Beneficial Ownership—
By-law Disclosure Proposal

September 8, 2008

Background
Activist investors often accumulate large, and sometimes dominant, positions in target companies secretly by using total return swaps and other derivatives. Despite legal claims that these derivative holdings are not the same as beneficial ownership—claims being tested in litigation arising from the recent CSX proxy fight—in reality activists demand that targets, and their board of directors, defer to the activists as though they were full owners of the stock represented by the derivatives.

The risks of failing to disclose the accumulation of positions in a timely manner are viewed by many activists as modest when compared to the benefits of the quiet consolidation of leverage over the target. In light of the clear potential for abuse from this tactic, corporate lawyers and their clients have been discussing various proposals to require third parties to disclose in a timely and informative manner (1) beneficial ownership interests that may be held through derivatives and (2) the intentions of the person(s) holding large economic positions (regardless of investment form), together with those acting in concert with them, with respect to any proposed changes in a corporation’s management, control or business strategy.

Some corporations have sought protection with a shareholder rights plan incorporating a broader concept of “beneficial ownership” that captures interests held through derivatives. However, this solution is likely to be problematic in many respects, including the difficulty a corporation will face monitoring its rights plan and dealing with inadvertent triggers that may come to light weeks or months after the fact. In addition, we understand ISS/Risk Metrics’ policy is to recommend that shareholders withhold their votes with respect to any board of directors that renews or adopts a rights plan without shareholder approval.

Other corporations have adopted by-laws requiring extensive disclosure of derivative positions at the time an activist nominates directors or sponsors a shareholder proposal, but that disclosure can occur months after an activist has built a significant position, depriving the corporation and its shareholders of vital, potentially market-moving information.

By-law Proposal Summary
For corporations that are in a position to consider innovative responses to the threat posed by the stealthy accumulation of a significant or potentially dominant position, we suggest considering an alternative approach of amending advance notice by-laws governing shareholder proposals to include new continuous disclosure obligations that incorporate and expand the existing Exchange Act and related SEC rules relating to disclosure of beneficial ownership interests, including those contained in Rule 13d and Schedule 13D.

A corporation’s by-laws would be amended to include the following concepts:

• An expanded definition of “beneficial ownership” expressly capturing derivatives.

• A continuous beneficial ownership interest disclosure obligation with a beneficial ownership disclosure trigger set at 7.5% or 10%. This obligation would be in addition to existing SEC/Exchange Act beneficial ownership disclosure obligations.

• Enhanced documentary disclosure requirements in order for shareholders to validly submit nominations for directors or to put forward any other proposal for consideration at the next annual shareholder meeting (or any special meeting). This would include disclosure of derivative interests of both the shareholder and all others acting in concert with that shareholder or on whose behalf that shareholder is making a nomination or proposal.

• If a shareholder or beneficial owner (together with those acting in concert with or on behalf of them) does not comply with either the continuous or enhanced documentary disclosure obligations in the time period between annual shareholder meetings, then they are ineligible to nominate directors or put any other proposal forward at the next annual shareholder meeting (or any special meeting occurring prior to the next annual meeting).
This kind of by-law would provide a self-help remedy for companies and their shareholders to prevent an activist from secretly accumulating a significant or dominant interest in a corporation without disclosure and then nominating directors or putting a proposal forward to shareholders.

To our knowledge, a by-law incorporating these concepts has not yet been adopted by any corporation.

An upcoming decision of the Second Circuit in the CSX matter may affect the need for a disclosure-based by-law amendment such as that discussed above. In any event, Boards of Directors should carefully weigh the benefits of adopting protections from secret ownership accumulation that may negatively impact shareholder value against the potential that an innovative solution to this problem may attract attention or criticism.

Please feel free to contact us if we can provide further information, or if you would like to receive a draft of the proposed by-law provisions.

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