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Rethink Your Director Nomination Rules

Law360, New York (July 10, 2013, 11:55 AM ET) -- This article identifies and discusses a number of steps public companies may wish to consider regarding director nomination requirements and conduct in light of the heightened potential for arrival of activist shareholder-nominated directors.

Background

Increased Incidence of Nomination Proposals: Based on publicly reported information published by Activist Insight,[1] during 2012, activist shareholders threatened to initiate or initiated 58 director election proposals, and in 45 of them, succeeded in electing at least one director either in an election contest or by agreement with the target's board.

Meanwhile, during the first quarter of 2013, activist shareholders are reported by Activist Insight[2] to have threatened to initiate or initiated 36 director election proposals, and in an election contest or by agreement, succeeded in electing at least one director in 13 of them. By way of comparison, in the first quarter of 2012, activist shareholders threatened to initiate or initiated only 18 director election proposals.

Reaction of Investment Community: Moreover, the activist call for adding shareholder-sponsored directors, typically less than a majority, to public company boards is receiving increasing support in the investment community.

Need for Proactive Board Assessment: With short-slate election contests by activist shareholders becoming an increasing risk and reality for public companies, incumbent boards should be taking a proactive approach to assessing the implications of this development and to determining what steps, if any, would be appropriate to take in response.

Legitimate Subject for Board Consideration — Timing: To be clear, this suggestion is not motivated by a knee-jerk bunker mentality that shareholder-sponsored directors are an automatic threat. Of course, that is not the case.

However, it would be equally incorrect to conclude that the arrival of an activist shareholder-sponsored director is an inherently positive event. The fact is that dealing with the phenomenon of activist shareholders nominating directors is a perfectly legitimate subject for sitting boards to consider.

As the body ultimately responsible for overseeing a company's business and affairs, the board of directors should be interested in mitigating the risk of dysfunction that often results from directors representing specific interests rather than shareholders as a whole — which can lead to, among other things, a loss of confidentiality with respect to company information, including discussions among and views expressed by directors. The optimal time to focus on mitigating this risk is "on a clear day," without the pressures and

confusion about motives surrounding a threatened or pending election contest.

Exercise Thoughtful Judgment: Before addressing various issues, one point should be underscored — any nomination requirement or conduct rule to be applied to a proposed new director sponsored by an activist shareholder should be tested against the following question: Would we, the incumbent board, be prepared to apply the requirement or rule to ourselves and to new nominees proposed in the future by us? This is not to say that a "one size fits all" approach to director nomination requirements and conduct is mandatory.

However, if there is to be a difference in application, the board should be prepared to articulate a legitimate basis for it, grounded in proper corporate interests — and should be comfortable that the differentiation does not overstep the bounds of public policy that in Delaware protects the exercise by shareholders of their voting rights and imposes some limits on directors constraining other directors.

Communication of Confidential Information to Sponsoring Activist Shareholder

The Information Conduit Risk

The Kalisman Decision: In a recent decision (Kalisman[3]), the Delaware Court of Chancery declared: "When a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director."

This proposition appears to have originated in cases involving shareholder designation of a director pursuant to a contractual right or by a controlling shareholder. In Kalisman, however, neither was present.

OTK Associates LLC, the designating shareholder, owned 13.9 percent and was the largest shareholder of Morgans Hotel Group, a publicly traded company. Kalisman, a founding member of OTK, appears to have been invited on Morgans' board following conversations with Morgans about OTK's investment in it, but without any formal agreement.

Accordingly, the Kalisman decision suggests that, at least in the absence of an appropriately imposed limitation, an activist-sponsored director (elected after conversations between the activist shareholder and the company with or without a formal agreement, or after a settlement of or a vote pursuant to an election contest) might be free to serve as a confidential information conduit to the activist sponsor. The Kalisman opinion would also require that the designee be "understood" to be acting as the shareholder's "representative" — each of which determinations would seem to be factual in nature to be made on a case-by-case basis.

Potential for Board Disruption: The existence of a pipeline of confidential company information to an activist shareholder from its sponsored director would be genuinely disruptive to the effective functioning of a public company board, particularly in light of the Delaware rule recited in Kalisman that "[a] director's right to information is 'essentially unfettered in nature.'"

Moreover, the confidential information flow likely would be quite unexpected by the company, given the normal proposition that once elected to the board, a director owes his or her fiduciary duties, including the duty of confidentiality, to the company and shareholders as a whole.

Remedial Steps to Consider

Ability to Impose Limitations: Companies should fix this potential problem upfront. In Kalisman, the court acknowledged that some limitations can be imposed, noting that "[a]ny dispute on this issue [of conveying information to a shareholder for whom the director acts as representative] is not yet ripe, because Kalisman has undertaken not to share privileged information with OTK ...."

Possible Fixes: A number of fixes to the problem may exist. One would be for the board to establish in the company's bylaws a director nomination requirement that, prior to being accepted as a nominee, each proposed nominee must confirm in writing — in a form acceptable to the company — that she or he will abide by all policies applicable to directors from time-to-time, including policies defining and specifying the treatment of company confidential information. (Some public company advance notice bylaws for shareholder-sponsored director nominations contain a similar requirement.)

Two, in conjunction with that requirement, the company would establish a confidentiality policy (or amend its existing one, if needed) specifically providing that, without limiting the director's confidentiality obligations under the policy or otherwise, the director will not disclose company confidential information to any shareholder that nominated the director to serve on the company's board.

Three, alternatively (or in addition), all proposed nominees would be required pursuant to a board-adopted company bylaw to represent and agree in writing, prior to being accepted as nominees and in a form satisfactory to the company, 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 (other than as a member of a committee established by the board).

Communication of Confidential Information to Others

The Broader Information Disclosure Risk

Breaches of Confidentiality Obligations: Another potentially difficult area of director conduct that can be exacerbated when activist shareholder-nominated directors sit on a company's board is them communicating with the media, investors and others about confidential company matters — in breach of fiduciary duties, company policies and/or express agreements. Particularly, in situations where the nominee becomes a director in the context of an activist-shareholder initiative (e.g., proposing the company put itself up for sale, spin off certain operations or return capital to shareholders), or where subsequent to election, the activist shareholder starts such an initiative, the activist shareholder-sponsored director may be more vulnerable than other board members to private inquiries seeking information and, even if not contacted, may want to express himself or herself.

Remedial Steps to Consider

Use of Situation-Specific Reminders: Most companies have codes of ethics and/or confidentiality policies that would prohibit such communications by directors. Nonetheless, they sometimes occur, including by nonshareholder-sponsored directors. Accordingly, companies should consider adopting a policy/practice of providing targeted reminders to all directors when problematic situations arise as a means of reinforcing on a situation-specific basis both the existence of the prohibitions and the seriousness of a breach. (Certain other useful reminders can be provided at the same time, including regarding the company's policy with respect to responding to media, shareholder and other inquiries, and to whom and when such inquiries should be reported within the company.)

One mechanism for implementing this type of reminder might be a memorandum from the general counsel to the board, perhaps to be countersigned by each director.

Resignation in Event of Intentional Confidentiality Breach: A more severe potential remedial step would be to require the shareholder-sponsored director nominees (or all nominees) to submit a resignation upfront, the effectiveness of which is conditioned on a finding by a court of competent jurisdiction that the director intentionally disclosed confidential company information to a third party in breach of the director's confidentiality obligations to the company under law and/or any policy, code, agreement or understanding applicable to the director. Such a conditional resignation is contemplated by Section 141(b) of the Delaware General Corporation Law.[4] (This remedial step would tie together with the confidentiality policy provision discussed above in connection with the Kalisman case.)

Requirements for Acceptance of Shareholder-Nominated Directors

Prevalence of Advance Notice Bylaws: Many public companies have adopted bylaws requiring advance notice of shareholder-proposed directors. Over time, in response to increased efforts by hedge funds and other shareholder activists to take positions in and influence target companies, advance notice bylaws have become vehicles for requiring — as preconditions for acceptance of the nominees — various disclosures, representations and agreements by both nominees and shareholder sponsors.

Potential Areas for Enhancement: Companies should consider (1) the process for informing potential shareholder sponsors and nominees regarding what disclosures, representations and agreements will be required of them and (2) what additional disclosures, representations and agreements, if any, might be appropriate.

Process Requirements

Improved Decision-Making About Requirements — A Two-Step Process: As to process, advance notice bylaws today provide for a one-step submission process, with all required material submitted with the notice of nomination, based on forms of questionnaires and disclosures, representations, and agreements provided beforehand.

However, some disclosures, representations and agreements might be better framed if the company knew, before providing its requirements, the identity of the sponsoring shareholder and of the nominees, and much of the information that otherwise would be obtained through required disclosures to the company at the time of submission of a nomination.

Accordingly, in order to make more informed decisions about how precisely to frame the disclosures, representations and agreements to be required in a particular case, companies may wish to consider adopting a two-stage advance notice process. The first stage would expressly require identification of the proposed nominees and their shareholder sponsor, and the concurrent submission of completed preliminary questionnaires by those parties, made available to them through the company's secretary. This would seem easily manageable within the timing for advance notice of shareholder-sponsored director nominations provided by most advance notice bylaws.

Reservation of Right to Require More: Another process point to consider is to reserve explicitly the right to require additional disclosures, representations and agreements even after shareholder-sponsored nominations have been submitted. Developments may occur both in applicable law and in awareness of relevant facts and circumstances during the course of an election contest, and it would seem prudent for the company to preserve the flexibility to respond to any such developments.

An Important Caveat: One caveat should be kept in mind. Attempts to manage the shareholder-sponsored nomination process may at some point be challenged as improperly

interfering with the right of shareholders to nominate directors. Accordingly, care should be taken in structuring and applying both the two-stage process and the reservation of rights suggested above so that each separately and the advance notice requirements taken as a whole are supportable as rationally tied to legitimate company interests as determined by the informed business judgment of the board.

Other Requirements

Review Other Precedents: As to additional disclosures, representations and agreements, a number of public company advance notice bylaws for shareholder-sponsored director nominations contain a broad array of disclosure, representation and agreement requirements as a predicate for acceptance of a shareholder-sponsored nominee. (See, for example, the bylaws of Pfizer Inc., The Allstate Corp. and Verizon Communications Inc.) These are useful reference points for assessing the adequacy of a company's advance notice bylaws in this era of shareholder activism.

Focus on Independence: One noteworthy provision in some companies' advance notice bylaws is the reservation of the right to require a proposed nominee to furnish such additional information as the company may reasonably require to determine the eligibility of the proposed nominee to serve as an independent director, or that could be material to a reasonable shareholder's understanding of the proposed nominee's independence.

On its face, preserving the right to request such information about an activist shareholder's proposed director nominee seems plainly in the interest of shareholders as a whole. The issue may well go beyond whether the activist shareholder nominees would be independent for purposes of serving on the company's audit, compensation or nominating committee.

For example, in the context of an election contest linked to an activist shareholder proposing a course of action for a company that its board has rejected, the independence of the shareholder activists' director nominees in reviewing that course of action as a director is likely to be an important election issue — and this independence issue may require understanding the nominee's direct and indirect business and personal relationships with the activist shareholder sponsor and its affiliates. The formulation set forth above provides flexibility to probe the full reach of "independence" depending on the facts and to decide when to make a request. At the same time, care should be taken to apply this flexibility in a reasonable manner.

Negate Special Director Compensation: Another area of recent focus is activist hedge funds providing special compensation arrangements to their director nominees if, after being elected, the activist's program is successfully accomplished. These arrangements are quite troubling as a matter of director independence, overall corporate governance and board dynamics. They seem well within the prerogative of a board to negate through a provision in an agreement required to be submitted by the nominee as part of a shareholder-sponsored director nomination. Such agreement would represent that there are no such special arrangements in connection with the nomination and commit that there will be none going forward.

It should be noted that a number of advance notice bylaws require disclosure that would encompass such arrangements but do not affirmatively require that there are none and will be none. This disclosure approach may well be sufficient as a practical matter to curb the use of special compensation arrangements, given the likelihood that, once disclosed, they will constitute an attack point against and detract from the activist shareholder's campaign and nominees.

Conclusion

As noted, we believe that in this era of heightened shareholder activism, particularly as manifested by the increased use by shareholder activists of election contests in support of their nominees, incumbent boards should proactively consider whether and, if so, what and how, additional director nomination requirements and conduct rules should be explored and adopted with a view to enhancing the protection of shareholders as a whole. Some particular suggestions in this regard are noted above.

At the same time, informed and balanced board judgment should be exercised and documented to mitigate both the risk of successful legal challenge to such measures, predicated on claims of breach of duty or public policy, and the risk of other adverse reactions, including from shareholder activists, other investors, proxy advisory firms and the media.

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[1] Source: Shareholder Activism Review 2012.

[2] Source: Activism Monthly, Volume 2, Issue 4.

[3] Kalisman, et al. v. Friedman, et al., C.A. No. 8447-VCL, letter op. (Del. Ch. Apr. 17, 2013).

[4] Whether such a resignation can be irrevocable is an open question under Delaware law. However, even if revocable, for a director who cared about his or her reputation, including for integrity, it seems doubtful he or she would actually revoke the resignation (which would amount to the director publicly reneging on his or her prior agreement to accept automatic resignation if, but only if, found by a court to have breached his or her confidentiality obligation to the company).