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Staying Ahead of Activist Stockholders
Six Steps Every Public Company Should Be Taking to Maintain Control This Year

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Even with the credit crisis raging and a hedge fund industry troubled by heavy losses, public companies and their boards of directors should not expect to see any relief from stockholder activism in 2009. On the contrary, after the dramatic drop in stock prices in 2008, activists are expected to continue their recent high level of activity during the upcoming 2009 proxy season.

The heightened anger of investors over perceived poor performance and rich compensation packages for management will likely encourage these activists to expect widespread support as they again target boards of directors for change. Heavy media coverage of bankruptcies and bailouts are likely to make government officials and the general public less than sympathetic to the concerns of management and board members.

Proxy contests, which have roughly doubled in number in recent years from 63 in 2001 to 124 in 2008 according to FactSet SharkRepellent, can be relatively inexpensive to conduct. Solicitation and advertising expenses can be greatly reduced through the use of Internet publication and distribution, and no minimum level of investment or share ownership is required in most jurisdictions, other than the basic requirement of being a shareholder.

With these challenges ahead, board members and senior management should consider a detailed review and planning process as a critical component in preparing their companies for the upcoming proxy season.

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The first step in preparing for activist stockholders is to designate a small team responsible for planning for and responding to activist activity. In addition to several senior company officers such as the chief financial officer, the general counsel, and the director of investor relations, this team should include a financial advisor and legal counsel experienced in responding to activists.

The company should also consider retaining a proxy soliciting firm and a communications or PR firm experienced in these types of stockholder issues—both to facilitate communications with stockholders and to have these advisors on retainer if an activist stockholder emerges. Most of these advisors will be fairly inexpensive to engage as they generally require only minimal up-front financial retainers in the hope of being involved in any future conflict.

This working group, once established, should identify the precautionary steps to be taken immediately and then meet periodically to update their plans to reflect recent market activity.

Precautionary Steps

The company's proxy solicitor should be directed to institute a stock watch program that monitors daily trading activity in the company's stock and provides a weekly report to the company. These programs can provide advance notice of share accumulations by activist holders and potential acquirers, among others. In addition, the company should closely monitor Schedule 13D and 13G filings with the SEC, which show changes in stock ownership for holders owning in excess of 5% of the outstanding shares.

Finally, larger public companies should ensure that they monitor filings under the Hart-Scott-Rodino (or HSR) statute as these filings require disclosure in certain circumstances of acquisitions of voting securities in excess of approximately $63 million.

An activist stockholder will research the composition of your board to determine which directors may be vulnerable to public pressure. By reviewing your annual meeting results (reported in the Form 10-Q after your annual meeting), the activist stockholder will be able to determine which directors have had high withhold vote totals at his or her last election.

In addition, they will likely review past public disclosures to determine whether any directors have related party transactions with the company that can be criticized, approved controversial pay packages as compensation committee members, or have served as directors at a time when a poison pill or other antitakeover measure was implemented.

For these reasons, the company should strive to maintain a unified board on key strategic decisions so that the board is not easily divided if opposed by an activist that focuses its public pressure on vulnerable members.

In many states, a stockholder can present a proposal at or immediately prior to a meeting of stockholders unless a company's bylaws restrict such an action. This means that, absent a bylaw restriction, stockholders with sufficient voting power could attend a company's annual meeting and, with little or no advance notice to the company, nominate and elect an alternate slate of board members.

To avoid such surprises, a company should consider instituting an advance-notice bylaw provision providing that a stockholder can only make a proposal (including one to nominate an alternative board slate) if timely and proper written advance notice is provided to the company. Typically, such a provision would provide that notice must be provided no more than 120 days and no less than 90 days prior to the anniversary date of the prior year's annual meeting.

The provision also would include requirements that such notice contain specified information, such as the specific business proposed and the identity of stockholders seeking to bring the matter to a vote. If the proposal involves an alternate slate of director nominees, the bylaw provision typically would provide that the stockholder must notify the company of all proposed nominees, including the professional background and company shareholdings of each such nominee.

Because of recent litigation regarding the level of clarity required in these provisions, a public company should ensure that its advanced-notice provision be carefully crafted and reviewed by experienced legal counsel.

In states such as Delaware, special meetings of stockholders may be called by a company's board of directors

or any person authorized by the company's articles of incorporation or bylaws. If stockholders are permitted to call a special meeting, this can be a useful tool for activists.

For example, an activist might call a special meeting during the year to remove certain directors and replace them with their own candidates, or to amend the company's bylaws in a manner that empowers the activist. In each case, a proxy contest in connection with a special meeting can be an unneeded and costly distraction to a company's board and management team, especially when these matters can be more efficiently raised at the company's annual meeting.

Moreover, the activist may provide, depending on the bylaws, little or no notice to the company when seeking to call the special meeting and may do so at a time when the company is temporarily weakened by poor operational performance or market, or economic conditions that are beyond its control.

In Delaware, amending a company's articles of incorporation requires board and stockholder approval; however, a board can amend the company's bylaws unilaterally without any such stockholder approval. Therefore, if a Delaware company's bylaws give stockholders the power to call special meetings, the board should consider amending the bylaws, either to eliminate this right or to fix the ownership threshold required for stockholders to call special meetings at a high level, such as 50%.

Alternatively, the board might consider amending the bylaws to provide that stockholders are not permitted to call a special meeting if the proposed business (such as the election of directors) was already voted on at an annual or special meeting held during the prior 12-month period.

Indemnification Provisions

In the recent Delaware Chancery Court decision, *Schoon v. Troy Corp.*, the Court held that a former director's right to expense advancement contained in the corporation's bylaws did not vest until an indemnifiable claim was asserted against the director and that the corporation could amend its bylaws at any time before an indemnifiable claim against the director was asserted to eliminate the director's rights to expense advancement.

As a result of this case, Delaware companies should be mindful that while current indemnification provisions contained in bylaws may provide for expense advancement, there is no guarantee that the bylaws will not be subsequently amended to reduce or eliminate these critical rights if an activist stockholder ultimately takes control of the board. Even though a former director may have broad indemnification rights, a loss of expense advancement can place an enormous personal financial burden on the former director in the event that litigation ultimately arises.

To protect against such a situation where the bylaws are later amended to narrow expense advancement and indemnification rights, companies should consider entering into contractual indemnification agreements with directors.

Without such agreements, some directors may feel pressure to settle with activists or to resign hastily from the board due to fear that they will be exposed to personal financial harm if the activist ultimately takes control. In addition, without such contractual indemnification, directors may be perceived as being more willing to permit the activist to obtain board representation in exchange for a settlement and release agreement in which the activist agrees not to sue the company or members of the board.

By instituting a contractual indemnification agreement with its directors in advance, a company may be more likely to maintain a united board in the face of an aggressive stockholder activist.

Tips on How to Maintain Control of Your Company

- **Prepare Immediate Reaction Team**
  Create a small group that plans for and is then capable of responding to activist activity.

- **Monitor Trading Activity**
  Watch out daily for share accumulation by activist holders and potential acquirers.

- **Know and Prepare Your Board**
  Maintain board unification on key decisions to keep activists from targeting vulnerable directors.

- **Institute Advance Notice Provisions**
  Restrict activists' opportunity to force board turnover by adding advance notice bylaw.

- **Limit Stockholder Special Meetings**
  Eliminate or make difficult the right of stockholders to call special meetings.

- **Implement Indemnification Rights**
  Avoid potential loss of expense advancement by entering into contractual agreements with directors.

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