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Revisiting Corporate Bylaws for the Universal Proxy Era

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By Eduardo Gallardo

On August 31, 2022, the universal proxy rules adopted last year by the Securities and Exchange Commission (SEC) will go into effect. The rules require proxy cards distributed by public companies and activist shareholders in a contested director election to include both sides' director nominees, so that shareholders can "mix and match" nominees from the company's and dissident's slates. In this post, I discuss possible changes to customary forms of public company bylaws to address issues likely to result from the implementation of the new universal proxy rules.

Overview

Mandatory universal proxy will have significant repercussions for activist campaigns at publicly traded companies. One of the traditional barriers for an activist shareholder to conducting a director proxy contest has been the expense of printing and mailing proxy materials to a large number of shareholders, potentially more than once. These expenses are often inconsequential for a well-funded hedge fund activist – a so-called Type I ***A***ctivist – but have traditionally kept Type II ***a***ctivists – which include social activists, unions, government pension plans, and gadflies – from running director slates at annual meetings. Instead, Type II activists have focused on submitting non-binding proposals under the auspices of Rule 14a-8 of the Securities Exchange Act. The benefits of Rule 14a-8 do not extend to director nomination proposals but have historically allowed Type II activists with minimal share ownership to include business proposals in the corporation's proxy statement and proxy card at no expense. These proposals, though non-binding, give Type II activists a free platform and publicity to further their narrow agendas.

With the advent of universal proxy and the associated lower costs to run a director contest, Type II activists might become inclined to pursue director nominations rather than submit a precatory 14a-8 shareholder proposal. In fact, an inexpensive director contest may not only attract a higher level of press coverage and general attention to the Type II activist's cause but also be more effective in bringing management to the negotiating table to avoid a high-profile director election contest, where the settlement does not include the addition of the activist's nominee to the board. While Rule 14a-8 permits companies to exclude certain proposals that are not the proper subject of shareholder action, the threat of a director contest potentially gives activists greater flexibility to force management to negotiate on a vanity cause.

Although commentators have focused over the last nine months on how universal proxy could affect director contests run by Type I Activists, more burdensome for public corporations might be how universal proxy increases the number of director contests led by Type II activists seeking publicity and the leverage against management to further their vanity cause.

With that in mind, I propose changes to standard public company bylaws that would put corporate boards and management in a better position to react and inform shareholders regarding Type II activist director contests. The changes are described in the rest of this post and reflected in the blacklined version of a form of public company bylaws contained in the Appendix. The usual caveats apply: This is not necessarily a comprehensive proposal, and one size does not fit all. Companies will necessarily have to adapt them to their own facts and circumstances. Further, the proposed changes will have to be discussed with counsel for the jurisdiction where the corporation is incorporated.

Enforcement of Universal Proxy Guardrail Provisions

In adopting universal proxy, the SEC built various guardrails to regulate the proxy process and mitigate abusive practices. For example, under new Rule 14a-19, activist shareholders must provide companies with notice of their intent to solicit proxies and provide the names of their nominees no later than 60 calendar days before the anniversary of the previous year's annual meeting. The activist must also solicit the holders of shares representing at least 67 percent of the voting power of the shares entitled to vote at the meeting.

Enforcement of guardrail provisions in the universal proxy rules will generally reside with the staff of the SEC, which oversees election contests with limited resources. However, absent SEC intervention, the target corporation may be limited in its ability to seek remedy against an activist that fails to satisfy the minimum guardrail requirements of the SEC universal proxy rules. Therefore, it seems appropriate that corporate bylaws should establish as a clear prerequisite to the nomination of directors that a dissident comply with the SEC requirements around the submission of a director candidate and related filings (See Section 2.10(a)(ii) of form in the Appendix). This will give the corporation a mechanism to privately review and enforce the SEC guardrail provisions.

Distribution of Solicitation Materials

Rule 14a-19 requires an activist running a director contest to solicit the holders of shares representing at least 67 percent of the voting power of the shares entitled to vote at the meeting. The rule, however, lacks specificity as to how the solicitation should occur. To establish a clear floor on what the dissent needs to do to solicit the minimum number of shareholders, bylaws may require that a dissident undertake to deliver in advance of the meeting either a definitive proxy statement or a notice of internet availability of proxy materials to the requisite number of shareholders. (See Section 2.10(a)(ii)(E)(1) of form)

Enhanced Informational Requirements

It is standard practice for bylaws of U.S. publicly traded companies to require dissidents to give the corporation advance notice of their intent to make director nominations. Further, these bylaws require that the dissident provide to the corporation information that is important for the board to provide transparency to investors around the dissident nominating stockholder and nominees. By way of example, the bylaws may require that the nominating shareholder provide information about their derivative positions and ownership of corporate debt instruments that might otherwise not be disclosed to voting shareholders that need to cast a vote in a contested election.

Informational requirements in bylaws have historically been designed to compel disclosure of relevant information from traditional Type I Activist investors, who could for example be otherwise concealing interests in derivative instruments that could misalign their interests from those of other shareholders. The mandatory disclosure requirements are less likely to identify relevant information when the nominating shareholder has a small economic stake in the company and might be working with social activists, unions, or pension plans. The bylaws could address this disconnect through requiring that entities that may be working in concert with the nominating shareholder disclose the same level of information that a traditional "participant" in the solicitation of proxies would have to disclose in SEC filings for the benefit of investors. (See Section 2.10(a)(ii)(E)(2)-(9) of form below). The enhanced disclosure should generally not impose additional burdens of Type I Activists, who are exempted from the definition of "Related Person" in the proposed form contained in the Appendix.

With the great power of universal proxy should come great responsibility to fellow stockholders.

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This post comes to us from Eduardo Gallardo, a partner in the New York office of Paul Hastings and global co-chair of the firm's Mergers and Acquisitions Practice Group. The opinions in this post are solely his and do not necessarily represent those of Paul Hastings or any of its other partners. This post and the Appendix are not intended as legal advice.

Appendix: Proposed Modifications to Form of Advance Notice Corporate Bylaws

The blackline below reflects the author's proposed changes to a form of public company bylaws.

Section 2.10 Notice of Stockholder Business and Nominations.

(a) Annual Meeting.

(i) Nominations of persons for election to the Board of Directors and the proposal of business other than nominations to be considered by the stockholders may be made at an annual meeting of stockholders only: (A) pursuant to the Corporation's notice of meeting (or any supplement thereto); (B) by or at the direction of the Board of Directors (or any authorized committee thereof); or (C) by any stockholder of the Corporation who is a stockholder of record at the time the notice provided for in this Section 2.10(a) is delivered to the Secretary of the Corporation, who is entitled to vote at the meeting and who complies with the notice procedures set forth in this Section 2.10(a). For the avoidance of doubt, the foregoing clause (C) shall be the exclusive means for a stockholder to make nominations or propose other business at an annual meeting of stockholders (other than a proposal included in the Corporation's proxy statement pursuant to and in compliance with Rule 14a-8 under the Exchange Act).

(ii) For nominations or other business to be properly brought before an annual meeting by a stockholder pursuant to clause (C) of the foregoing paragraph, (1) the stockholder must have given timely notice thereof in writing to the Secretary of the Corporation and, in the case of nominations, the completed and signed questionnaire, representation and agreement required by Section [X] of these Bylaws, and in the case of business other than nominations, such business must be a proper subject for stockholder action, (2) the stockholder must have complied in all respects with the requirements of Regulation 14A under the Securities Exchange Act of 1934, as amended, including, without limitation, the

requirements of Rule 14a-19 (as such rule and regulations may be amended from time to time by the Securities and Exchange Commission ("SEC") including any SEC Staff interpretations relating thereto), and (3) the Board of Directors or an executive officer designated thereby shall determine that the stockholder has satisfied the requirements of this clause (ii), including without limitation the satisfaction of any undertaking delivered under paragraph (E) below. To be timely, a stockholder's notice must be delivered to the Secretary at the principal executive offices of the Corporation not later than the close of business (as defined in Section 2.10(c)(ii) below) on the 90th day nor earlier than the close of business on the 120th day prior to the first anniversary of the preceding year's annual meeting; provided, however, that in the event that the date of the annual meeting is more than 30 days before or more than 60 days after such anniversary date, or if no annual meeting was held in the preceding year, notice by the stockholder to be timely must be so delivered not earlier than the close of business on the 120th day prior to such annual meeting and not later than the close of business on the later of the 90th day prior to such annual meeting or the 10th day following the date on which public announcement (as defined in Section 2.10(c)(ii) below) of the date of such meeting is first made by the Corporation. For the avoidance of doubt, a stockholder shall not be entitled to make additional or substitute nominations following the expiration of the time periods set forth in this Section 2.10(a)(ii) and in these Bylaws. In no event shall an adjournment or recess of an annual meeting, or a postponement of an annual meeting for which notice of the meeting has already been given to stockholders or a public announcement of the meeting date has already been made, commence a new time period (or extend any time period) for the giving of a stockholder's notice as described above. The number of nominees a stockholder may nominate for election at the annual meeting (or in the case of a stockholder giving the notice on behalf of a beneficial owner, the number of nominees a stockholder may nominate for election at the annual meeting on behalf of the beneficial owner) shall not exceed the number of directors to be elected at such annual meeting. Such stockholder's notice shall set forth:

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(E) with respect to any director nominations:

(1) a written undertaking by the stockholder giving the notice or, if the notice is given on behalf of a beneficial owner on whose behalf the nomination is made, by such beneficial owner, that such stockholder or beneficial owner will deliver to beneficial owners of shares representing at least 67% of the voting power of the stock entitled to vote generally in the election of directors either (x) at least 20 calendar days before the annual meeting, a copy of its definitive proxy statement for the solicitation of proxies for its director candidates, or (y) at least 40 calendar days before the annual meeting a Notice of Internet Availability of Proxy Materials that would satisfy the requirements of Rule 14a-16(d) of the Securities Exchange Act;

(2) the name and address of any Related Person of the Nominating Person;

(3) the class or series and number of shares of stock and debt instruments of the Corporation or any subsidiary thereof which are beneficially owned by any Related Person of the Nominating Person;

(4) any agreement, arrangement or understanding between any Nominating Person, on the one hand, and a Related Person, on the other hand, related to any subject matter that will be material in the Nominating Person's solicitation of stockholders (including, without limitation, matters of social, labor, environmental and governance policy), regardless of whether such agreement, arrangement or understanding relates specifically to the Corporation;

(5) any agreement, arrangement or understanding between any Nominating Person or any Related Person thereof, on the one hand, and the director nominee, on the other hand, related to any subject matter that will be material in the Nominating Person's solicitation of stockholders (including, without limitation, matters of social, labor, environmental and governance policy), regardless of whether such agreement, arrangement or understanding relates specifically to the Corporation;

(6) any plans or proposals on the part of such Nominating Person or any Related Person to nominate directors at any other Public Company within the next 12 months;

(7) any proposals or nominations submitted on behalf of such Nominating Person or any Related Person seeking to nominate directors at any other Public Company within the past 36 months (whether or not such proposal or nomination was publicly disclosed);

(8) with respect to each Related Person, the information that would be disclosed with respect to them under Item 5(b) of Schedule 14A under the Exchange Act, assuming that each such Person was deemed a "participant" as defined in paragraphs (a)(ii), (iii), (iv), (v) and (vi) of Instruction 3 to Item 4 of Schedule 14A; and

(9) such other information as may be reasonably requested by the Corporation to facilitate disclosure to stockholders of all material facts that, in the reasonable discretion of the Corporation, are relevant for stockholders to make an informed decision on the director election proposal, including information regarding any Related Person.

For purposes of this paragraph (E):

- A Nominating Person shall be deemed to be "Acting in Concert" with a Person if such Nominating Person has knowingly acted (whether or not pursuant to an express agreement, arrangement or understanding) at any time during the prior two years in concert with such Person (or Control Person thereof) in relation to matters (whether or not specific to the Corporation) that will be material to the Nominating Person's solicitation of stockholders, including, without limitation, matters of social, labor, environmental and governance policy; provided, however, that a Nominating Person shall not be deemed to be Acting in Concert with a Person whose primary business is to serve as investment manager or adviser with respect to investing and trading in securities for a client or its own account.

- "Control Person" shall mean, with respect to any Person, collectively, (1) any direct and indirect control Person of such first Person, and (2) such first Person's and any control Person's respective directors, trustees, executive officers and managing members

(including, with respect to an entity exempted from taxation under Section 501(1) of the Internal Revenue Code, each member of the board of trustee, board of directors, executive council or similar governing body thereof);

- "Family Member" means a Person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares the Person's home.
- "Nominating Person" means, collectively, any stockholder giving the notice of director nomination or, if the notice is given on behalf of a beneficial owner on whose behalf the nomination is made, such beneficial owner, and if such stockholder or beneficial owner is an entity, each Control Person thereof (in each case of a stockholder, beneficial owner or Control Person, together with any Family Member thereof);
- "Public Company" means any Person with a class of equity securities registered pursuant to Section 12 of the Exchange Act, whether or not trading in such securities has been suspended.
- "Related Person", with respect to a Nominating Person, shall be deemed to be a Person (and any Control Person thereof) with respect to which such Nominating Person is Acting in Concert.

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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings New York lawyer:

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