E P

DEAL LAWYERS

Vol. 6, No. 4 July-August 2012

Proxy Access Proposals: 2012 Review & 2013 Outlook

By H. Rodgin Cohen, Glen Schleyer and Janet Geldzahler, Sullivan & Cromwell LLP

Pursuant to SEC rule changes that took effect in September 2011, shareholders are now permitted to submit and vote on "proxy access proposals"—that is, proposals to give shareholders the right to include director nominees in the company's proxy materials. Over 20 such shareholder proposals (half of which were binding) were submitted during the 2012 proxy season, of which only nine have come to a vote. Many of the proposals that did not come to a vote were deemed excludable from proxy statements by the staff of the SEC for a variety of technical reasons. Below is a chart of the terms and outcomes of proxy access proposals submitted to date.

The vote results from this limited pool suggest that shareholders are hesitant to approve proposals that would give a proxy access right to holders of a small number of shares, but are more supportive of proposals that have ownership requirements that are similar to the 3%/3-year threshold that would have applied under the SEC's now-vacated mandatory proxy access rule.

With the benefit of lessons learned in 2012, it seems likely that proponents will formulate more potent proxy access proposals in the future—both by avoiding the problems that allowed companies to exclude the proposals under SEC rules and by including thresholds that will achieve broader shareholder support. Companies should begin thinking about steps to prepare for and respond to such proposals, including maintaining a dialogue with key shareholders and monitoring market trends in this area. In addition, companies may wish to consider the terms of a proxy access provision that might be acceptable to the company.

Although there seems to be little benefit to the unilateral adoption of a proxy access provision on a preemptive basis, there may be a benefit to a company in putting its own proxy access proposal up for a shareholder vote at an annual meeting, particularly because doing so should permit the exclusion of a conflicting shareholder proposal. We summarize at the end of this memorandum certain steps companies should consider taking, including potential terms that a company might find desirable if it were to put forth its own proxy access proposal.

TABLE OF CONTENTS

DealLawyers.com • P.O. Box 21639 • Concord, CA 94521-0639 • (925) 685-5111 • Fax (925) 930-9284 • info@DealLawyers.com
ISSN 1944-7590

Summary of 2012 Proxy Access Proposals

Proponent	*Company*	*Threshold/ Holding Period*	*ISS Rec.*	*Outcome*
Norges Bank (Binding)	Charles Schwab	1%/1 year	For	31% of votes cast
	CME Group	1%/1 year	For	38% of votes cast
	Pioneer Natural Resources	1%/1 year	For	Withdrawn in response to governance improvements
	Staples	1%/1 year	N/A	SEC deemed excludable (conflicted with another bylaw)
	Wells Fargo	1%/1 year	For	32% of votes cast
	Western Union	1%/1 year	For	33% of votes cast
Chevedden/ McRitchie/ Steiner/Monier (USPX form) (Precatory)	Bank of America	1%/2 years or 100 14a-8 holders/1 year	N/A	SEC deemed excludable (multiple proposals)
	Chiquita Brands	1%/2 years or 100 14a-8 holders/1 year	N/A	SEC deemed excludable (vague due to 14a-8 reference)
	Dell	1%/2 years or 100 14a-8 holders/1 year	N/A	SEC deemed excludable (vague due to 14a-8 reference)
	Ferro Corp.	1%/2 years or 100 14a-8 holders/1 year	Against	13% of votes cast
	Forest Laboratories	1%/2 years or 50 holders of $2,000/1 year	N/A	Appears to be pending for August meeting. Proposal omits provisions SEC found problematic. SEC denied exclusion request
	Goldman Sachs	1%/2 years or 100 14a-8 holders/1 year	N/A	SEC deemed excludable (multiple proposals)
	Medtronic	1%/2 years or 50 holders of $2,000/1 year	N/A	Appears to be pending. Proposal omits provisions SEC found problematic. SEC denied exclusion request
	MEMC Electronics	1%/2 years or 100 14a-8 holders/1 year	N/A	SEC deemed excludable (vague due to 14a-8 reference)
	Princeton National Bancorp	1%/2 years or 100 14a-8 holders/1 year	Against	32% of votes cast

Chevedden/ McRitchie/ Steiner/Monier (USPX form) (Precatory)	Sprint Nextel	1%/2 years or 100 14a-8 holders/1 year	N/A	SEC deemed excludable (vague: due to 14a-8 reference)
	Textron	1%/2 years or 100 14a-8 holders/1 year	N/A	SEC deemed excludable (multiple proposals)
Various Pension Funds (Precatory)	Chesapeake Energy	3%/3 years	For	60% of votes cast
	Nabors Industries	3%/3 years	For	56% of votes cast
Amalgamated Bank (Precatory)	Hewlett Packard	3%/3 years	N/A	Withdrawn—HP to put forth proposal in 2013
D. Rudewicz/ Furlong Fund (Binding)	Cadus Corp	1%/1 year	N/A	Not voted on
	KSW	2%/1 year	Against	21% of votes cast. Issuer had adopted 5%/1 year provision
	Microwave Filter	15%/1 month	N/A	Not presented at meeting. This was not a 14a-8 proposal—shareholder solicited separately

I. Background

"Proxy access" refers to the right of shareholders to include their own nominees for director in the company's proxy statement and on the company's proxy card. As a state law matter, shareholders generally have the right to nominate directors. However, because substantially all shareholder voting occurs through the granting of proxies, as opposed to voting in person at the annual meeting, a shareholder nominee will not have a chance of being elected unless the nominating shareholder gathers proxies from other shareholders to vote for the nominee. Because creation and mailing of proxy soliciting materials (which requires the filing of a proxy statement with the SEC with specific detailed disclosures), as well as the actual solicitation effort, is very costly, election contests in which a shareholder solicits proxies have been relatively infrequent.

Vacating of Mandatory Rule. The SEC has at various times sought to allow a qualifying shareholder to include nominees in the company's proxy materials, thereby avoiding the cost to the shareholder of preparing and mailing materials. Most recently, in August 2010, the SEC adopted Rule 14a-11, a mandatory proxy access rule, which would have allowed shareholders (or groups of shareholders) who have held 3% of the company's voting securities for a three-year period to include director nominees in the company's proxy materials.

Rule 14a-11 was subject to legal challenge by business groups shortly after its adoption, and the SEC stayed effectiveness of the rule (and all related rules) in October 2010. In July 2011, the U.S. Court of Appeals for the D.C. Circuit vacated Rule 14a-11 in its entirety, holding that the SEC did not adequately assess its costs and benefits.[1] The SEC determined not to appeal this decision, and the SEC chairman has indicated recently that the Agency does not intend to pursue a mandatory proxy access rule in the near future.

Change to Rule 14a-8(i)(8). Rule 14a-8 permits shareholders who have owned at least $2,000 of shares of a company's common stock for at least one year to include shareholder proposals in the company's proxy statement. In adopting Rule 14a-11, the SEC also amended Rule 14a-8(i)(8), the so-called "election exclusion." Prior to the revision, this provision allowed a company to exclude a shareholder proposal

[1] *See Business Roundtable and Chamber of Commerce of the United States of America* v. *SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

that related to the company's election or nomination procedures. The amendment to Rule 14a-8(i)(8) narrowed this provision so that it allowed exclusion only of proposals that related to specific elections. The change to Rule 14a-8(i)(8) survived the vacating of the mandatory access rule, and went into effect in September 2011.[2]

The effectiveness of the change to Rule 14a-8(i)(8) set the stage for so-called "private ordering" in the area of proxy access—that is, the development over time of a market standard or a range of market standards arising from the interplay of shareholder pressure and company reactions. Beginning with the 2012 proxy season, shareholders are now able to submit proposals under Rule 14a-8 that seek to cause the company to adopt proxy access bylaws.

Precatory vs. Binding Proposals. Shareholders may submit proxy access proposals either in the form of a "precatory" proposal requesting the board to adopt proxy access provisions, or in the form of a direct binding proposal that actually amends the bylaws to add proxy access provisions (because shareholders may, under the law of most states, amend the bylaws unilaterally). Shareholders have, in the past, tended not to propose governance-related proposals as binding bylaw amendments, largely because this requires them to draft the actual language of the bylaw amendment in a way that works with and is tailored to the company's governing documents. In addition, many institutional investors are more likely to favor precatory proposals, because they believe that companies should be in charge of drafting specific bylaw language. Some shareholders, however, prefer to make binding proposals, because it prevents companies from diluting the impact of the proposal through nuances in drafting.

It should be noted that, if the board does not implement a successful precatory proposal, then the directors may face negative vote recommendations in subsequent years. For example, under the policies of Institutional Shareholder Services ("ISS"), the proxy advisory firm, directors will face negative vote recommendations if a precatory proposal receives the support of a majority of the outstanding shares, or receives the support of a majority of votes cast twice in three years, and the board does not implement the proposal in a way that ISS deems "responsive."

II. 2012 Proxy Access Proposals

The following is a summary of the various forms of proxy access bylaws that were submitted for the 2012 proxy season:

A. Norges Bank binding proposals (1%/1 year)

Terms of Proposals. Norges Bank Investment Management, which manages the Norwegian government pension fund, submitted a number of binding bylaw amendments that would give a proxy access right to a shareholder or group that holds 1% of the outstanding stock and has held those shares for at least one year. Each eligible shareholder or group would be permitted to nominate up to 25% of the board. There is no overall limit on the number of nominees, though the number of access nominees actually elected to the board cannot exceed 25% of the board.

Selection of Issuers. Norges Bank, in its public filings and statements, indicated that it submitted proposals to S&P 500 companies that it believed had governance practices that were in need of improvement.[3] However, the specified governance deficiencies are, in some cases, nearly universal practices among U.S. public companies, such as the ability to issue blank check preferred stock and the right of the board to amend the bylaws unilaterally. Other specified governance problems at selected companies include combining the role of CEO and chairman, multiple share classes, lack of majority voting in director elections, lack of a shareholder right to act by written consent or call special meetings, and failure to implement or to announce a plan to implement successful shareholder proposals from prior years. Norges Bank also made statements indicating that they viewed efforts by a company to seek to exclude a shareholder

---

[2] *See* Facilitating Shareholder Director Nominations; Notice of Effective Date, Rel. Nos. 33-9259, 34-65343, IC-29788 (Sept. 15, 2011), available at http://www.sec.gov/rules/final/2011/33-9259.pdf.

[3] *See, e.g.*, Norges Bank Investment Management, Proxy Access Proposals, Investor Presentation, filed via Edgar under SEC Rule 14a-6(g), available at http://www.sec.gov/Archives/edgar/data/72971/000095015912000203/px14a6g.htm.

proposal under SEC rules as a negative governance practice. Finally, in some, but not all, cases, Norges Bank highlighted that the company's five-year total shareholder return was lower than at peer firms.

Norges Bank withdrew its proposal at one company, Pioneer Natural Resources, after the board approved the adoption of majority voting and destaggering of their board. It is not clear from company statements whether these actions (which were responsive to shareholder proposals on these topics that had passed in 2011) were in response to the Norges Bank proposal or dialogue with other shareholders, but Norges Bank stated that it viewed the actions as a successful outcome of their proposal.

Norges Bank Publicity Efforts. Norges Bank engaged in a number of novel publicity efforts in support of its proposals, which gave it the ability to make more detailed and extensive arguments than it could include in the proxy statement under SEC rules, which provide a 500-word limit for proponents' supporting statements. First, Norges Bank included a link in each proposal to a website that had extensive, company-specific arguments in favor of their proposal. As noted below, the SEC staff viewed this reference to external materials as permissible. Second, Norges Bank filed a detailed slide presentation on the SEC's Edgar system under Rule 14a-6(g). Filings under Rule 14a-6(g), which show up on the company's Edgar website under form PX14A6G, are required by SEC rules if a holder of more than $5 million in stock engages in an exempt solicitation. It is unclear whether Norges Bank was required to make these filings under SEC rules, but an increasing number of shareholder proponents have used these filings on a voluntary basis, as a way of getting broader publicity for their arguments in support of their proposals.[4]

Company Exclusion Efforts. Most companies that received the Norges Bank proposal submitted exclusion requests to the SEC staff, arguing that the proposal was excludable as vague and indefinite because the internet address referenced in the proponent's supporting statement did not lead to an active webpage. The SEC staff disagreed, noting that the proponent provided the companies with the information that would be on the webpage upon filing of the proxy statement, and that the companies did not allege that the webpage material was materially false or misleading. See letters to Charles Schwab, Wells Fargo and Western Union.[5]

The only company that was able to exclude the proposal under SEC rules was Staples, and this was as a result of a drafting error in the proposal—a demonstration of the danger to proponents of submitting proposals in the form of binding proposals. In particular, the proposal failed to remove or qualify a statement in the existing bylaws that expressly disclaimed any shareholder right to include a nominee in the company proxy statement, and the SEC staff agreed that the resulting inconsistency made the proposal vague and indefinite.

Voting Results. The Norges Bank proposal failed at all the companies where it came to a vote, garnering the support of between 31% and 38% of shares voting, despite receiving a "for" recommendation in all cases from ISS.[6] It seems likely that many institutional investors believed that a 1% threshold is simply too low.[7]

B. U.S. Proxy Exchange Form of Proposal (1%/100 holders)

Terms of Proposals. The most common form of proxy access proposal this year was based on a model issued by the United States Proxy Exchange, a shareholder advocacy group, which was tailored and submitted on a number of companies by individual shareholder activists. The precatory proposal requested a bylaw amendment permitting holders of 1% of the outstanding stock for a two-year period, or alternatively 100 holders who satisfy the $2,000/one-year requirement of Rule 14a-8, to include director nominees in the

---

[4] Forty-five different companies have been the subject of PX14A6G filings so far in 2012, compared to 24 companies in all of 2011 and 21 in all of 2010.

[5] Western Union had initially advanced an alternative argument that the shareholder proposal was excludable under Rule 14a-8(i)(9) as conflicting with the company's own proxy access proposal, which it intended to put to a shareholder vote at the 2012 annual meeting. The company withdrew this argument, however, when it decided that it would not, in fact, advance its own proxy access proposal this year.

[6] ISS maintains that it does not have a bright line policy on proxy access proposal, but reviews them on a case-by-case basis, in light of the company's shareholder base and the terms of the proposal.

[7] For example, the 2012 proxy voting policies of T. Rowe Price indicate that they support proposals suggesting an ownership level of at least 3%.

company's proxy statement. The proposal would permit each eligible shareholder or group to nominate up to one-twelfth of the board, but had no overall limit on nominees or elected access directors. The proposal also provided that the company and its directors and officers could not consider the election of a majority of access nominees to be a "change in control."

Company Exclusion Efforts. Every company that sought to exclude this proposal under SEC rules was successful in doing so. The SEC staff agreed with the companies that this proposal could be excluded on two separate bases:

- The proposal constituted multiple proposals in violation of Rule 14a-8(c), due to the inclusion of the provision noting that an election of proxy access nominees would not be a "change in control" of the issuer. See letters to Bank of America, Goldman Sachs and Textron.

- The proposal was vague and indefinite under Rule 14a-8(i)(3) because it referred to the eligibility requirements of Rule 14a-8 without explaining what those requirements were. See letters to Chiquita Brands, Dell, MEMC Electronic Materials and Sprint Nextel.

Following the issuance of these SEC no-action letters, the U.S. Proxy Exchange issued a new form of proposal that eliminated the reference to Rule 14a-8 and the problematic "change of control" provision, and also reduced the 100 holder provision to 50 holders. Proponents have submitted this form of proposal to Medtronics and Forest Laboratories. Both companies submitted exclusion requests to the SEC staff, arguing alternative bases for exclusion, but the exclusion requests were denied.

Voting Results. This form of proposal has come to a vote at only two companies—Ferro Corporation and Princeton National Bancorp—and received the support of 13% and 32% of the votes cast, respectively. ISS recommended against the proposal, noting that the 100 shareholder provision could allow a nominee supported by shareholders holding as little as $200,000 in shares, which represents a negligible percentage of the company.

C. Precatory 3%/3-Year Proposals

Terms of Proposals. A coalition of state and municipal pension funds submitted precatory proposals at Nabors Industries and Chesapeake Energy—two companies that have been the subject of significant shareholder scrutiny and criticism—seeking to create a proxy access right for 3% shareholders (or groups) who have held their stake for at least three years. These thresholds are the same as those that would have applied under the SEC's now-vacated mandatory proxy access rule.

Selection of Issuers. The proposals submitted at Nabors and Chesapeake detail the perceived governance failings that spurred the submission of the proposals, including excessive CEO compensation and low shareholder support for the say-on-pay vote and for certain directors in 2011.

Voting Results. These proposals passed at both Nabors (with the support of 56% of votes cast) and Chesapeake (with the support of 60% of votes cast). These companies have been experiencing above average levels of negative shareholder sentiment (for example, each company failed to receive majority approval of their 2012 say-on-pay vote), and it is possible that a 3%/3-year proposal would receive less support (and might fail) at other companies. Nevertheless, it seems likely that a proposal such as this one, which tracks the thresholds that the SEC sought to impose under its mandatory access rule, would achieve a significant level of support at many companies that did not already have any proxy access provisions at all.

Hewlett-Packard Withdrawn Proposal. A similar 3%/3-year precatory proposal was submitted to Hewlett-Packard by Amalgamated Bank, but was withdrawn when Hewlett-Packard agreed to put its own 3%/3-year proposal up for a vote at the 2013 annual meeting.

D. Furlong Fund Proposals

The final set of 2012 proxy access proposals consists of three different binding proposals advanced by the Furlong Fund LLC and its founder at relatively small companies.

Binding 2% Proposal. KSW, Inc. received a binding 2%/1-year proposal from the Furlong Fund. The proposal would have limited each nominating shareholder or group to one nominee, but had no overall cap on nominees. KSW argued to the SEC staff that it should be permitted to exclude the proposal because it was "substantially implemented" under Rule 14a-8(i)(10) by the company's adoption of a bylaw granting proxy access to 5% shareholders who had held for one year. The SEC staff disagreed, noting the differences between the proposal and the bylaw adopted by the company.

The outcome may have been different if KSW had been putting its own proxy access proposal up for a shareholder vote at the annual meeting. Under existing SEC staff precedents, if a company is actually putting its own proxy access provision to a shareholder vote at the upcoming annual meeting (which was not the case for KSW), then the company should be able to exclude a shareholder proxy access proposal as "conflicting" with the company's proposal under Rule 14a-8(i)(9), notwithstanding differences between the company proposal and the shareholder proposal.

In any event, the proposal went to a vote at the KSW annual meeting and received the support of only 21% of votes cast—a lower level of support than all but one of the 1% or 3% proposals received by other companies. Although it is difficult to draw conclusions from a single vote, it seems likely that a number of shareholders deemed the 5% proxy access right adopted by the company to be sufficient.

Binding 1%/1-year Proposal. Cadus Corporation received a binding 1%/1-year proposal from the managing member of the Furlong Fund. Like the KSW proposal, the Cadus proposal would have limited each shareholder or group to one nominee. This proposal was not, however, presented for a vote at Cadus's June 21 annual meeting.

Binding 15%/1-month Proposal. The Furlong Fund had also included a proxy access proposal as part of a proxy contest for board seats at Microwave Filter. The proposal was for a bylaw amendment providing a proxy access right to any 15% shareholder who had held for one month. This was not a Rule 14a-8 proposal to be included in the company's proxy statement, but rather a component of a contested election set forth in the dissident's own proxy filings. Ultimately, the proponent's director candidates, and the proxy access proposal, were withdrawn and not voted on at the meeting.

III. Considerations Ahead of 2013 Proxy Season

The 2012 proxy season will likely be viewed as the start of a learning curve for shareholders and companies in the area of proxy access. Although the vast majority of proxy access proposals were either excluded under SEC rules or voted down by shareholders, the 2012 proxy season has given shareholder activists valuable information on how to craft proposals that have a better chance of success.

Engage with Shareholders. In anticipating the receipt of proxy access proposals for the 2013 proxy season, companies should consider the best ways to gauge the views of their largest shareholders on proxy access provisions, including their general views on the principle of proxy access, as well as specific provisions that they would or would not support. This background will be invaluable to management and the board in assessing how to deal with any proposals that are received. A number of institutional investors have expressed concern over proxy access proposals that have low thresholds or otherwise may be subject to abuse.[8]

Consider Early Announcements of Governance Enhancements. As discussed above, many companies became the target of proxy access proposals because of perceived deficiencies in governance practices or structures. To the extent a company is anticipating any actions that would be seen by shareholders as governance enhancements (such as adopting majority voting or destaggering the board), the company should consider announcing this action in the fall, before shareholder proposals are received, because it may have the side benefit of removing the company from the list of proxy access proposal targets.

---

[8] For example, as mentioned above, the 2012 proxy voting policies of T. Rowe Price indicate that they support proposals suggesting an ownership level of at least 3%. In addition, a governance expert at Blackrock has indicated their view that "any company establishing a proxy access process must have sufficient protections in place to avoid its abuse."

Preemptive Adoption of Proxy Access Has Limited Benefits. Companies that wish to be in the forefront of governance practices might be drawn to the idea of adopting their own proxy access provisions unilaterally. This approach presents significant difficulties at this stage and may have limited benefits. In the near term, there will be limited guidance as to how market practice will develop, and the terms that should be adopted. Proxy access bylaw provisions that are appealing to the company may not be appealing to shareholder activists, and the adoption by a company of its own proxy access provisions will not prevent shareholders from submitting proposals under Rule 14a-8(i)(8) to amend the company-adopted bylaw. For these reasons, there does not appear to be much benefit in acting preemptively and unilaterally—and few companies are expected to do so. The only way this approach would seem to be acceptable and not open to significant criticism would be if the company were to adopt provisions substantively identical to now-vacated Rule 14a-11.

Evaluate Standard SEC Exclusion Bases. The SEC no-action letters issued in the 2012 season serve as a reminder that proxy access proposals will not be afforded special treatment under the SEC rules and will continue to be subject to exclusion under the traditional bases set forth in Rule 14a-8, as applicable. Upon receiving a proxy access proposal (or any other Rule 14a-8 proposal), companies should work with counsel to identify any viable grounds for exclusion, and should work with their investor relations team to determine whether appropriate shareholder engagement efforts might lead to the proposal being withdrawn.

Consider Potential Conflicting Management Proposal. If a company receives a proxy access proposal that it believes has a reasonable chance of passing in 2013, that has terms the company does not support (particularly a binding proposal), and that the company is not able to get withdrawn through dialogue with the proponent, one option would be for the company to submit its own proxy access bylaw and/or charter amendment for shareholder approval at the 2013 annual meeting. Under SEC Rule 14a-8(i)(9), a shareholder proposal can be omitted from the proxy statement if it conflicts with a company proposal being submitted for shareholder vote at the same meeting.[9]

This company proposal would likely be in the form of a bylaw and/or charter amendment adopted by the board, but with its effectiveness conditioned on receiving shareholder approval. This is a similar construct to that used in the context of special meeting proposals in recent years. The increased prevalence of shareholder rights to call special meetings at U.S. public companies can be largely attributed to the receipt by companies of shareholder proposals on this topic. However, the actual contours of the rights granted to shareholders have developed through management proposals, which contain various provisions designed to prevent abusive, wasteful or frivolous use of the right.

A similar dynamic could occur in the proxy access context—if shareholders begin to advance proxy access proposals that have a reasonable chance of passing, then companies may propose implementing provisions that have reasonable terms designed to prevent abuse. Companies may want to begin thinking now about the potential terms that a management proxy access proposal would have. If the company finds itself in the position of wanting to put forward a proposal at the 2013 annual meeting, there will be little time for management and the board to arrive at suitable terms. In particular, companies might want to consider such terms as the following:

- ***Ownership threshold***. For example, companies may decide that 5% is an appropriate threshold, because then the company and other shareholders would benefit from the disclosure requirement imposed on 5% shareholders or groups by the SEC's Section 13(d) and (g) rules.[10]

---

[9] It should be noted that in a very limited number of situations, the SEC staff has refused to allow a company to exclude a conflicting shareholder proposal under Rule 14a-8(i)(9) when the company expressly acknowledged that it was submitting its own proposal as a reaction to receiving the shareholder proposal. *See, e.g.*, Genzyme Corp. (Mar. 20, 2007). However, in recent years, the SEC staff has not followed this view, despite the objections of shareholder proponents.

[10] The SEC had adopted an exception from the loss of passive Schedule 13G status for shareholders who formed a nominating group under Rule 14a-11. It should be noted that, by its terms, this exception would NOT be available for shareholders acting to form a group under a company proxy access bylaw. *See* Exchange Act Rule 13d-1(c)(1).

- ***Definition of ownership.*** Companies should consider whether ownership levels should be measured on a "net long" basis (that is, net of short sales, derivative hedges and other short provisions), in order to ensure that the nominating shareholders have a true economic stake in the shares that they hold.

- ***Deadline for notice.*** The company's existing advance notice bylaws may not provide a sufficient amount of time for the processing of candidates to be included in the company's proxy statements. Companies may determine that the deadline for notice should be earlier—for example, within a 30-day window ending on the Rule 14a-8 120-day deadline.

- ***Treatment of incumbent access directors.*** Companies should consider whether incumbent directors who were access nominees should count against the maximum number of nominees for a number of years after their election, to prevent the company from having an incentive not to renominate them.

- ***Nominee eligibility.*** A management-proposed proxy access provision might include a number of reasonable eligibility standards for access nominees, including independence under relevant stock exchange standards, eligibility for committee memberships, and the completion of a standard directors' questionnaire.

- ***Director qualifications.*** Even prior to the proposal of a proxy access provision, companies should consider whether to adopt bylaws setting out minimum qualification standards, or disqualification standards, that the company would apply to all its directors—for example, satisfaction of certain regulatory requirements, or prohibition on affiliations with competitors or conflicts of interest. Having such provisions in the bylaws may be helpful when proxy access is a possibility, because the company might then be faced with director nominees who were not subject to the nominating committee's approval process. The adoption of such qualification provisions at a time when the company is faced with an actual shareholder nominee would likely attract greater scrutiny due to concerns of entrenchment—therefore, there is some benefit to doing so at an earlier stage.

- ***Required Information.*** The company's bylaws may provide for the provision of reasonable information about the candidate and the nominating party, similar to what is called for by typical advance notice provisions. In this regard, it should be noted that the SEC's Schedule 14N, which was adopted in conjunction with Rule 14a-11, remains in effect and would apply in the case of a nomination under a company proxy access bylaw. The company bylaw should be drafted to work in conjunction with Schedule 14N.

- ***Other limitations.*** Companies may determine to place reasonable limitations on the use of proxy access, including making it unavailable in a year where there is already a proxy contest in place, or restricting the resubmission of failed candidates who receive below a specified threshold of support.

M&A Indemnification Provisions: What Drafters May Be Critically Missing

By Joshua Silverstein and Anastasia Sheffler-Wood, a Partner and Associate of Stradley Ronon Stevens & Young, LLP

Many attorneys who negotiate purchase agreements for merger and acquisition transactions make one of two mistakes when it comes to drafting the indemnification provisions, which, in simple terms, relate to the buyer's and seller's remedies against the other for breaching the contract.

The first mistake is to believe that these provisions are strictly boilerplate and that little needs to be said beyond the idea that each party should "make the other whole" for its breach. The second mistake is to understand that there is something more to these provisions and to negotiate a few of the terms (such as a "basket," a "cap" and a "survivability period," all of which are discussed below), but then to stop there. The truth of the matter is that the indemnification provisions in a purchase agreement are arguably the most critical provisions in the document, that there is quite a lot to be negotiated and that the failure to address certain issues can have very serious implications for a client. This article addresses both the most basic and the more advanced terms that should be considered when drafting indemnification provisions.

Understanding the Basics

The basic terms to consider when drafting an indemnification provision are who is indemnifying whom, for what, for how long and for how much. A party's stance on these issues will clearly be affected by where the party sits. The attorney representing a buyer will clearly want the greatest protection for his or her client for the longest possible period of time, to try to help protect the client against buying into a bad situation. The attorney representing a seller will clearly want the indemnification to be as narrow as possible for the shortest period of time, to help his or her client sleep at night knowing that the buyer is not likely to bring a major claim.

Scope of Indemnification

The first question to ask when drafting or analyzing an indemnification provision is, what is the seller indemnifying the buyer for? This question involves several distinct yet important considerations. First, is the seller indemnifying the buyer only for breaches of representations and warranties or for all pre-closing liabilities? A buyer will want the seller to indemnify for all pre-closing liabilities, so that the buyer does not risk incurring losses due to the seller's pre-closing activities. Conversely, a seller will argue that all aspects of the business that are important to the buyer should be covered in the representations and warranties in the purchase agreement.

The second inquiry that helps answer the scope-of-indemnification question is whether the buyer's knowledge of a breach on or before closing should be taken into consideration. A seller will argue that it is unfair for a buyer to know prior to closing that a representation of the seller is untrue but wait until after closing to disclose such knowledge, thereby triggering an indemnification obligation by the seller. To avoid this arguably unfair result, a seller may insert an "anti-sandbagging" provision in the purchase agreement, stating that the buyer may not seek indemnification post-closing for a breach by the seller that the buyer had knowledge of prior to closing. Conversely, a buyer will argue that the seller is responsible for ensuring the correctness of each representation made by the seller in the purchase agreement and therefore request that a "pro-sandbagging" provision be inserted in the purchase agreement, stating that the buyer's right to seek indemnification will not be hindered by any knowledge of the buyer prior to closing. A third alternative is that the purchase agreement remain silent on the issue of sandbagging.

The third inquiry that frames the scope of indemnification is whether the representations and warranties expressly stated in the purchase agreement constitute the universe of all representations and warranties given by the seller. Many sellers will strongly push for insertion of language into the purchase agreement disclaiming all express or implied representations and warranties except those expressly set forth in the purchase agreement. The thinking behind adding such language is that if the buyer understands the seller to be making a certain representation or warranty, then the buyer will insist that such representation or warranty be included in the purchase agreement.

Disclaiming representations and warranties not set forth in the purchase agreement acts as a kind of integration clause and guards against a buyer later claiming that it relied to its detriment on a representation or warranty made orally or on a statement in a business summary presentation, for example. Avoiding a "reliance" claim by the buyer, as mentioned in the preceding sentence, sometimes leads sellers to insert additional language stating that the buyer has not relied on any representations or warranties except as set forth in the purchase agreement. Another advantage for the seller when including such nonreliance language is that reliance upon the other party's misrepresentation is the linchpin of a fraud claim under the laws of many jurisdictions. Therefore, including nonreliance language in the purchase agreement can act as a barrier to a successful fraud claim brought by the buyer against the seller after closing.

Limitation of Losses

After an attorney has considered the scope of an indemnification provision, he or she should then determine what limitations are or should be included with respect to the losses covered by indemnification, which could have the effect of limiting a payout in the event that the indemnification provision is triggered. For example, a seller may seek to carve out consequential, incidental and punitive damages as categories of damages for which the seller will not be liable to the buyer. Even if a buyer is agreeable to this concept as between buyer and seller, the buyer likely will not want to exclude such categories of damages in connection with third-party claims.

Another provision that a seller may insert in the purchase agreement as a means of limiting its losses in the event that the indemnification provision is triggered involves language stating that the seller is not obligated to indemnify the buyer to the extent that the buyer reaped a tax benefit from the loss. Buyers, however, usually counter with the argument that such tax savings would be difficult to calculate and want the seller to fulfill its payment obligation absent consideration of possible benefits to the buyer as a result of the loss.

Two other provisions that a seller may place in the purchase agreement to limit its payout due to indemnification include a reduction in the payment owed by the seller to the extent the buyer's losses are covered by insurance proceeds. The buyer's argument against such language will again be the seller's responsibility to fulfill its payment obligation in the event that the indemnification obligation is triggered, rather than making the buyer's insurance carrier pay a portion of the buyer's losses, which may ultimately result in an increase in the buyer's insurance premium. The seller may also insert language requiring that the buyer mitigate its losses to reduce the seller's payout in connection with an indemnification claim.

Finally, the most important limitation provision that a seller should place in a purchase agreement is language stating that the indemnification provision will serve as the buyer's sole and exclusive remedy in the event of a breach. This "sole and exclusive remedy" language is vitally important to the seller, because absent such language, technically a buyer may be able to ignore the carefully negotiated indemnification language and instead sue for damages under general breach of contract theory, as if the indemnification provision did not exist.

Baskets

Many purchase agreements include a "basket," which is the aggregate dollar amount that the buyer's losses must exceed before the seller will be obligated to make an indemnification payment. Inclusion of a basket protects the seller from being liable to the buyer for every minor claim and makes the seller responsible to pay only for losses that stem from a significant breach. The dollar amount of the basket is usually stated as a percentage of the purchase price, and the applicable percentage typically ranges anywhere from 0.5 percent (or less) up to 2 percent. Sellers will often argue that the basket should serve as a deductible, whereby the seller will pay only for losses in excess of the basket amount. Buyers, on the other hand, will advocate for a "tipping basket," which requires the seller to pay all losses starting at dollar one, when the threshold basket amount of losses has been reached.

An important consideration is what to include in the basket. For example, representations and warranties should be included in the basket, but a buyer will argue that covenants should not be included, because the seller should be fully responsible to fulfill its promises under the purchase agreement. Also, a buyer may include indemnification language related to a specific known problem, and losses related to that problem may be expressly excluded from the basket. A buyer may also want to exclude from the basket breaches of representations and warranties regarding ownership, organization, authority, taxes and fraud. The reasoning behind excluding fundamental representations like ownership, organization and authority is that the seller should undoubtedly know that it owns the entity/assets being sold, it is duly formed entity and is authorized to engage in the sale transaction. Similarly, pre-closing tax liabilities constitute another category for which a buyer will want to place full liability for payment on the seller.

One method by which a seller may make the basket threshold amount even more difficult for the buyer to obtain with respect to its losses is to include an additional dollar amount threshold that each claim must meet in order to be counted toward the basket. For example, if the purchase agreement already has a $200,000 basket, the seller might add additional language stating that each individual claim must be at least $10,000 before such claim may count toward the $200,000 basket amount.

Caps

Closely related to the basket is the "cap," or maximum dollar amount of the buyer's losses for which the seller may be liable. Like the basket, the cap is typically stated as a percentage of the purchase price and can range widely from the full amount of the purchase price to less than 10 percent of the purchase price. Buyers often push back against including a cap in the purchase agreement, arguing that the seller should pay all losses related to pre-closing liabilities. For a seller, on the other hand, a cap enables the seller to sleep at night, knowing that there is a definite limit to its liability post-closing.

One way that buyers limit the financial risk associated with including a cap in the purchase agreement is to exclude breaches of certain representations and warranties from the cap. Exclusions to the cap often, but need not, mirror the exclusions to the basket described above (i.e., breaches of representations and warranties regarding ownership, organization, authority, taxes and fraud). The result is that the seller's liability is not limited by the cap with respect to these fundamental representations and warranties.

Survivability

The final major consideration with respect to an indemnification provision is how long the indemnification obligations remain in effect. The buyer will want language in the purchase agreement stating that the representations, warranties and covenants of the seller will survive indefinitely after closing. Conversely, the seller will want assurance that after a certain period of time has passed post-closing, the seller will be free from the possibility of a claim being raised by the buyer. Like the cap, insertion of a survivability period enables the seller to sleep at night. Although survivability periods vary, 12 to 18 months is typical. A buyer with specific doubts about the seller's pre-closing activities may want to negotiate an extended survivability period, such as 24 months. Whatever the stated survivability period, the buyer must bring a claim within such time frame.

Like the other aspects of an indemnification provision, survivability likewise often includes certain carve-outs that are negotiated into the purchase agreement by the buyer. For example, fundamental representations and warranties such as ownership, organization and authority may expressly have an unlimited survivability period. Also, the purchase agreement may include separate provisions whereby tax or other representations have a survivability period equal to the applicable statute of limitations plus a certain number of months thereafter.

Conclusion

By considering the five key components of indemnification provisions highlighted in this article—the scope of indemnification, limitations of losses, baskets, caps and survivability—counsel for either the buyer or seller will give the indemnification language the thoughtful consideration it deserves in connection with a merger or acquisition, with the ultimate goal of adequately protecting the client's interests.

Private Equity Clubs Today: Keeping It In The Family

By Hendrik F. Jordaan, Erik G. Knudsen & Tyler J. Sewell, attorneys of Morrison & Foerster LLP

Buy-outs of larger companies remain alluring for many private equity sponsors. Traditional logic and not too recent history suggest that teaming with another private equity sponsor or multiple sponsors in a club was an attractive path to buying-out these larger targets by maximizing resources while minimizing a single sponsor's exposure to a transaction. This strategy, though successful in many instances, is also not without its perils. We need to look no further than the anti-trust claims set forth in *Dahl v. Bain Capital Partners, LLC*, Civ. No. 07-12388-EFH (D. Mass.) to see the potential for pitfalls, whether actual or not.

Given the above, and a changing investment/buy-out landscape, private equity sponsors are increasingly teaming with select limited partners ("LP") to form a more exclusive club—a "family club." "Family clubs" are appealing to the sponsor as they allow the sponsor to lead the transaction, which often simplifies the execution of the investment over a multiple sponsor club, and allows the LP(s) to co-invest outside of the carry and management fees—which can further bolster the sponsor/LP relationship on a going-forward basis. No surprise that, assuming they have the capability, LPs appreciate the ability to invest directly in certain transactions (while remaining outside the fees mentioned above). While these "family clubs" may be mutually beneficial to the sponsor and the LP and may mitigate many of the potential issues that multiple sponsor backed clubs raise (*e.g.*, anti-trust concerns, lack of autonomy and sponsor differentiation), such transactions still require initial diligence and, in many cases, unique planning and documentation.

Despite retaining the lead position, the private equity sponsor should consider and document as soon as possible the following:

1. Amounts of committed equity and how the relevant equity commitment letters interplay (e.g., whether the LP will be jointly liable for the equity commitment or if the sponsor will enter into a contribution agreement with the LP);

2. How to approach the transaction/auction in light of LP participation;

3. Allotment of the club's liabilities, including breakup fees, and how the transaction fees and expenses will be reimbursed, in both broken and successful transactions;

4. Internal governance of the buyer (e.g., board composition, negative/positive rights); and

5. Exit strategy for the investment.

No surprise that, assuming they have the capability, LPs appreciate the ability to directly invest in certain transactions.

Private equity sponsors are experts at analyzing the merits, risks and rewards of transactions of all shapes and sizes—picking a partner in a transaction, whether an LP or another sponsor, is no different. Assuming careful up-front consideration of the issues presented by a club with LPs and any other issues specific to the private equity sponsor and the LP(s), the "family club" provides an attractive alternative investment partnership for buy-outs involving larger companies. In today's environment, driving value to LPs is as important as ever—thus, we may very well see "family clubs" being formed in even smaller transactions.

Boilerplate Matters: Severability Clauses

By William Greason and Joseph B. Ramadei, a Partner and Associate of Chadbourne & Parke LLP

The purpose of a severability clause is to deal with a potentially unenforceable or illegal provision in an agreement, and in general, to sever such a provision while keeping the remainder of the agreement intact and in effect. However, drafters of contracts sometimes will cut and paste a severability clause from a recent contract into a document and move on, with what may be a false sense of security because they failed to reflect upon the nuances of these clauses and the objectives of the parties.

Clearly, lawyers should be on higher alert when dealing with provisions that are more likely to be subject to challenges as to their enforceability. If an agreement contains provisions that are frequently scrutinized by courts or are regularly drafted in ways that may run afoul of laws or public policy, the impact that a severability clause may have on these provisions, and the agreement as a whole, may be profound. The following are examples of provisions whose legality and validity are commonly called into question:

- Non-competition;
- Indemnification;
- Interest rates;
- Choice of law;
- Anti-assignment;
- Releases;
- Guaranties;
- Penalty or liquidated damages; or
- Any provision drafted in a manner that may be deemed unfair, unconscionable or an agreement to agree.

Lawyers should consider which of the numerous approaches to designing severability clauses might be most appropriate for the particular circumstances at hand, especially in cases where any of the above types of provisions come into play.

While there is no "correct" way to structure a severability clause, the various ways to address the issue of severability can each lead to starkly different outcomes. Pausing while drafting to reflect on whether certain of these outcomes would be unacceptable to the parties might prevent major headaches down the road.

Dealing With Unenforceable Provisions

One consideration when drafting a severability clause is determining what should be done with a provision in an agreement which has been deemed to be illegal, invalid, unenforceable or against public policy. A typical boilerplate severability clause will state that such a provision will simply be *deleted*, or otherwise held to be ineffective, while the remaining provisions in the agreement remain in full force. However, this standard severing mechanism may result in the elimination from a contract of a concept or matter which is of significant consequence to either or both of the parties.

In order to avoid this outcome, the severability clause may be drafted so that invalid provisions are to be *replaced* with a valid and enforceable provision covering the same subject matter. Alternatively, the clause may require that the invalid provision be *modified* in such a way that it becomes valid and enforceable. Along similar lines, some severability clauses state that invalid provisions will be *narrowed*, and deemed effective only to the extent they are enforceable. For drafting purposes, clauses requiring replacement of, or modification to, an invalid provision may be enhanced by specifying that such replacement or modification shall be composed in a way most closely akin to the parties' intent. Language that makes clear that a replacement or modified provision must adhere as strictly as possible to the parties' original business purposes or other objectives will provide clearer direction when implementing a severability clause.

Execution of a Severability Clause

The question of who exactly will execute the performance that may be required under a severability clause is a second consideration when drafting such a clause. Certainly, a standard severability clause which simply deletes an invalid provision will not cause much concern in this respect, as the ineffective provision will be struck automatically. But if the clause requires a replacement or narrowing of, or modification to, an invalid provision, who is responsible for these acts, which essentially function as amendments to the agreement? Too often, severability clauses require such revisions to be made, but are silent as to whom the parties intend to draft the alterations necessary to make the provision enforceable.

One option is for the severability clause to call for the court which finds a certain provision to be illegal or invalid to itself replace, modify or narrow the provision. However, not all courts will take on this obligation. Another means to come up with an effective provision is for a mediator or some independent third party to be engaged to perform this undertaking. Choosing either of these options as a solution takes the process out of the hands of the parties to the agreement, which may or may not be desirable. Hopefully this approach will result in the severed provision being replaced or modified as required, but a third party's attempt to fairly perform this responsibility (even when required to stick as closely as possible to the apparent intent of the parties) may leave one party feeling that with the provision so restructured, they will no longer attain the full benefit for which they bargained.

Perhaps because of this concern, the task of preparing a legal and enforceable replacement or modified provision is frequently left to the parties to the agreement. However, a severability clause that goes this route should not extend beyond requiring the parties to negotiate (perhaps in good faith) to replace or modify an ineffective provision, in order to avoid creating an agreement to agree which may itself be unenforceable. Drafters of severability clauses should also specify exactly what happens if the negotiating parties are unable to settle on a replacement or modification to an invalid or unenforceable provision. It should be made clear if the intent of the parties is to terminate the agreement or unwind the transaction in such an event.

Carving Out Essential Provisions

Special attention must be paid to the possibilities that the replacement or modification of an invalid provision may prevent the parties from reaping the full benefits for which they bargained, or that the parties left to their own devices may not be able to negotiate a mutually satisfactory replacement or modification and are therefore left to walk away from their agreement. The significance of these possibilities leads to a third consideration when constructing a severability clause—whether certain provisions in a contract should be deemed more important than others because they represent the crux of the agreement.

When forming a severability clause, the parties and their counsel should be aware of whether there are circumstances when a severed or otherwise replaced or modified provision should not be applicable as a solution. By and large, these considerations arise in situations where severing, replacing or modifying an invalid provision in an agreement would damage or materially impact the essence of the contract or a core part of the agreement.

A severability clause may be drafted to provide for a carve-out, i.e., stating that its method of dealing with an invalid provision would not apply if any of the essential terms of the agreement was invalid. This general carve-out statement expresses the parties' understanding that certain provisions are too important to simply sever or modify, but it may leave the determination of what constitutes an essential term up for interpretation. If the parties desire, the clause may be more explicit, providing a list of specific provisions which, if invalidated, would not be subject to the severability clause. If this more precise version of the severability clause is chosen, the parties must first identify the key provisions which if severed, replaced or altered would deprive a party of a major element of the agreement, one that was critical or indispensable to that party during negotiation.

While the inclusion of a carve-out ensures the parties that the severability clause will not be used to deny a party of the advantages of a vital term, it also leads to the question of what happens when these essential terms are not enforceable. If the basis of the bargain is so thoroughly affected by an invalidated provision, will the whole agreement be void? Again, clauses are often silent as to this next step, but the termination of the entire contract may be inferred from such silence. If parties wish to avoid this and come up with a middle ground, they must think through to these potential outcomes and expressly state their intent.

As this discussion makes clear, raising one question about how to deal with a severability clause often leads to another, and then another. What at first may seem to a contract drafter to be a boilerplate "throw-in" clause may quickly become a tangled vine of possibilities and methods to handle the various consequences. Failure to consider these consequences may prove detrimental to all involved.

When drafting severability clauses, it is best to approach the situation carefully and assess the best means to resolve potential enforceability issues while protecting clients from having major benefits of their contract inadvertently gutted. In this light, an old carpenter's axiom comes to mind—in the matter of severability, the wise craftsman measures twice, and cuts just once.

A sister publication of the popular newsletter, *The Corporate Counsel, Deal Lawyers* is a bi-monthly newsletter for M&A practitioners to keep them abreast of the latest developments and analyze deal practices.

Publisher: **Jesse M. Brill.** Formerly an attorney with the Securities and Exchange Commission and a leading authority on executive compensation practices, Mr. Brill is the Publisher/Editor of *The Corporate Counsel,* Chair of the National Association of Stock Plan Professionals, CompensationStandards.com and DealLawyers.com.

Editor: **Broc Romanek**, former SEC attorney and Editor of DealLawyers.com and TheCorporateCounsel.net. Broc can be reached at broc@deallawyers.com.

DealLawyers.com • P.O. Box 21639 • Concord, CA 94521-0639 • (925) 685-5111 • Fax (925) 930-9284 • info@DealLawyers.com