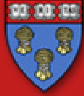
The Harvard Law School Forum on Corporate Governance and Financial Regulation

Second Generation Advance Notice Bylaws and Poison Pills

Posted by Charles M. Nathan, Latham & Watkins LLP, on Wednesday April 22, 2009

(Editor's Note: This post comes to us from Charles Nathan and Stephen Amdur of Latham & Watkins LLP.)

This article is a reply to the post appearing in the Harvard Law School Corporate Governance Forum authored by Marc Weingarten and Erin Magnor of Schulte, Roth & Zabel on March 17, 2009 and entitled "Second Generation Advance Notice Bylaws." That post is available here.

Introduction

The past year has been marked by a wave of new or revised advance notice bylaws and a similar but smaller surge in adoption or amendment of poison pills to accomplish one or both of the following goals:

• To achieve transparency (to use the favorite term *du jour*) concerning attributes of traditional stock ownership (often called "physical ownership") that have been facilitated by the increasing use of equity derivative products by activist investors and others and, where the equity derivatives or other mechanisms are used to create either the economic or voting equivalent of beneficial ownership, to impose accountability for those "synthetic" equity and "empty voting" positions; and

• To achieve transparency concerning activist investor "wolf pack" tactics that are calibrated to avoid the rules requiring aggregation and disclosure under Section 13(d) of the 1934 Act and similar regulatory provisions and, where a wolf pack exists, to impose accountability among its members for their aggregate ownership position, physical and synthetic.

Second generation advance notice bylaws and poison pills did not appear spontaneously. Rather, each is a response to a growing phenomenon in the market for corporate control, not just in the United States, but also in Europe, Asia and Australia. The pioneering literature that exposed the use of derivatives and "empty voting" in corporate control contexts was a product of the academic legal community, particularly Professors Henry Hu, Bernard Black, Edward Rock and Marcel Kahan, who have written a number of articles about the phenomena of "empty voting," "morphable" equity ownership, "decoupling of economic and voting interests," "record date

capture" and other uses of derivatives and market mechanics to separate the voting rights of stock ownership from its economic attributes and to divide the economic attributes[1] of ownership into a bundle of rights and obligations that can be separated, just as the voting rights can be separated from economic attributes. Moreover, the academic observers were not abstractly speculating about behavior that could revolutionize the markets for corporate control. They were reporting on existing methodologies, frequently but not always practiced by event driven hedge funds and other activist investors in control contexts.[2]

The second phenomenon of utilizing wolf pack behavior to avoid aggregation for purposes of equity reporting requirements, such as Section 13(d), has not generated as much academic interest, but certainly has galvanized target companies, and in many countries financial market regulators or even the political establishment, by its successful end-running of customary concepts such as the "group" definition under the 1934 Act and the European, Asian and Australian "acting in concert" or "concert party" concepts in the equivalent share ownership disclosure regimes in many of the world's more developed equity markets.[3] It is also notable that, unlike the use of equity derivatives to decouple attributes of share ownership which arose in the context of, and was driven by, trading strategies and economic considerations unrelated to change of control campaigns, the wolf pack has been used virtually exclusively by the activist investor community in campaigns against companies, often culminating in successful proxy contests or other change of control events.

The final ingredient in the recent rush to adopt second generation advance notice bylaws and poison pills was the celebrated *CSX* decision in the Southern District of New York.[4] Ironically, notwithstanding its finding of Section 13(d) violations based on the use of total return swaps (a very common and usually benign equity derivative product) and on the formation of an unreported Williams Act "group", the decision effectively provides an accurate road map for future activist investors of how to successfully avoid Section 13(d) reporting requirements. Thus, rather than

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[1] *See, e.g.*, Henry T. C. Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811-908 (2006) (hereinafter "New Vote Buying"); Henry T. C. Hu and Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Penn. L. rev. 625-739 (2008) (hereinafter "Equity and Debt Decoupling"); Marcel Kahan and Edward B. Rock, *The Hanging Chads of Corporate Voting*, 96 Geo. L. Rev. 1227 (2008).

[2] Henry T. C. Hu and Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 Eur. Fin. Mgmt. 663, 703-709 (Sept. 2008) (hereinafter "Debt, Equity and Hybrid Decoupling").

[3] *See e.g.* Financial Services Authority, Disclosure and Transparency Rules, (2006) and Financial Services Authority, Contracts for Difference, (2009) (U.K.); Wertpapierhandelgesetz [Securities Trading Act] Sections 21, 25 (F.R.G.); Ley del Mercardo de Valores 24/1998 [Public Companies Act], de 28 de Julio, por la que se apruebla (1998) and Real Decreto 1362/2007 [Regulation on Transparency Requirements Applicable to Listed Companies], de 19 de Octubre (2007) (Spain).

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

acting as a deterrent to wolf pack conduct and the use of synthetic equity to pressure a company to change its core strategies, *CSX* enables a more confident continuation of these two fundamental behavioral patterns.

It is no wonder that companies, left by Congress, the SEC and the courts to their own devices to plug the obvious loopholes in the Section 13(d) reporting system, have sought alternative means to create:

- Transparency and accountability for shareholdings, real and synthetic, and voting rights coupled with or divorced from the economics of share ownership; and

- Transparency and accountability for wolf pack behavior.

Transparency and Accountability for Synthetic Equity and Empty Voting

Second Generation Advance Notice Bylaws. Transparency and accountability for decoupled equity and voting interests in the context of actual or potential proxy contests was the first problem addressed by private ordering. About a year ago, law firms began recommending that their clients insert requirements in their advance notice bylaws calling for proxy contest proponents to include in their required advance notice of matters they proposed to bring to a shareholder meeting information concerning their decoupled equity and voting interests, whether consisting of synthetic equity without votes, or votes decoupled, in whole or in part, from the economic exposure of traditional equity investment. These provisions have now been inserted in over 550 second generation advance notice bylaws, a number that will likely grow significantly over the next few years.

As second generation advance notice bylaws proliferate, “improved” versions are appearing utilizing better and more complete definitions of synthetic equity and empty voting techniques, including provisions exempting reporting of physical ownership or other hedges held by swaps dealers, as counterparties to the derivative positions intended to be captured by the second generation bylaws. Later versions of second generation advance notice bylaws have introduced additional features, such as required disclosures concerning the relationship between the nominees in an election contest and their proponent, about the proponent itself beyond its mere name and about prior “campaigns” against the company involving the proponent. Another important improvement in the technology of second generation advance notice bylaws has been the addition of updating requirements to deal with the obvious problem of potentially very dated information contained in a notice that typically would be received by the company some 60-90 days prior to the actual shareholders meeting.

In this context, it is notable that the Weingarten & Magnor Article concedes:

"Such increased disclosure requirements [for synthetic equity and empty voting in second generation advance notice bylaws] should not be problematical for shareholder proponents, or objectionable. While such disclosures may provide a company with more information than it would have based on SEC filings alone, the overall-consequences of companies learning more about the holdings of proponent shareholders should not significantly affect the ability of proponents to nominate directors or propose business to shareholder meetings." [5]

Second Generation Poison Pills. In addition to requiring disclosure of synthetic equity and empty voting in second generation bylaws, companies have begun to include comparable language encompassing synthetic equity ownership as part of the definition of beneficial ownership for purposes of their poison pills.[6] The rationale for the inclusion is simple:

• Given the relative ease by which synthetic equity can be converted to traditional equity, it is a functional equivalent of traditional equity and should be treated as such under a shareholder rights plan; and

• Whatever technical arguments can be made to refute the prior assertion, empirically event driven hedge funds and other activists have routinely converted their synthetic equity into traditional equity and/or used their synthetic equity openly as a traditional equity equivalent in their attempts to bend companies to their will.[7]

To date, the only overt resistance to the inclusion of synthetic equity in poison pill definitions of beneficial ownership has been from the Delaware plaintiffs' bar. A suit is now pending against Atmel Corporation in Chancery Court in Delaware which seeks invalidation of an amendment to Atmel's poison pill adding synthetic equity to the definition of beneficial ownership. The gravamen of the complaint and plaintiffs' arguments is that the amendment is impermissibly vague in that neither affected investors nor the company would be able readily to determine the number of notional shares covered by the equity derivative position. The defense, as one would expect, is that the determination is not very complicated, and the long party to the derivatives (that is the

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[5] Marc Weingarten and Erin Magnor of Schulte Roth & Zabel LLP, "Second Generation Advance Notice Bylaws" Harvard Law School Corporate Governance Forum 17 Mar. 2009, available here (hereinafter "Weingarten and Magnor Article").

[6] The traditional definition of beneficial ownership picks up empty voting so no change is necessary to capture that aspect of activist investor tactics. Like second generation advance notice bylaws, bona fide swaps dealers acting as counter-parties should be exempted from operation of the pill, which is not intended to interfere with market participants without any control intent.

[7] *See CSX Corp.*, 562 F. Supp at 511; *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 2008 WL 660556 (Del. Ch. March 13, 2008), aff'd 2008 WL 2031337 (Del. S. Ct. May 13, 2008); *See also New Vote Buying, supra* note 1; *Equity and Debt Decoupling, supra note 1; Debt, Equity and Hybrid Decoupling, supra* note 2.

holder of the synthetic equity) knows perfectly well how many notional shares are covered by each of its derivative contracts. It seems most unlikely that this litigation will result in a decision invalidating the concept of including synthetic equity in the definition of beneficial ownership for purposes of a poison pill. Rather, the far more likely outcome would be either a total victory for Atmel or, at worst, a decision requiring greater drafting precision.

Transparency and Accountability for "Wolf Packs"

Second Generation Advance Notice Bylaws. As was the case for synthetic equity and empty voting, companies are now also beginning to rely on private ordering to require disclosure of wolf pack formation and aggregate share ownership in second generation advance notice bylaws to deal more effectively with the economic reality of this favorite activist investor strategy. Recognizing that the Williams Act requires mutual commitment to a shared course of action—that is, an agreement—and that the wolf pack strategy eschews such an agreement, pioneers in this area have turned to the antitrust concept of conscious parallelism, most commonly used in price fixing situations.

Most of us are familiar with the antitrust conundrum posed by industry trade associations or similar multi-company groups where pricing policies are openly disclosed. but there is no vote or similar decision by the group to adopt or enforce them; Yet, those prices are widely copied by most or all industry participants. Wolf pack tactics by activist investors are not different in methodology or outcome. There are one or two pack leaders who drive the strategy and tactics, take a forward and public role and seek to attract other activists to their cause through the use of telephone and internet communications. In doing so, they will communicate ideas and proposals for action but not ask for or receive responses indicating agreement. Self-selected members of the wolf pack follow and support the leaders through such measures as accumulating equity positions below the 5% disclosure threshold, voicing support for the leaders' positions in separate one-on-one conversations with the company, investors and others, voting in support of the leaders' proxy proposals and the like. The effect from the standpoint of the company and the truly non-aligned shareholders is the same as if a Williams Act group had been formed, but without the benefits of disclosure and accountability imposed on 5% or greater groups under the Williams Act.

To date the only and best solution to the wolf pack problem facing companies has been to include in the definition of beneficial ownership under a second generation advance notice bylaw an expanded concept of acting in concert along the following lines:

"A person shall be deemed to be acting in concert with another person …if such person *knowingly* acts … toward a *common goal* relating to the management, governance or control of the company *in parallel with such other person* where (A) each person is *conscious* of the other person's conduct or intent and this *awareness is an element in their decision-making* process and (B) at least one additional factor suggests that persons *intend to act in parallel*, which additional factors may include attending meetings, conducting discussions or making or soliciting invitations to act in parallel." (Italics added).

The addition of conscious parallelism to the traditional 1934 Act definition of beneficial ownership was criticized on several grounds in the Weingarten & Magnor Article. The Article first states that "the plain intention of this provision is to cover mere consciousness of each other plus discussion." [8] This criticism is not well founded because it ignores the elements of the definition requiring knowing behavior by the first person to achieve a common goal in parallel with the second person. The plain language and clear intent of the conscious parallelism definition clearly requires more than discussions between two shareholders or mere knowledge of each other's position. To use an analogy from antitrust principles dealing with price fixing: operators in the market are free to adapt intelligently to the market conditions and this includes parallel pricing behavior. However, they must not engage in any form of contact or information exchange which allows them to predict their competitors' actions in the market, and allows them to adapt their own conduct in the market accordingly.

A second criticism of the conscious parallelism definition advanced in the Weingarten & Magnor Article is that:

"The plain intention of this provision is to force activist shareholders to disclose the identity of *every other* shareholder they've spoken to as a "concert party" or risk forfeiture of their shareholder rights. The provision is intended to *chill* protected and legitimate shareholder communication, *encouraged* by the SEC…."(Italics added).[9]

The hyperbole in the first sentence of this quotation is apparent. The proposed concept of conscious parallelism would not require disclosure of the identity of *every other* shareholder spoken to, but only those who are *consciously* acting together toward a shared goal. The second sentence employs faulty logic in asserting that the pre-proxy contest communications among shareholders is encouraged by the SEC. In fact, the SEC neither encourages nor discourages such discourse. It merely exempts it from the provisions of the SEC proxy rules. This exemption

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[8] Weingarten and Magnor Article, supra note 5.

[9] Weingarten and Magnor, supra note 5.

may be an appropriate regulatory policy, but it certainly does not speak to the interests of a company and its shareholders in knowing the identity of participants in a wolf pack proxy contest attack on a company and its policies. The presumably unintentional irony of the second sentence is also apparent—that in today's environment of widespread concern about increasing transparency regarding hedge fund behavior, proponents of hedge funds are complaining that disclosure of their wolf pack activities in the context of a proxy contest is objectionable because it may "chill" their collusive behavior.

The Weingarten & Magnor Article concludes with a ringing statement of event driven hedge fund entitlement to operate in secrecy:

"Discouraging shareholders from sharing their viewpoints on the management or governance of a company is not a *legitimate purpose*, and shareholders *should have the right* to discuss the actions of a company in which they are invested without having to disclose the participants in all such conversations to the company simply in order to be eligible to exercise shareholder rights." (Italics added).[10]

As with the prior quotations, this sentence makes extensive use of hyperbole and further omits important limitations on the reach and purpose of the conscious parallelism definition. First, the definition, as previously noted, does not sweep in all participants in all conversations, but merely requires disclosure of those shareholders who act in conscious parallelism to achieve a common goal. Second, that goal is not the exercise of any or all shareholder rights. Rather it is limited to participation in a proxy contest that is being announced through the mechanics of the advance notice bylaw. When these considerations are factored in, the statement takes on a very different cast. It becomes an assertion that requiring disclosure of the existence of a wolf pack which is launching a proxy contest "is not a proper purpose" for a company advance notice bylaw and that event driven hedge funds and other activists "should have the right" to form a wolf pack and engage in a proxy contest without any disclosure to a company or its shareholders.

Second Generation Poison Pills. The absence of an agreement has also insulated wolf packs from poison pills in cases where their aggregate ownership exceeded the pill's trigger threshold, because traditional shareholder rights plan uses a Williams Act definition of beneficial ownership, including its group concept which is premised on an actual agreement or understanding to act in concert. The result is that under a conventional pill a wolf pack could control 20% or even 30% of a company's shares, effectively a dominant control block, and the company would be powerless to protect its other shareholders from such a change of control—which of course, is one of the key rationales for the poison pill.

[10] Weingarten and Magnor, supra note 5.

For this reason, in addition to including conscious parallelism in the beneficial ownership provisions of advance notice bylaws, some companies have also included the same language in the beneficial ownership definition of their poison pill. The intended effect, of course, is to deter the formation of wolf packs aggregating in excess of the pill's trigger threshold, typically 15% of the outstanding shares of the company.

This adaptation of the poison pill to wolf packs seems eminently sensible. After all, if the poison pill is intended to, and historically has, successfully deterred Section 13(d) groups from acquiring more than the trigger threshold, why should it not similarly regulate an excessive stock accumulation by a wolf pack, which economically and functionally poses most, if not all, of the same threats to the best interests of the shareholders?

To date, seemingly the only challenge to the inclusion of a conscious parallelism concept in a pill came not from an activist investor but from a hostile bidder, which sued the target company claiming that the conscious parallelism provision was unduly vague and rendered the pill unenforceable. The only substantive confusion asserted in the complaint, oddly, was that the provision could be read to say that tendering shareholders were acting in concert with the bidder. The complaint, however, did not address the savings clause in the beneficial ownership definition excluding shares tendered pursuant to a tender offer. Similarly it did not address how a seller and buyer could be said to be acting in a parallel fashion, a necessary predicate to a finding of beneficial ownership attribution under the conscious parallelism provision. The issue was never joined, however, because a white knight bidder appeared, and the original hostile bidder withdrew its bid and its lawsuit.

Conclusion

Notwithstanding the logic and policy reasons supporting the addition of derivative ownership and empty voting disclosures in both advance notice bylaws and poison pills, it is likely these provisions will be the subject of litigation attack by event driven hedge funds and other activist shareholders. The same is true for the anti wolf pack conscious parallelism provisions that are now starting to appear in second generation advance notice bylaws and poison pills.

The most obvious direction of a hedge fund attack will be on the asserted breadth of the new provisions and their asserted vagueness. The argument in the context of both provisions, at least as advanced to date, seems at best very weak and perhaps wholly untenable. In the first place, the fact that a provision may require interpretation and or application in the context of a totality of facts and circumstances does not make it unenforceable. Were that our jurisprudence, we would not have courts dealing with interpretation prone concepts such as obscenity. Moreover, the

argument assumes a totally cynical view of board behavior and essentially asserts that because, in the abstract, a board could interpret the new provisions beyond their purpose and intent, the bylaw or the pill should be invalidated. The same argument, of course, could be mounted against other bylaw provisions giving the board authority to exercise discretion and can and has been used to indict the poison pill since its inception. To date, however, courts have not been willing to adopt a presumption that boards will abuse their discretion and act in bad faith to misuse a bylaw or shareholder rights plan. Accordingly, courts do not invalidate bylaws or poison pills merely because they are capable of being abused by an entrenchment-minded board.

An alternative route of attack, of course, would be policy based. In 2009, for event driven hedge funds to persuade courts that it is fundamentally bad policy for shareholders to be informed about the full extent of a proxy contestant's equity exposure and source and nature of its voting power has the ring of implausibility. The same is true for disclosure of the existence and size of a wolf pack whose members are starting a proxy contest. Nor are the policy justifications for inclusion of both derivative ownership and wolf pack ownership in a poison pill any less compelling.

As a result, second generation advance notice bylaws and poison pills containing carefully drafted and policy circumscribed provisions dealing with synthetic stock ownership, empty voting and wolf pack formation make good sense, enhance good corporate governance and will continue to proliferate.

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