Client Alert

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Responding to Activist Hedge Funds and Threatened Proxy Contests

In *In re Ebix, Inc., Stockholder Litigation*, C.A. No. 8526-VCN, mem. op. (Del. Ch. Jan. 15, 2016), the Delaware Court of Chancery reviewed a board of directors' response to a potential proxy contest threatened by an activist hedge fund. The board entered into a settlement agreement giving the hedge fund board representation in exchange for various standstill covenants. The board then amended the company's bylaws to further regulate the stockholder meeting process. The court held that the settlement agreement with the activist hedge fund was reviewable under the deferential business judgment rule. In contrast, the court found that the bylaw amendments were subject to enhanced judicial scrutiny as potential entrenchment devices.

Settlement Agreement with Activist Hedge Fund

The standstill agreement with the activist hedge fund provided for, among other things: (i) expanding the size of the company's board from six to eight members; (ii) filling the newly created vacancies on the board with two of the hedge fund's designees; (iii) reimbursing the hedge fund for $140,000 of its expenses; (iv) requiring the hedge fund to vote in favor of re-electing the incumbent directors; and (v) prohibiting the hedge fund from engaging in certain types of activism (a "standstill").

The *Ebix* plaintiffs argued that the settlement agreement should be reviewed under the *Unocal* test. Under Delaware law, *Unocal* imposes enhanced judicial scrutiny when a board takes unilateral defensive action (for example, by adopting a "poison pill" in response to a takeover attempt). *Unocal* requires a court to determine that the board's response was reasonable and proportionate to the perceived threat. In *Ebix*, the plaintiffs claimed that the settlement agreement was approved for the improper purpose of entrenching the incumbent directors and avoiding a proxy contest for majority control of the board.

The court disagreed. It said that "[a]pplying *Unocal* to the Board's agreement to *give up* board seats, though conceivable as entrenching insofar as that concession was part of a *quid pro quo* earning [the company] the extinction of [the hedge fund's] not-yet-launched proxy contest, is counterintuitive" (emphasis in original). The court explained that the incumbent directors had diluted their position on the board and that any "collateral effects" of preserving their incumbency did not justify enhanced judicial scrutiny. The court thus dismissed the plaintiffs' claim under the business judgment rule.

Bylaw Amendments

The plaintiffs also invoked *Unocal* to challenge certain bylaw amendments governing, among other things, the manner in which stockholders could call special meetings and make nominations and other proposals at annual meetings. Among other things, the bylaw amendments allowed the board to deny a special meeting request if a "similar item" was considered at a prior annual meeting or the matter could reasonably be deferred until the next annual meeting. The bylaws were first prepared just days after the activist hedge fund had threatened a proxy contest, but they were not adopted until after the settlement was reached. The defendants argued that the bylaw amendments were not defensive because the settlement eliminated the threat of a proxy contest.

The court inferred that the bylaw amendments were a "forward-looking prophylactic" designed with the activist hedge fund in mind since the settlement would not preclude future proxy contests and other activist strategies. The court further stated that *Unocal* is not limited to "immediate" threats. For purposes of the motion to dismiss, the court held that the hedge fund's "known future capacity to re-initiate dissenting behavior and the bylaws' conception closely after [the hedge fund's] emergence – creates, at least, a reasonable inference that improper motives were at work." As a result, the court denied the defendants' motion to dismiss this claim.

Conclusion

Activist investing has become a distinct asset class with numerous participants. Activist investors have also been successful at garnering support from institutional investors. As a result, companies should expect activist campaigns to continue among all sizes of companies. In fact, according to SharkRepellent.net/FactSet Research Systems Inc., 2015 was a record year in terms of announced activist campaigns and resulting board seats. Most of those board seats were granted before going to a vote at a stockholders meeting.

An activist campaign will force the targeted company to decide whether to fight a proxy contest or reach a settlement with the activist. In recent years, many companies have opted for the latter in order to, among other things, avoid the cost and disruption associated with proxy contests. *Ebix* is a helpful affirmation that an incumbent board's decision, in a dynamic situation, to reach a settlement with an activist investor is subject to the business judgment rule and will not be second-guessed by courts.

The court's refusal to dismiss the claims challenging the bylaw amendments deserves monitoring as the *Ebix* litigation progresses. Many companies have adopted bylaws that are similar to those at issue in the litigation. Generally speaking, these types of bylaws serve valid corporate purposes, including to (i) ensure an orderly process, (ii) ensure that the dissident's interests are fully disclosed to the board and other stockholders, and (iii) at least under the *Ebix* bylaw, avoid the costs of a special meeting when action can or could have been considered recently at an annual meeting. It is not clear why the presence of a particular activist hedge fund should influence the court's analysis if the bylaws would have been valid on a "clear day." Moreover, under Delaware law, stockholders do not have a default right to call special meetings. Thus, if a corporation allows its stockholders to call a special meeting, it is not clear why placing limitations on that ability should result in enhanced judicial scrutiny.

Ebix is a reminder that "state of the art" special meeting and advance notice bylaws have not been fully tested by the courts. In addition, the court's opinion makes clear that, when possible, it is preferable for boards of directors to enact such provisions on a so-called "clear day."

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