Corporate Board Member
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and Acting in Concert –
What a Board Does Not Know Can Hurt"
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Cravath, Swaine & Moore llp

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Activist Shareholders, Equity Derivatives and Acting in Concert – What a Board Does Not Know Can Hurt

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For many years, boards of directors of United States public corporations have engaged in planning in anticipation of potential contests for control of the corporation or over its strategic direction, whether through hostile tender offer, on-market accumulation of shares or proxy contest. A key assumption underlying those planning processes has been that the board would receive substantial advance notice of any challenge to corporate control or strategy, including information concerning the acquiror or shareholder that is making the challenge (including those acting in concert), its plans and proposals with respect to the corporation and its ownership of economic or voting power with respect to shares of the corporation. The basis for this assumption was the interplay among the federal securities laws (particularly the rules relating to disclosure of substantial shareholdings), the laws relating to advance notice to the antitrust authorities of substantial acquisitions, state takeover defensive statutes, stockholder rights plans (or "poison pills") and requirements in corporations' bylaws for advance notice of proposals to be put to shareholders.

The world has changed. On the financial side, we have seen an increase in use of equity derivative transactions, which has facilitated the separation of economic ownership from voting control and thus substantially impaired the effectiveness of the advance notice and disclosure rules based primarily on direct or explicit voting control. On the shareholder side, shareholder activists are more willing to take aggressive positions with respect to the application of the advance notice and disclosure rules to their own behavior. In addition, the U.S. investment community is hostile to takeover defensive measures such as stockholder rights plans, which has reduced their utility in monitoring accumulations of shares. On the legal side, changes to the U.S. federal proxy rules and substantial shareholder disclosure rules have reduced their effectiveness in alerting investors and boards of directors to the formation of shareholder groups and their accumulation of economic interests or voting power in corporations. Any one of these changes alone would not have substantially impaired the effectiveness of the advance notice and disclosure regime taken as a whole. Taken together, however, the effect of all these changes is that it is no longer a reasonable assumption that a board will receive advance notice of a contest for corporate control that both is timely and fully discloses the proponents of the contest, their plans for the corporation and their ownership position.

The diminished efficiency of the advanced notice and disclosure regime should be of concern to directors. The ability of a board of directors to maximize value for, and ensure fair treatment of, all shareholders in connection with potential control-changing transactions is enhanced by advanced notice and full disclosure. The possibility of substantial trading in a corporation's equity securities while the market is uninformed, particularly if the protagonist of a change of corporate control or strategy is acquiring economic ownership of securities during that period, may not be consistent with fair treatment of all shareholders. In addition, in those instances in which the board of directors may wish to consider resisting the challenge to corporate control or strategy, either by rejecting a tender offer or contesting a proxy solicitation, the board will need full information in a timely manner to make a decision whether and how to contest the transaction. The board will also want shareholders to have full information in a timely manner to permit them to make an informed decision with respect to the merits of the issues and the board's actions.

There are few satisfactory alternatives available to boards to respond to these concerns. Various proposals have been made to the Securities and Exchange Commission for expansion of the disclosure obligations with respect to substantial shareholdings, as well as information required to be disclosed in connection with the conduct of proxy solicitations. Directors cannot, however, rely on those amendments being adopted in the near future. Boards can usually set advance notice requirements in bylaws, and it is important that each board of directors review carefully the bylaws of their own corporation to ensure that shareholders planning to engage in proxy solicitations are required to make available in a timely fashion all material information. Even these revisions may not be sufficient. The most important lesson may be that the process of planning, as traditionally undertaken by boards of directors, for potential contests for control of the corporation or over its strategic direction should be turned on its head. Boards of directors cannot wait to act until a challenge for control of the corporation is known and clearly delineated; in the current world of activist shareholders, equity derivatives and loose alliances of like-minded shareholders, boards of directors must anticipate challenges to corporate control (including strategic direction) and take appropriate action even before the threat is known.

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