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A Second Bite at the Apple for Shareholder Activists to Nominate Directors?

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Editor's note: Steve Wolosky, Andrew Freedman, and Ron Berenblat are partners at Olshan Frome Wolosky LLP. This post is based on an Olshan publication by Mr. Wolosky, Mr. Freedman, and Mr. Berenblat.

Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

Now that we are midway into the 2018 proxy season, most deadlines for shareholder submissions of director nominations for upcoming annual meetings have come and gone. Nevertheless, shareholder activists who have missed a nomination deadline for whatever reason should be aware that in certain circumstances they may have a second bite at the apple. Where a company experiences a material change in circumstances set in motion by its board of directors after the passing of the nomination deadline, the shareholder may have grounds to compel the company to reopen the nomination window if the shareholder can demonstrate that the change in circumstances would have been material to its decision whether or not to nominate directors had it been known at such time. There is already case law in Delaware holding that it is inequitable for directors to refuse to grant a waiver of an advance notice deadline under such circumstances.

In his highly publicized campaign against Xerox Corp. ("Xerox"), Darwin Deason, the third largest shareholder of Xerox, recently commenced an action in New York State Supreme Court seeking to enjoin Xerox from enforcing its December 11, 2017 nomination deadline based on the Delaware standard on this issue. This post provides an overview of Deason's allegations and his legal claim seeking to compel Xerox to reopen the nomination window for him and all shareholders as a matter of New York law. This is a case of first impression in New York and the adoption of the Delaware holding by a New York court would be a major victory for shareholder activists. However, as a vast majority of corporations are incorporated in Delaware, this post is also intended to remind shareholder activists who desire to nominate directors after a deadline has passed that material developments triggered by a company's board that come to light after the deadline may give them grounds to request a waiver of the deadline.

Deason's Allegations in the Xerox Case

Deason is a long-time shareholder and outspoken critic of Xerox. In May 2017, almost seven months prior to Xerox's nomination deadline, Deason sent a private letter to Xerox expressing concerns regarding the company's relationship and contractual arrangements with Fujifilm Holdings Corporation ("Fuji") and Fuji Xerox, created by Xerox and Fuji in 1962 as a joint venture, and calling upon Xerox to explore its strategic alternatives with respect to Fuji. Deason claims the letter was ignored.

Deason alleges that later in the summer of 2017, he privately requested Xerox to provide copies of certain agreements relating to the Fuji Xerox joint venture that were entered into in 2001. Under one such agreement, Fuji obtained the exclusive rights to Xerox's intellectual property and the manufacture and sale of Xerox products in the burgeoning Asia and Pacific Rim markets—referred to by Deason as the "crown jewels" of Xerox. Deason alleges that Xerox refused to provide copies of the agreements unless he signed a non-disclosure agreement with a standstill provision. Deason refused to sign the agreement.

Approximately one month after the December 11, 2017 nomination deadline, rumors of a potential transaction between Xerox and Fuji were reported in the media. Shortly thereafter, on January 17, 2018, Deason sent his first public letter scolding Xerox for its lack of disclosure regarding its venture with Fuji that has left shareholders "speculating at the incredible materiality of its secret terms." Deason stated that in light of recent revelations of a potential alteration of the existing Xerox-Fuji relationship, the omission of the material agreements governing the relationship has left shareholders "guessing" as to how to evaluate a potential deal. Deason concluded by once again calling upon Xerox to publicly disclose the material agreements governing Fuji Xerox so that shareholders "can engage the Company, provide their views and make their investment and voting decisions with at least the minimum cards on the table."

On January 22, 2018, Deason and Carl Icahn, the largest shareholder of Xerox, announced that they formed a Section 13(d) group to solicit proxies for the election of a slate of four director candidates nominated by Icahn (prior to the nomination deadline) for election at the upcoming annual meeting. Deason alleges at that point in time he was still unaware of the full terms of the Fuji Xerox venture or the potential transaction between Xerox and Fuji and therefore "he had not yet determined that it was necessary to nominate his own slate of director candidates."

On January 31, 2018, Xerox and Fuji announced that they entered into a definitive agreement to combine Fuji Xerox with Xerox. Under the terms of the agreement, Fuji will own 50.1% of the combined company and Xerox shareholders will own 49.9% of the combined company and receive a special cash dividend of approximately $9.80 per share. Deason believes the transaction amounts to a scheme intended to allow Fuji to take control of Xerox without paying a "realistic control premium" while leaving Xerox shareholders "hostage and subject to abuse by Fuji."

On the same day the transaction was announced, Xerox also publicly disclosed the material agreements relating to the Fuji Xerox venture. Deason alleges that these agreements for the first time revealed the existence of a "crown jewel" lock-up right providing that if Xerox engages in a transaction with a specified competitor for more than 30% of the voting power of Xerox, Fuji has the right to terminate the main agreement governing Fuji Xerox, which in turn would strip Xerox of

its decision-making authority with respect to the joint venture. However, Fuji would still retain the exclusive rights to Xerox's "crown jewels." Deason alleges that these provisions effectively gave Fuji a "blocking position on Xerox's ability to sell itself to anyone other than Fuji." Deason also alleges that the proposed deal contemplates making permanent Fuji's "crown jewel" lock-up right.

On February 26, 2018, Deason sent a letter to Xerox expressing his desire to nominate a full slate of directors at the company's upcoming annual meeting. Deason stated that while the December 11 nomination deadline had passed, he had the right to nominate directors at the annual meeting since the revelations regarding the proposed business combination and public disclosures regarding the existing joint venture agreements constituted a "material" change in Xerox's circumstances that was caused by the Xerox directors after the nomination deadline. Specifically, he asserted that the disclosure of the proposed business combination (that he believes would be detrimental to Xerox shareholders), the disclosure of the "crown-jewel" lock-up (that he believes restricts the company's strategic flexibility) and his belief that the lock-up and other rights under the joint venture agreements would become permanent "were highly material to the shareholders' decisions concerning potential nomination of directors." Deason requested a waiver of enforcement of the nomination deadline in order to allow him and other shareholders to nominate directors at the upcoming annual meeting. Xerox rejected Deason's waiver request.

Deason's Legal Claims and the *Hubbard* Case

On March 2, 2018, Deason filed a lawsuit against Xerox in New York State Supreme Court seeking a preliminary injunction enjoining enforcement of the nomination deadline and permitting Deason to nominate a full slate for election at the upcoming annual meeting. In his brief, Deason acknowledges the absence of controlling New York case law and asks the court to look to *Hubbard v. Hollywood Park Realty Enters., Inc.*, the leading Delaware Chancery Court case on this issue.

The 1991 *Hubbard* case involved a fascinating set of facts. Hollywood Park Realty Enterprises, Inc. ("Realty") and its sister company Hollywood Park Operating Company ("Operating") were the owners and operators of Hollywood Park Race Track near Los Angeles. R.D. Hubbard, a significant shareholder of Realty and Operating, filed suit against both companies after they refused his request to extend their respective nomination deadlines in order to allow him to submit nominations. After both companies denied his request, he submitted nominations prior to the deadlines and filed an action for a declaratory judgment that the advance notice bylaws were invalid. Nevertheless, shortly thereafter Hubbard and Realty entered into a settlement agreement under which Hubbard was elected to the board in return for Hubbard's agreement to drop his proxy contest. Under the settlement agreement, the Realty board also agreed not to waive the advance notice bylaw provisions to permit a shareholder to nominate an opposing slate at the upcoming annual meeting.

To everyone's surprise, once Hubbard joined the board, he quickly gained the support of a majority of the existing directors to alter the operational direction and management policies at the race track. The new management slate, including Hubbard and his new allies, were set to run uncontested at the upcoming annual meeting. The other directors who unexpectedly found themselves in the minority, including Merv Griffin, Aaron Spelling and John Forsythe, sought to nominate a competing slate based on a platform that the company be sold. Since the nomination deadline had already passed, the minority directors asked for a waiver. After determining that a

sale of the company would not be in the best interest of shareholders, the board denied the waiver request.

The minority directors brought cross-claims in the lawsuit to enjoin enforcement of Realty's nomination deadline. They contended that the enforcement of the deadline would be inequitable because they had no reason to believe it would be necessary for them to run a dissident slate while the nomination window was open. Prior to the nomination deadline and the appointment of Hubbard, the minority directors believed the board was "united in their opposition to Hubbard" and had no reason to believe that after the deadline had passed, Hubbard would win over a majority of the existing directors or that the directors would contractually bind themselves not to waive the advance notice provision.

In granting the motion for preliminary injunction, the court stated:

> [T]his is a case where the Realty board itself took certain action, after the by-law nomination deadline had passed, that involved an unanticipated change of allegiance of a majority of its members. It was foreseeable that that shift in allegiance would result in potentially significant changes in the corporation's management personnel and operational changes in its business policy and direction. Such material, post-deadline changes would also foreseeably generate controversy and shareholder opposition. Under those circumstances, considerations of fairness and the fundamental importance of the shareholder franchise dictated that the shareholders be afforded a fair opportunity to nominate an opposing slate, thus imposing upon the board the duty to waive the advance notice requirement of the by-law.

Many years later, in *AB Value Partners, LP v. Kreisler Manufacturing Corp.*, the Delaware Chancery Court distilled the above holding into the following three questions that the court in *Hubbard* focused on in determining whether enjoinment of an advance notice nomination provision is warranted:

1. Did a change in circumstances occur after the nomination deadline?
2. Was the change "unanticipated" and "material"?
3. Was the change caused by the board?

In the Xerox case, Deason is relying heavily on the *Hubbard* principles. Deason asserts that the three-pronged *Hubbard* test has been satisfied as several weeks **after the nomination deadline** (prong 1), the **Xerox board** (prong 3) made a series of decisions and disclosures described above that were **highly material** (prong 2) to a shareholder's decision concerning the potential nomination of directors. By refusing to waive the nomination deadline, Deason claims that the Xerox board breached its fiduciary duty of loyalty to him and other shareholders and is "unjustly preventing Xerox shareholders from exercising their fundamental corporate voting rights or even considering whether to replace the Xerox Board responsible for the Transaction described above." Deason goes a step further by claiming that the Xerox board's refusal to waive the nomination deadline was primarily an entrenchment tactic. In addition to seeking to enjoin Xerox from enforcing the nomination deadline and allowing him to nominate a slate, Deason is also asking the court to declare that Xerox and its directors breached their fiduciary duties by refusing to grant the waiver.

Importance of *Hubbard* and Outcome of the Xerox Case

While the *Hubbard* decision is over 25 years old and has not been heavily cited by the Delaware Chancery Court, it is nevertheless controlling law on this issue. Interestingly, Deason's Section 13(d) cohort Carl Icahn was the last person to successfully invoke *Hubbard* in Delaware by convincing the court to grant his motion for an expedited proceeding in a lawsuit he filed against Amylin Pharmaceuticals, Inc. following its board's rejection of an acquisition proposal from Bristol-Meyers Squibb Co. after Amylin's nomination deadline had passed. Shareholder activists should become familiar with *Hubbard* and its three-pronged standard as it is not uncommon for companies to make highly significant decisions and disclosures right after a nomination deadline has passed. Resorting to a withhold campaign may not necessarily be the next best option for shareholder activists to pursue if they missed a nomination deadline.

As we are not aware of any state court outside Delaware that has adopted the *Hubbard* standard, a ruling by the New York State Supreme Court favorable to Deason that embraces the standard would be a great victory for shareholder activists. The Xerox case is currently ending the expedited discovery phase, with the parties having submitted a first round of additional briefing under seal, and a hearing on the preliminary injunction motion scheduled for April 26.