

AS THE MARKET TURNS: CORPORATE GOVERNANCE LITIGATION IN AN AGE OF STOCKHOLDER ACTIVISM

DAVID J. BERGER AND KENNETH M. MURRAY* **

INTRODUCTION

The last several years have seen considerable changes in the way corporations are governed. At the most basic level, there has been a shift from a “director-centric” notion of corporate governance to a “stockholder-centric” model. Historically, there were certain business decisions largely, or even exclusively, within the province of directors, such as how to compensate executives, whom to nominate for the board, and how to deploy the company’s capital and operating assets. However, under the stockholder-centric model, such decisions—even what type of accounting procedures to employ—have now become, at a minimum, issues for discussion between stockholders and directors, and in many circumstances, issues to be resolved by stockholders alone.

Interestingly, the stockholder-centric model is not being driven by either law or statute, and the public policy benefits of this movement are far from certain. Moreover, there has been no clear empirical evidence to support the notion that the national economy or investors generally benefit from giving stockholders more control over the corporate machinery. To the contrary, as discussed in more detail below, recent case law continues to demonstrate that the business judgment rule is as strong as ever, with courts continuing to defer to the informed, good faith decisions of boards. Similarly, there have been no dramatic statutory changes resulting in more power

* Mr. Berger is a partner at Wilson Sonsini Goodrich & Rosati and Mr. Murray is an associate at the firm. Mr. Berger received his J.D. from Duke University School of Law. Mr. Murray received his J.D. from New York University School of Law. Wilson Sonsini Goodrich & Rosati was involved in some of the cases discussed herein, but the opinions expressed in this article are those of the authors and not necessarily those of Wilson Sonsini Goodrich & Rosati or its clients.

** This Article was accepted for publication in Fall 2008. All cases are good law at the time this issue went to press in Spring 2009.

to stockholders. While it may not be entirely accurate to say the opposite is true, the fact remains that no state or federal legislation has significantly impacted the internal relationships that govern the roles and responsibilities of directors to stockholders.¹

The statutory authority of directors to act under Delaware law, in particular Section 141 of the Delaware General Corporation Law (“DGCL”), remains unchanged, as this bedrock principle of corporate governance still provides that the “business and affairs of every corporation. . . shall be managed by or under the direction of a board of directors.”² Even the Sarbanes-Oxley Act of 2002, which certainly created some greater obligations under the federal securities laws, particularly regarding an officer’s responsibility for a company’s financial statements, did not result in any real changes to the governance question. In addition, the Securities and Exchange Commission (“SEC”) has also not issued, or attempted to issue, any significant new policies that would impact the changing nature of corporate governance. Nor has the SEC put forward new regulations on proxy disclosures concerning the election of directors or related issues impacting stockholder control, such as updating the disclosure regime required under Section 13(d) of the Securities Exchange Act of 1934 (“Exchange Act”).³

If neither courts nor legislators are driving these governance changes, one might ask what is the catalyst? Probably the

1. The obvious exception to this is recent legislation based on the Troubled Asset Relief Program (“TARP”) which includes significant limitations on such things as executive compensation. *See generally* Wachtell Lipton Rosen & Katz, *Congressional Leaders Agree to Eliminate Incentive Compensation and Impose Other Compensation Restrictions for TARP Participants*, February 13, 2009. However, by its terms, TARP legislation only applies to companies receiving funds under the TARP program.

2. DEL. CODE tit. 8, § 141(a) (2006).

3. The SEC has recently published for comment the New York Stock Exchange (NYSE)’s proposal with respect to Rule 452, also known as the “10 day rule.” *See* Self-Regulatory Organizations, Exchange Act Release No. 34-59464 (Feb. 26, 2009). This proposal developed following the NYSE’s establishment of a “Proxy Working Group” in April 2005 to review the NYSE rules regulating the proxy voting process, with a particular emphasis on Rule 452. Among the Working Group’s recommendations was that the NYSE should eventually eliminate Rule 452 with respect to director elections. Mr. Berger was counsel to the NYSE’s Proxy Working Group.

simplest answer is money; stockholders have come to believe that they have a better chance of achieving a higher return if they take a more active role in a company's day-to-day activities than if they let those decisions remain exclusively in the hands of the board of directors and simply vote on a periodic basis for directors.⁴ Put another way, many stockholders no longer believe that boards will necessarily act in the best interests of the company and its stockholders when making decisions about the company's future. This skepticism has been driven by a variety of factors over the last several years, including substantial corporate frauds such as Enron Corp. and WorldCom, Inc., questionable executive compensation practices, and other similar issues.

Another factor contributing to the growth in stockholder activism is the rise of hedge funds as investors. Today, there are an estimated nine thousand hedge funds worldwide, controlling by some estimates up to \$2 trillion in assets (although both of these numbers have declined significantly beginning in the second half of 2008). Over the last few years, these funds have been growing at a double-digit rate annually.⁵ Perhaps even more significant, there are about ninety "activist" hedge funds worldwide, estimated to control over \$100 billion in assets.⁶ These funds have become experts in pushing for change in corporate boardrooms, including removing and replacing directors in numerous circumstances. The funds have significant economic incentives to take risks and often seek short-term gains from companies in which they invest, particularly given the traditional "2%/20%" economic model of these funds. Under this system, funds typically can expect to receive 2% of money under management and 20% of any profits from

4. Again, however, the empirical evidence supporting this view is ambiguous at best, and certainly the central assumption contained within it—that better governance or greater shareholder control will lead to greater investor returns—remains largely unproven.

5. See Robert Whitelaw & Sujeet Banerjee, *Hedge Funds for the Rest of Us*, J. OF INDEXES, Jul.-Aug. 2007, at 10, available at <http://www.indexuniverse.com/publications/journalofindexes.html?magazineID=&year=2007&issue=115>.

6. See Michelle Leder, *Wolves at the Gates*, WORTH, Dec. 1, 2006, <http://www.worth.com/Editorial/Wealth-Management/Business-Entrepreneurship/Best-Practices-On-The-Board-Wolves-at-the-Gates.asp>.

investments.⁷ This type of structure encourages the hedge fund manager to make profits as fast as possible, both to assist the fund in raising future funds (which can lead to more money under management) and because it is only when the investment is liquidated that the profit (including the fund's profit) from that investment is determined.

The growth and wealth of hedge funds has led these funds to employ ever more sophisticated tactics in their challenges to corporate boards, as well as analyses of the alternatives available to the corporation. For example, now funds not only use their own analysts to review a company's condition but may retain independent investment banks to provide alternatives to a board's business plan. The use of independent experts has not just increased the intellectual capital available to funds, but also enhances the image and ideas of the fund with stockholders, investors and others. Some notable examples of this tactic in the last few years include Lazard's retention by Carl Icahn in his bid to have Time Warner Inc. split off AOL;⁸ Pershing Square Capital Management's (Pershing Square) retention of Blackstone Group in connection with its effort to restructure Wendy's International;⁹ the retention of UBS AG on a number of occasions, including Highfields Capital Management's bid for Circuit City Stores;¹⁰ and ValueAct Capital Partners' attempt to control Acxiom Corporation.^{11 12}

Hedge funds have also developed very sophisticated techniques to pressure boards and to maximize and magnify their influence. For example, it has become common for several hedge funds to invest in a company after one hedge fund takes

7. See Mark Hulbert, *2+20, and Other Hedge Fund Math*, N.Y. TIMES, Mar. 4, 2007, § 3, at 4, available at <http://www.nytimes.com/2007/03/04/business/yourmoney/04stra.html>.

8. See Andrew Ross Sorkin, *Icahn Finds Ally in Bid to Change Time Warner*, N.Y. TIMES, Nov. 30, 2005, at C1, available at <http://www.nytimes.com/2005/11/30/business/media/30icahn.html>.

9. See Michael Brush, *Follow the Smart Money to Wendy's*, MSN MONEY, July 6, 2005, <http://moneycentral.msn.com/content/P119359.asp>.

10. See Andrew Ross Sorkin & Riva D. Atlas, *A Hedge Fund May Try to Buy Circuit City, but It May Not*, N.Y. TIMES, Feb. 16, 2005, at C1, available at <http://www.nytimes.com/2005/02/16/business/16place.html>.

11. See Ari Levy & Ian King, *Silver Lake, ValueAct to Buy Acxiom for \$2.24 Billion*, Bloomberg.com, May 17, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=amI_bjyY148w&refer=home.

12. Wilson Sonsini Goodrich & Rosati served as counsel to Acxiom.

a public position advocating change. As a result, there is often significant turnover in a company's stockholder base once one hedge fund publicly announces an intention to challenge the board, with stock turnover in selected activist situations being as high as 20% in the first ten trading days following announcement of the investment. This has led to the so-called "wolfpack" effect, whereby a significant number of a company's shares are sold by the company's existing investors to other hedge funds who have views more sympathetic to the activist investor than to the incumbent board, and also, may have a shorter investment horizon than either the incumbent board or the company's more traditional shareholders. Further, the activist nature of the wolfpack means that these investors are more likely to vote in any proxy contest, to question a board's longer-term plans, and to express views publicly that are opposed to the board.¹³

In addition to increasing their influence through the wolfpack effect, hedge funds and stockholder activists have also developed sophisticated public relations strategies to express their views to stockholders and to challenge boards. For example, Carl Icahn maintains a blog,¹⁴ and many of the most active hedge fund managers have developed relationships with the media, earning well-deserved reputations for giving colorful, newsworthy quotes. Additionally, these activists are very good at communicating with analysts, and in turn, use the analysts' reports (which the activists may have helped shape) in publicly criticizing the company's plans or strategic direction. Further, while participating in a high profile public relations campaign about business strategy has become a common event for leading activists, the same cannot be said of direc-

13. For a more detailed discussion of wolf pack behavior, see Laurie B. Smilan, David A. Becker, & Dane A. Holbrook, *Preventing 'Wolf Pack' Attacks*, NAT'L L. J. (Nov. 20, 2006), available at http://www.lw.com/upload/pubContent/_pdf/pub1710_1.pdf.

14. See David Marcus, *Icahn Does Not See Eye-to-Eye with Lipton on Beer Deal*, THE DEAL, Aug. 25, 2008, available at http://www.thedeal.com/dealscape/2008/08/icahn_does_not_see_eyetoeye_wi.php (providing a good example of Mr. Icahn's use of this blog, which includes his response to Marty Lipton's comments on the possible effect that Anheuser-Busch's decision to eliminate its "staggered" board had on InBev's successful takeover bid); see also Carl Icahn, *Lipton Defends the Indefensible, Again and Again*, THE ICAHN REPORT, Aug. 25, 2008, <http://www.icahnreport.com/report/2008/08/lipton-defends.html>.

tors, who are often unprepared for this type of campaign and feel significantly constrained by the federal securities laws. Public relations pressure has been magnified in the Internet age, with the news cycle increasingly compressed and the need to respond in a timely fashion even greater.

Hedge funds also engage in very sophisticated financial transactions in order to maximize both their influence and their return. These tactics include the use of derivatives and similar types of hedging strategies that can result in a decoupling of economic and voting interests, an increase in the return of the fund, as well as an increase in the fund's equity ownership once it is reported in the press. For example, although widely reported that Pershing Square owned 9.9% of Wendy's stock, approximately 8.7% of that ownership came in the form of options.¹⁵ Such strategies can also be used to increase the financial benefits to a fund when the share price of the target rises following the fund's investment. For example, JANA Partners ("JANA") and Sandell Asset Management used swaps and other derivatives to gain a 21% economic interest in CNET Networks, Inc. ("CNET") prior to CNET's acquisition by CBS.¹⁶ The extensive use of derivatives has even spread to Europe, where Schaeffler Group won control of the much larger automotives-parts and tire-supplier Continental AG by using a variety of derivatives and hedging strategies that gave the former the potential to acquire a significant ownership position in the latter before having to disclose the extent of its interest. At one point, Schaeffler directly owned 3% of Continental's stock, but it was able to control an additional 33% of the company through stock options and swap agreements related to Continental's stock without publicly disclosing this additional interest.¹⁷

15. See ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *The Implications of Alternative Investment Vehicles for Corporate Governance: A Synthesis of Research About Private Equity Firms and "Activist Hedge Funds"* 42 (July 2007), available at <http://www.oecd.org/dataoecd/60/11/39007051.pdf>.

16. See Andrew Ross Sorkin, *Jana Meets with CNet and No Love Is Lost, Report Says*, N.Y. TIMES, Dealbook, Mar. 10, 2008, <http://dealbook.blogs.nytimes.com/2008/03/10/jana-meets-with-cnet-and-no-love-is-lost-report-says/>.

17. For an interesting discussion of the use of derivatives in the battle between Continental and Schaeffler, see Dirk Zetzsche, *Continental AG vs. Schaeffler, Hidden Ownership and European Law — Matter of Law or Enforcement* (Ctr. for Bus. and Corporate Law, Working Paper No. 0039, 2008), available

Yet, hedge funds are not alone in their support of a more stockholder-centric notion of governance. Indeed, the stockholder-centric model was perhaps developed by some of the largest institutional investors and fostered by the growth of certain stockholder advisory services, most notably RiskMetrics Group (“RiskMetrics”) (formerly known as Institutional Shareholder Services or “ISS”). The influence of RiskMetrics in the development of a stockholder-centric model of governance is difficult to overstate because many institutional investors either follow, or are significantly influenced by, RiskMetrics’ recommendations on how to vote their shares. As a practical matter, it is these investors whose votes often decide corporate elections, since institutional investors typically own a controlling, if not a majority, position in many public companies.¹⁸

As a result, the recommendation by RiskMetrics on how to vote in a particular proxy campaign frequently determines the outcome of that election, and as a policy matter, RiskMetrics generally supports a stockholder-centric model of governance. For example, RiskMetrics generally endorses policies giving stockholders a “say on pay,” which allow stockholders to vote

at <http://ssrn.com/abstract=1170987>. For a more general discussion of the use of derivatives, “empty voting,” and their implications for contests for corporate control, see Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008); Henry T. C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343(2007); Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and the Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811-908 (2006); Mara Lemos-Stein, *Poison Pills Target Derivatives*, WALL ST. J., June 18, 2008, at B5C; David Marcus, *The Unbearable Emptiness of Voting*, THE DEAL, Feb. 1, 2008, http://www.thedeal.com/servlet/ContentServer?cid=12010571_71353&pagename=TheDeal%2FNWStArticle&c=TDD Article; Andrew Ross Sorkin, *A Loophole Lets a Foot in the Door*, N.Y. TIMES, Dealbook, Jan. 15, 2008, <http://www.nytimes.com/2008/01/15/business/15sorkin.html?fta=y>.

18. Probably the single greatest factor giving rise to the growth of ISS was the so-called “Avon Letter” by the Department of Labor in 1988, which made clear that ERISA fiduciaries had the obligation to vote the shares in their portfolio in the interest of the beneficiaries. See Opinion Letter from Dep’t of Labor to Helmuth Fandl, Chairman of the Ret. Bd., Avon Prods., Inc. (Feb. 29, 1988). This growth of ISS, when combined with the tremendous growth of institutional ownership of U.S. equities in the 1990s and thereafter (from less than 40% in 1980 to more than 60% by 2005), has dramatically increased the role of institutions—and the proxy advisory firms that support them—in proxy elections.

on executive compensation; supports significant limitations on a board's use of stockholder rights plans (which have the effect of limiting the ability of a company to be acquired without the approval of the board); and supports policies which open the process of director nominations to stockholders. RiskMetrics has also established a forensic accounting division to review a company's accounting policies and make recommendations on those policies to the board's audit committee members.¹⁹

As mentioned above, RiskMetrics' recommendations have significant impact on a company, particularly in proxy contests for the election of directors. This occurs for at least two reasons. First, the institutions that follow RiskMetrics' recommendations generally control a large percentage of the target company's outstanding stock. Second, when the vote of these institutions is combined with the vote of the stockholder activists bringing the proxy challenge, as well as their wolfpack allies, the dissidents can often easily obtain a sizeable plurality, if not absolute majority, vote in favor of the dissident slate. This pattern of RiskMetrics recommending that stockholders vote in favor of a dissident candidate, and then, the dissident securing election to the board, is particularly common where the dissident seeks less than a majority of the seats on the company's board. For example, RiskMetrics has supported dissident slates in as many as 23 of 27 significant proxy contests this year, and in 51 of the most significant contests over approximately the last two years, it supported at least one dissident in 37, or approximately 73%, of those contests. When RiskMetrics does support a dissident, the dissident usually prevails and wins at least one seat on the board about 70% of the time.²⁰

RiskMetrics is not the only proxy advisory service supporting stockholder activism. Other services such as Glass, Lewis & Co. ("Glass Lewis"), while less influential than RiskMetrics, are also frequent supporters of activist campaigns. For example, Glass Lewis has historically supported dissidents in proxy contests in about 6 of every 10 situations, and when it does sup-

19. For more information concerning RiskMetrics and its policies, see RiskMetrics Group, <http://www.riskmetrics.com>.

20. See David J. Berger, Joele Frank, Alan M. Miller, & Christopher L. Young, Presentation to the New York Stock Exchange, December 8, 2008 at 10-13 (on file with the author).

port a dissident, the dissident has won at least one seat about 75% of the time.²¹ Another factor significantly impacting the changing nature of corporate governance is the role of the media and the Internet. Today, business news is more popular than ever, with several cable channels devoted to 24-hour coverage of business events and a myriad of blogs, chatrooms, and internet columns focused on the business of business. What is especially popular for all of these media outlets are extraordinary corporate events, such as takeovers and proxy contests, as well as executive compensation and other controversial decisions by corporate boards. These items, rather than long-term strategic decisions or investments, can easily become the subject of discussion and criticism by pundits and academics, leading to further scorn of directors.

The concern board members have for how they are perceived in the press and by their peers is not surprising. Contrary to what is often alleged, most directors choose to be directors not because of the financial compensation or other perquisites, but because they believe it is both an interesting and important position. Board members who are the subject of public criticism often find the trade-off is not worth the trouble, since the financial compensation for being a director is minor in comparison to any reputational damage one may incur. As a result, the call from a New York Times or Wall Street Journal reporter indicating that a director or the board is about to be chastised in the press is often as distressing a message to the board as hearing that a lawsuit has been filed challenging one of its decisions. In fact, information about a forthcoming article may be even worse; most directors who join a board today recognize that lawsuits are a fact of life, but seeing their decisions challenged publicly is something they may have less experience handling.

Yet, at the same time that boards are dealing with all of these stockholder challenges to their authority, courts continue to emphasize the bedrock legal principles of corporate governance, including the strength of the business judgment rule and the fact that the corporation is managed by or under the board of directors. Several recent decisions evince this trend:

21. *See id.*

- In *McPadden v. Sidhu*, the court dismissed plaintiff's claims against the director defendants despite finding that their actions during a sales process were "either recklessly indifferent or unreasonable" because their conduct did not amount to an "intentional dereliction of duty or the conscious disregard for one's responsibilities," and the company's charter included a Section 102(b)(7) exculpatory provision.²²
- In *In re Bear Stearns Litigation*, the court held that "it should not, and [would] not, second guess" the decision of the Bear Stearns board to "expeditiously" approve its merger with JPMorgan and agree to deal protection provisions, including selling 39.5% voting control to JPMorgan.²³
- In *In re Citigroup Inc. Shareholder Derivative Litigation*, the court dismissed claims that the director defendants breached their fiduciary duties by permitting the company to become involved in debt obligations and investment vehicles that resulted in massive losses because there was no "evidence that the directors consciously disregarded their duties or otherwise acted in bad faith."²⁴
- In *Globis Partners, L.P. v. Plumtree Software, Inc.*, the court dismissed, with prejudice, a complaint alleging disclosure violations and breaches of the fiduciary duty of loyalty in connection with board's decision to approve a merger; the central allegation was that the board agreed to a lower merger price after discovering potential corporate liability, allowing the board to avoid disclosing this liability and potential litigation arising.^{25 26}
- In *Mercier v. Inter-Tel (Delaware), Inc.*, the court upheld a board's decision to postpone a stockholder meeting

22. *McPadden v. Sidhu*, No. 3310-CC, 2008 WL 4017052 (Del. Ch. Aug. 29, 2008).

23. 870 N.Y.S.2d 709 (Sup. Ct. 2008).

24. 964 A.2d 106 (Del. Ch. 2009).

25. No. 1577-VCP, 2007 WL 4292024 (Del. Ch. Nov. 30, 2007).

26. Wilson Sonsini Goodrich & Rosati was counsel to Plumtree Software in this litigation.

over a potential merger transaction because the board believed it would lose the vote, and the delay in the meeting would help the board obtain the requisite stockholder support for the merger.²⁷

While courts continue to recognize, and perhaps even expand on, the protections afforded a board's decisions under the business judgment rule, in the last year, courts have issued a number of important decisions closely scrutinizing any conduct that impacts the stockholder franchise. Indeed, one could say that while greater deference is given to substantive board decisions, at the same time, courts are placing more limitations on board or corporate action that may negatively impact the stockholder franchise. In other words, it may be viewed that courts recognize that stockholders have more opportunities than ever to impact substantive board decisions, and thus, are unwilling to second-guess boards on those decisions, while simultaneously ensuring that stockholders have appropriate access to the proxy process. One effect of this is that there has been considerable litigation over the last year on the scope and interpretation of a company's bylaws, particularly as the bylaws are implicated in a proxy contest or situation involving the stockholder franchise.

The end result is that while a board continues to have considerable discretion in exercising its decision-making authority, it must be careful to ensure that the exercise of that power does not improperly limit stockholders' access to proxy statements or their ability to vote at meetings. Similarly, in a time where activist stockholders have exhibited an increasing ability to effect changes in company policies, strategies, and board composition, the power that stockholders have exhibited has resulted in greater scrutiny of stockholders' responsibility to provide public disclosure of their interests and intentions. In 2008, there were at least five important decisions that will impact how corporations and stockholders behave in this period of heightened stockholder activism. Each of these decisions is discussed below.

27. 929 A.2d 786 (Del. Ch. 2007).

I.

DELAWARE CHANCERY COURT DETERMINES THAT ADVANCE-
NOTICE PROVISION OF BYLAWS DID NOT APPLY TO PROXY
SOLICITATION FUNDED BY ACTIVIST STOCKHOLDER

In *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, the Delaware Chancery Court ruled that JANA's independently funded proxy solicitation to obtain majority control of the board of directors of CNET was not prohibited by CNET's bylaws.²⁸ Specifically, the court ruled that a provision in CNET's bylaws, stating that a stockholder must own company stock for a full year before seeking "to transact other corporate business" at the annual meeting, did not apply to JANA's actions because other language in the bylaw made it clear that the bylaw only applied to situations in which a stockholder was seeking to put its proposal on the company's proxy statement.²⁹

The instant case arose out of JANA's effort to obtain control of the CNET board.³⁰ JANA and its affiliates owned approximately 11% of the outstanding common stock of CNET.³¹ CNET's certificate of incorporation and bylaws provided that CNET had a classified board, and two of the eight members of the board were up for election.³² In an effort to take control of the board without having to win the two elections ordinarily required when a company has a classified board, JANA notified CNET that it intended to take a number of actions at CNET's annual meeting, including (i) contesting the election of the two seats up for election; (ii) amending CNET's bylaws to expand the number of board seats from eight to thirteen; and (iii) nominating five individuals to fill the newly created board positions.³³ If CNET's stockholders approved all of JANA's proposed amendments, as well as JANA's candidates for the CNET board, then these new candidates would have constituted a majority of CNET's directors.³⁴

28. No. 3447-CC, 2008 WL 894774 (Del. Ch. Mar. 13, 2008), *aff'd*, 947 A.2d 1120 (Del. 2008) (unpublished table decision).

29. *See id.*

30. *See id.* at *1.

31. *Id.*

32. *Id.*

33. *Id.* at *1-2.

34. *Id.* at *2.

On December 26, 2007, JANA informed CNET of its intention to solicit proxies in favor of its nominees and proposals and requested inspection of CNET's stocklist materials.³⁵ On January 3, 2008, CNET responded and refused to provide the requested stocklist materials claiming that JANA failed to state a proper purpose because the proposed proxy solicitation violated CNET's bylaws.³⁶ Specifically, CNET cited JANA's "fail[ure] to comply with the provisions of the Company's bylaws which require a shareholder seeking to nominate candidates for director election or seeking to transact other corporate business at an annual meeting to beneficially own \$1,000 of the Company's common stock for at least one year."³⁷ According to CNET, JANA made its initial investment in CNET stock in October 2007 and would have held shares of CNET for only eight months at the expected time of the annual meeting in June 2008.³⁸ Thus, CNET argued that under the company's bylaws, JANA was not entitled to either nominate candidates or "transact other business" in connection with the company's 2008 annual meeting.³⁹

On January 7, 2008, JANA filed a declaratory relief action asking the court to find either (i) that the bylaw at issue was inapplicable to JANA because it was clearly intended to apply solely to solicitations under Exchange Act Rule 14a-8⁴⁰ or (ii) that CNET's interpretation of the bylaws was invalid under Delaware law.⁴¹ In response, CNET argued that its "Notice By-law" was not intended to be limited to solicitations under Rule 14a-8, but rather governs all stockholder nominations for directors and other stockholder proposals.⁴² CNET further argued that the bylaw was not illegal because it was validly adopted under Delaware law, was not prohibited by the DGCL, and reasonably served a valid corporate purpose.⁴³

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.* at *3.

39. *Id.* at *2.

40. 17 C.F.R. § 240.14a-8 (2008) ("This section addresses when a company must include a shareholder's proposal in its proxy statement and identify the proposal in its form of proxy when the company holds an annual or special meeting of shareholders.").

41. *JANA*, 2008 WL 894774, at *3.

42. *Id.*

43. *Id.* at *4.

CNET's bylaw provision stated, in pertinent part, that:

Any stockholder of the Corporation that has been the beneficial owner of at least \$1,000 of securities entitled to vote at an annual meeting for at least one year *may seek to transact* other corporate business at the annual meeting, provided that such business is set forth in a written notice. . . and received no later than *120 calendar days in advance of the date of the Corporation's proxy statement* released to security-holders in connection with the previous year's annual meeting of security holders. . . . [S]uch notice must also comply with any applicable federal securities laws establishing *the circumstances under which the Corporation is required to include the proposal in its proxy statement or form of proxy.*⁴⁴

In reviewing these contentions, the court ruled as a matter of law that the "language of the Notice Bylaw leads to only one reasonable conclusion: the bylaw applies solely to proposals and nominations that are intended to be included in the company's proxy materials pursuant to Rule 14a-8."⁴⁵ The court stated that there were three reasons that the bylaw could only be read to apply to proposals under Rule 14a-8.⁴⁶

First, the court found that while stockholders "may seek" to bring proposals under Rule 14a-8, outside of that rule stockholders simply "may bring" such proposals and do not need permission to bring proposals or conduct business at the company's annual meeting.⁴⁷ The court stated that the language "may seek," as used in the bylaw, was a key consideration in its analysis, and that the phrase suggested that a stockholder must request permission or approval to make such a proposal, thereby envisioning use of the company's proxy under Rule 14a-8.⁴⁸ However, if a stockholder wished to put a proposal before fellow stockholders in the form of an independently financed proxy solicitation, that stockholder was not required to "seek" the board's approval. Because JANA financed its own

44. *Id.* at *3-4 (emphasis added).

45. *Id.* at *7.

46. *Id.*

47. *Id.*

48. *Id.* at *13-14.

proxy solicitation, the “may seek” language indicated that the Notice Bylaw did not apply to JANA’s proposals.⁴⁹

Second, the court noted that the Notice Bylaw established a deadline in order to permit the company to include approved proposals in its form of proxy and stated that this was another indication that the bylaw did not apply to JANA’s independently funded proxy solicitation.⁵⁰ The court stated that the most reasonable explanation for such a requirement is that the bylaw was designed to allow the board time to include the stockholder proposal in its own proxy materials and pointed to a similar requirement in Rule 14a-8 itself.⁵¹

Third, the court found that the final sentence of the Notice Bylaw clearly referred to Rule 14a-8 and defined its scope by referring to the “applicable federal securities laws” that establish “the circumstances under which the Corporation is required to include” stockholder proposals in proxy materials.⁵² The court held that the “specific language used in the final sentence of the bylaw mandates my conclusion that the bylaw only applies to Rule 14a-8 proposals.”⁵³ In construing CNET’s bylaws in this manner, the court explicitly did not rule on the broader question of whether a bylaw requiring stockholders to own stock for a certain period before nominating directors or conducting other business at a stockholder meeting is valid under Delaware law.⁵⁴

Two months after the court’s decision, CBS agreed to buy CNET for \$1.8 billion in cash, which represented a 45% premium on the closing price the day prior to the announcement of the merger.⁵⁵ It was reported that the premium offer increased JANA’s stake in CNET from around \$118 million at

49. *Id.* at *14-15.

50. *Id.* at *14.

51. *Id.* at *13.

52. *Id.* at *16.

53. *Id.* at *17.

54. The court noted that it had upheld advance-notice bylaw provisions in the past, but warned that “when advance notice bylaws unduly restrict the stockholder franchise or are applied inequitably, they will be struck down.” *Id.* at *15 (citing *Openwave Sys. Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*, 924 A.2d 228, 239 (Del. Ch. 2007)).

55. See Alistair Barr, *Jana Wins Big as CBS Acquires CNet*, WALL ST. J., MarketWatch, May 15, 2008, <http://www.marketwatch.com/news/story/jana-partners-wins-big-cbs/story.aspx?guid={73FBE825-AC96-4B9C-A21C-F2FC369EF872}>.

the end of March 2008 to more than \$189 million.⁵⁶ JANA subsequently supported the CBS offer and dropped its effort to win control of CNET's board.⁵⁷

II.

DELAWARE CHANCERY COURT ALLOWS ACTIVIST STOCKHOLDER TO NOMINATE DIRECTOR CANDIDATES WITHOUT COMPLYING WITH ADVANCE-NOTICE PROVISION OF BYLAWS

In *Levitt Corp. v. Office Depot, Inc.*, the Delaware Chancery Court ruled that Levitt Corp.'s (Levitt) nomination of two candidates for election to Office Depot, Inc.'s (Office Depot) board of directors was not prohibited by Office Depot's bylaws even though Levitt did not follow the advance-notice provision contained therein.⁵⁸ Specifically, the court ruled that Levitt was not required to give advance notice of its intent to nominate directors because the "business of electing and nominating directors at the Annual Meeting" was properly brought before Office Depot's stockholders by Office Depot's own annual meeting notice, which presented the general issue of electing directors to the stockholders.⁵⁹

The dispute arose out of Levitt's desire to replace two members of Office Depot's twelve-member board.⁶⁰ On March 14, 2008, Office Depot distributed a Notice of Annual Meeting of Shareholders (notice), which included the date, time, and location of the annual meeting.⁶¹ The notice also included the following agenda item under an "items of business" heading: "1. To elect twelve (12) members of the Board of Directors for the term described in this Proxy Statement."⁶² The proxy materials that accompanied the notice disclosed, among other things, that the twelve current directors had been nominated for election.⁶³

On March 17, 2008, Levitt filed its own preliminary proxy statement soliciting proxies in support of its two nominees de-

56. *Id.*

57. *Id.*

58. No. 3622-VCN, 2008 WL 1724244 (Del. Ch. Apr. 14, 2008).

59. *Id.* at *6.

60. *Id.* at *1.

61. *Id.*

62. *Id.*

63. *Id.*

spite the fact that Levitt had not given advance notice pursuant to the bylaw provision of its intent to nominate candidates to the Office Depot board.⁶⁴ The same day, Levitt filed a declaratory relief action in the Delaware Chancery Court asking the court to find that it was permitted to nominate its two candidates for election to the Office Depot board despite its failure to follow the advance-notice provision.⁶⁵

Office Depot's advance-notice provision stated, in pertinent part:

At an annual meeting of stockholders, only such business shall be conducted as shall have been properly brought before the meeting. To be properly brought before an annual meeting, business must be (i) specified in the notice of the meeting (or any supplement thereto) given by or at the direction of the Board of Directors, (ii) otherwise properly brought before the meeting by or at the direction of the Board of Directors, or (iii) otherwise properly brought before the meeting by a stockholder of the corporation who was a stockholder of record at the time of giving of notice provided for in this Section, who is entitled to vote at the meeting and who complied with the notice procedures set forth in this Section. For business to be properly brought before an annual meeting by a stockholder, the stockholder must have given timely notice thereof in writing to the Secretary. . . . To be timely, a stockholder's notice shall be received at the company's principal office. . . ., not less than 120 calendar days before the date of the Company's proxy statement released to shareholders in connection with the previous year's annual meeting. . . .⁶⁶

The court noted that neither this provision nor any other provision of Office Depot's bylaws expressly mandated advance notice of competing director nominations.^{67 68}

64. *Id.* at *2.

65. *Id.* at *1.

66. *Id.* at *2.

67. *Id.*

68. The court further noted that, under Delaware law, no advance notice of a stockholder's intent to nominate directors at an annual meeting has to

Furthermore, the court rejected Levitt's argument that the advance-notice provision did not encompass director nominations.⁶⁹ Turning to the first sentence of the advance-notice provision, the court stated that the plain meaning of the term "business" in this context was an "affair" or "matter," and the nomination of directors constitutes an affair or matter.⁷⁰ The court held that Office Depot's advance-notice provision included director nominations by stockholders because the nomination of directors was unambiguously within the purview of the term "business."⁷¹

However, the court also rejected Office Depot's contention that Levitt was required to give advance notice in accordance with the bylaws of its intention to nominate directors.⁷² First, the court held that the business of electing directors had properly been brought before the annual meeting by Office Depot's notice, which stated that one item of business before the annual meeting was to "elect twelve (12) members of the Board of Directors."⁷³ Second, the court analyzed whether the business of electing directors included the nomination of directors,⁷⁴ noting that neither the law nor the language of Office Depot's bylaws discussed or imposed limitations on the director-nomination process, going on to state that it could not discern a "persuasive reason why the business of electing directors should not include the subsidiary business of nominating directors for election, especially where no guidance on the nomination process is found in Office Depot's Bylaws or in the Delaware General Corporation Law."⁷⁵ Consequently, the court held that "having properly brought the business of electing and nominating directors before the Annual Meeting through the Notice, Office Depot's Board cannot prevent Levitt from nominating candidates for election to the Office Depot Board at that meeting."^{76 77} Thus, "Levitt was relieved of

be given unless the corporation has properly imposed such a requirement. *Id.* at *4.

69. *Id.* at *6.

70. *Id.* at *5.

71. *Id.* at *6.

72. *Id.* at *7.

73. *Id.* at *6.

74. *Id.*

75. *Id.*

76. *Id.* at *7.

complying with the advance notice provision because the business of nominating directors for election had already been properly brought before the meeting.”⁷⁸

III.

FEDERAL COURT ALLOWS ACTIVIST STOCKHOLDERS TO VOTE SHARES AT ANNUAL MEETING DESPITE FAILURE TO COMPLY WITH DISCLOSURE OBLIGATIONS OF FEDERAL SECURITIES LAWS

In *CSX Corp. v. The Children’s Investment Fund Management (UK) LLP*,⁷⁹ the court ruled that the defendants⁸⁰ violated Section 13(d) of the Exchange Act⁸¹ because (i) TCI failed to file required disclosures with the SEC within 10 days of acquiring “beneficial ownership” in 5% of CSX Corporation (CSX) shares,⁸² and (ii) the defendants failed to file required disclo-

77. In response to Office Depot’s argument that its advance-notice provision would be “rendered a nullity in regard to director nominations” by the court’s ruling, the court noted that “Office Depot, through careful drafting of the Notice, may have separated precisely the business of the election from the business of the nomination. If the Notice had so provided, a different result may have obtained.” *Id.* at *6 n.43.

78. *Id.* at *6.

79. 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff’d*, 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

80. The defendants were The Children’s Investment Fund Management (UK) LLP (TCIF UK), The Children’s Investment Fund Management (Cayman) Ltd., The Children’s Investment Master Fund (TCI Fund), Christopher Hohn, Snehal Amin (collectively, “TCI”), and 3G Capital Partners Ltd., 3G Capital Partners, L.P., 3G Fund, L.P., and Alexandre Behring (collectively, “3G”). The court stated that Hohn runs TCI, Amin is a partner of TCIF UK, and Behring runs 3G. *Id.* at 518.

81. Section 13(d) was adopted “to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control.” *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971).

82. Section 13(d)(1) provides in relevant part, “Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 12 of this title . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement containing” the information required to be disclosed by Section 13(d)(1).” 15 U.S.C. § 78m(d)(1).

tures with the SEC within 10 days of forming a “group.”⁸³ While the court issued an injunction restraining future violations of Section 13(d) and the rules thereunder by the defendants, it concluded as a matter of law that it could not enjoin the defendants from voting the CSX shares that they owned at the upcoming annual meeting.⁸⁴

The case arose out of the defendants’ plan to elect a slate of five nominees to CSX’s twelve-member board of directors, and a dispute between CSX and the defendants concerning the amount of CSX stock that the defendants beneficially owned.⁸⁵ CSX accused the defendants of entering into total-return equity swaps referencing CSX shares,⁸⁶ and secretly coordinating efforts to change or influence control of CSX by acquiring a large stake in the company while evading the reporting requirements of the federal securities laws.⁸⁷ CSX argued that the defendants acquired beneficial ownership of the CSX stock referenced in the swap arrangements they entered into, but failed to accurately disclose this alleged beneficial interest. Specifically, CSX contended that TCI violated Section 13(d) by failing to accurately disclose its beneficial ownership of CSX shares referenced in its swap arrangements,⁸⁸ and that

83. Section 13(d)(3) provides, “When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a ‘person’ for the purposes of this subsection.” 15 U.S.C. § 78m(d)(3).

84. *CSX Corp.*, 562 F. Supp. 2d at 573-74.

85. *Id.* at 518.

86. These swap arrangements were sophisticated derivative transactions between the defendants and investment-bank counterparties that gave the defendants all of the indicia of stock ownership except that the defendants did not have record ownership of the referenced CSX shares and did not have the legal right to vote those shares; both the record and voting right remained with the investment banks. *See, e.g., id.* at 519-20 (describing the mechanics of total return swaps).

87. When the defendants first filed a Schedule 13D disclosing that they had formed a group, they also publicly disclosed for the first time that they already had amassed ownership of approximately 8.3% of the outstanding CSX shares, and that they had entered into swap arrangements that referenced approximately an additional 11.8% of the outstanding CSX shares. *Id.* at 536.

88. “Beneficial ownership” is defined by Exchange Act Rule 13d-3, which provides in relevant part: “(a) For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relation-

the defendants violated Section 13(d) by failing to timely disclose the formation of a group.⁸⁹

CSX also asserted that the defendants violated Section 14(a) of the Exchange Act⁹⁰ by filing a preliminary proxy statement with the SEC that similarly failed to make these disclosures,⁹¹ further alleging that Behring, Hohn, and Amin were personally liable for the violations of Sections 13(d) and 14(a) as control persons under Section 20(a) of the Exchange Act.⁹² Finally, CSX argued that the defendants' Notice of Proposed Director Nominees and Bylaw Amendments (notice) failed to comply with CSX's Amended and Restated Bylaws (bylaws) because the notice failed to accurately identify the defendants' beneficial ownership of CSX stock despite the requirement in the bylaws that stockholders must disclose "the number of shares of capital stock of the Corporation that are owned beneficially and of record by such shareholder and such beneficial owner" in order to properly bring a nomination or other business before an annual meeting.⁹³

In response to CSX's claims, the defendants argued that they did not obtain beneficial ownership in the CSX stock referenced in the their swap arrangements because any economic

ship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) Investment power which includes the power to dispose, or to direct the disposition of, such security. (b) Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) or 13(g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security." 17 C.F.R. § 240.13d-3.

89. *Id.* at 538.

90. Section 14(a) and Rule 14a-9 thereunder govern the disclosures made in proxy statements. *See* 15 U.S.C. § 78n(a); 17 C.F.R. § 240.14a-9.

91. *CSX Corp.*, 562 F. Supp. 2d at 556-57.

92. *Id.* at 558. Section 20(a) of the Exchange Act states, "Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a) (2000).

93. *CSX Corp.*, 562 F. Supp. 2d at 560.

interests in CSX stock came via the swaps, which did not confer any voting, investment, or dispositive control over any CSX stock.⁹⁴

The court held that TCI used the swap arrangements with the purpose and effect of preventing beneficial ownership of the referenced CSX shares from vesting in TCI as part of a scheme to evade the reporting requirements of Section 13(d); thus, the court deemed that TCI beneficially owned those shares based on Rule 13d-3(b).⁹⁵ The court cited the following TCI actions as evidence that TCI should be deemed a beneficial owner of the CSX securities referenced in the swap arrangements: the chief financial officer of TCI Fund told its board that one of the reasons for using swap arrangements was “the ability to purchase without disclosure to the market or the company”; TCI emails discussed the need to make certain that its swap counterparties stayed below 5% share ownership in order to avoid triggering a disclosure obligation on the part of the counterparty; TCI admitted that one of its motivations in avoiding disclosure was to avoid paying a higher price for the shares of CSX that it expected would have occurred if its interests in CSX shares were disclosed to the market; and TCI acquired only 4.5% in physical CSX shares to remain safely below the 5% reporting requirement until it was ready to disclose its position.⁹⁶

Having determined that under Rule 13d-3(b), TCI was a beneficial owner of the CSX shares referenced in the swap arrangements due to its evasive behavior, the court decided not to rule on the legal question of whether TCI was the *per se* beneficial owner under Rule 13d-3(a).⁹⁷ However, the court did state that there were substantial reasons for concluding that TCI was the beneficial owner of the CSX shares referenced in the swap arrangements under Rule 13d-3(a): first, the court believed that TCI had the manifest economic ability to cause the investment banks with which it entered into the swap arrangements to buy and sell CSX shares; and second, it found reason to believe that TCI was in a position to influence the investment banks with respect to the exercise of their vot-

94. *Id.* at 546.

95. *Id.* at 548.

96. *Id.* at 548-49.

97. *Id.* at 548.

ing rights.⁹⁸ The court criticized TCI's argument that it did not have beneficial ownership of the shares because it had no legal right to direct the investment banks to buy, sell, or vote shares as exalting form over substance: "The securities markets operate in the real world, not in law school classrooms. Any determination of beneficial ownership that failed to take account of the practical realities of that world would be open to the gravest abuse."⁹⁹ ¹⁰⁰

The court then turned to the question of whether the defendants violated Section 13(d) because they failed to timely disclose that they had formed a group. The court noted that the touchstone of a group within the meaning of Section 13(d) is that the members combined in furtherance of a common objective.¹⁰¹ The court analyzed the defendants' activities and motives throughout the relevant period and found that they had formed a group under Section 13(d) as early as February 13, 2007—nine months prior to the date they filed a Schedule 13D with the SEC disclosing formation of a group.¹⁰² The court noted that all of the following had occurred prior to or on February 13, 2007: TCI and 3G had a close relationship for years; one of 3G's funds was an investor in TCI; Hohn and Behring discussed TCI's investment in CSX, including its approximate size; 3G began buying CSX shares shortly after the conversation between Hohn and Behring; and Hohn and Behring spoke about CSX as a result of market excitement regarding CSX attributable in whole or part to 3G's heavy buying of CSX shares. The court held that these circumstances all suggested that the defendants' activities were products of concerted action notwithstanding the defendants' denials.¹⁰³

98. *Id.* at 546.

99. *Id.* at 547.

100. The court also stated, "Some people deliberately go close to the line dividing legal from illegal if they see a sufficient opportunity for profit in doing so. A few cross that line and, if caught, seek to justify their action on the basis of formalistic arguments even when it is apparent that they have defeated the purpose of the law. This is such a case." *Id.* at 516.

101. *Id.* at 552.

102. *Id.* at 554.

103. *Id.* at 553. The court also found that it was undisputed that Hohn and Behring controlled TCI and 3G and that their actions plainly induced the Section 13(d) violations. As a result, the court found that Hohn and Behring were jointly and severally liable under Section 20(a) for the violations of Section 13(d). *Id.* at 559.

The court proceeded to analyze CSX's claims concerning the notice. It found unpersuasive CSX's argument that notice was deficient because defendants' statement of beneficial ownership did not include the shares referenced in the swap arrangements, even though these swap positions were disclosed in an annex to the notice.¹⁰⁴ The court stated that CSX was focusing on form over substance by disregarding the defendants' disclosure of the swap arrangements, albeit without characterizing the arrangements as conferring beneficial ownership.¹⁰⁵ Accordingly, the court ruled that the defendants complied with the notice requirements in substance, if not in all trivial particulars, because it satisfied the essential purpose of the notice to provide disclosure of the defendants' interest.¹⁰⁶ The court also advised that CSX drafted its own bylaws and could have defined beneficial ownership in a manner that would have required the precise disclosure that it contended was required.¹⁰⁷

Finally, the court addressed CSX's requests for relief regarding the defendants' violations of Section 13(d). While the court enjoined the defendants from committing further Section 13(d) violations, it refused to grant CSX's request for an injunction prohibiting the voting of any CSX shares owned by the defendants at the upcoming annual meeting.¹⁰⁸ The court held that, as a matter of law, a threat of irreparable injury was essential to obtain an injunction sterilizing any of the defendants' voting rights and that CSX had failed to establish such a threat.¹⁰⁹ The court found that while the defendants' action arguably altered composition of the corporate electorate, it did nothing more than increase their likelihood of prevailing in the current proxy contest, and therefore, could not be regarded as an irreparable injury to be properly remedied by preventing the defendants from voting their stock, regardless of whether the stock was acquired while the defendants were

104. *Id.* at 561.

105. *Id.*

106. *Id.* at 560.

107. *Id.* at 561.

108. *Id.* at 573.

109. *Id.* at 571.

in violation of Section 13(d).¹¹⁰ However, the court did state that if it were free to do so as a matter of law, it would have enjoined the defendants from voting the shares they acquired while in violation of Section 13(d), but that any penalties for the defendants' violations had to come by way of appropriate action by the SEC or the Department of Justice.¹¹¹

Despite the court's ruling that the dissidents violated the federal securities laws, RiskMetrics recommended a vote in favor of four of the five nominees put forward by the dissidents;¹¹² all four of those nominees were seated after the U.S. Court of Appeals for the Second Circuit affirmed the court's decision.¹¹³

IV.

DELAWARE SUPREME COURT HOLDS THAT PROPOSED BYLAW REQUIRING COMPANY TO REIMBURSE STOCKHOLDER FOR EXPENSES INCURRED IN UNSEATING DIRECTORS IS PROPER SUBJECT FOR ACTION BY STOCKHOLDERS

In *CA, Inc. v. AFSCME Employees Pension Plan*,¹¹⁴ a dispute arose out of AFSCME Employees Pension Plan's ("AFSCME") March 13, 2008 submission of a bylaw for inclusion in CA, Inc.'s ("CA") proxy materials for its upcoming annual stockholder's meeting. AFSCME's proposed bylaw directed that CA's "board of directors shall cause the corporation to reimburse a stockholder. . . for reasonable expenses incurred" in successfully unseating at least one CA director using a "short slate" of directors—a set of candidates running for fewer than half of the seats on CA's board (Proposed Bylaw).¹¹⁵ On April

110. *Id.* Moreover, the court granted CSX's request to recover the costs of the action from the defendants. The court denied all of the other claims and requests of the parties. *See id.* at 574.

111. *Id.* at 574.

112. *RiskMetrics Group – ISS Governance Services (ISS) Recommends CSX Shareholders Elect Four TCI/3G Board Nominees*, BUSINESS WIRE, June 17, 2008, http://findarticles.com/p/articles/mi_m0EIN/is_2008_June_18/ai_n27501877.

113. *See CSX Loses Appeal to Block TCI from Winning Two Seats*, BLOOMBERG, Sept. 15, 2008, <http://www.bloomberg.com/apps/news?pid=conewsstory&refer=conews&tkr=1187L%3AUS&sid=a33HM6oRkpng> (stating that the June 25 director vote showed "four nominees backed by TCI won seats on the 12-member board . . .").

114. 953 A.2d 227 (Del. 2008).

115. *Id.* at 230.

18, 2008, CA sent a letter to the SEC's Division of Corporation Finance ("Division") in which CA wished to exclude the Proposed Bylaw from its proxy materials because under Delaware law, it was not a proper subject for action by stockholders and would violate the law if implemented.¹¹⁶ CA also requested a "no-action letter" from the Division stating that the Division would not recommend any enforcement action to the SEC if CA excluded the Proposed Bylaw from its proxy materials.¹¹⁷ On May 21, 2008, AFSCME sent a letter to the Division arguing that the Proposed Bylaw did not conflict with Delaware law and could not be properly excluded from the proxy materials.¹¹⁸

Faced with two conflicting opinions on Delaware law about whether the Division could agree to CA excluding the Proposed Bylaw from its proxy materials, the SEC certified two questions to the Delaware Supreme Court: (1) Was the Proposed Bylaw a proper subject for action by stockholders as a matter of Delaware law? (2) Would the Proposed Bylaw, if adopted, cause CA to violate any Delaware law to which it was subject?¹¹⁹ On July 1, 2008, the court accepted the two questions for review, stating that there were "important and urgent reasons for an immediate determination of the questions certified."¹²⁰ Both CA and AFSCME submitted briefs in support of their positions and the court heard oral argument.

CA asserted that Sections 102¹²¹ and 141¹²² of the DGCL provide that any limits on the substantive decision-making authority of a board must be included in either the DGCL or the corporation's certificate of incorporation.¹²³ CA argued that

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* at 231.

120. *Id.*

121. Section 102(b)(1) provides that a certificate of incorporation may contain "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders". DEL. CODE ANN. tit. 8, § 102(b)(1).

122. Section 141(a) provides that the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE ANN. tit. 8, § 141(a).

123. *See CA, Inc.*, 953 A.2d at 230 (noting that CA's certificate of incorporation included language that mirrored Section 141(a) and fully empowered

neither the DGCL nor CA's certificate of incorporation limited the authority of CA's board over the reimbursement of proxy-related expenses or allowed stockholders to exert power over the reimbursement of such expenses.¹²⁴ CA also argued that the Proposed Bylaw usurped the decision-making authority of its board because it would be automatic in operation, leaving no role for board discretion about whether reimbursement of a subset of CA's stockholders' costs was in the best interests of CA and all of its stockholders. CA concluded that because the Proposed Bylaw would direct CA's board to automatically spend corporate funds on a particular matter, in a particular way, regardless of circumstances, the Proposed Bylaw intruded into the realm of exclusive discretionary board authority and violated the DGCL and CA's certificate of incorporation.¹²⁵

AFSCME contended that the Proposed Bylaw was an appropriate exercise of stockholder authority to adopt and amend corporate bylaws under DGCL Section 109 because it related to the process of director elections.¹²⁶ Under Section 109(b), a bylaw may "contain any provision, not inconsistent with law or the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."¹²⁷ AFSCME argued that Section 109 vests in stockholders the authority to adopt and amend corporate bylaws, and that the Proposed Bylaw would not be invalid solely due to the fact that stockholders voted to adopt it.¹²⁸ Finally, AFSCME asserted that there was nothing in the DGCL or CA's certificate of incorporation that would render invalid a bylaw requiring CA to reimburse proxy ex-

the board of directors to manage the affairs and business of CA); *id.* at 234 (noting CA's argument that the proposed Bylaw can only be in CA's Certificate of Incorporation, as distinguished from its bylaws, because Section 102(b)(1) contemplates that any provision that limits the broad statutory power of the directors must be contained in the certificate of incorporation).

124. *Id.* at 234.

125. *Id.*

126. *Id.* at 233.

127. 8 DEL. CODE ANN. tit. 8, § 109(b).

128. 953 A.2d at 233.

penses incurred in connection with a successful campaign to elect directors to the board.¹²⁹

As to the first question, the court held that the Proposed Bylaw was a proper subject for stockholder action,¹³⁰ stating that “[i]t is well established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.”¹³¹ The court acknowledged that the wording of the Proposed Bylaw was couched in terms of a substantive mandate to expend corporate funds, but concluded that the Proposed Bylaw had “both the intent and the effect of regulating the process for electing directors of CA.”¹³² It further held that the purpose of the Proposed Bylaw was “to promote the integrity of [the] electoral process by facilitating the nomination of director candidates by stockholders,”¹³³ which the Proposed Bylaw aimed to accomplish “by committing the corporation to reimburse the election expenses of shareholders whose candidates are successfully elected.”¹³⁴

However, the court also answered the second question in the affirmative, holding that the Proposed Bylaw would violate Delaware law if enacted by CA’s stockholders.¹³⁵ The court held that the Proposed Bylaw “would violate the prohibition. . . against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders”;¹³⁶ that the Proposed Bylaw mandated “reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude”;¹³⁷ and that where a proxy contest was “motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation, the board’s fiduciary duty could compel that reimbursement be

129. *Id.*

130. *Id.* at 235-36.

131. *Id.* at 234-35.

132. *Id.* at 235-36.

133. *Id.* at 237.

134. *Id.*

135. *Id.* at 238.

136. *Id.*

137. *Id.* at 240.

denied altogether.”¹³⁸ The court stated that, as drafted, the Proposed Bylaw obligated the directors to grant only the reasonable expenses of a successful short slate but would not allow CA’s directors to exercise their fiduciary duty to decide whether or not it was appropriate to award reimbursement at all.¹³⁹

V.

DELAWARE CHANCERY COURT DISMISSES FIDUCIARY DUTY CLAIMS WHERE BOARD AGREED TO MERGER WITH TERMINATION FEE DESPITE RECOGNIZING THAT STOCKHOLDERS WERE UNLIKELY TO APPROVE PROPOSED MERGER

In *In re Lear Corporation Shareholder Litigation*, the Delaware Chancery Court dismissed plaintiffs’ claims seeking damages from the board of Lear Corporation (“Lear”) for agreeing to pay a bidder a termination fee payable upon a no vote on a merger in exchange for the bidder increasing its bid, even though the board allegedly knew it was improbable that the stockholders would approve the deal.¹⁴⁰ Specifically, the court ruled that, under the business judgment rule, directors are free to adopt a merger agreement and seek stockholder approval of the merger, provided they act in good faith and believe that the stockholders will benefit, even if they recognize that the company’s stockholders are unlikely to support the proposal.¹⁴¹

In the instant case, the dispute arose out of a proposed merger between Lear and Carl Icahn, his fund, and its subsidiaries (collectively, “AREP”).¹⁴² Originally, the parties agreed to a merger price of \$36 per share, subject to approval of the Lear stockholders.¹⁴³ While the price was only a 3.8% premium over the closing price before AREP’s first public bid, it

138. *Id.*

139. *Id.* The court concluded by stating, “Those who believe that CA’s shareholders should be permitted to make the [P]roposed Bylaw as drafted part of CA’s governance scheme, have two alternatives. They may seek to amend the Certificate of Incorporation to include the substance of the [Proposed] Bylaw; or they may seek recourse from the Delaware General Assembly.” *Id.* (emphasis in original).

140. C.A. No. 2728-VCS, 2008 WL 4053221, at *1 (Del. Ch. Sept. 2, 2008).

141. *Id.* at *9.

142. *Id.* at *2.

143. *Id.*

was a 46.4% premium over the price of Lear's stock on the date when Icahn substantially increased his equity interest in Lear—an event which resulted in substantial upward momentum in Lear's stock price.¹⁴⁴ The merger agreement provided for a 45 day post-signing market check, but no topping bids were made.¹⁴⁵

After the proposed merger was announced, three proxy voting advisory services (ISS, Glass Lewis, and Proxy Governance) recommended that Lear stockholders vote against the merger.¹⁴⁶ Prior to the stockholder vote on the merger, the special committee of Lear's board was also advised that the reaction of its largest stockholders to the deal was mixed and that many thought that improved terms were warranted.¹⁴⁷ Based on this information, as well as the fact that the proxies submitted to date were against the merger, the special committee authorized its chairman and Lear's CEO to collaborate in negotiating improved terms with Icahn.¹⁴⁸ Eventually, the negotiations bore fruit and AREP agreed to pay an additional \$1.25 per share in exchange for a fee of \$25 million in the event that Lear's stockholders voted down the deal (no-vote termination fee).¹⁴⁹ When the vote on the revised merger was held, the stockholders rejected it.¹⁵⁰

After the vote, plaintiffs amended their previously-filed complaint to state a derivative claim without making a demand on the board, based on the theory that the Lear board breached its fiduciary duties when it granted AREP the no-vote termination fee in exchange for the \$1.25 per share increase in its offer price.¹⁵¹ Plaintiffs did not allege that a majority of the board was interested or not independent.¹⁵² Further, Lear's charter contained a Section 102(b)(7) exculpatory provision.¹⁵³ Thus, in order to state a claim, plaintiffs were required to plead specific facts that supported the inference that

144. *Id.*

145. *Id.* at *3.

146. *Id.* at *4.

147. *Id.*

148. *Id.*

149. *Id.* at *5.

150. *Id.* at *6.

151. *Id.*

152. *Id.*

153. *Id.* at *7.

the Lear directors breached their duty of loyalty by acting in bad faith.¹⁵⁴ Plaintiffs argued that bad faith was shown because the board knew that the \$1.25 per share increase would not result in the stockholders approving the merger, rendering the no-vote termination fee a gift to AREP.¹⁵⁵ Plaintiffs also alleged that the board did not have a basis for concluding that the offer price was financially advantageous to Lear's stockholders, and thus, knew that offer price was unfair.¹⁵⁶

The court held that plaintiffs' "argument is not the stuff of which viable derivative complaints are made" and dismissed the case.¹⁵⁷ The opinion began by stating that plaintiffs had not even created the inference of gross negligence on the part of the directors required to state a duty of care claim, and thus, certainly did not satisfy the far more difficult task of showing bad faith in order to state a duty of loyalty claim.¹⁵⁸ The court explained that "[d]irectors are entitled to make good faith decisions even if the stockholders might disagree with them. Where, as here, the complaint itself indicates that an independent board majority used an adequate process, employed reputable financial, legal, and proxy solicitation experts, and had a substantial basis to conclude a merger was financially fair, the directors cannot be faulted for being disloyal simply because the stockholders ultimately did not agree with their recommendation."¹⁵⁹ In addition, the court found that plaintiffs' primary argument of bad faith was not even supported by the complaint, which itself conceded that there was a chance that the stockholders would approve the merger.¹⁶⁰ "Thus, the plaintiffs [were] in reality down to the argument that the Lear board did not make a prudent judgment about the possibility of success. That is, the plaintiffs [were] making precisely the kind of argument precluded by the business judgment rule."¹⁶¹

Having decided that plaintiffs' claim was precluded by the business judgment rule, the court stated that plaintiffs did "not

154. *Id.*

155. *Id.*

156. *Id.* at *8.

157. *Id.* at *9.

158. *Id.* at *7.

159. *Id.* at *1.

160. *Id.* at *9.

161. *Id.*

come close to pleading facts suggesting that the Lear directors ‘consciously and intentionally disregarded their responsibilities’ and thereby breached the duty of loyalty.”¹⁶² The court further explained that “[i]n the transactional context, a very extreme set of facts would seem to be required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties,” and advised that courts should be “extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith.”¹⁶³ Specifically, the court held that it would be inconsistent with the business judgment rule to sustain a complaint grounded in the concept that directors act disloyally if they adopt a merger agreement in good faith simply because stockholders might, or even almost certainly would, reject it.¹⁶⁴

The court also noted the role that proxy advisory firms played in the case. As noted above, three proxy advisory firms recommended that Lear stockholders vote against the merger when AREP was offering \$36 per share.¹⁶⁵ When the offer price increased to \$37.25 per share, ISS reiterated its previous negative recommendation and suggested that Lear stockholders were better off holding on to their shares.¹⁶⁶ In particular, ISS questioned why the board agreed to the no-vote termination fee in light of the fact that in certain other deals, bidders had raised their bids in order to obtain stockholder approval without demanding a quid pro quo.¹⁶⁷ In fact, the complaint relied heavily on the fact that the board was advised that a price increase to \$37.50 to \$38.00 per share may have been necessary to get an affirmative recommendation from ISS.¹⁶⁸ In response, the court stated:

[T]he notion that directors might face a loyalty claim for failing to secure the approval of a proxy advisory firm, such as ISS, before adopting a merger agreement is not one consistent with the tradition of our

162. *Id.* at *11.

163. *Id.*

164. *Id.* at *12.

165. *Id.* at *4.

166. *Id.* at *6.

167. *Id.*

168. *Id.* at *9.

law. Such firms have no ownership stake in the corporation's shares and owe no duties to it. Their shifting sentiments are part of the business landscape boards must now address in seeking proxies, but directors who believe in good faith that a merger is good for the corporation's actual stockholders are entitled to push for its approval, irrespective of whether the merger is one that the proxy advisory firms might not ultimately favor.¹⁶⁹

VI.

LIMITS ON THE EXERCISE OF BOARD AND STOCKHOLDER POWER

While courts have generally supported both the decisions of directors and stockholders' proxy efforts, there are limits on what will pass muster in each instance; courts will rule against the respective parties when they feel it is necessary to protect the other from an improper exercise of power.

For example, in *Apache Corp. v. New York City Employees' Retirement System*, the court found that Apache Corporation ("Apache") properly excluded a stockholder proposal from the proxy statement that Apache mailed to its stockholders.¹⁷⁰ The proposal provided, in part: "The Shareholders request that management implement equal opportunity policies based on the aforementioned principles prohibiting discrimination based on sexual orientation and gender identity."¹⁷¹ The proposal sought, among other things, to have Apache implement policies incorporating sexual orientation and gender identity into the company's employee benefits allocation, corporate advertising and marketing activities, sales activities, and charitable contributions.¹⁷² The court found that Apache was permitted to exclude the proposal because it "deals with a matter relating to the company's ordinary business operations."¹⁷³

169. *Id.* at *12. The court noted that "[w]ith Lear's stock price now trading around \$13 per share – less than the range it was in before Icahn made his first purchases in March 2006 – many Lear stockholders might wish they had taken the recommendation of their directors to accept \$37.25 per share." *Id.*

170. No. H-08-1064, 2008 WL 1821728 (S.D. Tex. Apr. 22, 2008).

171. *Id.* at *6.

172. *Id.*

173. *Id.*

The court also found that the proposal sought to micromanage the company to an unacceptable degree.¹⁷⁴

Similarly, in *Ryan v. Lyondell Chemical Co.*, a dispute arose out of a \$13 billion cash-for-shares merger that offered Lyondell Chemical Company (“Lyondell”) stockholders a 45% premium over the closing price on the last trading day before public announcement of the proposed transaction, which the Lyondell stockholders overwhelmingly approved.¹⁷⁵ Despite the substantial premium and stockholder support, the court denied the director defendants’ motion for summary judgment concerning plaintiff’s *Revlon*¹⁷⁶ claims and his challenges to the deal protection measures included in the merger agreement.¹⁷⁷ The court found that the board took no affirmative action to confirm that a better deal could not be obtained; that the record did not show that the board was so knowledgeable about the value of Lyondell that no further effort was appropriate;¹⁷⁸ and that the directors were not able to explain why the deal protection measures adopted were appropriate under the circumstances—the merger agreement included a no-shop provision, matching rights, and a \$385 million break-up fee.^{179 180}

174. *Id.*

175. No. 3176-VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008), *rev'd*, 2009 WL 1024764 (Del. Mar. 25, 2009).

176. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

177. *Ryan v. Lyondell Chem. Co.*, 2008 WL 2923427, at *3.

178. *Id.* at *2.

179. *Id.* at *3.

180. On March 25, 2009, the Delaware Supreme Court reversed the Chancery Court’s denial of the defendants’ motion for summary judgment. Specifically, the Delaware Supreme Court held that in the sale process, “an extreme set of facts is required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties” and the judicial inquiry is limited to “whether those directors utterly failed to attempt to obtain the best sale price.” *Lyondell Chem. Co. v. Ryan*, 2009 WL 1024765 (Del. Mar. 25, 2009). For a more detailed discussion of the Delaware Supreme Court’s decision and its significance, see “Delaware Supreme Court Defines Limits of Revlon Duties in a Change of Control,” Wilson Sonsini Goodrich & Rosati Alert, Mar. 30, 2009, *available at* http://www.wsg.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgalert_revlon_duties.htm.

CONCLUSION:
POTENTIAL IMPLICATIONS OF A STOCKHOLDER- CENTRIC MODEL
OF GOVERNANCE FOR CORPORATE GOVERNANCE LITIGATION

These cases demonstrate that courts will continue to carefully scrutinize a board's decision to tamper with the corporate machinery but simultaneously give the board substantial deference on fundamental issues of business judgment. In fact, one could say that the most striking reality about the legal landscape during the growth of a stockholder-centric governance movement is how little change there has been in the fundamental legal rules governing director conduct, particularly when contrasted with the very dramatic changes occurring on the broader corporate governance landscape.¹⁸¹

Recently, Delaware's definition of a director-centric model of governance was eloquently described by Vice Chancellor Strine, one of the country's most brilliant corporate law scholars, in the *Lear* opinion. By dismissing the claims against the directors, the Vice Chancellor definitively rejected the notion of directors' liability for following a course of conduct unfavored by a majority of shareholders. Indeed, the court held that such an argument is:

grounded in a fundamental misunderstanding of the role of a director of a Delaware corporation. Directors are not thermometers, existing to register the ever-changing sentiments of stockholders. Directors are expected to use their own business judgment to advance the interests of the corporation and its stockholders. During their term of office, directors may take good faith actions that they believe will benefit stockholders, even if they realize stockholders do not agree with them.¹⁸²

Yet, in today's marketplace for corporate control, a very different view has taken hold. This view provides that stockholders should be making decisions about the corporation

181. Perhaps recognizing this fact, Carl Icahn recently stated that he intends to use his "blog as a forum and a focal point to push for legislative changes to make corporate managements more accountable to shareholders." The Icahn Report: September 2008, <http://www.icaohnreport.com/report/2008/09/index.html> (last visited Dec. 2, 2008).

182. In re *Lear*, No. 2728-VCS, 2008 WL 4053221, at *12 (Del. Ch. Sept. 2, 2008).

and that directors should act primarily (if not exclusively) in accordance with the views of stockholders. Having gained considerable currency among many, this view, has resulted in great battles for corporate control moving from the courtroom to the boardroom and on to the marketplace. While many of the most significant takeover battles of the 1980s and 1990s were decided in court—and became the names of famous legal standards, such as *Revlon*, *Unocal*, *Time-Warner*, and *QVC*—what is perhaps most striking is that today's great takeover battles are being decided by boards and stockholders outside the courtroom. Thus, while there has recently been significant hostile M&A activity and stockholder activism for such prominent companies as Yahoo, Dow Jones, the New York Times, and Anheuser-Busch, these battles did not lead to any significant legal decisions or litigations. Perhaps this is the best evidence of the strength of the stockholder-centric model of governance; stockholders no longer believe that their only alternative to a decision they do not agree with is to sue the board.