



Negotiating a Settlement with an Activist Investor

In his regular column, Frank Aquila drafts a sample memo to a board explaining the issues to consider when negotiating a settlement with an activist investor seeking to designate individuals to serve as directors.



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MEMORANDUM

TO: The Board of Directors
FROM: Frank Aquila
RE: Issues When Negotiating A Settlement with an Activist Investor

As we have discussed, you are in the process of negotiating an agreed settlement with the Investor regarding its request to designate two individuals to serve as directors of the Company. In February, the Investor filed a Schedule 13D with the Securities and Exchange Commission (SEC) indicating that it is considering nominating one or more individuals to serve as members of the Board for election at the 2015 annual meeting. The Investor recently purchased additional shares

and now holds 9.76% of the Company's common stock, and has succeeded in electing directors to the boards of other public companies in contested situations in the last 12 months.

The Investor has told you that while its objective is to work with you cooperatively, if the Board considers it inappropriate for the Investor to have board representation or if the Investor is not satisfied with the terms of the Board's offer, the Investor would consider other options to seek board representation, including a proxy contest.

After careful deliberation you have concluded that reaching a settlement in advance of a proxy contest would be in the best interests of the Company and the stockholders. Your primary focus at this stage should be negotiating a settlement that addresses the legal and practical concerns of both the Investor and the Company, while sending a balanced and positive message to the Company's other stakeholders.

In accordance with the Company's advance notice by-laws requiring stockholders to submit a notice of intent to nominate directors, you and the Investor have 30 days to reach an agreement before the Investor would need to take formal action to preserve its right to engage in a proxy contest in connection with the 2015 annual meeting. Although many settlements have been struck mere hours before an annual meeting, both parties should recognize that there are numerous incentives to settling sooner rather than later, before expending significant resources and before the influential proxy advisory firms issue their recommendations regarding the proxy contest. The timing of the settlement, as well as the parties' respective goals and leverage, will inform the specific terms of a settlement agreement.



Search [By-laws \(DE Public Corporation\): Advance Notice](#) for form by-laws that require advance notice of stockholder proposals.

Search [Proxy Contests](#) for more on proxy contest risk mitigation strategies and how to maximize a company's chances to prevail in a contest.

Although settlement agreements tend to be highly situation-specific, most of these agreements address: (1) board representation; (2) restrictions on the investor; (3) corporate governance changes and other initiatives to enhance stockholder value; (4) expense reimbursement; and (5) other mutual covenants and public presentation of the settlement.

This memo explains the terms that appear most frequently in agreed settlements, highlighting some of the major issues that will likely arise as you negotiate with the Investor. These issues are important whether the Board settles with the Investor before, during or after a proxy contest.

1. BOARD REPRESENTATION

A. NUMBER OF DIRECTOR NOMINEES AND THEIR AFFILIATION

The Investor is primarily concerned at this stage with obtaining board representation. It has provided you with the names and qualifications of three potential director nominees, one of whom is affiliated with the Investor. As you negotiate terms that relate to the Investor's board representation, you should consider the threshold matters of how many seats you are willing to provide the Investor, and whether you are willing to include director nominees who are affiliated with the Investor. As we have already discussed, there are good reasons for a board to be cautious about adding an affiliated nominee (such as potential conflicts of interest and the duty of loyalty).

It is typical for a board to add one to three of an investor's nominees. The number of an investor's director nominees that a company is willing to add often depends on, among other things, the overall size of the company's board and the investor's ownership stake in the company.



Search [Memorandum to Board: Issues When Selecting Directors Designated by an Investor](#) for more on selecting affiliated director nominees.

B. INFLUENCE AND COMMITTEE POSITIONS

Even if an investor's nominees are appointed to a company's board, the company may still insulate certain important decisions from the influence of the investor's board representatives. Delaware state law gives corporations much latitude to delegate decision-making power to new or existing committees of the board. Absent a contractual obligation, a company has no legal duty to place an investor's designees on existing committees. A board could also vote to create new committees that are empowered to decide issues of concern to an investor and exclude the investor's designees from these new committees.

The committee appointment terms in agreed settlements have ranged from vague to extremely specific. Some settlements simply state that the investor's designees shall have the "same rights" as other directors, including "for the avoidance of doubt, with respect to consideration for committee appointments." At the other end of the spectrum, some settlement agreements explicitly name one of the new directors for placement on the audit, compensation or nominating/governance committees, and provide that at least one of the investor's designees shall sit on any new committee that is created after the settlement. In some cases, a company may agree to give an investor's designees board leadership positions in addition to, or instead of, committee membership. In those cases, the parties can choose whether or not to make incumbent directors' resignation from these leadership positions an express term in the settlement agreement.

C. REMOVAL AND REPLACEMENT

The removal and replacement of the investor's designees will be noteworthy issues as you negotiate the Investor's board representation. Many investors do not think that, within the duration of the settlement agreement, the board should be able to remove an investor's designee under any circumstances short of legal wrongdoing. Contractual terms to that effect appear in some settlement agreements, although they are usually conditioned on the investor's compliance with its obligations under the settlement agreement, and subject to the board's ability to exercise fiduciary duties. In contrast, companies that do not want a small stakeholder to retain board seats have negotiated settlement agreements that require one or more of the investor's designees to resign if the investor's holdings fall below a certain percentage (such as 5% of outstanding shares).

For example, Carl Icahn regularly employs tiered ownership thresholds in his settlement agreements so that one of his director designees must resign if the Icahn Group's ownership falls below an initial threshold and an additional director must resign if the Icahn Group's ownership falls below a lower threshold. In the latter scenario, the investor's designees must submit irrevocable resignations before they take their seat on the board. The company agrees not to enforce the director's resignation unless the investor's stake falls below the specified threshold.



Search [Director Resignation Letter: General](#) for a form letter of resignation for a director who must offer to resign, in accordance with a company policy, following a triggering event.

Many investors also want the right to appoint a replacement in the event that their designee resigns or is unable to serve. If a company agrees to provide the investor with this right, the settlement agreement typically includes a caveat that the replacement director must meet certain minimum standards and be reasonably acceptable to the company. A common practice is for the board and the investor to agree on a list of replacement directors during the settlement negotiation, well before a vacancy occurs. Within the standstill period (discussed in Section 2 below), if an investor's designee leaves the board mid-term, the board will fill the resulting vacancy by appointing a candidate from the vetted list, as long as the investor has not breached its obligations under the settlement agreement.

If more than one board election occurs during the standstill period, the parties should discuss whether the board must nominate the investor's designees during each election. Without express terms regarding the subsequent elections, the board has no obligation to nominate the investor's designees for reelection.

D. TIMING OF APPOINTMENT

The timing of when an investor's nominees will take office is an issue that often causes some contention when parties negotiate the investor's board representation. Investors generally want their nominees to be appointed without delay, whereas boards often prefer a delay. From an investor's perspective, a delay could give the board time to make substantial changes without input from the investor's designees, including changes that would minimize their influence. On the other hand, if the company simply expanded its board size following a settlement, the investor would be concerned about diluting the influence of its board representatives. A settlement agreement that requires incumbent directors to resign immediately presents an unpleasant task for the board. As a result, a board may wish to delay the addition of the new directors to avoid the awkward matter of forcing incumbents to resign immediately after the execution of the settlement agreement.

More and more, recent settlements reconcile these concerns by initially expanding the size of the board to accommodate the new directors, then phasing out incumbent directors until the board returns to its original size. Many settlements provide for the incumbent directors to step down by the next annual meeting, but some have built in longer transition periods.

For example, to accommodate Third Point's three new director nominees, Sotheby's increased its board size to 15 people in a 2014 settlement, but Sotheby's will have until the 2016 annual meeting to return its board size to 12. Other investors agree to delay the addition of new directors until they are nominated and elected at the next annual meeting, provided that the investor's nominees have the power to attend any board meetings as an observer in the meantime (subject to confidentiality agreements and legal privileges).

2. RESTRICTIONS ON THE INVESTOR

In the standstill provisions of a settlement agreement, the investor agrees to refrain from activities designed to influence the corporate governance or control of the company for a specified period. Standstill provisions tend to be the most uniform provisions across different settlement agreements. Some settlement agreements tie the termination of the standstill period to an event (for example, until the investor's designees are no longer board members), but investors usually prefer a short period with a fixed end date so that they can preserve the option of taking a "second bite" to exert further influence on the company.

The typical duration of a standstill period ranges from one to two years, ending on a date before the deadline by which the investor must provide notice of its intent to nominate new directors under the company's advance notice by-laws. The investor may agree to a longer standstill period if the company in turn agrees to reelect the investor's designees at each annual meeting occurring during the standstill period.

A. TRANSFER RESTRICTIONS

From the board's standpoint, transfer restrictions are probably the most crucial restrictions on an investor's share ownership, since the board could come under pressure from another investor during the standstill period. A typical transfer restriction prohibits the investor from selling or otherwise transferring any of its securities without giving the company prior written notice. Because the notice requirement is the standard, the investor may need to make concessions in other aspects of the settlement in exchange for limited exceptions, such as private transfers that would not put the transferee above a particular ownership threshold or private transfers to the investor's controlled affiliates.

Assuming that the board agrees to these exceptions, the investor is still restricted in its share transfer activities by Section 13(d) of the Securities Exchange Act of 1934. If the investor engages in what could be considered coordinated activity with other stockholders, they may be required to file a Schedule 13D as a "group" soon after their combined ownership stake exceeds 5% of the company's common stock. Since the company may be able to allege a Section 13(d) violation if the investor coordinates with other investors and fails to report share transfer activities to the SEC, some investors will negotiate for settlement terms that provide assurance that the company will not attempt to classify the investor as being part of a Section 13(d) group.

On the other hand, the investor may instead agree not to form a Section 13(d) group as part of the standstill provisions.



Search [Section 13\(d\) Beneficial Ownership Reporting](#) for more on the beneficial reporting obligations under Section 13(d).

Search [Filing Schedule 13D and 13G Reports](#) for more on filing as a group.

B. PROHIBITION ON ACQUIRING ADDITIONAL VOTING SECURITIES

Another standard feature of the standstill provisions is a prohibition on the investor acquiring additional voting securities of the company during the standstill period. An investor may negotiate for exceptions that will allow it to acquire up to a specified percentage of the company's common stock (such as 10%) or enter into swap agreements. In the last few years, some investors have surprised companies by accumulating significant stakes using swap agreements, which could give a board pause about agreeing to provide the investor with a swaps exception.

C. RESTRICTED INVESTOR ACTIVITIES

In addition, investors typically agree to refrain from taking additional actions, including prohibitions on: (i) submitting stockholder proposals, (ii) participating in the solicitation of the company's proxies in opposition to the board, (iii) attempting to obtain additional board representation, (iv) calling a special meeting of the company's stockholders, (v) submitting a demand to inspect the company's books and records, (vi) acting alone or in a group to seek control of the management or board of the company, or (vii) seeking or proposing an extraordinary transaction involving the company, such as a merger.

Often, a board will negotiate for terms that expressly forbid the investor from publicly opining on a merger or other major company transactions. However, investors tend to push back against provisions that would prevent them from exercising their right to publicly criticize or oppose a transaction that could materially impact the future of the company. Settlements with an investor who has commenced a proxy contest should also include the investor's agreement to irrevocably withdraw any nomination notices and terminate all actions to solicit proxies.

D. VOTING AGREEMENTS

Apart from restrictions on the Investor's activities, the Company may consider it valuable to obtain the Investor's support at future stockholders' meetings for elections, other management proposals and stockholder proposals. If so, you should negotiate voting agreements that obligate the Investor to vote in accordance with the Board's recommendations. For example, you may ask the Investor to commit to vote: (i) in favor of each director that the Board recommends for election (including the Investor's nominees) at one or more annual meetings within the standstill period, (ii) against any director that the Board has not nominated for election, (iii) in favor of proposals submitted to a stockholder vote by the Board, such as say on pay or a new stock option plan, and (iv) in accordance with the Board's recommendations when certain types of stockholder proposals arise, such as a by-law amendment or social policy proposal. With voting agreements, as with the other terms in the standstill provisions, mapping out the exact parameters of the Investor's commitment will improve efficiency and reduce transaction costs down the road.

3. CORPORATE GOVERNANCE CHANGES AND OTHER INITIATIVES TO ENHANCE STOCKHOLDER VALUE

Although the Investor has not made it explicit, it may be interested in negotiating corporate governance or other policy changes as part of the settlement. In addition to board representation, many investors propose changes to the company's governance policies or by-laws as part of the settlement terms. Settlements frequently include a company's agreement to: (i) eliminate or alter a stockholder rights plan, (ii) restrict board size or composition, (iii) de-stagger a classified board, (iv) form a new committee to review certain practices, such as executive compensation, (v) disband or restructure existing committees, (vi) revise the procedures for calling special meetings or acting by written consent, (vii) separate the CEO and chairman positions, or (viii) begin searching for a new CEO.

Many investors seek to implement strategic alternatives that are intended to enhance stockholder value. The company may agree to declare a cash dividend or execute or expand a stock buyback plan, sell the company, spin off or divest any underperforming or non-core business lines, or retain advisors to explore other strategic alternatives.

If the Investor negotiates for any of these terms and you agree to them, it is prudent to work out and include in the settlement agreement details regarding how and when these changes should take place and what happens if these changes become impracticable.

4. EXPENSE REIMBURSEMENT

A. EXPENSES INCURRED IN SETTLING A PROXY CONTEST

In some settlement agreements, each party agrees to be responsible for its own fees. However, many companies agree to reimburse investors for legal fees and other expenses related to settling a proxy contest. Some companies have by-laws that require them to reimburse proxy solicitation expenses, which have been recognized as valid under Delaware General Corporation Law. The legal expenses of preparing, filing and revising proxy statements constitute the majority of an investor's expenses during a typical proxy contest.

The investor will also likely engage a proxy solicitor and public and/or investor relations firm to assist it in soliciting proxies and campaigning in favor of its director nominees. If an investor has only threatened a contest but has not prepared or filed a proxy statement with the SEC or begun soliciting proxies, it may not have incurred significant expenses and may not be concerned about reimbursement. For an investor who has engaged in a protracted proxy fight with a company, the investor's expenses are likely to be substantial, and reimbursement will become a bigger issue.

B. TYPES OF REIMBURSED EXPENSES

If the company agrees to reimburse the costs that an investor incurs over the course of the settlement, the parties should negotiate what types of expenses will be reimbursed. Reimbursed expenses generally include the legal, advertising and travel expenses that arise from: (i) threatening or initiating a proxy contest, (ii) preparing and filing the initial proxy statement and Schedule 13D, (iii) negotiating and executing a settlement agreement, (iv) preparing and filing a Schedule 13D amendment after the settlement agreement, and (v) reviewing disclosure documents filed by the company. Reimbursements also tend to cover the investor's reasonable payments to attorneys, public and investor relations firms, and proxy solicitors for their work on any joint press releases, mailings to stockholders, direct communications with stockholders and preparation for meetings with proxy advisory firms.

Most companies will negotiate to cap the amount of the reimbursement. In recent settlement agreements, caps for reimbursements have ranged from \$10,000 to over \$10 million. An investor may seek exceptions to the cap on reimbursement, especially for legal fees that are incurred in enforcing the terms of the settlement agreement.

5. MUTUAL COVENANTS AND PUBLIC PRESENTATION OF THE SETTLEMENT

The parties' willingness to compromise on the negotiating points mentioned above will determine the outcome of the settlement. When the investor reaches a settlement with the company, the parties may choose to record their agreed settlement in a formal document, or they may choose not to draw up official papers. If the parties choose to record their settlement terms in a formal document, the parties' attorneys should make sure that the document contains



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confidentiality provisions, mutual non-disparagement clauses, mutual releases and covenants against litigation, choice of law provisions, remedies for breach of the agreement, and other mainstays of a properly drafted settlement agreement. The parties should discuss these issues even if they choose not to draft a formal document.

Some parties that create a formal settlement document make the settlement agreement public by filing a current report on Form 8-K to announce the settlement and attaching the document as an exhibit. Whether or not they decide to file a Form 8-K, the parties often agree to issue a joint press release. If the parties agree to issue a joint press release, they will negotiate over the wording of the announcement and usually append the text of the announcement as an exhibit to the settlement agreement. A joint press release typically begins by stating the parties' pleasure at reaching an agreement, followed by a sketch of the important terms of the settlement, and concludes with the parties' hopes for the future of the company. Parties that reach informal or undocumented settlement agreements often choose to issue a joint press release as well.

A settlement agreement is not just a contract between a particular board and a particular investor. Other investors and companies, along with proxy advisory firms and members of the general public, may factor the terms and overall tone of a settlement agreement into their evaluation of the investor and the board. As a consequence, the Board has an interest in appearing firm but open-minded about stockholders' credible suggestions. On the other hand, the Investor has an interest in creating working relationships with the Board and building a public reputation for playing fair, which can facilitate future negotiations with the Board and the boards of other companies.

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Although reaching a settlement with the Investor will be difficult, it is likely to be preferable to a protracted and distracting proxy contest. Nevertheless, you must recognize that providing the Investor with representation on the Board is simply the beginning and not the end of your discussions with the Investor. Once the Investor is represented on the Board, it will likely seek changes that it believes are in the best interests of the Company and its stockholders. Further, the Company should expect boardroom dynamics to change as well.

F.J.A.