



Preparing for Proxy Contests: Practical Steps Every Company Should Consider

Originally published in 24 February 2014 **Bloomberg BNA: Mergers & Acquisitions Law Report**

By Joseph E. Gilligan, Asher M. Rubin and James J. Benson

The 2013 proxy season demonstrated again the increasingly powerful role of activist investors in the public investment markets, particularly with respect to contested elections for a company's board of directors, referred to as proxy contests.¹ Proxy contests among the Russell 3000 companies increased from 24 in 2012 to 35 in 2013, and proxy contests among companies in the S&P 500, usually less common, increased from two in 2012 to five in 2013.²

Such numbers are almost equal to those seen during the credit crisis—in 2009, the number of proxy contests launched among the Russell 3000 companies reached 39, while for companies in the S&P 500, there were five³—and their level indicates that proxy contests have become an increasingly common risk for a broad set of public companies, including those with favorable stock prices and respected corporate governance policies. Perhaps most notable is that size is no longer a deterrent: in 14 of the 35 proxy contests among the Russell 3000 companies in 2013, the “target” company had a market capitalization of more than \$1 billion when the contest was announced.⁴

As demonstrated by Elliott Management's 2013 proxy contest with Hess Corp. (a company with an approximately \$20 billion market capitalization), even the largest public companies are now susceptible to activist stockholders seeking to reshape the board of directors in favor of their nominees. Moreover, in 2013, activist stockholders showed no hesitancy in engaging in advocacy campaigns to attempt to force their preferred strategic changes at Apple, Procter & Gamble and Microsoft.

The Appeal of Proxy Contests

The appeal of proxy contests to activist stockholders (or, as discussed below, stockholders who may not frequently be “activist” but are seeking strategic or other change) is the result of a number of factors. Taken together, these factors suggest that public companies will continue to face an increased likelihood of proxy contests by activist or discontented stockholders.

First, proxy contests can be relatively inexpensive to conduct. Most jurisdictions require that the activist stockholder own shares of stock in the company in order to launch a proxy contest but do not require a minimum level of stock ownership—although the amount of the company's stock owned by an activist stockholder may affect its ability to influence both the company and other stockholders. (For example, in 2013, ValueAct Capital owned less than 1 percent of Microsoft when it successfully sought change at the company. Instead of further accumulations, it chose to seek the support of other large stockholders and to threaten a proxy contest to force change.) Solicitation and advertising expenses can be minimized through the use of online publications and the electronic dissemination of most campaign materials to stockholders. In addition, activist stockholders who succeed in having one or more of their nominees elected to the board of directors can and often do seek reimbursement of the expenses they incurred in mounting the proxy contest; while results are mixed in “short slate” proxy contests (in which an activist stockholder seeks to replace less than the entire board of directors), in cases where the entire board is elected by an activist stockholder, reimbursement of its expenses is commonplace.



Preparing for Proxy Contests: Practical Steps Every Company Should Consider

Proxy contests generally face less structural opposition now than they did before the wave of corporate governance reform over the past decade led many U.S. public companies to reexamine their takeover defenses. In recent years, many U.S. public companies have removed or eliminated a number of such defenses: according to SharkRepellent.net, only 15 percent of the S&P 500 companies have a classified board and only 7 percent have a stockholder rights plan, or “poison pill,” in place.⁵ In seeking to protect a public company’s board of directors against immediate and wholesale change as a result of a proxy contest, a classified board is the single most effective defense, and the increased frequency of proxy contests seeking to replace the entire board of directors reasonably may be correlated with the decrease in the number of classified boards at U.S. public companies.

Proxy contests allow truly activist stockholders (as opposed to long-term stockholders driven to activism out of concern for a specific issue for which they seek change) the ability to act opportunistically. A stock price that is low as compared to its historical valuation or recent analyst predictions can be interpreted and portrayed by an activist stockholder as proof of the need for change at the board level. Similarly, a reduced stock price during a delayed product development, a difficult product rollout or an industry-wide slowdown, to name but a few examples, can be presented to fellow stockholders as proof of management failings or a lack of foresight by the company’s directors that can be appropriately remedied through the election of the activist’s opposing slate of director nominees.

Proxy contests in recent years very often have resulted in success of one form or another for the activist stockholder. According to ISS, for example, the “win rate” of activist stockholders in proxy contests in 2013 was 70 percent.⁶ Moreover, due to their contentious and sometimes dramatic nature, proxy contests receive a disproportionate amount of media coverage, and certain frequent activist stockholders, such as Carl Icahn or Daniel Loeb, can on occasion effect changes in a company’s corporate governance or strategic or financial behavior merely by positioning themselves to launch a proxy contest or engage in other stockholder activism (but without actually commencing the contest). In addition, the post-proxy contest sale of stock acquired by an activist stockholder in advance of its commencement of the contest, whether such contest ultimately was successful or otherwise, often may result in significant short-term gains for such activist stockholder—possibly due as much to the media attention and investor focus as to any fundamental change in underlying valuation. The net effect of these developments has been to popularize proxy contests and encourage institutional and other investors to invest in the underlying funds used by these activists to conduct their activities, thus increasing their capacity for everlarger targets.

Proxy contests were not, of course, the only form of stockholder activism faced by public companies in 2013. Public companies faced binding and nonbinding (commonly referred to as “precatory”) stockholder proposals and other pressuring campaigns on a range of topics, and they continue to be engaged from time to time in contests in favor of or against a takeover proposal or other proposed action. There also have been a number of well-publicized financial campaigns, usually in which one or more activist stockholders seeks a special dividend or the issuance of preferred stock. This article focuses on the steps a company can take to prepare itself for a proxy contest in which a stockholder is seeking board representation, usually in connection with a disagreement with the existing board about the strategic direction of the company, or the suitability of one or more current directors to execute such strategy. However, many of the steps discussed herein are equally applicable to the range of actions that activist stockholders may take to force change at public companies.



Preparing for Proxy Contests: Practical Steps Every Company Should Consider

What Companies Can Do to Prepare for Proxy Contests

With the potential for a proxy contest in mind, 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. The company's initial goal simply should be to avoid a proxy contest: they are time-consuming, expensive and result in significant distraction of the company's management from its primary focus.

Examine and Strengthen Corporate Defenses

The company's first step should be to commence a review of its corporate defense framework, including its advance notice provisions, in light of the threat of possible proxy contests. Advance notice of any actual or potential actions to be taken by the company's stockholders is of vital importance. Such review should include the following considerations:

Advance notice provisions

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

To avoid such surprises, a company should consider instituting an advance-notice by law provision providing that a stockholder can only make a proposal (including one to nominate an alternative board slate) if timely and proper advance written notice has been 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 of stockholders.

The provision also would include requirements that such notice contain specified information, such as the specific business to be proposed and the identity of stockholders seeking to bring the matter to a vote. If the proposal involves an alternative 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 stockholdings of each such nominee. A company should ensure that its advanced-notice provision is carefully crafted and reviewed by experienced legal counsel.

Special meetings called by stockholders

In states such as Delaware, special meetings of stockholders may be called by a company's board of directors, persons authorized by the company's articles of incorporation or bylaws, such as a corporate officer or committee of the board, or by one or more stockholders. Stockholders being permitted to call a special meeting can be a powerful tool for activist stockholders. For example, an activist stockholder (if not prohibited by the articles or bylaws) might call a special meeting during the year to remove certain directors and replace them with its own candidates or to amend the company's bylaws in a manner that empowers the activist. Moreover, the activist stockholder may provide, depending on the bylaws, little or no notice to the company when seeking to call the special meeting and, acting opportunistically, may do so at a time when the company is temporarily weakened by poor short-term operational performance, or market or economic conditions that are beyond its control.

A photograph of a Wall Street sign with the text '11-21 → WALL ST' and a blurred American flag in the background.

Preparing for Proxy Contests: Practical Steps Every Company Should Consider

Supermajority voting provisions

A public company board may wish to consider as part of its review and planning process whether a supermajority voting provision is appropriate to include in the company's bylaws. These provisions require a heightened stockholder approval threshold, often two-thirds or three-quarters of the outstanding stockholder voting power instead of a simple majority, to approve an amendment to specified portions of the company's bylaws. In Delaware, amending a company's articles of incorporation requires both board and stockholder approval; however, either the board or the stockholders can amend the company's bylaws unilaterally. Therefore, for example, if a Delaware corporation's bylaws give stockholders the power to increase the size of the board and thus add new members by a plurality vote at the next annual or special meeting, the board should consider amending this provision to provide instead that the size of the board shall be set solely by the existing board. This provision can then be made subject to a supermajority vote provision in order that an activist stockholder cannot easily change the provision once it has been adopted by the board.

A range of other defensive steps also may be helpful and appealing, but certain of these steps are likely to be very difficult or impossible for a public company to implement due to opposition by large sectors of the investment community. For example, attempting to institute a classified board by amendment of a company's articles of incorporation currently is highly disfavored by many institutional investors and governance advisers and therefore is not likely to be approved by a company's stockholders. Therefore, a careful but thorough review should be conducted periodically by experienced legal counsel to ensure the board and senior management are advised with respect to the company's current defensive and advance notice framework and additional available provisions.⁷ Companies also should consider, and obtain the advice of their financial advisers with respect to, the likely reaction to the adoption of such available defensive provisions by the institutional stockholder advisory services, the companies' major institutional investors and the public.

Review of Indemnification Agreements

The company also should consider what protections are in place for its existing directors and senior management should an activist stockholder wage an ultimately successful proxy contest. Some proxy contests (though certainly not all) are accompanied or followed by litigation against one or more of the company's former directors or officers. In Delaware and many other states, directors are protected from retroactive elimination of rights to indemnification or other protections contained in a company's articles of incorporation or bylaws. In Delaware, such protection was the result of a legislative amendment to that state's law governing corporations that was effected after the (opposite) decision of the Delaware Chancery Court in *Schoon v. Troy Corp.*⁸ However, while the indemnification of directors in a company's articles of incorporation or bylaws is relatively widespread, many such governing documents of public companies are silent (or not sufficiently clear) with respect to, among other things, the right of directors and officers to expense advancement in the event of a claim (even an indemnifiable one) being brought against any such persons. The absence of expense advancement can place an enormous personal financial burden on a former director or officer in the event that litigation ultimately arises.

To protect against such a situation or other matters (including procedural matters) that often arise in these circumstances, companies should consider entering into contractual agreements with directors and certain senior executive officers expressly providing for expense advancement, explicit and protective procedural provisions and any other specific indemnities that may be appropriate under the circumstances.

A photograph of a Wall Street sign with the text '11-21 → WALL ST' and a blurred American flag in the background.

Preparing for Proxy Contests: Practical Steps Every Company Should Consider

Without such agreements, some directors may feel (or, in hindsight, may be perceived to have felt) pressure to settle with activist stockholders 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—or even elects simply to engage in a war of attrition through endless litigation. In addition, without such contractual protection, 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.

Finally, a company's board of directors should be actively engaged in the process of reviewing the company's corporate defenses and making any changes thereto in advance of the appearance of a potential proxy contest. With respect to actions taken by a company's board in response to an existing hostile threat, in Delaware and certain other states, a court likely will apply a heightened standard of review and seek to determine if the board of directors acted reasonably, after due deliberation and in a fully informed manner, and whether its actions were not disproportionate to the issue (or threat) faced by the company. Establishing a clear and fulsome record of the board's actions and deliberations in considering and making changes to the company's corporate defense framework therefore is an important step for the board to take in seeking to ensure that such changes will withstand potential judicial review.

Communicate With Stockholders

Most public companies already have both the policy and the practice of communicating regularly with their significant stockholders; many will have formalized an investor relations function within the company and may even have arranged to have regularly scheduled meetings with their significant stockholders. Such communications are critical: If a company's significant stockholders come to believe that achieving successful engagement with the company is unduly difficult or unlikely, they are more inclined to consider engaging in, or supporting, activism.

A company that does not already communicate regularly with its significant stockholders should consider arranging formal meetings with such stockholders. Preparation for such meetings should involve the assistance of experienced legal counsel to ensure that the company's representatives remain in compliance with the rules of the Securities and Exchange Commission (SEC) relating to full and fair disclosure to stockholders. The company also should consider whether one or more of its independent directors should periodically join or conduct such meetings in order to give the company's stockholders a chance to raise issues directly with the board that they may not wish to discuss with the company's current management. In particular, the company should consider whether its strategic plan has been clearly explained in its public disclosures and whether such plan has the support of its significant stockholders.

While the board of directors has the duty and discretion to set the strategic direction of the company, the company should ensure that its significant stockholders know that their views are being heard and considered. Regular communications with a company's stockholders also may provide the company with informal advance notice of a frustrated and therefore potentially activist stockholder.

Establish a Working Group and an Early Warning System

In advance of the appearance of a proxy contest, the company should designate a small team responsible for planning for, and responding to, activist stockholder activity. In addition to several senior company officers, such as the chief executive officer, chief financial officer, the general counsel and the director of investor relations, this team should include a financial adviser and legal counsel experienced in responding to activist stockholders.

A photograph of a Wall Street sign with the text '11-21 → WALL ST' and a blurred American flag in the background.

Preparing for Proxy Contests: Practical Steps Every Company Should Consider

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. An early step should be to retain a proxy soliciting firm and a communications or public relations firm experienced in these types of stockholder issues—to facilitate the communications with stockholders discussed above, to engage in the early warning activities described below and to ensure such advisers have a thorough understanding of the company, its strategy and its stockholders if a proxy contest materializes.

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 biweekly or monthly report to the company, as well as real-time alerts for significant developments. These programs can function as an "early warning" system that provides prompt notice to the company's management of stock accumulations by known activist stockholders or discontented and therefore potentially activist stockholders, among others.

Although the company's internal investor relations department can monitor certain trading activity in the company's stock, proxy solicitors often are able to utilize a sophisticated network of contacts to access more immediate and not initially apparent information about trading in a company's stocks (including short sale arrangements, swaps, etc.). Also, proxy solicitors often are familiar with the identities and approaches of current activist stockholders and can provide the company with strategic advice based on their experience working in a range of contested situations.

The company and its proxy solicitor should closely monitor Schedule 13D and 13G filings with the SEC, which show the initial acquisition of an ownership position and then changes in stock ownership, in each case for holders owning in excess of 5 percent of a company's outstanding shares of stock, and quarterly Form 13F filings that show holdings by large institutional investment managers. In addition, the Hart-Scott-Rodino statute's filing requirements may provide an even earlier warning to larger public companies in which a stockholder could acquire securities valued at more than approximately \$71 million without reaching the SEC's 5 percent reporting threshold. Although such filings are not made public, the target company is notified of any accumulation of stock in excess of such threshold; as a result, larger public companies also should ensure that they monitor notifications delivered to them pursuant to the Hart-Scott-Rodino statute.

Finally, the company's working group should develop detailed written responses, Q&A's and "do's and don'ts" guidance lists for members of the board and senior management. A common tactic among some activist stockholders is to surprise senior managers and board members and seek to elicit a response that can be used later in the proxy contest, even if taken out of context. A clear "no comment" policy should be adopted, and can serve a helpful role in the event an individual is approached. A further policy that designates the chief executive officer as the sole person authorized to speak on behalf of the company with respect to strategic matters also may serve to manage and control communications and to protect individuals. Clear, practical guidance should be provided in advance and reinforced periodically throughout the company, including with respect to these policies.

Concluding Considerations

After taking the foregoing steps, companies may wish to consider the strategies activist stockholders would seek to employ in a proxy contest. An activist stockholder may request a meeting with the company's management to discuss one or more issues of concern to such stockholder.

A photograph of a Wall Street sign with the text '11-21 → WALL ST' and an American flag in the background. The sign is black with white text. The flag is blurred and in the foreground.

Preparing for Proxy Contests: Practical Steps Every Company Should Consider

Depending on the response by the company's management at such meeting, the activist stockholder may publicly disclose its concerns (and the company's reaction) in a preface to commencing a proxy contest. The effect of any such public statement by an activist stockholder likely would be diminished, however, if the company were to be able to issue a cohesive response highlighting the previous meetings held with such stockholder and the issues raised at such meetings.

An activist stockholder often will research the composition of a company's board of directors to determine which directors may be vulnerable to public pressure. By reviewing the company's annual meeting results (reported in the company's SEC filings after its 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, an activist stockholder likely will review the company's past public disclosures to determine whether, for example, any directors have engaged in related-party transactions with the company that can be criticized, approved controversial pay packages as compensation committee members, served as directors at a time when a poison pill or other often criticized antitakeover measures were implemented or served during a period in which the company suffered from a delayed product development, a difficult product rollout or a falling stock price.

For these reasons, the board itself should consider conducting a frank assessment of its strengths and weaknesses so as to anticipate points on which it may be criticized.

Finally, companies also should consider the likely reaction of their significant stockholders to a proxy contest. Traditionally, large institutional investors were reluctant to support activist stockholders except in extreme situations, but companies no longer can rely on such reluctance. Instead, as several recent proxy contests have demonstrated, large institutional investors appear to be increasingly willing to support an activist stockholder's nominees if such stockholder's agenda or concerns about the company's strategic direction align with those of the institutional investors. The effect of this change, together with the somewhat reduced influence of the stockholder advisory services (which correlates with the trend of some institutional investors internalizing the proxy analysis function), is to reduce the ability of companies to predict the reaction their significant stockholders are likely to have to an activist stockholder launching a proxy contest.

Proxy contests are not unlike modern political campaigns: They often involve a debate over both substantive and superficial issues. And the movement of the company's stock price during such contest, like the economy during a political campaign, can be a deciding factor. Thus, from a company's perspective, the best proxy contest is likely the one that never occurs. In light of the increased number of proxy contests and the broadened scope of companies potentially the targets of such proxy contests, however, companies should consider improving their position immediately with respect to any such contest by taking the precautionary steps outlined above.

1 - A proxy contest is defined for purposes of this article as a contested election to the board of directors in which a dissident stockholder seeks to elect its own director nominee(s) in opposition to one or more of the company's nominees.

2 - Content reproduced with permission from The Conference Board, Inc. 2013 The Conference Board, Inc. The Conference Board in collaboration with FactSet, Proxy Voting Analytics (2009-2013) Executive Summary at 9, available at <http://www.conference-board.org/proxy2013> (the "PVA"). Depending on the criteria used and the period examined, other observers confirm a similar increase: Institutional Shareholders Services Inc. noted an increase from 19 proxy contests in 2012 to 24 in 2013 (United States Research Team, Institutional Shareholder Services Inc., 2013 Proxy Season Review, United States at 47, available at <http://www.issgovernance.com/2013postseasonreportus> (the "PSR")), and Georgeson noted an increase from 34 proxy contests in 2012 to 37 in 2013 (Georgeson, 2013 Annual Corporate Governance Review at 58, available at <http://www.georgeson.com/us/resource/Pages/acgr.aspx>).

3 - PVA at 9.

4 - PVA at 9. SharkRepellent.net also reported that as of April 22, 2013, almost 30 percent of the companies targeted in a financial campaign or proxy contest in 2013 had a market capitalization of more than \$1 billion when the campaign or proxy contest was announced. This was a higher proportion of campaigns or proxy contests among companies of such size—after fewer than four full months of 2013 having elapsed—than had occurred in the previous seven years during which SharkRepellent.net tracked such information. John Laide, SharkRepellent.net, "Research Spotlight: Activists Continue to Target Larger Companies," April 24, 2013, available at https://www.sharkrepellent.net/request?an=dt.getPage&st=undefined&pg=/pub/rs_20130424.html&Activists_Continue_to_Target_Larger_Companies&rnd=37879.

5 - John Laide, SharkRepellent.net, "Research Spotlight: Governance Activists Set Their Sights on Netflix's Annual Meeting," May 9, 2013, available at https://www.sharkrepellent.net/requestan=dt.getPage&st=undefined&pg=/pub/rs_20130509.html&Governance_Activists_Set_Their_Sights_on_Netflix_Annual_Meeting&rnd=475222.

6 - PSR at 48.

7 - In recent years, there have been a number of instances in which companies have included defensive provisions in their bylaws rather than their articles of incorporation, apparently as a result of legal or strategic error. Certain defensive provisions are required by the state law under which a company is incorporated to be included in the articles of incorporation, and the erroneous inclusion of such provisions in the bylaws will render such provisions inoperative. From a strategic perspective, including a defensive provision in a company's articles of incorporation (if legally permissible) is usually preferable, as amending a company's articles of incorporation in most states requires the approval of the board of directors and the company's stockholders, while amending the bylaws may be done by the stockholders alone. As a result, a defensive provision in the bylaws can be eliminated or amended by the company's stockholders without the approval of the board of directors. If a defensive provision is included in the bylaws (and doing so is permissible under state law), the board of directors should consider whether to require that amendments to such provision require a supermajority vote of the company's stockholders.

8 - 948 A.2d 1157 (Del. Ch. 2008).

Authors



Joseph E. Gilligan
Partner, Washington, D.C.
T +1 202 637 5945
joseph.gilligan@hoganlovells.com



Asher M. Rubin
Partner, Baltimore
T +1 410 659 2777
asher.rubin@hoganlovells.com



James J. Benson
Associate, Washington, D.C.
T +1 202 637 4820
james.benson@hoganlovells.com

www.hoganlovells.com

Hogan Lovells has offices in:

Alicante
Amsterdam
Baltimore
Beijing
Brussels
Budapest*
Caracas
Colorado Springs
Denver
Dubai

Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta*
Jeddah*
Johannesburg

London
Los Angeles
Luxembourg
Madrid
Miami
Milan
Moscow
Munich
New York
Northern Virginia

Paris
Philadelphia
Prague
Rio de Janeiro
Riyadh*
Rome
San Francisco
São Paulo
Shanghai
Silicon Valley

Singapore
Tokyo
Ulaanbaatar
Warsaw
Washington, DC
Zagreb*

"Hogan Lovells" or the "firm" is an international legal practice that includes Hogan Lovells US LLP and Hogan Lovells International LLP.

The word "partner" is used to refer to a member of Hogan Lovells International LLP or a partner of Hogan Lovells US LLP, or an employee, or consultant with equivalent standing and qualifications, and to a partner, member, employee or consultant in any of their affiliated businesses who has equivalent standing. Where case studies are included, results achieved do not guarantee similar outcomes for other clients. Attorney advertising.

For more information, see www.hoganlovells.com

© Hogan Lovells 2014. All rights reserved. Q00281

* Associated offices