stunning access to capital and can acquire significant equity stakes in very large companies (as with Bill Ackman's recent acquisition of an almost 10% stake in Allergan for about $4 billion). Other activists act in "wolf packs" and exert further pressure on a target company in support of the initial activist's investment. Presumably, there is no company large enough to be immune from what has become the activists' most successful strategy-- a stealth market accumulation of a significant equity stake followed by a campaign to achieve a specific agenda. If a company is too large for any one activist to acquire a significant stake on its own, one can expect that activists will simply evolve to a model in which they act together from the outset. While the debate continues as to whether activists are boon or bane to corporate America and its shareholders, there is no doubt that this is, and for the forseeable future will remain, the age of the activist-- no less so in M&A than in other spheres.

* * *

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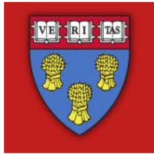
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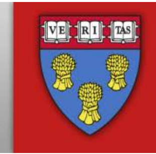

The Allergan Aftermath

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Thursday December 4, 2014

Editor's Note: The following post comes to us from Philip Richter, partner and co-head of the Mergers and Acquisitions Practice at Fried, Frank, Harris, Shriver & Jacobson LLP, and is based on a Fried Frank publication by Mr. Richter, John E. Sorkin, David N. Shine, and Gail Weinstein.

Valeant's failed acquisition bid for Allergan has underscored longstanding M&A principles—even as the involvement of shareholder activists in the M&A arena has introduced new technologies, opportunities, and challenges. In the aftermath of the Allergan saga, it is clear that Pershing Square was richly rewarded for having crafted a novel bidder-activist collaboration model. The outcome for Valeant, however, notwithstanding the creative collaboration, is that its bid ultimately failed, and in the most conventional of ways (losing to a superior offer from an alternative bidder).

The Allergan outcome highlights the benefits of the Valeant-Pershing Square collaboration model to the activist partner, while underscoring the disadvantages of the model for bidders. We expect that the Valeant-Pershing Square model will be followed only under limited circumstances, but that bidder-activist collaborations will continue and evolve, and that other new technologies for bidders, activists, and target companies will emerge.

In this post, we discuss: (i) the broad lessons learned from the Allergan situation; (ii) the circumstances under which we expect that the Valeant-Pershing Square model may be followed by others; (iii) restructuring of the model that may be considered by future bidders and activists; (iv) specific lessons learned for bidders and target companies (the activist appears to need no lesson!); and (v) some new ideas to be considered by bidders, activists, and target companies in their respective quests to deliver shareholder value.

In our view, the broad lessons learned from the Allergan situation are:

- Activists, bidders, and target companies will continue to develop creative M&A technologies as part of their respective efforts to deliver value to shareholders.
- Bidder-activist collaborations, as they continue to evolve, are likely to create profit opportunities for activists and bidders and also to lead to shareholder value.
- Target companies, focused on shareholder value and not on entrenchment, are likely to develop ways to establish a timeframe needed to create shareholder value and mechanisms to ensure that all shareholders participate in the value creation.
- The best result for shareholders—and optimal functioning of our capital market system—requires both that activists have avenues to advance ideas that will deliver value for all stockholders (while protecting shareholders against those that deliver value for the activist at the expense of the other shareholders) and that companies have a reasonable period of time to respond to unsolicited bids (while protecting shareholders against entrenchment of boards and management teams).

Circumstances under which the Valeant-Pershing Square collaboration model may be followed.

Pershing Square's inspired crafting of the collaboration model resulted in a gain to Pershing Square of well over $2 billion on its toehold stake in Allergan. While some saw a meaningful risk in the substantial investment Pershing Square made in Allergan without knowing whether Valeant's (or any other) bid for Allergan would succeed, our view from the outset has been that there was almost a certainty that either the Valeant bid would succeed or that Allergan would deliver equivalent or greater value to the shareholders in some other way. There is every reason to believe that activists would want to follow what appears to be a high reward-low risk model.

There are significant disadvantages of the model to bidders, however. As we have discussed in previous memoranda, these include: the high economic cost to the bidder (most importantly, the bidder's forgoing the opportunity to capture all or most of the gain on the toehold stake for itself); the inherent distraction to the deal from the activist's involvement (reducing the critical focus on and "selling" of the deal and the bidder's equity); and the conflicts of interest between the activist and the bidder (primarily that the activist is advantaged by an alternative superior transaction that thwarts its bidder-partner)—all of which occurred in the Allergan situation and played a part in Valeant's ultimate failure. To these issues, serious legal uncertainty for the model was added when a California federal district court judge recently found that the model raised "serious questions" about whether the activist's buying of the toehold stake constituted insider trading, as

it was based on the activist's knowledge of the bidder's nonpublic intention to make a bid for the company and the activist, in the court's view, probably was not a "true" co-bidder.

While the insider trading issues may be resolved by future judicial or SEC action, and while we believe in any event that they are not insurmountable (as discussed below), in our view, it is unlikely that the model will be followed by a bidder who has the financial ability and overall credibility to proceed on its own—unless the model is restructured and the bidder is more economically advantaged. The model may, however, on balance be beneficial to a bidder that has cash constraints and weak credit, or who has other reasons to seek assistance with the funding of the pre-announcement toehold stake in a target company (and/or an upfront commitment for assistance with funding the acquisition of the company). Thus, we expect that the model, as currently structured, may be followed in the following circumstances:

The bidder requires assistance with funding the toehold stake (and/or the acquisition of the company). While the primary benefit of a toehold stake in a target company is the economic benefit of the gain on the investment once the announcement of the bid is made—and while that benefit is largely transferred from the bidder to the activist in the Valeant-Pershing Square model—acquisition of the toehold stake should increase the bidder's leverage with the target board and shareholders. Thus, the advantages of the model to a bidder may outweigh the disadvantages if the bidder cannot fund the acquisition of the toehold stake (and/or the acquisition of the target company) on better economic terms. As discussed in our previous memoranda, for most bidders, we would expect that the significant costs of the model would make more conventional financing a preferred choice.

The market for the target's stock and/or options is highly liquid. The significant and aggressive pre-announcement purchase of stock and/or options by the activist (which is the linchpin of the model) is practical only if the market for the target's stock and/or options is highly liquid, so that the buying does not dramatically move the market price and give notice of a bidder/activist's interest.

There is reasonable certainty that a target shareholders meeting, at which the toehold shares can be voted in support of the bid, will be held without significant delay. Assuming that neither the activist nor any of its portfolio companies is a competitor of the target company, the activist generally can obtain Hart-Scott-Rodino clearance (which is needed before the shares can be voted) in a shorter timeframe than the bidder can, assuming the bidder is a competitor of the target. Thus, the purchase of the toehold stake by the activist instead of the bidder can provide the bidder with a significant advantage by making the toehold shares available quickly to be voted in support of the bid. The advantage of early Hart-Scott-Rodino clearance for the voting

of the shares would not be meaningful, however, if it is not reasonably certain that a shareholder meeting at which the bidder could obtain control of a majority of the board would be held promptly. Thus, the timing advantage of the model is largely eliminated if either a) the target has a classified board, or b) the bid cannot be made shortly before the target's annual meeting (although the target will have some ability to delay that meeting) and the target's charter and bylaws do not provide reasonable certainty that the bidder can call a special meeting that would have to be held promptly.

The potential for insider trading liability for the activist partner is eliminated or significantly reduced. Neither activists nor bidders are likely to follow the model unless greater clarity on the insider trading issues is provided by the courts or the SEC, or the model is restructured (as discussed below) to eliminate or significantly reduce the potential liability (and distraction for the bid).

How the bidder-activist collaboration model could be re-structured.

No tender or exchange offer. Absent further clarity on the insider trading issues by judicial or SEC action, the risk of insider trading liability could be substantially reduced by restructuring the bid as an acquisition offer and proxy contest only—with the record supporting that no tender or exchange offer was commenced or contemplated in the early stages. Rule 14e-3 provides for insider trading liability for a person who purchases shares of a target company at a time he knows that another person has plans to seek to acquire the company and has taken "a substantial step toward" commencing a tender or exchange offer. While a tender or exchange offer can create added momentum for a bid and pressure on a target, a "fully" priced offer and proxy contest by a credible buyer—without a tender or exchange offer initially—can be almost as compelling, since a bidder generally cannot buy shares in a tender or exchange offer in any event until it wins a proxy contest, replaces the board, and redeems the target's shareholder rights plan.

Making the activist a "true" co-bidder. A person making a bid (alone or as a co-bidder) does not have liability for trading on its own information that it intends to make a bid. While Pershing Square and Valeant labeled Pershing Square as a "co-bidder", the California court indicated that the underlying collaboration arrangements had no indicia of Pershing Square's being a true co-bidder. We expect that it would be possible for a viable co-bidder model to be developed.

More beneficial economic terms for the bidder. Pershing Square appears to have benefitted from a strong "first-mover" advantage. As with any new technology, the cost to the user (and gain to the provider) can be expected to decrease once the technology is known and begins to be used more widely. We expect that the model will develop to reduce the outsized-return-with-

limited-risk of the activist partner. The most critical change would be a different split of the profits from the toehold stake. In the Allergan situation, the Pershing Square-Valeant split was 85%-15%, costing Valeant $7-8 per share that could have been used to increase the price of its bid, and, in the context of its bid not having succeeded, resulting in a $300 million profit for Valeant as compared to well over $2 billion for Pershing Square. A possible alternative would be a tiered profit split where, for example, the bidder shares a lower percentage of the gains up to a certain amount, and then a higher percentage of gains above that amount. A bidder might also try to negotiate for more financing, a greater commitment with respect to the stock portion of the consideration to be received by the activist in the offer if the bidder succeeds, a longer commitment with respect to retention of stock received in the offer, a post-acquisition standstill agreement, and so on, depending on the bidder's greatest areas of need or concern. Of course, each situation will require a review by the bidder and the activist of their respective options, risks , and potential rewards—including whether the collaboration terms could both meet the risk-reward ratio required by the activist and induce the bidder to enter into the arrangement.

"Minimum" and/or "preferred" return for the activist. Other alternatives would be a "minimum" or "preferred" return to the activist partner. For a minimum return, the activist would receive all the profits up to a specified amount, with the remaining profits being split with the bidder. For a preferred return, the activist would receive a stated percentage return, with the remaining profits allocated to the bidder.

Lessons learned for bidders.

Need for a singular and continuous focus on "selling" the deal. To the extent possible, the focus on the activist and the collaboration should be limited, as it distracts from the fundamentals of the transaction, the bidder, and the value of the bidder's equity.

Consider a contingent value right. A critical aspect of success for a bid that includes the bidder's equity as part of the deal consideration is the ability to convince the target board and shareholders of the value of that equity. Under appropriate circumstances, a bidder should evaluate the utility and risks of a contingent value right or other value assurance mechanism to backstop the equity portion of the offer price.

Benefits of the process being concluded as quickly as possible. A bidder is advantaged when the target has less time to develop strategic alternatives to a bid.

- **Commence and effect the proxy contest as early as possible in the process**. In the Allergan situation, the activist's early effort at an "informal" shareholder meeting to pressure the target board was unproductive, wasted time, and created a distracting focus on the collaboration. Moreover, it is unclear why Valeant waited for months after that to commence the proxy contest.
- **Consider whether to offer the best and final offer price early in the process**. Offering the best price early in the process may a) deter white knights from emerging and b) may induce the target company to agree to the transaction before white knight possibilities have emerged.

Negotiate a better deal with the activist. As discussed above, it is possible that bidders may now be able to negotiate better terms with activists.

Consider collaboration after the bid is made rather than before.

- **Benefits to the bidder**. A well-financed and credible bidder who does not need an activist to fund or execute the pre-announcement toehold stake but believes that collaboration with an activist would still be beneficial, would probably be advantaged by entering into a collaboration arrangement after making a bid rather than before. At that time, the bidder will have gained the full post-announcement profit on the toehold stake for its own account, and will have more information about the Hart-Scott-Rodino timing, the target's reaction, the market reaction, the emergence (or not) of competing bidders, and so on, before deciding what arrangement, if any, would be most appropriate. In addition, the bidder will have avoided at the critical early stage the inherent distraction from the financial merits of the bid that the collaboration causes when in place at the outset, including, as in the Allergan situation, the attention the arrangement generated relating to the perception of unfairness in dealing with shareholders by selectively providing the activist partner with an opportunity to trade based on non-public information.
- **Benefits to the activist**. Similarly, under some circumstances, an activist may be advantaged by collaborating only after it has bought shares in a potential target company. While adding some degree of risk for the activist (that a bid partner may not be found or that the partner that emerges will not be the optimal bidder), a credible and well-financed activist can on its own put a company into play by buying shares and filing a 13D, sending a public letter, or making a proposal. With this approach, the activist could obtain the full profit on the initial equity stake and would eliminate the insider trading risk.

Lessons learned for target companies.

Need to monitor trading in the company's stock and options in order to have as much notice as possible of a possible threat.

Need to define a compelling "message" and to deliver it consistently. Allergan was advantaged in the process by a) quickly developing a coherent and compelling message that cast serious doubt on Valeant's business and growth plans and b) delivering the message consistently and effectively throughout the process.

Target shareholder patience, providing the company with reasonable time to respond to a bid, can lead to the best result for the shareholders. In the face of an unsolicited bid, target companies must have the objective (and must persuade shareholders that it is their objective) to deliver value for shareholders and not to entrench the board or management. In the Allergan situation, eight months after the unsolicited bid was received, Allergan announced a white knight transaction that nominally provided shareholders with $66 billion rather than Valeant's $54 billion final offer price.

Dismantling of defensive protections increases a company's vulnerability to unsolicited bids. In response to shareholder pressure for "good governance", many companies have voluntarily declassified boards, shortened or simplified advance notice provisions, and otherwise dismantled defensive protections. In the Allergan situation, the earlier declassification of the board made the company significantly more vulnerable to a third party unsolicited bid. Allergan's bylaw provisions—which gave the board broad authority with respect to calling a shareholder meeting and imposed requirements with respect to advance notice of director nominations—provided the company with time to consider and respond to the bid, including finding and considering alternatives. Notably, if Allergan had not had its unusual bylaws that ultimately led to a shareholder meeting date that was nine months after the bid was launched, Allergan could have had as little as 30 days (the period of the advance notice bylaw) to respond to the bid. The longer timeframe did not lead to entrenchment but to a much better result for the shareholders. A shorter timeframe likely would have made it less likely that the company could have found and negotiated a superior offer at a significantly higher price or even have caused Valeant to significantly raise its offer price, thus enriching the bidder at the expense of the shareholders.

New ideas for activists and bidders to consider.

Acquiring more than a 10% toehold, in appropriate circumstances. If there is sufficient liquidity in the market for a target's stock and/or options to avoid a dramatic rise in the price or notice of the buying (and if there is no required regulatory approval, or a target company

shareholder rights plan, that would be triggered), an activist or bidder might want to consider buying through the Section 16(b) 10% limit—thereby further increasing the pressure on the target, having additional capacity to increase the bid price and, if not successful, increasing the profit from the toehold stake. In most cases there should be no issue of 16(b) recapture, given that the process generally will continue for more than six months and/or the shares will be converted in a merger.

Marketing collaboration plans to bidders. To the extent activists believe that collaboration will generate better returns or less risk for them than go-it-alone investments that may put a company in play, and to the extent that they wish to profit as Pershing Square has but are willing to realize lower profit, activists may market their availability for similar collaborations on terms less favorable to the activist. Activists may actively approach potential bidders having the appropriate characteristics on a general basis or with a particular target in mind. Even under these circumstances, potential bidders may prefer to go it alone with a bid or to wait for an activist to put a company into play and then be available as a white knight (where the likelihood of successfully acquiring a company is heightened).

Joining with other activists to spread risk. Smaller or less established activist investors may become more involved in bidder activist collaborations by joining together in order to diversify their bidder-collaboration activities and otherwise spread their risk in this area. These arrangements would be complicated, raising legal and business issues about how decisions will be made; whether the activists will be a group for purposes of Section 13(d) or Hart-Scott-Rodino; and the potential for the triggering of shareholder rights plans (especially those that contemplate protection against "wolf packs").

New ideas for target companies to consider.

In the context of increasing involvement of activists in the M&A arena, a convergence of the focus of activists and companies on delivering shareholder value, a general dismantling of traditional corporate defenses (such as classified boards), and new M&A technologies being developed by activists and bidders, target companies also may seek to develop new ways of responding to unsolicited bids.

Shareholder-friendly, tailored rights plans. Currently, when a company receives, or perceives that there is an actual threat of, an unsolicited bid, the typical response is a) to adopt a shareholder rights plan to prevent bidders from acquiring more than a threshold ownership interest and b) unless there is a classified board, to seek ways to obtain time to consider and respond to the threat. Once adopted, a shareholder rights plan in effect prevents further

purchases of target stock by a bidder (through the threat of severe economic dilution of the bidder's shares once the rights are triggered), but can be redeemed by the bidder if the bidder obtains control of a majority of the board. Target companies may wish to consider alternative shareholder rights plans that would be more shareholder-friendly than current rights plans, while being more specifically tailored to address target company concerns.

- "**Reasonable time response plan**": For a company that does not have a classified board, this plan would facilitate both a) stockholder decision-making, by putting acquisition bids and change-of-control proxy contests on a more predictable timetable, and b) value creation, by providing a company with a reasonable period of time for its response to an unsolicited bid. The plan would require that a target company that has received an unsolicited Qualified Proposal would have to take action to schedule and hold a meeting of shareholders to vote on the proposal within [12] months. A "Qualified Proposal" would be any bona fide acquisition proposal for all shares that the bidder's bankers confirm is financeable or any bona fide proxy contest seeking a change in [25]% or more of the board. The plan would be redeemable at the typical nominal redemption price, except that it could be redeemed by Non-Plan Directors only at a redemption price of [200]% of the unaffected market price. "Non-Plan Directors" would be directors proposed by a person making an unsolicited acquisition proposal or conducting a proxy contest for more than [25]% of the board unless elected at the meeting contemplated by the rights plan. Possible modifications to these terms that could be considered would include: reducing the 12-month time period; limiting a proxy contest Qualified Proposal to only those proxy contests that are made in connection with an acquisition bid; and/or making the plan non-redeemable by Non-Plan Directors.
- It should be noted that the legal validity of a rights plan of this type has not been tested. In addition, institutional shareholders and proxy advisory firms have not generally been supportive of shareholder rights plans and other actions that may deter activism and acquisitions. However, in the context of the current environment of an overall decrease in defensive protections, shareholders should favor this type of plan, which is more shareholder-friendly and tailored—particularly if experience proves that it does not deter bids or permit entrenchment and that it creates additional value for shareholders.
- "**13D disclosure plan**": This plan would be designed to recapture for target company shareholders the profits made by a purchaser of target shares after crossing the 5% ownership threshold without public disclosure of the ownership. Currently, the SEC's Schedule 13D rules permit a person who has acquired 5% of a company's shares to wait for up to 10 days before filing a 13D that discloses the ownership, during which time additional shares can be purchased. Pershing Square, for example, disclosed in its first

13D filing on Allergan that it had purchased a 5% stake over several months and then had almost doubled that, to a 9.7% stake, during the 10-day 13D filing window period. Thus, the Allergan shareholders and option holders who sold to Pershing Square during that 10-day period did not know that they were selling to someone who had already bought 5% and who was buying their equity to assist Valeant in acquiring the company. A window-closing rights plan—which would cause severe dilution of the shares of a bidder who did not file a 13D immediately after crossing the 5% ownership threshold—has been proposed in the past but has never been adopted. A target company may wish to consider the 13D disclosure rights plan—which would only seek to recapture for the target shareholders the purchaser's profit on the shares purchased after the 5% threshold is crossed and before a 13D is filed (or, alternatively, could seek to recapture the purchaser's profit on all of the shares purchased prior to the 13D filing). (One issue that would have to be addressed is how and when the profit would be measured, and whether, for timing and implementation purposes, the recapture would have to be of a "presumed profit".) Importantly, since this type of rights plan would have to be in place before an activist started buying shares, a company should, before adopting this type of plan, consider the reaction of stockholders and proxy firms.

Other possible actions to protect shareholders. Depending on the circumstances, target companies may wish to consider other novel approaches, each of which generally would be reviewable based on whether the action taken represented a proportionate response to the threat faced by the target company. Each of the possible approaches noted below would present practical and legal issues, and the advantages and risks would have to be evaluated by a target company to determine in any given case whether any of them might be in the company's best interests under the applicable circumstances.

Possible actions could include the following: (i) if the target is of roughly equal size or bigger than the bidder and the bid is highly leveraged, the target company could acquire the bidder's shares in order to vote against the bidder's issuance of equity and/or make financing of the bid more difficult; (ii) if there are concerns about the value of the bidder's equity, the target could create a value assurance plan that would protect against underperformance of the bidder's equity (which would focus attention on concerns regarding the bidder's equity—even if the plan were redeemable, or the bidder responded by lowering its price or by conditioning its offer to purchase shares on the value assurance rights being attached); and (iii) if appraisal rights are not statutorily available (and particularly if the bid significantly undervalues the company), the target could provide a kind of "quasi-appraisal right" for an impartial arbitration to determine an appraised value (based on state law), with a claim against the company for the appraised value by any

stockholder who did not vote in favor of the bidder's transaction and agreed to forgo the merger consideration it would receive in the deal in exchange for the appraisal amount.

Conclusion

In our view, the Valeant-Pershing Square saga highlighted the value that can be delivered through activist involvement in M&A, while at the same time underscoring the risks to shareholders of companies not having protections that provide a reasonable amount of time for them to respond to unsolicited bids. As we have discussed in previous memoranda, we expect that the Valeant-Pershing Square model of bidder-activist collaboration will be followed only in limited circumstances (even if there is a final judicial determination or SEC action that removes the insider trading liability issues). Nonetheless, we expect that bidder-activist collaborations, and other new M&A technologies, will continue to evolve, with the arrangements in each case depending on the circumstances of the particular bidder, activist, and target company.

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Over-Reaction to Use of Merger Price to Determine Fair Value

Posted by Philip Richter, on Friday, May 1, 2015

Editor's note: Philip Richter is co-head of the Mergers and Acquisitions Practice at Fried, Frank, Harris, Shriver & Jacobson LLP. This post is based on a Fried Frank publication authored by Mr. Richter, Steven Epstein, John E. Sorkin, and Gail Weinstein. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

The Delaware Chancery Court has used the merger price in the underlying transaction as the primary or sole factor in determining the "fair value" of dissenting shares in two recent appraisal cases. The Delaware Supreme Court recently upheld one of those decisions. However, the court's use of the merger price in both cases was based on the same *limited fact situation*, suggesting that—contrary to much of the recent commentary—the merger price will *not* frequently be used as a key factor in determining fair value in appraisal cases.

The limited fact situation in which the court in both cases found the merger price to be the best indication of value involved:

- the standard available financial analyses being *particularly unreliable* indications of value—because of the absence of (a) ordinary course projections and (b) sufficiently comparable companies or transactions (due to unique business circumstances); *and*
- the sale process being a *particularly reliable* indication of value—because it was conducted at arm's length and with an effective market check.

In the past, the court sometimes has accepted, but most often has rejected, consideration of the merger price as a relevant factor in determining appraised fair value. Instead, to determine fair value—which the Delaware appraisal statute defines as going concern value immediately prior to the merger, excluding any value arising from the merger itself—the court typically has relied primarily or exclusively on a Discounted Cash Flow (DCF) analysis. The court has also relied at times on analyses of comparable companies and transactions as a check on the DCF analysis results—but has considered the merger price, when considered *at all*, as a factor secondary to the financial analyses.

In a departure from common practice, Vice Chancellor Glasscock found in *Huff v. CKx* (Nov. 1, 2013) (affirmed by the Supreme Court in a ruling issued without an opinion (Feb. 12, 2015)) that the merger price was the best indicator of the fair value of the CKx dissenting shares. Vice Chancellor Glasscock again found the merger price to be the best indicator of fair value in his appraisal of the dissenting shares in *In re Appraisal of Ancestry.com* (Jan. 5, 2015). Notably, in

Laidler v. Hesco (June 25, 2014)—the appraisal case decided by the Chancery Court between *CKx* and *Ancestry*, which has attracted far less attention and commentary—Vice Chancellor Glasscock *rejected* use of the merger price in determining appraised fair value on the basis that the transaction there, by contrast with *CKx*, had been "nothing like" an arm's length competitive process. Under those circumstances, the court stated, the merger price, which had been "decided by the 90 percent parent," was *not* a reliable indicator of value.

Based on these recent cases, and in particular the Supreme Court's endorsement of the *CKx* decision, we can expect that the merger price may be used as the primary or even exclusive factor in determining appraised fair value more often—but, nonetheless, absent further developments, only when the standard financial analyses available are particularly unreliable (i.e., there are no ordinary course projections or sufficiently comparable companies or transactions available) and the sale process was conducted at arm's length and with an effective market check.

Failure to Adjust the Merger Price When Used to Determine Fair Value

A critical issue that arises when the merger price is considered in determining fair value in an appraisal proceeding is that the Delaware appraisal statute requires that fair value be determined exclusive of "any element of value arising from the accomplishment or expectation of the merger." Thus, presumably, in determining appraised fair value, there should be an *adjustment downward* from the merger price to exclude the impact on value of expected merger synergies and to exclude value attributable to the control premium reflected in the merger price, and an *adjustment upward* to account for any non-merger-related increase in value between the signing and closing of the merger.

In *CKx*, however, the court declined to make any adjustments. The court reasoned that there was no evidence as to whether or not value arising from the merger itself had been included in the merger price, as there was no indication that the cost savings attributable to the merger could have been accomplished only through the merger or that the buyer had included the cost savings when determining the merger price. The issue of exclusion of the value of a control premium was not addressed.

In *Ancestry*, the court again gave only glancing attention to the issue of adjustments to the merger price, noting simply that the acquiror, as a financial buyer, "had no apparent synergies." The court relied on a DCF analysis as a "double-check" on the merger price's reflection of value, stating that it derived comfort in using the merger price because the DCF result was within a few cents of the merger price.

We have discussed previously the difficulties inherent in determining what *is* a merger synergy and how to quantify its value. Similar complexity is inherent in determining the amount of the merger price that reflects a control premium—as well as how much of a control premium is simply attributable to the sheer volume of purchases of shares in a merger (as opposed to the value of control). We have noted in previous memoranda and articles that these difficulties may underlie the courts' previous reluctance to use the merger price at all as a basis for determining appraised fair value. (*See, e.g.,* our article, "Delaware Appraisal: Practical Considerations" (Oct. 17, 2014).) To the extent that the court follows the *CKx* precedent and the merger price may be more frequently used as a primary or the exclusive factor in determining fair value, we expect that the

parties in appraisal proceedings and the courts will have to grapple more often with the difficult and uncertain issues relating to adjustments for merger synergies, control premiums, and post-signing pre-closing developments.

In anticipation of this development, a party to a merger possibly should seek to quantify the merger synergies and control premium aspects of the merger price and to negotiate an agreement with respect to these values in the merger agreement—particularly in the case of a strategic buyer (where merger synergies are likely). The utilization of this technique may, of course, be limited because of lack of guidance from the court and the difficulties in deriving estimates that the parties will agree to.

Proposed Amendment to the Appraisal Statute to Permit Tolling of Statutory Interest

Under DGCL Section 262(h), interest is payable on an appraisal award, from the effective date of the merger through the date of payment of the award, at a rate that is 5 percent over the Federal Reserve discount rate. In *CKx*, after the court had determined that fair value would be based on the merger price, but then extended the proceedings so that the parties could submit evidence supporting any adjustments that should be made to the merger price, CKx sought the court's permission to pay the merger price and toll the further accrual of the statutory interest on that undisputed portion of the ultimate appraisal award. The Chancery Court held that it did not have statutory authority to toll the interest; and the Supreme Court has affirmed that holding.

The Delaware Legislature is currently considering an amendment to the Delaware statute to *permit* tolling of the interest in a case, such as *CKx*, where the respondent company wishes to pay a part of the anticipated appraisal award before the proceeding has been completed in order to toll the further accrual of the statutory interest on that amount. In the event the amendment is adopted, a number of new practical and strategic factors will have to be considered in a company's determination whether, when, and how much to pay in advance of the final determination of an appraisal award. (*See* our memorandum, "Proposed Appraised Statute Amendments Would Permit Companies to Lower Their Interest Cost" (March 23, 2015).) We discuss below the likely effect of the amendment, if it is adopted, on appraisal arbitrage.

Other Developments

A development that occurred early in the first quarter of 2015 (and that we discussed in our article on appraisal in the Fried Frank 4th Quarter 2014 M&A Quarterly (published in January 2015)) was the Chancery Court decision in *Merion Capital v. BMC Software* (Jan. 5, 2015)—which confirmed the December 2014 holding in *In re Appraisal of Dole Food Company*—that a dissenting shareholder who purchases shares after the record date for the stockholder vote on the transaction need not prove that the shares were voted against the transaction in order to exercise appraisal rights.

In early April 2015, a group of corporate law firms submitted a joint letter to the Delaware Corporate Law Council urging that the Legislature amend the appraisal statute to override these decisions and make appraisal rights *unavailable* to shareholders who have no right to vote on

(and therefore dissent from) the underlying transaction. The firms advocate that appraisal rights be denied to anyone who purchases shares of the target company after announcement of a transaction or, at a minimum, after the record date for the vote on the transaction. There is no indication at this point that there is momentum within the Legislature for consideration of the approach advocated by the law firm group.

A separate development was the Chancery Court's broad discovery order in *Dole* requiring that the petitioning stockholders produce all pre-litigation valuation or analytical materials that they had prepared, reviewed, or otherwise considered when deciding whether to purchase or sell the target company's shares or to seek appraisal.

Effect on Appraisal Arbitrage

A statutory amendment—such as the one advocated by the group of law firms, as noted above—that would eliminate appraisal rights for shareholders who buy their shares after announcement of (or, alternatively, after the record date for the stockholder vote on) a transaction likely *would* cause a significant reduction in appraisal arbitrage. However, there is no indication that the Legislature is considering any such amendment. The amendments being considered by the Legislature, to permit the tolling of statutory interest, if adopted, would, in our view, be likely to discourage appraisal arbitrage to some extent. After all, in *CKx*, the petitioner waited about four years, and in *Ancestry*, the petitioner waited over two years—just to have the court determine that the appraised value was the same as the amount the acquiror had paid in the merger years earlier. In addition, the Supreme Court's affirmation of the use of the merger price to determine fair value may discourage appraisal claims to the extent that there is a perception that there is an increased risk of the court determining fair value to be equal to (or below) the merger price.

However, in our view, the current developments in the use of the merger price in determining fair value and (if adopted) the proposed tolling of interest are *not* likely to result in a *significant* reduction in appraisal arbitrage or the volume of appraisal claims because:

- **Use of the merger price in determining fair value will likely continue to be limited.** Based on *CKx, Laidler,* and *Ancestry.com*, the circumstances in which the merger price will be considered a key factor in determining appraisal should continue to be limited—i.e., where the merger is a third party transaction with a robust sale process *and* reliable results from standard financial analyses are unavailable. (Notably, these are the very cases *least likely* to result in a determination of fair value in an appraisal that is significantly higher than the merger price.)
- **Complexity relating to merger price adjustments will highlight the possibility of fair value determinations *below* the merger price.** As discussed above, we expect that any increased use of the merger price as a basis for fair value will underscore the complexity of the adjustments required by statute—which will lead to more uncertainty as to whether appraised value could be *below* the merger price in any given case (particularly in the case of strategic transactions with significant expected synergies).
- **The tolling of interest and the utilization of the merger price to determine fair value will likely discourage "weaker" appraisal claims but not "stronger" claims—and thus are likely to drive appraisal activity to the "right" situations.** While there has been much commentary about "above-market statutory interest" encouraging appraisal arbitrage, it is not at all clear that the interest rate actually is "above-market" for all

relevant purposes, nor that tolling would make a significant difference. Our view is that the proposed amendment to permit the tolling of interest, if adopted, and the utilization of the merger price to determine fair value, if increasingly prevalent, would likely reduce the volume of "weaker" appraisal claims (i.e., those that are made with respect to transactions that are *unlikely* to result in an appraisal award that is significantly higher than the merger price) and would *not* reduce the volume of "strong" claims. At the same time, we believe that the number of shares included in strong cases likely would increase and that the settlement of strong cases likely would become more difficult and unlikely as a large upfront payment made by the company during an appraisal proceeding would reduce the incentive a company now has to settle to avoid continued accrual of the statutory interest.

These developments highlight the trend we have identified in previous publications—that appraisal awards significantly above the merger price are likely in "interested" transactions without a robust sale process but not likely in arm's length third party transactions with a robust sale process. As discussed, we expect that the key effect of recent developments will be not to reduce the volume of appraisal activity significantly, but to drive appraisal activity to those deals where there is the greatest potential for awards significantly higher than the merger price.

We have updated below (to include the most recent appraisal decisions) the charts included in certain of our previous memoranda.

Please *see* our previous memoranda relating to appraisal and the topics discussed above:

- "Proposed Appraisal Statute Amendments Would Permit Companies to Reduce Their Interest Cost" (March 23, 2015)
- "Chancery Court's Use of the Merger Price in Determining Fair Value in Appraisal Actions—What Will the Impact Be?" (Feb. 10, 2015)
- "Delaware Appraisal Decisions—Merger Price and Market Price are Relevant Indications of Appraised Value; Internal Valuation Materials Must Be Produced; and a Dissenting Stockholder Who Bought Shares After the Record Date Need Not Prove How the Shares Were Voted" (*Fried Frank M&A Quarterly* 4th Quarter 2014)
- "Delaware Appraisal: Practical Considerations" (Oct. 17, 2014) (published by the American Bar Association)
- "New Activist Weapon—The Rise of Delaware Appraisal Arbitrage: A Survey of Cases and Some Practical Implications" (June 18, 2014)

Delaware Appraisal Decisions 2010—Feb. 2015: Premium Over Merger Price

Date	**Case**	**Appraisal amount higher than merger price**	**Premium over merger price represented by appraisal amount**	**Estimated additional premium over merger price represented by statutory interest**	**Number of years from merger date to appraisal decision**	**Sale process included market check and minority shareholder protections**
INTERESTED TRANSACTIONS						

5/12/14, 6/25/14	*Laidler* v. *Hesco*	Yes	86.6%	24.7%	2.5	None
9/18/13	*In re Orchard Enterprises*	Yes	127.8%	36.1%	2.0	–
6/28/13	*Towerview* v. *Cox Radio*	Yes	19.8%	26.9%	3.9	Weak
4/23/10	*Global* v. *Golden Telecom*	Yes	19.5%	14.7%	2.2	Weak
2/15/10	*In re Sunbelt Beverage*	Yes	148.8%	213.8%	12.4	None
DISINTERESTED TRANSACTIONS						
1/30/15	*In re ancestry.com*	No	0%		2.1	–
11/1/13, 5/19/14, 2/12/15	*Huff* v. *CKx*	No	0%	12.7%	2.3	–
7/8/13	*Merion* v. *3M Cogent*	Yes	8.5%	14.3%	2.6	–
3/18/13	*IQ* v. *Am. Commercial Lines*	Yes	15.6%	13.7%	2.3	–
4/30/12	*Gearreald* v. *Just Care*	No	(14.4%)	11.7%	2.6	–

Delaware Appraisal Decisions 2010—Feb. 2015: Valuation Methodologies Used

Date	Case	Merger consideration (per share)	Court's valuation method/appraised amount	Petitioner's valuation method/proposed value	Respondent's valuation method/proposed value
INTERESTED TRANSACTIONS					
6/25/14	*Laidler* v. *Hesco*	$207.50	DCCF $387.24	DCCF $515	DCCF (Primary) Comparable Companies Comparable Transactions Merger Price $205.30
7/18/13	*In re Orchard Enterprises*	$2.05	DCF $4.67	DCF $5.42	DCF (1/3) Comparable

					Companies (1/3) Comparable Transactions (1/3) $1.53
6/28/13	*Towerview* v. *Cox Radio*	$4.80	DCF $5.75	DCF $12.12	DCF (Primary) Comparable Companies Merger Price $4.28
4/23/10	*Global* v. *Golden Telecom*	$105	DCF $125.49	DCF $139	DCF $88
2/15/10	*In re Sunbelt Beverage*	$45.83	DCF $114.04 Comparable Companies Comparable Transactions ($104.16)	DCF $114.04	DCF $36.30 Asset Based ($42.12) Earlier Sunbelt Transaction ($45.83)
DISINTERESTED TRANSACTIONS					
1/30/15	*Ancestry.co m*	$32.00	Merger Price $32.00 DCF $31.79	DCF $43.05	DCF $30.63
11/1/13 , 5/19/14 , 2/12/15	*Huff* v. *CKx*	$5.50	Merger Price $5.50	DCF (60%) Comparable Companies Comparable Transaction (40%) $11.02	DCF $4.41
7/8/13	*Merion* v. *3M Cogent*	$10.50	DCF $10.87	DCF $16.26	DCF (1/3) Comparable Companies (1/3) Comparable Transactions (1/3) $10.12
3/18/13	*IQ* v. *Am. Commercial Lines*	$33.00	DCF $38.16	DCF Comparable Companies Comparable Transactions $45.01	DCF Comparable Companies Comparable Transactions $25.97
4/30/12	*Gearreald* v. *Just Care*	$40M (Whole Company)	DCF $34.24M	DCF $55.2M	

Court Leaves Open Whether Appraisal Rights May Be Waived By Agreement—*Halpin v. Riverstone*

Underscores need for explicit waiver of appraisal rights in, and compliance with the terms of, a drag-along provision

In a separate appraisal-related development, in *Halpin v. Riverstone* (Feb. 26, 2015), the Delaware Chancery Court raised—and left open—the issue whether common stockholders, by agreeing to a "drag-along" provision in an agreement among stockholders, waive their statutory appraisal rights.

The court, finding that the controlling stockholder had not properly exercised its drag-along right, noted—but left unanswered—two important issues relating to the waiver of appraisal rights by minority stockholders:

- *Can* a minority stockholder agree to waive its statutory right to appraisal?
- *Assuming* a stockholder *can* agree to waive its statutory right to appraisal, does its agreement to a drag-along provision *implicitly* constitute a waiver of appraisal rights?

A drag-along provision requires minority stockholders to vote in favor of and participate in a transaction if requested to do so by the majority stockholder. On the other hand, the exercise of appraisal rights requires that the shares not have been voted in favor of the transaction and that the merger consideration not have been received. Thus, *if* common stockholders *can* legally agree in advance to waive statutory rights for consideration to be determined later by a controlling stockholder, then, arguably, a drag-along provision (because the affirmative vote requirement precludes the dissent from the merger required for the exercise of appraisal rights) would effectively result in the waiver of appraisal rights.

While drag-along provisions are common in stockholder agreements between controlling stockholders and minority stockholders, no Delaware decision has determined whether common stockholders may agree in advance to waive their statutory right to appraisal. The court did not answer this question in *Halpin*. In addition, while the court noted in *Halpin* that a contractual waiver of a statutory right, where permitted, is effective only to the extent clearly set forth by the parties in the contract, the court also did not answer the question whether the absence of an express waiver of appraisal rights in the *Halpin* drag-along provision was itself fatal. Instead, the court found it unnecessary to decide these issues because it concluded that the majority stockholder had not properly invoked the drag-along right and that, therefore, the minority stockholders were not obligated to vote in favor of the merger and thus could seek appraisal rights.

The drag-along provision in *Halpin* provided that, when the 91% controlling stockholder "propose[d]" to enter into a change of control transaction, the controller could, on providing "notice in advance" to the minority common stockholders, require that the minority stockholders vote in

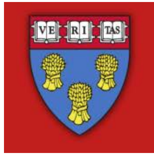
favor of the transaction. The court interpreted the notice provision as requiring that the notice be received prior to a stockholder vote on the merger. The controller, however, provided notice only *after* it had already approved the merger by written consent and had consummated the merger. The notice stated that the controller had "exercised its drag-along right" and was now requiring that the minority stockholders execute a written consent approving the merger. The drag-along provision did not include an explicit waiver of appraisal rights.

The court presumed for purposes of its analysis that, as the company had argued, the sole purpose of the drag-along was to accomplish a waiver of appraisal rights. The court held that, given the requirement in the drag-along provision that advance notice of the merger be given, the drag-along required that notice be given *prior to* a vote on the merger. The court further determined that by itself approving and consummating the merger, and only then requesting that the minority stockholders sign a written consent approving the merger retrospectively, the controller was seeking action that the drag-along did not provide for. Even assuming the validity of appraisal waivers, then, contractual compliance was not effected and the minority stockholders were free to exercise appraisal rights, according to the court.

Thus, after *Halpin*, it remains an open question whether a drag-along provision would be enforceable if it (i) clearly provides for forfeiture of appraisal rights by common stockholders and (ii) is exercised properly. (The court noted that, by contrast, it is well established Delaware law that *preferred* stockholders *may* contractually waive appraisal rights—because their rights are derived largely by contract whereas common stockholders' rights are mainly governed by statute and the common law relating to fiduciary relationships).

Practice points. Controllers seeking to enforce a waiver of appraisal rights through a drag-along should:

- include in the drag-along agreement an explicit acknowledgment by the minority stockholders that they waive their appraisal rights if the drag-along is invoked; and
- exercise the drag-along precisely in accordance with its terms—for example, if the drag-along calls for a vote in favor of the merger, request the vote *before* the controller itself approves and consummates the merger, and comply with any prescribed time periods or other requirements of the drag-along provision.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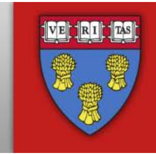


Delaware Poised to Embrace Appraisal Arbitrage

Posted by Trevor Norwitz, Wachtell, Lipton, Rosen & Katz, on Monday March 9, 2015

Editor's Note: Trevor Norwitz is a partner in the Corporate Department at Wachtell, Lipton, Rosen & Katz and Lecturer in Law at Columbia Law School. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

Delaware corporations and their advisers have been eagerly awaiting the response of the Delaware legislature to the recent surge in appraisal arbitrage and judicial pronouncements allowing this activity and suggesting that lawmakers should step in if they perceive a problem. It now appears based on a proposal released by the Delaware Corporation Law Council that the legislature may act as soon as this week. If the lawmakers follow the recommendations of the Council (which they usually do) the changes will likely disappoint Delaware corporations, make mergers and acquisitions in that important state more difficult, reduce deal flow, and lead to lower prices being paid to selling shareholders. The beneficiaries of this legislation will be the small (but growing) group of short term speculators specializing in appraisal arbitrage and the advisors who support that industry. Some of the problems created by appraisal arbitrage are described in my post on this subject a few weeks ago.

The Council does propose to provide some relief by allowing a corporation facing an appraisal claim to cut off the accrual of statutory interest as to the amount it pays to all claimants. This should help reduce the perverse incentives that have afflicted Delaware companies for years, whereby even meritless appraisal claims often turn out to be good investments because of the above market compound statutory interest rate. It is unfortunate that the Council is not also proposing to lower this above-market interest rate. If a company facing an appraisal claim were, for example, to pay 75% of the deal price to the claimants while continuing to argue that the 75% is the fair value to which they are entitled, the company would only be liable to pay interest on any amount above that 75% that the claimant is awarded. Such partial payments may change the calculus for appraisal arbitrageurs, and hopefully discourage unmeritorious claims, although they would also provide cash to fund appraisal litigation. The Council also recommends allowing corporations to dismiss *de minimis* claims (involving less than $1 million and less than 1% of the

outstanding shares) with limited exceptions. Those small claims were never a serious threat to buyers or deal making, but the change should enhance judicial efficiency.

The disappointing aspect of the Council's proposal is that they have determined not to take this opportunity to limit appraisal arbitrage by requiring that appraisal seekers demonstrate that the shares they are asking the courts to appraise were not voted in favor of the transaction. In a note accompanying their proposal, the Council offers several reasons for their affirmative embrace of appraisal arbitrage, but these explanations do not appear to appreciate the deal-threatening and value destructive nature of this activist tactic or to justify the failure to act.

The Council states that "to the extent that the appraisal remedy is necessary to protect stockholders, its effectiveness would be curtailed if the statute were amended to limit the ability to transfer the right" and notes that Delaware case law has for years recognized the right of a stockholder who has otherwise perfected his appraisal rights to pursue appraisal of shares purchased after the terms of the merger were announced. But this is a straw man. The proposed solution is not that shares entitled to appraisal should not be transferable with that right. The point is that *only* shares that were not voted in favor of the transaction should be entitled to appraisal, because appraisal is a *dissenters' remedy*. Appraisal should not be available for shares that were voted in favor. If an arbitrageur buys shares, for example in a private transactions, and can show that they were not voted in favor of the deal, appraisal rights would always have been available. (That said, one can certainly argue that the simplest and purest solution to the problems created by appraisal arbitrage would be to disallow appraisal claims by anyone who bought shares after public announcement of the transaction.)

The real question is whether the appraisal remedy is actually "necessary to protect stockholders," and here the Council can only point to conflict transactions as cases where "fiduciary duties and litigation may not be sufficient to ensure that the merger price reflects the fair value of the acquired shares." Such transactions, they argue "have a greater potential for unfairness and frequently result in appraisal awards at a premium to the merger price, sometimes a very significant premium." If that is the case, why not limit appraisal arbitrage to those sorts of suspect transactions? Moreover, why should fiduciary duty litigation not be the appropriate remedy for those cases? The fact that it is easier for the plaintiffs lawyers to win, because they do not have to prove any wrongdoing by the board but simply show higher value (often with the benefit of hindsight or even changed circumstances), is not an adequate explanation. An obvious advantage of fiduciary duty litigation is that all shareholders in the class share in any incremental value required to be paid by the buyer. It is likely that buyers will respond to increased appraisal arbitrage by lowering the price payable to all shareholders and holding back some incremental value to grease the squeaky wheels. It is somewhat ironic that if the board process can be shown

to have been flawed, all shareholders share the benefit, but if the board did all they could to get the best available deal, some portion of the shareholders' value should be siphoned off and diverted to short-term speculators in appraisal rights.

The Council's third line of argument for not limiting appraisal arbitrage is that it is unnecessary to do so because it is not at crisis levels ("only 17% of the appraisal eligible transactions during 2013 resulted in appraisal litigation in Delaware"—that number does not seem low to me) and the courts tend to get to the right place eventually anyway. They note that "[r]ecent case law has suggested that a market test of a transaction will serve as a proxy for fair value in appraisal suits" and that "[a]ppraisal cases attacking the merger consideration in non-conflict transactions are fewer in number and often result in appraisal results below or near the merger consideration." This is of course true (although the Delaware Supreme Court has ruled that the Court of Chancery may not defer, even presumptively, to the merger price in determining fair value[1]) but it still leaves purchasers facing an unquantifiable risk they have to take into account in offering to buy a company. Moreover, it is not a reason to protect market behavior which is otherwise destructive and almost certainly inconsistent with the original legislative purpose for granting dissenters appraisal rights. Indeed another group that is unlikely to welcome this rule-making are the Delaware judges themselves, who will continue to have to spend a significant portion of their time playing investment banker (but without commensurate compensation) as appraisal cases make up a significant and growing part of their dockets.

Finally the Council argues that the legislature does not have to address appraisal arbitrage because "[t]o the extent that the buyer in a merger has concern about an increased number of merger claimants and the overall cost of the transaction, the buyer can negotiate an appraisal out condition (e.g. a right not to close the merger if more than a specified percentage of shareholders dissent and demand appraisal)." This is of course also true, but hardly a positive development for buyers or for sellers. The fact that such appraisal-out conditions remain fairly rare does not suggest "that the availability of appraisal arbitrage is not a significant factor in the market." Appraisal out conditions disappeared because appraisal claims were vanishingly rare, and because they give rise to potential hold-ups and other value-destroying outcomes. But these conditions can be expected to reemerge if this new activist abuse is given a legislative imprimatur.

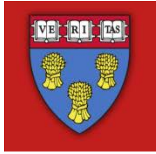
The Council's reasoning does not address the additional risk I had highlighted in my earlier piece that appraisal arbitrage may make it extremely difficult, if not impossible, to sell companies with upside contingencies (such as a biotech company awaiting FDA approval for a new drug).

[1] Golden Telecom, Inc. v. Global GT LP, No. 392, 2010, C.A. No. 3698 (Del. Dec. 29, 2010) (Steele, C.J.)

In short, the Council's recommendation that the Delaware legislature not address appraisal arbitrage (other than to discourage interest arbitrage and eliminate *de minimis* claims) is disappointing and may significantly harm Delaware corporations and their shareholders.

It has been reported that billions of dollars are now devoted to appraisal arbitrage, and with the blessing of the courts in Delaware and soon perhaps the legislature as well, it is likely that even more transactions will be subjected to appraisal claims. As a result, corporate acquirers will have to resort to self-help if they want to know in advance how much an acquisition is going to cost them (which is always important but especially critical in leveraged transactions). This self-help may take the form of the appraisal closing conditions suggested by the Council, or differential pricing (such as an automatic price reduction if too many shareholders assert appraisal). More likely it will just mean lower acquisition prices being offered to all shareholders, as buyers now know they will have to contend with a new category of hold-up artists. Some companies with near-term contingences they would like to de-risk may find it hard to sell themselves at all. It is difficult to see how this shift of value from shareholders as a whole to a small group of short-term speculators is socially advantageous or in the best interests of State of Delaware.

Tab 3: Engagement with Investors in General


The Harvard Law School Forum on Corporate Governance and Financial Regulation

Directors Should Communicate with Shareholders

Posted by John Wilcox, Sodali, on Thursday October 16, 2014

Editor's Note: John Wilcox is chairman of Sodali and former Head of Corporate Governance at TIAA-CREF. This post is based on a Sodali publication by Mr. Wilcox.

To demonstrate their effectiveness, corporate boards should increase transparency, provide an annual report of boardroom activities and take charge of their relations with shareholders.

With shareholders continuing to press for ever-deepening levels of engagement, companies must find a way to answer the most basic question of corporate governance: *"How effective is the board of directors?"* It is a question that can only be answered by the board itself, but it presents directors with a challenge as well as an opportunity. The challenge is to overcome the mindset, habits and perceived risks that have long kept boardroom activities under wraps. The opportunity, on the other hand, is to define governance and strategic issues from the board's perspective, manage shareholder expectations, take the engagement initiative away from shareholders and reduce the likelihood of activism. Directors should give careful consideration to this opportunity. Over the long term, it will be far better for companies to control the process by which board transparency is achieved rather than waiting for yet again another set of governance reforms that could further erode the board's authority.

Despite widespread support for board primacy and the board-centric governance model, boardroom transparency and director-shareholder relations are not a priority at most companies. A recent DealBook column in *The New York Times* described the situation as follows:

> "What if lawmakers never spoke to their constituents? Oddly enough, that's exactly how corporate America operates. Shareholders vote for directors, but the directors rarely, if ever, communicate with them."

The problem is not limited to corporate America. Opaque boardrooms are a global phenomenon, particularly common in markets where companies are dominated by founding families, control groups, or the state.

The column concludes:

> "…[S]ome form of engagement with shareholders—rather than directors simply taking their cues from management—would go a long way toward helping boards work on behalf of all shareholders…"
> [Andrew Ross Sorkin, *The New York Times*, July 21, 2014]

Cues from management are not the only concern. In many global markets the board's role is broadly defined, requiring directors to balance the competing demands of insiders, resolve conflicts of interest, deal with related-party transactions and juggle competing business and public policy goals in addition to their basic oversight duties. In these markets the need for transparency is even more compelling than in highly regulated markets, such as the UK, the European Union and the USA, where comprehensive legal, disclosure and accounting standards are well established.

Boards are under Pressure…

Pressure for greater board transparency and more open communication continues to come from the usual suspects: activist investment funds, hedge funds with a range of long and short-term investment strategies, governance reform professionals, NGOs, shareholder advocacy groups, trade unions, individual shareholder activists, special interest proponents and other adversaries. Proxy advisory firms compound the pressure by providing a global audience for these disputes. When issues of policy are involved, the media and politicians often step in to further amplify the pressure on companies.

Companies have fought defensive rearguard actions against activism, occasionally prevailing in specific campaigns, but ultimately they have had to concede defeat on most policy disputes relating to governance and board accountability. The decade-long evolution of the say-on-pay vote exemplifies this pattern of opposition and retreat.

Despite the chain of losses, the high-volume debate between companies and shareholders about the merits of governance reform continues today: Are corporate governance standards good or bad for companies? Does shareholder activism produce value or destroy value? Should shareholders have more power or less? Are directors sufficiently independent or not? Should corporate governance be director-centric or shareholder-centric? Is chronic short-termism the fault of greedy shareholders, or greedy CEOs, or weak boards, or does it represent the inevitable decline of free-market capitalism, or all of the above? The list of questions goes on and on. The debate has not lessened in intensity, but it has not resolved the questions either. The few answers that have been provided remain largely determined by research methodologies, policy

perspectives or the merits of individual cases. The real answer to most of the big questions seems inevitably to be “It depends…”

As 2015 approaches, it remains unclear how much the debate really matters or whether answers to these questions would be helpful to businesses and investors. For individual companies, the answer would seem to be No.

…But Institutional Investors are under Pressure, Too

Today’s governance and regulatory environment is changing rapidly for shareholders and the investment community as well as for companies. In the extended wake of the financial crisis, institutional investors remain under the regulatory microscope. They can no longer claim privileged status or remain exempt from the governance and accountability standards they impose on portfolio companies.

Stewardship codes and new laws in several major markets now require institutional investors to intensify their oversight of portfolio companies and disclose publicly their governance policies, voting practices and engagement activities. These requirements have further led to the development of new means of collective institutional engagement through organizations such as the UK Investors Forum.

Proxy advisory firms, themselves under regulatory and industry pressure to provide less standardized governance reviews as well as more information about the integrity of their research and vote recommendations, are relying much less on their traditional check lists of governance externalities. In response to client demand, they are digging for more detailed information about board effectiveness at individual companies.

The financial crisis awakened the investment community and the general public to the failures that resulted from overreliance on quantitative analysis to evaluate companies’ performance and risk. In response to new rules, institutional investors are now beginning to include intangibles and non-financial performance metrics in their analytical models. This wider lens embraces corporate governance, environmental practices, social policies, ethics, culture, reputation and other non-quantitative elements that are predictive of long-term performance. The terms “ESG” (Environmental, Social, Governance) and “sustainability” have become a form of shorthand for defining this new way of looking holistically at business enterprises. A recently issued Directive on disclosure of non-financial and diversity information by the EU Council puts the legal imprimatur on this broader set of data.

The enlarged analytical framework has important implications for companies—and specifically for boards of directors. Responsibility for ESG and sustainability falls squarely on the board. The

directors, rather than management, are deemed by shareholders to be answerable for ESG and sustainability.

Investor focus on non-financial criteria is producing some interesting results. In the U.S., the Council of Institutional Investors and its members have taken an approach that involves a carrot rather than a stick. CII has begun publishing periodic reports, based on member surveys and feedback, identifying companies whose disclosure practices exemplify best practice. A February 2014 CII report named six U.S. companies—Coca-Cola, GE, Pfizer, Prudential Financial, Microsoft and Walt Disney—as examples of excellence in disclosure of director qualifications and skills. In September 2014 CII published an additional report on board evaluation practices, citing GE (USA), Potash, Agrium (both Canadian companies), BHP Billiton (Australia), Dunelm (UK) and Randstad Holdings (Netherlands) as examples of excellence. According to deputy director Amy Borrus, CII plans to continue publishing reports on issues deemed important for its members to evaluate board effectiveness.

Organizations in other jurisdictions have also begun to identify companies with excellence in ESG/Sustainability and board communication. The annual UK ICSA Excellence in Governance Awards are a prominent example.

Transparency Instead of Engagement

Companies' efforts to deal with activists tend to focus heavily on engagement (i.e., letters, meetings and outreach campaigns). However, engagement is reactive and does not establish a long-term basis for preventing activism. Companies seeking to reduce confrontation with shareholders in the future should look for strategies that preempt activists and forestall engagement rather than erecting more defenses.

Board transparency is surely the most effective form of prevention. Providing information about what the board is doing and why its decisions are aligned with business goals is the most direct means to avoid the shareholder misperceptions and discontent that can lead to activism.

Board transparency has long been acknowledged as the essential board accountability mechanism for companies in jurisdictions that rely on voluntary, principles-based, comply-or-explain governance systems. Admittedly, the comply-or-explain process is far from perfect. Explanations are mandated only where companies are non-compliant with governance principles, encouraging a narrative that can be haphazard and unrelated to other disclosures. The European Commission has been aggressively vocal about the poor quality of companies' explanations and has threatened regulation to compel better results. Even when companies are diligent, a system designed on an exception basis will encourage piecemeal, ad hoc communication rather than a coherent narrative.

Lopsided communication also results from mechanisms such as the say-on-pay vote. Companies are obligated to prepare lengthy and detailed explanations in support of the complex remuneration programs that are now standard around the world. In addition to being burdensome to both companies and investors, this type of excessive regulatory micromanagement can distort board function by shifting directors' attention to a particular issue of importance to regulators rather than letting the board set its own priorities based on business considerations.

A more coherent and self-directed approach to board transparency would enable companies to avoid these problems.

Transparency—Defining the Board's Responsibilities

A board seeking to increase transparency should begin the process by clearly differentiating its role from that of management. The first step is to articulate the board's specific tasks and responsibilities separately from those of the CEO and management. This division of responsibilities is already implicit in today's global corporate governance principles. Essentially, the board of directors is responsible for its statutory duties plus ESG and sustainability, while management is responsible for everything else—day-to-day business operations, financial performance and the execution of strategy. Affirmation by companies of this allocation of responsibilities would by itself go a long way toward defining the scope and limits of board transparency.

Enumerating the board's specific tasks does not mean that one size fits all. Each company needs to carefully review what its board does and compile a list of responsibilities that takes into account the history, culture and characteristics of the enterprise as well as regulatory requirements. Lists will be different for companies in different jurisdictions and with different profiles—dispersed ownership, family or group control, IPO companies, mature companies, state-owned enterprises, privately held companies, and so forth. But at a minimum, board responsibilities will include the following:

- Long-term strategy, company values, culture and "tone at the top";
- Oversight of management and long-term performance;
- Accounting principles and the audit process;
- Policies relating to ESG and sustainability;
- Director nomination, selection and competence;
- CEO succession planning;

- Board evaluation;
- Executive and board compensation;
- Risk oversight;
- Ethics, conflicts of interest and related-party transactions;
- Non-financial performance goals and metrics;
- Engagement and communication with shareholders and other constituents.

Differentiating the board's role from that of the CEO and management is more than a mechanistic exercise. It establishes an important principle for board transparency: *There are limits to the topics that directors can discuss with shareholders.* By contrast, there are no such limits (other than legal and regulatory) applicable to topics that the CEO and executive management can discuss with shareholders. If companies respect this principle, they will eliminate most of the risks associated with transparency because the dreaded "material, non-public information" will generally not be the subject matter of board communications. Problems related to duplication, leaks, market confusion, selective disclosure and unfairness will be unlikely to arise if directors articulate these limits and require shareholders to respect them.

Transparency—An Annual Board Narrative

Given the board's acknowledged primacy—its governing position at the top of the business enterprise, its fiduciary duties and its statutory role as the shareholders' elected representative body—the absence of an annual written report from the board is an anomaly. If the buck stops with the board, shouldn't the directors be obligated to explain their actions? Assuming that "director-centric" is the preferred governance model, why is there no requirement for an annual report from the board? Director-centric does not mean "No questions asked." Even the business judgment rule—the keystone of board authority—should encourage transparency rather than silence. An annual narrative describing the policies and decisions of the board and its committees should be the sine qua non of director-centric corporate governance.

If an annual board report were to be required, its content and scope should be defined—but not dictated—by the board's enumerated responsibilities. The narrative "story" should otherwise be free form. In some cases the board might describe how its committees and governance policies work in the business context. In other cases, the story might focus on an extraordinary business transaction or on the board's strategic vision. The story might give extra attention to controversial issues, such as compensation, where the board wants to explain a divergence from standard practice. The storyboard for directors should be as varied as the business conditions and issues

faced by the companies they oversee. The essential point is that the board itself should decide what story it wants to tell.

The quality of a board narrative should be judged by its impact. Is it clear? Does it tell a compelling story about board effectiveness? Does it reveal a commitment to the company's business goals and sustainability? Are the shareholders convinced?

"Director Relations"—A Practical Approach to Board Engagement with Shareholders

In addition to providing a written annual report of its activities, the board should have an independent voice and the means to exercise it.

A company planning to have its board meet directly with shareholders or participate in an engagement campaign should ensure that the process is planned, initiated and controlled by the company, not by shareholders. The agenda for meetings should be set by the company, not by shareholders. In most cases the board's purpose in meeting with shareholders should be for the directors to listen and learn rather than to debate.

A company may decide to go further and establish a formal program for conducting periodic board-shareholder engagement. In that case, the first step is to make sure that opening boardroom windows won't reveal internal problems. To ensure a clean house, the board should review the results of its annual evaluation and take steps to implement any meaningful recommendations. If an annual board evaluation process is not already in place, the board should initiate one. Shareholders have come to view regular board evaluation as an important accountability mechanism for the uniquely self-administered powers of corporate boards.

The board should commission independent experts to conduct a governance benchmarking and perception survey that examine the company's governance profile, competitive standing, reputation, risk factors, media coverage and other relevant measures of shareholder satisfaction with the company's board of directors, executive leadership and strategic direction.

The board should also be given access to the company's information and databases that relate to share ownership, investor profiles and the views of institutional portfolio managers, financial analysts and governance decision makers. Voting results, contacts with activists, feedback from the annual general meeting and other shareholder and media commentary should be summarized for board review.

Armed with these resources and information, the board will then be in a position to determine whether engagement is necessary and, if so, to address the logistical questions of organizing a campaign: What topics should be on the agenda? Who should speak for the board? With whom should the board engage? When should engagement occur? Who from management should

participate? The answers to these questions will vary, but they should be worked out in advance by the board in close collaboration with management.

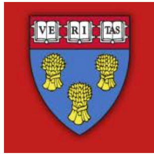
Director relations programs are an aspiration, not a reality. Over time, however, as board transparency increases and companies become more comfortable with dialogue between directors and shareholders, such programs are likely to emerge. A few conceptual models for administration and logistics are worth considering:

- ***Holistic Investor Relations***. A management-led IR team can incorporate governance, environmental, sustainability and other board issues into an integrated IR program addressed to an expanded institutional investor audience of governance and voting decision-makers as well as analysts and portfolio managers. Directors can participate as needed, but they receive regular IR/ESG/sustainability feedback. Proviso: the effectiveness of this model relies on the willingness of institutional investors to integrate financial and non-financial metrics into their investment decision-making models.
- ***Institutional Investor Relations***. An expanded office of the Company Secretary, Board Secretary, or Corporate Governance Officer, within the management's budget, can be charged with a mixture of board and management administrative duties that combine board-shareholder communication and engagement together with such related duties as organization of the annual meeting, proxy solicitation, regulatory filings, disclosure and compliance.
- ***Director Relations***. The company can set up an independent department dedicated exclusively to serving the board. With its own budget and staff, reporting to the board and serving its committees, the Director Relations office would provide administrative support for internal activities such as director selection, board evaluation, compensation policy, D & O insurance and other ad hoc board projects, as well as external communications and engagements with shareholders. It would also organize the retention of independent experts to advise the board as needed.

There can be many variations on these configurations that take into account the unique characteristics of individual companies and the issues facing their boards.

Conclusion

Although global corporate governance standards continue to uphold the director-centric model, information about board effectiveness remains fragmentary and inconsistent. Both companies and shareholders would benefit from an annual board narrative and a structured program for directors to communicate and engage with shareholders.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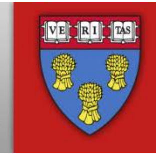

NACD Investor Perspectives: Critical Issues for Board Focus in 2015

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Saturday February 7, 2015

Editor's Note: The following post comes from Peter Gleason, president of the National Association of Corporate Directors (NACD), and is based on an NACD publication; the complete publication, including appendix and additional resources, is available here.

As part of our mission to advance exemplary board leadership, the National Association of Corporate Directors (NACD) engages in ongoing dialogue with major U.S. institutional investors representing approximately $14 trillion in assets under management.[1] This post reflects NACD's perspectives on recent conversations, including group and individual discussions with eight leading investors and several roundtable meetings between investors and Fortune 500 committee chairs. Several themes emerged regarding important issues for boards to consider in preparation for the upcoming proxy season:

- Investors are focused on "drivers" of effective board leadership.
- Investors will hold directors accountable when they believe shareholder rights have been undermined.
- High-quality communication between boards and investors is about context, not volume.

Investors are focused on "drivers" of effective board leadership.

Discussion participants noted that even where investors share priorities on a particular corporate governance issue, their "tactics"—such as specific proxy voting policy guidelines or approaches to engagement with portfolio companies on that issue—may be quite different.

Despite those differences, when asked about their 2015 priorities for the director community in general, several investors agreed with one who said, "*Increasingly, compensation is often viewed as an outcome. We're much more interested in what we see as the drivers [of such outcomes],*

[1] This post reflects NACD's use of a modified version of the Chatham House Rule in which the names and institutional affiliations of participants are published, but their comments (shown in italics) are made anonymously. See the Appendix of the complete publication for a list of participants.

including key board processes." Discussion participants highlighted two particular categories of boardroom processes:

- **Board "refreshment" practices**. The importance of board composition, director succession planning, board evaluation processes, and director skillsets has been a common theme in NACD's multi-stakeholder dialogues across 2014, and investors emphasized these issues will continue to be top-of-mind in 2015. Several investors noted that "*observable components such as director tenure and backgrounds are neither inherently good nor bad, but they help investors get a picture of what's important to the board and the company*." Evidence that boards are taking a strategic approach to director succession planning is of critical importance to investors: "*At companies where one-third or even half of the board will be at retirement age in the next three to five years, what's the plan? Will there be a staggered replacement or a wholesale change? We believe tenure has value, and continuity is important, so it's very valuable to investors to understand how boards will be approaching this issue proactively*." Participants agreed that these responsibilities are particularly central to nominating/governance committees, but pointed out that certain investors "*will hold the entire board responsible for good stewardship of its own succession plan*."
- **Board engagement in strategy-setting and oversight of risk management activities**. The recently released *Report of the NACD Blue Ribbon Commission on Strategy Development* recommends that boards move from a traditional "review and concur" approach to strategy, to a model of "engage[ment] with management on strategy issues on an ongoing basis, including early involvement to improve strategy development, adjustment, and monitoring."[2] Investors strongly supported this approach in recent dialogues with NACD. "*Everyone has an annual offsite, [but] how much and how often does the board get involved beyond that?"* Several discussion participants observed that conversations with directors about executive compensation can be important indicators to investors of the quality of boardroom dialogue on strategy: *"We always ask directors to talk about how the company's compensation plan is linked to strategy. In that conversation, if a director can't articulate the strategy clearly and concisely, it's difficult to see them as actively engaged in oversight."* Similarly, investors are seeking indicators that the board is using, as one put it, "*an inclusive and holistic definition of risk*." One investor asked, "*How [are directors] keeping up—for example, are they getting access to a broad range of information on industry issues and new threats, or are they only hearing presentations from management?"*

[2] National Association of Corporate Directors (NACD), Report of the Blue Ribbon Commission on Strategy Development (Washington, DC: NACD, 2014), 19.

Investors noted that they look at both of these drivers of effective board leadership to understand how effective a board is likely to be at helping management navigate emerging risks, such as cyber threats, or dealing with unexpected crises and volatile economic conditions: "*Cyber is the hot topic today, but risks change constantly*," one investor said. "*If boards have the fundamentals in place, it inspires confidence among shareholders.*" Conversely, investor concerns about director qualifications, the board's approach to succession planning, and/or the level of board engagement in strategy and risk oversight may increase the likelihood that a company will appear on an activist investor's target list.

Investors will hold directors accountable when they believe shareholder rights have been undermined.

In previous dialogues with NACD, investors highlighted the importance of "governance basics" such as majority voting, the right to call special meetings, and declassified boards. In the view of many investors, these mechanisms are—or should be—generally accepted practice, especially at large and mature companies.[3]

Bylaws are a case in point. While recognizing that directors "*should be able to adopt amendments to improve [board] efficiency and effectiveness*" and understanding that boards "*sometimes need to take actions quickly*," investors emphasized that unilateral actions to change bylaws and/or their application in ways they believe adversely affect shareholder rights can be cause for significant concern. Said one investor, "*We encourage directors to have some discussion—why a particular action is being taken, the potential impact on shareholders, whether investors should be allowed to weigh in—and provide a rationale where appropriate. Otherwise the board appears blind to investors' views*."

Several discussion participants wondered if some board decisions that investors categorize in this way are a result of director reliance on the recommendations of outside advisors in the absence of broader input, especially feedback from major shareholders. One investor reported, "*In the past few months, when we've met with some boards to discuss these issues, it became clear that they were unaware [of the impact the decision had on investors]. It makes us wonder about the quality of the advice they're getting*."

High-quality communication between boards and investors is about context, not volume.

In a roundtable meeting earlier this year, investors noted that when it comes to proxy disclosures, "laundry lists and boilerplate statements about good governance just add length without adding

[3] NACD: Investor Perspectives—Critical Issues for Board Focus in 2014 (Washington, DC: NACD, 2014), 5.

very much meaning."[4] Discussion participants elaborated on this advice, explaining that they are increasingly placing focus on the quality of responses to investor feedback: "*When a board tells us, 'We heard X [from shareholders] and we did Y,' we're now stepping back and saying, 'Okay, but tell us more about why the board felt that action was appropriate.' We want to know that the rationale goes beyond just checking a box because ISS said so*." Another investor observed, "*We know many boards are already doing a lot in areas such as evaluation, but there's often not much disclosure about the process or the intended outcomes. Sometimes directors just need to explain these things better*."

One investor observed, "*So often, 'engagement' is defined as one company to one investor. There is a time and place for those meetings, but we also encourage companies and boards to look for one-to-many forms of communication. Beyond the proxy, those vehicles include investor days or video interviews with board members on the company website*."

Investors emphasized that providing a rationale for the board's decisions is a valuable way to establish credibility and gain investor confidence. "*When directors say, 'We realize this was not a popular choice but we weighed the alternatives and here's why we came to this conclusion,' it sends a very positive signal about the board's judgment.*" Lack of disclosure, particularly on contentious issues, can be a red flag. "*Outliers really stand out to investors these days. If you're an outlier on a particular issue, it's best to own it. Either provide a rationale for why the board believes its position is the right one, or outline how you plan to fix it*."

The complete publication is available here.

[4] *Id.*

Harvard Law School Forum on Corporate Governance and Financial Regulation

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US Proxy Season Halftime Report—Governance Trends

Posted by Frank B. Glassner, Veritas Executive Compensation Consultants, LLC, on Friday, May 29, 2015

Editor's note: Frank B. Glassner is the Chief Executive Officer of Veritas Executive Compensation Consultants, LLC (Veritas). This post is based on a Veritas publication.

As we hit the halfway point for the 2015 U.S. proxy season, a number of trends related to governance practices are carrying through from recent years, an analysis of ISS Voting Analytics data shows.

Director Elections

Shareholders have largely endorsed directors standing for election in 2015, with average support levels of upwards of 96 percent, similar to last year. However, as is the case every year, a number of directors have not fared well at the ballot box. Fourteen directors have failed to receive majority support so far this season, compared with 12 board members at this time last year.

The lion's share (12 of the 14) of year-to-date 2015 failed director votes have been at firms outside the Russell 3000 index. On a sector basis, most of the failed director elections have occurred at firms in the Technology Media and Telecom sector (with seven failed votes) and financial services firms (3 failed votes). Companies in the financial services sector topped last year's list with the most failed director votes.

Drivers of Low Votes

The primary drivers of low director support come as no surprise to governance observers. Similar to prior years, affiliated directors on key committees, non-responsiveness to majority supported shareholder proposals or majority opposed directors and say on pay plans, unilaterally adopted poison pills, unilaterally adopted bylaw amendments, directors sitting on too many boards, and persistent pay-for-performance concerns are the major drivers of low shareholder support for directors.

Shareholder Proposals

Of roughly 950 resolutions submitted at almost 500 firms for the 2015 proxy season, 600 shareholder proposals have so far appeared on proxy ballots at close to 350 companies. In aggregate, about 18 percent of the proposals have been withdrawn and approximately 14 percent excluded from ballots with the SEC's assent. Voting Analytics has average investor support for the approximately 190 shareholder resolutions where vote results are currently available at 33.5

percent support. Twenty eight (or roughly 15 percent) of these have received majority support, with proxy access proposals accounting for almost half of the majority votes. For context, these tallies compare with about 560 proposals at almost 330 companies in all of 2014, which received, on average, 32.7 percent support, and 83 of which received majority votes.

Governance Proposals Most Ubiquitous

Governance proposals account for half of all resolutions on ballots this year, followed by environmental and social (E&S) proposals with 37 percent of the total tally, and compensation proposals at 13 percent.

Governance proposals have received 43 percent average support of votes cast "for" and "against," whereas shareholders have supported E&S and compensation resolutions by 22.6 percent and 33.4 percent on average, respectively. Governance proposals have also drawn 25 of the 28 majority votes thus far this year, with the remaining three majority votes for compensation resolutions. No E&S proposals have thus far received majority support, in contrast to this time last year when a lobbying disclosure proposal obtained majority support in early May. In 2014, seven E&S resolutions received majority support—six of which were opposed by boards.

Proxy Access Aplenty

In terms of volume, proxy access is the highest-profile shareholder proposal topic this proxy season, with 84 shareholder proposals on the ballot to date, or more than four times the number of proposals that appeared on ballot in 2014. Nearly all of the proxy access shareholder proposals are modeled on the 3 percent-for-three-years formulation featured in the SEC's vacated proxy access rule. Voting Analytics data shows that access proposals have so far received 54.9 percent shareholder support at the 32 companies where vote results are available. Fourteen have received majority support.

The boards of seven companies have sponsored proxy access proposals that compete with the shareholder proposals on ballot, with terms that are more restrictive. Of the two dueling proposal vote outcomes available, investors voted down the board-sponsored 5 percent-for-three-years proposal at *AES Corp. (Governance Quickscore: 2)* which received just 36 percent support, favoring the 3 percent-for-three-years shareholder proposal with more than 66 percent support. At *Exelon (Governance Quickscore: 6)*, however, shareholders did the exact opposite, and passed the 5 percent-for-three-years board proposal with more than 52 percent support, whereas the 3 percent-for-three-years shareholder proposal received 44 percent support.

Continued Calls for Independent Board Chairs

After proxy access, the next most frequently occurring shareholder resolution is that calling for an independent board chair, with 64 proposals on ballot so far this year. Average shareholder support for the 29 proposals for which vote results are available currently stands at 29.5 percent, down slightly from last year's 31.1 percent average support. So far in 2015, no independent chair shareholder proposals have received majority votes—the proposal at *Baxter International (Governance Quickscore: 10)* came close, with 48.9 percent shareholder support. Last year, four independent chair proposals received majority support, two of which are on ballot again in 2015.

Management Say on Pay Update

As expected in 2015, management say-on-pay (MSoP) ballot volumes are down thanks to the dearth of biennial and triennial advisory votes falling in the 2015 calendar year. For the typical proxy voter, this should translate to a 10 percent year-over-year drop in MSoP ballot volumes. For many investors, this may turn out to be a false economy, however, since the focus simply shifts to the compensation committee and the election of directors. Levels of support have, however, remained relatively unchanged from last year, with average shareholder support for MSoP proposals at 92.3 percent. Eleven firms have so far received less than majority support, compared with 16 failed votes at this time last year. Most of this year's failed votes have occurred at Russell 3000 firms and in the Industrials sector.

Roller Coaster Rides

A number of boards witnessed reversals of fortune with year-over-year support for say on pay increasing by 50 percentage points or more. Support at *Sensient Technologies (Governance Quickscore: 1, Compensation Pillar Quickscore: 3)* jumped to 98 percent in 2015 from 46 percent support in 2014, and at *FirstMerit Corporation (Governance Quickscore: 2, Compensation Pillar Quickscore: 6)*, shareholders approved say-on-pay by a margin of 93 percent this year, up from 42 percent support last year.

Other companies experienced the opposite reversal of fortune. *Walter Energy (Governance Quickscore: 3, Compensation Pillar Quickscore: 9)* saw support for say on pay drop by nearly 70 percentage points, from 95 percent in 2014 to 28 percent this year. Shareholders also thumbed down pay at *Schnitzer Steel (Governance Quickscore: 9, Compensation Pillar Quickscore: 8)* this year, with just 24 percent support, down from 76 percent support in 2014, and, at *Nuance Communication, (Governance Quickscore: 10, Compensation Pillar Quickscore: 10)*, where the say on pay vote just barely passed last year with 51 percent support, votes in favor dropped significantly in 2015, with just 14.6 percent support.—*Edward Kamonjoh, ISS' Head of U.S. Strategic Research Analysis and Studies*.

Council of Institutional Investors
The Voice of Corporate Governance

Via Email

March 5, 2015

Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Proxy Voting Roundtable, File Number 4-681

Dear Mr. Secretary:

The purpose of this letter is to express our appreciation to the Securities and Exchange Commission ("commission" or "SEC") and staff for holding the February 19, 2015, Proxy Voting Roundtable ("roundtable") and to provide you with our comments on the roundtable discussion addressing universal proxies.[1]

As you are aware, the Council of Institutional Investors ("CII") is a nonprofit association of employee benefit plans, foundations and endowments with combined assets under management exceeding $3 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of American workers.[2]

On January 8, 2014, CII filed a detailed rulemaking petition with the SEC to amend Section 14 of the Securities Exchange Act of 1934 to facilitate the use of universal proxies in contested elections of directors ("petition").[3]

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[1] Throughout this letter we use the term "universal proxy" or "universal proxies" rather than "universal ballot" or "universal ballots." Universal proxy or proxies refers to a proxy card on which the names of all candidates for the board appear, regardless of whom nominated them. In contrast, a universal ballot or ballots refers to what is distributed for voting by shareowners who attend the meeting in person, and includes the names of all candidates who have been nominated and permits the shareowner voting at the meeting to pick and choose whatever combination of nominees they prefer.
[2] For more information about the Council of Institutional Investors ("CII") and our members, please visit the CII's website at http://www.cii.org/about_us.
[3] Letter from Glenn Davis, Director of Research, Council of Institutional Investors, to Ms. Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission (Jan. 8, 2014), http://www.cii.org/files/issues_and_advocacy/correspondence/2014/01_08_14_CII_letter_to_sec_petition%20_for_rulemaking.pdf [hereinafter Petition].

The petition addressed, at least in part, many of the issues raised at the roundtable. Consistent with the petition, the following is our response to those issues:

The problem is clear

The problem that universal proxies would resolve is a problem that was clearly articulated by the SEC's own Investor Advisory Committee ("IAC") more than a year ago: Namely, investors are currently disenfranchised in a proxy contest because they have no practical ability to "split their ticket" and vote for the combination of shareowner nominees and management nominees that they believe best serve their economic interests.[4]

As the commission well knows, proxy contests are pivotal events for both companies and their owners. It is, therefore, critically important that investors are able to cast their votes in accordance with their actual preferences when board seats, and in some cases, board control are at stake.

The inability of investors to choose from among all individuals nominated from all parties limits shareowner choice and diminishes director accountability by precluding shareowners from choosing the best candidates amongst all of those who have been duly nominated.[5] This limitation weakens the quality of corporate governance in the United States.[6]

The importance of this issue to long-term institutional investors is evidenced by the approval of our general membership of the following amendment to CII's corporate governance best practices for director elections:

> To facilitate the shareholder voting franchise, the opposing sides engaged in a contested election should utilize a proxy card naming all management-nominees and all shareholder-proponent nominees, providing every nominee equal prominence on the proxy card.[7]

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[4] Recommendations of the Investor Advisory Committee Regarding SEC Rulemaking to Explore Universal Proxy Ballots 2 (Adopted July 25, 2013), http://www.sec.gov/spotlight/investor-advisory-committee-2012/universal-proxy-recommendation-072613.pdf [hereinafter IAC].
[5] *See id.* at 4.
[6] *Id.*
[7] CII, Corporate Governance Policies, § 2.2 Director Elections (updated Oct. 1, 2014), http://www.cii.org/files/policies/10_01_14_corp_gov_policies(1).pdf.

What perhaps, unfortunately, was not evident from the roundtable discussion is that a growing number of companies and their legal advisers generally support universal proxies.[8] As one example, last April, Keith Gottfried, formerly the head of the shareholder activism defense practice at Alston & Bird LLP said:

> [A]s shareholder activism ramps up and more institutional investors are cozying up to activist campaigns, corporate America is beginning to see the upside of the proposed switch [to a universal proxy] . . . .
>
> "A lack of universal ballot, or the inability to have [a] shareholder be able to combine nominees . . . is very frustrating . . . ."[9]

<u>Rulemaking on universal proxies should be a commission priority</u>

We understand and continue to support the commission giving priority to completing the congressionally mandated rulemakings assigned to the SEC in the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Jumpstart Our Business Startups Act.[10] Outside of those projects, however, we believe the commission should prioritize its rulemaking agenda based on consideration of the following two factors: (1) is the rulemaking project broadly supported by the constituency in which the SEC is explicitly and uniquely designed to protect—investors, and (2) would the rulemaking project lower or eliminate the roadblocks that inhibit the ability of investors to exercise their fundamental rights as shareowners. Accepting those two criteria, there is little question that rulemaking to facilitate universal proxies should be given a high priority on the SEC's agenda.

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[8] *See, e.g.*, Karlee Weinmann, Logistics Questions Loom as SEC Mulls Proxy Ballot Reforms, Law360, Apr. 4, 2014, at 3 (registration required), http://www.law360.com/articles/525002/logistics-questions-loom-as-sec-mulls-proxy-ballot-reforms.

[9] *Id.*

[10] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Scott Garrett, Chairman, Subcommittee on Capital Markets and Government Sponsored Enterprises et al. 2, 4 (July 23, 2014), http://www.cii.org/files/issues_and_advocacy/correspondence/2014/07_23_14_letter_Subcommittee_Capital_Markets.pdf.

We note that last August, CII's Advisory Council, representing $1.6 trillion in combined assets under management, issued a letter to the commission on this topic stating:

> Electing directors is a fundamental right of shareowners and an effective way to ensure that directors are accountable. But the Commission's proxy rules can impede shareowners' ability to choose their preferred candidates unless they attend the shareholder meeting in person. . . .
>
> We believe *it is time* for the Commission to ensure that investors voting by proxy have the same rights as those voting in person. Universal proxy cards for contested elections would make that possible. It would also enhance the confidence of market participants in the integrity of U.S. public companies and financial markets.[11]

Continued strong support from our general membership for SEC rulemaking to facilitate the use of universal proxies was a message we heard loud and clear at our annual conference in Washington, DC last spring.[12] As we described in a letter to the Director of the Division of Corporation Finance following the conference:

> [I]ssues relating to universal proxy cards and CII's related petition for rulemaking were prevalent topics of discussion for both conference presenters and CII members in attendance.
>
> Conference presenters addressing issues relating to universal proxy cards included SEC Commissioner Kara Stein. As reported by Reuters:
>
>> Stein drew applause when she threw her support behind requiring universal proxy ballots, a plan that CII formally petitioned the agency to consider in January.

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[11] Letter from Tim Goodman, Associate Director, Hermes Equity Ownership Services Limited et al., to Ms. Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission 1-2 (Aug. 21, 2014), http://www.cii.org/files/issues_and_advocacy/correspondence/2014/08_21_14_CII_letter_to_SEC_Universal%20Proxy.pdf.

[12] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Keith F. Higgins, Director, Division of Corporation Finance, Securities and Exchange Commission 3-4 (May 22, 2014), http://www.cii.org/files/issues_and_advocacy/correspondence/2014/05_22_14_letter_to_SEC.pdf.

> "It is time for the commission to consider permitting, if not mandating, universal proxy ballots, Stein said."

We wholeheartedly agree with Commissioner Stein that "it is time" for the SEC to act on our rulemaking petition.[13]

Universal proxies would lessen investor confusion

While a corporate lawyer at the roundtable and some other parties have expressed concern that universal proxies would cause "investor confusion," we are unaware of any CII General Members who share those views.[14] In fact, we believe the views of most investors are exactly the opposite—investors believe that universal proxies *would lessen investor confusion*. As explained in our petition:

> The current proxy rules are the real source of complexity. The Commission's explanation of the steps a shareholder must take to vote for management nominees using a shareholder proponent's proxy in a contest for a minority of the board provides an apt example:
>
> > The [shareholder proponent's] proxy statement and form of proxy will refer the shareholder to management's soliciting materials for the names, background and qualifications of the company's nominees. Thus, shareholders will know precisely which company nominees their shares will be voted for by comparing the full company slate with the list of company nominees the proxy holder will not vote for, and by indicating additional company nominees with respect to whom the shareholder wishes to withhold authority.
>
> *Changing the proxy rules to facilitate universal proxies would eliminate this confusion* and ensure a less cumbersome voting process.[15]

Beyond the investor community, the actions of some SEC registrants indicate that they too are confused by the current SEC rules governing shareowner voting in proxy contests.[16]

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[13] *Id.* at 4 (footnotes omitted).
[14] Yin Wilczek, Panelists at SEC Roundtable Spar Over Benefits of Universal Proxy Cards, BBNA Daily Report for Executives, Feb. 20, 2015, at EE-13 (on file with CII) [hereinafter BBNA].
[15] Petition, *supra* note 3, at 8 (emphasis added and footnote omitted).
[16] *See, e.g.,* Ronald Barusch, Dealpolitick: Management Takes Page from Activist Playbook with 'Short Slates,' Wall St. J., July 31, 2014, at 1-2, http://blogs.wsj.com/moneybeat/2014/07/31/dealpolitik-management-takes-page-from-activists-playbook-with-short-slates/.

As described last July in a Dealpolitik commentary in *The Wall Street Journal*:

> Tessera Technologies Inc. last year tried to defeat Starboard in a proxy fight by proposing a slate of only six directors to fill eight seats that were up for election. Tessera suggested shareholders write in, on the company's proxy card, the names of the Starboard nominees they wanted to elect to fill the remaining two seats. In a series of letters commenting on Tessera's proxy materials, the SEC indicated that it was less than pleased with this tactic. The agency said the company's proxy card violated a rule that prohibits proxies for being used for the election of people not named in the proxy statement and prohibits the naming of director candidates without their consent. Tessera and Starboard ultimately settled (Starboard got to name a majority of the board) and it does not appear that the SEC issue was ever resolved.[17]

The commentary concludes with the following statement:

> *Despite the current confusion over how shareholders can vote for candidates from both sides*, it looks like management short slates are here to stay as they try to hold on to control. *The SEC needs to catch up with the times.*[18]

Finally, we agree with the "consensus" reached by the SEC's IAC that any investor confusion that might potentially result from "voter inability to easily determine the recommended candidates nominated by a contestant . . . could be mitigated with conspicuous disclosure on proxy cards."[19]

<u>Universal proxies would lower investors' costs to vote</u>

It is our understanding that none of the roundtable participants disputed the fact that universal proxies would *lower* the "substantial" costs that investors currently face if they wish to exercise their full voting rights by picking and choosing among all the candidates who are duly nominated in a proxy contest.[20]

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[17] *Id.*
[18] *Id.*
[19] IAC, *supra* note 4, at 4; *see* Petition, *supra* note 3, at 9 (("Additionally, the Commission may wish to consider whether nominees should be grouped by slate (e.g., 'ABC Corp. Nominees' and 'Shareholder Proponent Nominees'), and whether the order in which candidates appear on the card should be consistent between the two cards)).
[20] IAC, *supra* note 4, at 1.

In addition, we believe that the benefits to the shareowner voting franchise provided by universal proxies far outweigh any costs that universal proxies might add to proxy contest participants.[21] On this point, we agree with roundtable participant Drexel University Professor Michelle Lowry who indicated that universal proxies "may not have that much impact on the costs of proxy contests."[22]

When evaluating the costs of universal proxies, we also believe it is instructive to look to our neighbor to the north, Canada, as an example of a jurisdiction that has demonstrated that universal proxies are both feasible and cost effective. As the SEC's IAC concluded, "[r]ecent experience in Canada (including large-cap issuers with substantial shareholders in the U.S.) suggests that technical implementation for a universal ballot regime is cost effective."[23]

Whether universal proxies would result in election of more shareowner or company nominees is unclear and should be irrelevant

Several roundtable participants expressed an opinion on whether or not universal proxies would favor shareowner or company nominees.[24] We believe it is unclear whether universal proxies would result in the election of more shareowner or company nominees and none of the roundtable participants provided empirical evidence indicating otherwise. We note that roundtable participant, Charles Penner, chief legal officer at investment manager JANA Partners LLC, indicated that "'[a]ll the evidence supports' that companies are more productive and shareholders benefit over sustained periods as a result of shareholder activism . . . ."[25]

More broadly, we believe the debate about whether universal proxies would favor shareowner-proponent nominees over company-nominees should be irrelevant. The more relevant question for the commission is whether universal proxies would provide investors, its primary constituent, with the ability to more fully exercise their fundamental right to vote for the election of directors in a proxy contest. The answer to that question is unequivocally yes.

[21] Petition, *supra* note 3, at 3 ("We believe the reform being requested would result in *de minimus* changes in costs for proxy context participants, and that the benefits of the shareholder voting franchise would far outweigh those costs.").
[22] BBNA, *supra* note 14, at EE-13.
[23] IAC, *supra* note 4, at 3.
[24] BBNA, *supra* note 14, at EE-13-14 (David Katz, partner, Wachtell, Lipton, Rosen & Katz LLP stating that universal proxies could "potentially lead to activists fielding more candidates" and Sarah Teslik, senior vice president at Apache Corp. indicating that universal proxies would "help" activism.)
[25] *Id.* at EE-13.

As explained by roundtable participant Anne Simpson, senior portfolio manager and director of global governance at the California Public Employees' Retirement System, and a current CII board member:

> [T]he SEC must facilitate, "not frustrate," the important exercise of shareholder rights. We need a system that works without that physical presence" where shareholders must be present to vote for the full slate of candidates . . . ."
>
> The whole purpose of [universal proxies] . . . is to "level the playing field" and ensure that shareholders voting by proxy have the same rights as if they attended the meeting. "All we're doing is ironing out a wrinkle."[26]

Universal proxy rulemaking would require some implementation guidance

We agree with those roundtable participants who indicated that SEC rulemaking to facilitate universal proxies would necessarily require some guidance on "mechanics."[27] We, however, do not believe such implementation guidance would necessarily be difficult to develop, or be complex, or voluminous.

We believe that the commission can and should provide basic guidance in its proposed rulemaking on the physical design of universal proxies.[28] The guidance might simply require that the cards "list the names of all director nominees clearly, equally in terms of form, and on the front of the proxy card."[29]

In other words, the guidance might require that "fonts and styles should be consistent for all candidates, and the names should not be permitted to appear on separate pages of the proxy card."[30] Finally, as indicated, we believe the proposed rulemaking guidance might also appropriately require that the nominees be grouped by slate.

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[26] *Id.*
[27] *Id.*
[28] Petition, *supra* note 3, at 8 ("We expect the Commission may be required to provide guidance on the physical design of universal proxy cards.").
[29] *Id.*
[30] *Id.*

As outlined in this letter, and as described in more detail in our petition, we believe the commission should propose promptly rules to facilitate the use of universal proxies for contested elections and fulfill "the Commission's goal of ensuring that the proxy process functions, as nearly as possible, as a replacement for an in-person meeting of shareholders."[31]

We thank you again for holding the roundtable and look forward to commenting on the proposed rule. In the meantime, should you have any questions or require any additional information about the views expressed in this letter or the petition, please feel free to contact me at 202.261.7081 or jeff@cii.org.

Sincerely,

Jeff Mahoney
General Counsel

[31] Petition, *supra* note 3, at 9.

The Quest for Universal Ballots: Might Boards Benefit Too?

By Tom Ball, Senior Managing Director, Morrow & Co.

The universal ballot, which has been sought after by shareholder activists for many years, is squarely on the SEC's radar. At the October 9th meeting of the SEC's Investor Advisory Committee, SEC Chair Mary Jo White speaking broadly about the proxy system, specifically mentioned the use of a universal ballot in proxy contests. Regarding the universal ballot, Ms. White remarked, "…this is a very important issue for investors and other market participants, and is also—like so many other parts of the proxy system—tied to a range of other critical issues." To address these proxy plumbing issues, she said the SEC "…will hold a roundtable early next year on a number of proxy matters, including universal ballots."

A universal ballot would list board nominees for both management and a dissident shareholder on the same ballot, enabling effective vote splitting on the election of directors. Under the current regime, it is very difficult for a shareholder to vote for nominees from each of the competing slates. The universal ballot has the potential to substantially change the dynamics in contested director elections. While activists have led the push for universal ballots, in practice, the universal ballot could also have strategic benefits for corporate boards in certain situations.

The Big Hurdle: The Bona Fide Nominee Rule

To implement a universal ballot in the US, changes will need to be made to the proxy rules. Under the existing proxy rules, in a proxy contest, a nominee up for election as a director can only be named in a proxy statement—and on a proxy card—if they have consented to being named in the proxy statement and to serve if elected. This is known as the "bona fide nominee" rule. As a result of this rule, a dissident shareholder can't list management nominees on its proxy card—unless the management nominees have consented (and vice versa).

Historically, there have been virtually no proxy contests in the US where the management and dissident candidates have consented to being named on each side's proxies. As a result, in most proxy contests, it is very difficult for shareholders to "split the ticket" and vote for a combination of dissident and management nominees.

While there are ways in which to split your vote, practically speaking, most shareholders are limited to voting on either management's proxy card or the dissident's, regardless if they wish to split their vote for nominees on each competing slate.[1] The same, of course, holds true for the voting recommendations provided by ISS and Glass Lewis in proxy contests.

A split vote recommendation by ISS or Glass Lewis can have unintended consequences.[2] For example, in a change-of-control situation, ISS and Glass Lewis could decide that change is necessary on the board, but not a change-of-control; and recommend a split vote on the dissident's proxy card (*e.g.*, vote "For" three of the dissident nominees and "Withhold" on four). Since an institutional shareholder following the recommendation would be giving all its vote on the dissident proxy card and no votes to management, in a worst case scenario, this could result in all of the dissidents being elected, and a change of control.

As a result, there has been a call over the years for eliminating—or amending—the bona fide nominee rule so that nominees for both the management and dissident slates can be listed on one universal ballot (also known as a "universal proxy"). This call has come primarily from labor and public pension funds and has support from ISS and the Council of Institutional Investors, in addition to interest on the part of the SEC's Investor Advisory Committee.

In September 2013, CII members approved a policy calling for the use of universal ballots. Following up on this, CII increased its pressure in January by sending a rulemaking petition to the SEC requesting

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[1] The most effective way to vote for a combination of management and dissident nominees is by attending the shareholder meeting and voting by ballot. There are also ways that institutional shareholders can split the ticket by instructing their broker or bank (or Broadridge), but the process can take time and may be subject to challenge.

[2] When the proxy advisory firms make a split vote recommendation, they instruct institutions to vote on either the dissident or management proxy card and vote for some of the nominees and withhold on the remaining nominees.

that the agency amend the proxy rules to eliminate the bona fide nominee rule and introduce universal ballots in *all* contested elections.

The SEC is also focusing on the topic of a universal ballot, primarily due to the interest of its Investor Advisory Committee. In July 2013, the IAC recommended that the SEC amend the bona fide nominee rule to allow for universal ballots. The IAC recommendation differed from CII in that the use of the universal ballot would be optional and could only be used in connection with a short slate contest (where the dissident is seeking only a minority of the board).

Over the years, in proxy contests, ISS has recommended split votes in many instances. In its split recommendations, ISS has noted the limitations of the current proxy system to allow for effective vote splitting, saying it is "…one of the weaknesses of the current voting regime as it applies to proxy fights"— and that "ISS supports a universal split vote/ballot option for all shareholders."

A Little History

While the bona fide nominee rule inhibits the use of a universal ballot, there is some limited history in the US with the universal ballot.[3] In 2009, Bill Ackman of Pershing Square ran a proxy fight at Target. Early in the fight, Pershing lobbied Target to allow for a universal ballot. Target rejected the request and the universal ballot did not see the light of day.

In late April 2013, Tessera Technologies, which was in a proxy fight with Starboard Value and Opportunity Master Fund, Ltd., sent a letter to Starboard proposing that they consent to the use of a universal proxy card. While Starboard acknowledged "the potential benefits for using a universal ballot", they rejected the request because it could cause delays and confusion.

Despite Starboard's rejection, in May 2013, Tessera sent out supplemental proxy materials with a form of universal proxy card that would allow shareholders to vote for two of Starboard's nominees by writing in the name of the nominees. However, the SEC opposed Tessara's use of such a proxy card and, as a result, the company was forced to send another letter to shareholders noting the SEC's objection, and warning shareholders that "…votes on the Revised VIF or the Company's form of supplemental proxy card may ultimately be deemed invalid in any subsequent litigation."

Strategic Considerations for Management Using Universal Ballots

As its brief history indicates, attempts to use the universal ballot have been made by both management and dissidents and, interestingly, have been rejected by both sides as well. This may point to the fact that while shareholders have traditionally been the champions of the universal ballot, there is utility in a universal ballot for management as well.

If the SEC were to amend the proxy rules and allow for the optional use of a universal ballot, the strategic consideration for using a universal ballot would be fact-specific and based on the shareholder profile, the influence of ISS and Glass Lewis, the particulars of the situation and, ultimately, your view on the outcome of the vote. In addition, if your opponent were to opt for using a universal ballot, this may force your hand.

For example, if there are concerns about a possible split recommendation from ISS and/or Glass Lewis, by choosing a universal ballot, you may avoid the unintended consequences of a split ballot recommendation as outlined above, where shareholders are forced to vote on only one proxy card. The universal ballot could increase the chances that at least some of your nominees are elected.

It will also be interesting to observe how corporate bylaws will be amended should the SEC bless the universal ballot.

[3] The universal ballot has been used successfully in Canada, most prominently in the Canadian Pacific / Pershing Square proxy contest in 2012.

The Elusive Promise of Reducing Shareholder Litigation Through Corporate Bylaws

Posted by Holly J. Gregory, Sidley Austin LLP, on Monday June 9, 2014

Editor's Note: Holly J. Gregory is a partner and co-global coordinator of the Corporate Governance and Executive Compensation group at Sidley Austin LLP. This post is based on a Sidley update, and is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

Corporations today are routinely subject to expensive shareholder litigation for which shareholders ultimately foot the bill. Even weak shareholder claims pose significant costs and uncertainty, and exert significant settlement pressures, on corporations. Several recent state court decisions, however, underscore the potential for corporate bylaws, including those adopted by boards, to reduce incentives for the plaintiffs' bar to file such lawsuits:

- The Delaware Court of Chancery has upheld, at least as a general matter, the statutory and contractual validity of board-adopted bylaws that seek to limit the forum for intra-corporate litigation.
  - State courts in Louisiana, New York and Illinois have, in turn, enforced Delaware exclusive forum clauses.
- The Delaware Supreme Court has upheld the statutory and contractual validity of bylaws that allocate the cost of intra-corporate litigation to a losing plaintiff.
- A state court in Maryland has upheld a corporate bylaw that requires the arbitration of intra-corporate disputes.

Although these court decisions have spurred significant interest in board-adopted bylaws aimed at reducing incentives for the plaintiffs' bar to file claims, caution is advised. Notwithstanding strong arguments in favor of deterring nuisance suits, which are costly to companies and their shareholders, some shareholders, shareholder rights advocates and proxy advisory firms have expressed disfavor with board-adopted exclusive forum and arbitration bylaws. Moreover, the Corporation Law Section of the Delaware State Bar Association has proposed a legislative amendment to the Delaware General Corporation Law (the "DGCL") that would effectively prohibit Delaware stock corporations' use of fee-shifting bylaws.

Exclusive Forum Bylaws

Prior to the late 1990s, plaintiffs commonly filed intra-corporate complaints in the jurisdiction of the state of incorporation. "The choice of law embedded in the decision to incorporate in any given state thus also operated as a de facto choice of forum provision." Joseph A. Grundfest, *The History and Evolution of Intra-Corporate Forum Selection Clauses: An Empirical Analysis*, 37 DEL. J. CORP LAW 333, 373 (2012). However, as plaintiffs' counsel have increasingly searched for the most generous forum for plaintiff counsel fee awards, it is now routine for a corporate action to be challenged in multiple jurisdictions. For example, according to an oft-cited paper authored by Matthew Cain and Steven Davidoff, 97.5% of takeover transactions valued at over $100 million in 2013 resulted in shareholder litigation, up from 39% in 2005 (link here).

Delaware Vice Chancellor J. Travis Laster proposed a potential solution to the problem of forum shopping in March 2010, in *In re Revlon, Inc. Shareholders Litigation*, 990 A.2d 940, 960 (Del. Ch. 2010) (link here), when in dicta he suggested the use of exclusive forum clauses in corporate charters: "[I]f boards of directors and shareholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes."

Three years later, the Delaware Court of Chancery upheld exclusive forum bylaws adopted by two boards. *Boilermakers Local 154 Retirement Fund and Key West Police & Fire Pension Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013) (link here). The fact that some shareholders had made their investments prior to the boards' adoption of such bylaws was not an impediment. According to then-Chancellor Leo E. Strine, Jr., "the bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and shareholders … This contract is, by design, flexible and subject to change in the manner that the DGCL spells out and that investors know when they purchase stock in a Delaware corporation." The certificates of incorporation of each corporation authorized the boards to adopt bylaws unilaterally. Chancellor Strine noted, however, that based on the facts and circumstances of a particular case, a board-adopted exclusive forum bylaw may be subject to challenge if it operates unreasonably as applied or has been adopted or used for an inequitable purpose. He also emphasized that shareholders who object to such provisions have recourse in the form of board elections and shareholder proposals to amend or repeal such bylaws. The Delaware Supreme Court has not yet weighed in on this issue.

Decisions in three cases outside of Delaware suggest that foreign courts will respect exclusive forum bylaws, particularly if such provisions are adopted on a "clear day," before a dispute has arisen:

- ***Miller v. Beam Inc.***, 2014-CH-00932 (Ill. Ch. Ct. Mar. 5, 2014), granting the defendants' motion to dismiss and enforcing an exclusive forum bylaw that provided that Delaware was the exclusive forum for M&A litigation.
- ***Genoud v. Edgen Group Inc.***, No. 625,244 (19th Jud. Distr. Ct., East Baton Rouge, La. Jan. 17, 2014), granting the defendant's motion to dismiss and enforcing an exclusive Delaware forum clause in a corporate charter.
- ***Hemg Inc. v. Aspen Univ.***, No. 650457/13, 2013 WL 5958388 (N.Y. Sup. Ct. Nov. 14, 2013), granting the defendants' motion to dismiss shareholder derivative claims based upon an exclusive Delaware forum clause in Aspen's bylaws.

Fee-Shifting Bylaws

Generally, in the United States, including in the state of Delaware, unless parties to a lawsuit have otherwise agreed by contract (or a specific statute provides that the court can allocate costs against a losing party), each litigant is responsible for paying its own attorneys fees and court costs. Some jurisdictions outside the United States rely on a "loser pays" system to help discourage lawsuits of questionable merit and avoid pressures on corporations to settle non-meritorious suits early in the interests of saving the corporation time and money and avoiding uncertainty.

On May 8, 2014, the Delaware Supreme Court sitting en banc ruled, in *ATP Tour, Inc. v. Deutscher Tennis Bund*, — A.3d –, 2014 WL 1847446 (Del. May 8, 2014) (link here), that a board-adopted bylaw that provided for a losing plaintiff to pay defendants' attorneys fees and costs associated with its intra-corporate suit was consistent with the provisions of the DGCL and Delaware common law. In 2006, the board of ATP Tour, Inc. ("ATP"), a non-stock, Delaware membership corporation, had amended its bylaws to provide that if a current or former member brought suit or counterclaimed against ATP, fellow members, or certain affiliates, and the member asserting the claim failed to "obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought," the member must reimburse the fees, costs, and expenses incurred by ATP or other such parties defending against the claim or counterclaim. Thereafter, two members sued the company and six directors in the U.S. District Court for the District of Delaware and lost the claims on the merits. ATP moved to recover its fees, costs, and expenses under the fee-shifting bylaw, and ultimately the District Court certified the issue of bylaw validity and enforceability to the Delaware Supreme Court.

Although the Court warned that an otherwise valid bylaw would not be enforced if adopted or used for inequitable purposes, it stated that "intent to deter litigation … is not invariably an improper purpose." In finding the bylaw at issue facially valid and enforceable, the Court also noted that a valid fee-shifting bylaw could require the plaintiff to bear the defendants' expenses

and could validly provide that such fee-shifting will occur only if the plaintiff is wholly unsuccessful, or as in the case before it, even if the plaintiff was partly successful. Further, the Court noted that fee-shifting bylaws can be enforced against pre-existing members of the corporation. Although the suit arose in the context of a non-stock membership corporation, the provisions of the DGCL concerning bylaws that were at issue apply to both stock and non-stock corporations, and therefore the ruling is not on its face limited to non-stock membership corporations.

This ruling has given rise to interest in the use of fee-shifting bylaws in traditional stock corporations. Yet, the potential use of fee-shifting bylaws as a mechanism to discourage nuisance suits may be short lived. The Corporate Law Section of the Delaware State Bar Association has reacted swiftly by proposing that the DGCL be amended to limit the effect of the *ATP* ruling. The stated concern is that requiring a shareholder plaintiff to bear the costs in a losing litigation would:

- Unduly chill meritorious claims from being brought, and
- Undermine the limited liability protections afforded to shareholders by Delaware corporate law.

The proposed amendments would clarify that fee-shifting bylaws, or other charter or bylaw provisions, may not impose monetary liability on shareholders of Delaware stock corporations (link here). Some have noted the irony of the Delaware corporate bar, usually stout defenders of Delaware corporations, petitioning the legislature to ensure the continuation of fiduciary duty lawsuits against Delaware corporations.

Arbitration Bylaws

In a pair of recent decisions relating to a real estate investment trust ("REIT"), a Maryland state court upheld bylaw provisions requiring shareholders to arbitrate rather than litigate claims. *See Katz v. CommonWealth REIT*, Case No. 24-C-13-001299 (Md. Cir. Ct. Feb. 19, 2014) (link here); *Corvex Management LP v. CommonWealth REIT*, Case No. 24-C-13-001111, 2013 WL 1915769 (Md. Cir. Ct. May 8, 2013) (link here).

The Circuit Court for Baltimore City, Maryland considered the *Boilermakers* decision of the Delaware Court of Chancery regarding the board's ability to unilaterally adopt provisions addressing intra-corporate litigation, and held that Maryland law granted the trustees of REITs the unilateral authority to amend such bylaws. The Maryland Court concluded that all "shareholders assent to a contractual framework that explicitly recognizes that they will be bound by bylaws adopted unilaterally" and, further, that they have "purchased their shares with constructive knowledge that the arbitration bylaws were in effect and that their shares were subject to them." The Maryland court explained that such constructive notice prior to purchase "is enough to

constitute mutual assent of the parties." Note that in a related case, *Delaware County Employees Retirement Fund v. CommonWealth REIT*, No. 13-10405-DJC (D. Mass. Mar. 26, 2014) (link here), the U.S. District Court for the District of Massachusetts observed that in light of the earlier Maryland decisions, the District Court would deny the plaintiffs' request for a declaratory judgment that the arbitration bylaw adopted by the trustees was invalid and would not prevent the defendants from seeking to arbitrate the plaintiffs' shareholder claims.

Practical Implications

In addition to the efforts to amend the DGCL noted above to prohibit fee-shifting in Delaware corporate bylaws or certificates of incorporation, shareholder pressures and pressure from influential proxy advisory firms may well inhibit the broad use of such provisions. For example, some shareholder groups and pension and union funds have expressed their disfavor of certain of these provisions, as follows:

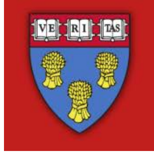
- **Council of Institutional Investors**. According to CII's Corporate Governance Guidelines (Section 1.9), "Companies should not attempt to restrict the venue for shareowner claims by adopting charter or bylaw provisions that seek to establish an exclusive forum. Nor should companies attempt to bar shareowners from the courts through the introduction of forced arbitration clauses."
- **AFL-CIO**. Under the Proxy Voting Guidelines (Section D.16) of the AFL-CIO, "The voting fiduciary should vote against management proposals to restrict the venue for shareowner claims by adopting charter or bylaws provisions that seek to establish an exclusive judicial forum. Rules about where shareholders may sue are generally set by statute through the legislative process which balances competing concerns. Corporations should not deprive shareholders of the ability to bring lawsuits in the judicial forum of the shareholders' choosing."
- **New York State Common Retirement Fund**. It has been reported that the Fund generally disfavors exclusive-forum provisions because the Fund believes that such provisions limit shareholders' ability to hold corporations accountable.

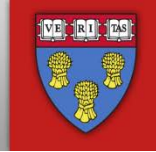
Moreover, proxy advisory firms are likely to support shareholder proposals seeking to repeal exclusive forum, fee-shifting and arbitration bylaws. Both Institutional Shareholder Services ("ISS") and Glass Lewis purport to review exclusive forum proposals on a case-by-case basis, taking into consideration, among other things, whether the company has adequately disclosed compelling arguments or evidence of abuse of legal process in other, non-favored jurisdictions. Note that ISS supported shareholder proposals to repeal exclusive forum bylaws at Chevron and United Rentals, Inc. in 2012, notwithstanding good corporate governance practices and public

disclosures concerning the harms of multi-jurisdictional lawsuits by both companies. ISS stated that it was unable to determine that such harms were material.

Accordingly, we recommend that corporate counsel consider carefully the opportunities—and risks—associated with board-adopted bylaws that are intended to require a particular forum, arbitration or fee-shifting in connection with intra-corporate disputes. In particular:

- Counsel should follow developments in this area closely. Counsel should be wary of adopting fee-shifting bylaws given ongoing legislative activity in Delaware and note that the Delaware courts have not yet weighed in on the enforceability of arbitration bylaws.
- A company that is going public and has the opportunity to deter nuisance litigation by adopting provisions protecting against forum shopping or requiring arbitration of intra-company disputes in its certificate of incorporation or original bylaws should carefully consider doing so. There are advantages to this approach, given that later-board adopted bylaws could subject the board to criticism from shareholders and other groups. In addition, such later-adopted provisions may not be enforced if they are not adopted on a "clear day."
- A company interested in these bylaw provisions should first review the certificate of incorporation to confirm that it specifically grants the board the power to amend the bylaws.
- Consideration of these bylaw provisions should be undertaken on a "clear day," at a time when the company is not under a specific threat of litigation. Additionally, a board adopting these bylaw provisions should ensure that the board minutes accurately and fully reflect the board's deliberations and the reasons why the board believes such provisions are in the best interests of the corporation and its stockholders. This may help to avoid equitable concerns that might lead a court to decline to enforce the bylaw as written.
- A company considering board-adopted bylaw provisions should also consider the potential reaction of shareholders and shareholder rights groups, as well as proxy advisors. The reaction of some groups to exclusive forum and arbitration bylaws has historically been negative, and the response to the ATP decision regarding fee-shifting bylaws remains to be seen.
- Delaware public companies will also need to review ongoing legislative developments when considering whether to adopt a fee-shifting bylaw. If approved by the Executive Committee of the Delaware State Bar Association and adopted by the legislature, the amendments proposed by the Corporate Law Section would become effective on August 1, 2014.


The Harvard Law School Forum on Corporate Governance and Financial Regulation



Delaware (Again) Proposes Sledgehammering Fee-Shifting Bylaws

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Thursday March 12, 2015

Editor's Note: The following post comes to us from John L. Reed, chair of the Wilmington Litigation group and a partner in the Corporate and Litigation groups at DLA Piper LLP, and is based on a DLA Piper Corporate Governance Alert by Mr. Reed and Ed Batts. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

As part of the annual update cycle for Delaware's General Corporations Law (DGCL), the Delaware Bar has returned to last year's controversy on fee-shifting provisions in bylaws and certificates of incorporation to propose, yet again, destroying the ability of Delaware corporations to, in their organizing documents, have the losing party in an intra-company (i.e. fiduciary duty) lawsuit pay the prevailing party's legal fees.

The proposal is among several 2015 legislative changes to the DGCL proposed by the Council of the Corporation Law Section of the Delaware State Bar Association, which is the working-level body that, historically through consensus, creates changes to the DGCL.

In addition the Council has proposed:

- that the right to seek appraisal rights be limited to stockholders who own at least $1 million of stock or 1 percent of the disputed company
- that exclusive forum provisions be officially sanctioned, so long as the exclusive forum is the State of Delaware and
- a revised approach to having the Chancery Court supervise arbitration proceedings, in an attempt to work within the federal judiciary's quashing of direct Chancery Court private adjudication of disputes in secret.

While one can question whether Delaware should allow another state's courts to become the exclusive forum of a corporation for disputes centered on the DGCL, **it is the renewed recommendation of outright proscription of the hotly debated fee-shifting bylaws that is**

the most controversial. Accordingly, while the other provisions are slated to be voted upon by the Delaware State Bar Association's Corporation Law Section on March 13, the fee-shifting prohibition vote has been slated for a vote at an unspecified point in April.

In an unusual move, for the fee-shifting prohibition the Council not only released the actual proposed legislative language, but also has circulated both an "Explanatory Note" and an "FAQ" with respect to the proposed changes.

The Council argues that:

- "Because the consequences of any corporate decision affect investors only commensurately with the scope of their investments, few stockholders will rationally be able to accept the risk of exposure to millions of dollars in attorneys' fees to attempt to rectify a perceived corporate wrong, no matter how egregious."

- "Without stockholder-initiated litigation, there would be essentially no effective enforcement mechanism for statutory or fiduciary obligations."

- Other avenues exist for penalizing potentially frivolous stockholder litigation, including Rule 11 sanctions from the bench for abusive claims, motions to dismiss early in the case, determining an accurate/representative plaintiff, scrutiny and potential rejection of proposed settlements, and limiting plaintiff's lawyers fees.

- For those who would posit that the Council is self-interested as loser-pays bylaws would potentially decimate the total addressable market for the Delaware plaintiffs' bar, "that criticism, of course, does not address the substance or merits of the issues; it is simply an assertion that whatever the Council does or does not recommend in relation to stockholder litigation is inherently tainted. In any event, we reject that criticism.

- "Those who argue that the legislation is protectionist will also note that the DGCL is often praised for its flexibility, and that the inflexibility of the proposed legislation is counter to that tradition. This argument fails to recognize that while the DGCL and fiduciary law do provide remarkable flexibility, they also contain certain 'bottom line' provisions that cannot be changed, such as information rights and the fiduciary duty of loyalty."

However, the Council **failed to adequately address** the following:

- ***The legislative amendment would abolish, wholesale, loser-pays provisions***: there is no room for a middle ground of proportionate fee allocation, or a measured cap system—so that the deterrent effect is material but not overwhelming for a particular plaintiff class. While the plaintiff's bar may argue that the mere cost of filing and pursuing a claim is a sufficient lower level deterrent, it is substantially less than what a modest cap amount could be. The Council did not address that, presumably, an insurance marketplace could emerge if loser-pays provisions were implemented that could be purchase by plaintiffs and, in candor, plaintiffs' law firms which stoke the embers on many of these types of lawsuits. Claims with clear merit could be expected to receive insurance at a reasonable premium.

- ***There is no explanation of the philosophical standard by which loser-pays bylaws are against the bottom-line, wholly subjective scaffolding of Delaware's sense of fairness***, whereas other corporate governance devices (in particular, dual-class corporations where a select number of stockholders dwarf the voting power of the other stockholders) are perfectly acceptable. Of course, dual-class stock structures, while many stipulate stifle the democratic process at annual meetings, conversely do not threaten the workload of the Delaware plaintiff's bar.

- ***The Council's proposal abolishes the ability for fee-shifting provisions in both the bylaws and the certificate of incorporation***. The current practical bifurcation of the bylaws versus the certificate of incorporation is that bylaws provisions may be adopted by a board of directors whereas the certificate of incorporation requires stockholder approval. That said, proxy advisory firms take a dim view of a board's unfettered discretion to revise bylaws and voice these concerns at annual meetings when such directors are up for re-election. Nonetheless, one could see Delaware objecting to a bylaws inclusion (without stockholder approval), but allowing for inclusion in the certificate of incorporation (requiring stockholder approval) and preserving the state's history of respecting and allowing the right of contract to prevail.

- ***The ringfencing of exclusive jurisdiction provisions to Delaware alone, whether based on valid substantive grounds or not, when taken together with the ban on fee-shifting bylaws, creates forced bundling and lends the appearance of a litigation land grab***. Delaware has long prided itself on its many corporate-friendly features, including a responsive Secretary of State's office, an evolved and thoughtful body of law in both the DGCL and decades of case law and a dedicated judiciary.

> Limiting exclusive forum provisions to Delaware forces a corporation to take those features as a “bundle.” There may be a good reason to do so, specifically that one presumes Delaware does not want a proliferation of other courts trying to interpret its laws without parties having recourse to Delaware’s courts. However, the likely outcome is that corporations will almost certainly want exclusive forum provisions, which eliminate multi-forum stockholder suits, but will now shift that litigation entirely and exclusively to Delaware, again much to the benefit of the Delaware plaintiff’s bar.

When taken as a whole, Delaware’s approach as a practical matter incents corporations to concentrate an enormous amount of discretion and latitude, and thus power, in a hitherto unprecedented amount, with the Delaware bench, while protecting, and in fact greatly increasing, the market for the Delaware plaintiffs’ bar.

The delay in the voting on the fee-shifting provisions demonstrates the ongoing friction in Delaware regarding the Council’s decision. While the most recently released changes were done in due course following the annual cycle for DGCL amendments, following the standard process has not changed in any way what appears to be the expected result—which is the further of the initial visceral reaction in the aftermath of the *ATP* decision. Indeed, the Council noted that *ATP* created room for counsel to posit that fee-shifting bylaws were now acceptable in Delaware. Lest that misconception pervade, the proposed changes will once and for all end the debate, albeit using the dullness of a butter knife instead of the precision of a scalpel.

Proskauer

State Bar Council Proposes New Legislation for Delaware Fee-Shifting Ban and Delaware Court of Chancery Considers Fee-Shifting Bylaw

In December, we reported on the Delaware Court of Chancery's continued validation of board-adopted forum-selection bylaws in *City of Providence v. First Citizens BancShares, Inc.*, 99 A.3d 229, 234 (Del. Ch. 2014), and the proposed amendment to the Delaware General Corporation Law (DGCL) that would eliminate the ability of Delaware stock corporations to impose liability for attorneys' fees on shareholders through bylaw and charter provisions—a response to the Delaware Supreme Court's decision in *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 555 (Del. 2014).

With a new legislative proposal from the Delaware Corporation Law Council this month, legislative action may be on the horizon. This new proposal would not only prohibit stock corporations from imposing liability on shareholders through fee-shifting but also from designating a forum other than Delaware as the exclusive forum for resolving intracorporate disputes.

When the legislature passed a resolution delaying debate on the proposed amendment to the DGCL last June, it called upon the Delaware State Bar Association, its Corporation Law Section, and the Council of that Section "to continue its ongoing examination of the State's business entity laws" and "submit to the 148th General Assembly for consideration any legislative proposals deemed meritorious in continuing and promoting the adoption and use of the State's business entity laws by corporations and their investors." S.J. Res. 12, 147th Gen. Assemb., Reg. Sess. (Del. 2014). On March 6, 2015, the Council issued a second proposed amendment and explanatory paper advocating the proposal and addressing some of the issues raised by critics during the debate over the proposal's previous incarnation.

Like the Council's previous proposal, the new proposal would ban stock corporations from imposing liability on shareholders through fee-shifting provisions in bylaws or charters. The proposal also introduces new provisions, notably a statutory endorsement of bylaw or charter provisions that designate Delaware as the exclusive forum for intracorporate claims and a prohibition of bylaws or charter provisions that designate a forum other than Delaware as the exclusive form for such claims. As with the previous proposal, this proposal would not prevent membership corporations like *ATP* from enacting fee-shifting bylaws. Fee-Shifting FAQs.

In the explanatory paper accompanying the proposal, the Council grounds its renewed support for a fee-shifting ban on the need to maintain the balance among the interests of directors, officers, and shareholders that has evolved through more than a century of shareholder litigation before Delaware

courts. Central to the Council's justification for the proposal is the position that fee-shifting bylaws or charter provisions would virtually eliminate shareholder litigation. Thus, the Council emphasizes that corporations can enact bylaws and charter provisions that deter abusive litigation only to the extent that shareholders can challenge them through litigation. The Council observes that tools such as poison pills, advance-notice bylaws, and fiduciary outs in merger agreements all developed through the DGCL's broad enabling structure and have been "regulated by common law developed through stockholder litigation." Explanation of Council Legislative Proposal.

One such tool is a forum-selection bylaw requiring shareholders to bring all actions in Delaware courts, such as the bylaw validated by the Delaware Court of Chancery in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013). The new proposal would provide legislative support for these provisions, which the Council hopes will give courts in other jurisdictions "additional reason to honor" exclusive forum-selection provisions. However, believing that "the choice of Delaware incorporation and resulting implicit choice of Delaware corporation law should result in a preference for Delaware courts to resolve disputes," the Council also proposes preventing a Delaware corporation from designating an exclusive forum other than Delaware for intracorporate disputes, even though the Delaware Court of Chancery Court recently validated such a bylaw in *City of Providence*.

Shortly after the Council's proposal was announced, Lisa A. Rickard, President of the U.S. Chamber Institute for Legal Reform, commented that the "proposal does precious little to solve the broadly-recognized problem of abusive mergers and acquisitions litigation, while taking away the fee-shifting approach some companies have used to combat it." She called the proposal "a huge win for Delaware's lawsuit business at the expense of shareholders in Delaware companies." See Hazel Bradford, "Delaware bar association law council recommends fee-shifting limits," Pensions & Investments Online, March 9, 2015; Jonathan Starkey, "Chamber: Proposal threatens $1B corporate franchise," *The News Journal*, March 9, 2015.

If the proposal is approved by the Bar Association's Corporation Law Section and Executive Committee, it will be formally submitted to the General Assembly. If enacted, the amendments would become effective on August 1, 2015.

While the Delaware legislature considers banning fee-shifting provisions, the Delaware Court of Chancery earlier this week issued its first decision involving fee-shifting bylaws since *ATP*. At issue in *Strougo v. Hollander*, C.A. No. 9770-CB (Del. Ch. Mar. 16, 2015), was whether a Delaware corporation's non-reciprocal fee-shifting bylaw applied to a *former* stockholder's challenge to the fairness of a 10,000-1 reverse stock split that the corporation undertook at the behest of its Chief Executive Officer and controlling stockholder in order to take the company private.

The question whether the bylaw itself was facially valid under Delaware law was not before the Chancery Court. Rather, the plaintiff moved for partial judgment on the pleadings on the basis that the bylaw did not apply in this case because it was adopted after his stock had been cashed out by the consummation of the reverse stock split.

The Court concluded that the bylaw did not apply in those circumstances because (1) it "was adopted after Plaintiff's equity interest in the company was eliminated," and (2) "Section 109(b) of the DGCL did not authorize a bylaw that regulates the rights or powers of a stockholder whose equity interest in the corporation has been eliminated before the bylaw was adopted." Chancellor Bouchard distinguished

this case from *ATP* and other decisions relied upon by the defendants because “none of them addressed whether a bylaw adopted *after* a stockholder’s interest has been eliminated applied in a lawsuit initiated by that former stockholder.”

We will continue to update you on the status of the legislation under consideration that might prohibit fee-shifting bylaws in stock corporations and other notable cases in this arena.

Shareholder Proposal Developments During the 2014 Proxy Season

Posted by Amy L. Goodman, Gibson, Dunn & Crutcher LLP, and John F. Olson, Gibson, Dunn & Crutcher LLP and Georgetown Law Center, on Wednesday July 2, 2014

Editor's Note: Amy Goodman is a partner and co-chair of the Securities Regulation and Corporate Governance practice group at Gibson, Dunn & Crutcher LLP and John Olson is a founding partner of Gibson, Dunn & Crutcher's Washington, D.C. office and a visiting professor at the Georgetown Law Center. The following post is based on a Gibson Dunn alert; the complete publication, including footnotes, is available here.

This post provides an overview of shareholder proposals submitted to public companies during the 2014 proxy season, including statistics, notable decisions from the staff (the "Staff") of the Securities and Exchange Commission (the "SEC") on no-action requests and information about litigation regarding shareholder proposals.

Shareholder Proposal Statistics and Voting Results

According to data from Institutional Shareholder Services ("ISS"), shareholders have submitted approximately 901 proposals to date for 2014 shareholder meetings, which already surpasses the total of 840 proposals submitted for all 2013 shareholder meetings. In 2014, proposals on environmental and social issues, while always prevalent, comprised a majority of proposals for the first time. The most common 2014 shareholder proposal topics, along with the approximate number of proposals submitted, were:

- political and lobbying activities (126 proposals),
- independent chair (68 proposals) and
- climate change (56 proposals).

By way of comparison, the most common 2013 shareholder proposal topics were (as of a comparable time last year):

- political and lobbying activities (115 proposals),

- board declassification (79 proposals) and
- independent chair (70 proposals).

While John Chevedden and shareholders associated with him submitted by far the highest number of shareholder proposals for 2014 shareholder meetings, there were several other proponents that were reported to have submitted at least 20 proposals. These proponents were the New York State Common Retirement Fund (54), New York City Pension Funds (48), the AFL-CIO (25), Trillium Asset Management LLC (23), the United Brotherhood of Carpenters Pension Fund (22), and Calvert Investment Management, Inc. (21).

Shareholder proponents withdrew approximately 19% of the proposals submitted for 2014 shareholder meetings to date, a decrease as compared to approximately 28% of the proposals submitted for 2013 meetings and approximately 26% of the proposals submitted for 2012 meetings (as of comparable times during both years).

Shareholder Proposal No-Action Requests

During the 2014 proxy season, companies submitted fewer no-action requests to the Staff as compared to the previous proxy season. The following table summarizes the responses to no-action requests that the Staff issued between October 1, 2013 and May 31, 2014, and during the same period in 2012-2013:

	2013-2014	2012-2013
Total Staff responses issued	286	328
No-action requests withdrawn	60	68
Responses granting or denying exclusion	226	260
Exclusion granted	161 (71%)	170 (65%)
Exclusion denied	65 (29%)	90 (35%)

Based on a review of the no-action requests for which no-action relief was granted, shareholder proposals were excluded for the following principal reasons:

- 30% based on procedural arguments, such as timeliness or defects in the proponent's proof of ownership;
- 18% because the proposal was vague or false and misleading;
- 14% based on ordinary business arguments;
- 12% because the company had substantially implemented the proposal; and

- 11% because the shareholder proposal conflicted with a company proposal that was to be submitted for a vote at the same meeting.

Of the shareholder proposals for which no-action relief was denied, 58% were challenged as being either vague or false and misleading under Rule 14a-8(i)(3), making these arguments the most frequently rejected arguments, as they were during 2012-2013. Other unsuccessful arguments made were that the company substantially implemented the proposal (25% of denials), that the proposal related to the company's ordinary business operations (17% of denials), and that there was a procedural defect in the submission of the proposal (22% of denials).

Shareholder Proposal Voting Results

Most shareholder proposals voted on at 2014 shareholder meetings did not receive majority support. Based on the 432 shareholder proposals for which ISS provides voting results, proposals averaged support of 32.5% of votes cast. Five proposal topics that received high shareholder support, including three that averaged majority support, were:

- Board declassification, averaging 84.0% of votes cast, compared to 78.7% in 2013;
- Elimination of supermajority vote requirements, averaging 69.6% of votes cast, compared to 70.5% in 2013;
- Adoption of majority voting in director elections, averaging 57.2% of votes cast, compared to 58.6% in 2013;
- Shareholder ability to call special meetings, averaging 41.6% of votes cast, compared to 44.5% in 2013; and
- Written consent, averaging 38.5% of votes cast, compared to 40.9% in 2013.

Based on the 432 shareholder proposals for which ISS provides voting results for 2014 shareholder meetings, 14.8% received support from a majority of votes cast, compared to 19.2% in 2013 (as of a comparable time last year). The table below shows the principal topics addressed in proposals that received a majority of votes cast at a number of companies:

	2014 Majority Votes	2013 Majority Votes
Majority voting in director elections	15	14
Board declassification	14	28
Elimination of supermajority vote requirements	9	15
Shareholders’ ability to call special meetings	4	3
Independent chair	4	5
Proxy access	4	3
Shareholder approval of shareholder rights plan	4	1
No accelerated vesting of equity awards upon a change of control	4	0
Political and lobbying activities	3	1
Shareholders’ ability to act by written consent	0	3
Other	3	4

2014 Shareholder Proposal Developments

Procedural Issues

Use of representatives in shareholder proposal process. Companies are increasingly concerned about the submission of proposals by individuals purporting to have authority from a shareholder but where the shareholder appears to have no involvement with the proposal. Some companies have argued that such practices, in which the proponent of a proposal does not provide appropriate authorization from the shareholder, are inconsistent with the Commission’s rationale for adopting a minimum share ownership requirement for Rule 14a-8, which was a need for “shareholders who put the company and other shareholders to the expense of including a proposal in a proxy statement to have some measured economic stake or investment interest in the corporation.”

As we discussed in our client alert regarding the 2013 shareholder proposal season, Waste Connections, Inc. sought and received a declaratory judgment from the U.S. District Court for the Southern District of Texas in April 2013, allowing it to exclude from its 2013 proxy materials a shareholder proposal submitted by John Chevedden on behalf of James McRitchie. Mr. Chevedden himself owned no shares of the company’s stock, but he had obtained a “proxy” to

submit the proposal from Mr. McRitchie, who had submitted proof of ownership under the rules. Waste Connections argued, among other things, that Rule 14a-8 does not permit a shareholder to grant a proxy to another individual to submit a shareholder proposal. The district court granted summary judgment to Waste Connections without specifically addressing the issue and, at the same time, denied Messrs. Chevedden and McRitchie's motion to dismiss the case for lack of subject matter jurisdiction. In February 2014 (after we issued our 2013 client alert), the U.S. Court of Appeals for the Fifth Circuit affirmed the district court's denial of the motion to dismiss. Because the appeal involved only the jurisdictional issue that was involved in the motion to dismiss (which is discussed further below), the Fifth Circuit did not address the company's "proposal by proxy" argument.

During the 2014 shareholder proposal season, a number of companies submitted no-action requests to the Staff making the *Waste Connections* "proposal by proxy" argument and other arguments regarding the submission of proposals by representatives. For example, in *The Brink's Co.* (avail. Jan. 17, 2014), Mr. Chevedden submitted a shareholder proposal under purported "proxy" authority from William Steiner. Brink's asserted that, because Rule 14a-8 does not provide for the submission of a proposal pursuant to a grant of "proxy" authority, Mr. Chevedden was the true proponent of the proposal but had not demonstrated his ownership of company shares. The Staff rejected this argument, noting that "John Chevedden submitted the proposal on behalf of William Steiner, the proponent, and a written statement was provided to Brink's verifying that the proponent satisfied the minimum ownership requirement for the one-year period required by rule 14a-8(b)."

Several companies also made other arguments related to shareholders' use of representatives. For example, in *Chevron Corp.* (avail. Mar. 11, 2014, *recon. denied* Apr. 4, 2014)*, Investor Voice submitted a proposal on behalf of a Chevron shareholder, Eric C. Rehm, and requested that it be identified in the proxy statement as the proposal's "sponsor." After Chevron replied with a deficiency notice requesting proof that Mr. Rehm had authorized Investor Voice to submit the proposal, Investor Voice provided an authorization letter from Mr. Rehm that was more than one year old and that did not identify the proposal or the subject company. Chevron argued that this type of broad grant of authority "serves as *carte blanche* for Investor Voice to submit any proposal that it wishes at any company where [Mr. Rehm] own[s] stock. If this type of a broad grant of authority were to be permitted, a market for free trade in stockholder proposals could develop, circumventing Rule 14a-8(b)'s requirement that only a stockholder may submit a stockholder proposal." However, the Staff determined that the proposal could not be excluded based on this argument.

The Staff also declined to concur that companies could exclude under Rule 14a-8 shareholder proposals in the following scenarios:

- ***No explicit grant of authorization:*** The shareholder's letter to the representative was undated and did not explicitly grant any authorization, stating instead that the shareholder was "pleased with the engagement practices of [the representative], including proxy voting, company dialogues, and the filing of shareholder resolutions." *See JPMorgan Chase & Co. (Zevin Asset Management, LLC)* (avail. Mar. 11, 2014).
- ***Change of proponents:*** The company received a shareholder proposal from the Environmental Working Group ("EWG") that was accompanied by a cover letter stating that EWG was a beneficial owner of the company's stock and was submitting the proposal as the "primary filer." Although an undated authorization letter from another shareholder also was included, EWG's cover letter did not reference this letter or the other shareholder. In response to the company's deficiency notice requesting EWG's proof of ownership, EWG stated that it was submitting the proposal on the other shareholder's behalf and provided that shareholder's proof of ownership. *See The Coca-Cola Co. (Vanderryn)* (avail. Jan. 15, 2014).

Given companies' concern over whether such practices reflect abuse of the shareholder proposal process, we expect companies to continue to focus on these issues.

Scrutiny of deficiency notices and proof of ownership. The Staff continued to closely examine companies' deficiency notices regarding defects in proponents' proof of ownership letters and to allow proponents an additional opportunity to provide proof of ownership where the notice was deficient.

In 2012, the Staff expressed concern in Staff Legal Bulletin No. 14G (Oct. 16, 2012) ("SLB 14G") that when a shareholder's proof of ownership verifies ownership as of a date that falls either before or after the proposal's "submission" date, "some companies' notices of defect make no mention of the gap in the period of ownership covered by the proponent's proof of ownership letter." Consistent with this concern, in *DST Systems, Inc.* (avail. Feb. 4, 2014), the Staff found the company's deficiency notice to be insufficient because, although the notice discussed the requirement to provide proof of ownership through the submission date, it did not explicitly inform the proponent that the proponent's proof of ownership failed to comply with this requirement.

SLB 14G also specified that a deficiency notice must "identif[y] the specific date on which the proposal was submitted." In both *DTE Energy Co.* (avail. Jan. 24, 2014) and *NCR Corp.* (avail. Jan. 24, 2014), the deficiency notices stated the dates on which the companies had *received* the

proposals but did not explicitly identify the proposals' *submission* dates. The Staff determined that the notices were insufficient despite the fact that, in the specific fact patterns at issue, the proposals had been submitted electronically (by fax in *DTE Energy* and by email in *NCR*), meaning the submission dates were the same as the receipt dates that were identified in the notices.

The Staff insisted on precision in documenting ownership as of the submission date not only with respect to deficiency notices but also with respect to proponents' proof of ownership letters. For example, the proof of ownership letters in *Cliffs Natural Resources Inc.* (avail. Jan. 30, 2014) and *Marathon Petroleum Corp.* (avail. Jan. 30, 2014) stated that the proponent had held the requisite amount of stock in the company "continuously for at least one year prior to the date of submission of the shareholder proposal." The companies argued that these proof of ownership letters were insufficient because, although they referenced the "date of submission," they did not identify the date itself. The Staff concurred that the companies could exclude the proposals even though in prior years it had determined that proof of ownership letters containing identical language were sufficient. *See, e.g.*, *Verizon Communications Inc.* (avail. Feb. 12, 2010).

Materially False or Misleading Arguments

Rule 14a-8(i)(3) permits the exclusion of a shareholder proposal that is "contrary to any of the Commission's proxy rules, including Rule 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials." Notable no-action letters involving this exclusion during the 2014 season included arguments regarding false statements, references to non-public materials and vagueness of a proposal on a company's use of preliminary voting results.

Exclusion of false statements. As in recent prior seasons, the Staff denied many requests for exclusion of the entire proposal or portions of the supporting statement under Rule 14a-8(i)(3) where companies argued that portions of a proposal's supporting statement were materially false or misleading. *See, e.g.*, *Verizon Communications Inc. (Kenneth Steiner)* (avail. Jan. 15, 2014) (denying exclusion where company argued that the supporting statement contained several false statements about the company's corporate governance and executive compensation); *Starbucks Corp.* (avail. Dec. 23, 2013)* (denying exclusion where company argued that the supporting statement included multiple false statements about the company's corporate governance and labor practices).

However, this season a court considered similar issues and ruled in favor of the company. In *Express Scripts Holding Co. v. Chevedden*, the U.S. District Court for the Eastern District of Missouri granted a declaratory judgment that the company could properly exclude a shareholder

proposal received from John Chevedden. The proposal requested a policy requiring the chairman of the board to be independent, and the supporting statement included several statements about the company's corporate governance and executive compensation practices that the company argued were false. In reaching its decision that the proposal could be excluded pursuant to Rule 14a-8(i)(3), the court stated:

> [W]hen viewed in the context of soliciting votes in favor of a proposed corporate governance measure, statements in the proxy materials regarding the company's existing corporate governance practices are important to the stockholder's decision whether to vote in favor of the proposed measure.… As such, the Court finds these misstatements are material and, therefore, not in compliance with SEC rules and regulations.

Prior to 2004, the Staff was more willing to concur in the exclusion of false statements in shareholder proposals and supporting statements (similar to *Express Scripts*), but the Staff changed its position in Staff Legal Bulletin No. 14B (Sept. 15, 2004) ("SLB 14B") in an effort to move away from editing shareholder proposals based on asserted deficiencies relating to clarity, relevance or questionable accuracy. In SLB 14B, the Staff stated that going forward "exclusion or modification under rule 14a-8(i)(3)" would be "appropriate" only in limited situations, such as where the company "demonstrates objectively that a factual statement is materially false or misleading." However, since SLB 14B, the Staff has viewed few statements as satisfying this standard. The *Express Scripts* decision may cause the Staff to reconsider its position and cause more companies to consider or pursue litigation to exclude such proposals.

References to non-public materials. Several companies sought exclusion of proposals because the supporting statements included unfavorable assertions about the companies that were purportedly based on the non-public reports of GMI Ratings, an investment research firm. For example, the supporting statement of the proposal in *NextEra Energy, Inc.* (avail. Feb. 25, 2014) referenced negative information about the company's corporate governance and executive compensation, citing as its source "GMI Ratings, an independent investment research firm." The company requested from the proponent a copy of the GMI Ratings report, but the proponent declined to provide a copy. The company argued in its no-action request that the proposal was excludable under Rule 14a-8(i)(3) because the company was unable to evaluate the basis for the information, but the Staff rejected this argument. Many other companies made similar arguments, all of which were rejected. *See, e.g.*, *Northrop Grumman Corp.* (avail. Mar. 11, 2014); *General Electric Co.* (avail. Jan. 15, 2014)*; *Starbucks Corp.* (avail. Dec. 23, 2013)*.

Vagueness. The Staff stated in SLB 14B that a proposal may be excludable under Rule 14a-8(i)(3) if it "is so inherently vague or indefinite that neither the stockholders voting on the proposal, nor the company in implementing the proposal (if adopted), would be able to determine with any reasonable certainty exactly what actions or measures the proposal requires."

Several companies received, and successfully challenged, a proposal that requested a bylaw or a policy that would prohibit the company's management and board from accessing preliminary voting results on uncontested matters. The companies challenged this proposal under Rule 14a-8(i)(3), arguing that it was impermissibly vague and indefinite because it provided that the prohibition would apply to management-sponsored say-on-pay resolutions or to resolutions "for other purposes," but also provided that the prohibition would *not* apply to the company's monitoring of votes cast for the purpose of achieving a quorum or to "solicitations for other proper purposes." The Staff concurred that this proposal could be excluded as vague and indefinite, noting that "the proposal does not sufficiently explain when the requested bylaw would apply. In this regard, we note that the proposal provides that preliminary voting results would not be available for solicitations made for 'other purposes,' but that they would be available for solicitations made for 'other proper purposes." *See, e.g.*, *Amazon.com, Inc.* (avail. Mar. 6, 2014)*; *The Home Depot, Inc.* (avail. Mar. 6, 2014)*; *The Southern Co.* (avail. Mar. 6, 2014)*. Since the time of these Staff responses, a revised version of the proposal has been submitted to at least one company, NetApp, Inc. NetApp's no-action request is currently pending.

Ordinary Business

Rule 14a-8(i)(7) permits a proposal to be excluded if it "deals with a matter relating to the company's ordinary business operations." However, the Commission has stated that proposals "focusing on sufficiently significant social policy issues … generally would not be considered to be excludable, because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote."

Although the Staff did not recognize any new significant policy issues under Rule 14a-8(i)(7) during the 2014 season, there were developments on previously recognized significant policy issues involving healthcare reform and incentive compensation. In 2008, the Staff denied exclusion for a number of healthcare reform-related shareholder proposals because the Staff concluded that these proposals focused on a significant policy issue. These 2008 proposals asked the companies "to adopt principles for health care reform," such as "[h]ealth care coverage should be universal" and "[h]ealth care coverage should be affordable to individuals and families." *See United Technologies Corp.* (avail. Jan. 31, 2008). This season, a proposal similarly asked companies to "adopt … Health Care Reform Principles," but the proposed "Principles" were much

more specific, such as “[r]epeal state-level laws that prevent insurance companies from competing across state lines” and “[r]eform federal tax laws to allow individuals to receive a standard deduction for health insurance costs or receive tax credits.” *See Johnson & Johnson* (avail. Feb. 18, 2014, *recon. denied* Mar. 5, 2014)*. The companies argued that these proposals were excludable under Rule 14a-8(i)(7), and the Staff agreed, noting:

> [T]he proposal appears directed at involving Johnson & Johnson in the political or legislative process relating to an aspect of Johnson & Johnson’s operations. We note in particular that, although the proposal asks the company to adopt principles of health care reform, it advocates specific legislative initiatives, including the repeal of specific laws and government mandates and the enactment of specific tax deductions or tax credits that appear to relate to Johnson & Johnson’s business operations.

The Staff also granted exclusion for a proposal that sought to invoke a significant policy issue involving incentive compensation at financial institutions that the Staff recognized in 2011. In 2011, the Staff granted exclusion for a proposal requesting a report on, among other things, the compensation paid to the company’s 100 highest paid employees. While the Staff determined that the proposal was excludable because it “relates to the compensation paid to a large number of employees without regard to whether the employees are in such a position or are executive officers,” it nevertheless stated (in a somewhat unique instance of Staff dicta) that “the incentive compensation paid by a major financial institution to its personnel who are in a position to cause the institution to take inappropriate risks that could lead to a material financial loss to the institution is a significant policy issue.” *See Wells Fargo & Co.* (avail. Mar. 14, 2011, *recon. denied* Apr. 5, 2011)*. This season, the same proponent submitted a revised version of its 2011 proposal. The revised proposal requested that the company prepare a report disclosing whether the company has identified employees that have the ability to expose the company to possible material losses, and if the company has identified these employees, the report was also to disclose additional information, including (but not limited to) information about these employees’ incentive compensation. The companies receiving the proposal argued that the overall thrust and focus of the proposal did not relate to risks arising from incentive-based compensation structures, but to the identification of all possible material losses and liabilities from all employee activities throughout the Company. The Staff concurred that the proposal could be excluded under Rule 14a-8(i)(7), citing the 2011 significant policy issue and then noting that “the proposal relates to the compensation paid to any employee who has the ability to expose [the company] to possible material losses without regard to whether the employee receives incentive compensation and therefore does not, in our view, focus on the significant policy issue.” *See Bank of America Corp.*

(avail. Feb. 19, 2014, *recon. denied* Mar. 10, 2014, *appeal denied* May 22, 2014)*; *Wells Fargo & Co.* (avail. Feb. 14, 2014, *recon. denied* Mar. 10, 2014, *appeal denied* May 22, 2014)*.

Substantial Implementation

Many companies implemented proposals that they received and thus either negotiated a withdrawal of the proposal or were able to exclude the proposal under Rule 14a-8(i)(10) as substantially implemented. This season, 174 proposals were withdrawn, with 59 of those withdrawals occurring after the companies submitted their no-action requests. Nineteen proposals were excluded as substantially implemented, as the companies either took steps to implement the proposals or elaborated on how they already had implemented the proposals.

For example, Hewlett-Packard Company received a proposal that discussed a number of human rights issues and requested that the board of directors "review and amend, where applicable, … Hewlett-Packard's policies related to human rights that guide its international and U.S. operations." A committee of the company's board of directors reviewed the company's human rights policies and determined that the policies already reflected a comprehensive understanding of human rights and that, therefore, no amendments were necessary. The company noted in its no-action request that "the [p]roposal does not identify any particular changes to the Company's human rights policies that are expected," and the Staff concurred that the proposal could be excluded as substantially implemented. *See Hewlett-Packard Co.* (avail. Dec. 18, 2013)*.

Proposals Requesting Corporate Action to Maximize Shareholder Value

Over the past few years there have been numerous shareholder proposals requesting that a company take various actions to maximize shareholder value, including: requests that the board break up the company or divest the company of specific assets; conduct a sale, merger, or liquidation of the company; engage an advisor to evaluate alternative strategies for the company that could maximize shareholder value; and issue dividends to return capital to shareholders.

During the 2014 season, 14 of these shareholder value proposals were submitted, ten of which were submitted pursuant to Rule 14a-8 and four of which were proposed from the floor of a shareholder meeting pursuant to state law (and in accordance with a company's advance notice bylaw procedures) ("Floor Proposals").

Building on the California State Teachers' Retirement System ("CalSTRS") and Relational Investment LLC's successful campaign during the 2013 season to force a spin-off of The Timken Company's steel business, a number of proponents submitted particularly aggressive shareholder value proposals seeking to effect significant changes at target companies. For example, Carl

Icahn and several related investment funds (collectively, the “Icahn Group”) sponsored a non-binding Floor Proposal requesting that eBay Inc. conduct a carve-out IPO of its Paypal business in which eBay would sell 20% of Paypal to the public and retain 80% control. The Icahn Group also proposed the election of two of its nominees to eBay’s board. After a series of contentious public exchanges between eBay and the Icahn Group, eBay announced that it had reached an agreement with Mr. Icahn under which eBay would appoint one of the Icahn Group’s nominees to the board and the Icahn Group would withdraw the proposals it had submitted for consideration at eBay’s 2014 annual meeting.

Shareholder Proposal Litigation

This proxy season also saw an increase in litigation related to shareholder proposals, primarily by companies seeking declaratory judgments to exclude proposals from shareholder activist John Chevedden. This increased inclination to litigate was driven by some companies’ successes in excluding proposals through litigation in recent years, though this season’s litigation has yielded mixed results for companies that sued to exclude proposals. Some of the litigation this season has been brought by shareholders. The following sections highlight some of the litigation brought this season.

Jurisdictional Issues

As noted above, in *Waste Connections, Inc. v. Chevedden*, the U.S. Court of Appeals for the Fifth Circuit affirmed the district court’s denial of a motion to dismiss for lack of subject matter jurisdiction by John Chevedden, James McRitchie and Myra K. Young (collectively, the “Defendants”). Waste Connections had sued for a declaratory judgment that it could exclude from its 2013 proxy materials a shareholder proposal submitted by the Defendants. After receiving Waste Connections’ complaint, the Defendants filed a motion to dismiss, in which they stated that they “covenant that they will not sue [Waste Connections] if it elects to exclude the proposal from its proxy materials and their decision not to sue is irrevocable.” Based on this covenant, the Defendants argued that they “have not caused any injury in fact of sufficient immediacy to confer standing upon [Waste Connections].” In April 2013, the district court rejected this argument and denied the motion to dismiss, and the Fifth Circuit affirmed the district court’s decision in February 2014. In reaching its decision, the Fifth Circuit noted that despite the covenant not to sue, excluding the proposal could subject the company to an SEC enforcement action. It therefore concluded that Waste Connections had standing to seek a declaratory judgment.

However, three district courts in 2014 declined to follow *Waste Connections*. In each of *Omnicom Group, Inc. v. Chevedden*, *Chipotle Mexican Grill, Inc. v. Chevedden* and *EMC Corp. v.*

Chevedden the shareholder proponents, Mr. Chevedden, Myra K. Young (a co-proponent in *Chipotle*) and James McRitchie (a co-proponent in *EMC* and *Chipotle*), “irrevocably promise[d]” not to sue the companies if they omitted the shareholder proposals. Based on these promises, the courts in these cases held that the companies lacked standing. Unlike the Fifth Circuit in *Waste Connections*, these courts determined that the possibility of an SEC enforcement action was not certain or immediate enough to establish an “imminent injury in fact.” Accordingly, all three suits seeking declaratory judgments in favor of EMC, Omnicom and Chipotle were dismissed for lack of subject matter jurisdiction.

Company’s Statement in Opposition to a Shareholder Proposal

In *Silberstein v. Aetna, Inc.*, plaintiff Stephen W. Silberstein brought suit against Aetna, Inc., its Chairman, CEO and President and members of its board of directors in the U.S. District Court for the Southern District of New York in November 2013 for alleged false and misleading statements in Aetna’s 2012 and 2013 proxy statements. These proxy statements included shareholder proposals related to Aetna’s political contributions followed by statements in opposition referencing the company’s political contribution reports. Among other allegations, the complaint alleges (1) that the statements in opposition overstated the audit committee’s oversight of Aetna’s political contributions and (2) that the political contribution reports contained several inaccuracies, including understatement of Aetna’s political contributions to certain organizations. Mr. Silberstein sought to have the court “[d]eclar[e] void the vote of the Aetna shareholders in opposition to” the 2012 and 2013 shareholder proposals, to require Aetna to amend its 2006-2012 political contribution reports, to require Aetna to inform shareholders that its 2012 and 2013 statements in opposition included “inaccurate and incomplete information” and to require Aetna to resubmit the 2012 and 2013 proposals in its 2014 proxy statement. Mr. Silberstein filed a motion for preliminary injunction to prohibit Aetna from distributing its 2014 proxy materials and from holding its 2014 annual meeting until it had amended its 2010-2012 political contribution reports, issued its 2013 political contributions report and informed shareholders of the alleged errors in the previous reports. The court denied this motion because Mr. Silberstein “failed to demonstrate irreparable harm.” Aetna has since distributed its 2014 proxy materials (which included a shareholder proposal that is similar to the 2013 shareholder proposal), and it held its 2014 annual meeting on May 30, 2014. The shareholder proposal that was similar to the 2013 shareholder proposal was approved by 5.3% of votes cast at the annual meeting, less than the 6.7% approval it received at the 2013 annual meeting. The litigation is still pending in the Southern District of New York.

Conclusion

The developments discussed above demonstrate the continued complexity of the shareholder proposal process, particularly when litigation is involved. Some lessons that companies should keep in mind as they begin to look toward 2015 include:

- ***Attention to detail with procedural issues:*** Because Staff decisions often hinge on minor nuances in language, companies should pay close attention to detail as they evaluate proponents' proof of ownership letters and draft deficiency notices to proponents.
- ***Shareholder engagement:*** Companies have been successful in engaging with shareholder proponents, as reflected by the fact that the number of withdrawn proposals before and after filing a no-action request (174) exceeds the number of no-action letters allowing exclusion (161).
- ***Proponent abuses of the shareholder proposal process:*** Companies remain concerned about abuses in the shareholder proposal process, but to date the Staff has not been amenable to arguments regarding representatives and false statements. The Staff has been urged to provide more guidance in these areas.
- ***Litigation:*** While litigation is a viable option in some circumstances, experience this season indicates that predicting the outcome of litigation in this area is difficult.

Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance

Commissioner Daniel M. Gallagher

New Orleans, LA

March 27, 2014

Thank you, David [Katz], for that kind introduction. I'm very pleased to be here with you this afternoon.

In April 2010, when my friend and former colleague Troy Paredes spoke at this conference, he expressed his misgivings about the draft legislation moving through Congress that ultimately became the Dodd-Frank Act.[1] Today, nearly four years after its enactment, the fundamentally flawed nature of the Act has become clear—or, to those of us who recognized its many faults from the start, clearer.

Title I of Dodd-Frank, for example, created the apparently unaccountable and inherently politicized Financial Stability Oversight Council, or FSOC. The FSOC is dominated by bank regulators, and Title I authorizes it to designate non-bank financial services companies as systemically important financial institutions, thereby making them subject to prudential regulation. This can happen without regard for whether that regulatory paradigm is appropriate for non-bank entities operating in the capital markets—or, as I like to call them, the "non-centrally controlled" markets.

I believe it is important for the SEC and other capital markets regulators to openly debate and resist where necessary the encroachment of the bank regulatory paradigm into the capital markets. I hope that market participants and lawmakers will join the debate about the proper regulatory framework for non-bank markets. To be clear, this is not a partisan issue. The structure of FSOC vests tremendous authority to appointees from the President's party. Those who enthusiastically support FSOC today may well be singing a different tune upon a change in administration.

I should also make clear that I'm not motivated by turf wars or empire building. In fact, I believe the SEC should be willing to recognize areas where we should be the ones to stand down in favor of an alternative legal regime that is a better fit.

And so today I'd like to focus on an area where the SEC should be taking less of a role: the regulation of corporate governance.

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[1] See Troy A. Paredes, Speech by SEC Commissioner: Remarks at the 22nd Annual Tulane Corporate Law Institute (Apr. 15, 2010), available at http://www.sec.gov/news/speech/2010/spch041510tap.htm.

I. Federalization of Corporate Governance

Unfortunately, the trend towards increased federalization of corporate governance law seems well-entrenched.[2] The Sarbanes-Oxley Act included significant incursions into state corporate governance regulation, but Title IX of Dodd-Frank may cause some of you to long for the simpler days of SOX § 404.

Title IX mandates an array of new federal regulations relating to matters traditionally left to state corporate governance law, the most infamous being a requirement to hold a shareholder vote on executive compensation, or "say on pay." Concerns that a negative vote may harm a company's reputation or encourage litigation can lead companies to expend significant resources to guarantee passage of the vote. Even more concerning, boards of directors could substitute proxy advisors' views on pay for their own judgment as a means of minimizing potential conflict.

And that's just one of the new Dodd-Frank requirements encroaching on corporate governance. Others include the politically-motivated pay ratio disclosure requirement, proposed by a majority of the Commission in September 2013,[3] as well as mandated rules micromanaging certain incentive-based compensation structures, which were proposed jointly with other regulators, again by a majority of the Commission, in March 2011.[4] In addition, Dodd-Frank calls for rules regarding compensation clawbacks in the event of an accounting restatement, pay for performance, and employee and director hedging of company stock.

Some of these requirements unashamedly interfere in corporate governance matters traditionally and appropriately left to the states. Others masquerade as disclosure, but are in reality attempts to affect substantive behavior through disclosure regulation. This mandated intrusion into corporate governance will impose substantial compliance costs on companies, along with a one-size-fits-all approach that will likely result in a one-size-fits-none model instead. This stands in stark contrast with the flexibility traditionally achieved through private ordering under more open-ended state legal regimes.

II. Shareholder Proposals

One area where the SEC's incursions into corporate governance have had a particularly negative effect is shareholder proposals.

1. The Problem

While the conduct of the annual shareholder meeting is generally governed by state law, the process of communicating with shareholders to solicit proxies for voting at that meeting is regulated by the Commission. The Commission's rules have for decades permitted qualifying shareholders to require the company to publish certain proposals in the company's proxy statement, which are then voted upon at the annual meeting.

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[2] See Daniel M. Gallagher, Speech, Remarks before the Corporate Directors Forum (Jan. 29, 2013), available at www.sec.gov/News/Speech/Detail/Speech/1365171492142; see also, e.g., J. Robert Brown, Jr., The Politicization of Corporate Governance: Bureaucratic Discretion, the SEC, and Shareholder Ratification of Auditors, 2 Harv. Bus. L. Rev. 61, 62 (2012).

[3] Rel. 33-9452, Pay Ratio Disclosure (Sept. 18, 2013).

[4] Rel. 34-64140, Incentive-based Compensation Arrangements (Mar. 29, 2011).

Unfortunately, the Commission has never adequately assessed the costs and benefits of this process. Currently, a proponent can bring a shareholder proposal if he or she has owned $2,000 or 1% of the company's stock for one year, so long as the proposal complies with a handful of substantive—but in some cases discretionary—requirements. Activist investors and corporate gadflies have used these loose rules to hijack the shareholder proposal system.

The data and statistics are striking. In 2013, the number of shareholder proposals rose,[5] with an amazing 41% of those proposals addressing social and environmental issues.[6] And while proposals calling for disclosure of political contributions or lobbying activities continued to predominate,[7] these proposals received particularly poor support from shareholders.[8] Overall, only 7% of shareholder proposals received majority support in 2013.[9]

These proposals are not coming from ordinary shareholders concerned with promoting shareholder value for all investors. Rather, they are predominantly from organized labor, including union pension funds, which brought approximately 34% of last year's shareholder proposals, as well as social or policy investors and religious institutions, which accounted for about 25% of 2013's proposals. Approximately 40% were brought by an array of corporate gadflies, with a staggering 24% of those proposals brought by just two individuals.[10]

In other words, the vast majority of proposals are brought by individuals or institutions with idiosyncratic and often political agendas that are often unrelated to, or in conflict with, the interests of other shareholders. I find it particularly notable that corporations that donated more funds to Republicans than to Democrats were more than twice as likely to be targeted with political spending disclosure proposals sponsored by labor-affiliated funds.[11]

Astonishingly, only 1% of proposals are brought by ordinary institutional investors—including hedge funds. As you all know, hedge funds are not shy about elbowing their way into the boardroom when they believe a shake-up is overdue. The low level of hedge fund activism here implies that their

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[5] James R. Copeland & Margaret M. O'Keefe, Proxy Monitor 2013: A Report on Corporate Governance and Shareholder Activism (Manhattan Institute, Fall 2013) at 2 (average Fortune 250 company faced 1.26 proposals in 2013 versus 1.22 in 2012); Gibson, Dunn & Crutcher LLP, Shareholder Proposal Developments During the 2013 Proxy Season (July 9, 2013) at 1 (noting more proposals in 2013 (~820) than 2012 (~739)).

[6] Proxy Monitor 2013 at 7.

[7] Proxy Monitor 2013 at 12 ("[P]roposals related to corporate political spending or lobbying have been more numerous than any other class of proposal in each of the last two years.").

[8] ISS reports political contribution/lobbying activity approval percentage at 29%, an increase of 7.3% over 2012. See Gibson Dunn at 6. However, Proxy Monitor finds the opposite trend, at least with respect to the Fortune 250 companies. See Proxy Monitor 2013 at 2. Specifically, disaggregating lobbying and political spending proposals shows a *decline* in y-o-y support for both proposal classes: 22% in 2012 to 20% in 2013 for lobbying, and 17% to 16% for political spending. *Id.* But a change in the mix of proposals—there were more lobbying-related proposals, which typically garner higher support, given that 2013 is a non-election year—creates the impression of an increasing overall rate.

[9] Proxy Monitor 2013 at 2 (contrasting with 9% in 2012).

[10] Proxy Monitor 2013 at 6–7.

[11] Proxy Monitor 2013 at 8 ("Those companies [giving at least $1.5 million to candidates or PACs], as a group, were much more likely to be targeted by shareholder proposals introduced by labor-affiliated pension funds in 2013: 44 percent of these politically most active companies faced a labor-sponsored proposal, as opposed to only 18 percent of all other companies. What's more, those corporations that gave at least half of their donations to support Republicans were more than twice as likely to be targeted by shareholder proposals sponsored by labor-affiliated funds as those companies that gave a majority of their politics-related contributions on behalf of Democrats.").

concerns with corporate management are being addressed using avenues other than shareholder proposals—as most legitimate concerns can be.[12]

Given all of this, it's time we asked whether the shareholder proposal system as currently designed is a net negative for the average investor.[13]

2. Needed Reforms

a. Who should be able to bring a proposal?

All of this isn't to condemn shareholder activism per se. I'll leave that debate to Marty Lipton and Lucian Bebchuk. But existing shareholders who are unhappy with management have a range of well-accepted responses other than proposals. Given the depth and liquidity of today's markets, passive investors can simply sell their position—taking the so-called "Wall Street Walk." Activist investors can threaten to take this Walk as a means of influencing management. Investors can also vote against directors who are not sufficiently overseeing management—this strategy doesn't have a clever name, but perhaps "vote the bums out" will do.

And, of course, where management is breaching its fiduciary duties, investors can have recourse to the courts. This "see you in court" strategy is particularly viable given the outstanding job the Delaware courts do, day in and day out, in refereeing disputes between shareholders and management. Given these and other strategies, I'm not sure we need shareholder proposals at all.

But if we must have shareholder proposals, the SEC's rules can and should do a better job ensuring that activist investors don't crowd out everyday and long-term investors—and that their causes aren't inconsistent with the promotion of shareholder value.

One thing is clear: we can't continue to take the approach of our current regulatory program, especially the all too liberal program of the last five years, and simply err on the side of over-inclusion. It is enormously expensive for companies to manage shareholder proposals. They must negotiate with proponents, seek SEC no-action to exclude improper ones, form and articulate views in support or opposition in the proxy, include the proposal and the statement in the proxy itself, then take the vote on it at the annual meeting. Conversely, companies can simply fold and acquiesce to the activists' demands. Both approaches are costly, and these costs are borne by all shareholders. Taking money out of the pocket of someone investing for retirement or their child's education and using it instead to subsidize activist agendas is simply inexcusable. It is incumbent on the Commission to create a regulatory environment that promotes shareholder value over special interest agendas. I have a few suggestions.

First, the holding requirement to submit proxies should be updated. $2,000 is absurdly low, and was not subject to meaningful economic analysis when adopted.[14] The threshold should be substantially more, by orders of magnitude: perhaps $200,000 or even better, $2 million. But I don't believe that this

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[12] James R. Copeland, Proxy Monitor 2011: A Report on Corporate Governance and Shareholder Activism (Manhattan Institute, Sept. 2011) at 4.

[13] Allan T. Ingraham & Anna Koyfman, Analysis of the Wealth Effects of Shareholder Proposals–Vol. III (U.S. Chamber of Commerce, May 2, 2013).

[14] See Rel. 34-40018, Amendments to Rules on Shareholder Proposals (May 21, 1998) (describing the change from $1,000 to $2,000 as an adjustment for inflation).

is actually the right fix: a flat number is inherently over- or under-inclusive, depending on the company's size. A percentage threshold by contrast is scalable, varies less over time, better aligns with the way that many companies manage their shareholder relations, and is more consistent with the Commission's existing requirements. Therefore, I believe the flat dollar test should be dropped, leaving only a percentage test.

Of course, we'd have to make sure we get the percentage holding requirement right. Requiring a sufficient economic stake in the company could lead to proposals that focus on promoting shareholder value rather than those championed by gadflies with only a nominal stake in the company. We would need to apply rigorous economic analysis to determine what percentage would be an appropriate default, as well as what factors should be taken into account when deviating from that default. This could be an opportunity to address the practice of "proposal by proxy," where the proponent of a resolution—typically one of the corporate gadflies—has no skin in the game, but rather receives permission to act "on behalf" of a shareholder that meets the threshold. While I would support banning proposal by proxy, we could also consider alternatives such as requiring a proponent acting on behalf of one or more shareholders to meet a higher percentage threshold of outstanding shares than would be the case for a proponent who owns the shares directly.

I also think we need to take another look at the length of the holding requirement. A one-year holding period is hardly a serious impediment to some activists, who can easily buy into a company solely for the purpose of bringing a proposal. All that's needed is a bit of patience, and perhaps a hedge. A longer investment period could help curtail some of this gamesmanship.

Making adjustments along these lines will go a long way towards ensuring that the proposals that make it onto the proxy are brought by shareholders concerned first and foremost about the company—and the value of their investments in that company—not their pet projects.

b. What issues should proponents be able to raise?

I also believe that we need to do a better job setting requirements as to the substance of proposals. While I don't think a complete reevaluation of the existing categories for exclusion is necessary, we do need to re-think their application.

For example, the "ordinary business" criterion for exclusion in our rules has been perennially problematic.[15] This provision permits exclusion of a proposal that deals with the company's "ordinary business operations," unless it raises "significant policy issues." However, these terms are not defined and the Commission has given no guidance, leaving the Staff to fend for itself in determining whether to issue no-action relief pursuant to the provision.

As a result, we have seen a number of dubious "significant policy issue" proposals. For example, in 2013 the Staff denied no-action relief to PNC Bank with respect to a proposal requesting a report on greenhouse gas emissions resulting from its lending portfolio, on the grounds that climate change is a significant policy issue—arguably a reversal of a prior Staff position.[16] And, in 2012, Staff denials of no-

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[15] Exchange Act Rule 14a-8(i)(7).

[16] See, e.g., Hunton & Williams, Client Alert, SEC Refused to Allow Bank to Omit Climate Change Proposal from Proxy Materials (Mar. 2013). It has been argued, however, that PNC was not a reversal, but rather was driven by some substantive differences with PNC's lending portfolio. See Gibson Dunn at 9–10 (citing a "SEC spokesman" commenting to

action relief forced AT&T, Verizon, and Sprint to include a net neutrality proposal, even though proposals on that same topic were excludable in prior years as ordinary business. That year, 94% of AT&T shareholders voted "no" on the net neutrality proposal despite the best efforts of Michael Diamond, who some of you will know as Mike D. of the Beastie Boys—who, by helping to bring the proposal to a vote, at least succeeded in his fight for the *right* to proxy.[17]

It is a disservice to the Staff—and, more importantly to investors—when the Commission promulgates a discretion-based rule for the Staff to administer without providing guidance as to how to exercise that discretion. In addition to providing better guidance, the Commission needs to become more involved in the administration of this rule. In particular, I believe that the Commission should be the final arbiter on the types of proposals for which the Staff proposes to deny no-action relief on "significant policy issue" grounds. The Presidential appointees should vote on these often-thorny policy issues and not hide behind the Staff.

We also need to take another look at the rule which permits the exclusion of proposals that are contrary to the Commission's proxy rules—including proposals that are materially false and misleading or that are overly vague.[18] In Staff Legal Bulletin 14B, issued in 2004,[19] the Staff curtailed the use of this ground for exclusion in light of the extensive Staff resources that were being consumed in their line-by-line review of shareholder proposals, instead forcing issuers to use their statement in opposition to take issue with factual inaccuracies or vagueness.[20] I believe issuers have raised some legitimate concerns with this approach. For example, while issuers are not legally responsible for the proposals or statements in support, they are still being forced to publish, in their proxy, statements they believe are false or misleading. Moreover, use of the statement in opposition is sometimes an incomplete remedy. Taking valuable space to correct misstatements distracts from a substantive discussion about the proposal itself, and proposals that are overly vague make it difficult to draft a sensible rebuttal.

In light of these competing concerns, I believe the pendulum has swung too far in the direction of non-intervention. And I'm not alone in this belief. Recently, a district court in Missouri granted summary judgment to Express Scripts, permitting it to exclude a proposal that contained four separate misstatements.[21] While I support companies exercising their right to take matters to the court system,[22] which can serve as a useful external check on the SEC's no-action process, companies shouldn't have to go through the time and expense of litigation to vindicate their substantive rights under our rules. The burden to ensure that a submission is clear and factually accurate should be placed on the proponent, not the company. I believe that the Staff should take a more aggressive posture toward proponents that fail to meet that burden. And I hope issuers would refrain from using our rule to quibble over minutiae. If this happy medium is not achievable, I believe the SEC needs to revisit our rules: we

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that effect). This may indicate a need for the Staff to provide fuller statements of their reasoning in no-action letters, so as to avoid confusion among practitioners and the public.

[17] See Larry Downes, AT&T, Verizon, and Sprint Net Neutrality Proposals: Simply Awful, Forbes.com (Apr. 12, 2012, updated Apr. 27, 2012), at http://www.forbes.com/sites/larrydownes/2012/04/12/att-verizon-and-sprint-net-neutrality-proposals-simply-awful/.

[18] Exchange Act Rule 14a-8(i)(3).

[19] See SLB 14B (2004).

[20] Of 90 denials of exclusion during the 2013 proxy season, 63% of them had raised (i)(3) arguments. Gibson Dunn at 2. While there could be several reasons for this trend, it calls for further examination.

[21] Express Scripts Holding Co. v. Chevedden, No. 4:13-CV-2520-JAR (E.D. Mo., Feb. 18, 2014).

[22] See Waste Connections v. Chevedden, No. 13-20336, slip op. (5th Cir., Feb. 13, 2014) (affirming court's subject matter jurisdiction over company's declaratory judgment action despite Chevedden's promise not to sue if company excluded the proposal).

as a Commission either need to give the Staff the capacity to enforce the rule as it is currently written, or craft a rule that is enforceable.

c. How many times may a proposal be repeated?

The final issue I want to raise today with respect to the shareholder proposal process is the frequency of reproposals. Currently, once a proposal is required to be included in the proxy, it can be resubmitted for years to come, even if it never comes close to commanding majority support. Proposals need only 3, 6, or 10% of votes in support to stay alive, depending on whether the proposal has been brought once, twice, or three times or more in the past five years.[23] So a proposal that gets a bare 10% of the votes, year after year, is not excludable on that basis under our current rules. Such proposals are an enormous waste of time and shareholder money.

We need to substantially strengthen the resubmission thresholds, perhaps by taking a "three strikes and you're out" policy. That is, if a proposal fails in its third year to garner majority support, the proposal should be excludable for the following 5 years. The thresholds for the prior 2 years should be high enough to demonstrate that the proposal is realistically on the path toward 50%, for example, 5% and 20%.

3. Conclusion

Implementing these kinds of reforms can, I believe, help provide some much-needed improvement to the shareholder proposal system. I hope the Commission can consider such common-sense issues in the near future. These are real and substantial issues, and the Commission has the authority to effectuate needed change. We should not dare Congress to intervene due to our inaction, as it had to with the JOBS Act.

III. Remaining the Right Regulator

Finally, I want to return to my original theme: good government requires that, when we must regulate, we should do so in the most efficient manner possible. This means assigning the right regulator to the issue and minimizing unnecessary regulatory overlap. And of course, the Commission must continue to ensure that its regulatory approach advances its core goals of investor protection and the promotion of efficiency, competition, and capital formation.

That means, for example, pressing ahead with much-needed reforms to our corporate disclosure requirements to ensure that our filings provide investors with the information they need to make informed investment decisions and are not overwhelmed by extraneous information—like conflict minerals reports.

We must also take exception to efforts by third parties that attempt to prescribe what should be in corporate filings. It is the Commission's responsibility to set the parameters of required disclosure.

The somewhat confusingly-named Sustainability Accounting Standards Board provides a good example of an outside party attempting to prescribe disclosure standards. I say "confusingly-named"

[23] See Exchange Act Rule 14a-8(i)(12).

because the SASB does not actually promulgate accounting standards, nor does it limit itself to sustainability topics, although I suppose it is in fact a Board. The SASB argues that its disclosure standards elicit material information that management should assess for inclusion in companies' periodic filings with the Commission.[24]

I don't mean to single out the SASB, but it's important to stress that, with the sole exception of financial accounting—where the Commission, as authorized by Congress, has recognized the standards of the Financial Accounting Standards Board as generally accepted, and therefore required under Regulation S-X—the Commission does not and should not delegate to outside, non-governmental bodies the responsibility for setting disclosure requirements. So while companies are free to make whatever disclosures they choose on their own time, so to speak, it is important to remember that groups like SASB have no role in the establishment of mandated disclosure requirements.

With respect to information that the Commission requires to be included in filings, we need to be sure that our requirements are eliciting decision-useful and up-to-date information. We should be willing to reexamine all of our disclosure requirements. Indeed, the Commission should be engaged in a comprehensive program of periodic re-assessment of its disclosure rules to ensure that the benefits of disclosure continue to justify its often-substantial costs.

This is of course a tall order, but I know the fine men and women who serve the public at the Commission are up for the challenge.

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Thank you all for your time and attention today, and I hope you enjoy the rest of the conference.

[24] See, e.g., SASB, Commercial Banks Sustainability Accounting Standard, Provisional Version (Feb. 2014) ("SASB Standards are comprised of (1) disclosure guidance and (2) accounting standards on sustainability topics for use by U.S. and foreign public companies in their annual filings (Form 10-K or 20-F) with the U.S. Securities and Exchange Commission (SEC). To the extent relevant, SASB Standards may also be applicable to other periodic mandatory fillings with the SEC, such as the Form 10-Q, Form S-1, and Form 8-K. SASB's disclosure guidance identifies sustainability topics at an industry level, which may be material—depending on a company's specific operating context—to a company within that industry. Each company is ultimately responsible for determining which information is material and is therefore required to be included in its Form 10-K or 20-F and other periodic SEC filings.").

PROXY MONITOR 2014

A Report on Corporate Governance and Shareholder Activism

EXECUTIVE SUMMARY

Recent trends in corporate governance at large, publicly traded companies in the United States include increased shareholder power relative to that of boards. This trend in part involves—and in part has been driven by—activism on the part of shareholders who introduce proposals on companies' annual-meeting proxy ballots. This report looks at the 2014 proxy season by analyzing data from the ProxyMonitor.org database and finds:

- **Shareholder support for shareholder proposals is down.** In 2014, only 4 percent of shareholder proposals were supported by a majority of voting shareholders, down from 7 percent in 2013. The percentage of shareholder proposals to win majority support in 2014 was below that of any previous year in the ProxyMonitor.org database, which dates back to 2006. Among Fortune 250 companies, only ten proposals have won majority support to date this year, and only seven over opposition from the company's board of directors.
- **A small group of shareholders continues to dominate the shareholder-proposal process.** In 2014, one-third of all shareholder proposals were sponsored by just three individuals and their family members: John Chevedden, the father-son team of William and Kenneth Steiner, and the husband-wife team of James McRitchie and Myra Young. Twenty-eight percent of all 2014 shareholder proposals were sponsored by investors with an express social, religious, or public-policy orientation, a majority of which were "social investing" funds organized around various principles beyond share-price maximization. Twenty-four percent of all 2014 shareholder proposals were sponsored by labor-affiliated investors; labor-sponsored shareholder proposals were less common in 2014 than in 2013, chiefly because of less activity on the part of private multiemployer plans such as the AFL-CIO.
- **Almost half of all shareholder proposals in 2014 involved social or policy concerns, though shareholders continued to reject these proposals.** Forty-eight percent of 2014 shareholder proposals involved social or policy concerns. One hundred and thirty-five of 136 shareholder proposals involving social or policy concerns in 2014 failed to win the support of a majority of shareholders, the exception being a proposal for a corporate resolution on animal welfare that the company's board supported. From 2006 through 2014, among 1,141 shareholder proposals at Fortune 250 companies that involved social or policy concerns, *not a single proposal* has won the support of a majority of shareholders over board opposition.
- **Shareholder proposals involving corporate political spending or lobbying were again the most regularly introduced class of proposal in 2014, but they continue to be rejected by most shareholders.** Twenty-two percent of all 2014 shareholder proposals involved these topics, but 80 percent of shareholders, on average, voted against them, in line with earlier years. Among 329 such proposals introduced at Fortune 250 companies from 2006 through 2014, not a single one has received the support of a majority of voting shareholders over board opposition.
- **Labor-affiliated investors' shareholder activism in 2014 has centered on corporate political spending or lobbying and may be related to support for Republicans among company executives and PACs.** The 43 Fortune 250 companies facing shareholder proposals sponsored by labor-affiliated investors in 2014 were twice as likely to orient their political efforts to support Republicans than was the average Fortune 250 company. A majority of shareholder proposals sponsored by labor-affiliated investors in 2014 have involved corporate political spending or lobbying, and only one company targeted by these proposals gave more money to Democrats than Republicans. On average, executives and PACs at companies facing at least one politics-related shareholder proposal sponsored by

a labor-affiliated investor sent 67 percent of their dollars to support the GOP, versus 59 percent for all companies in the Fortune 250.

- **The leading proxy advisory firm Institutional Shareholder Services (ISS) continues to be much more likely to support shareholder proposals than the median investor.** ISS policy is "generally for" separating a company's chairman and CEO roles, establishing cumulative-voting rules in director elections that empower minority shareholder blocks, and increasing disclosure of corporate political spending—ideas that have been supported by a majority of shareholders between 0 and 4 percent of the time. Whether new SEC rules governing proxy advisors and a new owner for ISS will change these patterns over time will be interesting to watch in 2015.

Even more so than in recent years, the 2014 proxy season suggests that the shareholder-proposal process may not be serving the ordinary investor's interests. Almost half of all shareholder proposals this year involved social or policy issues; but no such proposal has received majority support at a large company over board opposition. The shareholder-proposal process is costly to the corporation: in 2014, Fortune 250 companies facing a shareholder proposal filed an SEC petition seeking to exclude the proposal 46 percent of the time. Small investors, holding only $2,000 of company stock, can impose these costs on all other investors in corporations with market capitalizations in the billions of dollars. These costs can recur year after year under the SEC's loose resubmission rules, at least assuming that ISS can be persuaded to support the proposal. The SEC's current rules governing the shareholder-proposal process are thus inconsistent with the agency's stated goals of efficiency, competition, and capital formation.

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Proxy Access—a Decision Framework

Posted by Richard J. Sandler and Margaret E. Tahyar, Davis Polk & Wardwell LLP, on Tuesday March 3, 2015

Editor's Note: Richard J. Sandler is a partner at Davis Polk & Wardwell LLP and co-head of the firm's global corporate governance group. Margaret E. Tahyar is a partner in the Financial Institutions Group at Davis Polk & Wardwell LLP. This post is based on a Davis Polk client memorandum.

Recent high-profile developments have thrust proxy access back onto the agenda for many U.S. public companies. Here is a framework for how to approach the topic.

Proxy access is back in the news and back on the agenda for many U.S. public companies. Four years after the DC Circuit invalidated the SEC's proxy-access rule, we are seeing company-by-company private ordering with a vengeance, including a record number of Rule 14a-8 shareholder proposals in the current 2015 proxy season. Events have moved at high speed in the past few weeks, leading many companies to wonder whether they should be initiating their own approach to proxy access.

As we argued in 2009 in response to an earlier SEC proxy-access proposal, we believe that each company's approach to proxy access should be grounded in a consideration of its particular circumstances. Despite recent high-profile adoptions of proxy-access procedures, we don't believe that most U.S. public companies should, in knee-jerk fashion, be preparing to revise their bylaws proactively. We do, however, think that boards should be assessing on an ongoing basis the broader issues of board composition, tenure and refreshment, which are not only important in their own right but also relevant to potential vulnerability to proxy-access proposals. We also think that boards should communicate a willingness to exercise their discretion in considering all shareholder suggestions regarding board membership in order to assure shareholders of a means of expressing their views and to create a level playing field for shareholders.

Background

Prelude to the 2015 Proxy Season. The SEC's Rule 14a-11 granted proxy access to 3% shareholders who had held their shares for at least 3 years, limited to 25% of the board. Although that rule was struck down by the DC Circuit in 2011, the basic approach of the rule has formed the basis for the most successful form of proxy-access proposal, beginning in 2013: most notably Verizon (a 3%/3 year/20% proposal that carried by 53% despite board opposition); Hewlett-Packard (a 3%/3 year/20% proposal that was recommended by the board and carried by 97%) and Chesapeake Energy (a 3%/3 year/25% proposal that was recommended by the board and carried by 99%). The success of these proposals led to the abandonment, by 2015, of an alternative retail approach, which featured much lower ownership thresholds and holding periods and which never gained traction with institutions or proxy advisory services. Even so, only 17 proxy-access proposals were voted on in the 2014 proxy season; of 10 proposals that hewed to the SEC model, 5 passed and 3 narrowly failed, while all 7 retail proposals failed.

2015 Proxy Season. The private-ordering process has ramped up dramatically in the 2015 proxy season, with over 90 companies receiving proxy-access proposals—and an unexpected SEC announcement that upended planning at more than one company. The chronology illustrates how dynamic this subject has become—

- ***Whole Foods requests no-action relief.*** In October 2014 Whole Foods submitted a no-action request to the SEC staff seeking to exclude an SEC-style proxy-access proposal, on the grounds (prescribed in Rule 14a-8) that the company's board intended to present its own, "conflicting," proxy-access proposal, which would permit a shareholder, but not a group of shareholders, owning 9% or more of the company's stock for five years to make proxy-access nominations, limited to 10% of the board. While the SEC staff had not before considered the "conflict" exclusion in the context of proxy-access proposals, it has frequently permitted companies to exclude shareholder proposals on other topics, such as special meeting rights, where elements of the shareholder's proposal were inconsistent with the company proposal.
- ***New York City Comptroller submits 75 proxy-access proposals.*** While the Whole Foods decision was pending, in November the New York City Comptroller announced a campaign called the Boardroom Accountability Project, filing 75 proxy-access proposals that targeted companies based on climate change, board diversity and CEO compensation. The proposals used the 3%/3 year/25% framework and requested shareholder approval of the proxy-access bylaw after adoption by the board.
- ***SEC staff grants no-action relief to Whole Foods.*** On December 1 the SEC staff granted Whole Foods' exclusion request, triggering similar requests from some 16 other

companies by mid-January. These proposals included minimum ownership thresholds that ranged between 5 and 8%, some of which were limited to one shareholder or a group of shareholders with a cap, with holding periods of 3 to 5 years, and restricting the number of board nominees from 1 director to 10% or 20% of the board.

- ***An outcry ensues.*** The Whole Foods shareholder proponent, supported by the Council of Institutional Investors, asked the SEC staff to reconsider its December 1 decision, with CII expressing concern over both the decision and the different ownership thresholds proposed by companies in subsequent no-action requests, asserting they were “unworkable” and “wildly at odds” with the SEC-style bylaw that CII believes is “broadly supported” by investors. While setting ownership thresholds higher than 3% drew criticism, what particularly bothered some investor advocates were the restrictions on aggregating holdings to achieve the ownership threshold.
- ***Whole Foods revises proxy-access proposal.*** On December 30, after engaging with “many of its shareholders to discuss their views on various matters, including corporate governance,” Whole Foods filed a preliminary proxy with a proxy-access proposal that lowered the 9% ownership threshold to 5% and counted a family of funds as a single shareholder.
- ***Institutional investors chime in.*** On January 14 Vanguard updated its proxy voting policies to indicate that it will likely support proxy-access proposals featuring a 5%/3 year/20% model, permitting aggregation of shareholders. A couple of days earlier, BlackRock reiterated its belief that proxy access is a fundamental right, and that it preferred the SEC model, with the ability to aggregate shareholdings. Other investors have, at least publicly, continued to support a case-by-case approach.
- ***SEC abruptly reverses course.*** Before the SEC staff had ruled on any of the other pending Whole Foods-style no-action requests, on January 16 Chair White directed the staff to review the “conflicting proposal” exclusion from Rule 14a-8 and report back to the Commission, whereupon the Division of Corporation Finance announced that it was withdrawing its Whole Foods no-action letter and would express no views on the application of the conflicting proposal test during the 2015 proxy season.
- ***Companies rethink their strategies.*** Companies with proxy-access shareholder proposals that had pursued no-action letters, and expected to put forth their own conflicting proposals, began to evaluate their options after the SEC announcement. None of the choices were appealing. Although many expressed the view that a company did not need an SEC no-action letter in order to exclude a shareholder proposal that conflicted with a company proposal, companies worried about potential litigation if they were to go that route, and also worried about how taking that approach would be perceived by influential institutional investors and the major proxy advisory services.

- ***Monsanto shareholders approve proxy access.*** On January 30 Monsanto's shareholders adopted a 3%/3 year/25% proxy-access shareholder proposal opposed by the board. The proposal carried by 53%, even though at the same meeting shareholders otherwise showed significant support for management, approving a say-on-pay proposal with 97% support and rejecting a proposal calling for an independent chairman by more than 80%. It appears that advisory firm recommendations played a decisive role in the differing vote tallies.
- ***GE proactively adopts proxy access.*** Surprising many, GE announced on February 11 that it had adopted a 3%/3 year/20% proxy-access bylaw, limiting to 20 the number of shareholders whose holdings may be aggregated. Although two much smaller companies also announced the adoption of proxy access around the same time, the news that one of the nation's largest and most high-profile companies had adopted proxy access before seeing the matter put to a shareholder vote caused some to ask whether the issue had reached a tipping point. GE's actions may not have been entirely unprompted, however, as GE earlier received a 3%/3 year/20% shareholder proposal, with no aggregation limits, for the 2015 season that in December GE tried unsuccessfully to exclude.
- ***Whole Foods postpones its annual meeting.*** Citing the SEC's decision to withdraw its no-action letter, on February 13 Whole Foods postponed the date of its annual meeting to a later, to-be-announced time, with no indication of how it would proceed on proxy access.
- ***Companies continue to evaluate their options.*** Although the 2015 proxy season is still young, different paths are being considered. Many companies with proxy-access proposals will opt for the traditional route of including the shareholder proposal on the ballot, and opposing it through written arguments and shareholder engagement. Others may include both the shareholder proposal and the company proposal in the same proxy, advocate for the company proposal and see which one gets more votes. Still others may include the shareholder proposal and recommend in favor of it. And we can't rule out the possibility that a company may seek a court order confirming its ability to omit the shareholder proposal. Whatever an individual company decides, it's clear that we will hear a lot more on this topic as the 2015 proxy season swings into high gear.

A Decision Framework

The vast majority of companies are not facing the immediate pressure of a proxy-access shareholder proposal, but it is not too early for companies to be considering the implications of these recent developments. While we expect to see some companies taking the GE approach, in response to a shareholder proposal or otherwise, at this juncture we do not think it is necessary

for most companies to do so, and we think that a company can make the decision in light of its own facts, and in many cases on its own timetable.

Below, we sketch out some of the factors we think a company should consider in reaching its decision.

Consider the Broader Governance Picture. We believe that proxy access is best viewed in the larger corporate governance context that takes into account a number of overlapping concerns regarding board composition and other governance issues that have gained increasing prominence in the past few years—

- ***Board composition—***Does the board count among its members individuals with a diverse mix of skills, experience, genders and backgrounds relevant to the company and its operations?
- ***Board refreshment—***Is the board regularly adding new members in order to ensure the presence of fresh perspectives and avoid a tendency towards self-reinforcing viewpoints?
- ***Board tenure—***Does the board strike the right balance between having directors of sufficiently long tenure to understand the company and its operations, but not so long that, rightly or wrongly, they become viewed as less likely to bring an independent, outsider's eye to the company's challenges and opportunities?
- ***Shareholder engagement and outreach—***Is the board open to nominee and board-composition suggestions from the company's shareholders, and does it have a formal process for considering such suggestions? How does management or the board communicate their willingness to engage with the company's largest shareholders and consider director suggestions from shareholders?

Other things being equal, we believe that a board (or a nominating and governance committee) that has an active and ongoing internal process and an appropriate external dialogue on these matters should be in a better position to know whether a proxy-access proposal is likely to arrive and to assess the company's chances for resisting a proposal if the board concludes it is not in the shareholders' best interests. This is just good corporate governance hygiene, even apart from the proxy-access question.

Is the Company Likely to Receive a Proxy-Access Proposal in the Near Term? Predicting when or if a particular company will receive a proxy-access shareholder proposal is speculative at best. But there are a handful of factors that empirically affect the probabilities—

- ***Company size—***Larger companies—companies in the Fortune 100 or S&P 500, for example—tend to get the bulk of Rule 14a-8 shareholder proposals and are more likely to receive a proxy-access shareholder proposal. Conversely, smaller companies, including many that have just recently IPO'd, tend to be somewhat more under-the-radar of governance activists, or may be enjoying a governance grace period as they develop a record of performance, and may have many more years before being prodded to confront the issue.
- ***Financial performance—***Companies whose recent financial performance has lagged their peers are always at a greater risk of activist and institutional shareholder attention, and we would expect that to be a factor in decisions about which companies to target for proxy-access proposals.
- ***Negative publicity—***Recent negative publicity—particularly if attributed to lax risk oversight or poor corporate governance—can increase shareholder concerns about board stewardship and be a motivating factor in targeting a company for proxy access.
- ***Significantly differing from peers—***Boards that lack gender, racial and/or ethnic profiles comparable to their peers, or who have executive compensation practices that are richer than their peers, may be appealing targets for proxy-access proposals by public and union-affiliated investors in particular.
- ***Operating in a scrutinized industry—***We also expect public and union-affiliated investors to focus their proxy-access efforts on companies that operate in industries under scrutiny for environmental, public health, public safety or consumer financial practices.

We believe that many companies will conclude that they are not likely targets in the short term. Even these companies should, however, recognize the possibility of being swept up in a broad-based campaign, like those that have effectively eliminated staggered boards at larger companies.

Is the Company Better Off Acting Proactively or Better Off Waiting? There are both upsides and downsides to acting proactively to institute proxy access before receipt of (or, as in GE's case, holding a vote on) a proxy-access shareholder proposal—

- ***On the upside***, the company would have greater leeway to tune the details to its preferences. These details include—
  - Ownership threshold and length of ownership
  - Limits on aggregation of ownership
  - Prioritizing among multiple nominations in a given year
  - Treatment of hedged or derivative holdings

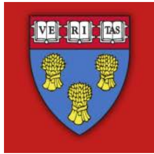
- Proportion of board seats eligible to be held by shareholder nominees
    - Whether a shareholder nominee that is included on the management slate in later years should continue to count against the proportional limit
    - Objective criteria (such as independence and sources and types of compensation) that a shareholder nominee must satisfy
    - Information required of shareholder nominees and nominating shareholders
    - Requiring nominating shareholders to disclaim a control purpose

Although shareholder proposals are typically "precatory" (i.e., non-binding) and companies therefore have some leeway in how, or if, to implement them, at least one proxy advisor has stated that it will scrutinize proxy-access bylaws adopted by companies in response to shareholder proposals, with the implication being that the advisor could recommend a "withhold" vote against any directors that it felt did not adequately carry out shareholder intent.

- ***On the downside—***
    - We are still at a very early stage in the development of proxy access and we have no empirical record as to whether it is of benefit to companies and their shareholders and, if so, which provisions are most effective. We believe that many boards will, if given the choice, concede to others the honor of early-adopter status. It is also unclear whether a company will receive laurels for being proactive. If a company adopts a different threshold that it believes is better suited to its own circumstances, that may itself trigger a proposal in response.
    - While an increasing number of boards are open to the idea of engagement with and even board representation for certain activist shareholders, adopting a proxy-access bylaw in effect creates a *carte blanche* that can be used even where the board concludes that it would not be in the interests of shareholders. The risk of unintended consequences is real.
    - Many of the benefits of proxy access that a board might wish to secure—such as increased shareholder involvement in the nomination process—are obtainable even if the board does not act on proxy access itself.
    - In many instances, a proxy-access bylaw will create a race to be first among proposing shareholders—thus increasing the likelihood of shareholder nominees. If the board is doing a good job of fairly considering shareholder suggestions, the use of the governance committee as a filter may be best for the company's governance and fairest to all shareholders.

If a company does not expect to be high on the list of companies that will be targeted in the near term, and is comfortable that it has done a good job of addressing legitimate shareholder

concerns about board composition, board refreshment and board tenure, the company may well feel comfortable waiting until it receives a proxy-access shareholder proposal, and even seeing the results of the subsequent shareholder vote, before deciding how to proceed.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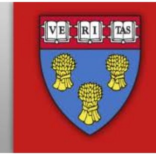

Proxy Advisors Clarify Proxy Access and Bylaw Amendments Voting Policies

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Thursday March 5, 2015

Editor's Note: The following post comes to us from Ariel J. Deckelbaum, partner and deputy chair of the Corporate Department at Paul, Weiss, Rifkind, Wharton & Garrison LLP, and is based on a Paul Weiss client memorandum.

On the heels of SEC Chair White's direction to the Division of Corporation Finance to review its position on proxy proposal conflicts under Exchange Act Rule 14a-8(i)(9), both Institutional Shareholder Services ("ISS") and Glass Lewis have issued clarifying policies on proxy access, entering the fray of what is becoming the hottest debate this proxy season. The publication of ISS's updated policy in particular means that market forces may have outpaced the SEC's review process. In order to avoid risking a withhold or no-vote recommendation from ISS against their directors, many companies will be faced with the choice of (i) including any shareholder-submitted proxy access proposal in their proxy materials (either alone or alongside a management proposal) (ii) excluding the shareholder submitted proposal on the basis of a court ruling or no-action relief from the Division of Corporation Finance on a basis other than Rule 14a-8(i)(9) (conflict with management proposal) or (iii) obtaining withdrawal of the proposal by the shareholder proponent.

Proxy Access

Glass Lewis estimates that approximately 100 companies will receive proxy access shareholder proposals in 2015, with the majority being submitted by the New York City Comptroller as part of the New York City pension funds' "Boardroom Accountability Project." In mid-January 2015, SEC Chair Mary Jo White directed the Division of Corporation Finance to review its position on Exchange Act Rule 14a-8(i)(9), which allows a company to exclude a shareholder proposal from its proxy materials if it "conflicts" with the company's own proposal to be submitted to shareholders at the same meeting. Pending such review, Corporation Finance will express "no views" on the application of Rule 14a-8(i)(9), leaving companies in a quandary about what to do if they find themselves in the situation of having conflicting proxy proposals. (See our previous Client Memorandum on this development.)

While previously operating on a “case-by-case” approach to evaluating proxy access proposals, ISS has now adopted a more definitive position, stating that it will generally support management and shareholder proxy access proposals that have (i) a share ownership threshold of 3% or less, with minimal or no limits on the number of shareholders that can form a proposing group, (ii) a share ownership duration of three years or less for each shareholder in the proposing group and (iii) a cap on nominees of generally 25% of the board. Expectedly, ISS will now generally recommend against proposals that are more restrictive than the foregoing, while reviewing any other prescriptions for reasonableness.

ISS further stated that it will generally recommend a vote against one or more directors if a company chooses to exclude a properly submitted shareholder proposal from its proxy materials (regardless of whether there is a conflicting management proposal or not) except where (i) the proponent has voluntarily withdrawn its proposal, (ii) the company has received SEC no-action relief or (iii) the company has obtained a U.S. District Court ruling allowing exclusion. If, however, the company has taken unilateral steps to implement the proposal, ISS will take into account the extent to which the proposal is implemented and any material restrictions added to it.

While Glass Lewis also published its views on proxy access late last month, it continues to take what is essentially a case-by-case perspective. Glass Lewis stated that while significant, long-term shareholders should be able to nominate their own board representatives, the possible distraction and disruption to a company dictates that minimum ownership, holding period and shareholder nominee caps are reasonable. Unlike ISS, Glass Lewis did not specify what those thresholds should be, but provided general principles of analysis. When considering shareholder proposals, Glass Lewis will review such proposals to assess whether they are “overly prescriptive,” contain minimum ownership calculations that could be abused or would unduly or unnecessarily burden the company or the board.

Glass Lewis will review company responses to a proxy access shareholder proposal for reasonableness and proportionality. When considering management proxy access proposals, Glass Lewis will review the proposal to ensure that it does not present overly burdensome hurdles or other restrictions that would “fundamentally vitiate” the proxy access right. Further, for alternate management proxy access proposals, Glass Lewis will examine numerous factors, including whether the company proposal varies materially from the shareholder proposal with respect to ownership, holding period and nominee cap thresholds; the company’s performance and governance profile; the board’s independence, leadership, responsiveness to shareholders and oversight; the opportunities for shareholders to effect change (such as the ability to call a special meeting); and the company’s rationale for its alternate proposal. Finally, Glass Lewis may

recommend against certain directors if the management's proposal is materially different from the shareholder proposal without sufficient rationale.

Other Updates

In addition to the foregoing proxy access policy updates, ISS also clarified its prior released policy to recommend a vote against the board if it unilaterally adopts a bylaw or charter amendment that materially diminishes, or is materially adverse to, shareholder rights. Under this updated policy, ISS stated that the following bylaw amendments are generally not considered materially adverse (although each will be evaluated on a case-by-case basis):

- Advance notice bylaws that set customary and reasonable deadlines;
- Director qualification bylaws that require disclosure of third-party compensation arrangements; and
- Exclusive forum provisions (when the venue is the company's state of incorporation).

ISS has, however, also included a lengthier list of amendments that would be considered materially adverse, including the following:

- Authorized capital increases that do not meet ISS's Capital Structure Framework;
- Board classification to establish staggered director elections;
- Director qualification bylaws that disqualify shareholders' nominees or directors who could receive third-party compensation;
- Fee-shifting bylaws that require a suing shareholder to bear all costs of a legal action that is not 100 percent successful;
- Increasing the vote requirement for shareholders to amend the company's bylaws or charter;
- Removing a majority vote standard and substituting plurality voting;
- Removing or restricting the right of shareholders to call a special meeting (including raising thresholds or restricting agenda items); and
- Removing or materially restricting the shareholder's right to act in lieu of a meeting via written consent.

We note that ISS has issued other FAQs on its independent chair, equity plan scorecard and selected compensation policies. For all of these updated ISS policies, see http://www.issgovernance.com/policy-gateway/2015-policy-information/

For Glass Lewis's proxy access views, see http://www.glasslewis.com/blog/glass-lewis-views-proxy-access-developments/