Binding By-Law Shareholder Proposals: The Next Frontier for Corporate Activists

Highlights

• Activist investors are shifting their focus to shareholder proposals for by-law amendments to implement corporate governance reform in place of traditional non-binding shareholder proposals that merely recommend board action.

• The impetus for this strategic change includes:
  o Continued frustration with company boards that either fail to act in response to a successful non-binding shareholder resolution or “water down” implementation of the proposal;
  o Concern that boards can too easily amend or rescind board adopted policies under the umbrella of fiduciary duty obligations;
  o Recognition that the SEC staff will not grant no-action requests for proxy statement exclusion of shareholder by-law proposals based on opinions of counsel where the underlying law is unsettled; and
  o Judicial decisions in Delaware that may signal the courts’ willingness to interpret Delaware corporate law as giving shareholder adopted by-laws more leeway than many observers previously expected.

• We predict the following:
  o Continued submission of by-law proposals implementing the activist agenda for majority voting, frequently if not universally precluding board amendments of the by-law;
  o Proliferation of by-law proposals barring poison pills without prior shareholder approval, sometimes but not always tempered by a limited exception for board action in an “emergency”; and
  o An attempt by many companies to deflect shareholder adopted by-law proposals with board adopted policies and/or board adopted by-laws.

New Activist Investor Strategy to Implement Corporate Governance Reform

Activist institutional investors are increasingly using shareholder proposals to adopt binding by-laws to implement corporate governance reforms in place of the traditional non-binding resolutions that have predominated for the last two decades. This development raises the stakes considerably for public companies in the corporate governance gamesmanship that permeates the world of shareholder proposals.
Background
By way of background, the SEC requires (under its Rule 14a-8) that a public company include a shareholder proposal in its proxy statement if the proponent meets relatively easy tests of share ownership, timeliness and length of proposed proxy statement submission. The burden then shifts to the company, which must claim one or more of 12 specific reasons enumerated in the SEC rules to justify exclusion of the shareholder proposal.

A critical issue for activist institutional investors historically has been their relative inability to translate successful shareholder proposals into compliant corporate action. Shareholder proposals have traditionally been couched as non-binding recommendations because under typical state corporation law shareholders do not have the power to require the board to take action (on the basis that requiring such action would interfere with the board’s ability to govern the affairs of the corporation). Accordingly, a shareholder proposal purporting to require board action would, in the usual case, run afoul of one or two prongs of the SEC rules permitting exclusion of a shareholder proposal—that the proposal not be “improper under state law” and that it not “violate” state law.

For example, the activist investor campaign to force repeal of poison pills through non-binding shareholder proposals has been highly successful in terms of repeated passage of the proposals, but spotty at best in terms of motivating board action. The momentum shifted dramatically toward board implementation of poison pill proposals only when the activist investors, together with Institutional Shareholder Services (ISS), invented the withhold vote campaign to sanction boards that were not appropriately “responsive” to successful shareholder resolutions. Even with the threat of withhold vote campaigns, however, activist investors continue to chafe at their inability directly to translate a successful shareholder proposal into corporate action.

The historical and legal reality of the board’s mediating role between shareholder sentiment (as evidenced by votes on non-binding shareholder proposals) and implementation has led activists to search for ways to circumvent the board’s traditional oversight of the company’s corporate governance policies. The most direct method of bypassing the board’s oversight role, of course, is by using the shareholders’ near universal power to adopt by-laws, which has the added benefit that a shareholder adopted by-law can provide that it may not be further amended by the board.

The obvious advantage to activist investors of proposing by-laws to be voted at the annual meeting, instead of mere recommendations for board action, has long been noted. The problem has been finding ways to fashion by-laws that do not run afoul of the SEC’s rules permitting exclusion of proposals that are either “improper” or in “violation” of state law.

A number of years ago the activists embarked on an initiative to ban poison pills by by-law amendment and actually won a test case under Oklahoma law. The initiative faltered for Delaware companies, however, in large part because the Delaware bar reached a consensus that a by-law simply prohibiting maintenance or adoption of a poison pill impermissibly interfered with the board’s exercise of its fiduciary duty and/or contravened the statutory provision giving the board plenary authority to issue rights and warrants. Companies utilized reasoned opinions from Delaware law firms to this effect to support exclusion of binding poison pill by-law proposals, and the SEC staff acquiesced.

The New Era of Corporate Governance by Shareholder Adopted By-Law
As the song has it, however, “times are a changing” in the world of binding by-law shareholder proposals. Two major corporate governance initiatives—rescission of poison pills and imposition of majority voting in lieu of plurality voting for directors—are now the battleground for the latest activist institutional investor campaign to impose its corporate governance vision on Corporate America through shareholder adopted by-laws. The reasons for this critical evolution toward shareholder imposed corporate governance mandates include:
• Non-binding shareholder resolutions for corporate governance change are frequently either not implemented by boards or implemented with significant changes that in the view of the activists water-down or virtually eliminate the basic reforms being sought.

• Although the advent of withhold vote contests in the last several years has gone part of the way toward changing this dynamic, it is a blunt tool, to say the least, for dealing with the competing versions of corporate governance reform.

• In the majority voting arena, many state laws (notably including Delaware) permit adoption of a majority voting structure through by-law amendment. Moreover, the Model Business Corporation Act was amended this Spring to permit a specified form of majority voting to be adopted by by-law amendment, rather than requiring a charter amendment as had previously been the case for any change in voting structure. As a result, in most cases activist investors can propose binding by-law amendments to reform a company’s voting structure without raising any basis for exclusion under the SEC’s proxy rules.

• Although most shareholder proposals regarding majority voting have been non-binding, a trend toward utilizing direct by-law amendments is emerging. At the very least, there is no reason a binding by-law format cannot be used and it will remain an ever present threat to a company opposed to any specific shareholder proposal dealing with majority voting—whether it be good, bad or indifferent.

• The move toward binding by-law proposals on poison pills undoubtedly owes some of its impetus to the ready availability of binding by-laws dealing with majority voting. Other forces, however, are also clearly at work.

  o One is the brouhaha over News Corporation’s poison pill and the Delaware court’s initial decision regarding the validity of the board’s action in extending its pill. In brief, the News Corporation board, at the time of its re-incorporation in Delaware from Australia, adopted a policy that it would not adopt a poison pill with a duration of more than a year without shareholder approval. About a month later, Liberty Media raised its ownership in News Corporation from 9% to 17% and the News Corporation board responded by adopting a poison pill with a one year term. One year later Liberty Media continued to own 17% of News Corporation, and the board extended the poison pill without obtaining shareholder consent in contravention of its announced policy. While institutional shareholders have sued News Corporation for violation of its board policy, the obvious moral of the story is that board actions on poison pills ordinarily are not binding.

  o Contrast the typical flexibility of board policies with an effective by-law that limits board flexibility with regard to poison pills and is expressly not subject to board modification without shareholder approval. The activist investor motivation to develop an effective structure for corporate governance by-laws that can be proposed and adopted by shareholders in compliance with state law is obvious.

• In the Spring of 2006, Lucian Bebchuk, a law professor at Harvard, set out on the mission to resurrect valid shareholder proposals for binding poison pill by-laws.

  o He sponsored a shareholder proposal to adopt a by-law limiting the right of the board of CA, Inc. to adopt or maintain a poison pill except by a unanimous vote and, more importantly, limiting the term of a board adopted pill to one year absent shareholder approval. When CA obtained a reasoned legal opinion concluding that the by-law would not be valid under the Delaware corporate statute, Bebchuk sued for declaratory judgment in Delaware to establish the validity of his by-law.

  o The Delaware court held that the controversy was not ripe for adjudication, but in doing so made clear that the by-law was not invalid on its face and that there were substantial grounds on which it might be found valid if and when the case became ripe for decision. These observations in the CA case, along with some of the language in the News Corporation case, have given activist shareholders new hope and basis for launching binding by-law proposals to limit or prohibit poison pills.
Additionally and perhaps most importantly, the SEC staff is no longer permitting exclusion of poison pill by-law proposals on the basis of reasoned opinions of counsel as to their invalidity. As a practical matter, the staff’s refusal to continue issuing no-action positions in these circumstances means that most shareholder poison pill by-law proposals will go to a shareholder vote, even though the company may assert that the by-law is invalid and that it considers purported shareholder adoption a nullity.

**Issues for the 2007 Proxy Season**

The 2007 Proxy Season effectively begins in the Fall of 2006 when the SEC mandated window opens for shareholder proposals for 2007 annual meetings. Moreover, many boards and their corporate governance committees are now in the process of evaluating their positions in light of their and others’ experiences in the 2006 proxy season. In light of the probability that shareholder sponsored by-law proposals will continue to proliferate with respect to both majority voting and poison pills, how should boards and governance committees deal with these issues?

Poison Pill By-Law Proposals

- In the poison pill arena, opposing a by-law proposal limiting or eliminating poison pills by asserting its invalidity may be a questionable strategy. The evidence seems clear that a poison pill by-law proposal will almost always receive a majority of votes cast, which is frequently sufficient for by-law amendment; and there have been instances where such a by-law proposal received a majority of outstanding votes, which will always be sufficient for by-law adoption.
  - Relying on a reasoned legal invalidity opinion may technically solve the company’s problem of a shareholder adopted poison pill by-law (at least until there is a contrary definitive ruling in Delaware or the relevant state of incorporation), but it will not deter a withhold vote campaign that will likely be supported by ISS.
  - Moreover, a company relying on a poison pill in contravention of a shareholder adopted by-law runs the risk that an unsolicited bidder, or market raider, will challenge the pill as being invalid on the basis that the shareholder adopted by-law was effective and binding on the company.
  - While a court test would probably be necessary to determine the issue, ambiguity about the validity of a pill is unlikely to help the company’s defense. It also could result in the unintended consequence of having an aggressive raider trigger a pill it believes to be invalid, only to discover later that the court disagrees and the pill has in fact been triggered with possibly adverse consequences to the company’s shareholders, as well as to the raider.

- An alternative would be for a board to try to pre-empt the binding by-law proposal, either before receipt of a shareholder proposal or in response to such a proposal, by adopting a policy or by-law implementing a poison pill policy that meets ISS’ published standards for poison pill policies.

- An obvious advantage to the company being the first mover is that it will be able to shape its poison pill policy and make it as flexible as permitted by ISS policy. Being the first mover might also dissuade activists from launching counter proposals because of the lower likelihood of finding institutional investor voting support to oppose a poison pill policy that meets ISS standards.

Majority Voting By-Law Proposals

- Unlike poison pill by-laws, there is no legal issue in most jurisdictions about the validity of majority voting by-law proposals. As a result, the issues are clearer and more easily dealt with.
The 2006 proxy season saw a number of majority voting by-law proposals, most of which were in the context of companies that had adopted majority voting corporate governance policies. The voting pattern was that the by-law proposals did not attract a majority vote in situations where the board policy adhered closely to the published ISS policy on majority voting. Whether that remains the voting pattern in 2007 is the question.

Since the end of the 2006 proxy season, Delaware corporate law has been amended to provide that a shareholder adopted majority voting by-law cannot be amended by the board, but only by a subsequent shareholder vote. A similar provision is included in the recent amendments to the Model Business Corporation Act.

- As a result, the stakes have been raised significantly because a board will not have the ability to even make technical amendments to correct errors or fill in gaps in a shareholder adopted majority vote by-law in Delaware and other states that follow this statutory pattern.
- Moreover, there is always the possibility that a proponent of a shareholder by-law will seek to go beyond the statute by requiring a greater-than-majority shareholder vote to further amend the shareholder adopted by-law.
- As a consequence, boards and governance committees must take any shareholder majority voting by-law proposal seriously and consider whether the company’s interests are fully served by a decision to rely on a board adopted voting policy rather than a pre-emptive by-law amendment that embodies the board’s views on the optimum majority voting structure and preserves the ability of the board to further amend the by-law if experience or future developments warrant.
- Of course there is no guaranty that shareholders will be sufficiently content with a board adopted majority vote by-law, even one that complies fully with ISS policy. The likelihood of a sufficient number of investors feeling strongly enough to enact a shareholder proposed alternative, however, seems far less than in the case of a board adopted voting policy.

**Conclusion**

Activists shareholders are likely to resort increasingly to binding by-law shareholder proposals in lieu of the traditional non-binding proposals. A number of factors, including a change in the SEC staff’s no-action position on shareholder proposed poison pill by-laws, has both motivated and facilitated this trend. From a company board and governance committee standpoint, shareholder proposed governance by-laws raise a number of difficult issues not customarily presented by non-binding shareholder proposals. Accordingly, boards, governance committees and their advisers need to be sensitive to the trend toward by-law proposals and should consider possible pre-emptive steps the company might take to mitigate or avoid problems that could arise from passage of an activist shareholder by-law proposal, particularly one limiting or eliminating poison pills or imposing a less than optimum majority voting structure.
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