

SECURITIES LITIGATION & REGULATION

EXPERT ANALYSIS

Shareholder Activism and the Federal Proxy Rules

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Given the increasing incidence of share-holder activism, companies and activist shareholders alike must understand how the federal proxy rules apply to activist situations. The purpose of this commentary is to provide a basic understanding of the proxy rules as they apply to increasingly common situations — shareholder proposals and proxy contests — and to demystify the process.

BASIC STATUTORY SCHEME

Under the federal proxy rules, no proxy solicitation may be made unless each person who is solicited is furnished with a publicly filed preliminary or definitive proxy statement. Furthermore, no person who is conducting a proxy solicitation may deliver a proxy card unless the shareholder receives a definitive proxy statement that has been filed with the U.S. Securities and Exchange Commission.

Limited exceptions to these rules exist. Most notably, the federal proxy rules do not apply to any solicitations made otherwise than on behalf of the company in cases in which the total number of people solicited is not more than 10. This means the activist shareholder can solicit and obtain proxies from shareholders without complying with the federal proxy rules, other than the anti-fraud provisions of SEC Exchange Act Rule 14a-9, 17 C.F.R. § 240.14a-9.

As a result, an activist shareholder may be able to conduct a stealth solicitation to acquire substantial voting power in a company, especially one that has highly concentrated stock ownership and no advance-notice bylaw provision.

The adoption of Rule 14a-12 leveled the playing field somewhat. This rule provides that a solicitation may be made before furnishing shareholders with a publicly filed proxy statement if a definitive proxy statement meeting the requirements of Rule 14a-3(a) is provided to shareholders before or when a proxy card is furnished to or requested from shareholders.

Thus, under Rule 14a-12, the company and the activist shareholder can communicate with an unlimited number of shareholders so long as a proxy card is not sent to the shareholders before the definitive proxy statement is sent. If the communication is in writing, it must contain certain legends and be filed with the SEC no later than the date on which it is provided to shareholders. If the solicitation is oral, however, it need not be reduced to writing and filed.

In short, anyone, including the company, can communicate orally to an unlimited number of shareholders and file nothing with the SEC so long as the soliciting person does not furnish a proxy card without first or concurrently furnishing a publicly filed, definitive proxy statement.



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SHAREHOLDER PROPOSALS

There are two ways in which a shareholder can bring a proposal to a vote before a shareholder meeting. First, the shareholder can ask the company to include its proposal in the company's proxy materials. Alternatively, a shareholder can solicit its own proxies in favor of its proposal. The shareholder can also do both, but this alternative only makes sense when the shareholder is nominating a slate of directors in addition to making a proposal (*i.e.*, when it is soliciting proxies anyway).¹

14A-8 PROPOSAL

Rule 14a-8 is probably the most familiar rule in this area. In short, if a shareholder is eligible and follows certain procedures, a company must include the shareholder's proposal in the company's proxy materials. Only under a few specific circumstances, and after following certain procedures, may the company exclude the proposal.

A detailed explanation of how a shareholder can submit, and how a company can exclude, a shareholder proposal under Rule 14a-8 is beyond the scope of this article. All eligibility and procedural requirements are addressed in a question-and-answer format in Rule 14a-8.

If the company has an advance-notice bylaw provision, the shareholder should also make sure the proposal is submitted before the deadline included in such provision. Typically, however, the company's advance-notice deadline is well after the Rule 14a-8 deadline, so this shouldn't be an issue. However, if the advance-notice deadline, or some other procedural requirement, is not met, the shareholder runs the risk that the company may rule the proposal out of order from the meeting floor even though it was included in the company's proxy materials.

OTHER PROPOSALS

So long as the proposal is not improper under state law or the company's charter or bylaws, there are almost no limits on what proposals a shareholder may bring before an annual meeting, even if the proposal could be excluded under Rule 14a-8.

Of course, the only way a non-14a-8 proposal will pass is for the proponent to have enough shares alone to pass the proposal or to solicit proxies. In this regard, aside from getting enough support, adoption of the proposal may depend on whether the company has discretionary authority to vote on the proposal.

The rules on discretionary authority are probably some of the most complex proxy rules to understand, but it is critical to understand them. First, however, I will explain what is meant by discretionary authority.

In its simplest form, a proxy card lists each proposal to be acted on separately and provides the ability to vote for or against or to abstain from voting on the proposal. If the proxy card is properly signed and the boxes are appropriately marked, the proxy holder will vote the shares represented by the proxy card as the shareholder indicated.

If the shareholder does not sign the proxy card, no proxy is granted. But, what if the shareholder signs the card and doesn't check any boxes? Or, what if a proposal is properly brought before the meeting, but it was not listed on the proxy card? This is when discretionary voting authority may be implicated.

DISCRETIONARY AUTHORITY

There are two types of discretionary authority. The first, and less complicated, one is discussed in Rule 14a-4(b)(1), which provides that if a proposal is included on the proxy card and a shareholder returns a signed proxy card without indicating how to vote on the matter, the proxy holder may vote the shares in accordance with its own recommendation. This rule applies to both the company and the shareholder proponent.

The second, more complicated type of discretionary authority deals with a proposal that is not included on the proxy card. To more fully understand how this discretionary authority works, it is helpful to understand how the proxy card is formatted and the strategic implications of the discretionary authority rule.

Rule 14a-4(a) provides, in relevant part, that the proxy card “shall identify clearly and impartially each separate matter intended to be acted upon ... and whether proposed by the registrant or by security holders. No reference need be made, however, to proposals as to which discretionary authority is conferred pursuant to paragraph (c) of this rule.” Rule 14a-4(b)(l) provides further that “[m]eans shall be provided in the form of proxy whereby the person solicited is afforded an opportunity to specify by boxes a choice between approval or disapproval of, or abstention with respect to, each separate matter referred to therein as intended to be acted upon, other than elections to office” and say when on pay.

Thus, unless discretionary authority is conferred as to a proposal, each proposal must be included, impartially, on the proxy card and the shareholder must be able to vote for or against or abstain with respect to each proposal. And, unless a proposal is specifically listed on a proxy card or the proxy holder has discretionary authority to vote on a matter that is not on the proxy card, a proxy card may not confer authority to consent to or authorize any other action.

In its simplest form, the proponent’s strategy is to force a company to include a proposal in the company’s proxy materials. The proponent does not want the company to have discretionary authority to vote on the proposal without including it on the company’s proxy card. The company, by contrast, wants to be able to vote against the proposal without even having to mention it in its proxy materials. With this backdrop, I will explain the rule.

Rule 14a-4(c)(l) provides that if the company did not have timely notice of the proposal, the proxy card may confer discretionary authority on the company to vote on the proposal if a specific statement is made to that effect in the proxy materials. This is the part of all proxy statements that says something like, “The board is not aware of any other matter to be acted upon at the meeting. If any other proposal is properly brought before the meeting, it is intended that the proxies will be voted on any such matters in accordance with the judgment of the persons voting such proxies.”

In short, if the company did not have timely notice of the proposal, the proposal need not be discussed specifically in the company’s proxy statement, it may be excluded from the proxy card and the company’s proxy committee may vote in its discretion on the matter, which usually means against the shareholder proposal.

The application of discretionary authority starts to get significantly more complicated if the shareholder does give timely notice of the proposal.

Rule 14a-4(c)(2) provides that if the company receives timely notice of the proposal, it can still obtain discretionary authority to vote on the proposal if it includes, in its proxy statement, advice on the nature of the matter and how the company intends to exercise its discretion to vote on the proposal. The shareholder proponent, however, may eliminate the company’s discretionary authority if the shareholder meets all of the procedural requirements set forth in Rule 14a-4(c)(2), in which case the company must include the proposal in its proxy materials if it wants to vote on the proposal.²

ELECTION OF DIRECTORS

In contrast to other shareholder proposals, the discretionary authority conferred by Rule 14a-4(c) plays virtually no role in a contest for the election of directors.³ Rule 14a-4(b)(2) provides that a proxy card that provides for the election of directors must only set forth the names of the nominees and provide a means for shareholders to withhold authority for each nominee.⁴ In short, any proxy card that is signed and returned to the company or the shareholder proponent will be deemed “for” votes unless authority to vote for the nominee is withheld.

So long as the proposal is not improper under state law or the company’s charter or bylaws, there are almost no limits on what proposals a shareholder may bring before an annual meeting.

Under the federal proxy rules, neither the company nor a shareholder may name a person as a nominee for election as a director unless that person has consented to being named in the proxy statement and to serve if elected. A problem arises when a shareholder nominates fewer persons for director than the number of directorships to be filled: the so-called “short slate.”

Running a short slate is not a problem under plurality voting.⁵ If there are six seats to be filled in the election, and 10 candidates are running — six from the company and four from the shareholder — the six highest vote-getters win. Shareholders who want to vote for the activist’s four nominees, however, are effectively disenfranchised from voting to fill the other two seats if they vote by proxy. They will have no vote on those seats unless they show up at the meeting to vote by ballot.

The SEC’s workaround for this problem is not elegant. Rule 14a-4(d) provides that a person soliciting proxies in support of nominees, who, if elected, would constitute a majority of the board of directors of the company, may seek authority to vote for nominees named in the company’s proxy statement if the soliciting party:

- Seeks authority to vote for the aggregate number of directorships subject to election.
- Represents that he or she will vote for all of the company nominees other than those specifically identified.
- Provides shareholders an opportunity to withhold authority with respect to any other company nominee not identified by the proponent above.
- States on his or her proxy card that there is no assurance that the company’s nominees identified by the soliciting party will serve with the soliciting party’s nominees if elected.

In other words, in the scenario described above, the soliciting shareholder would be required to indicate that if the other shareholders signed and returned his or her proxy card, the soliciting shareholder would vote the shares represented by the proxy card for its four nominees and for all of the company’s nominees other than four specifically identified persons, resulting in authority to vote for six persons.

If the voting shareholder did not want to grant authority to vote for the two company nominees the activist would vote for, he or she can withhold authority from the soliciting shareholder to vote for one or both of those persons. The voting shareholder, however, must go to the company’s proxy statement to read about the company’s nominees for which the soliciting shareholder will vote.

CONCLUSION

No one article can capture all the nuances of the federal proxy rules.⁶ The purpose of this article is to present some of the basics. Unfortunately, no one can fully appreciate the nuances of these issues until he or she has faced a proxy contest and had to apply these rules in a real-life situation. It is hoped that this article will assist in that process. Also, stay tuned, since the SEC has started the process of possibly revising these proxy rules.

NOTES

¹ The shareholder could also make a proposal at the meeting without having the company include the proposal in its proxy statement or without soliciting proxies. Unless the shareholder owns enough stock to pass the proposal himself or herself or can convince enough other shareholders to show up and vote, this alternative is probably doomed to failure.

² The registrant would still have the first type of discretionary authority — that is, to vote on the matter if the proposal is specifically listed on the registrant’s proxy card and a shareholder returns a signed but unvoted proxy card.

³ The only relevant discretionary authority under this rule is that if a bona fide nominee is named in the proxy statement and this nominee is unable to serve, the proxy holder may use his or her discretionary authority to vote for the person named to replace such nominee.

⁴ Instruction 2 to Rule 14a-4(b)(2) provides that if applicable state law gives legal effect to votes cast against a nominee, then in lieu of, or in addition to, providing a means for shareholders to withhold authority, the proxy card should provide a similar means for shareholders to vote against each nominee.

⁵ Even companies that have majority voting in the election of directors typically provide for plurality voting in a contested election.

⁶ In addition to the federal proxy rules, there are issues related to the following: how cumulative voting works, expanding the board, changing the date of the meeting and adjourning the meeting once it's convened, how the meeting is conducted, and the strategies used to convince shareholders to vote one's proxy card.



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