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Shareholders' Rights & Shareholder Activism

USA
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Trends and Developments

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COVID-19's Impact on Shareholder Rights
As life dramatically changed in 2020, so did shareholder rights. In the United States, we witnessed a dramatic and substantial change to how companies conduct annual meetings, a reignited debate on the purpose of the corporation, new defensive strategies for companies, as well as a reshaping of the shareholder activist model, as some activists adopted tactics historically associated with private equity. Below we note some of the major developments that took place over the past year.

The coronavirus (COVID-19) pandemic that brought much of the world's economy to a standstill in 2020 also presented new challenges for publicly held companies and shareholders seeking to exercise their rights. Some of the effects of the pandemic were immediate and visible, such as the widespread switch from in-person to virtual annual shareholder meetings. We expect the pandemic will also impact the debate over the purpose of a corporation and the role of shareholders, and provide activist shareholders with new opportunities to campaign for change to unlock shareholder value.

Switch to Virtual Shareholder Meetings and Negative Impact on Shareholder Participation
The premier forum for shareholders to exercise their rights, hold a board of directors and management accountable, and make their voices heard is the annual shareholder meeting. Public companies in the United States are required to hold an annual meeting of shareholders every year to elect directors and conduct other shareholder business. Traditionally, these meetings have been held in person (and often broadcast online) and included opportunities for shareholders to question management and the board. As every voting shareholder, whether holding ten shares or ten million shares, has the right to attend annual shareholder meetings, these meetings provided all types of shareholders the opportunity to participate meaningfully.

As a result of health concerns, restrictions on travel and in-person gatherings, and the need for social distancing amidst the COVID-19 pandemic, many public companies rapidly switched from physical in-person meetings to virtual meetings. Delaware, the leading jurisdiction for public companies, has long permitted virtual shareholder meetings, while other states such as New York have passed legislation temporarily allowing virtual-only meetings for the duration of the pandemic. The board of directors typically has the sole discretion to determine whether to hold a virtual meeting and to establish any procedures and rules governing such meetings.

Whereas in-person meetings provided shareholders with the opportunity to confront management and the board face-to-face and ask questions "live," and limited the company's ability to use scripted answers, virtual Q&As proved to be poor substitutes for in-person meetings. Most virtual shareholder meetings nominally provided shareholders with the ability to submit questions, typically by typing questions into a text box that only the company can see. This provided companies with the opportunity to cherry-pick and reword questions, have subordinates prepare scripted answers, and in some cases, ignore questions altogether. While helping directors and officers avoid embarrassing confrontations, this virtual text format effectively sterilised shareholder participation in meetings and often prevented shareholders from feeling as if they were able to participate meaningfully in meetings.

While it is understandable for companies to utilise virtual shareholder meetings during the pandemic, many shareholders hope that companies return to physical in-person shareholder meetings after the pandemic is over. In fact, legislation in some states like New York and New Jersey have authorised virtual meetings only for the duration of their COVID-19 emergency disaster declarations. We, however, expect that some companies that found comfort in the insulation from shareholder accountability offered by virtual meetings will continue to hold online-only shareholder meetings even after business returns to normal.

Impact on Debate over Corporate Purpose (Shareholders v Stakeholders)
The COVID-19 pandemic emerged during a public debate between scholars, jurists, executives and industry organisations about whether the primary purpose of a corporation is to serve shareholders or stakeholders (including employees, customers and communities). On one side of the debate, it is argued that the primary purpose of a corporation is to maximise shareholder wealth and, accordingly, management should

make every decision with shareholders in mind, with no focus being paid to other stakeholders. The opposing side argues that companies should have no duty to focus on shareholders and should be required to consider other stakeholders when making decisions. This debate typically treats this dichotomy as a zero-sum game where shareholders benefit exclusively at the expense of other stakeholders or vice versa.

The responses of both companies and shareholders during the pandemic provide important evidence that this debate is largely academic and that in the real world, the interests of shareholders and other stakeholders are often aligned in the long run rather than representing a zero-sum game. When companies reacted to the spread of COVID-19 by prioritising the health and safety of employees and customers, shareholders reacted with fulsome support rather than complaining. Shareholders did not object to companies pausing their share buy-back programme in order to conserve cash and flexibility during the pandemic. Activist shareholders that were planning proxy fights or had already submitted board nominations sought to settle quickly with management to avoid the distraction of a proxy fight and in many cases withdrew their campaigns with the express purpose of giving management time to navigate the pandemic. When companies focused on other stakeholders while their business was suffering, shareholders responded by being patient and giving companies room to respond.

Shareholders' patience and deference to management's emphasis on health and safety during the pandemic is real-world evidence that there is not a zero-sum game between serving the interests of shareholders and other stakeholders. Companies were always expected, and given leeway, to consider the interests of other stakeholders in maximising firm value. After all, the "business judgement rule" has meant that courts defer to the decisions of independent boards. With activist shareholders holding their fire just as companies were at their most vulnerable, activists have shown that they are aligned with the long-term interests of companies and other stakeholders.

Pandemic Performance will Highlight Underachievers

While shareholders have largely sat on the sidelines during the pandemic, companies should not expect such great deference once business starts returning to normal. Public companies with poor leadership and governance and ineffective strategic plans and risk planning will not be able to blame their under-performance against peers on the pandemic forever. Shareholders are eager to resume their engagement with public companies, and under-performing companies that fail to manage their way through the pandemic or embrace necessary change may find themselves to be future targets of activists as business continues to return to normal.

Shareholder Activism in the Regulated Fund Space: The Re-emergence of State Control Share Statutes

Shareholders have long faced regulatory challenges in achieving meaningful results when engaging with closed-end management investment companies regulated under the Investment Company Act of 1940, as amended (1940 Act), including registered investment companies and business development companies (collectively, Regulated Funds). Restrictions imposed under the 1940 Act, including pursuant to Section 12(d)(1), limit the amount of voting securities that any single private fund may hold in a Regulated Fund. Similarly, restrictions on transactions with affiliates can place an artificial ceiling on the percentage of a Regulated Fund's voting securities that an activist investment adviser can control in certain circumstances. As a result, activists engaged in the Regulated Fund space have historically paid careful attention to the nuances of the 1940 Act when crafting strategies focused on Regulated Funds. Developments within the Regulated Fund space, including as a result of recent actions taken by the staff of the US Securities and Exchange Commission (SEC), have made careful planning even more of a necessity when considering any potential activist engagement within the Regulated Fund space.

Specifically, on 27 May 2020, the staff of the Division of Investment Management of the SEC (Staff) withdrew previously issued Staff guidance addressing the relationship between state control share acquisition statutes, or "control share statutes," and the voting requirements of Section 18(i) under the 1940 Act. The Staff's action effectively overturned a decade-old position set forth in the Staff's no-action letter issued to Boulder Total Return Fund Inc. As a result, Regulated Funds may now opt into state control share statutes, even where those statutes may limit voting rights of certain larger shareholders. Approximately half of the states in the United States have adopted control share statutes, which typically restrict voting rights above specified ownership thresholds in the absence of board approval. Such control share statutes serve as a defensive measure and were intended to protect corporations and their existing shareholders from hostile or speculative takeovers. The Staff had previously expressed its view in Boulder that such control share statutes were inconsistent with Section 18(i) under the 1940 Act, which requires that every share of stock issued by a Regulated Fund must be a "voting stock" and have "equal voting rights" as every other share of outstanding stock.

The Staff's reversal of Boulder will likely have a chilling effect on activism within the Regulated Fund space, particularly in view of the many challenges insurgents already face under the 1940 Act. For example, for the many Regulated Funds incorporated in Maryland, a simple board resolution often permits a Regulated Fund to opt into that state's control share statute, and thereby block an investor from obtaining a meaningful stake of a

Regulated Fund's outstanding shares. Similarly, given the brevity of the Staff's statement withdrawing Boulder, it remains an open question whether Regulated Funds structured as statutory trusts can adopt indenture or bylaw provisions that provide similar protection as state control share statutes. In the absence of clear Staff guidance, certain Regulated Fund managers will likely opt for more aggressive interpretations of the Staff's current position, and courts will potentially need to wade into the interplay between the 1940 Act and state law on a more granular level. In addition, states with robust control share statutes, such as Maryland, will likely see some influx of Regulated Funds formed in other jurisdictions, either through mergers with affiliated funds or reincorporation.

The impact of the above developments are likely to be two-fold. First, any potential activist shareholder will need to understand fully the structure and mechanics of any control share statutes in the state where a particular Regulated Fund is formed or incorporated. Regulated Funds in states with robust control share statutes will likely face less activist pressure as a result, regardless of their financial performance. Second, the imposition of such control share statutes – and the resulting chilling effect on activism within the Regulated Fund space – may further reduce institutional investor interest in the Regulated Fund space generally, and in turn further exacerbate the discount to net asset value at which many Regulated Funds trade. As a result, poorer performing Regulated Funds may face even steeper discounts to net asset value relative to their better performing peers.

Convergence of Shareholder Activism and Private Equity

Traditional differences between private equity firms and activist hedge funds

Traditionally, private equity firms and activist hedge funds have operated in separate spheres of the alternative investment marketplace, each using fundamentally distinct investment strategies. With respect to their investments in public companies, private equity firms have historically been focused on acquiring full or majority ownership of their target companies. The typical private equity model has focused on co-operative engagement with a target company's board of directors and management and the negotiation of a "take-private" transaction where the private equity firm will acquire a controlling or total stake in the target company. The private equity firm will then operate and maintain the target company as a "portfolio company" for several years. The private equity model is centred on implementing operational and financial strategies to promote greater efficiency and profitability in the portfolio company, after which time they will cash out on their long-term investment by selling the portfolio company to another private equity firm or strategic buyer, or by reintroducing it into the public markets and profiting from the proceeds earned in the initial public offering. The private equity firm, by acquiring all or a majority of the target company, is the principal beneficiary of the gains that result from the target company's increase in market value.

In contrast, activist hedge funds direct their efforts not on acquiring ownership of a target, but on effecting governance and strategic changes at an undervalued target company in an attempt to unlock shareholder value. They do this by acquiring a small minority position, typically less than 10%, to push for change in the target company by persuading its leadership to pursue strategies they view as value-enhancing for shareholders. Activists use a broad range of approaches from co-operative engagement with the target's board of directors, to shareholder proposals at the target company's annual shareholders' meeting, to proxy contests where the activist seeks board changes.

Unlike private equity firms, which capture nearly all of the gains incurred by promoting greater efficiency, all shareholders profit from the gains resulting from the successful adoption of activist strategies at the target company. The activist is entitled only to a share of the gains proportional to its equity holdings, despite incurring the brunt of the expenses associated with promoting their proposed changes.

Causes of the blending of private equity and activist strategies

In recent years, the delineation in strategies between private equity firms and activist hedge funds has eroded. Prominent private equity firms have begun adopting shareholder activist strategies and activist hedge funds have made several significant private equity-style investments. There are a number of market forces driving the convergence of shareholder activism and private equity. They include:

- intense competition for positive returns on investment throughout the alternative investment space;
- the record amounts of capital raised and dry powder on hand;
- similarities in research and due diligence capabilities when evaluating prospective target companies;
- a shared investor base of sophisticated investors as well as a shared talent pool of employees; and
- a fundamentally similar approach to earning profits that involves identifying under-performing companies, stimulating operational and financial efficiency in the target company, and capitalising on the increase in shareholder value that emerges once inefficiencies are corrected.

Private equity firms adopting activist strategies

Private equity firms have taken note of the success activist hedge funds have achieved in spurring value-creation without the expense of full on "take private" deals, and have made their own forays into using strategies familiar to activism, but typically with a significant difference — they are doing so on a friendly, non-activist basis focusing on adding value. While there are examples of private equity doing true activism, for the most part they choose to avoid pure strategies in order not to antagonise companies and risk tainting their reputation in a marketplace where they seek acquisition opportunities. Activists have been able to ensure that the corporate policies they advocate for are at least discussed in earnest by the target company's board of directors, even if the number of seats held by activist directors constitute a minority of the board. Private equity firms are taking board seats (eg, our representation of KKR earlier in 2020 at Dave & Buster's Entertainment Inc). In addition, January 2020 saw a proxy contest where private equity firms Atlas Holdings and Blue Wolf Capital Advisors IV teamed up to launch a proxy contest against Verso Corporation. The proxy contest resulted in a settlement in which the private equity firms received three out of the seven seats on the Verso board of directors. Private equity stalwarts are seemingly beginning to realise that they can achieve significant returns while deploying less capital by using activist strategies, while some of the perceived negatives of using activist tactics are diminishing as market perceptions evolve.

Activist hedge funds entering the private equity space

In many ways, the convergence of private equity and activism can be seen as part of the maturation of activism as a market practice. Traditionally, private equity firms have enjoyed significantly more robust capitalisation, often fielding multi-billion-dollar funds, which provided the means to acquire ownership stakes in target companies. Activist hedge funds historically did not have the means to acquire enough of the outstanding equity to assume direct ownership of a target company. Consequently, they focused their efforts on influencing the board of directors, as such strategies only necessitated enough funds to acquire a marginal position and finance a proxy campaign. Several successful activists have launched dedicated private equity arms (eg, our clients, Elliott Capital and Starboard Value) and partnered on occasion with private equity firms in acquisitions (eg, the transaction we did where Elliott's Evergreen Coast Capital Corp partnered with Veritas Capital to purchase Athenahealth Inc in 2018 for USD5.7 billion and the transaction with Siris Capital Group to acquire Travelport Worldwide Limited for USD4.4 billion in 2019). Strategic investments have also garnered attention in this space (eg, our representation of Starboard's USD200 million private equity-style investment in Papa John's International Inc in 2019). Prominent activist firms are well positioned to take advantage of the synergies offered by the convergence of activism and private equity. The private equity arms of established activists can lean on their parent organisation's extensive experience of cajoling boards to act when necessary, thereby back-stopping their engagement with an implied threat that the firm could take its case to shareholders if the board is not co-operating in good faith.

Defensive bylaw amendments spur litigation

In the litigation space, activists sued incumbent boards that aggressively amended or attempted to amend the company's bylaws in the middle of ongoing proxy contests. They are reflective of a pendulum swing where boards have been more willing to take aggressive action when faced with a strong challenge by a shareholder who nominated directors.

In litigation arising in a campaign where we represented Harbert Discovery Fund, Harbert Discovery Fund v Enzo Biochem Inc, 20-cv-1021 (S.D.N.Y. 2020), two Harbert-managed funds had nominated two independent directors to serve on Enzo's five-person board for election at an annual meeting on 31 January 2020. As of 28 January 2020, the preliminary voting reports showed that Harbert's two nominees were highly likely to win. That day, Enzo announced, purportedly "based on feedback from its shareholders," that the annual meeting would be delayed until 25 February 2020 to allow shareholders more time to consider their voting options. The incumbent board also proposed a bylaw amendment to expand the size of the board, which would have had the effect of diluting the influence of Harbert's two nominees and keeping on the board one of the founders of the company who was in danger of being voted out of office.

The incumbent board took the position that the proposed bylaw amendment needed to be approved only by a majority of votes cast at the meeting, despite the company's charter, which specified that amendments to expand the size of the board required a super-majority vote of all shares outstanding – not only those present at the meeting. Each of the three leading proxy advisory services – Institutional Shareholder Services, Glass Lewis and Egan Jones – harshly criticised the Enzo board for taking those actions, with Glass Lewis stating that "the current Enzo directors have manipulated Enzo's corporate machinery in the extreme, giving rise to a brazen 11th-hour effort to supersede a shareholder vote in order to further the entrenchment of an incumbent member."

On 5 February 2020, the authors of this article brought suit on behalf of Harbert in the Southern District of New York seeking, among other things, an injunction preventing the Enzo board from moving the meeting again and a declaration that the proposed bylaw amendment required the approval of the super-majority of all shares outstanding. During a preliminary conference, Judge Mary Kay Vyskocil noted that Enzo's delay tactics "smack a little bit of gamesmanship."

With litigation pending, the incumbent board did not again attempt to move the annual meeting, which proceeded as rescheduled. At the meeting, both of Harbert's nominees were elected, and the incumbents' proposed bylaw was defeated.

Another recent litigation in Arizona state court involved bylaw amendments made in the midst of a proxy contest, which attempted to protect incumbent directors based on the distinction between using shares outstanding as opposed to shares voted at the meeting as the denominator for when calculating whether a director nominee received a majority of votes. See CV 2020-005293 (Ariz. Super. Ct. 26 June 2020). On 3 March 2020, a shareholder notified the company (a trust) that it intended to nominate a slate of trustees to replace the entire board. On 13 April 2020, the incumbent board announced that it had amended the bylaws to change the voting standard for the election of a trustee from a plurality of shares voted to 60% of all outstanding shares.

On 1 May 2020, the nominating shareholder sued in Arizona Superior Court, alleging that the bylaw amendment changing the voting standard "effectively guarantees that the election will 'fail,' ie, that no nominee… will receive the votes needed" under the bylaw amendment. The shareholder argued that the result would be that the existing trustees would remain in their seats as "hold-over" trustees indefinitely. The shareholder sought an injunction preventing the bylaw amendment from taking effect.

After expedited proceedings, the court granted the shareholder's request for a preliminary injunction, finding that "the record is plain – the likelihood that sufficient shareholders will participate such that any nominee could reach 60% is so low as to render the new standard a legal impossibility." This effectively deprived the shareholder of its "most sacred right" to "participate in corporate democracy." The company has appealed this ruling.

The two litigations share important parallels. Both illustrate the lengths to which incumbent boards will sometimes go in amending bylaws in the midst of a heated proxy contest. In particular, both sought to revise the rules for determining the winner in order to increase the likelihood that their positions would prevail.

The Delaware Supreme Court addresses timely responses to additional requests for information in nomination processes

In early 2020, the Delaware Supreme Court issued a decision with direct impact on the director nomination process. See 224 A.3d 964 (Del. 2020). There, the company's bylaws contained certain information requirements for nominations to enable incumbent directors to determine whether the nominees are qualified. The shareholder nominated a slate of dissident trustees and, with its nomination notice, provided what it believed to be sufficient information to comply with the company's director qualification bylaws. The bylaws further provided that "any subsequent information reasonably requested by the Board of Directors to determine that the Proposed Nominee has met the director qualifications" must be delivered or mailed to the company "no later than five business days after the request."

Several weeks after the shareholder nominated its director candidates, the company requested, via an extensive questionnaire, that the shareholder provide additional information within the five-business-day deadline set by the bylaws. After the five business days elapsed without the shareholder providing a response, the company notified the shareholder that its nominations were "invalid" because it had not complied with the deadline set in the bylaws.

The shareholder sued the company in the Delaware Court of Chancery challenging the invalidity determination. The Court of Chancery agreed with the shareholder that the questionnaire was not reasonably requested or necessary for the board to determine whether the nominees were qualified and held that the shareholder's nominees had been validly nominated.

The Delaware Supreme Court reversed. The Supreme Court acknowledged that the questionnaire included sections that were outside the scope of the information required by the bylaws, but held that the shareholder "was obligated to respond prior to the expiration of the five-business-day deadline" and that "it should have raised" its concern about over-breadth with the company "before the expiration of the deadline."

In reversing the Chancery Court and remanding for further proceedings, the Supreme Court held "[a]lthough the Court of Chancery's decision hinged upon the Questionnaire's 'overbreadth,' the record does not suggest that the Questionnaire's overbreadth precluded a timely response." Significantly, the Supreme Court noted that the bylaw requiring the five-day response had been adopted on a "clear day."

The practical lesson for investors nominating dissident slates is that, when faced with a follow-up information request it views as duplicative, over-broad or irrelevant to the qualification determination, the investor should respond to the portion of the request it views as fair game and object to the rest within the response deadline (if any) provided in the bylaws.

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Schulte Roth & Zabel LLP (SRZ) is widely regarded as the dominant global law firm for activist investing. From offices in New York, Washington, DC and London, the firm's lawyers bring a sophisticated knowledge of market practices and unparalleled expertise in all areas related to activist investing. SRZ has more than 30 years of experience advising clients on more than 1,000 shareholder activism matters. The team assists with all matters relating to activism, including campaign strategies, corporate governance, proxy rules, trading and affiliate rules, Sections 13 and 16 compliance, antitrust regulations, federal and state securities and corporate laws, tax and regulatory issues and litigation. SRZ helps clients navigate applicable law and regulations on a global scale, and the 18-person legal team provides guidance on both the strategic and tactical level in everything ranging from running proxy contests, consent solicitations or withhold campaigns, calling special meetings or engaging in exempt solicitations and partnering with management and corporate boards to effectuate high-level changes that make a significant impact.

The law firm would like to thank Brandon Gold for his contribution to this guide.

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