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Renewed Focus on Takeover Defenses

Re-Tooling Advance Notice Bylaws and the Return of the Stockholder Rights Plan

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To say the least, 2008 was a tumultuous time in the financial markets. In addition to failures and bargain-basement sales of major financial institutions, unprecedented governmental intervention in the markets, aborted M&A deals and a record-sized Ponzi scheme, the year witnessed an increased volume of hostile and unsolicited takeover activity. By Sept. 28, 2008, according to Jessica Hall, "Hostile Takeovers Hit Record As Market Swoons," Reuters.com, Sept. 29, 2008, U.S. hostile deal activity was at a record high, representing a 140% increase from 2007.

While attitudes a year ago might have suggested that 2008 would be a year of great stockholder activism with takeover defenses continuing to fade from the scene, the drying up of credit for M&A transactions and plunging stock prices and asset values actually caused public companies to re-examine their preparedness for hostile activity and, ironically, led to the re-emergence of a takeover defense that had fallen out of favor in recent years — the stockholder rights plan (a/k/a "poison pill"). In addition, many public companies re-tooled their advance notice bylaws in response to court decisions arising from proxy contests initiated by activist investors.

Some commentators have predicted that hostile takeover activity will continue to trend upward in 2009. As public companies with depressed stock prices return their focus to protecting themselves from hostile takeover activity, it is important for their boards of directors and managements to evaluate whether their advance notice bylaws and stockholder rights plans remain effective — or whether takeover defenses abandoned in the face of pressure from activist investors and corporate governance advisers should be reinstituted — in view of the changes in practice and developments in case law during 2008. This article describes the more important changes impacting these two key takeover defenses.

Key Judicial Developments During 2008

In two separate decisions, the Delaware Court of Chancery ruled — somewhat surprisingly — that advance notice provisions contained in corporate bylaws did not preclude stockholder proposals that the companies claimed had not been timely submitted. The effectiveness of certain advance notice bylaw provisions have been called into question as a result of these decisions.

The CNET Networks *and* Office Depot *Decisions*

In *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 947 A.2d 1120 (Del. Ch. 2008), the court declared a Delaware company's advance notice bylaw inapplicable to a stockholder's independently financed proxy solicitation. Parsing the language of CNET's advance notice bylaw, the court determined that the provision was intended to apply only to a stockholder's attempt to include a proposal in the company's proxy materials pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, but not to independently financed proxy solicitations. Accordingly, the court allowed the investor to proceed with its campaign to elect its own slate of directors even though it had not satisfied the bylaw's deadline for submitting alternative nominations and proposals.

One month later, in *Levitt Corp. v. Office Depot, Inc.*, No. 3622-VCN, 2008 WL 1724244 (Del. Ch. Apr. 14, 2008), the court upheld a stockholder's right to nominate directors without advance notice, even though Office Depot's bylaws purported to regulate the conduct of "business" at annual meetings by requiring advance notice of stockholder proposals. Following receipt of Office Depot's proxy materials for its annual stockholders meeting, a stockholder filed preliminary proxy materials with the SEC announcing its intent to nominate alternative director candidates to Office Depot's board. The court ruled that because Office Depot itself had initiated the process for electing directors by filing its own proxy materials, subsequent nominations of alternative candidates by individual stockholders did not require separate advance notice.

The *CNET Networks* and *Office Depot* decisions demonstrate that Delaware courts will be reticent to disallow stockholder proposals — despite a proponent's failure to comply with advance notice requirements — if ambiguities or contradictions in a company's bylaws can be construed to allow the proposal to be submitted to stockholders. In fact, these decisions emphasize that Delaware courts will generally bend over backward to interpret charter provisions to support the exercise by stockholders of their rights to nominate and vote for directors and submit related proposals.

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The CSX *Decision*

In another important decision handed down in 2008, the U.S. District Court for the Southern District of New York considered the issue whether "synthetic" ownership of securities in the form of derivatives constitutes "beneficial ownership" of those securities under Section 13(d) of the Exchange Act. In *CSX Corp. v. Children's Investment Fund Management (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), the court ruled that two hedge funds violated the Federal securities laws by using total return equity swaps — a type of derivative that gives the holder substantially all of the indicia of stock ownership other than formal voting rights — in a "plan or scheme to evade" the beneficial ownership reporting requirements of Section 13(d). This strategy has been employed by hedge funds to amass significant economic positions in companies as a prelude to launching a proxy contest.

The *CSX* decision has attracted much attention, both in financial and political circles. Even though the court did not rule that all equity swaps and other derivatives convey beneficial ownership under the Exchange Act as a matter of law, a court, for the first time, determined that activist investors can, based on their motivations and actions relating to those equity swaps and other derivatives, be deemed to have beneficial ownership of the underlying corporate shares. The *CSX* decision also warns activist investors who pursue a coordinated approach with respect to voting and ownership of a company's stock that they may be deemed to constitute a "group," and as a result have beneficial ownership of each other's shares.

Because of this decision, the utility of equity swaps and other derivatives will likely be diminished for activist investors, who will be subject to closer scrutiny by target companies, the courts and the SEC. However, because the *CSX* court did not declare that swaps and other derivatives automatically convey beneficial ownership of the underlying securities as a matter of law, numerous companies have amended their advance notice bylaws and stockholder rights plans to incorporate derivative securities into their definitions of beneficial ownership.

Re-Tooling Advance Notice Bylaws

According to our research of filings made with the SEC between April 1, 2008 and the end of the year, more than 400 companies amended their advance notice bylaws to address the issues raised in the *CNET Networks*, *Office Depot* and/or *CSX* decisions. In particular, we found that companies amended their advance notice bylaws to, among other things: 1) make it clear that they govern stockholder proposals not made pursuant to Rule 14a-8; 2) clearly distinguish between stockholder proposals to nominate a director candidate and proposals for other business; 3) clarify that the company's announcement of the agenda for its annual meeting does not relieve stockholders who wish to nominate director candidates or put forth other proposals from providing the required notice on a timely basis; and 4) require stockholders to disclose any hedging, swap or derivative agreements, or similar arrangements, when they seek to nominate director candidates or propose other business.

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Considering the tendency of Delaware courts to strictly construe advance notice bylaw provisions in favor of stockholder proponents, and taking note of the relatively large number of companies that have amended their advance notice bylaws in light of the recent decisions, it certainly makes sense for all public companies to re-examine their advance notice bylaws and consider adopting some or all of the revisions discussed above. In doing so, however, care must be taken to ensure that the drafting does not create further ambiguities or contradictions that will allow a court to adopt an interpretation that actually results in a less effective advance notice bylaw.

The Return of the Stockholder Rights Plan

Stockholder rights plans, which may be implemented by boards of directors without obtaining stockholder approval (assuming the company has sufficient authorized shares), are designed to encourage potential corporate raiders to negotiate with a target company's board of directors rather than accumulating shares on the open market or launching a tender offer. This is accomplished by giving the target company's other stockholders the right to purchase target company stock at 50% of market value if any stockholder (or group of stockholders) purchases shares, without prior board approval, above a designated triggering threshold. In response to pressure from activist investors and corporate governance advisers such as RiskMetrics Group (RMG), which leveraged the accounting scandals of 2001–2002 and the adoption of the Sarbanes-Oxley Act to press their cases for abandonment of rights plans and other takeover defenses such as classified boards, the popularity of rights plans declined significantly. In fact, contrary to the advice given prior to 2002, takeover defense experts began advising their clients to defer adoption of a rights plan until hostile activity or unwanted share accumulations surfaced.

However, our research of filings made with the SEC during 2008 shows that more than 80 companies adopted rights plans last year, signifying a noteworthy shift in attitudes. Indeed, the number of rights-plan adoptions increased dramatically throughout 2008, most noticeably following the market dislocations of last September. Also, as discussed below, the terms of the rights plans themselves have evolved in response to case law and positions taken by stockholder activist groups.

Triggering Thresholds

Rights plans generally have included triggering thresholds of 10%, 15% or 20%. RMG has announced that it will support only those rights plans that incorporate at least a 20% triggering threshold. However, among Delaware companies that adopted rights plans in 2008, the majority used a 15% triggering threshold. Further, of the Delaware companies that amended their rights plans in 2008 to change

their triggering thresholds, nearly two-thirds incorporated a triggering threshold of 15%.

Inclusion of Derivative Positions in the Definition Of 'Beneficial Ownership'

Traditionally, a holder of economic interests through derivative positions has not been considered a "beneficial owner" of the underlying company stock, for purposes of rights plans. Consequently, a holder of such interests could accumulate a significant economic interest in a company without worrying about exceeding the triggering threshold under the company's rights plan. However, following the *CSX* decision, the percentage of companies adopting rights plans who have incorporated derivative positions in their definitions of "beneficial ownership" increased. Notably, companies have effected this incorporation in several different ways: some delineate various types of derivative positions; others incorporate an additional defined term, "Synthetic Long Position"; and others use the term "derivative," but do not define it or list which types of derivatives are encompassed by the term.

Expiration Periods

Rights plans customarily have been effective for ten-year terms. RMG has announced that it will support only those rights plans that have two- or three-year terms. However, among Delaware companies that adopted rights plans in 2008, the majority used a ten-year term. Perhaps as a middle ground, some companies adopted three-year independent director evaluation provisions, also called TIDE provisions, under which a committee of independent directors must review and evaluate the company's rights plan, at least every three years, to determine if it remains in the best interests of the company's stockholders. After this review, the committee is required to report its recommendations to the board. Although TIDE provisions have increased in popularity, they were employed only by a minority of Delaware companies adopting rights plans in 2008.

Stockholder Approval Provisions

RMG also has adopted a policy recommending that its clients withhold votes for directors at companies that adopt a rights plan, or amend one to extend the expiration date, without in either case obtaining stockholder approval within 12 months following adoption or amendment. Seeking stockholder approval of a rights plan may create issues for a company, however. For instance, if stockholders reject a plan, the company could very well become a target of a hostile bidder seeking to take advantage of a potentially disaffected stockholder base. Moreover, the board might be reluctant to adopt a rights plan, or might be more susceptible to second guessing if it reinstitutes a rights plan, in response to hostile takeover activity. Stockholder approval provisions did not seem to take hold with Delaware companies adopting rights plans during 2008, with only a small minority incorporating such provisions.

NOL Rights Plans

Section 382 of the Internal Revenue Code may limit a corporation's ability to carry forward its net operating losses (NOLs) and to utilize certain built-in losses to offset future Federal taxable income following an "ownership change" (as defined in Section 382 and its accompanying Treasury Regulations). In an effort to maximize a corporation's use of its NOLs and other tax attributes, the corporation may adopt a rights plan with a triggering threshold of just under 5% to minimize the likelihood of a Section 382 ownership change.

NOL rights plans have become increasingly popular with companies that have incurred significant tax losses in the current economic downturn but anticipate becoming profitable, and therefore benefiting from their NOLs, in the future. For instance, homebuilder Hovnanian Enterprises and building-materials manufacturer and distributor USG Corp. each adopted an NOL rights plan in 2008. Both plans incorporated a 4.9% ownership trigger and both companies stated that the purpose of their plans was not to thwart hostile takeovers, but rather to ensure that they are able to maximize use of their NOLs.

Conclusion

It makes good sense for public companies, and particularly those with depressed stock market prices, to revisit the effectiveness of their takeover defenses. For companies that abandoned takeover defenses under pressure from institutional stockholders and/or corporate governance activists, the recent spate of advance notice bylaw amendments and stockholder rights plan adoptions should provide a measure of cover to corporations who feel the need to enhance their defenses. Moreover, all public companies need to be aware of the judicial decisions handed down during 2008, as well as the continued development of financial products that allow for quiet share accumulations, to make sure that their takeover defenses remain viable and effective. And, as always, advance planning allows a board of directors and its management team to fully address their companies' vulnerabilities and particular needs in a thoughtful and deliberative manner, before an actual threat arises.

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