Client Alert

June 2018

Advance Notice Bylaws: A Key Defense Against Shareholder Activists

A highlight from the 2018 proxy season was a Washington state court's enforcement of an advance notice bylaw against an activist hedge fund. Although the hedge fund notified the company of its intent to nominate directors before the company's deadline, the court held that the hedge fund failed to provide all of the disclosures required by the advance notice bylaw. As a result, the hedge fund was foreclosed from conducting a proxy contest at the company's annual meeting.

Background

HomeStreet, Inc., a Washington corporation (the "Company"), had a detailed advance notice bylaw typical of most public companies. It established a deadline for stockholders to notify the Company of their intent to nominate candidates for election to the board of directors or to propose other business at the annual stockholders meetings. It also required the stockholder's notification to include various information about the stockholder, its affiliates and associates, and its director nominees.

On the day before the advance notice deadline, an activist hedge fund notified the Company that it intended to make three proposals and nominate two candidates for election to the board of directors at the 2018 annual meeting. The hedge fund's notice was approximately 17 pages. It also requested the Company to inform the hedge fund if it believed the notice was deficient.

Six days later (and thus five days after the deadline), the Company informed the hedge fund that the notice did not comply with the advance notice bylaw and, therefore, the proposals and nominations had not been properly made. The Company's letter identified a litany of purported non-compliance with the advance notice bylaw, including, among other things:

- failure to specifically state the number of shares beneficially owned by the stockholder, even though the notice disclosed the share ownership of various affiliates;
- failure to provide the information that, as required by the advance notice bylaw, would have to be disclosed in a proxy statement in a contested election under Section 14 of the Securities Exchange Act of 1934 (the "Exchange Act"), such as:
    - the methods the hedge fund would employ to solicit the Company's security holders, including the manner and nature in which any of its employees would solicit security holders;
    - in the event specially engaged employees, representatives, or other persons were or would be employed to solicit security holders, (i) the material features of any contract or arrangement for such solicitation and the identity of the parties, (ii) the cost or anticipated cost thereof, and (iii) the approximate number of such employees or employees of any other person (naming such other person) who would solicit security holders;

  - the hedge fund's estimated costs and total expenditures to date in connection with the proxy solicitation;
  - whether the hedge fund would seek reimbursement of its costs from the Company;
  - the amount of indebtedness if any part of the Company's securities purchased by the hedge fund or its affiliates was represented by funds borrowed;
  - the amount of securities held by each "associate" of the "participants" in the proxy solicitation, including their names and addresses; and
  - the name and principal business of the organization in which each director nominee had worked during the past five years;

- the absence of a representation that the hedge fund intended to vote its shares at the annual meeting;
- various omissions or incomplete answers in the directors' questionnaire, which had been provided by the Company and completed by the nominees; and
- failure to include any statements concerning the existence of any direct and indirect compensation arrangements during the past three years between the hedge fund and its affiliates, on the one hand, and the nominees, on the other hand.

Many of the deficiencies appear to have been oversights by the hedge fund. Others were seemingly based on the hedge fund's failure to provide explicit negative confirmation that there was nothing to disclose in response to various disclosure items.

The Court's Order Enforcing the Advance Notice Bylaw

In a brief order, a Washington state court denied the hedge fund's motion for a preliminary injunction barring enforcement of the advance notice bylaw.[1] The court stated that "[a]dvance notice bylaws like the one at issue in this case are common" and that the hedge fund "failed to comply with [its] requirements." It further stated that the "board of directors' decision to reject Plaintiff's submission is an exercise of its business judgment that the Court will not disturb." It also noted, however, that the Plaintiff could not establish irreparable harm because, for example, it could seek a special meeting of stockholders.

Take-Aways

Advance notice bylaws are a critical safeguard against shareholder activists and hostile bidders. In particular, they serve a legitimate purpose of ensuring that a dissident stockholder's interests are fully disclosed.[2] They also give nominating committees information about the stockholder's nominees before nominating the board's slate of directors. In addition, they bring some order to the process in which

[1] *See Blue Lion Opportunity Master Fund, L.P. v. HomeStreet, Inc.*, Case No. 18-2-06791-O SEA (Apr. 2, 2018).

[2] *See, e.g., Brisach v. The AES Corp.*, C.A. No. 4287-CC, transcript of settlement hearing at 20 (Del. Ch. July 8, 2009) (Strine, V.C.) ("[T]he idea of someone who has 200 shares purporting to speak for everyone in determining that these information aspects of the original bylaw might not be something that many other investors with far more real skin in the game would want, I don't accept that. I'm sure there are members of the class … who might well want to know information of exactly the kind that was in the proposed bylaw. Why? Because they are investors. And when people propose something that affects their rights, it's nice to know what the proponent's interests are."); *see also id.* at 21 (noting that a diminished disclosure requirement "impoverishes the informational base available to other investors in a situation when it may be extremely relevant to know what the economic motivations are of the proponents of some important corporate action.").

stockholders can attempt to remove the incumbent directors or take other unilateral action—which could have significant consequences for the corporation.

Corporations are strongly advised to review their advance notice bylaws periodically to ensure they remain "state of the art." For example, some companies have recently amended their advance notice bylaws to prohibit "placeholder nominations" (i.e., the ability of the dissident to substitute nominees on its slate after the deadline), although this does not appear to be a widespread trend. Occasionally, there are also judicial decisions finding fault with the drafting of advance notice bylaws that may warrant revisions for companies with similar bylaws.[3] In addition, while advance notice bylaws have developed into a fairly common form at US public companies, there are still items that may need to be customized to a particular company's situation. For example:

- if a company has convertible debt, debt securities that vote with common stockholders, or preferred stock outstanding, the advance notice bylaw might require the stockholder to disclose its ownership of such interests and not just common stock[4];

- similarly, if the company has a subsidiary that has issued equity or debt securities, the advance notice bylaw might require disclosure of the stockholder's ownership of those securities too; and

- if the company operates in an industry with a limited number of competitors, the advance notice bylaw might include more detailed disclosure about any interests the stockholder has in those competitors.

The *HomeStreet* case shows a court's very strict enforcement of an advance notice bylaw. Given both the ubiquity and complexity of advance notice bylaws and the potentially decisive role they can play in proxy contests, there is surprisingly little case law on them.[5] For that reason, *HomeStreet* will cause many corporations and advisors to reconsider potential litigation strategies in proxy contests based on a dissident's non-compliance with an advance notice bylaw's disclosure requirements, even if the non-compliance does not appear to be a deceitful omission of a material fact.[6] This strategy would depend on the notice's deficiencies, the scope of the bylaw, the governing law, and the venue for litigation, among other factors. Of course, boards would also need to consider the potential fallout from their other investors, who may perceive the directors to be acting inappropriately by barring a proxy contest on perceived technicalities.

It is not clear whether all courts will follow the Washington state court's approach in *HomeStreet* or give stockholders a little more leeway.[7] Delaware courts have recognized advance notice bylaws as "commonplace" and "frequently upheld as valid."[8] Nevertheless, Delaware courts have also said that

[3] *Levitt Corp. v. Office Depot, Inc.*, C.A. No. 3622-VCN (Del. Ch. Apr. 14, 2008); *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, C.A. No. 3447-CC (Del. Ch. Mar. 13, 2008); *Hill Int'l v. Opportunity Partners, L.P.*, No. 305, 2015 (Del. July 2, 2015).

[4] For example, in one Delaware case, the plaintiff alleged that the buyer had surreptitiously acquired the company's convertible debt and then used its position as a key creditor to gain an advantage in negotiating an acquisition of the company. *See, e.g., In re Comverge Inc. S'holders Litig.*, Consol. C.A. No. 7368-VCP, trans. (Del. Ch. May 8, 2012) (noting that "Plaintiffs' strongest claim of objectively unreasonable conduct by the [company's] directors is that without adequate information, the board refused to take legal action against [the buyer] for this alleged breach of the NDA [via acquiring the company's convertible debt that made it difficult to sell the company to a third party] and thus acquiesced to economic leverage [the buyer] may have obtained improperly").

[5] *See generally* Lawrence A. Hamermesh, *Director Nominations*, 39 DEL. J. CORP. L. 117 (2014).

[6] This is not to say some of the disclosures in *HomeStreet* were immaterial. In addition, the requirement to disclose information that would be required by securities laws in a proxy contest is neither new nor unique. *See, e.g., McKee & Co. v. First Nat'l Bank of San Diego*, 265 F. Supp. 1, 12 (S.D. Cal. 1967).

[7] *See, e.g., IBS Fin. Corp. v. Seidman & Assocs., LLC*, 136 F.3d 940 (3d Cir. 1998) ("Mere absence of prejudice to the corporation does not empower a court to veto a board of directors' exercise of a discretionary authority vested … by the certificate of incorporation").

[8] *Goggin v. Vermillion, Inc.*, 2011 WL 2347704 (Del. Ch. June 3, 2011).

advance notice bylaws cannot "unduly restrict the stockholder franchise or [be] applied inequitably."[9] The disputes in Delaware, furthermore, have tended to involve compliance with the deadline rather than the disclosure requirements. In some cases, the Delaware courts have also allowed stockholders to bypass nomination deadlines in bylaws due to a radical change in circumstances after the deadline but before the annual meeting.[10] A New York court recently reached a similar result.[11]

HomeStreet should prompt activist hedge funds to meticulously review their notifications under advance notice bylaws. In addition, one would think that activists will try to submit their notices well in advance of the company's deadline to give themselves an opportunity to cure deficiencies. It should also be noted that enforcement of the advance notice bylaw does not necessarily win the war. There are other tools available to activists, such as a public "vote no" campaign or even soliciting proxies against the incumbent directors despite the absence of a competing slate of nominees.

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[9] *Openwave Sys. Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*, 924 A.2d 228, 239 (Del. Ch. 2007).

[10] *See, e.g, Icahn Partners LP v. Amylin Pharm., Inc.*, 2012 WL 1526814 (Del. Ch. Apr. 20, 2012) (finding that "Plaintiffs have adequately alleged that, after the Advance Notice Bylaw prevented Amylin stockholders from submitting Board nominations for the Annual Meeting, the Board radically changed its outlook for the Company"); *Hubbard v. Hollywood Park Realty Enterprises, Inc.*, 1991 WL 3151 (Del. Ch. Jan. 14, 1991) (enjoining enforcement of an advance notice bylaw due to "an unanticipated change of allegiance of a majority of [the board]" that would "foreseeably generate controversy and shareholder opposition"); *but see AB Value Partners, L.P. v. Kreisler Mfg. Corp.*, 2014 Del. Ch. LEXIS 264 (Del. Ch. Dec. 16, 2014) (denying request to extend the advance notice deadline).

[11] *In re Xerox Corp. Consol. S'holder Litig.*, Index No. 650766/18 (N.Y.S. Apr. 27, 2018).