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# Corporate Governance Update: Advance Notice Bylaws: Lessons From Recent Cases

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The advance notice bylaw, a corporate housekeeping tool with potentially powerful effects, has come under the spotlight in several recent Delaware cases. These cases provide sobering reminders of the importance of the advance notice bylaw itself as well as the need for careful drafting. In both *Jana Master Fund, Ltd. v. CNet Networks, Inc.*[1] and *Levitt Corp. v. Office Depot, Inc.*,[2] decided by the Delaware Chancery Court in March and April of this year, the court interpreted language often found in advance notice bylaws to rule in favor of activist stockholders, and the Delaware Supreme Court recently affirmed the Chancery Court's *CNet* decision without issuing a separate opinion, choosing to rely on the Chancery Court's opinion.[3] In light of these cases, companies must carefully review their own advance notice bylaws to ensure that they are up-to-date and written clearly to convey the intended meaning.

## Background

The primary purpose of an advance notice bylaw is to help ensure orderly business at stockholder meetings. It requires a stockholder to submit "advance notice" of his or her intention to introduce business at a stockholder meeting, such as the nomination of director candidates or the introduction of a stockholder proposal. An

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[1] 2008 WL 660556 (Del. Ch. Mar. 13, 2008), *aff'd*, 2008 WL 2031337 (Del. S. Ct. May 13, 2008) (hereinafter "*CNet*").

[2] 2008 WL 1724244 (Del. Ch. April 14, 2008) (hereinafter "*Office Depot*").

[3] 2008 WL 2031337 (Del. S. Ct. May 13, 2008) ("[T]he Court having considered this matter after oral argument and on the briefs filed by the parties has determined that the final judgment of the Court of Chancery, dated March 17, 2008, should be affirmed on the basis of and for the reasons stated in its Memorandum Opinion dated March 13, 2008.").

advance notice bylaw serves three significant functions: first, to inform a company of stockholder business to be brought at the stockholder meeting an adequate time in advance of the meeting; second, to provide an opportunity for all stockholders to be fully informed of such matters an adequate time in advance of the meeting; and third, to enable a company's board to make informed recommendations or present alternatives to stockholders regarding such matters. As a result, such advance notice bylaws typically require not only notice of stockholder business but also the information necessary to determine that a stockholder-nominated director candidate is qualified to be elected, as well as information demonstrating that the person introducing business is actually a stockholder of the company.

Until recently, advance notice bylaws have been unremarkable and fairly simple provisions, generally easily complied with and largely uncontroversial. In the *CNet* and *Office Depot* decisions, the Delaware courts allowed activist stockholders to exploit potential drafting ambiguities to circumvent the well-intended rationale of the advance notice bylaw. As a result, advance notice bylaws have emerged as an important battleground in the conflict between companies and activist stockholders.

## The *CNet* and *Office Depot* Decisions

In the *CNet* case, investment fund Jana sought to gain control of the classified board of CNet by nominating director candidates and increasing the size of the board. Jana informed the company of its intention to solicit proxies for its proposals in a self-financed mailing to stockholders. CNet contended that Jana did not comply with CNet's advance notice bylaw, which required that a stockholder must have held $1,000 worth of stock in CNet for a full year before it could properly "seek to transact other corporate business at the annual meeting,"[4] because Jana would have owned CNet stock for only eight months by the scheduled date of the meeting. The court, however, took the view that, primarily because CNet's notice bylaw stated that the notice provided by the stockholder had to "comply with the federal securities laws governing shareholder proposals a corporation must include in its own proxy materials," it unambiguously applied only to proposals that stockholders wished to have included in the company proxy statement.[5] This reading of the advance notice requirement is unlikely to reflect the intention of companies with similarly drafted bylaws.

By ruling that CNet's advance notice bylaw was simply inapplicable, the court avoided the question of whether CNet's stockholding requirement was an

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[4] *CNet*, at *2.

[5] *Id.* at *3. The other reasons cited by the court for its determination that the bylaw applied only to Rule 14a-8 proposals were: (1) the phrasing "[a stockholder] may seek to transact other corporate business" made sense only in the 14a-8 context; and (2) the fact that the deadline for notice was based on the timing of the release of management's proxy statement implied that the bylaw applied only to proposals to be included therein. *Id.*

unreasonable restriction of stockholder rights. The court noted that advance notice bylaws are a well-settled feature of Delaware corporate governance, although Delaware precedent does not permit such bylaws to "unduly restrict the stockholder franchise or [be] applied inequitably."[6] It is not clear whether the result in *CNet* signals a willingness on the part of the Delaware courts to revisit accepted standards of reasonableness in the details of advance notice bylaws, such as the amount of time required for notice and any required stockholdings of proponents. A lawsuit claiming that customary requirements are unreasonable infringements upon the stockholder franchise may well be next on the activist agenda.

The *Office Depot* case, like *CNet*, centered on a stockholder's attempt to nominate director candidates at the company's 2008 annual meeting. Shortly after the company filed its definitive proxy materials with the Securities and Exchange Commission, the stockholder filed its own proxy materials but did not give advance notice to the company of its intention to propose director candidates. Concurrently, the stockholder sued the company in the Delaware Chancery Court seeking confirmation that no additional notice was required for the stockholder to nominate director candidates. In the *Office Depot* case, the company argued that its bylaws, which required that "[f]or business to be properly brought before an annual meeting by a stockholder, the stockholder must have given timely notice thereof in writing to the Secretary," required advance notice for the stockholder nominations to be properly brought before the meeting. The stockholder argued that, for various reasons, the bylaws did not require advance notice of director nominations, and, alternatively, if they did, that the company itself had already made nominations an item of business in its own notice of meeting, and that advance notice by the stockholder was therefore not required. Like the plaintiff in the *CNet* case, the plaintiff also argued that, if applicable, the requirements of the company's advance notice bylaw (in this case, at least 120 days before the anniversary of the previous year's proxy statement mailing) was an unreasonable restriction of stockholder rights.

As in the *CNet* case, the *Office Depot* court did not reach the question of whether the contours of the company's advance notice bylaw were unduly restrictive. The court focused on the part of the advance notice bylaw which read: "At an annual meeting of the stockholders, only such business shall be conducted as shall have been properly brought before the meeting."[7] The court agreed with the company that "business" included director nominations,[8] but reached the unexpected conclusion that, although notice of nominations therefore was required by the bylaw, the company itself had brought the business of nominating and electing directors – including both its own

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[6] *Id.* at *6.

[7] *Office Depot* at *2.

[8] In the *CNet* case, the court reached the same conclusion: "[t]he business of an annual meeting is the election and voting process." *CNet* at *5.

nominees and the competing slate – before the annual meeting via its notice to stockholders included as part of the company's proxy statement. The court's interpretation could be read as eviscerating advance notice bylaws with respect to nominations, as every annual meeting would involve the election of directors and the company always would provide notice to that effect. The court held that the specific wording used by the company in its notice of meeting satisfied the advance notice provision of the company's bylaw;[9] thus, as the court noted, "careful drafting of the Notice" is now needed to avoid such results.[10] For example, in the proxy statement for its 2008 annual meeting, Wal-Mart Stores' notice for the meeting provides that one of the purposes of the meeting is "to elect as directors the 15 nominees named in the attached proxy statement" as opposed to the more general language that was in its 2007 notice of meeting.[11]

Taken together, the *CNet* and *Office Depot* decisions indicate that Delaware courts are favoring narrow interpretations of language in advance notice bylaws. Customary wording such as that found in the bylaws of those two companies no longer may be adequate to fulfill the purposes for which advance notice bylaws are intended. Companies should review and update their advance notice bylaw provisions in order to assure that they will operate as intended in an effective manner. Guidance on important items to be considered as part of such review is discussed below.

Features to Include in an Advance Notice Bylaw

An advance notice bylaw is an important feature of corporate housekeeping. In light of the *CNet* and *Office Depot* decisions, and in view of the increasingly complicated mechanisms through which investors hold stock, there are several important points that companies should consider when reviewing their bylaws and bringing them up to date. Although the most recent cases on the issue of advance notice bylaws have been decided in Delaware, corporations incorporated in jurisdictions outside of Delaware should also review their advance notice bylaws to make sure that they will operate as intended.

First, as the *CNet* and *Office Depot* decisions make very clear, an advance notice bylaw should state unambiguously that for any nominations or other business to be properly brought before an annual meeting by a stockholder, the stockholder must have given timely notice thereof in writing to the company and the business must be a proper matter for stockholder action. The bylaws should clearly differentiate between nominations and other business to be considered at the stockholders' meeting. Typically

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[9] *Office Depot* at *6.

[10] *Id.* at *6 n.43.

[11] In 2007, Wal-Mart Stores' proxy statement simply listed as one of the purposes of the meeting "To elect 15 directors."

this is accomplished with separate bylaw provisions – one for nominations and one for other business, including stockholder proposals.

Second, an advance notice bylaw should require a stockholder proponent to disclose fully all ownership interests, including derivatives, hedged positions and other economic and voting interests. Synthetic and temporary ownership techniques, as well as swaps, securities loans and timed stock purchases can result in hidden incentives on the part of investors. In order for a company to inform other stockholders as to the true nature of a stockholder proposal, and for a board of directors to make a recommendation on such a proposal, the company must have the benefit of full information. The bylaw should be as complete as possible in this regard.

Third, an advance notice bylaw should require that a proponent of business other than nominations describe the business proposed to be conducted at the meeting, any material interest that the proponent may have in the business, and any agreements the proponent may have with other entities in connection with the proposed business. Again, this information is essential for a company and its board to be able to make recommendations to other stockholders with respect to the proposal.

Fourth, an advance notice bylaw should require information that will enable the company to determine whether a proposed nominee is qualified for election to the board of directors. A stockholder that proposes to nominate director candidates should be required to provide all the information about the candidates that would be required to be disclosed in a proxy statement in a contested election. The bylaw also should require the stockholder to include information as to any material relationships, including financial transactions and compensation, between the stockholder and the proposed nominees. Further, the bylaw should include a requirement that any proposed nominee complete a questionnaire, in a form provided by the company, to be submitted with the stockholder proponent's notice, that inquires as to, among other issues, the proposed nominee's independence. In particular, candidates should be required to represent that they do not have, nor will they have, any undisclosed voting commitments or other arrangements with respect to their actions as a director.

Fifth, an advance notice bylaw should provide equivalent provisions for business to be conducted at a special meeting of stockholders depending upon whether stockholders have the ability to put matters on the agenda for a special meeting or whether such right has been reserved to the board of directors. To the extent that directors are to be elected at a special meeting of stockholders, appropriate advance notice provisions relating to nominations are as important as they would be in the context of an annual meeting.

Sixth, an advance notice bylaw should clearly distinguish its requirements from the requirements under Rule 14a-8 of the federal proxy rules for companies to include stockholder proposals in the company's proxy statement. As the *CNet* decision shows, any ambiguity in this area is likely to be construed against the company and in favor of the activist stockholder.

Seventh, if the company has a majority voting bylaw, it needs to clearly describe when the election is "contested" and plurality voting will apply (and the circumstances where it would revert back to majority voting). In the Office Depot proxy fight, the dissident stockholder terminated his proxy contest shortly before the annual meeting was held. As drafted, the company's bylaws provided for majority voting in the election of directors generally but, as is common, plurality voting was required in a "contested election." Based upon the language in the company's bylaws, the dissident in dropping his proxy contest urged stockholders to withhold votes in the election of directors, claiming that majority voting now applied since it was no longer a "contested election." As RiskMetrics Group noted in a recent report, the "bylaw appears to contain a significant loophole (at least from the perspective of an issuer), in that it allows a dissident stockholder to launch a proxy fight (triggering a plurality standard), yet then withdraw (causing the standard to revert to majority) after the record date and after running a public campaign against incumbent directors. A dissident under these circumstances would be able to run a "vote no" campaign with teeth (*i.e.*, with real consequences) despite the fact that the election arguably remains contested, at least in spirit."[12] Companies should address this issue in their bylaws so that once the determination is made that it is a contested election (which can occur at the record date for the meeting or at the time the company's proxy materials are mailed), the plurality vote standard remains in place even if there is no contested election at the time of the actual stockholders' meeting.

## Conclusion

It is time for companies to take a fresh look at their advance notice bylaws in light of the Delaware court's interpretations of CNet's and Office Depot's bylaw language. With clear and thoughtful drafting, companies should be able to continue to use advance notice provisions to ensure an orderly process and protect the interests of all stockholders. The recent case of *TravelCenters of America, LLC v. Brog*,[13] which was decided in the Delaware Chancery Court last month, reinforces the principle that clear language is the best defense. In adjudicating a dispute over an advance notice bylaw, the court determined that the requirements were clear and, because the notice provided by the stockholder did not comply, it was invalid and insufficient.[14] The court emphasized

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[12] RiskMetrics Group, M&A Edge Note: North America, "Office Depot (ODP): Yes...It's More than 'What's the Harm?'" (Apr. 24, 2008). RiskMetrics Group is the parent company of Institutional Shareholder Services (ISS).

[13] C.A. No. 3516-CC (Del. Ch. Apr. 4, 2008) (ruling from bench), available at http://blogs.law.harvard.edu/corpgov/files/2008/04/bench-memorandum1.pdf.

[14] In an earlier decision in the case, Chancellor Chandler wrote that "Delaware does not impose a legal requirement on LLCs to draft their bylaws to be consistent with some abstract notion of 'good corporate governance'" apparently distinguishing LLCs from public companies. *See TravelCenters of America, LLC v. Brog*, 2008 WL 1746987 (Del. Ch. Apr. 3, 2008).

that, in the limited liability company (LLC) context, the LLC agreement controls. Similarly, in the public company context, a clearly drafted advance notice bylaw with reasonable requirements should be equally enforceable.

The *CNet* and *Office Depot* decisions provide timely reminders, as the 2008 proxy season winds down, that it is important for companies to keep control over the annual meeting process. When proper procedures are followed for the conduct of business at a meeting, when appropriate information is disclosed in advance, when a board of directors has a sufficient opportunity to react to insurgent campaigns and advise stockholders accordingly, and when all stockholders are held to the same requirements, a process that is fair to all stockholders is more likely to be the result.