Target's Challenge

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Despite the general economic downturn and the huge losses sustained by many corporate activist funds, this proxy season is already proving to be more contentious and active than last year. It also appears that we have our first hands-down battle brewing — the one between Bill Ackman's Pershing Square Capital and Target Corporation.

According to Factset SharkWatch, which looked at definitive proxy statements filed as of March 25, there are already more shareholder proposals than in the comparable period a year ago. So far, 283 shareholder proposals have been disclosed, compared with 252 for the same period last proxy season.

The rise is largely attributable to proposals on corporate governance issues. These are proposals related to boards of directors, takeover defenses and executive compensation, and they have increased to 199 this year, versus 174 in the same period last year.

Takeover defenses continue to be a target for corporate governance activists, Factset SharkWatch reports. So far this year, 81 proposals on takeover defenses have been disclosed. This figure is up from 61 in the same period last year.

Among these, attempts to declassify boards are again the No. 1 proposal, Factset SharkWatch says. There have been 29 such proposals year to date, down slightly from 32 in same period in 2008.

The biggest jump is in the number of proposals seeking to grant shareholders the right to call special meetings. There have thus far been 21, versus 10 in the comparable period in 2008.

In the most contentious arena, proxy contests, it appears that we are on pace to surpass last year's record total. As of March 25, Factset SharkWatch reports that 71 proxy fights for board seats at United States companies have been announced. At the same point last year, 69 had been announced.

All this activity is occurring despite a recent hesitancy among shareholder activists. As The New York Times reported last week, The Children's Investment Fund has essentially turned its back on shareholder activism after suffering losses of more than 40 percent on its investment in CSX.

Activist investors made just 59 new investments last month, compared with 87 a year earlier, according to Hedge Fund Solutions.

Nonetheless, it appears that this hesitancy may not be affecting the overall trend toward shareholder activism and the desire to seek potential profits in a down market. In other words, new activists may be springing up to take the mantle from those driven away or in hibernation. And some of these contests may be legacy ones related to investments from a prior year.

This leads us back to the attempts by Mr. Ackman at Pershing Capital to elect up to five directors to the board of Target, the discount retail chain. As is well known, Pershing has endured some tremendous losses with its investment in Target. Last year, its dedicated fund for this investment lost more than 90 percent in value. Mr. Ackman's funds still have an ownership interest in Target of 7.9 percent, consisting of shares and call options.

Pershing only nominated its candidates on March 16, but the parties are already squabbling over the number of directors that can be nominated to the board. Target currently has a staggered board, with 12 directors. Four of these directors are up for reelection for this year's meeting, scheduled to be held on May 28.

However, when Pershing submitted its nominees to the board, it submitted five nominees. Pershing claimed at the time that the board really comprises 13 members. Its claim of an extra member relates to Robert J. Ulrich's resignation from the board in January 2009. Pershing contends that, under Target's articles of incorporation, the board does not automatically shrink as a result of a resignation; rather, a vacancy is created — in this case, a vacancy for a 13th director to be elected this year.

Pershing bases its claim on Article VI of Target's articles of incorporation. The article states that:

The business and affairs of the corporation shall be managed by or under the direction of a Board of Directors consisting of not less than five nor more than twenty-one persons, who need not be shareholders. The number of directors may be increased by the shareholders or Board of Directors or decreased by the shareholders from the number of directors on the Board of Directors immediately prior to the effective date of this Article VI; provided, however, that any change in the number of directors on the Board of Directors (including, without limitation, changes at annual meetings of shareholders) shall be approved by the affirmative vote of not less than seventy-five percent (75%) of the votes entitled to be cast by the holders of all then outstanding shares of Voting Stock (as defined in Article IV), voting together as a single class, unless such change shall have been approved by a majority of the entire Board of Directors."

(emphasis added)

Pershing bases its argument on the italicized language, which states that only a 75 percent vote of the shareholders can reduce the size of the board. Target has disputed this claim, presumably relying instead upon the clause after the italicized language, which provides the power to the board to approve the change.

Target is claiming that the clause modifies the entire requirement for shareholder approval. In contrast, I presume that Pershing is claiming that this language modifies only the part about a 75 percent vote requirement, and otherwise a shareholder vote is mandatory. The ambiguity is certainly there, and given the penchant of courts to interpret articles and bylaws against the drafting companies and in favor of the shareholder franchise, Pershing has a viable claim. It would be more certain if Target were incorporated in Delaware, but it is actually incorporated in Minnesota.

Last week, Pershing offered to arbitrate the issue. Instead, Target has simply and rather cleverly put the matter to its shareholders in its proxy filed Monday. Target has ceded the issue to its shareholders, and asserted that because the change has been approved by a majority of the board of directors, it now only needs the affirmative vote of the majority of the outstanding shares of Target common stock voting at a meeting where the quorum requirement is met. Thus, Target has avoided an initial litigation skirmish that it had a real chance of losing, while appearing shareholder-friendly at the same time. A nice trick.

In case you are wondering, only Pershing has nominated a fifth director to take office if the resolution does not pass and Target's board remains at 13 members. Pershing Square's fifth nominee is Ronald Gilson, a professor of law at Stanford and Columbia. Mr. Gilson is following in the shoes of Lucian Bebchuk, the Harvard professor that Carl Icahn nominated for the Yahoo board last year.

Thus, if Target doesn't win the proposal and Pershing stays with five nominees, one of Pershing's nominees is automatically elected (given that Target is going with four nominees regardless of whether the proposal passes). So if shareholders want to elect only Target's four nominees and none of Pershing's, they will vote for the four nominees and for the proposal.

Ultimately, this is a small matter highlighting the way that ambiguous bylaw or articles provisions can work against a company, but also a precursor to what looks to be a true shareholder activist battle. In the meantime, we await to see if the remaining shareholder activists spur any other battles along the lines of last year, when the CSX and CNET Networks shareholder proxy contests ended in landmark court decisions.

One can only hope. But in the end, this is all a sign of the enduring power of shareholder activism, particularly by hedge funds.