May 9, 2014

Delaware Court of Chancery Upholds Rights Plans as a Defense to Activism

Last week, the Delaware Court of Chancery upheld the use of a shareholder rights plan in response to an aggressive public campaign by an activist shareholder. *Third Point LLC* v. *Ruprecht, et al.*, C.A. No. 9469-VCP (May 2, 2014). This important decision reaffirms that Delaware directors may take appropriate action to defend against any reasonably perceived danger to corporate effectiveness, whatever the source of the threat.

Last year, several activist funds, including Third Point LLC, accumulated large stakes in Sotheby's. In October, Third Point disclosed that it had increased its stake to 9.4%. It also publicly criticized Sotheby's board and management, demanded board representation, and announced that it had "already commenced informal discussions" with potential CEO replacements. Two days later, Sotheby's board adopted a two-tiered rights plan that triggered at a 10% level for 13D filers and at 20% for "passive investors" who file on Schedule 13G. The plan exempted whole-company tender offers that treat all stockholders equally.

This February, Third Point launched a short-slate proxy contest and requested an exemption from the rights plan to allow it to buy up to 20%. The board denied the request, and Third Point sued, seeking an injunction to delay the annual meeting. Third Point argued that the board could not lawfully enforce the 10% trigger in light of the proxy contest. Third Point did not assert that the plan precluded it from winning, as both sides expected the race to be close. But it was undisputed that allowing Third Point to go to 20% could make a difference.

The Court of Chancery denied the motion for injunctive relief, and found that Third Point's claims were not likely to succeed on the merits. Vice Chancellor Donald F. Parsons, Jr. rejected the claim that the only threat boards may consider when adopting and maintaining a rights plan is a full-company takeover, and held that rights plans can be deployed in activist situations even if they may affect a tight activist-led proxy contest. Most notably, though it found the case to be close one, the Court held that Third Point's aggressive conduct had led Sotheby's to reasonably fear that Third Point might come to exercise "negative control" over the company, and that this concern justified the board's refusal to exempt Third Point from the 10% trigger. Allowing "individuals or entities . . . to exercise disproportionate control and influence over major corporate decisions" can pose a threat to corporate well-being and justify a rights plan, the Court found, "even if [those individuals or entities] do not have an explicit veto power."

In so holding, the Court of Chancery reaffirmed thirty years of Delaware case law upholding the validity of rights plans, including the seminal *Household* and *Unocal* decisions in 1985, as well as then-Vice Chancellor (and now Chief Justice) Strine's *Barnes & Noble* decision in 2010. The Court's decision highlights the continued vitality of rights plans in the face of ever-evolving threats to corporate effectiveness. Rights plans are not a cure-all for activist attacks, but, in appropriate circumstances, they remain an important tool for directors.

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May 21, 2014

With a Note of Caution, Delaware Rules Fee-Shifting Bylaws Facially Permissible

In a recent decision, the Supreme Court of Delaware has reaffirmed the broad power of Delaware directors to adopt bylaws when consistent with the corporation's certificate of incorporation. *ATP Tour, Inc. et al.* v. *Deutscher Tennis Bund et al.*, No. 534, 2013 (Del. May. 8, 2014). The decision further confirms the utility of exclusive forum bylaws but reemphasizes that all corporate bylaws are subject to review for reasonableness in the circumstances of their adoption and use. While the opinion facially approves a "fee-shifting" bylaw that imposes the cost of defense in intracorporate litigation on the losing party, we advise caution for public company boards considering adopting such a bylaw to apply to stockholder litigation generally.

The case reached the Supreme Court as a certified question from the U.S. District Court for the District of Delaware. ATP is a Delaware non-stock corporation that operates a professional tennis tour and whose members include entities that operate tennis tournaments. ATP's bylaws contain a provision that shifts attorney's fees and costs to unsuccessful plaintiffs in intracorporate lawsuits. After two of ATP's members unsuccessfully brought suit in federal court to avoid a downgrading of certain tournaments, ATP invoked the fee-shifting bylaw to collect the costs of its defense. The federal court sought the assistance of the Delaware Supreme Court in deciding whether the bylaw complied with Delaware law.

Faced with an abstract legal question, the Supreme Court found no basis to hold the fee-shifting bylaw facially invalid. The Court took pains to emphasize, however, that "[b]ylaws that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose." Accordingly, "[w]hether the specific ATP fee-shifting bylaw is enforceable, [] depends on the manner in which it was adopted." The opinion declined to decide the as-applied validity of the bylaw because the certified question presented to the Court did not include the facts necessary to evaluate its situational reasonableness. The decision closed by citing the Court of Chancery's 2013 decision in *Boilermakers Local 154 Ret. Fund* v. *Chevron*, which announced, in the context of upholding an exclusive forum bylaw, that "stockholders will be bound by bylaws unilaterally adopted by their boards."

The *ATP* decision has led some commentators to urge broad adoption of fee-shifting bylaws to reverse the high tide of stockholder litigation. We believe caution is in order. The decision whether to adopt such a bylaw implicates a board's fiduciary responsibility, and, in the public company context (and unlike in *ATP*), an inherent tension between the goal of deterring litigation and the danger of self-interested director action—a concern not at play in the context of an exclusive forum bylaw. We are skeptical that the courts will approve public company bylaws of this sort absent a record of considered board deliberation establishing the bylaw's situational reasonableness. And shareholder groups and proxy advisors are likely to vigorously oppose fee-shifting bylaws, including possibly by deploying withhold recommendations. At the same time, however, the decision sends an important affirmative signal that the courts are sympathetic to exclusive forum bylaw provisions, which, as we have written, remain an attractive option for boards concerned to proactively rationalize potential derivative or class litigation.

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August 22, 2014

Progress and Challenges in the Battle against Multiforum Stockholder Litigation

Just over a year ago, the Delaware Court of Chancery upheld the facial validity of exclusive forum bylaws adopted by corporate boards as a means of rationalizing stockholder litigation. In the time since Chancery's landmark *Chevron* opinion, numerous corporations have adopted exclusive forum bylaws, and courts in New York, Texas, Illinois, Louisiana, and California have enforced such bylaws against stockholders bringing duplicative lawsuits in violation of their terms. The result, as one commentator recently noted, has been to disincentivize duplicative filings and reduce the concomitant litigation "deal tax" on merging parties. Yet, despite this progress, pernicious multijurisdictional litigation persists. A recent decision from a court in Oregon illustrates the potential harm from such litigation and the importance of continued authoritative articulation of the law to ensure the efficacy of exclusive forum bylaws. *Roberts* v. *TriQuint SemiConductor, Inc.*, No. 1402-02441 (Or. Cir. Ct. Aug. 14, 2014).

The *TriQuint* case involved a challenge to the stock-for-stock merger between TriQuint Semiconductor and RF Micro Devices. Cognizant of the heightened risk of wasteful, duplicative litigation attendant to merger transactions, TriQuint's board adopted a bylaw in connection with its approval of the transaction designating Delaware courts as the exclusive forum for intracorporate stockholder litigation. Following the announcement of the deal, and as the board had feared, TriQuint stockholders filed duplicative lawsuits in Delaware and Oregon courts challenging the transaction and alleging that TriQuint's directors entered into the merger only to fend off an activist stockholder's proxy contest threat. In a June opinion, Vice Chancellor Noble of the Delaware Court of Chancery denied expedition, holding that the stock-for-stock transaction was due business judgment deference under longstanding precedent from the Delaware Supreme Court and that the plaintiffs failed to articulate even a colorable claim against the directors.

Defendants then moved to dismiss the Oregon suits as barred by the exclusive forum bylaw and for failure to state a claim. The Oregon court denied the motions. While the court acknowledged *Chevron*'s teaching that "bylaws are not contractually invalid simply because they were adopted unilaterally," it nevertheless relied on non-Delaware authority, expressly disapproved in *Chevron*, to conclude that the board acted "inequitably" because it "enacted the bylaw in anticipation of this exact lawsuit" and without some undefined "ample time" the court believed was needed "for the shareholders to accept or reject the change." Then, even though it conceded that the stock-for-stock merger was entitled to business judgment review, the Oregon court declined to dismiss the lawsuit, apparently finding potential merit in the same Delaware law claims the Delaware Court of Chancery had already ruled were not even colorable.

The Oregon rulings, which stray far from settled and binding Delaware authority, highlight the indefensible cost and procedural unfairness of duplicative multiforum corporate litigation. We continue to believe exclusive forum provisions remain a viable deterrent against such wasteful duplicative litigation. In light of the *TriQuint* case and pending further elaboration and acceptance of the legal principles governing forum bylaws, however, boards should consider adopting such provisions on a "clear day" in advance of any particular anticipated litigation.

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June 25, 2013

Delaware Court of Chancery Upholds Forum Selection Bylaws

The Court of Chancery today held that directors of Delaware corporations may validly adopt bylaws limiting the courts in which certain types of internal-affairs shareholder litigation can be brought. *Boilermakers Local 154 Ret. Fund* v. *Chevron Corp.*, C.A. No. 7220-CS (Del. Ch. June 25, 2013). This important decision thus authorizes board-adopted forum selection bylaws—an innovation of this Firm—as a potential solution to the duplicative shareholder litigation epidemic about which we have written previously.

As Chancellor Strine explained, "a forum selection bylaw is a provision in a corporation's bylaws that designates a forum as the exclusive venue for certain stockholder suits against the corporation, either as an actual or nominal defendant, and its directors and employees." Such bylaws aim to regulate shareholder class actions alleging breaches of fiduciary duty (such as merger litigation), derivative suits, and other corporate-governance or internal-affairs cases. In February 2012, a shareholder plaintiffs' law firm began a coordinated attack on the boards of twelve different companies that had unilaterally adopted forum selection bylaws without shareholder approval. Two of those companies, Chevron and FedEx, chose to defend their bylaws, and they sought a prompt ruling from the Court as to their statutory validity.

Emphasizing the broad powers of Delaware boards to enact bylaws, Chancellor Strine concluded that the forum selection bylaws easily fit within the scope permitted by the statute. Drawing an analogy to the shareholder rights plan—which, like the forum selection bylaw, was attacked as an excessive exercise of director authority—the Chancellor rejected plaintiffs' "position that board action should be invalidated or enjoined simply because it involved a novel use of statutory authority." Thus, the Court held, "[j]ust as the board of Household was permitted to adopt the pill to address a future tender offer that might threaten the corporation's best interests, so too do the boards of Chevron and FedEx have the statutory authority to adopt a bylaw to protect against what they claim is a threat to their corporations and stockholders, the potential for duplicative law suits in multiple jurisdictions over single events."

Nor was the Court troubled by the fact that the bylaws were adopted by directors without shareholder approval, because "the overarching statutory and contractual regime the stockholders buy into explicitly allows the board" to unilaterally adopt and amend bylaws where permitted by the corporation's charter. Finally, the Chancellor declined to credit plaintiffs' "parade of horribles"—"an array of purely hypothetical situations in which they say that the bylaws of Chevron and FedEx might operate unreasonably"—because the bylaws will be subject to a situational reasonableness review whenever they are enforced and directors are always subject to fiduciary obligations.

Today's decision endorses the creative power of directors to adopt bylaws designed to promote the best interests of corporations and their stockholders when made on the basis of informed deliberation. We recommend that all Delaware boards carefully consider whether to adopt a forum selection bylaw.

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W/2125971

January 16, 2014

ISS Publishes Guidance on Director Compensation (and Other Qualification) Bylaws

In the latest instance of proxy advisors establishing a governance standard without offering evidence that it will improve corporate governance or corporate performance, ISS has adopted a new policy position that appears designed to chill board efforts to protect against "golden leash" incentive bonus schemes. These bonus schemes have been used by some activist hedge funds to recruit director candidates to stand for election in support of whatever business strategy the fund seeks to impose on a company.

In its new FAQ, ISS warns that if a board adopts "restrictive director qualification bylaws" designed to prohibit "golden leashes" without submitting them to a shareholder vote, ISS "may" recommend a withhold vote against director nominees "for material failures of governance, stewardship, risk oversight, or fiduciary responsibilities." The references to fiduciary responsibilities, risk oversight and governance are particularly ironic given the serious risks that such "golden leash" arrangements pose to fiduciary decision-making and board functioning, including the risks of conflicted directors, fragmented and dysfunctional boards and short-termist behavior, which ISS regrettably does not address or even acknowledge. The ISS FAQ position is consistent with the ISS November recommendation (previously discussed here) that shareholders withhold votes from director candidates of a small-cap bank holding company because the board adopted a director compensation bylaw without shareholder approval. The directors of that company were reelected but the ISS recommendation drove a significant withhold vote.

In light of ISS' threat that it may issue withhold vote recommendations against boards that adopt director compensation bylaws, it can be expected that many companies will decide that discretion is the better part of valor and avoid a confrontation with ISS, despite the risks posed by "golden leash" schemes. This would be a rational response given the hopefully low probability for any company of actually having to deal with this issue, the fact that "golden leash" arrangements taint dissident candidates and can be used against them in proxy contests, and the prospect that the courts may step in to address the conflicts of interest and duty of loyalty problems created by such schemes.

Some companies may still wish to protect themselves from the threats posed by "golden leash" arrangements through appropriate bylaws and in that case may wish to consider bylaws that permit payment of a reasonable one-time candidacy fee. At a minimum, all companies should require full disclosure of any third-party arrangements that director candidates may have, which has long been a common practice and does not (at least given ISS' current position) raise the risk of an ISS withhold recommendation. Companies that do choose to adopt such protective bylaws, with or without a shareholder vote, should consider appropriate shareholder outreach and engagement, focusing on the importance of discouraging third-party incentive compensation arrangements that may lead to board conflicts and divergent incentives, which the Council of Institutional Investors has noted "blatantly contradicts" its policies on director compensation.

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W/2207503

November 20, 2013

ISS Addresses Dissident Director Compensation Bylaw

ISS Proxy Advisory Services recently recommended that shareholders of a small cap bank holding company, Provident Financial Holdings, Inc., withhold their votes from the three director candidates standing for reelection to the company's staggered board (all of whom serve on its nominating and governance committee) because the board adopted a bylaw designed to discourage special dissident compensation schemes. These special compensation arrangements featured prominently in a number of recent high profile proxy contests and have been roundly criticized by leading commentators. Columbia Law Professor John C. Coffee, Jr. succinctly noted "third-party bonuses create the wrong incentives, fragment the board and imply a shift toward both the short-term and higher risk." In our memorandum on the topic, we catalogued the dangers posed by such schemes to the integrity of the boardroom and board decision-making processes. We also noted that companies could proactively address these risks by adopting a bylaw that would disqualify director candidates who are party to any such extraordinary arrangements.

We hope ISS's position that Provident's adoption of such a bylaw was a "material governance failure" was a reaction to the "extraordinary circumstances" they found in this case (including some governance features that ISS disfavors such as the staggered board and plurality voting and the fact that the bylaw was adopted after an investor group had disclosed a large 13D ownership position). To the extent this ISS recommendation is a harbinger of a new, and previously unannounced, one-size-fits-all policy, however, it may discourage companies from protecting themselves against inappropriate director conflict and enrichment schemes, and encourage activists to offer them. In our view this would be a most unfortunate development, because ISS would be unwittingly promoting fragmented and dysfunctional boards, conflicted and self-interested directors and short-termist behavior.

ISS clearly recognizes the risk of director conflicts arising from differential compensation (which has also been heavily criticized by the Council of Institutional Investors) but its recommendation draws a distinction between compensation paid for board service and for *candidacy*. ISS suggests that it may in some cases be appropriate for a dissident to pay candidates "a reasonable fee for agreeing to stand for election, in order to compensate them for the considerable time commitments incurred in proxy contests." But this should not lead to a more general opposition to bylaws designed to prevent special compensation arrangements that create conflicts for dissident nominees. Our strong objection to these special arrangements does not extend to a reasonable candidacy fee that would be paid if the nominee is not elected (even though proxy contests have been waged for decades without having to offer any special incentives). Indeed, many of the bylaws that companies have recently adopted would not preclude arrangements to compensate candidates who are defeated, in light of the effort they will have spent in the election contest. Candidates who are elected would be compensated in the same manner as company nominees, thereby avoiding any financial incentive conflict between the loyalties of dissident directors to their patrons and to the company.

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ISS faulted the Provident board for adopting this director qualification bylaw unilaterally, suggesting that "[i]f investors are concerned with a candidate's compensation arrangements, they are free to express their concerns at the ballot box." We believe it is perfectly appropriate for a board to adopt a default rule that discourages board conflicts and perverse economic incentives, and if shareholders wish to change the rule due to the particular circumstances of any specific company or election contest, the bylaw can be amended by shareholders in a straightforward manner, at the same meeting at which the election contest is held. What the bylaw approach does is require that a dissident wishing to offer special consideration to candidates "unbundle" the nomination and the special arrangement so that investors are indeed "free to express their concerns at the ballot box."

We believe that ISS should favor that transparency, and support a general principle that discourages special compensation arrangements that lead to board conflicts and divergent incentives (which the Council of Institutional Investors has noted "blatantly contradicts" its policies on director compensation) even as it retains the flexibility to support exceptions where circumstances warrant.

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May 9, 2013

Shareholder Activism Update

Bylaw Protection Against Dissident Director Conflict/Enrichment Schemes

This year, the practice of activist hedge funds engaged in proxy contests offering special compensation schemes to their dissident director nominees has increased and become even more egregious. While the terms of these schemes vary, the general thrust is that, if elected, the dissident directors would receive large payments, in some cases in the millions of dollars, if the activist's desired goals are met within the specified near-term deadlines.

These special compensation arrangements pose a number of threats, including:

- undermining Board prerogatives to set director pay and select the timeframe over which corporate goals are to be achieved;
- creating a multi-tiered, dysfunctional Board in which a subset of directors are compensated and motivated significantly differently from other directors;
- creating economic incentives to take the corporation in the specified direction, and within the timeframe, that would trigger outsized compensation, whether or not doing so would be in the best interests of all shareholders, would engender inappropriate and excessive risk, or would sacrifice long-term value for short-term gain;
- opening a schism between the personal interests of directors who stand to benefit in the short-term from the special compensation scheme and the interests of shareholders with a longer-term investment horizon;
- creating poisonous conflicts in the boardroom by creating a subclass of directors who have a significant monetary incentive to sell the corporation or manage it to attain the highest possible stock price in the short-run; and
- introducing unnecessary and problematic complexity and conflicts in strategic reviews and calling into question those directors' ability to satisfy their fiduciary duties.

These arrangements have been justly criticized by leading commentators. Columbia School of Law Professor John C. Coffee, Jr. has written that "third-party bonuses create the wrong incentives, fragment the board and imply a shift toward both the short-term and higher risk." Professor Stephen Bainbridge of UCLA has concurred, saying "if this nonsense is not illegal, it ought to be."

In order to proactively address the threats posed by such schemes to the integrity of the boardroom and board decision-making processes, companies should consider adopting a bylaw that would disqualify candidates that are party to any such arrangements from serving as directors.

Here is a bylaw formulation we recommend:

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"No person shall qualify for service as a director of the Corporation if he or she is a party to any compensatory, payment or other financial agreement, arrangement or understanding with any person or entity other than the Corporation, or has received any such compensation or other payment from any person or entity other than the Corporation, in each case in connection with candidacy or service as a director of the Corporation; *provided* that agreements providing only for indemnification and/or reimbursement of out-of-pocket expenses in connection with candidacy as a director (but not, for the avoidance of doubt, in connection with service as a director) and any pre-existing employment agreement a candidate has with his or her employer (not entered into in contemplation of the employer's investment in the Corporation or such employee's candidacy as a director), shall not be disqualifying under this bylaw."

The board of directors of a Delaware corporation can adopt this bylaw under the authority of Section 141(b) of the Delaware General Corporation Law which provides that "the certificate of incorporation or bylaws may prescribe other qualifications for directors". Most other states' corporation laws have comparable provisions. Adoption of such a bylaw should be a simple matter of the board's business judgment. Even if tested under an enhanced reasonableness standard, it should withstand scrutiny as a measured response to the threat posed by these inappropriate schemes. Adopting this bylaw would not prevent an activist from nominating candidates, reimbursing their expenses and indemnifying them in connection with the solicitation, or from providing customary compensation to nominees for their efforts if they are not elected (if they are elected they would normally receive director compensation as fixed by the Board). Nor does the bylaw disqualify a principal or employee of the nominating hedge fund (or other nominating shareholder) from director service on account of the fact that his or her compensation from the fund may depend in part on the price of target company shares owned by the fund.

The threats posed to board and corporate effectiveness by short-term oriented activist hedge funds are serious enough without having to worry about a subset of directors being compensated and motivated differently from the rest, and having misaligned incentives. We believe that corporations can and should act to proactively preclude these inappropriate arrangements.

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