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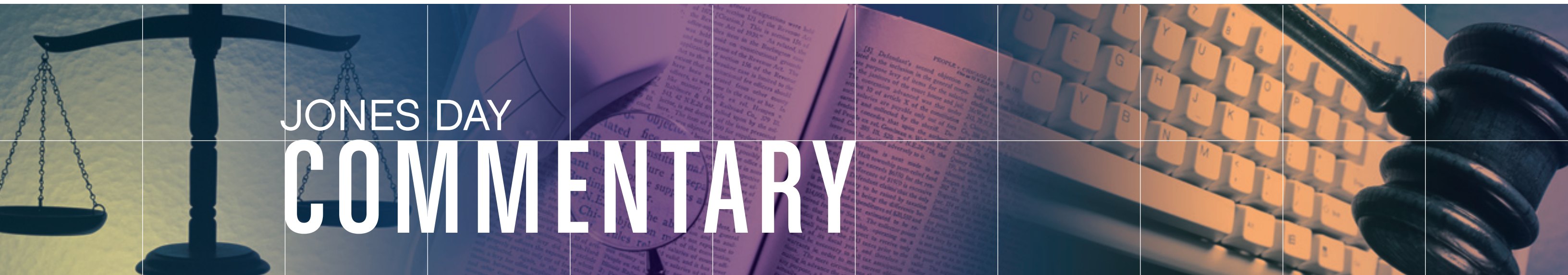

NOMINATING AND GOVERNANCE COMMITTEE ACTION ITEMS FOR AUTUMN 2008: NO TIME TO WASTE

Since the passage of Sarbanes-Oxley, much has been written about which corporate board committee will have the next turn in the hot seat. Given the Enron/WorldCom accounting scandals, it was only natural that audit committees sat there first. Compensation committees were not far behind, due to issues relating to options backdating and increased scrutiny of executive compensation generally. With recent declines in stock market prices, and in light of recent highly publicized proxy contests waged by activist shareholders and a few surprising court decisions seemingly favoring activists, issues within the purview of nominating and governance committees have become the focal point. While there is a window of opportunity to head off near-term problems, it is narrow and closing. Nominating and governance committees, particularly those of public companies with a December 31 fiscal year-end, should act now to prepare themselves for the approaching proxy season.

RECOMMENDATIONS

At a minimum, nominating and governance committees should place the following action items on their upcoming meeting agendas:

1. Confirm that the advance notice provisions of their company's corporate bylaws work in light of recent court cases and:
   - Are not limited (or applicable) to proposals sought to be included in the company's proxy materials pursuant to Rule 14a-8;
   - Require adequate advance notice of, and appropriately distinguish between, director nominations submitted by shareholders and other shareholder proposals;
   - Apply to any proposals permitted to be submitted for consideration at special meetings of shareholders, as well as those submitted for annual meetings;

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- Provide for an appropriately narrow time frame in which such proposals/nominations may be properly made; and
- Require adequate disclosure regarding the proposed business or director nominees, other parties associated with the proposing shareholder, material interests of the proposing shareholder in the business being proposed, and material arrangements between the proposing shareholder and its director nominees.

2. Consider whether their company's bylaws should require full disclosure by proposing shareholders of *all* arrangements affecting their economic interests in the company, including derivative positions and hedging transactions.

3. To the extent that the company's required vote for directors changes in the event of a contested election, consider whether their company's bylaws should be amended to ensure that the determination of the required vote is made prior to the mailing of the company's proxy materials, so that the vote and proxy disclosure are not thereafter subject to change based on changes in circumstances.

In addition, we are suggesting that companies at least consider amending their bylaws to require affirmative disclosure by shareholders generally of any significant economic interest in the company, whether or not disclosure is required by the federal securities laws or in connection with a business proposal or director nomination that implicates the advance notice provisions.

RECENT DELAWARE CASES

The following is a summary of the recent disputes that have prompted the action items described above, as well as recommended steps to implement them. Of course, facts and circumstances for every public company will vary, and you should consult with sophisticated advisors to determine whether and how to effect appropriate changes for your company's benefit.

The Delaware courts decided two cases this year arising out of election contests that address situations in which advance notice provisions apply, each of which evidences a judicial tendency to construe those provisions narrowly and prompts the need for most companies to examine their related bylaw provisions.

***CNET:* Advance Notice Deadlines May Be Construed to Apply Only to Shareholder Proposals Included in a Company's Proxy Statement Under Rule 14a-8.** In *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, an activist hedge fund (JANA) proposed to amend CNET's bylaws to increase the size of CNET's board and to nominate a slate of directors sufficient to take control of the CNET board. CNET argued that JANA was not entitled to make the proposal or the nominations due to its failure to comply with the advance notice provisions of CNET's bylaws. Those provisions included specific shareholding requirements that JANA would not have satisfied in relation to CNET's 2008 annual meeting. As a result, if JANA's proposal and nominations were subject to the advance notice provisions, it would not be permitted to submit them to CNET's shareholders at the meeting.

JANA argued that the advance notice provisions of CNET's bylaws applied only to proposals that a shareholder wished to include in CNET's proxy materials under Rule 14a-8. In other words, JANA claimed that because it had presented its nomination of director candidates and proposals in its own separate proxy materials, they were not subject to the advance notice provisions.

In March 2008, the Delaware Court of Chancery ruled in favor of JANA, holding that, as drafted, CNET's advance notice bylaw applied only to proposals made pursuant to Rule 14a-8. The court appears to have reached this conclusion because CNET's bylaw:

- Stated that a shareholder who satisfied its requirements "may *seek* to transact other corporate business at the annual meeting," which the court viewed as an indication that the bylaw was relevant only when a shareholder needed management's approval to include a proposal in the company's proxy statement;
- Set the deadline for notice based on the date of publication of the company's proxy materials rather than the date of the annual meeting, which the court viewed as evidence that it was designed only to provide management with sufficient time to include the proposal in the company's proxy materials; and

- Required the shareholder's notice to the company to also comply with any applicable federal securities laws establishing the circumstances under which the company is *required* to include a proposal in its proxy materials, which the court interpreted to mean that the intended scope of the bylaw was limited to proposals and nominations that a shareholder wished to include in the company's proxy statement.

The Delaware Supreme Court affirmed the *CNET* decision in May 2008 without issuing a separate opinion.

***Office Depot:* Nomination of Directors May Not Be "New Business" Requiring Advance Notice.** In an April 2008 decision, *Levitt Corp. v. Office Depot, Inc.*, a shareholder sought to nominate and solicit proxies for two nominees to Office Depot's board of directors. Office Depot claimed that the shareholder had not satisfied the requirements of its advance notice bylaw, which provided that "[a]t an annual meeting of the stockholders, only such business shall be conducted as shall have been properly brought before the meeting." As is customary, the Office Depot bylaw provided that business would be properly brought if it were:

- Specified in the notice of meeting given by or at the direction of Office Depot's board;
- Otherwise properly brought before the meeting by the Office Depot board; or
- Otherwise properly brought before the meeting by a shareholder who satisfies specified advance notice requirements.

The shareholder argued that it was not required to provide advance notice under Office Depot's bylaws because they did not apply to its nominations. The shareholder also contended that the nomination and election of director candidates were already properly brought before the meeting, given that Office Depot had included the "business" of director elections in its notice of the meeting. The Delaware Court of Chancery agreed, concluding that, while director nominations were "business" subject to the advance notice provisions, the shareholder could nominate director candidates at the meeting without providing advance notice to Office Depot because the nomination of directors was not a proposal to bring any new business before the meeting but rather within the scope of Office Depot's own proposal.

Lessons of *CNET* and *Office Depot*. In light of these Delaware cases, companies should review their advance notice provisions to ensure that they are not limited to proposals sought to be included in the company's proxy materials pursuant to Rule 14a-8. Our recommended approach to this, which has the salutary effect of avoiding arguments that an advance notice bylaw impermissibly intrudes upon rights arising under Rule 14a-8, is to provide that the advance notice requirements do not apply to proposals made pursuant to, or affect any rights of shareholders under, Rule 14a-8.

In addition, some advance notice provisions, like Office Depot's, attempt to capture director nominations as a subset of general proposals for business made by shareholders. In light of the *Office Depot* case, that practice should be avoided; advance notice provisions should clearly delineate—preferably with separate bylaw provisions—between director nominations and other proposals that may be made by shareholders. Companies with advance notice provisions that do not differentiate between the two should at a minimum ensure that their proxy statements expressly limit the "business" of director nominations to those individuals specifically nominated by management in the proxy statement in order to preclude shareholders from presenting their own candidates without notice.

OTHER SCOPE, TIMING, AND DRAFTING CONSIDERATIONS

With respect to special meetings, care should be taken to ensure that the bylaws impose comparable advance notice requirements on the shareholder calling the special meeting (if permitted) or proposing a director nominee for election. The bylaws should also limit the business that may be brought before any special meeting to that proposed by the company and, in the case of a shareholder-called meeting, that proposed by the shareholder calling the meeting. Alternatively, companies may want to address some of these concerns by eliminating the right of shareholders to call special meetings if applicable state law (as in Delaware) allows.

In order to maximize their effectiveness, advance notice bylaws should provide for only a limited window period, such as 30 days, in which shareholder nominations or other

proposals may be made in relation to a particular meeting. This window period should be designed to operate in harmony with the company's anticipated schedule for delivering proxy materials, including, to the extent applicable, the deadline for distributing notices of the electronic availability of proxy materials under the SEC's e-proxy rules. Similarly, companies that have majority voting requirements for directors generally, but that apply a different standard in contested elections, must be exceedingly clear as to when an election is contested or not. It is important that the deadline for determining whether an election of directors is contested or uncontested for purposes of voting requirements occurs prior to the mailing of the company's proxy materials in order to avoid a scenario in which the voting requirements change after proxies have been solicited.

In addition to increased disclosure requirements relating to nontraditional forms of economic interests as discussed below, advance notice bylaws should require adequate disclosure regarding the proposing shareholder (and related parties) and any nominees or other business proposed by the proposing shareholders in order to provide full disclosure of the proposal or nomination, as well as the motivation behind it. The required disclosure should include information that would be required concerning the proposing shareholder under the laws applicable to contested elections (regardless of whether the election is actually contested); the names of other shareholders supporting the nomination or business; a description of any material interests in, or arrangements involving the proposing shareholder with respect to, the proposal; and a description of any arrangements between the proposing shareholder and its director nominees.

In all events, when considering advance notice provisions, companies should keep in mind the tendency of courts to interpret these provisions narrowly and in favor of shareholder electoral rights. Accordingly, precision in drafting is critical.

FORMS OF OWNERSHIP AND OWNERSHIP STRATEGIES

Investors are increasingly using new and complicated techniques to enhance or hedge their equity interests in public companies. These techniques include the use of derivative instruments linked to the company's equity securities that result in enhanced economic exposure to, but not necessarily actual ownership of, such securities. They also include hedging strategies that reduce economic exposure to, but not necessarily actual ownership of, such securities. In either case, these techniques may distort the relationships between economic exposure and voting power that would otherwise exist in their absence.

Furthermore, hedge funds have popularized the "wolf pack" strategy of consciously parallel behavior among investors, often carefully designed to fall short of "group" activity as defined under the federal securities laws. As evidenced by an important recent case,[1] depending on the specific facts and circumstances, the use of some forms of these derivative positions may require investors to report beneficial ownership of the equity securities underlying derivative positions, as well as certain "group"-like activities, under Regulation 13D-G. In many cases, however, the reporting requirements under the securities laws remain unclear. Accordingly, companies should consider requiring disclosure (and periodic updates) by a proposing shareholder of all types of ownership interests, including derivatives, hedged positions, and other economic or voting interests, in their advance notice bylaws. As mentioned above, advance notice provisions are intended to give the company full disclosure not only of the shareholder proposal or nomination, but also of the shareholder's motivation for making the proposal or nomination. Because financial or other incentives that motivate a shareholder can be highly relevant in this context, it may be useful to require that this information be fully disclosed to the company, whether or not it is otherwise required to be disclosed publicly.

1 For a more detailed discussion of this case, please refer to the August 2008 *Jones Day Commentary* titled "The *CSX* Decision Regarding Beneficial Ownership and Group Formation," which is available on the Jones Day web site. The *Commentary* may be accessed by searching "CSX" on the "Publications" page on www.jonesday.com or at http://www.jonesday.com/files/Publication/a36397bb-637b-4574-9d64-4a5f9a5eb4cb/Presentation/PublicationAttachment/0f6a4ddc-ac6e-48a7-a622-95f35b2a76a7/CSX%20Decision.pdf.

As a longer-term undertaking, companies may also wish to consider whether their poison pills and change-in-control severance agreements should be revised in order to address these forms of ownership. In both of those arrangements, the definition of "beneficial ownership" could be broadened beyond the scope of Rule 13d-3 to include derivative long positions in the company's securities. Depending upon the circumstances, the decision to proceed in this manner may be influenced by, among other factors, the ability to monitor such positions effectively and, in the case of rights plans, the degree to which the dilutive potential of the rights plan would actually affect any derivative positions included in the plan's definition of "beneficial ownership" and the satisfaction of any proportionality requirements imposed under applicable law. In addition, companies that adopt this approach should consider whether to exempt passive investors in order to avoid unintended consequences. In all events, companies should monitor any changes to the definition of "beneficial ownership" in Rule 13d-3 to the extent that it is referenced in the company's rights plan and severance and other agreements, and consider whether the reference continues to be appropriate in light of the purposes of the plan or agreement.

DISCLOSURE OF ECONOMIC INTERESTS

Because case law makes it clear that Regulation 13D-G may not always reach interests such as derivative positions, investors may accumulate significant undetected economic positions. One way that commentators have suggested to fill this void is by adding a bylaw provision to require shareholders to disclose to the company their economic interest in the company once it reaches a certain threshold, whether or not the person is required to report its ownership under the securities laws or in connection with a business proposal or director nomination that implicates the advance notice provision. A bylaw of this type could make the company aware of persons accumulating such interests in relation to the company's securities before a director nomination or other overt initiative is made. While to date we are not aware of any company that has adopted such an innovative approach, this could be a way to fill the disclosure gaps in the current regulatory scheme. Recognizing that the validity of this type of bylaw has not been tested, we are of the view that mandating the disclosure of economic interests and attaching appropriate consequences for noncompliance, such as limiting the ability of noncompliant shareholders to make proposals or nominations, should generally be perceived as a reasonable construct for a board to adequately inform itself of relevant matters.

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