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STRUCTURAL DEFENSES TO SHAREHOLDER ACTIVISM

Institutional investors and the influential shareholder advisory services have become persistently and famously critical of structural defenses that companies may implement to defend against hostile takeover bids and shareholder activism. Nonetheless, the rising tide of shareholder activism leads the authors to suggest that public companies should analyze their defenses against such challenges. In this article, they review the most important structural defensives available to companies from a legal and business perspective.

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The surge of shareholder activism in recent years has featured highly experienced and well-capitalized activists. Activist investors, who acquire a small stake and then demand change under the threat of a proxy fight, have emerged as the most prevalent challengers to the incumbency and leadership of corporate directors. The recent collaboration of an activist hedge fund, Pershing Square, and a strategic bidder, Valeant Pharmaceuticals, in their unsolicited bid for Allergan has additionally raised the specter of a new wave of hostile takeover activity utilizing shareholder activism strategies.[1] Activism, as an investment strategy, enjoyed remarkable successes in recent years. Activist hedge funds returned around 16.6% to their investors in 2013 compared with an industry-wide average of 9.3%.[2] In turn, institutional investors are increasingly supporting activists, behind the scenes and sometimes openly, with funding and votes at the ballot box. Ten years ago, 36% of proxy contests initiated by activists resulted in settlements or victories for activists. This success rate

[1] In 2014, there have been only two hostile takeover bids for U.S. companies to date and there were only five hostile takeover bids in 2013. This is compared to 160 in 1988, when every board lived in fear of a hostile takeover fight. FACTSET MERGERS, https://www.factsetmergers.com (last visited Apr. 30, 2014); *see also* Steven M. Davidoff, *With Fewer Barbarians at the Gate, Companies Face a New Pressure*, DEALBOOK (Jul. 30, 2013, 1:49 PM), http://dealbook.nytimes.com/2013/07/30/with-fewer-barbarians-at-the-gate-companies-face-new-pressure.

[2] *Activists Trump Most Rival Hedge Funds with Double-Digit Returns*, REUTERS, Jan. 8, 2014, http://www.reuters.com/article/2014/01/08 (citing data from HEDGE FUND RESEARCH, https://www.hedgefundresearch.com). This firepower has in turn been used to target ever larger companies. In the past three years, activism against mid-cap companies with more than a $2 billion market cap increased approximately 230%. ACTIVIST INSIGHT, http://www.activistinsight.com. Activism against large-cap companies with more than a $10 billion market cap increased approximately 104%. *Id.*

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soared to 60% in 2013 and has been 77% for 2014 to date.[3] These successes have predictably attracted imitators. According to some calculations, there are currently at least 200 hedge funds employing activist strategies.[4] The sheer number of activist campaigns and proxy fights points to the continuing rise of shareholder activism: 2013 saw 219 reported campaigns, including 90 proxy fights,[5] and these are only the known cases. Many activist situations emerge, and are resolved, under the public's radar. In light of these developments, many observers are speaking of a "golden age" of activist investing.[6]

In this new era of shareholder activism, a public company should review not only its business plan, board composition, and investor relations, but also its structural defenses to shareholder activist campaigns. Companies pursuing an initial public offering (IPO) are particularly well advised to ensure that they go public with the best and most sophisticated defenses available, at least to the extent that the desired defensive measures do not jeopardize the marketing of the IPO. Powerful defenses against activism can be easily included in the charter of a company before it goes public, but it may be difficult to obtain the requisite stockholder approval for adding such defenses to the charter following an IPO. This is especially the case in today's climate, where institutional stockholders and proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis & Co. are encouraging companies to scale back their defenses. The proxy advisory services are persistently critical of corporate policies that could be viewed as interfering with the stockholder franchise.[7]

This article elaborates on the most important structural defenses available to public companies facing immediate or potential proxy contests or activism campaigns, and the discussion will focus on Delaware law. Not every defense will benefit every company when all considerations are weighed. Such considerations include the drawbacks of inviting criticism from institutional stockholders and proxy advisory services, the limiting effects and potentially costly consequences of running afoul of state law or the federal securities laws, and tax ramifications. Also, as a general matter, a board is well advised to implement structural defenses before an activist targets the company. Defensive measures adopted in response to a proxy contest or other activist efforts are likely to be subject to enhanced or even strict scrutiny by the Delaware courts and may receive a negative reaction from the proxy advisory firms, investors, and the media. While the analysis will be similar for companies in most other states, it is important to review the applicable state statutes and corporate law when analyzing the structural defenses of corporations incorporated outside Delaware.

1. MULTI-CLASS CAPITAL STRUCTURES

The best structural defense against shareholder activism is a controlling stockholder or another management-friendly stockholder with a large stake. Companies with these types of stockholders are not easily threatened by a proxy fight. As a result, activists typically stay away from these companies because activists lack the leverage of a proxy contest to push for change. A structure designed to ensure management-friendly control after an IPO is the "multi-class capital structure" (also known as "dual class capital structure").

While most IPO companies have a single class of common stock that provides the same voting and economic

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[3] SHARKREPELLENT, https://www.sharkrepellent.net (last visited Apr. 30, 2014) [hereinafter SHARKREPELLENT].

[4] *Activist Investor Project: Top 200 Activist Hedge Funds*, NATIONAL INVESTOR RELATIONS INSTITUTE, http://www.niri.org/Other-Content/Top200HedgeFunds.aspx (last visited May 1, 2014).

[5] SHARKREPELLENT, *supra* note 3.

[6] John Carney, *Welcome to the Golden Age of Activist Investors*, CNBC (Aug. 14, 2013, 3:37 PM), http://www.cnbc.com/id/100963166; Nathan Vardi, *The Golden Age of Activist Investing*, FORBES (Aug. 6, 2013, 8:25 AM), http://www.forbes.com/sites/nathanvardi/2013/08/06/the-golden-age-of-activist-investing.

[7] For given defensive provisions, the annual percentages of IPO companies implementing any given provision is generally higher than the percentage of post-IPO companies nationwide that have the provision. *See 2013 M&A Report*, WILMERHALE, http://www.wilmerhale.com/2013MAreport [hereinafter WILMERHALE, *2013 M&A Report*]; *see also infra* notes 8, 23, 55, 63, 142.

rights to every stockholder (a "one share, one vote" model), more and more companies go public with a multi-class capital structure.[8] Under this structure, a few specified pre-IPO stockholders (typically the founders) receive shares of common stock that are entitled to multiple votes per share, while the public is issued a separate class of common stock that is entitled to only one vote per share.[9] Companies with multi-class capital structures are typically safe from shareholder activism because the holders of the high-vote class of common stock are able to retain voting control over the company, making a proxy contest a fruitless exercise.

Few public companies, however, have a multi-class capital structure in place.[10] Although it is possible to introduce such a structure post-IPO, this is in most circumstances not realistic. The rules of the New York Stock Exchange and NASDAQ allow for the issuance of super-voting stock at the IPO stage but not after the company goes public.[11] Also, a company requires stockholder approval to introduce the structure, and institutional stockholders generally vote against proposals to create a dual class capital structure. ISS recommends voting against any proposals to create a new class of common stock, except in certain limited circumstances.[12]

2. BLANK CHECK PREFERRED STOCK

Blank check preferred stock means that the board is expressly empowered to determine the terms and conditions of authorized and unissued preferred stock. The primary purpose of blank check preferred stock is to raise capital, but it can also serve as an anti-shareholder activism device. First, blank check preferred stock facilitates the creation of a poison pill.[13] Second, a board can use blank check preferred stock to create a new series of preferred stock that has special voting, conversion or control rights, and sell such stock to a management-friendly third party (a "white squire"). A significant block of shares in the hand of a stockholder who is not interested in acquiring control of the company can make it more difficult or even impossible for an insurgent to win a proxy contest.

To create blank check preferred stock, a corporation must provide for the blank check preferred stock in its charter by authorizing a maximum number of shares of preferred stock that the corporation may issue and by granting to the board of directors the express authority to determine the voting rights, designations, preferences, rights and qualifications, and limitations or restrictions of such preferred stock.[14] Generally, preferred stock is convertible into common stock, its holders vote on an "as converted" basis, and it becomes redeemable upon a change of control. Once issued, the specific powers, rights, and preferences of the preferred stock can be set out in a certificate of designation and filed with the Delaware Secretary of State as an amendment to the charter.[15]

More important, however, a board's decision to issue stock must be consistent with the directors' fiduciary duties. Delaware courts have established a battery of controlling principles and legal tests to regulate the use of

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[8] In 2012, 13% of the IPO companies included a multi-class capital structure, as compared to 4% in 2007. *Id.*

[9] Most notably, Facebook, Google, LinkedIn, and Zynga went public with dual class capital structures.

[10] In 2012, 9% of the S&P 500 companies had a dual class capital structure. WILMERHALE, *2013 M&A* Report, *supra* note 7.

[11] NYSE, Listed Company Manual § 313.10 (2006) ("The restriction against the issuance of super-voting stock is primarily intended to apply to the issuance of a new class of stock, and companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super-voting stock without conflict with this Policy."); NASDAQ Stock Mkt., Inc., The Qualification, Listing and Delisting of Companies IM-5640 ("The restriction against the issuance of super-voting stock is primarily intended to apply to the issuance of a new class of stock, and Companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super-voting stock without conflict with this policy.").

[12] ISS, 2014 U.S. Proxy Voting Summary Guidelines 29 (Mar. 12, 2014) [hereinafter ISS Guidelines]. Also, ISS takes a multi-class capital structure into account as a negative factor when determining its recommendations for director elections. *Id.* at 11. The guidelines of Glass Lewis are silent on this subject. Glass Lewis & Co., Proxy Paper Guidelines: 2014 Proxy Season (2014) [hereinafter Glass Lewis Guidelines].

[13] *See infra* Section 15 (*Poison Pills*). While it is possible to create a poison pill using common stock, it is preferable to use preferred stock in order to avoid having to reserve for issuance (and thereby render unavailable for other uses) a substantial amount of the company's authorized and unissued shares of common stock. A modern poison pill is technically an issuance of warrants that initially represent the right to purchase 1/1000 of a share of preferred stock. Each 1/1000 of a share of preferred stock is usually designed to give a stockholder the same rights as one share of common stock. The purpose of using 1/1000 of a share of preferred stock instead of a full share is to minimize the number of authorized shares of preferred stock being used up. Blank check preferred stock allows the board to create such an equity security.

[14] 8 *Del. C.* §§ 151, 242(b).

[15] This is one of the rare instances in which the board of directors can effectively amend the charter without stockholder approval. 8 *Del. C.* § 151(a).

stock in the context of a prospective or pending proxy context. Depending on how and when a company issues stock, it will face different levels of judicial scrutiny. A company that issues stock with a sound business rationale before the advent of a contest for control is likely to be protected under the business judgment rule, which is generally deferential to the decisions of management.[16] Even if a company anticipates a proxy contest, it may still find protection under the business judgment rule if the court finds that the issuance of stock was designed more to enhance the company's business than to foil a would-be dissident at the ballot box.[17] On the other hand, if the company issues stock in the context of a takeover effort by an activist, the company could find its issuance reviewed in court under the *Unocal*[18] or *Revlon*[19] standards. If the company issues stock in a proxy context and appears to have done so for the "primary purpose" of thwarting the shareholder franchise, the company could face judicial review under either the *Unocal* or *Blasius*[20] standards. Finally, a company could find itself being reviewed under the demanding standard of entire fairness if a court has reason to believe that the issuance of stock occurred in a self-dealing context.[21] The takeaway is that although the analysis will always turn on the specific facts and circumstances, a company will usually be safer issuing stock before an activist emerges.

Most public companies have blank check preferred stock[22] and almost all IPO companies include this feature.[23] If a company is among the few that do not authorize the board to issue blank check preferred stock, stockholder approval is needed to change that policy.[24] In most circumstances, however, such approval may be difficult to obtain due to the impression created on stockholders. ISS and Glass Lewis generally recommend voting against the authorization of blank check preferred stock.[25]

[16] *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 285-86 (Del. Ch. 1989) (observing, for the purposes of extending business judgment protection, that the challenged transactions of the company had been "considered, reviewed and, in the case of the Preferred Stock issuance, negotiated, for several weeks, if not months, before [the dissident] announced the proxy contest").

[17] *Id.* (observing, for the purposes of extending business judgment protection, that although "[d]efendant directors were aware of the possibility of a proxy fight early . . . and . . . took that possibility into account[,] . . . . [the] directors were focusing more on ways to defeat [the dissident] in the market place than . . . at the polls").

[18] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Johnston v. Pedersen*, 28 A.3d 1079, 1089 (Del. Ch. 2011) ("When a board of directors takes action that affects the stockholder franchise, the board must justify its action under the enhanced scrutiny test."); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181 (Del. 1986) (stating that when a corporation exercises power to deal in its own stock "in an effort to forestall a hostile takeover, the board's actions are strictly held to the fiduciary standards outlined in *Unocal*" and that "[t]hese standards require the directors to determine the best interests of the corporation and its stockholders, and impose an enhanced duty to abjure any action that is motivated by considerations other than a good faith concern for such interests") (citing *Unocal*, 493 A.2d at 953-54); *cf. Williams v. Geier*, 671 A.2d 1368, 1377 (Del. 1996) ("*Unocal* analysis should be used only when a board unilaterally (*i.e.*, without stockholder approval) adopts defensive measures in reaction to a perceived threat.") (citing *Unocal*, 493 A.2d at 954-55).

[19] *Revlon*, 506 A.2d at 182 (holding that when a board of directors recognized that the company was for sale, the board's duties changed from the preservation of the company as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit).

[20] *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 652, 661 (Del. Ch. 1988); *cf. Williams*, 671 A.2d at 1376 ("[T]he application of the 'compelling justification' standard set forth in *Blasius* is appropriate only where the 'primary purpose' of the board's action [is] to interfere with or impede exercise of the shareholder franchise, and the stockholders are not given a 'full and fair opportunity to vote.'") (alteration in original) (quoting *Stroud v. Grace*, 606 A.2d 75, 92 (Del. 1992)) (internal quotation marks omitted); *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769, 776 (Del. Ch. 1967) (stating that where the objective sought in an issuance of stock was not merely the pursuit of a business purpose but also retention of control, the "control" effect of agreement cannot be considered "merely incidental to its primary business objective").

[21] *Keyser v. Curtis*, C.A. No. 7109-VCN, 2012 WL 3115453, at *12 (Del. Ch. July 31, 2012), *aff'd sub nom. Poliak v. Keyser*, 65 A.3d 617 (Del. 2013) (holding that an issuance of stock challenged on grounds of self-dealing was subject to entire fairness review).

[22] In 2013, approximately 94.93% of the S&P 500 companies had blank check preferred stock. *Takeover Defense Trend Analysis: 2013 Year End Snapshot*, SHARKREPELLENT, https://www.sharkrepellent.net [hereinafter SHARKREPELLENT, *2013 Year End Snapshot*].

[23] In 2012, 100% of the IPO companies included the provision in their governing documents, as compared to 78% in 2008. WILMERHALE, *2013 M&A* Report, *supra* note 7.

[24] 8 *Del. C.* § 242(b).

[25] ISS Guidelines, *supra* note 12, at 30; Glass Lewis Guidelines, *supra* note 12, at 38, 41.

3. CHARTER AND BYLAW AMENDMENTS

Structural defenses are best secured through charter provisions because stockholders cannot unilaterally amend the charter of a Delaware corporation.[26] Under the Delaware General Corporation Law ("DGCL"), charter provisions can be adopted, amended, or repealed only through a combination of board and stockholder approval.[27] For this reason, it is difficult to add structural defenses to the charter following a company's IPO because it may prove challenging for a board to obtain the required stockholder approval. Therefore, a company's board will want at least to be able to adopt bylaws unilaterally as a next-best means for implementing desirable defenses.

Bylaw Amendments by the Board

Under Delaware law, stockholders possess a "sacrosanct" right to adopt, amend, or repeal bylaws.[28] Boards, however, can obtain a right to unilaterally adopt, amend, or repeal the bylaws only if that power is granted in the charter.[29]

The charters of most large public companies and almost all IPO companies include this feature. If, however, such a provision is not already in place, a company requires stockholder approval to add it to the charter. Obtaining stockholder approval would not be impossible in this context. While ISS recommends that stockholders "vote against proposals giving the board *exclusive authority* to amend the bylaws," it recommends voting in favor of proposals giving the board the ability to amend the bylaws *in addition* to stockholders.[30]

Bylaw Amendments by the Stockholders

Stockholders' power to unilaterally adopt bylaws is one of the few inalienable powers stockholders have to directly change the ground rules of a corporation's governance.[31] Stockholders are empowered, specifically, to adopt bylaws that shape the "process and procedures" by which corporate decisions are made.[32] As such, stockholder-initiated bylaw amendments have become a preferred tool for activists seeking to advance their agendas for changing corporate leadership. Activists have proposed bylaw amendments that increase the number of directorships and that grant stockholders the power to fill newly created directorships. Activists have also proposed bylaws giving stockholders, rather than sitting directors, the power to fill vacancies on the board created by stockholder-initiated removals. Such amendments can allow activist stockholders to remove incumbent directors and appoint their replacements in a single meeting.[33]

A corporation can constrain the ability of activists to affect corporate control by requiring a higher threshold of stockholder votes for adopting bylaws. Although the default rule is that stockholders have the ability to propose and adopt a bylaw by at least a vote of the majority of stockholder voting power,[34] the charter or bylaws can require a supermajority vote for adopting any subsequent bylaw amendment. If such a provision is provided in a

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[26] 8 *Del. C.* § 242(b)(1)-(2) (requiring that after a corporation has received payment for its stock, a charter amendment first be proposed by the board of directors and then approved by stockholders entitled to vote thereon). An amendment generally requires only the approval of a majority of outstanding stock entitled to vote thereon, but § 242(b)(4) provides that the certificate of incorporation may require a greater than majority stockholder vote.

[27] *Id.*

[28] 8 *Del. C.* § 109(a); *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 232 (Del. 2008).

[29] 8 *Del. C.* § 109(a).

[30] ISS Guidelines, *supra* note 12, at 23 (emphasis added). Since it is impossible for boards in Delaware companies to have "exclusive" authority to amend bylaws if it means divesting stockholders of their own power to amend bylaws, 8 *Del. C.* § 109(a), this recommendation can be read to mean that ISS is opposed to giving boards the power to amend bylaws without

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stockholder consent. The Glass Lewis Guidelines are silent on this subject.

[31] 8 *Del. C.* § 109(a).

[32] This power, although inalienable, is not unlimited in scope. Stockholder-adopted bylaws cannot usurp from directors the power to manage the business affairs of the corporation. *CA, Inc.*, 953 A.2d at 234-35 ("[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."); *see also Kurz v. Holbrook*, 989 A.2d 140, 157 (Del. Ch. 2010), *rev'd on other grounds*, *aff'd in part sub nom. Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377 (Del. 2010) (holding that a bylaw provision cannot impose a requirement that would disqualify a sitting director and terminate his service).

[33] The default rule is that directors make director appointments to fill vacancies on the board between elections. 8 *Del. C.* § 223(a); *see infra* Section 8 (*Removal of Directors*).

[34] 8 *Del. C.* § 109(a) provides stockholders with the power to amend the bylaws but does not provide a default voting standard; David A. Drexler, Lewis S. Black, Jr. & A. Gilchrist Sparks, III, Del. Corp. Law & Practice § 9.04 (2013).

company's charter, it cannot be altered, amended, or repealed except by the same supermajority vote.[35]

Although most IPO companies include a supermajority requirement for bylaw amendments in their organizational documents,[36] many public companies do not have this defense.[37] Where the company seeks to impose the supermajority requirement through an amendment to the bylaws as opposed to the charter, case law is not decisive as to whether that amendment can only be adopted by a vote of the same supermajority of stockholders that such amendment would impose on stockholders thereafter seeking to adopt subsequent bylaw amendments.[38] A supermajority bylaw adopted unilaterally by a board, in the face of an incipient challenge to incumbent leadership, could trigger "compelling justification" review and be struck down in court on the basis of equity.[39] From a legal standpoint, obtaining stockholder approval for a supermajority-requiring bylaw would perhaps pose less risk of being struck down on the basis of equity, although courts have yet to resolve the question whether the power to amend bylaws requires not only nothing less than, but also nothing more than, a majority of stockholder voting power.[40] From a practical standpoint, at any rate, obtaining stockholder approval for such a bylaw could be challenging due to the strongly negative views of institutional investors and proxy advisory services regarding supermajority requirements.[41]

4. ANNUAL DIRECTOR ELECTIONS VS. CLASSIFIED BOARDS

The Delaware default rule provides for all directors to be elected annually.[42] However, a company may also organize its directors into two or three "classes," with the directors of each class facing election every two or three years.[43] Such a "classified" or "staggered" board is among the strongest defenses to proxy contests for corporate control. Although implementation of the classified structure has declined significantly in the past decade,[44] it is still common for companies to include this feature in the governing documents at the IPO stage.[45] The chief advantage from an incumbent perspective is that an insurgent cannot take control of a board in a single proxy

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[35] 8 *Del. C.* § 242(b)(4) ("Whenever the certificate of incorporation shall require for action . . . by the holders of any class or series of shares or by the members, or by the holders of any other securities having voting power the vote of a greater number or proportion than is required by any section of this title, the provision of the certificate of incorporation requiring such greater vote shall not be altered, amended, or repealed except by such greater vote.").

[36] In 2012, 71% of IPOs of Delaware corporations included this requirement, as compared to 44% in 2009. WILMERHALE, *2013 M&A Report*, *supra* note 7.

[37] In 2013, approximately 29.60% of the S&P 500 companies had this feature, down from approximately 67.62% in 2003. SHARKREPELLENT, *2013 Year End* Snapshot, *supra* note 22.

[38] Drexler et al., *supra* note 34, at § 9.04.

[39] *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000) (applying the "compelling justification" standard to strike down a board-adopted supermajority bylaw, where the board's "primary purpose" was to impair stockholders' ability to win a consent solicitation, on the basis that the company acted to "interfere with or impede . . . the shareholder franchise") (alteration in original) (quoting *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1995)) (internal quotation marks omitted) (citing *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 662-63 (Del. Ch. 1988)); *cf. Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971) (striking down a board-created bylaw advancing the stockholders meeting on the basis that authorized action under bylaws may not be permissible if the effect is to inequitably violate "established principles of corporate democracy"). In view of that principle, a board would be taking the greatest risk of having the bylaw struck down by adopting unilaterally the supermajority amendment. A board would take the second most risky action by proposing the amendment to stockholders and then soliciting only a majority stockholder vote (as opposed to a supermajority vote mirroring the same standard that would be subsequently imposed by the

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amendment). A board would take the least risk by proposing the amendment and then soliciting stockholder approval by the same supermajority that such amendment would subsequently impose on stockholders seeking to adopt bylaw amendments.

[40] 8 *Del. C.* § 109(a) provides stockholders with the power to unilaterally amend bylaws but does not explicitly state a voting standard. It is presently unclear if the majority voting generally imputed to stockholder power under § 109(a) constitutes both a floor and a ceiling for the exercise of such power.

[41] ISS Guidelines, *supra* note 12, at 28; Glass Lewis Guidelines, *supra* note 12, at 40. Also, ISS takes supermajority voting requirements into account as a negative factor when determining its recommendations for director elections. ISS Guidelines, *supra* note 12, at 11.

[42] 8 *Del. C.* § 211(b).

[43] *Id.* § 141(d).

[44] In 2013, only approximately 11% of the S&P 500 companies had a classified board, down from approximately 57.17% in 2003. SHARKREPELLENT, *2013 Year End* Snapshot, *supra* note 22.

[45] In 2012, 85% of IPOs of corporations included a classified board as part of company's governing rules, as compared to 50% in 2008. WILMERHALE, *2013 M&A Report*, *supra* note 7.

contest but needs successive victories in at least two annual elections to obtain control. It is widely believed that no activist or hostile bidder has ever won two consecutive elections to overcome a classified board.[46] A complimentary advantage of a classified board is that directors can only be removed "for cause."[47] This contrasts with default rules governing the annual election regime wherein directors may be removed by a majority vote of stockholders at any time "with *or without* cause."[48]

A classified board can be introduced through a charter provision, an initial bylaw, or a bylaw adopted by a vote of the stockholders.[49] As with other defensive measures, the classified board will be more secure if it is included in the charter. A classified board that is established pursuant to a bylaw, by contrast, can always be repealed if an activist subsequently pushes through a stockholder-adopted bylaw amendment to such effect.

Practically speaking, it is almost impossible to introduce a classified board following a company's IPO because this requires stockholder approval (even in the case of a bylaw amendment).[50] Institutional investors disapprove of classified boards on the theory that they deter unsolicited takeover offers, entrench management, and thereby harm the prospects for maximizing stockholder value.[51] Both ISS and Glass Lewis recommend that stockholders vote against proposals to classify the board and vote for proposals to repeal classified boards.[52]

[46] Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 928-29 (2002). *But see* Answering Brief on Appeal at 43-44 n.34, *Versata Enters., Inc. v. Selectica, Inc.*, No. 193,2010, 2010 WL 2464491 (Del. June 14, 2010) (pointing to six instances at micro-cap companies in which insurgents with less than 5% holdings had "some significant measure of success" against classified boards).

[47] That is, barring an additional charter provision to the contrary, 8 *Del. C.* § 141(k)(1).

[48] *Id.* § 141(k) (emphasis added); *see infra* Section 8 (*Removal of Directors*).

[49] 8 *Del. C.* § 141(d).

[50] *Id*.

[51] This opposition is strong in spite of the fact that companies with classified boards generally receive higher premiums in buyouts because bidders are forced to negotiate with the board.

[52] ISS Guidelines, *supra* note 12, at 17; Glass Lewis Guidelines, *supra* note 12, at 19. Also, ISS takes a classified board structure into account as a negative factor when determining its

5. STOCKHOLDER ACTION BY WRITTEN CONSENT

The default rule in Delaware is that any action that may be taken at a stockholder meeting may also be taken by written consent of the stockholders with the required vote.[53] Companies that allow stockholder action by written consent are particularly vulnerable to activism campaigns seeking to replace the board because stockholders can remove the incumbent directors at any time of the year and not only at the annual meeting.

Delaware law allows a company to opt out of this stockholder-friendly default rule through language in the charter providing that stockholders can act only at stockholder meetings.[54] And although many public companies and most IPO companies have elected to opt out of this rule, other companies have not.[55] However, as with many other defensive measures, it is difficult to adopt such a charter provision post-IPO because it requires stockholder approval. Proxy advisory services and institutional investors alike are opposed to restrictions on stockholder action by written consent.[56]

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recommendations for director elections. ISS Guidelines, *supra* note 12, at 11.

[53] 8 *Del. C.* § 228. *But see id.* § 211(b) ("Stockholders may, unless the certificate of incorporation otherwise provides, act by written consent to elect directors; provided, however, that if such consent is less than unanimous, such action by written consent may be in lieu of holding an annual meeting only if all of the directorships to which directors could be elected at an annual meeting held at the effective time of such action are vacant and are filled by such action."); *Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377, 401 (Del. 2010).

[54] 8 *Del. C.* § 228.

[55] In 2013, approximately 70.4% of the S&P 500 companies had a provision prohibiting stockholder action by written consent, and in 2003 approximately 73.77% of the S&P 500 had a similar provision. SHARKREPELLENT, *2013 Year End* Snapshot, *supra* note 22. Implementation of this provision has seen even higher levels at the IPO stage. In 2009, 70% of IPOs of corporations included the provision in the governing rules, and in 2012, 96% included the provision. WILMERHALE, *2013 M&A Report*, *supra* note 7.

[56] ISS recommends that stockholders generally vote against proposals to prohibit or restrict stockholders' ability to act by written consent. ISS Guidelines, *supra* note 12, at 27. Also, ISS takes the inability of stockholders to act by written consent into account as a negative factor when determining its recommendations for director elections. *Id.* at 11. While its

Even if eliminating stockholder action by written consent proves to be practically impossible, a company can still reduce its vulnerability to a consent solicitation by adopting procedural consent bylaws. The DGCL provides that if no record date is fixed by the board of directors, the record date for determining the stockholders entitled to consent is the first date on which a signed written consent is delivered to the company.[57] However, Delaware courts have upheld the right of companies to adopt a bylaw establishing the primary authority of the board to set a record date for determining stockholders entitled to act by written consent.[58] Furthermore, while there is no requirement under Delaware law for inspectors to be appointed for consent solicitations,[59] a company may adopt a bylaw that gives the company the right to appoint an inspector of elections for consent solicitations, thereby ensuring independent review of an insurgent's consents.[60] Proxy advisory services and institutional investors seem not to object to such procedural consent bylaws.

6. STOCKHOLDERS' RIGHT TO CALL SPECIAL MEETINGS

Delaware's default rule is that a board can call special meetings but stockholders are implicitly prohibited from doing the same.[61] However, a company's charter or bylaws may empower stockholders to call special meetings.[62] From the perspective of a company, a stockholder's right to call special meetings poses a significant concern because activists may call a special meeting between annual meetings, thereby making the company vulnerable to proxy contests at any time. In situations in which stockholders were empowered to call special meetings, activists have called special meetings for purposes that include the removal of directors and the filling of vacancies caused thereby, the creation of new directorships and the filling of newly created directorships, the repeal of bylaws that afford structural defenses to the incumbent board, and the adoption or amendment of bylaws to enhance the power of stockholders.

A significant number of public companies and almost all IPO companies prohibit stockholders from calling special meetings.[63] However, for those companies that have already granted stockholders the right to call special meetings, it is generally legal to re-establish, through the adoption of a charter provision or a bylaw, the prohibition on stockholder-called special meetings. A defensive provision in the charter or bylaws can either entirely prohibit the stockholder power or it can restrict the power to call a special meeting, short of a prohibition. A common limiting provision is to require that stockholders wishing to call a special meeting hold a given percentage of shares, such as 10%.[64] Companies can also adopt a bylaw that limits certain actions at a special meeting. For instance, many bylaws provide that a special meeting would not be required with respect to any matter within a certain time period (e.g., 12 months) after any annual or special meeting at which that matter was included on the agenda. Some bylaws also state that no special meeting may be held if the matter in question will be included on the agenda at an annual meeting to be held within a certain time period (e.g., 90 days) after the receipt by the company of the special meeting request.[65]

Institutional investors are typically opposed to new prohibitions and restrictions on stockholders' ability to call special meetings.[66] However, for companies that do not

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guidelines are silent on this subject, Glass Lewis typically also recommends voting against these kinds of proposals.

[57] 8 *Del. C.* § 213(b).

[58] *Empire of Carolina, Inc. v. Deltona Corp.*, 514 A.2d 1091 (Del. 1986); *Edelman v. Authorized Distrib. Network, Inc.*, No. Civ.A.1 1104, 1989 WL 133625 (Del. Ch. Nov. 3, 1989).

[59] 8 *Del. C.* § 231(a) (requiring corporations to appoint inspectors of elections only for all *meetings* of stockholders) (emphasis added).

[60] *Allen v. Prime Computer, Inc.*, 540 A.2d 417 (Del. 1988); *Datapoint Corp. v. Plaza Secs. Co.*, 496 A.2d 1031 (Del. 1985).

[61] 8 *Del. C.* §§ 211(a)(1), 211(d). Delaware is one of the few states that does not grant such power to stockholders by default. Other states allow that stockholders may call a meeting if they hold a minimum percentage that is generally between 10% and 25% of all entitled votes on any issue. 11 Fletcher Corporation Forms Annotated § 48:4 (5th ed. 2014).

[62] 8 *Del. C.* § 211(d).

[63] In 2013, approximately 43.55% of the S&P 500 companies prohibited stockholders from calling special meetings, from approximately 59.02% in 2003. SHARKREPELLENT, *2013 Year End* Snapshot, *supra* note 22. Prohibition on stockholder-called special meetings has seen higher levels at the IPO stage. In 2012, 98% of the IPO companies included this prohibition, as compared to 65% in 2009. WILMERHALE, *2013 M&A Report, supra* note 7.

[64] Fletcher, *supra* note 61.

[65] Typically, these provisions treat the election or removal of directors as the same matter with respect to all matters involving the election or removal of directors.

[66] ISS Guidelines, *supra* note 12, at 27. Also, ISS takes the inability of stockholders to call special meetings into account as a negative factor when determining its recommendations for director elections. *Id.* at 11. Although its guidelines are silent on this subject, Glass Lewis typically also recommends voting against these kinds of proposals.

already grant stockholders the ability to call special meetings, ISS deems it acceptable for stockholders to approve proposals that would empower stockholders to call special meetings on certain conditions, such as a minimum ownership threshold of 10% for the stockholders calling a meeting.[67]

7. ADVANCE NOTICE REQUIREMENTS

The default rule in Delaware is that stockholders can nominate director candidates and make other proposals at an annual meeting without prior notice or warning to the company.[68] From the company's perspective, the risk posed by this default rule is that the company may not have adequate time to evaluate the stockholders' nominees and proposals, and to consider their desirability or advisability. Generally, a company will want time to review the nominees and proposals, to negotiate a compromise or settlement, if possible, and to prepare for a proxy contest, if necessary. For these reasons, among others, Delaware courts generally permit a company's bylaws to require stockholders to furnish the company with advance notice of their intention to nominate directors or to present stockholder proposals.[69] However, the Delaware Court of Chancery warned that it is not averse to striking down advance notice bylaws that "unduly restrict the stockholder franchise or are applied inequitably."[70] Furthermore, Delaware courts will construe advance notice bylaws narrowly, against the company and in favor of the free exercise of stockholders' electoral rights.[71]

A typical advance notice bylaw requires delivery of a stockholder's notice to the company between 90 and 120 days in advance of a meeting. The notice is required to include disclosure related to the identity of the proxy-soliciting participants and specifics regarding their nominees and proposals. An advance notice bylaw will typically also require the proposing stockholder to be a record holder of the company's stock.[72]

In recent years, many companies have been able to adopt more extensive advance notice bylaws ("second-generation advance notice bylaws") without incurring negative judicial review in the courts.[73] These enhanced bylaws typically include requirements for the (i) completion of company-drafted director nominee questionnaires, (ii) submission of broad undertakings by nominees to comply with company policies (including a confidentiality policy that includes a confidentiality obligation for stockholder-designated directors[74]), (iii) minimum size and duration of holding requirements, (iv) continuous disclosure of derivative positions and, in the context of director elections, (v) disclosure of any arrangements related to the nomination or election (including voting agreements), and (vi) disclosure relating to the stockholder's nominees and director qualification requirements. Although enhanced notice requirements are unlikely to prevent a sophisticated activist from making valid nominations or proposals, such requirements nonetheless provide a company with vital information and adequate time to form a considered response. None of these second-generation advance notice bylaws have yet been tested in court.

One of the most recent second-generation bylaws addresses the undesirable consequences of so-called "golden leash" arrangements between activists and their director nominees providing that the nominees will receive additional incentive compensation from the activist. There is a concern that such golden leash arrangements can compromise the independence of the board. Therefore, some companies have adopted bylaws prohibiting such arrangements by requiring that all director nominees agree and represent to the company that they are not a party to any such agreement. ISS recently announced that it would recommend against anti-golden leash bylaws adopted by boards unilaterally but would consider such bylaws on a

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[67] *Id*. at 27-28.

[68] 8 Del. C. § 222(a); *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 344 (Del. Ch. 2008).

[69] *See, e.g.*, *Stroud v. Grace*, 606 A.2d 75, 95 (Del. 1992).

[70] *Jana Master Fund*, 954 A.2d at 344.

[71] *See, e.g.*, *id.*; *Harrah's Entm't, Inc. v. JCC Holding Co*., 802 A.2d 294, 310 (Del. Ch. 2002).

[72] This requirement forces an activist to first transfer some of its shares into record ownership, alerting the company that it may soon be the target of a proxy contest or other activism campaign.

[73] *See generally* John C. Coates IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 BUS. LAW 1323 (2001).

[74] *Kalisman v. Friedman*, C.A. No. 8447-VCL, 2013 WL 1668205 (Del. Ch. 2013) (holding that when a director serves as the designee of a stockholder on the board, the stockholder is generally entitled to the same information as the director). The existence of a pipeline of confidential information to an activist from its sponsored director could disrupt the effective functioning of the board in the event an activist is successful in having one of its candidates elected. Therefore, a company's confidentiality policy may provide that a director must not disclose confidential information to any stockholder that nominated the director. Alternatively, or in addition, the company could amend its advance notice bylaws to require all director nominees to agree in writing that they are not acting and will not act as the representative of any particular stockholder or group of stockholders while serving as a director.

case-by-case basis when put to a stockholder vote.[75] As a consequence, many companies have repealed their previously adopted anti-golden leash bylaws. However, there is reason to believe that ISS would not object to bylaws that require only full *disclosure* of golden leash arrangement (as opposed to a *prohibition*). There is benefit to this compromise because the disclosure of all golden leash arrangements would enable a company to make this a campaign topic in a proxy contest.[76]

Generally, advance notice bylaws have become commonplace both for existing public companies and IPO companies.[77] This feature is among the few defensive measures that ISS regards with some measure of approval.[78] By contrast, Glass Lewis unequivocally recommends that stockholders vote against any proposals that would require advance notice of stockholder proposals or director nominees.[79] Companies looking to adopt or improve existing advance notice provisions, however, should study carefully the precedents of other companies that drafted these bylaws, as well as limiting principles imposed on such bylaws by the courts. Moreover, it remains to be seen to what extent second-generation advance notice bylaws will be upheld by the Delaware courts.

8. REMOVAL OF DIRECTORS

The default rule in Delaware is that stockholders can remove any director, with or without cause, by a majority of shares entitled to vote at an election of directors.[80] This is assuming that all of the company's directors are elected annually in conformity with Delaware's default provisions. As previously noted, for companies that have adopted classified boards modeled upon the DGCL, a removal of this kind can only be accomplished "for cause," unless the charter otherwise provides.[81] Similarly, in a company with cumulative voting, no director can be removed without "cause" if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of directors.[82]

Definition of "Cause"

A company with a classified board or cumulative voting can enhance its defenses even further in this regard by adding provisions in the bylaws to define "cause." The DGCL does not provide a definition of "cause," which gives an activist room to argue, and possibly litigate, as to whether cause exists for director removal. Therefore, some companies have included a definition of "cause" in their bylaws.[83] While the definitions vary, many resemble the definitions of "cause" in employment agreements for senior officers of a public company. As a consequence, "cause" is commonly narrowly defined and is tied to either discrete

[75] ISS, Director Qualification/Compensation Bylaw FAQs (Jan. 13, 2014), http://www.issgovernance.com/files/directorqualificationcompensationbylaws.pdf.

[76] Elliott Management's nominees ultimately waived their incentive compensation in Elliot's proxy contest against Hess Corporation, admitting that the compensation plan had become a "distraction" in the campaign. William Alden, *Hedge Fund Rejects Proposal by Hess to End Proxy Fight*, DEALBOOK (May 13, 2013, 6:40 PM), http://dealbook.nytimes.com/2013/05/13/elliott-rejects-a-proposal-by-hess-to-end-proxy-fight.

[77] In 2012, approximately 95% of the S&P 500 had advance notice provisions. Implementation of this feature has seen even higher levels at the IPO stage. In 2012, 96% of the IPO companies included this feature, as compared to 85% in 2008. WILMERHALE, *2013 M&A Report*, *supra* note 7.

[78] ISS recommends that stockholders "[v]ote on a case-by-case basis on advance notice proposals, giving support to those proposals which allow shareholders to submit proposals/nominations as close to the meeting date as reasonably possible and within the broadest window possible, recognizing the need to allow sufficient notice for company, regulatory, and shareholder review." ISS advises further that stockholders "[i]n general, support additional efforts by companies to ensure full disclosure in regard to a proponent's economic and voting position in the company so long as the informational requirements are reasonable and aimed at providing shareholders with the necessary information to review such proposals." ISS Guidelines, *supra* note 12, at 23.

[79] Glass Lewis states: "We believe shareholders should be able to review and vote on all proposals and director nominees. Shareholders can always vote against proposals that appear with little prior notice. Shareholders, as owners of a business, are capable of identifying issues on which they have

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information and ignoring issues on which they have insufficient information." Glass Lewis Guidelines, *supra* note 12, at 38.

[80] 8 *Del. C.* § 141(k).

[81] *Id.* § 141(k)(1).

[82] *Id.* § 141(k)(2) ("In the case of a corporation having cumulative voting, if less than the entire board is to be removed, no director may be removed without cause if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of the entire board of directors, or, if there be classes of directors, at an election of the class of directors of which such director is a part.").

[83] It appears that no study to date has analyzed the data on how many public companies or IPO companies include this feature.

triggering events or objective criteria. Many bylaws limit the triggering events to the director's conviction of a serious felony involving moral turpitude or a violation of federal or state securities laws, the director's adjudication as legally incompetent by a court of competent jurisdiction and similar high thresholds. The board can typically introduce such a definition unilaterally by way of a bylaw amendment, which does not require stockholder approval. ISS and Glass Lewis have not yet taken a position on this kind of bylaw provision.

Voting Requirements

Delaware law allows a company's charter to set voting thresholds above the minimum thresholds imposed by the DGCL for achieving certain purposes.[84] Companies have set supermajority percentages at 66% and higher for votes to remove directors, without having those provisions overturned or even criticized by courts. The percentage of large companies implementing this provision has gone down over the past decade.[85] If this defense is not already in the charter, a company will most likely face difficulty convincing stockholders to adopt it. Both ISS and Glass Lewis recommend that stockholders vote against proposals to introduce supermajority vote requirements.[86]

Filling of Vacancies due to Removals

Finally, it is critical to determine the power to fill vacancies caused by director removals. If a company's governing documents do not prohibit stockholders from calling special meetings, stockholders could remove one or more — even all — directors from office between annual elections, possibly without cause. If stockholders are also empowered under the company's charter or bylaws to fill vacancies caused by removal, then the stockholders can fill the resulting vacancies with individuals whom stockholders nominate and elect.[87] Stockholders can accomplish the same ends through written consents between annual elections.[88] The DGCL's default rule is that the board can fill vacancies created by removal.[89] This rule can be altered in the charter or bylaws,[90] but most public companies do not deviate from the default rule.[91] Language in the charter confirming the default rule prevents stockholders from passing a bylaw to override it. In the absence of such a preventative charter provision, stockholders can pass a bylaw that transfers all or a share of vacancy-filling power to stockholders.[92] In the event a company's charter conveys this power to the stockholders, it will be difficult to obtain stockholder approval to return to the default rule. Institutional stockholders and proxy advisory services favor full stockholder control over the filling of vacancies.[93]

[84] *Id.* § 102(b)(4); *see also id.* § 216 (suggesting that bylaws may change the default majority rule for quorums and voting).

[85] In 2013, approximately 21.56% of the S&P 500 companies had this provision, down from approximately 32.79% in 2003. SharkRepellent, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies include this feature.

[86] ISS Guidelines, *supra* note 12, at 28-29; Glass Lewis Guidelines, *supra* note 12, at 40. Also, ISS takes supermajority voting requirements into account as a negative factor when determining its recommendation for director elections. ISS Guidelines, *supra* note 12, at 11.

[87] *Campbell v. Loew's, Inc.*, 134 A.2d 852, 855-56 (Del. Ch. 1957) (accepting as valid the effects of bylaws permitting stockholders to remove directors and to fill the vacancies thereby created, including at an authorized special meeting

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where such action is properly made an order of business, and further finding that acting on such bylaws did "not impinge upon the statutory right and duty of the board to manage the business of the corporation"). The courts, however, have placed limits on the ability of shareholders to pursue the same strategy by way of written consent between annual elections. *See infra* note 88.

[88] However, this cannot be accomplished with one-and-the-same consent, unless the consent removing directors and appointing their successors is unanimous (which is practically impossible in a public company). *Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377, 401 (Del. 2010) (holding that a stockholder's bylaw amendments regarding the election of directors were invalid, and further holding that a non-unanimous written consent, to operate in lieu of an annual meeting, must first remove all sitting directors and then fill the resulting vacancies); *Gentili v. L.O.M. Med. Intern., Inc.*, CIV.A. 7600-VCG, 2012 WL 3552685, at *2 n.28 (Del. Ch. 2012) (holding that the stockholders could not elect the "Challenged Directors" through their written consents in lieu of an annual meeting because the consents were not unanimous) (quoting *Crown EMAK Partners, LLC*, 992 A.2d. at 401).

[89] 8 *Del. C.* § 223(a)(1). This rule is applied to resignations in that resignations are treated as giving rise to a "vacancy." *Id.* § 223(a).

[90] *Id.* §§ 223(a), 109(a).

[91] In 2013, approximately 78.65% of the S&P 500 companies had the default rule, up slightly from approximately 75% in 2003. SharkRepellent, *2013 Year End* Snapshot, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies had the default rule.

[92] 8 *Del. C.* §§ 223(a), 109(a).

[93] ISS Guidelines, *supra* note 12, at 28-29; Glass Lewis Guidelines, *supra* note 12, at 40.

9. INCREASES IN THE SIZE OF THE BOARD

Another important consideration in reviewing a company's structural defenses is whether the board has the exclusive ability to set the number of directorships and the procedures for filling newly created directorships between scheduled elections.[94] If the power to fill newly created directorships does not rest exclusively with the board, an activist can persuade other stockholders to increase the board's size through a bylaw amendment and then elect the activist's own nominees to fill the newly created directorships.[95] A company seeking to prevent this activist strategy will want the board to possess the exclusive power to both set the number of directorships and fill newly created directorships.

While the DGCL includes a default minimum of one director,[96] it provides no default rule setting a maximum number of directorships, and it does not specify whether the board or stockholders set the number or by what procedure. Instead, Delaware law allows that the number of directorships and the method for changing that number can be established in the charter or the bylaws.[97] Post-incorporation, it is up to the company and its stockholders to determine whether the board, stockholders, or some combination of input from both groups will set the number of directorships.[98] A company seeking to place this power solely in the hands of directors will secure this objective best through a charter provision. Otherwise, the company can adopt a bylaw to this effect. As in most other cases, a charter provision trumps a bylaw provision; a bylaw provision can trump an earlier bylaw provision but not a charter provision.[99]

The DGCL's default rule on newly created directorships is that the board can fill such positions between scheduled elections.[100] Most public companies do not deviate from the default rule.[101] However, this default rule can be overridden by contrary text in the charter or bylaws. This means that a company seeking to lodge the power to fill newly elected directorships exclusively in the hands of directors is best served by adopting a charter provision to that effect. In contrast, a bylaw to this effect is subject to amendment by stockholders, who can adopt a bylaw affording stockholders the sole power to fill newly created directorships.[102]

A company could face an uphill climb in attempting to regain control previously granted to stockholders on these

[94] Under the DGCL, the power to fill "newly created directorships" is distinct from the power to fill "vacancies" caused by removal and resignation. 8 *Del. C.* § 223(a) (referring to "[v]acancies *and* newly created directorships") (emphasis added); *DiEleuterio v. Cavaliers of Del., Inc.*, Civ.A. No. 8801, 13 Del. J. Corp. L. 273, 278-82 (Del. Ch. Feb. 9, 1987) (addressing the distinction in law and governing documents between vacancies and newly created directorships); *Campbell v. Loew's, Inc.*, 134 A.2d 852, 857 (Del. Ch. 1957). *But see Comac Partners, L.P. v. Ghaznavi*, 793 A.2d 372, 383 (Del. Ch. 2001) (holding that if a corporation's charter or bylaws address "vacancies" with the intent that such term comprise "newly created directorships," the court will honor the intent if it is explicit).

[95] This could happen at a special meeting as well as an annual meeting, provided no conflict arises in law or with other rules of the company. *See, e.g.*, *Richman v. DeVal Aerodynamics, Inc.*, 183 A.2d 569, 572 (Del. Ch. 1962) (holding that, in the absence of a contrary charter provision, stockholders could amend the bylaws to give stockholders the right to create additional directors and elect directors to fill the newly created directorships without first amending the charter). A bylaw, however, cannot *decrease* the number of board seats at the expense of a sitting director. *Kurz v. Holbrook*, 989 A.2d 140, 157-58 (Del. Ch. 2010), *aff'd in part*, *rev'd in part sub nom. Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377 (Del. 2010).

[96] 8 *Del. C.* § 141(b).

[97] *Id.*

[98] *Id.*; *Siegman v. Tri-Star Pictures, Inc.*, Civ.A. No. 9477, slip op. at 17 (Del. Ch. May 5, 1989, *rev'd* May 30, 1989), (holding that a certificate provision can vest exclusive power in a board to fill newly created directorships).

[99] The general rule is that a charter provision overrides a bylaw, such that a conflicting bylaw becomes a "nullity." *Burr v. Burr Corp.*, 291 A.2d 409, 410 (Del. Ch. 1972). There are, however, instances under Delaware law where a bylaw amendment, although adopted, cannot override a pre-existing bylaw. *See, e.g.*, 8 *Del. C.* § 216 ("A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.").

[100] 8 *Del. C.* § 223(a)(1).

[101] In 2013, approximately 78.65% of the S&P 500 companies had the default rule, up slightly from approximately 75% in 2003. SharkRepellent, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies have the default rule.

[102] *Grossman v. Liberty Leasing Co.*, 295 A.2d 749, 753-54 (Del. Ch. 1972) (observing that the power of directors to fill vacancies is an innovation in the law as compared to the older rule reserving such power to stockholders); *Campbell v. Loew's, Inc.*, 134 A.2d 852, 855-56 (Del. Ch. 1957) (observing the validity of a bylaw conferring power on stockholders to elect new directors when newly created directorships arise); Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of Corporations & Business Organizations § 4.5 (2014).

matters. There is also the added risk of attracting negative attention from institutional stockholders and proxy advisory services. Although ISS's position on the power to change board size is more moderate than it is for other defensive measures, ISS unqualifiedly supports full stockholder control over the filling of newly created directorships.[103]

10. VOTING STANDARDS FOR DIRECTOR ELECTIONS

The default voting standard in Delaware for director elections is the plurality standard, which can be changed in the charter or bylaws.[104] However, as a result of pressure applied by institutional investors and proxy advisory services in recent years,[105] most large public companies have amended their charters or bylaws to adopt either a majority (cast or present) standard or a so-called "plurality plus" policy.[106] By contrast, it is rare for public companies to have "cumulative voting."[107]

Plurality Voting

Under the plurality standard, a director candidate is elected to office by receiving the most affirmative votes of the shares present and entitled to vote, as opposed to other voting standards, which include a plurality of votes cast or a majority of votes of shares outstanding, shares present and entitled to vote, or eligible votes cast. In a plurality regime, one vote in favor of a director candidate secures a nominee's election in an uncontested election. In contested elections, a director candidate needs only to receive one more vote than a competing candidate to win the election and need not receive a majority of the votes either present or cast. Under the plurality system, stockholders cannot prevent the re-election of a given candidate simply by "withholding the votes," since a candidate will still win an election even if he receives more "withhold" votes than "for" votes.

Plurality Plus Policies and Majority Voting

Under the "plurality plus" approach (also known as "plurality plus resignation"), a board member who receives less than a majority of votes (cast or present) must submit his resignation to a committee of the board consisting of independent directors. The committee has the discretion to reject or accept the resignation. A tendered resignation puts pressure on the board to accept it, but a board's decision to refuse a resignation is unlikely to be reversed by Delaware courts.[108]

The majority standard comes in two forms. Under a full-fledged majority system in an uncontested election, an incumbent who receives less than a majority of the votes will hold the directorship into the next term by virtue of the DGCL's holdover rule.[109] The same would be the case in a contested election if neither the incumbent nor the challenger obtains a majority because only the incumbent is qualified to hold the seat by the holdover rule.[110] Beyond the full-fledged system, some companies have adopted the "majority plus resignation" system to address the conceivable — albeit lawful — legitimacy problem introduced by a failed candidate who continues to hold office on the basis of the holdover rule. Under this system, a candidate who has failed to secure election tenders a resignation, and the board is free to use its discretion to accept or reject the resignation. Such a policy seeks to ameliorate an ostensible legitimacy problem, but will not necessarily solve the problem from the perspective of the stockholders.

Companies with majority voting standards or "plurality plus" policies are more vulnerable to shareholder activism because those voting standards "give bite" to "withhold the vote" campaigns.[111] Even if directors remain in office by virtue of the holdover rule or a rejected post-election resignation, the lack of stockholder approval for the sitting

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[103] ISS Guidelines, *supra* note 12, at 17, 19. The Glass Lewis Guidelines are silent on this subject.

[104] 8 *Del. C.* §§ 215(c)(3), 216(3).

[105] Bo Becker & Guhan Subramanian, *Improving Director Elections*, 3 HARV. BUS. L. REV 1, 11 (2013). The motives of institutional investors to push companies to adopt a majority voting standard have been various. Generally, proponents of enhanced stockholder power in corporate governance argue that majority voting makes boards more accountable to stockholders. Critics of the plurality system have also observed that since withhold votes have no actual impact on director elections, plurality voting does not allow stockholders adequate opportunity to express disapproval. *Id.*

[106] In 2013, approximately 85.41% of the S&P 500 companies had majority voting and approximately 8.67% had plurality plus voting. SHARKREPELLENT, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies have included this feature.

[107] In 2013, approximately 95.56% of the S&P 500 companies did not have cumulative voting, slightly up from approximately 89.75% in 2003. SHARKREPELLENT, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies have included this feature.

[108] *City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc.*, 1 A.3d 281, 288-89 (Del. 2010).

[109] 8 *Del. C.* § 141(b) ("Each director shall hold office until such director's successor is elected and qualified, or until such director's earlier resignation or removal.").

[110] *Id*.

[111] Becker & Subramanian, *supra* note 105.

directors often results in tremendous pressure to effect change.[112] If a company seeking a heightened defensive posture finds itself strapped with a higher standard than plurality for director elections because of amendments made to the charter or bylaws in prior years, the company may wish to look for options to return the voting standard to the simple plurality or plurality plus standard. If the voting standard is set forth in the charter, a company can scale back the standard only with stockholder approval, which is unlikely to be obtained in the current climate. If the voting standard is set forth in the bylaws, the board of directors can return to the plurality standard by amending the bylaws unilaterally. This presumes the company is willing to weather the potential risks in investor relations and negative reviews of proxy advisory services.[113] However, if the higher voting standard was implemented by a bylaw amendment adopted by stockholders, that bylaw cannot be unilaterally amended by the board of directors.[114] In such case, only a stockholder-adopted bylaw amendment can scale back the standard for electing directors.[115]

Cumulative Voting

Finally, there is "cumulative voting." Delaware law allows a company to adopt a charter provision that grants to each stockholder the number of votes each stockholder possesses multiplied by the number of open directorships for which a candidate has been nominated.[116] Thus, a stockholder with one share, facing an election of nine candidates, receives nine votes and can apply all nine votes to support a single candidate. This method allows minority stockholders to pool their votes for one candidate and thereby improves their likelihood of obtaining minority representation on the board.

Activists can use cumulative voting to counterbalance the power of the majority of the stockholders. A company should be concerned that affording such disproportionate influence to a minority may lead to internally adversarial boards. A positive point about cumulative voting from an incumbent's perspective is that, as we noted, no director can be removed without "cause" if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of the board of directors.

Not surprisingly, relatively few companies have adopted cumulative voting.[117] If a company is among the few that already have a cumulative voting provision in its charter, the sole defensive option is to amend the charter.[118] However, obtaining the required stockholder vote will likely be an uphill battle since institutional investors and proxy advisory services enthusiastically support cumulative voting.[119]

11. DELAYS OF STOCKHOLDER MEETINGS

Both the company and the insurgent receive daily interim voting results in a proxy contest from Broadridge. If an activist were ahead in the vote count, a board might prefer to delay either the upcoming stockholder meeting or the closing of the polls in a meeting already in progress, even if a quorum is present. The purpose in either case would be to solicit additional proxies. The DGCL is sparse and indirect concerning the conduct of meetings and mechanisms for effecting delays of meetings and votes.[120]

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[112] From the perspective of a company there are also other, less visible disadvantages. A so-called "failed election" might cause a loss of independent directors (and thus cause the company to run afoul of stock exchange rules) or violate the terms of the employment agreements of non-elected executives. It could also trigger the change-of-control provisions in debt instruments, thereby possibly requiring a refinancing. *See infra* Section 14 (*Change-of-Control Provisions in Debt Instruments*).

[113] ISS recommends that stockholders "generally vote for management proposals to adopt a majority of votes cast standard for directors in uncontested elections," and that they "vote against if no carve-out for plurality in contested elections is included." ISS also "strongly encourage[s]" companies to also adopt a resignation policy "to provide guidelines so that the company will promptly address the situation of a holdover director." ISS Guidelines, *supra* note 12, at 20-21; Glass Lewis Guidelines, *supra* note 12, at 21. Also, ISS takes the voting standard into account when determining its recommendations for director elections. ISS Guidelines, *supra* note 12, at 11.

[114] 8 *Del. C.* § 216.

[115] *Id.*

[116] *Id.* § 214.

[117] In 2013, approximately 95.56% of the S&P 500 companies did not have cumulative voting, up slightly from approximately 89.75% in 2003 SharkRepellent, *2013 Year End Snapshot*, *supra* note 22. It appears that no study to date has analyzed the data on how many IPO companies did not have cumulative voting.

[118] 8 *Del. C.* § 214 (providing that cumulative voting is permitted only where the charter so provides).

[119] ISS recommends that stockholders "[g]enerally vote against proposals to eliminate cumulative voting," and that they "[g]enerally vote for shareholder proposals to restore or provide for cumulative voting" if certain other conditions are met. ISS Guidelines, *supra* note 12, at 18; *see also* Glass Lewis Guidelines, *supra* note 12, at 39.

[120] Most authorities validate adjournments and other delays by reference to 8 *Del. C.* § 222 ("Notice of Meetings and Adjourned Meetings"), which does not explicitly permit

Controlling law distinguishes between "adjournments" and "postponements."[121]

Adjournments

An "adjournment" occurs when a stockholder meeting is properly convened, but then is subsequently, before a vote is taken, rescheduled for a later time and date.[122] The DGCL recognizes that a stockholders meeting may be adjourned but does not provide the procedures for adjourning a meeting.[123] The default rule appears to be that in lieu of a chairperson-empowering provision in the charter or bylaws, once a meeting is formally convened and the presence of a quorum acknowledged, the power to adjourn belongs to the stockholders.[124] Delaware courts have accepted that a charter provision or bylaw can grant to the meeting's chairperson[125] the exclusive power to adjourn the meeting.[126]

As a practical matter, however, the courts will not allow chairpersons to exercise that power for just any reason. The Delaware courts have hedged the adjournment power of the chairperson by reference to the countervailing equitable doctrine of protecting the stockholder franchise as well as the full scope of duties subsumed under the heading of "fiduciary duties."[127] The core principle to emerge from a string of pertinent cases is that even where a company has adopted a chairperson-empowering provision in the charter or bylaws, the company should formulate as weighty a business rationale as possible for adjourning the meeting, and should do so "independently, with due care, in good faith, and in the honest belief" that the adjournment is "in the stockholders' best interests."[128] The company's rationale for adjourning a meeting can make the difference between encountering judicial review under the lenient business judgment standard or encountering a much more demanding level of scrutiny under some iteration of the *Blasius* standard of "compelling justification."[129] It is not

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adjournments and other delay tactics, but nonetheless envisions delays occurring.

[121] A possibly emergent third category is "recess." *See* Steven M. Davidoff, *Dynegy's Unusual Approach to Delay a Vote*, DEALBOOK (Nov. 18, 2010, 2:25 PM), http://dealbook.nytimes.com/2010/11/18/dynegys-unusual-approach-to-delay-a-vote. Under the "recess" option, the meeting is called to order, but then "recessed" until a later time. This is conceivably allowed under 8 *Del. C.* § 231 ("The date and time of the opening and the closing of the polls for each matter upon which the stockholders will vote at a meeting shall be announced at the meeting.").

[122] *See generally* 5 William Meade Fletcher, Cyclopedia of the Law of Private Corporations § 2015 (1976).

[123] 8 *Del. C.* §§ 213, 222(c).

[124] Drexler et al., *supra* note 34, at § 24.05 (citing *In re Dollinger Corp.*, 274 N.Y.S.2d 285, 287 (N.Y. Sup. Ct. 1966) ("It is the shareholders' meeting, the owners of the company, who have the right to make a decision on a question of adjournment, and not of the president who has only the duty of presiding.")); *Gunzburg v. Gunzburg*, 425 N.Y.S.2d 151, 152 (N.Y. App. Div. 1980); Fletcher, *supra* note 122.

[125] This discussion takes for granted that the acts of the board and the acts of a meeting's chairperson are one and the same. However, a threshold consideration is that for a board to be empowered to delay a vote (*i.e.*, to adjourn), the board must also be permitted to designate the chairperson of the meeting and to make that chairperson the instrument of the board as far as legally possible. In lieu of a charter or bylaw provision to such effect, stockholders can empower themselves through a bylaw to appoint the meeting chairperson. *Duffy v. Loft, Inc.*, 151 A. 223, 225-27 (Del. Ch. 1930), *aff'd*, 17 Del. Ch. 376

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(1930) (holding that as per the corporation's bylaws stockholders were entitled to elect a chairman to preside at an annual meeting, notwithstanding the presence of a high-ranking corporate officer).

[126] *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786, 809 (Del. Ch. 2007) ("[D]irectors can use the legal means at their disposal in order to pursue stockholder approval, means that often include tools like the ability to set and revise meeting dates or to adjourn a convened meeting."); *id*. at 811 n.78 ("So long as the directors are motivated by a good faith belief that the proposal is in the stockholders' best interests, taking a short adjournment to gather additional votes in a fair way seems like the kind of business judgment the adjournment tool was designed to facilitate."); *Gentili v. L.O.M. Med. Int'l., Inc.*, C.A. No. 7600-VCG, 2012 WL 3552685, at *1, *3 (Del. Ch. Aug. 17, 2012) (acknowledging without issue a bylaw provision empowering the meeting's chairman to adjourn a meeting at "his or her sole discretion").

[127] *Gentili*, 2012 WL 3552685, at *3; *In re MONY Group, Inc. S'holder Litig.*, 853 A.2d 661, 673-74 (Del. Ch. 2004); *Wis. Inv. Bd. v. Peerless Sys. Corp.*, No. Civ. 17637, 2000 WL 1805376, at *7-10, *12, *19 (Del. Ch. 2000).

[128] *Peerless*, 2000 WL 1805376, at *8.

[129] *Id.* at *9 (stating that the compelling justification standard of *Blasius* may be used to review an adjournment "only where the primary purpose of the board's action [is] to interfere with or impede exercise of the shareholder franchise, and the stockholders are not given a full and fair opportunity to vote") (alteration in original) (citations omitted) (quoting *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1996)) (internal quotation marks omitted); *id.* ("In the absence of a finding that the primary purpose of the board's action was to interfere with or

certain, however, that directors could rely on the mere fear of losing an election to justify an adjournment, particularly if the board already had ample time under its own advance notice bylaws to evaluate a dissident slate and to solicit proxies.

Nonetheless, a company is therefore well advised to have a chairperson-empowering provision in its charter or bylaws.[130] After all, it is better for a board to endow itself with the power and then decide whether to wield it, as opposed to not giving itself the power at all.[131] If a company does not have a chairperson-empowering provision, a board is best served by unilaterally amending the bylaws to that effect. A charter amendment would have a lower likelihood of success due to the difficulties of obtaining stockholder approval. ISS recommends generally to vote against proposals to provide management with the authority to adjourn absent "compelling reasons," such as for the purpose of sufficiently informing stockholders in advance of a vote in the event of material events.[132]

Postponements

A "postponement" occurs when a scheduled stockholder meeting is never convened and then a new meeting is scheduled and held, at a later time and date, in place of the originally scheduled meeting.[133] Unlike adjournments, Delaware law regards postponed meetings as new meetings. Consequently, postponed meetings require that a new meeting notice be sent to stockholders.[134] The board could also be required to set a new record date.[135] The postponement of an annual meeting may also result in the re-opening of the advance notice period for director nominations and stockholder proposals under a company's bylaws.[136]

The DGCL does not contain any express provisions concerning postponed meetings or the notice and record date requirements regarding such meetings. For this reason, Delaware courts have allowed boards to postpone or reschedule stockholder meetings "as they see fit," without express authorization in the company's organizational documents, "so long as they do not violate the limitations" posed by the DGCL.[137] In addition, courts look to a board's actions and statements for indicia of good faith, independent decision-making, a serious business rationale, directors' concern for the best interests of stockholders, and other manifestations of allegiance to fiduciary duties. A company's record in this regard could make the difference, as it does in the adjournment arena, between review under the business judgment rule or review under an iteration of the *Blasius* "compelling justification" standard.[138]

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impede exercise of the shareholder franchise, the business judgment rule presumption applies.") (citing *Geier*, 671 A.2d at 1376); *Mercier*, 929 A.2d at 811 n.78 ("So long as the directors are motivated by a good faith belief that the proposal is in the stockholders' best interests, taking a short adjournment to gather additional votes in a fair way seems like the kind of business judgment the adjournment tool was designed to facilitate.").

[130] It appears that no study to date has analyzed the data on how many public companies or IPO companies include this provision on their organization documents.

[131] A company can be encouraged in this regard by Justice Moore's observation that "every valid bylaw is always susceptible to potential misuse." Such potentiality, he held, does not constitute a sufficient reason for a court to strike down a bylaw or a necessary reason for a company to avoid adopting a bylaw. *Stroud v. Grace*, 606 A.2d 75, 96 (Del. 1992).

[132] ISS Guidelines, *supra* note 12, at 7. The Glass Lewis Guidelines are silent on this subject.

[133] Fletcher, *supra* note 122.

[134] 8 *Del. C.* § 222(b) (requiring that stockholders be given written notice of the annual meeting no fewer than 10 days and no more than 60 days before the meeting). A proxy statement would probably also need to clearly state that a proxy will stay in effect for a postponement. A postponement could also mean that a company must amend or supplement its proxy statement.

[135] The DGCL provides that the record date for the determination of shareholders entitled to notice of any stockholder meeting must not be more than 60 nor less than 10 days before the date of such meeting. 8 *Del. C.* § 213(a). That date is also the record date for determining the stockholders entitled to vote at such meeting unless the board determines, at the time it fixes the record date, that a later date on or before the date of the meeting will be the date for making such determination. *Id.*

[136] *Sherwood, et al. v. Ngon, et al.*, C.A. No. 7106-VCP, 2011 WL 6355209 (Del. Ch. Dec. 20, 2011).

[137] *Airgas, Inc. v. Air Prods. and Chems., Inc.*, Civ.A. No. 5817-CC, 2010 WL 3960599, at *12 (Del. Ch. 2010), *rev'd*, 8 A.3d 1182 (Del. 2010) ("Directors and stockholders are free to specify when the annual meeting shall occur, and they are free to change it as they see fit, so long as they do not violate the limitations that do appear in the [DGCL].") (citing 8 *Del. C.* § 211(c)).

[138] *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1207 (Del. Ch. 1987) ("The burden of persuasion . . . must be upon those seeking to postpone the annual meeting to show that the postponement is in the best interests of the stockholders.");

An important takeaway from the line of cases on postponements is that fear of losing a directors' election,[139] in isolation and without a more substantial business rationale, may not satisfy the courts as a valid reason for postponing a scheduled meeting.[140] An additional consideration could be a potential negative reaction from institutional investors and stockholder advisory services.[141]

12. FORUM FOR STOCKHOLDER LITIGATION

Activists often exert pressure on companies not only by threatening costly and time-consuming proxy fights, but also by threatening companies with expensive litigation. A company dealing with activists faces an increased likelihood of being pulled into costly and distracting lawsuits on all manner of issues, including derivative actions, fiduciary duty claims, claims under the DGCL, and other claims regarding the internal affairs of a Delaware corporation.

Companies may find that they are especially likely to benefit from adopting bylaws that require all stockholder lawsuits relating to the internal affairs of the corporation be exclusively brought in Delaware courts. These provisions are becoming more and more popular.[142] Also, in 2013, the Delaware Court of Chancery held that boards of Delaware corporations may validly adopt exclusive forum bylaws.[143] Exclusive forum bylaws are designed to prevent stockholders from forum shopping and engaging in multi-forum and duplicative litigation, thereby reducing litigation costs for a company and ensuring that claims are adjudicated in Delaware. The provisions do not eliminate any causes of action or prevent stockholders from bringing claims but are designed to consolidate litigation in a single jurisdiction. While there can be no guarantee that a non-Delaware court will enforce an exclusive forum bylaw, it enables a company to invoke the exclusive forum provisions in its motion to dismiss should a stockholder file suit in another jurisdiction.

As a practical matter, however, boards need to analyze their stockholders' views on exclusive forum provisions. Some institutional investors support exclusive forum bylaws; others object on the theory that such provisions deprive investors of an important right.[144] A problem, however, is that the proxy advisor firms generally oppose exclusive forum provisions, although ISS at least claims to advise stockholders to vote on a case-by-case basis if the company meets other governance standards.[145] Glass

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MAI Basic Four, Inc. v. Prime Computer, Inc., Civ.A. No. 10868, 1989 WL 63900 (Del. Ch. June 13, 1989); *see also Gries v. Eversharp, Inc*., 69 A.2d 922 (Del. 1949).

[139] A postponement in the face of a merger proposal, however, is easier to justify. *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786 (Del. Ch. 2007) (holding that the company had "compelling justification" to postpone the vote on a proposed merger); *In re MONY Group, Inc. S'holder Litig.*, 853 A.2d 661 (Del. Ch. 2004) (holding that a change to a later record date in the face of a court injunction requiring additional disclosure and favorable amendments made to the merger agreement was a business judgment and that, even with a higher standard of review applied, such as the *Unocal* standard, there was no evidence that the decision did not satisfy that standard); *MAI Basic Four*, 1989 WL 63900 (finding that directors had "sufficient reason" for delaying a scheduled meeting in the face of a hostile tender offer).

[140] *Aprahamian*, 531 A.2d at 1207 (observing that "[i]f the incumbent directors were truly sincere in their desire to make sure that the stockholders are fully informed before voting, they would have postponed the annual meeting at the time they put forth their new proposal on April 25 and not have waited until the evening before the meeting date," and finding that "the present record does not reveal that one proposed slate of directors is any better, or more sincerely interested in the welfare of the stockholders, than is the other"). The court also rejected postponement on the company's stated grounds that the directors needed additional time "to advise the stockholders about the relative qualifications of competing slates," once they already had ample time to do so.

[141] ISS recommends that stockholders "[v]ote for management proposals to change the date, time, or location of the annual meeting unless the proposed change is unreasonable." ISS Guidelines, *supra* note 12, at 7. The Glass Lewis Guidelines are silent on this subject.

[142] In 2012, approximately 5% of the Delaware corporations among the S&P 500 companies had an exclusive forum provision. As far as IPO companies are concerned, 38% of the Delaware corporations included such provision in governing rules in 2012 as compared to 13% in 2011. WILMERHALE, *2013 M&A Report*, *supra* note 7.

[143] *Boilermakers Loc. 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).

[144] T. Rowe Price originally opposed exclusive forum provisions but has changed its view on the theory that "strike suits are effectively a tax on its investments." Claudia H. Allen, *Trends in Exclusive Forum Bylaws* 8, THE CONFERENCE BOARD (Jan. 2012), http://www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V6N2-141.pdf&type=subsite.

[145] ISS Guidelines, *supra* note 12, at 24. ISS's case-by-case policy takes into account whether a company has been "materially harmed" by stockholder litigation outside its state of incorporation. As a practical matter, ISS has yet to identify a company it believes has suffered such harm. Note that these policies do not apply to board-adopted bylaws, but it is nonetheless important to take these positions into account. *See*

Lewis takes its opposition one step further by recommending against the election of the governance committee chair if, during the past year, the board adopted a forum selection clause without stockholder approval.[146]

13. DELAWARE'S ANTI-TAKEOVER STATUTE

Delaware's "business combination" anti-takeover statute is Section 203 of the DGCL. The statute restricts a stockholder that has acquired 15% or more of the outstanding shares, without approval of the board, from engaging in certain business combinations for a period of three years.[147] The provision is not triggered if a stockholder can acquire 85% of the stock in a single transaction.

As far as defenses against activism are concerned, the chief limitation of Section 203 is that the provision does not stop activists from increasing their holdings beyond 15% and simultaneously waging a contest to obtain corporate control. Therefore, Section 203 acts as a *de facto* poison pill only with respect to activists seeking to acquire the entire company. Most activists are content with a small stake in their target companies. Only a few activists (such as Carl Icahn and Elliott Management) have shown the willingness and the financial wherewithal to buy a target company outright. Section 203 is a useful defense if such an activist appears at a company's doorstep.

Section 203 is a defense afforded to Delaware corporations by default rule. Companies can opt out of it through a charter provision.[148] Few public companies or IPO companies elect to opt out of Section 203.[149] In the event a company wants to opt back into Section 203, it would require stockholder approval for the necessary charter amendment. The proxy advisory firms do not appear to have adopted an official position on this topic.[150]

14. CHANGE-OF-CONTROL PROVISIONS IN DEBT INSTRUMENTS

Change-of-control provisions in debt instruments provide a defense to shareholder activism that derives not from Delaware law but rather from contractual arrangements entered into by companies and their creditors. Many debt instruments include a change-of-control provision that triggers acceleration of the debt (typically in loan agreements) or a put right[151] (typically in bond indentures) in the event a majority of the board members are replaced with directors that were not nominated or approved by the incumbent board. These provisions are also known as "proxy put" or "poison put."[152]

In the past, companies often used these provisions in their proxy campaigns. They would warn stockholders in their proxy materials of dire financial consequences in the event that insurgents obtained control of the board. However, in 2013 the Delaware Court of Chancery held that directors have a fiduciary duty to approve an insurgent slate for the limited purpose of avoiding the triggering of a

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also Glass Lewis Guidelines, *supra* note 12, at 12; Allen, *supra* note 144.

146 Glass Lewis Guidelines, *supra* note 12, at 37.

147 Under the statute, a person deemed an "interested stockholder" may not engage in a business combination with the company for three years following the time such stockholder became an interested stockholder. 8 *Del. C.* § 203(a). An "interested stockholder" means any person, other than the company or its majority-owned subsidiaries, that owns at least 15% of the outstanding voting stock. Under the law, a business combination can be entered into if: (1) before the stockholder became an interested stockholder, the board approved the transaction or the business combination that resulted in the stockholder's becoming an interested stockholder; or (2) subsequent to the completion of the transaction that resulted in the stockholder's becoming an interested stockholder, such stockholder owned at least 85% of the company's voting stock; or (3) at the time of or after the stockholder became an interested stockholder, the board approved the business combination and stockholders authorized it at a meeting by the affirmative vote of at least 66 2/3% of the outstanding voting stock not owned by the interested stockholder.

148 8 *Del. C.* § 203(b)(1). A corporation may also opt out of Section 203 by a stockholder-adopted amendment of the charter or bylaws; however, the effectiveness of a bylaw amendment is deferred for 12 months. *Id.* § 203(b)(3).

149 In 2012, approximately 95% of the Delaware corporations among the S&P 500 companies were subject to Section 203. As far as IPO companies are concerned, 79% of the Delaware corporations were subject to Section 203. WilmerHale, *2013 M&A Report*, *supra* note 7.

150 Glass Lewis addresses Section 203 only in a different context. Glass Lewis Guidelines, *supra* note 12, at 36 ("Given the existence of state law protections for minority shareholders such as Section 203 of the Delaware Corporations Code, we believe it is in the best interests of shareholders to remove fair price provisions.").

151 A typical put right allows the bondholder to sell the bond back to the company at a premium (commonly 101 cents on the dollar).

152 It appears that no study to date has analyzed the data on how many public companies or IPO companies include change-of-control provisions in their debt instruments, but in the authors' experience most companies seem to include such provisions.

change-of-control provision unless the insurgents pose a "specific and substantial risk" to their corporation.[153] The court indicated its willingness to apply a heightened level of scrutiny in such cases given the potential encumbrances on the stockholder franchise in the absence of a strong showing of actual coercive harm.

The decision also emphasized that the courts are interested in seeing that a board push back against creditors when negotiating a change-of-control provision. Delaware courts expect to see evidence that a company seriously negotiated the change-of-control provision.[154]

15. POISON PILLS

The poison pill, the famous defense against hostile takeovers, can also be used against shareholder activists. Also known as a shareholder rights plan, the typical poison pill provides that if an insurgent stockholder acquires more than a certain percentage of a company's shares (commonly 10% or 15%) without board approval, all other stockholders will have the right to buy additional shares at a steep discount (typically 50%).[155] The triggering of a poison pill results in severe economic and voting dilution to the insurgent stockholder. The dilutive effect of the poison pill is such a powerful deterrent there is only one known case where a poison pill in its modern form was intentionally triggered.[156]

Delaware courts have generally upheld poison pills as a defense against hostile takeovers.[157] The pill has proven to be effective in this context because a hostile bidder cannot close a tender offer before the pill is redeemed. This forces the bidder to negotiate with the target's board or wage a costly and time-consuming proxy contest to gain control of the target's board. The Delaware Court of Chancery recently upheld a board's refusal to grant a limited waiver of a poison pill in the shareholder activism context, arguing that a board's concerns over "creeping accumulation of control" or "negative control" by activist investors are legally cognizable threats under the *Unocal* standard.[158] However, even though the Delaware Court of Chancery upheld its use in this context, the effectiveness of a poison pill against shareholder activists is more limited.

The primary effect of a poison pill is to create a barrier to stock accumulations beyond a certain threshold. The problem is that most activists are perfectly content with less than 10%, the most common threshold for an activist-focused poison pill. In light of the significant support by institutional investors, activists can often wage effective proxy contests for director elections with small stakes and, as mentioned above, only a few activists have shown the willingness and the financial capability to take over a target company.

Another potential benefit of the poison pill is that it can impede the ability of activists to enter into informal arrangements with other activists (known as "wolfpacks"). If the language of the poison pill is drafted broadly enough, the stakes of members in would-be wolfpacks can be aggregated for purposes of determining whether the poison pill threshold has been crossed, thereby deterring activists. Although Delaware courts have not directly addressed the inclusion of "wolfpack language," the Court of Chancery has indicated that it will strike down impracticable and vague language, mitigating the deterrent effect of wolfpack language.[159] Similar legal uncertainty arises with another benefit of poison pills: many shareholder activists use derivatives to accumulate a position in the target company because one of the regulatory loopholes of the Schedule 13D regime is that certain derivatives are not picked up by the definition of "beneficial ownership."[160] Many poison pills try to deter activists from using derivatives by broadening the scope of "beneficial ownership" for purposes of determining whether the poison pill threshold has been crossed. Nonetheless, in practice there are numerous drafting issues associated with netting derivatives in poison pills. Although Delaware courts have suggested that reasonable derivatives language will be upheld, legal uncertainty in this area remains.[161]

Proxy advisory services and institutional investors have practically waged a war against the poison pill over the last decade and as a consequence, most companies have

[153] *Kallick v. SandRidge Energy, Inc.*, 68 A.3d 242, 248-49 n.22-23, 260–61 (Del. Ch. 2013).

[154] *Id.*

[155] While it is possible to create a poison pill using common stock, it is preferable to use preferred stock. *See supra* Section 2 (*Blank Check Preferred Stock*).

[156] *Versata Enters. v. Selectica, Inc.*, 5 A.3d 586, 590 (Del. 2010).

[157] *Air Prods. &Chems. Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1354 (Del. 1985).

[158] *Third Point LLC v. William F. Ruprecht* (Del. Ch. 2014) (No. 9497).

[159] *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 339 (Del. Ch. Aug. 12, 2010).

[160] The best known example of this is "total return swaps," whereby an activist can create the equivalent in economic terms of ownership of a security without ever acquiring actual ownership of the security.

[161] *In Re Atmel Corp. S'holders Litig.*, C.A. No. 4161-CC, slip op. at 3 (Del. Ch. May 29, 2009).

removed their poison pills.[162] However, while ISS and Glass Lewis are generally opposed to poison pills and tend to issue voting recommendations against boards who adopt poison pills, they accept short-term poison pills with terms of 12 months or less in response to a specific threat.[163] As a consequence, today most companies keep their poison pill "on the shelf," meaning that they have a draft form stockholder rights plan that can be adopted quickly in the event of a threat. The problem with such a "shelf" plan is that it does not prevent stock accumulations until the poison pill is actually adopted. The adoption of a poison pill comes too late if an activist accumulates a significant stake before the company learns about the stake — that is, during the 10-day period for Schedule 13D filings or under the current Hart-Scott-Rodino Act threshold of $75.9 million. While stock watch services offer to alert a company of any unusual and substantial activity in its shares, the reliability of their intelligence seems to vary.

In any event, placing a poison pill on the shelf entails minimal risk for a company and enables the board to adopt it overnight when an activist emerges. However, a company should be aware that a poison pill has limited benefits and does not prevent a proxy contest.

CONCLUSION

Although all shareholder activists claim to want what is best for the company, companies should be prepared to fend off activists whose plans would harm the company. In the current market, no company — regardless of its size or success — can comfortably conclude that it is immune to shareholder activism. Advance preparation before an activist emerges is the best means to a good defense and any such advance preparation should include a thorough review of a company's structural defenses. Companies are well advised to implement structural defenses before the advent of a proxy contest or other shareholder activism campaign. Once an activist is on a company's doorstep, defensive measures undertaken by a board could be interpreted by a court as interfering with the stockholder franchise and may receive a negative reaction from proxy advisory firms, investors, and the media. ■

[162] Whereas 57% of the S&P 500 companies had poison pills at the end of 2003, only 7% had pills in place at the end of 2013. SharkRepellent, *supra* note 3. As far as IPO companies are concerned, no company has gone public with a poison pill in force since 2008. In 2007, 8% of IPO companies had an active poison pill. WilmerHale, *2013 M&A Report*, *supra* note 7.

[163] ISS Guidelines, *supra* note 12, at 11; Glass Lewis Guidelines, *supra* note 12, at 17.