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Activism and Election Contests: Some Facts, Practice Tips, Defense Strategies, Tactics and Legal Considerations[1]

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In Case You're Wondering, Activism is Not Going Away Any Time Soon.

Stockholder activism is no longer a sideline venture. It's a legitimate asset class, a source of outsized returns for institutional investors, a core profit maker for many hedge funds, and an increasingly significant driver of M&A deals. Unlike "corporate raiding" in the 1980s, there is little to no stigma today associated with launching an activist campaign against an underperforming company. It's estimated that, in the aggregate, the 50 largest activist funds (constituting the "SharkWatch 50") currently have approximately $220 billion in total assets under management, compared to approximately $9 billion at the end of 2010. Capital investment in activist funds is also more long-term today than it was 10 years ago. Accordingly, the leading funds have assembled sizeable in-house professional teams to spend more time conducting valuation research and developing an investment thesis, accumulation strategy and overall plan of attack before a decision is made to target a specific issuer. Because activist hedge funds typically do not have strict asset diversification requirements or single investment limits, substantial sums can be deployed to wage an opposition campaign against a single target or just a couple of targets at one time.

Company size is no longer a factor and no issuer or industry is immune to attack. Approximately 30 percent of the issuers targeted by activists in 2014 had a market capitalization in excess of $1 billion and, reportedly, there were approximately 94 proxy fights (including election contests) announced in 2014 and approximately 495 from 2009 through 2013. In 2014, approximately 65 percent to 70 percent of proxy fights launched by activists resulted in settlements or the election of insurgent directors.

Due, in large part to pressure from institutional investors and the influence of ISS' and Glass-Lewis' voting recommendations, takeover defenses over the past 10-plus years have been dismantled by the overwhelming majority of S&P 500 issuers and by a significant number of Russell 3000 issuers. In fact, reportedly only 6 percent of S&P 500 issuers have a live poison pill in place today (compared to 57 percent in 2003), and only 10 percent of such issuers maintain a classified board of directors today (compared, also, to 57 percent in 2003). Rights plan adoptions as a purely prophylactic device and pills with five or 10-year terms are a thing of the past. Poison pills today are "on the shelf" and adopted typically for 12-month (or shorter) terms only in response to an overt takeover or creeping accumulation threat or, to a lesser extent, to facilitate an issuer-initiated sale of control process or protect an announced MOE or unique business combination.

Indeed, other structural defenses and organic "shark repellents" have been dismantled or scaled back over the past 10 years. For example, there has been a decline in: (i) the elimination of the right of stockholders to call special meetings, (ii) the elimination of stockholder action by written consent, (iii) supermajority voting requirements for stockholders to amend bylaws and charter instruments, and (iv) the right of stockholders to remove directors only "for cause." Notably, however, advance notice bylaw provisions (governing stockholder nominations of directors and the ability to present "other business" at annual meetings) have become increasingly potent and detailed over the past five years.

In the wake of the "Great Recession", many issuers still have record amounts of cash on their balance sheets that has not been returned to stockholders (via dividends or other distributions), used to fund acquisitions of synergistic and accretive businesses, or otherwise deployed to generate significant returns in today's historically low interest rate environment. Despite the long-standing bull market of the past six years and record (or near-record) breaking levels for the DJIA, S&P 500, Nasdaq Composite, NYSE Composite, Russell 3000 and other leading indices, the stock prices of a fair number of issuers across various industries are still trading at a discount to their implied disaggregated (or "break-up") value.

Stealth accumulation techniques (e.g., trading in complex derivative securities) have become more sophisticated and the SEC has not yet shortened the 10-day Schedule 13D initial filing window. Corporate governance activists (e.g., state and local retirement funds) are increasingly teaming up with economic activists. Last year a major pharmaceutical company and one of the most prominent activist hedge funds formed a co-bidder alliance in a high profile hostile takeover attempt of a strategic competitor, one of the world's leading private equity firms just announced a significant minority investment in a well-known hedge fund, and investors are more focused today than ever before on an issuer's trailing 12-month and five-year cumulative return performance, enhanced forward-looking disclosure, board accountability , and corporate governance best practices.

For all of these reasons, and due to the more widespread acceptance by index funds and other institutional stockholders of activist investment strategies and opposition initiatives, the surge in activism exhibited over the past 10-plus years is unlikely to subside any time soon.

The Proxy Access Movement

The SEC rescinded Rule 14a-11 approximately four years ago after it was vacated by the U.S. Court of Appeals for the D.C. Circuit. However, Rule 14a-8 was amended approximately at that time to facilitate private ordering and enable an "opt-in" model for direct proxy access. Subject to the procedural and eligibility requirements of Rule 14a-8, issuers no longer may seek to exclude from their proxy statements (pursuant to Rule 14a-8(i)(8)) stockholder proposals to amend the issuer's organizational instruments to facilitate director nominations. Such proposals may not, however, (i) seek to disqualify a director-nominee up for reelection, (ii) remove an incumbent director from office prior to the expiration of his or her term, (iii) question the competence, business judgment or character of a nominee or director, (iv) nominate a specific individual for election as a director, or (v) affect the outcome of an upcoming election of directors. Stockholder access proposals can be precatory (i.e., couched as a non-binding advisory vote or referendum) or, depending on applicable state corporate law (e.g., Section 112 of Delaware's General Corporation Law), drafted as proposed binding amendments to an issuer's bylaws.

Rule 14a-8 effectively establishes a two-year implementation cycle. For example, a stockholder seeking to amend an issuer's bylaws to enable direct access in connection with the issuer's 2017 annual meeting would have to submit its proposal to amend the bylaws prior to the Rule 14a-8(e) deadline for the issuer's 2016 annual meeting. If the proposed amendment is included in the issuer's 2016 proxy statement and approved by stockholders at the 2016 annual meeting, stockholders would then be able to submit the names and credentials of their nominees for inclusion in the issuer's 2017 proxy statement (to the extent the nominating stockholder satisfied the eligibility requirements and other conditions of the bylaw adopted the previous year).

After the amendments to Rule 14a-8 became effective, many anticipated that the foregoing path to direct access would become a cheaper and more expeditious alternative for activists to launch opposition slates. Indeed, there has been an increasing number of direct access proposals submitted in the last two years predominantly by corporate governance activists, including the proposals submitted in October 2014 by NYC Pension Funds to 75 target companies. Moreover, a number of issuers have either proposed direct access bylaw amendments for adoption at an annual meeting, or unilaterally adopted such bylaws. Either way, by "picking up the pen" in the first instance, issuers can prescribe their own definitions of ownership and aggregation limits, percentage ownership thresholds (e.g., 3 percent), length of ownership requirements (e.g., three years), board seat limitations (e.g., 20 percent or 25 percent of the board), notice deadlines (e.g., a 30-day window period ending coincident with the Rule 14a-8(e) deadline) and other eligibility requirements.

Earlier this year the SEC announced that it was suspending its consideration of no-action letter exclusion requests submitted pursuant to Rule 14a-8(i)(9) (i.e., the so-called "conflict exclusion"). A number of issuers sought to submit to stockholders their own direct access proposal (typically with more onerous eligibility requirements and conditions than the bylaw amendments proposed by a stockholder) and then exclude the stockholder's Rule 14a-8 proposal from the proxy statement on the grounds that it conflicted with the Board's proposal concerning the same subject matter. The SEC currently is reviewing the scope and application of Rule 14a-8(i)(9).

Although the direct access movement is gaining traction, it has not had a material impact, to date, on the way serial activists wage their election contests. The leading activist funds continue to fight the old fashioned way to retain 100 percent control over the process and the messaging campaign. Seasoned activists running a competing slate want to communicate with investors from day one using their own opposition proxy materials, fight letters, blogs, chat rooms, whitepapers, 13D filings, press articles, interview transcripts, town hall meetings, one-on-one presentations and roadshow materials. They have the experience, credibility and resources to conduct a widespread messaging campaign at their own cost.

Also, there has been an increase over the past few proxy seasons in majority or full board control contests which cannot be prosecuted under the short slate limitations contained in direct access bylaws.

Issuer Preparation and Planning

Sometimes, a good defense is a good offense. Issuers need to be proactive and well-prepared. At the first hint of trouble, it's very important to assemble the appropriate internal and external "special ops squad" (consisting, for example, of the CEO, lead independent director and/or corporate governance committee chair, IR head, general counsel, outside counsel, proxy solicitation firm, media consulting firm, financial advisor, and other "war time consiglieres"). Doing this will save valuable time once an activist surfaces and begins to agitate. The Board and management need to be educated by counsel on how to monitor, address and react to hypothetical activist threats and the techniques used by activists to target companies and put them "in play." These techniques are becoming more sophisticated and the activist playbook is continually being updated. Directors and management need to understand their fiduciary duties in all of these contexts and have a ready-to-go "Plan A" and "Plan B" (both offensively and defensively).

13D, F and G positions should be monitored closely, and an issuer's IR team needs to know the investment philosophy, exit horizon and historical cost basis of the top institutional holders. Outreach to the portfolio managers and proxy departments at top institutions is vitally important. Sudden shifts in ownership concentration – from index funds and non-activist private investment partnerships to hedge funds – are a yellow flag (and may ultimately be a red flag). It's important for management and the Board to keep abreast of M&A activity in the industry.

A frequent and open communication policy with stockholders is the best means of obtaining meaningful feedback. It's essential to identify investor concerns when they're still relatively nascent and not yet in the public domain. The Shareholder-Director Exchange (SDX) protocols (recently introduced by representatives from leading institutional investors and a consortium of independent directors) is an extremely helpful guide for developing and enhancing an issuer's disclosure practices and formalizing its stockholder engagement program. Likewise, the NACD"s Blue Ribbon Commission has published comprehensive recommendations for effective board-stockholder communications. Of course, not only is an open communication policy a matter of best practice and tactically important but, presciently, the SEC adopted Item 407(f) of Regulation S-K in 2003. Item 407(f) requires the issuer to disclose in its proxy statement (or publish on its website) whether it has established a process for stockholder communications with the board and, if so, how the process works. If the issuer has not established a process it must disclose such fact and the reasons therefor.

When communicating with stockholders, management and the board should speak in a consistent voice and not allow an activist to engage in ad hoc, or one-off, dialogues with directors and management in an attempt to elicit inconsistent responses. Inconsistent substantive messaging, or even nuanced differences in tone, can come back to haunt the issuer in a big way and enable an activist to drive a wedge between directors and between management and the board.

If underperformance (vis a vis stock indices, and in relation to ISS-constructed or issuer-selected peer groups) is a problem or, for example, if corporate governance practices and executive compensation policies need to be improved and updated, the company should address these issues right away. If an activist surfaces and a contest is threatened or ultimately ensues, reactive measures to improve corporate governance weaknesses and address performance problems by announcing new governance policies or a new business strategy will receive far less investor credit and ISS and Glass-Lewis recognition than if the issuer adopts and announces positive changes on a clear day. By getting out in front, the issuer can remediate the problem and control the messaging instead of being in reaction mode. It's much more difficult to respond convincingly and effectively after a detailed criticism is published in an open letter to the board, a 13D filing or in investor chat rooms. Moreover, an activist target does not want to get into a public "ping pong" match with an activist investor from both a disclosure and tactical perspective.

The board and management need to conduct regular risk assessments and review management's business plan and consider implementing modifications if the issuer's performance falls materially below internal forecasts or street estimates for more than a short-term period. At a minimum, the issuer should make known through public disclosure and investor outreach that it's aware of the problem and focused on prompt solutions. Issuers should not wait to read negative reports from sell side analysts, investors or the business media.

With respect to board composition and tenure, boards and nominating committees need to take a hard and realistic look at the composition of the board. Director tenure is a "hot button" for institutional investors and for ISS and Glass-Lewis. Rightfully or wrongfully, many institutions (as well as the leading proxy advisory firms) equate lengthy tenure (e.g., more than 12 years) with a decline in director objectivity and independence. The board and nominating committee also need to carefully review whether the company and stockholders would benefit from more diversity among the incumbent directors and whether there are notable gaps in terms of industry experience and gender, as well as corporate governance, financial and transactional expertise. Director term limits, overboarding, anti-hedge and pledge policies, the appointment of a lead independent director, elimination of affiliate transactions, and director stock ownership requirements, are check list issues for many institutional investors.

With respect to structural and organic defenses, issuers need to carefully review their anti-takeover arsenal to ensure that it's state of the art and properly protective of the company. If needed, updating older generation advance notice bylaws should be at the top of the "to do list." This is a first line of defense against a surprise opposition director campaign. The ability of stockholders to call special meetings and to take action by written consent should be reviewed so that the board understands the options available to activists who may seek compositional change. Of course, reversing course on the ability of stockholders to act by written consent requires a charter amendment in Delaware (and in most states) and is all but certain to receive a "vote no" recommendation from the leading proxy advisory firms and be voted down by stockholders. Altering the percentage necessary for stockholders to call special meetings may be viewed as unilateral board action that diminishes the substantive rights of stockholders which, depending on the issuer's overall governance rating, could result in "withhold authority" recommendations from ISS and Glass-Lewis. That said, there are certain amendments that can be implemented unilaterally, some of which (e.g., the adoption of special meeting and written consent record date procedures, enhanced information requirements, and other technical and clarifying amendments) are somewhat more subtle and innocuous than others.

It is far better to implement any organic changes on a clear day and prior to an overt activist threat (e.g., receipt of a nomination letter or a books and stockholder list inspection request, a 14a-12 filing or some other published statement by an activist of its campaign intentions). This is advisable both as an investor relations matter and to better survive potential legal challenges to the validity of such changes. Any organic shark repellent implemented unilaterally by the board – especially one that touches on stockholder voting rights – will be construed strictly against the issuer in the case of any facial ambiguity, and may strengthen the activist's (and other stockholder-plaintiff) arguments that "moving the goal posts" after a campaign commences is coercive, preclusive, and inequitable.

Rights plans on the shelf should be updated and reviewed with the board, and if the issuer does not have a shelf pill it should consider having one prepared by counsel. It's important to underscore that rights plans cannot be used to frustrate the proxy machinery and disenfranchise voting rights. The case law in Delaware for more than 30 years has made clear that pills cannot be used to impede the ability of stockholders to exercise their voting rights in a public proxy solicitation. Notably, for decades every rights agreement has excepted from the definition of "beneficial ownership" a voting arrangement evidenced exclusively by a revocable proxy or consent obtained in a public (non-exempt) solicitation conducted in accordance with the solicitation, filing and proxy dissemination requirements of Regulation 14A under the federal proxy rules (to the extent the arrangement is not then-reportable on Schedule 13D under Item 4 thereof or otherwise). That said, the courts have long-recognized that rights plans do have an incidental effect on stockholder voting and proxy contests. Depending on the flip-in percentage (e.g., 10 percent, 15 percent or 20 percent), a pill is designed to and will deter: accumulations of stock in the open market above the relevant threshold, certain group formation and "in concert" activity, formal voting agreements (involving a cumulative position higher than the relevant flip-in or "acquiring person" threshold), certain synthetic securities and derivatives trading activities, and other methods of acquiring beneficial ownership above the relevant threshold. Derivatives clauses in rights agreements are de rigueur today and, to a more limited extent, "wolf pack" clauses have crept into rights plan technology.

In the Delaware Court of Chancery's recent *Third Point LLC v. Ruprecht decision*, Vice Chancellor Parsons declined to enjoin a non-NOL "dual-trigger" rights plan in the context of an impending short slate proxy fight. After Third Point (a 13D filer and approximately 9.5 percent stockholder) publicly announced its intention to recruit new director candidates, seek the ouster of the company's CEO, and influence changes to the target company's operating strategy and corporate governance practices, the company adopted a dual-trigger pill. Specifically, the rights agreement contained two flip-in triggers – 10 percent for 13D filers (who did not expressly disclaim a control or other Item 4 intention) and 20 percent for passive investors eligible to file a Schedule 13G. The Vice Chancellor ruled that potential "wolf pack" activity by Third Point and two other activist hedge funds constituted an objectively reasonable and cognizable threat to the company because the hedge funds, were they to act in concert, could acquire "creeping control" of the company without paying a control premium. Accordingly, he concluded that the board's decision to adopt the pill was neither preclusive nor coercive and fell within a range of reasonable and proportionate responses to the threat. He also found that the board did not act for the primary purpose of disenfranchising stockholder voting rights, which would have required the board to demonstrate a "compelling justification" for such action.

In the wake of the *Third Point* decision, the jury is still out on the use of dual flip-in thresholds in non-NOL pills (at least in the context of a short slate proxy fight) and whether such features would be impermissibly discriminatory and inequitable under a given set of circumstances. Vice Chancellor Parsons observed that the dual-trigger provisions raised "some valid concerns" because they allowed passive investors who were likely to vote with management to acquire a 20 percent stake while activists were capped at 10 percent. However, he noted that any discriminatory impact was hypothetical because there were no passive 13G investors who owned more than 10 percent of the company at the time and the company's directors collectively owned less than one percent of the outstanding common stock.

Perhaps the most interesting portion of the *Third Point* decision is the discussion of whether and when a target board may be required to waive certain features of a poison pill because the threat that existed on the date the pill was adopted no longer is the same. After Third Point formally nominated three opposition directors, it requested a waiver from the 10 percent flip-in trigger to enable it to purchase up to a 20 percent block. Third Point reiterated that it had no intention of pursuing a tender offer or hostile acquisition of the company and intended only to wage a short slate election contest. When the company declined to grant a waiver, Third Point sought to preliminarily enjoin the company's annual meeting. The Delaware Court of Chancery noted that the threat of "creeping control" at the time the poison pill was first adopted (months earlier), no longer existed, but that if Third Point were allowed to acquire a 20 percent stake it could exert "negative control" of the company. The threat of "negative control" under all of the circumstances constituted a legitimate threat to the company and the company's refusal to grant Third Point's waiver request was deemed to be a reasonable response. That said, Vice Chancellor Parsons cautioned that the failure to grant the waiver presented a "much closer question" than the decision to adopt the rights plan on day one.

To date, a number of companies facing activist threats have adopted rights plans containing dual flip-in triggers that distinguish between passive and activist investors. In light of the fact-intensive *Third Point* decision, such features should be used carefully and examined very closely. A rights plan is a living and breathing instrument and, as a fiduciary matter, a board needs to be cognizant of materially changed circumstances (since the adoption date) that may warrant the grant of a waiver from the application of certain of the pill's features or an amendment to the pill's terms (prior to a trigger event), in each case to better ensure that the terms and use of the pill address the new or different threat in a reasonable and proportionate matter. This may be especially true in the absence of a hostile takeover threat where an activist announces its intention to wage a short-slate contest and is willing to sign a customary standstill agreement against other hostile activity. Suffice it to say, the Delaware courts have consistently announced that a poison pill must allow a proxy contestant a "real world shot" (in the mathematical sense) to wage and win a proxy contest.

Whether, When and How to Settle a Threat or Fight

There is no one-size-fits-all blueprint. Directors have an overarching fiduciary duty of care and loyalty and they must determine what's in the best interest of the issuer and all of its stockholders. Proxy fights are very costly, disruptive and distracting. Avoiding a fight is the better alternative almost all of the time. If an activist has gone to the trouble of publishing a whitepaper or presenting a detailed operating strategy or business plan, directors and management should not reject the presentation out of hand. Large funds today employ significant in-house teams of research analysts, valuation experts, investment bankers, tax and accounting experts, and legal staffs. Often, they have very constructive ideas and just because their critique or recommendations were not solicited by management or the board, that doesn't mean fresh ideas should be ignored as if they're merely rhetoric "from the enemy." There may be a way to incorporate some of the proponent's ideas into management's and the board's overall strategy, and engaging the activist at an early stage to work behind the scenes together in a constructive forum may yield the best outcome for the issuer and its stockholders.

Settling sooner than later is usually better (but not always). There always are offensive and defense tactics and the parties' relative bargaining power to consider. Settling early does not mean that an issuer should just concede and roll over at the very first salvo and under any set of circumstances. Many settlements are reached shortly before the annual meeting date, whereas others are reached prior thereto, but weeks or months after the activist first surfaces. The history of contacts and dialogue between the parties will dictate much of the strategy, tactics and tone. The strategy selected by the

Board and management must always be what they believe to be in the best interest of the issuer and its stockholders. They must make an independent and disinterested assessment and business decision.

If an activist overtly threatens or launches an election contest that could not be diffused through prior outreach, attempts at compromise and good faith engagement, the board might want to consider negotiating (as part of a proposed settlement) the replacement of one or two long-tenured directors with a new candidate or two. For example, the issuer might consider adding a director candidate selected by the activist (but who is not a principal or employee of the fund) and another candidate who is selected mutually by the fund and the issuer (and perhaps identified in the first instance by an executive search firm). Typically, agreeing to certain corporate governance best practices (if the issuer has been criticized historically by the fund and other stockholders or has a low corporate governance scorecard) is part of the settlement framework. Any candidates, of course, must meet requisite director eligibility criteria, be fully vetted by the nominating committee (and recommended to the board) and have industry, public company and other experience that will enhance the overall qualifications, credentials and capabilities of the board. Adding persons who might facilitate more constructive debate and diversity of viewpoints can be a healthy addition to the boardroom, but polarizing personalities and directors with a special interest agenda should be avoided.

If the issuer is comfortable that the new director candidates will selflessly and dispassionately champion the best interest of all stockholders, improved corporate governance practices are agreed to (as necessary), there is a meeting of the minds on overall corporate strategy and the execution of management's business plan, and the issuer can obtain a reasonably comprehensive standstill agreement from the activist (to enable positive changes to take root), this should create a path for an acceptable settlement agreement.

What are Solicitations, Non-Solicitations, and Exempt Solicitations?

The starting point is Rule 14a-1(l)(1) under Regulation 14A. Rule 14a-1(l)(1) defines "solicitation" to include (i) any request for a proxy, irrespective of whether the request is accompanied by or included in a formal proxy card; (ii) any request to sign or abstain from signing or to revoke a proxy; and (iii) the furnishing of a form of proxy or other communication to stockholders under circumstances reasonably calculated to result in obtaining, withholding or revoking a proxy.

Clause (iii) captures a broad range of communications (which may occur prior to the start of formal solicitation activities) that are designed to influence voting decisions. That said, Rule 14a-1(l)(2)(iv) provides that a communication by a stockholder (who does not otherwise engage in a solicitation) that is is limited to a statement of how the stockholder intends to vote and the reasons for its voting decision, is not a solicitation provided that the statement is communicated by certain prescribed means. Disclosure by a significant institutional holder regarding its voting intentions, and the reasons therefor, can be very useful for an activist stockholder or for the issuer depending on the circumstances. However, knowing the boundary between the third clause of Rule 14a-1(l)(1) and the exemption in Rule 14a-1(l)(2)(iv) requires careful analysis.

Rule 14a-2 also exempts certain solicitation activities from the full breadth of the federal proxy rules. For example, Rule 14a-2(b)(1) exempts solicitations by any person who does not, directly or indirectly, seek authority to act on its own behalf or on behalf of another person as a proxy or furnish or request a proxy. This exemption is often used in "vote no" campaigns—where a dissident stockholder is opposing a merger or similar transaction—and in "withhold authority" campaigns for the election of directors.

Importantly, the foregoing exemption does not apply to solicitations by the issuer or any of its officers, directors, affiliates or associates; any director-nominee on whose behalf proxies are being solicited; Schedule 13D filers, unless such persons have disclaimed in Item 4 any intention or reservation of the right to engage in a control transaction; and certain other enumerated persons. Pursuant to Rule 14a-6(g), persons who utilize the exemption for solicitations conducted in reliance on Rule 14a-2(b)(1) and who own securities with a market value in excess of $5 million, must file with the SEC (i.e., under cover of a "Notice of Exempt Solicitation") all written materials used in the solicitation not later than three days after their date of first use.

"The Rule of 10" is a private solicitation exemption sometimes used by activists. Under Rule 14a-2(b)(2) any solicitation by a person, other than on behalf of the issuer, where the aggregate number of persons solicited is not more than 10, is exempt from the proxy statement filing and informational requirements (but not the anti-fraud requirements) of the federal proxy rules. This can be meaningful exemption where the institutional ownership of an issuer is extremely concentrated. Many advance-notice bylaw provisions today require disclosure of whether an opposition stockholder intends to engage in a widespread proxy solicitation or, instead, rely on any one or more exemptions from solicitation.

If a dissident uses The Rule of 10, it elects to forgo public solicitation activities and cannot conduct a widespread (or full public) messaging campaign. Even in the case of an institutionally concentrated issuer, this can have some practical adverse consequences. For example, a number of large index funds, private investment partnerships and other non-hedge fund institutions may not, as a matter of policy, meet with an opposition contestant who has not filed with the SEC and mailed to stockholders an opposition proxy statement and proxy card. Moreover, ISS similarly may not meet (in person or by telephone conference) with an activist who has not filed definitive materials and will only reference in its report information that's in the public domain. Glass-Lewis, on the other hand, does not generally meet with the issuer or activist before issuing its report. Lastly, if the dissident is a 13D filer, the Rule of 10 may not be available depending on the dissident's Item 4 disclosures and, if the activist communicates with ISS, under certain circumstances such communication could be deemed to exceed the Rule's 10-person limitation.

Rule 14a-12 Solicitations Before Filing a Proxy Statement

Under Rule 14a-12, a contestant— whether the issuer or a dissident stockholder—is permitted to engage in a solicitation (and, therefore, furnish written solicitation materials) before furnishing a definitive proxy statement to stockholders. There are certain requirements to utilize the rule; namely, each communication has to identify the persons who are participants in the solicitation and describe their stock ownership and other interests in the solicitation. Alternatively, the communication can advise stockholders where to obtain such information so long as the disclosure is clear and prominent.

The 14a-12 communication also has to advise stockholders, again in a clear and prominent legend, that they should read the proxy statement once it becomes available because it contains important information, and where to obtain the proxy statement (e.g., on the SEC's EDGAR website) and other documents free of charge.

The 14a-12 communication cannot contain or furnish a form of proxy card, voting authorization, or written consent. These are furnished to stockholders together with or prior to furnishing the definitive proxy statement.

All 14a-12 communications must be filed with the SEC on the date they are first published, sent or given. This means before 5:30 p.m., Eastern time, on the day the communication is first disseminated. The filing is made on Schedule 14A and there is a "14a-12 box" to check on the cover page.

Registrants typically use 14a-12 for "stop, look, and listen" communications that caution stockholders not to make up their minds or take any action until they receive from the issuer all relevant information. 14a-12 can be used for a variety of messaging purposes and there are certain additional technical requirements where 14a-12 is used in opposition solicitations.

The SEC staff has made clear that Rule 14a-12 cannot be used unless, at the time of use, the user has a good faith intention to file with the SEC and furnish in definitive form to stockholder a proxy statement and proxy card. This is sometimes a point of attack by issuers where an activist in its nomination letter—or other communication—discloses an equivocal intention to file a proxy or merely reserves a right to do so.

SEC Filings and Staff Review Process

In a contest, the issuer's preliminary proxy materials and the insurgent's opposition proxy materials are filed publicly with the SEC. These are live filings with special EDGAR tags that denote "proxy contest" so that the filings are routed to the SEC's Office of Mergers & Acquisitions (OMA) for assignment to the appropriate staff attorneys.

The trigger event requiring the issuer to file preliminarily, in lieu of just mailing definitive proxy materials, is the disclosure in the proxy statement that refers to, or comments on, a commenced or impending opposition solicitation. If the issuer has received a formal nomination letter and/or books and records inspection demand, or the dissident already has filed a preliminary opposition proxy statement, a Rule 14a-12 notification or a 13D indicating its intention to wage an opposition solicitation, the issuer will be blocked from mailing definitively in the first instance. Sometimes there are "gray area threat letters and equivocal communications from an activist that may not constitute an absolute statement of intention to nominate and seek the election of its opposition slate. Whether the issuer can just file and mail its proxy statement definitively in such latter circumstances is a tough judgment call that requires careful analysis and advice from counsel.

The disclosure in the issuer's proxy statement about an impending contest is contained in a "background section" that describes the material past contacts, meetings and communications between the issuer and its opponent, and the events that led to submission of the nomination letter or other opposition notice.

The issuer's proxy statement also will state why the board believes that the reelection of its nominees or, if applicable, a vote for adoption of a transaction agreement, is in the best interests of the issuer and its stockholders. The issuer's proxy statement will notify stockholders that they may be receiving opposition proxy materials and that such materials should be disregarded, as well as other information about returning the issuer's (white) proxy card and not the dissident's (other color) proxy card; how to change a previously submitted vote by submitting a later dated and signed proxy card; the inability to "split votes" on cards; and other technical disclosures of such nature.

Under the federal proxy rules, definitive proxy materials cannot be filed and mailed until at least 10 calendar days after the preliminary filing. Never say never, but receiving no review or no comments from the staff in respect of a preliminary filing for a proxy contest is exceptionally rare (in fact, this author has never seen that happen). Also, in a contest it's unlikely to have proxy materials cleared within exactly 10 days from the filing date.

However, the OMA attorneys are extremely diligent about issuing comments and trying to get filings cleared quickly for mailing. The staff review process ordinarily is completed in approximately two weeks (plus or minus a day), depending on how careful the parties are with their disclosure. The staff understands how time sensitive a proxy contest is and the importance of enabling both sides to disseminate definitive materials. Hitting the street quickly with definitive materials provides stockholders with as much time as possible to digest the disclosure from each side about the history leading to, the nature of, the reasons for, and the consequences of, the proxy contest.

Often the OMA attorneys will work outside of ordinary business hours to review certain proposed disclosures in advance of formal EDGAR amendments to preliminary filings, depending on the sensitivities and time pressures involved. Therefore, it behooves both sides to expedite the SEC staff's review and comment process, and to get proxy materials disseminated as soon as possible.

Fight Letters

The best way to reduce SEC staff comments and to expedite the review process is to file preliminary materials that are relatively "light" in terms of advocacy and platform statements. The real campaign talking points and theme statements are saved for the "fight letters." Unlike the proxy statement—which is reviewed by the SEC staff in advance of definitive mailing—under the federal proxy rules, fight letters are additional solicitation materials and not pre-cleared by OMA. These materials can be mailed right away to stockholders so long as they are filed with the SEC no later than 5:30 p.m., Eastern time, on the date the materials are first used or disseminated.

Typically, both sides will file their preliminary proxy statements with minimal campaign statements, and on the day the definitive proxy statement is first mailed, it will be accompanied by a fight letter that was not pre-cleared by the SEC staff—although the fight letter will be filed with the SEC on the date it is first mailed. Stockholders receive the proxy statement and the first fight letter in the same initial mailing package.

Fight letters are two or three-page documents that advocate, in a pithy, attention-grabbing format, the contestant's most persuasive campaign talking points and themes. These communications contain what the contestant believes to be the most salient selling points to obtain stockholder votes. They usually contain both qualitative and quantitative historical performance information and, in the case of the issuer, its plans and proposals to improve financial results, increase the stock price and, if applicable, enhance corporate governance best practices. The issuer will set forth four or five examples of recent "success stories" and its plans to drive growth and enhance profitability over the medium and long-term. With respect to board composition, the registrant will explain why there is no need for change or, alternatively, what it has done recently or already is in the process of doing to refresh the independence, experience, qualifications and diversity of the board.

The activist's fight letters will advocate why it believes change is warranted and why its candidates are best-suited to implement such change. The opposition letters will include statistics regarding the registrant's past performance shortfalls relative to its peers, stock market indices and sometimes indices constructed by the activist (especially 12-month and five-year cumulative returns on investment). Sometimes the activist will publish a "whitepaper" detailing its plans and recommendations to redirect management's operating strategy, accelerate earnings growth, deploy stagnant cash reserves, reduce costs, simplify the issuer's capital structure, divest non-core assets, and pursue M&A opportunities. These whitepapers, which are used in roadshows with the issuer's top institutional investors and submitted to ISS and Glass-Lewis for their review, are additional solicitation materials that are filed with the SEC on their date of first use. Excerpts therefrom are typically included in the activist's fight letters. Conflicts of interest, perceived flaws in board composition, the registrant's affiliate transaction history, missed corporate opportunities, failed transactions, executive compensation in relation to issuer performance, corporate governance weaknesses, and the like, will be highlighted to the extent applicable.

In the typical proxy fight, each side will mail four (sometimes five) fight letters commencing on the definitive proxy statement mailing date and continuing until approximately one week prior to the stockholder meeting date. In an election contest, one or two of the letters usually are in the nature of an "attack ad" emphasizing the key negatives about the opposition candidates' non-independence, employment history, experience and qualifications.

Even though fight letters are not pre-cleared by the SEC staff they are reviewed after filing and mailing in definitive form. Therefore, the parties must make certain that they don't overreach with overstated, understated or other misleading statements or characterizations that are expressed as fact, if such statements are unsubstantiated or merely expressions of opinion or belief. Otherwise, such statements could violate Rule 14a-9, which could result in embarrassing corrective mailings or retractions.

Bed Bug Letters

Having preliminary proxy materials cleared by the SEC's staff as quickly as possible is key to giving a contestant more time to engage in full solicitation activities. Each contestant will try to delay the other side as much as possible in this process, and one of the tactics used is the poison pen (or "bed bug") letter.

From the perspective of counsel to the issuer, as soon as the dissident's opposition proxy materials are filed with the SEC in preliminary form, counsel and the appropriate personnel at the company will comb through every statement of fact, inference, statistic, past performance disclosure, as well as everything couched as a conclusion, statement of belief, innuendo and inflammatory statement, to identify anything that is factually inaccurate, unsubstantiated, mischaracterized or taken out of context, or anything that otherwise omits material information (or tells a half-truth).

The issuer will also look for any line-item disclosure defects and federal proxy rule compliance failures in the opposition's disclosures. In the case of a dissident who is a 13D filer, the issuer will examine whether there were any failures to timely file amendments, make requisite disclosures and file exhibits.

Then, any findings are addressed in correspondence to the SEC's examining attorney at OMA. With respect to every allegation of factual inaccuracy or mischaracterization, it's important to provide the examining attorney with copies of all supporting data, primary source information, published reports, and the like, to substantiate the allegations and to make his or her review easier. Of course, the dissident will go through the exact same process to challenge as much as possible in the issuer's preliminary filings.

Because it's important not to inundate the SEC staff, contestants should pick and choose their battles judiciously. Bed bug letters and all of the supporting materials can sometimes be quite lengthy, so it's important to submit them as quickly as possible after the opponent's preliminary materials are first filed.

The purpose of bed bug letters—which are not live EDGAR correspondences, although they eventually become publicly available—is not to convince the staff to halt the proxy contest or commence an enforcement proceeding against the opponent (although in the most egregious and rare case, that could be a possibility). Instead, it's to bring to the SEC staff's attention any disclosures that, in good faith, a contestant believes is inaccurate so that the disclosures are either corrected or deleted.

In effect, the bed bug letter assists the SEC staff in ensuring that stockholders have fair, complete and accurate disclosure to base their voting decision. Tactically, they're designed to dilute the opponent's message.

The bed bug letter also is used to delay the OMA attorney's issuance of comments (or to increase the number of comments they issue) so that clearing the opposition's proxy statement for definitive mailing takes additional time (sometimes days). If the examiner agrees with a number of comments provided in the letter and, in turn, issues them (in one form or another) in a staff comment letter, the proponent has done its job. At a minimum, the bed letter gives the examiner a head start and may influence the way he or she reads the opposition's materials.

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[1] Portions of this article have been derived from Mr. Neimeth's published discussion contained in the transcript of the DealLawyers.com webcast, "Anatomy of a Proxy Fight: Process, Tactics & Strategies." which first aired Oct. 22, 2014, and portions of this article have been excerpted, in part, from a subsequent article authored by Mr. Neimeth and published by DealLawyers, Vol. 9, No. 1, in February 2015. The webcast was chaired by Mr. Neimeth, with co-panelists from Institutional Shareholder Services; Joele Frank Wilkinson Brimmer & Katcher; and MacKenzie Partners. These excerpts have been published herein with the permission of DealLawyers and Executive Press, Inc. Statistical information in the forepart of this article was derived from SharkRepellent.net, FactSet- SharkWatch and FactSet-Hedge Fund Ownership.

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