

## Utilizing Advance Notice Bylaws In Activist Investor Defense

By **Michael Dell and Daniel Ketani** (March 21, 2023, 4:26 PM EDT)

Activist investor campaigns to elect directors at annual stockholder meetings are increasing, and the activists' burden has been reduced by the U.S. Securities and Exchange Commission's universal proxy rules requirement that public companies include activist nominees on their proxy cards.

Advance notice bylaws are an important tool that boards of directors can use to regulate stockholder nominations.

Such bylaws can require a stockholder to provide notice of any board nominations or stockholder proposals during a defined period before an annual meeting, as well as call for a stockholder to provide detailed information concerning the qualifications of its board nominees and any conflicts the stockholder and nominees may have.

Typically, such bylaws further require a nominating stockholder to be a stockholder of record both at the time it gives notice of its nomination and on the record date for the annual meeting, meaning the stockholder must register at least some stock in its own name and not in its "street name."

The Delaware Supreme Court has upheld such bylaws, ruling that boards may reject nominations that fail to comply.

In *BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund Ltd.*, for example, the Delaware Supreme Court in 2020 found that two closed-end investment funds had advance notice bylaws that required stockholders to provide, among other things, "information to establish to the satisfaction of the Board of Directors that the Proposed Nominee satisfies the director qualifications as set out in" the bylaws.

The nominating stockholder provided timely notice of its nominations for the boards of the two funds, which in turn then sent the stockholder a questionnaire with almost 100 questions. When the stockholder did not respond in the time allotted, the boards rejected its nominations, and the stockholder sued.

The Delaware Court of Chancery found that the funds' questionnaire asked for information that was not necessary to assess whether the plaintiff's nominees satisfied the qualifications in the bylaws, but the



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state Supreme Court reversed.

The state Supreme Court explained that advance notice bylaws "are designed and function to permit orderly meetings and election contests and to provide fair warning to the corporation so that it may have sufficient time to respond to shareholder nominations."

It ruled that at least a third of the funds' questions sought information that related to the director qualifications in the funds' bylaws, finding that the plaintiff:

should have raised [its] concern [about the other questions] with the Trusts before the expiration of the deadline. What it could not do, without risking disqualification of its nominees, was to stay silent, do nothing, and let the deadline pass.

The court emphasized that advance notice bylaws are "commonplace" and that the funds' bylaws were adopted on a "clear day" before any proxy contest, determining that "a rule that would permit election-contest participants to ignore a clear deadline and then, without having raised any objection, proffer after-the-fact factual inquiries ... into missed deadlines could potentially frustrate the purpose" of the bylaws.

The plaintiff's speculation that the board had a "bad intent or purpose" was not enough to challenge its conduct, the court added.

Following BlackRock, the Court of Chancery has issued at least three decisions concerning challenges to board rejections of stockholder nominations for failure to comply with advance notice bylaws. In each of them, the court denied relief to the nominating stockholders.

In the Chancery Court's 2021 decision in *Rosenbaum v. Cytodyn Inc.*, Cytodyn's bylaws required the nominating stockholder to disclose any "agreements" or "understandings" concerning its nominations, and complete and sign a "questionnaire with respect to the background and qualification of such proposed nominee and ... any other person or entity on whose behalf the nomination is being made."

The bylaws also provided "that any stockholder proposal or nomination ... not made in accordance with [those] provisions ... shall be disregarded."

The plaintiffs provided timely notice of their nominations and a completed questionnaire, but Cytodyn's board rejected the notice on the grounds that the questionnaire failed to identify other stockholders who were providing financial support for the proxy contest and did not disclose that one of the nominees was the CEO and a significant stockholder of a competitor.

The plaintiffs submitted a revised notice, but the board rejected that too. The plaintiffs sued.

After a trial, Vice Chancellor Joseph Slight's upheld the board's rejection of the nomination and found that plaintiffs did not meet their burden to prove "compelling circumstances" that establish inequitable conduct of a sort that would permit the court to set aside the board's rejection of the nomination.

The court explained that it was "vital" to the board to know whether other stockholders were financially supporting the nomination and that it was reasonable for the board to conclude that the plaintiffs' denial that other shareholders were doing so was "facially disingenuous."

Vice Chancellor Slight also observed that the board "legitimately suspected" that the nominees sought a merger with the company of which one nominee was the CEO, saying that is "the type of potential conflict that stockholders are entitled to know about when voting for directors."

In the Court of Chancery's 2022 case *Strategic Inv. Opportunities LLC v. Lee Enterprises Inc.*, only days before a nomination deadline, the plaintiff made a nonbinding proposal to acquire Lee and attempted to nominate candidates for election to its board.

Lee's advance notice bylaw required the nominating stockholder to complete a questionnaire, but the board refused to provide it to the stockholder because the stockholder was still in the process of satisfying the bylaw requirement to register its stock in its own name. The plaintiff tried to get around that by submitting a generic questionnaire, but the board rejected it together with the plaintiff's nomination notice, and the plaintiff sued.

After a trial, Vice Chancellor Lori Will concluded that the board did not breach Lee's bylaws and that there was no equitable basis to override the rejection of the plaintiff's nomination.

The court found that because there was "no evidence of manipulative conduct" and the plaintiff was not a stockholder of record at the relevant time, the board was justified in rejecting the nomination and declining to send its questionnaire to the plaintiff.

The plaintiff "failed to comply with a validly enacted bylaw that had a legitimate purpose" and was "adopted on a clear day," according to the decision, which added that the plaintiff should not have waited "until the last minute to begin the process of submitting a nomination," leaving "no room for error."

Finally, in the Chancery Court's 2022 case *Jorgl v. AIM ImmunoTech*, AIM's advance notice bylaw required that nominations provide "a description of all arrangements or understandings" between the nominating stockholder "and each proposed nominee and any other person ... pursuant to which the nomination(s) are to be made."

The plaintiff submitted a nomination in coordination with third parties, who agreed to pay his legal fees. The board rejected the nomination, and the plaintiff sued.

Vice Chancellor Will denied the plaintiff's motion for injunctive relief. Applying enhanced scrutiny, the court disagreed with the plaintiff's argument that the board's rejection of his nominations was inequitable.

The court found that the plaintiff was unlikely to succeed on the merits because the advance notice bylaw "required [the plaintiff] to disclose any advance plan, measure taken, or agreement — whether explicit, implicit, or tacit — with any person towards the shared goal of the nomination."

It held that the plaintiff failed to show his notice complied with the bylaw because the notice did not disclose "an arrangement pursuant to which [he] was asked to purchase AIM shares and put them into record name." However, the court explained that it "can envision an advance notice bylaw with so broad a reach that it" would not "have a legitimate corporate purpose" or "be reasonable."

New York courts have applied the same principles under New York law to permit boards to enforce advance notice bylaws.

In 2020's *Franchi v. Enzo Biochem Inc.*, Justice Andrea Masley of the Commercial Division of the New York Supreme Court, New York County, denied a motion by a beneficial owner of Enzo stock to delay Enzo's annual meeting and extend the nomination period after the board found that a nomination of directors was untimely under its advance notice bylaws.

The court held that the business judgment rule applied because the plaintiff did not establish "bad faith or a disabling interest on the part of the majority of the directors," adding that the fact that the plaintiff was not a record holder of Enzo shares was "fatal to this application."

The question of whether and when advance notice bylaws may be considered unreasonable continues to be tested.

Most recently, in *Politan Capital Management LP v. Masimo Corp.* before the Chancery Court, the plaintiff alleged that after an activist investor acquired an ownership stake in the company, the board amended its bylaw to become "perhaps the most preclusive advance notice bylaws in Delaware history."

According to the plaintiff, in addition to requiring broad disclosures concerning "agreements or understandings," the bylaw required nominating stockholders that are investment funds to disclose the identities of limited partners and potentially the source of their investments, as well as for nominating stockholders that are individuals to disclose the source of investments of family members. The bylaw also required nominating stockholders to make disclosures concerning plans for proxy contests at other companies.

However, a week before the scheduled trial, Masimo's board withdrew the advance notice bylaw amendment.

BlackRock and its progeny offer important lessons concerning the enforcement of advance notice bylaws:

- Boards of directors should enact advance notice bylaws on a "clear day" before the threat of a proxy contest. Courts are more likely to enforce advance notice bylaws to reject dissident nominations when the bylaws are not adopted in response to the nominations.
- The advance notice bylaws should clearly state the information that stockholders should include in a nomination notice or the board may otherwise request. The Court of Chancery has upheld advance notice bylaws that require nominating stockholders to disclose information concerning the qualifications and potential conflicts of nominees and any "agreements or understandings" with the nominees or others relating to the nomination. Disclosure requirements that are more intrusive and less directly related to the nomination, as plaintiffs alleged was the case in *Masimo*, may be more difficult to sustain in court.
- Activist investors should be ready to make their nominations when the nomination window opens. That may require the investors to become stockholders of record or to prepare to respond to information requests from the board. Courts have not been sympathetic to stockholders who wait until the last minute to provide notices that the board later determines are deficient.

- Activist investors should be cautious before declining to provide information that the board reasonably requests, particularly if that information is required by an advance notice bylaw. Stockholders whose nominations are rejected for failure to provide requested information may face an uphill battle to prove in court that the rejection was not justified.

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***Disclosure: The authors of this article represented Enzo and its directors in Franchi v. Enzo Biochem Inc.***

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