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The Wrong Prescription? Revisiting the Justification for Poison Pills

By Mark Lebovitch and Laura Gundersheim

One of the fundamental tenets of market capitalism is the freedom of willing buyers and willing sellers to transact business. Ironically, this basic rule does not apply in the world of corporate mergers and acquisitions. Because of so-called "poison pills," deals effectively require the support of the target company's board of directors. Here we consider how "poison pills" evolved, allowing directors to prevent shareholders from selling their property to third parties offering premium prices. Based on massive value losses from withdrawn tender offers in the last few years, however, we suggest that it is time to revisit the broad judicial deference that has allowed directors to use poison pills to stand between bidders and stockholders indefinitely.

Poison pills emerged as a solution to a significant problem facing corporations and shareholders. In the early 1980s, corporate raiders used "two-tiered" tender offers to coerce shareholders into tendering their shares for unfair prices. In short, the bidder offered cash for enough shares to acquire majority control, but offered junk bonds or other securities of questionable value to the remaining shareholders to "squeeze out" those who did not tender. This offer structure created an artificial rush to tender because shareholders wanted to get cash on the front end rather than risky securities in the second transaction.

Martin Lipton, perhaps history's most successful corporate takeover advisor, created the "poison pill" to solve this problem. Triggered when a bidder unapproved by the board acquires more than a preset

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percentage of the company's stock, a poison pill lets all shareholders except the hostile bidder buy shares at a fraction of their market value. These new share issuances drastically dilute the bidder's position, making it prohibitively expensive to acquire the company. Since directors do not need shareholder approval to adopt poison pills and can be redeemed by the target's board, directors control whether a bidder can actually close its tender offer.

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POISON PILLS

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In *Moran v. Household Int'l Inc.,* the Delaware Supreme Court upheld directors' power to use this powerful defensive device, but with conditions. The Court seemingly tied its validation of the poison pill on two points: (1) a board's decision to keep a pill in place is always subject to fiduciary duties (and therefore open to judicial review) and (2) if shareholders do not like how a board is using the pill, the shareholders preserve their ability to remove the directors from their jobs by running a proxy fight.

The validation of the poison pill in *Moran* coincided (and arguably caused) the decline of the coercive hostile takeover bids that marked the 1980s. Once poison pills were held to be lawful, however, boards used these devices to prevent shareholders from accepting all-cash for all-shares tender offers. In *City Capital Associates v. Interco,* the Delaware Court of Chancery upheld a board's power to employ the pill to give itself time to develop an alternative transaction or provide previously undisclosed information to stockholders, presumably to persuade against accepting the tender offer. However, the Court held that once those purposes were achieved, the stockholders should have the right to decide for themselves whether to accept a non-coercive offer. The Court recognized that corporate directors — even those acting in subjective good faith — could seriously harm shareholder interests by using a pill to preclude a legitimate alternative to the board's preferred course.

The conventional wisdom often presented by corporate advisors is that besides protecting against coercive offers, poison pills cause bidders to pay higher prices to gain director support than the price shareholders would otherwise demand for their shares. Whatever intuitive appeal this argument may have, we have not found empirical proof that poison pills actually create this positive effect.

Inside Look

As the world contends with the aftermath of last year's financial meltdown, investors and regulators continue to grapple with the details of how to build a more sound and stable capital market.

In this issue of the *Advocate*, BLB&G Partner Mark Lebovitch and BLB&G Associate (and *Advocate* Co-Editor) Laura Gundersheim bring their expertise in M&A litigation to bear as they examine the utility of poison pills and other anti-takeover defenses in the deal context with the cover article "The Wrong Prescription? Revisiting the Justification for Poison Pills."

BLB&G Associate Katherine Sinderson also considers corporate governance from a slightly different angle as she analyzes the SEC's recent proposals on shareholder rights in "SEC Stands With Shareholders on Proxy Access."

In a follow up to our recent coverage of the culpability of credit ratings agencies in the financial collapse (see the 2nd Quarter 2008 issue of the *Advocate*), BLB&G Associate Ian Berg updates us on the status of the reforms to the ratings agencies quasi-regulatory role now taking shape in "Credit Rating Agency Oversight Reform: Addressing the Weak Link in the Chain."

In addition to providing a perceptive compilation of the most significant recent developments in securities litigation, regulation and corporate governance in our regular "Eye on the Issues" column, BLB&G Associate Takeo Kellar takes a look at efforts to reform crucial legal tools in "Senator Specter Proposes Reforms to Securities Pleading and Liability Standards."

Max Berger

Also, please note that we always make the current issue of the *Advocate* (as well as all past issues) available on our website at www.blbglaw.com. Many of our readers receive the *Advocate* via email and we encourage you to let us know if you would prefer to save paper and receive your copy in pdf format via email as well.

We trust that you will find this issue of the *Advocate* both informative and insightful. As always, we welcome your comments, questions and input.

Max W. Berger

Shareholder Value Lost Due to Poison Pills: Recent Examples

Target	Acquirer	Offer amount above target's stock price	Subsequent target stock price decline (%)*		
			1-Day	30-Days	90-Days
Asyst Technologies Inc.	Aquest Systems Corp	66%	(82)	(93)	(94)
Atmel Corp	Microchip Technology Inc.	52%	(30)	(39)	(29)
Axcelis Technologies Inc.	Investor Group	29%	(26)	(76)	(91)
Charlotte Russe Holding Inc.	Charlotte Russe Hldg Inc SPV	31-38%	(53)	(35)	(47)
Diebold Inc	United Technologies Corp.	66%	(29)	(29)	(29)
Emulex Corp.	Broadcom Corp.	40%	(19)	(18)	(N/A)
International Rectifier Corp.	Vishay Intertechnology	13%	(44)	(50)	(41)
Mentor Graphics	Cadence Design Systems Inc.	30%	(34)	(33)	(64)
PeopleSupport Inc	Investor Group[1]	18%	(31)	(54)	(46)
Rentech Inc	Sherwood Invest Overseas Ltd.	30%	(35)	(44)	(42)
Republic Services Inc	Waste Management Inc.	22%	(36)	(34)	(34)
SanDisk Corp	Samsung	80%	(65)	(78)	(56)
Take-Two Interactive	Electronic Arts	64%	(36)	(48)	(56)
WCI Communities	Investor Group	16%	(64)	(67)	(81)
Yahoo!	Microsoft	62%	(21)	(15)	(36)

*** (% Difference between final offer price and post-withdrawal target stock price)**

The balanced rule of *Interco* was short-lived. Soon after Lipton's law firm publicly advised clients to reincorporate outside of Delaware if *Interco* remained good law, the Delaware Supreme Court issued its landmark decision in *Paramount Communications, Inc. v. Time, Inc. ("Time-Warner")*. The *Time-Warner* opinion suggested (but did not expressly rule) that directors can use a poison pill to reject indefinitely any bid, so long as the directors believe their long-term strategy will eventually generate greater wealth for stockholders. Thus, boards seemingly could "just say no" to a premium bid that a majority of a company's shareholders prefer over staking their future on the current board's managerial skill.

Why should a board of directors have this significant power? Does a pill create shareholder benefits that justify its use to override majority rule? The conventional wisdom often presented by corporate advisors is that besides protecting against coercive offers, poison pills cause bidders to pay higher prices to gain director support than the price shareholders would otherwise demand for their shares. In other words, in the absence of any pill, bidders can pay price "X," which is the amount needed to get a majority of shareholders to sell their shares in a takeover bid. In theory, a pill allows boards to elicit a price higher than "X." Whatever intuitive appeal this argument may have, we have not found empirical proof that poison pills actually create this positive effect. There is little reason to conclude that shareholders would accept materially lower premiums than boards are able to elicit, suggesting that any higher premium the poison pills elicit is marginal, at best. Also, poison pills may be no more effective in eliciting higher premiums than other less aggressive defenses.

Conversely, by looking at the past three years alone, we find ample empirical evidence of poison pills contributing to massive destruction of shareholder and firm value. The chart above lists recent cases where a board rejected an unsolicited takeover bid and refused to redeem the company's poison pill, and the bidder withdrew its bid rather than wait for whatever time it would take to replace the board through a proxy fight. The chart shows the loss in value following withdrawal of the bid.

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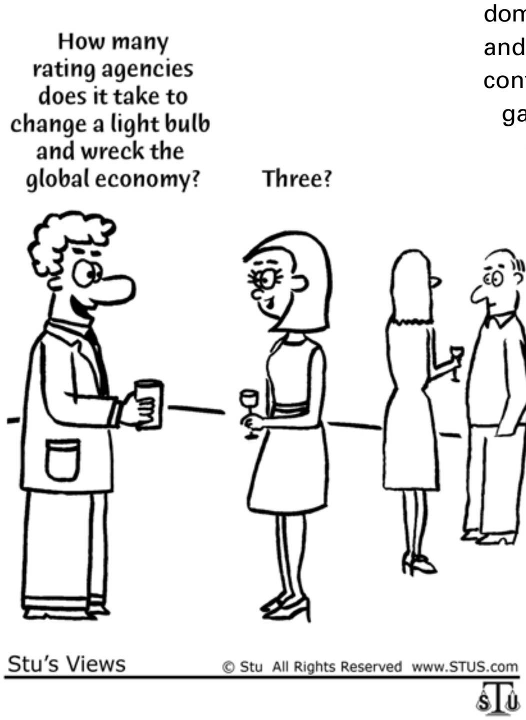
Credit Rating Agency Oversight Reform: Addressing the Weak Link in the Chain

By Ian Berg

In June 2008, the SEC took its first significant steps toward rating oversight when, after a ten-month investigation, it issued a report stating that the three dominant rating agencies — S&P, Moody's and Fitch — failed to adequately manage conflicts of interests when rating mortgage-backed securities ("MBS") and other ABS over the past several years.

"Credit rating agencies are the weak link in the chain," said Congressman Keith Ellison (Minnesota), echoing the March 2008 assessment of the President's Working Group on Financial Markets and prevailing investor sentiment that the credit rating agencies were a "principal underlying cause" of the recent financial market melt-down. Congressman Ellison issued his remarks on July 8, 2009, when he introduced legislation to strengthen the regulation of credit rating agencies. Under Congressman Ellison's proposed legislation, the Federal Reserve would have oversight authority when the rating agencies analyze and rate structured financial products. This would extend to all asset-backed securities ("ABS") the oversight power that the Federal Reserve has already assumed over ABS issued in accordance with the government's $200 billion Term Asset-Backed Securities Loan Facility (TALF) bail-out program. The credit rating agencies currently fall under the purview of the U.S. Securities & Exchange Commission (the "SEC"), pursuant to the Credit Rating Agency Reform Act of 2006, but Ellison believes that the "oversight to which they are subject is wholly inadequate." Newly-appointed SEC Chairman Mary Schapiro would likely agree, but she maintains that the SEC needs more authority to better regulate credit rating agency conduct as opposed to extending new authority to the Federal Reserve.



In June 2008, the SEC took its first significant steps toward rating oversight when, after a ten-month investigation, it issued a report stating that the three dominant rating agencies—S&P, Moody's and Fitch—failed to adequately manage conflicts of interests when rating mortgage-backed securities ("MBS") and other ABS over the past several years. Specifically, analysts charged with rating the securities were often aware that a high rating would improve the financial success of the firm, and altered their conduct accordingly. The SEC report additionally concluded that the rating agencies failed to maintain adequate resources to properly assess and track the issues they rated. Since then, Chairman Schapiro has been trying to answer the loud calls for meaningful reform from various investors, regulators and legislators.

In March 2009, Schapiro testified during her first Congressional hearing as Chairman that the SEC needs broader authority from Congress to oversee the credit rating agencies. Since then, Chairman Schapiro has been active in her reform efforts, examining how rating agencies are compensated, how they manage conflicts of interest and what role they should play in the markets. On April 15, 2009, Chairman Schapiro held a roundtable discussion on the SEC's oversight of the rating agencies that included industry leaders and leading academic experts. The roundtable discussed topics including: the rating agencies' perspective on what went wrong to cause the current credit crisis and the remedial steps being taken by the agencies; competition issues that present barriers to entry for competing ratings agencies; ratings users' perspectives on the rating industry; and, approaches to improving rating agency oversight. As suggested by the roundtable agenda, Chairman Schapiro's ultimate goal is for the SEC to explore ways to diminish the market's dependence on the inherently unreliable ratings by the large rating agencies.

Despite Chairman Schapiro's efforts to work within the current regulatory framework, it has become clear that the best chances to enact meaningful reform would require new legislation and enhanced regulatory oversight power. To that end, on July 21, 2009, the U.S. Treasury Department proposed an 18-page draft bill to Congress that would prevent credit rating agencies from consulting for the companies they are responsible for evaluating. Under the Treasury Department's proposal, the SEC would have increased powers to regulate the credit rating agencies, including requiring debt issuers to disclose all preliminary ratings that they receive from rating agencies prior to selecting a firm to conduct the final issued rating. The idea is to stop issuers from shopping around for the best rating and leveraging rating agencies against each other.

Whether or not these latest proposals are enacted, the mere existence of the Treasury Department bill is a positive indication that the Obama administration will be active in seeking reform. Of course, questions remain over who should be charged with administering and enforcing any additional regulations. There is an ongoing debate over whether the SEC should retain exclusive authority over the credit rating agencies, or if oversight should be shared by other agencies, such as the Federal Reserve, as Congressman Ellison proposes. In addition, there is considerable debate over what role, if any, investors should have in holding the credit rating agencies accountable.

In his recent report commissioned by the Council for Institutional Investors, titled, "Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective," Frank Partnoy, Professor of Law and Director of the Center of Corporate Securities Law at the University of San Diego Law School, examined what types of legislative reform would be needed to ensure the integrity of the ratings industry, particularly from the perspective of institutional investors. Professor Partnoy joined many other voices calling for enhanced government oversight of the rating agencies, either by the creation of a new "Credit Rating Oversight Board" or by increasing the authority of the SEC. However, Professor Partnoy also called for a better judicial enforcement mechanism, which would include removing rating agencies' exemption from liability under the Securities Act and otherwise making rating agencies subject to private rights of action under the anti-fraud provisions of securities laws.

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Fittingly, Professor Partnoy's report was released two weeks after Senator Jack Reed (Rhode Island) circulated the proposed Credit Rating Agency Reform Act of 2009 (the "2009 Reform Act") to the United States Senate seeking to, *inter alia,* amend Section 21D(b)(2) of the Exchange Act, 15 U.S.C. 78u-4(b)(2), to allow for a private right of action against credit rating agencies for failing to conduct a reasonable investigation of a rated security. The 2009 Reform Act would also eradicate the First Amendment protections from litigation that judges have liberally afforded to rating agencies in the past. These reforms would enable investors to play a critical role in policing the rating agencies and to help hold rating agencies accountable for their misconduct. On July 14, 2009, Chairman Schapiro indicated support for this private right of action, telling a Congressional panel that it could result in higher-quality work by the rating agencies.

In addition to creating a private right of action, the 2009 Reform Act (in its current form) would require rating agencies to implement written controls policies, greater disclosures and record keeping, and new compliance measures to deal with conflicts of interest and ratings model issues. The 2009 Reform Act would also grant the SEC more authority to oversee the rating agencies, which is a compliment to legislation introduced to the United States House of Representatives by Representative Gary Ackerman (New York) that would prohibit rating agencies from issuing SEC-recognized ratings on debt securities without a "documented history" showing how the particular pool of assets would likely perform.

Ultimately, credit rating reform mandates, whether governmental or private, have become an integral part of the financial markets and of critical importance to securities market participants and creditors. Despite some reckless and harmful past conduct, ratings — and credit rating agencies — are a necessary link in the financial market's proverbial chain. Absent meaningful legislative reform, including an enforceable private right of action for civil liability, the rating agencies will continue to operate unfettered at the expense of investors, and the securities market could become increasingly vulnerable to another financial crisis in the future.

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Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Takeo Kellar

SEC Proposes Bar On "Pay-To-Play" Pension Schemes

The Securities and Exchange Commission ("SEC") voted unanimously to propose measures intended to curtail "pay to play" practices by investment advisers that seek to manage money for state and local governments. According to the SEC, the measures are designed to prevent an investment adviser from making political contributions or hidden payments to influence their selection by government officials. The selection process of investment advisors can be undermined if elected officials or their associates ask investment advisers for political contributions or otherwise make it understood that only advisers who make contributions will be considered for selection, hence the term "pay to play." Under the proposed rule, an investment adviser who makes a political contribution to an elected official in a position to influence the selection of the adviser would be barred for two years from providing advisory services for compensation, either directly or through a fund. The rule being proposed for public comment by the SEC includes prohibitions intended to capture not only direct political contributions by investment advisers, but other means advisers may use in pay to play arrangements. *SEC Press Release 2009-168 (http://www.sec.gov/news/press/2009/2009-168.htm) (July 22, 2009)*

SEC Inspector General Proposes Reforms To Securities Laws

Congressman Paul E. Kanjorski, the Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, released a letter from Securities and Exchange Commission ("SEC") Inspector General H. David Kotz in which the Inspector General responds to Chairman Kanjorski's requests for suggestions for modifying the federal securities laws based on the Bernard Madoff scheme and other similar investigations. Mr. Kotz recommended extending the regulatory jurisdiction of the Public Company Accounting Oversight Board ("PCAOB") to audit reports prepared by a domestic registered or foreign public accounting firm regarding issuers, broker-dealers, investment advisers and any companies subject to U.S. securities laws. According to the Inspector General, "extending the regulatory jurisdiction of the PCAOB would allow for increased oversight of these accounting firms and reduce the risks associated with unknown accounting firms that have been able to avoid scrutiny."

In addition, among other recommendations, the Inspector General urged reforms to broaden the SEC's whistleblower program. Mr. Kotz recommended that the Securities Exchange Act of 1934 be amended to authorize the SEC to award a bounty for information leading to the recovery of a civil penalty from any violator of the federal securities laws, not simply insider trading violations. The letter indicates that such bounties have been an effective tool to encourage whistleblowers to come forward, but current SEC bounty rules are limited and relatively few awards have been made. *Letter to Congressman Paul E. Kanjorski (available at http://kanjorski.house.gov/) (July 1, 2009)*

SEC Creates Investor Advisory Committee

Securities and Exchange Commission ("SEC") Chairman Mary Schapiro announced the formation of an Investor Advisory Committee "to give investors a greater voice in the Commission's work." Chairman Schapiro stated that through this committee, the SEC was "reaching out to investors in a new and significant way" and is looking forward "to hearing their views on new products, trading strategies, fee structures, and the effectiveness of disclosure, among other issues." The Investor Advisory Committee's charter provides for a broad scope of interest, including: (i) advising the SEC on matters of concern to investors in the securities markets; (ii) providing the SEC with investors' perspectives on current, non-enforcement, regulatory issues; and (iii) serving as a source of information and recommendations to the SEC regarding the Commission's regulatory programs from the point of view of investors. The Committee's 17 members include leaders from institutional investors and individual investor organizations. *SEC Press Release 2009-126 (http://www.sec.gov/news/press/2009/2009-126.htm) (June 3, 2009)*

U.S. Treasury Department Releases Investor Protection Bill

The U.S. Treasury Department recently released proposed legislation — the "Investor Protection Act of 2009" — which aims to increase the authority of the SEC to protect investors. According to the Treasury Department's press release, "[T]he legislation outlines steps to establish consistent standards for all those who provide investment advice about securities, to improve the timing and the quality of disclosures, and to require accountability from securities professionals." Among other things, the Treasury bill would authorize the SEC to: (i) establish consistent standards for broker-dealers and investment advisers; (ii) prohibit mandatory arbitration clauses in broker-dealer, municipal securities dealer, and investment advisory agreements; (iii) expand protections for whistleblowers, including establishing a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards; and (iv) bar regulated persons who engage in misconduct from all aspects of the securities industry, rather than just a specific segment. *Available at http://www.treas.gov/press/releases/tg205.htm (July 10, 2009)*

SEC Seeks To Improve Corporate Governance And Enhance Investor Confidence

On July 1, 2009, the Securities and Exchange Commission ("SEC") voted on three measures intended to "better inform and empower investors to improve corporate governance and help restore investor confidence." The SEC proposed requiring public companies receiving money from the Troubled Asset Relief Program ("TARP") to provide a shareholder vote on executive pay in their proxy solicitations. The Commission also voted to propose better disclosure of executive compensation at public companies in their proxy statements, and approved a New York Stock Exchange ("NYSE") rule change to prohibit brokers from voting proxies in corporate elections without instructions from their customers. As to the new proxy disclosure requirements, companies would be required to provide information about: (i) the relationship of a company's overall compensation policies to risk; (ii) the qualifications of directors, executive officers and nominees; (iii) company leadership structure; and (iv) potential conflicts of interests of compensation consultants. According to the SEC, "the proposals are aimed to improve the reporting of annual stock and option awards to company executives and directors as well as to require quicker reporting of election results." As to the NYSE rule change, the SEC seeks to address concerns that brokers' discretionary voting for directors has improperly impacted election results. Under current rules, brokers may vote on behalf of their beneficial owner customers in uncontested elections of directors if the customers have not returned voting instructions. Specifically, the new SEC proposal would add "election of directors" to the list of enumerated items for which a member generally may not give a proxy to vote without instructions from the beneficial owner. *SEC Press Release 2009-147 (http://www.sec.gov/news/press/2009/2009-147.htm) (July 1, 2009)*

"Say-On-Pay" Legislation Heading To Congress

Both the House Committee on Financial Services, led by Chairman Rep. Barney Frank, and the U.S. Treasury Department have been working on legislation designed to address executive pay practices that would require all publicly traded companies to give shareholders a vote on executive compensation packages, so called "say-on-pay." Chairman Frank's proposed bill, titled the "Corporate and Financial Institution Compensation Fairness Act of 2009" stems from similar say-on-pay legislation that the U.S. House of Representatives passed in 2007 and the Obama administration's proposals. The bill includes provisions to give shareholders the opportunity to cast advisory votes on compensation once a year and requires similar advisory votes on any golden parachute packages. In a statement, Chairman Frank said "[i]t's a question of empowering the shareholders to decide the appropriate level because it's their money and giving regulators the ability to prevent compensation incentives that encourage taking inappropriate and excessive risk." *http://www.house.gov/apps/list/press/financialsvcs_dem/pressd_071709.shtml (July 17, 2009)*

Study Released On Securities Fraud Filings

Federal securities class action filings have slowed in 2009, according to a report by the Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research. Securities filings declined by more than 22% during the first half of 2009 compared to the same period last year, "when there was a surge of litigation against financial services firms." The researchers offer two explanations for the decline: (1) the reduced number of filings might reflect the fact that the largest financial services firms were already sued last year; and (2) the financial markets have stabilized compared to last year. According to the report, 87 federal securities class actions were filed during the first half of 2009, compared to 112 in both the first and last six months of 2008, for a total of 224. If filings hold steady during the final six months of 2009, the year would end with 174 lawsuits. Financial services firms were named as defendants in 67% of the federal securities class actions filed thus far during 2009, up from 50% in 2008. According to the report, recent filings have tended to focus on the smaller financial services firms that had yet to be sued. The researchers also noted an up-tick in federal class action securities filings targeting foreign corporations. About half of the federal securities class action filings thus far in 2009 were driven by the credit crisis, and 15 were related to Ponzi schemes. In a separate report by NERA Economic Consulting, entitled "Recent Trends in Securities Class Actions Litigation: 2009 Mid-Year Update," NERA analyzed similar trends in securities filings, but reported a higher number of filings than the Stanford and Cornerstone Research report. NERA found that 127 new securities lawsuits had been filed by June 30. The NERA report notes that although filings peaked in March 2009 with 31 cases, and gradually declined each month in the second quarter, the filings remain on pace for over 250 filings for the full year, which would be more than in 2008. According to NERA, the aggregate investor losses associated with the cases filed in the first six months of this year are over $158 billion. *The National Law Journal, July 20, 2009; NERA.com (July 27, 2009)*

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SEC Stands With Shareholders on Proxy Access Rules

By Katherine Sinderson

When investors' concerns over lax oversight and out-of-control executive compensation are ignored by a company's board of directors, the most direct method of demonstrating investor displeasure is to replace the board. However, the current SEC rules and incumbent-friendly state laws have made it almost impossible for shareholders to replace directors who have shown a tin ear to investors. Proposed "proxy access" rules by the Securities and Exchange Commission ("SEC") may change that.

Under existing rules, a shareholder cannot require a company to include shareholder director nominees in the company's annual proxy materials. Furthermore, a company can exclude from its proxy statement any shareholder proposal relating to the election or nomination of directors, including any shareholder proposal to adopt a "proxy access" bylaw (the "election exclusion" rule). Thus, any shareholder who wishes to elect a director without the company's consent is required to prepare and distribute its own proxy materials, waging a full-blown election contest — often a prohibitively expensive endeavor. As Harvard Law School Professor Lucian Bebchuk put it in a 2003 article, "the safety valve of potential ouster via the ballot is currently not working…[T]he prospect of being removed in a proxy contest is far too remote to provide directors with incentives to serve shareholders." Conversely, incumbent directors' campaign expenses are often fully funded by the company.

In response to "one of the most serious economic crises of the past century," the SEC has released proposed proxy access rules to permit shareholder participation in board elections. As the SEC announcement explains, "[t]his crisis has led many to question whether boards of directors are truly being held accountable for the decisions that they make. These concerns include questions about whether boards are exercising appropriate oversight of management, whether boards are appropriately focused on shareholder interests, and whether boards need to be held more responsible for their decisions regarding such issues as compensation structures and risk management."

Current SEC rules and incumbent-friendly state laws have made it almost impossible for shareholders to replace directors who have shown a tin ear to investors. Proposed "proxy access" rules by the Securities and Exchange Commission may change that.

The SEC's proposed rules would make two major changes.

First, large shareholders or groups of shareholders in certain circumstances would have the right to place shareholder-selected nominees on the company-issued proxy statement. Only those shareholders owning at least a specified percentage of company shares (1-5%, depending on the size of the company) and who have owned those shares for at least a year would be able to place nominations on the company proxy. Shareholders would be permitted to aggregate their holdings to meet the minimum share ownership threshold.

However, the proposal allows companies to place a cap on the number of shareholder nominees — one nominee or 25% of the current board, whichever is greater. If the company has a staggered board (or a board in which the directorships are voted on in different years, rather than all at once), any shareholder-nominated director whose term extends past the election would count towards the 25% cap. If shareholder nominees exceed the 25% cap, then the nominees are accepted onto the ballot on a "first come" basis. If a shareholder or a shareholder group has an agreement with the company to nominate a director, that director will not count towards the 25% cap.

The proposed rules would allow the company to indicate on the proxy form whether the board recommends a vote "for" a director nominee, but the company cannot otherwise differentiate among the nominees. Significantly, the company would be prohibited from providing a company-recommended slate of directors for which a shareholder could vote with a single check of a box. Instead, where shareholder nominees are included, shareholders will have to vote for each director individually.

Notably, any shareholder nominating a new director would be required to certify that the shares were not acquired "for the purpose of or with the effect of changing control of the company" or "to gain more than a limited number of seats on the board." This is because the SEC proposal is intended to fill the gap where shareholders are dissatisfied with company leadership and wish to change that leadership without assuming control of the company themselves.

Second, the SEC's former "election exclusion" rule would be repealed. This change would mean that companies would generally no longer be able to prohibit from the proxy shareholder proposals that address the director nomination process. Furthermore, this change will allow shareholders to determine the election process, rather than the very directors whose election is being decided.

Most importantly, the SEC proposal would provide a "floor" for shareholder proxy access that could not be undermined by state law or by incumbent directors through a unilateral change to a company's bylaws. Indeed, the SEC proposal, if adopted, would preempt and render irrelevant Delaware's recently-adopted proxy access statute that is scheduled to take effect on August 1. The Delaware statute sets a permissive standard where a Delaware corporation is allowed to adopt a bylaw that requires it to include in its proxy statements one or more shareholder nominees to the company's board. The circumstances under which the shareholder is provided access would be set by the bylaws. The SEC proposed rules would instead require each corporation to provide such access in a uniform manner.

While the SEC proposal is an improvement over the recently-enacted Delaware statute, investors may question whether the SEC proposal goes far enough in protecting shareholder rights. For example, where an incumbent director's campaign costs (beyond those of inclusion on the proxy ballot) are covered by the corporation, the corporation should also finance the campaigns of shareholders where they meet the stringent requirements discussed above. Furthermore, the SEC should prohibit the board from repealing election laws adopted by shareholders under the new rules.

The SEC proposal will likely face court challenges related to the SEC's authority to issue such rules, as board elections are generally governed by state law. SEC chair Mary Schapiro has indicated that she would welcome legislative support from Congress making clear the SEC's authority to issue these rules.

The SEC proposal is intended for the 2010 proxy season, so shareholders may soon see the benefits of increased proxy access. Although these proposed rules are merely tentative steps in the right direction, they indicate that the SEC is finally recognizing the benefits of shareholder democracy.

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Quarterly Quote...

"As a result of the PSLRA, recent Supreme Court decisions, and recently tightened class certification standards, the truly 'frivolous' securities class action is today relatively rare — possibly even a mythic creature of folklore, like the unicorn, in that it is much discussed, but seldom objectively observed."

Columbia University School of Law Professor John C. Coffee

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Senator Specter Proposes Reforms to Securities Pleading and Liability Standards

By Takeo Kellar

Senator Specter said that immunity under the two Supreme Court decisions has removed incentives for firms "to avoid complicity in and even help prevent securities fraud…and that a public company's auditors, bankers, business affiliates, and lawyers "all too often actively participate in and enable the issuer's fraud."

United States Senator Arlen Specter (D-Pa.) recently issued two bills which would reverse recent Supreme Court decisions that limit plaintiffs' ability to bring civil lawsuits. On July 22, 2009, Senator Specter introduced a bill designed to return the pleading standard for civil lawsuits to what it was prior to 2007, when the Supreme Court handed down its ruling in *Bell Atlantic Corp. v. Twombly.* That case and another case, *Ashcroft v. Iqbal,* decided in May 2009, have raised the standard that a complaint must meet to avoid being dismissed, upending long-standing precedent. At issue is how specific a pleading must be under the Federal Rules of Civil Procedure. Rule 8 requires that a complaint include "a short and plain statement of the claim showing that the pleader is entitled to relief," while Rule 12 allows for the dismissal of complaints that are vague or that fail to state a claim. Under *Iqbal*, a 5-4 decision written by Justice Anthony Kennedy, many courts are now requiring plaintiffs to plead specific facts in order to prevail on motions to dismiss. However, such specific facts are often not available until formal discovery is allowed to commence under the Federal Rules — that is, after the motions to dismiss have been decided. When introducing the legislation, Senator Specter commented that "The effect of the Court's actions will no doubt be to deny many plaintiffs with meritorious claims access to the federal courts and, with it, any legal redress for their injuries. I think that is an especially unwelcome development at a time when, with the litigating resources of our executive-branch and administrative agencies stretched thin, the enforcement of federal antitrust, consumer protection, civil rights and other laws that benefit the public will fall increasingly to private litigants." Senator Specter's bill directs federal courts to interpret the pleading rules as the Supreme Court did in its 1957 decision, *Conley v. Gibson* — often referred to as the "notice pleading" standards.

In a second bill, Senator Specter introduced legislation that would amend section 20 of the Securities Exchange Act of 1934 to allow private Rule 10b-5 actions against persons that knowingly or recklessly provide substantial assistance to primary violators, thus overturning the Supreme Court's rulings in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.* and *Central Bank of Denver v. First Interstate Bank of Denver.* Under these Supreme Court decisions, shareholders are barred from suing parties that only had an indirect role in a fraud, so-called "secondary actors." In his accompanying remarks, Senator Specter said that immunity under the two Supreme Court decisions has removed incentives for firms "to avoid complicity in and even help prevent securities fraud." Specter also said that a public company's auditors, bankers, business affiliates, and lawyers "all too often actively participate in and enable the issuer's fraud," citing cases of Tyco International Ltd., WorldCom Inc., Refco Inc. and Enron.

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Quarterly Quote…

"[Financial firms'] decisions on compensation… look self-serving and greedy in hindsight."

Goldman Sachs' CEO Lloyd Blankfein in an April 2009 speech before the Council of Institutional Investors just three months before Goldman Sachs announced that it was setting aside a record $11.4 billion for compensation to its employees for 2009.

POISON PILLS

Continued from page 3.

The data illustrate that tens if not hundreds of billions of dollars of potential shareholder gains have been lost when bidders withdrew offers in the face of boards refusing to redeem their poison pills. Whether or not the target boards acted for improper entrenchment or out of a good faith belief in their own long-term strategies is irrelevant to the shareholders who were denied the chance to tender shares and saw the stock price then plummet. Notably, these examples do not even address the billions of dollars of firm value that shareholders never knew they could have enjoyed from offers that were never made public because the target CEO deters a bid by making clear that the board will leave the pill in place and actively oppose any takeover efforts. This empirical evidence is particularly salient given that numerous scholars, such as Harvard Law School's Lucian Bebchuk and Allen Ferrell, have shown that poison pills are among the anti-takeover provisions contributing most to managerial entrenchment and the reduction of firm valuation.

Given the above data, we believe the arguments favoring the use of poison pills may make more sense in theory than in reality. Even assuming that pills allow boards to elicit marginally higher

"She then bit into the poison apple, hoping it would fend off the hostile takeover."

Notably, the examples cited here do not even address the billions of dollars of firm value that shareholders never knew they could have enjoyed from offers that were never made public because the target CEO deters a bid by making clear that the board will leave the pill in place and actively oppose any takeover efforts.

takeover premia in the normal course, it only takes a few boards who overplay their hand to wipe out any gains attributed to poison pills, and to turn the effect of pills into massive shareholder and societal losses. While we are not advocating the invalidation of poison pills in all instances, we believe the standard under which Delaware courts examine fiduciaries' use of poison pills should be reexamined. At the least, we believe that Delaware courts should return to the standard articulated in *Interco*, and require that in order to maintain a poison pill in the face of a significant premium offer, a board demonstrate a legitimate need for more time to adequately inform its shareholders about the company's standalone prospects or to pursue a realistic and imminent alternative transaction. The first step in changing the status quo is for shareholders to just say no to "Just Say No."

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