

# Investors Press Their Demands, The Path to Power in the Boardroom May Pass Through the Courtroom

*The National Law Journal*

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October 9, 2006

A new front has opened in the long, litigious battle between shareholders and corporations.

In the past, investors used litigation to guarantee boards of directors greater oversight power over management and to oust board members when accounting scandals happened on their watch.

The latest development is less about fraud and more about power. Shareholder activists are suing for a say in corporate decision-making, and have won some cases. Investors and their attorneys couch this not as a matter of staging corporate coups, but rather as exercises in corporate democracy.

At issue in these cases is whether shareholders can force companies to place shareholder proposals on proxy statements for a shareholder vote.

In one lawsuit, shareholders sought to change a company's bylaws and allow their nominees for the board of directors to appear on the proxy. A federal appeals court last month agreed with the shareholders that the company could not refuse to include their proposal.

In two other cases, investors sued to force companies to stage shareholder votes on poison-pill provisions designed to blunt hostile takeovers. Although the courts never reached the underlying merits of these cases, shareholders claimed victory when the companies settled and allowed the issues to go to a shareholder vote.

Litigation offers shareholders the leverage to gain 'more access to the ballot and more power in the corporation,' said Larry E. Ribstein, business law professor at the University of Illinois College of Law.

And with a handful of wins to their credit, shareholders are flexing their muscles.

'Institutional investors are now the 300-pound gorilla of corporate America,' said Robert J. Giuffra Jr., partner at New York's Sullivan & Cromwell who defended a shareholder ballot access suit that settled recently. Shareholder groups are 'more organized and vocal than ever before.'

Institutional investors gained new clout under the Private Securities Litigation Reform Act of 1995, said Giuffra, who as chief counsel to the U.S. Senate Committee on Banking, Housing and Urban Affairs was a primary author of the legislation.

The law gave large, institutional investors the power to make decisions on behalf of fellow plaintiffs with smaller stakes in securities class actions, he noted. That includes the authority to approve settlement terms on their behalf.

Shareholders increasingly are using ‘aggressive, activist measures to promote corporate governance goals,’ said Jay W. Eisenhofer, managing partner in the securities litigation firm Grant & Eisenhofer in Wilmington, Del. The firm represents institutional investor plaintiffs.

But the number of ballot-access cases is ‘hardly an avalanche,’ Eisenhofer said. The goal in these cases is an injunction or declaratory judgment, and securing either can be expensive.

Moreover, he said, the legal framework for these disputes—a complex mixture of U.S. Securities and Exchange Commission (SEC) rules and federal and state laws—favors corporate over shareholder control.

‘The problem is, economically speaking, if you disagree with the SEC’s concept, it’s not economical 99.9% of the time for a shareholder to go to court and challenge the SEC’s position.’

Eisenhofer noted, however, that there are ‘limited and isolated circumstances’ in which shareholders can gain power through litigation.

### **A significant, if tentative, win**

In one of those circumstances, shareholders claimed a significant victory in a September federal appeals court ruling.

The plaintiffs were institutional shareholders of insurance giant American International Group (AIG). They sued the company in 2005 seeking to place a proposal on the proxy allowing shareholders to nominate candidates. The investors prevailed before the 2d U.S. Circuit Court of Appeals, which issued a pro-shareholder ruling that triggered widespread debate. The plaintiffs, represented by Eisenhofer, were led by American Federation of State, County and Municipal Employees pension plan. *AFSCME v. AIG*, No. 05-2825.

AIG defender Lewis R. Clayton, partner at Paul, Weiss, Rifkind, Wharton & Garrison in New York, declined to comment for this story.

The appeals court held that companies may not block shareholder efforts to propose amendments to corporate bylaws allowing investors to nominate director candidates in the company’s proxy. The SEC had proposed a similar rule in 2003, but tabled it amid sharp criticism from the U.S. Chamber of Commerce and other large business interests. Under existing rules, shareholders seeking to nominate board candidates must produce and distribute their own proxy statements.

Although lauded as creating a power shift in favor of shareholders, the effect of the ruling may be short lived. One day after the appeals court ruled, the SEC announced that it would take up the issue during its Oct. 18 meeting.

The AIG suit ‘forced the issue’ upon the SEC, said D. Gordon Smith, who teaches corporate law at University of Wisconsin Law School and writes about shareholder authority issues. But the suit may backfire if the SEC winds up banning shareholder proposals, he said. Shareholder

groups hope that the SEC will allow them greater participation, but their hopes are not high, he said.

In another high-profile ballot-access case claimed as a shareholder win, the plaintiff was shareholder-power advocate Lucian Bebchuk, a Harvard Law School professor and director of Harvard's Program on Corporate Governance. As a shareholder of CA Inc., formerly Computer Associates, Bebchuk proposed a bylaws amendment involving the way the company adopts a poison pill. The company declined to put the proposal on the proxy, saying that the bylaw would violate Delaware law.

Represented by Eisenhofer's firm, Bebchuk sued in Delaware Chancery Court, challenging the company's adoption of the poison pill policy without the promised shareholder approval. *Bebchuk v. CA Inc.*, No: 2145-N (Del. Ch. Ct.). The case, which Giuffra defended, settled when CA agreed to put the issue to a shareholder vote. The proposal failed, however, collecting just 41% of the shareholder vote.

### **A 'socially useful' argument**

Although no judge ever ruled on the merits of the case, it was important to press the point, said Bebchuk, who noted that he typically writes about shareholder issues from the 'ivory tower.'

The important thing, he said, was to test the arguments for corporate democracy. 'Having this issue decided is something that is socially useful for both shareholders and boards,' he said.

The anticipated SEC rule-making is not likely to affect shareholder proposals like Bebchuk's, which invoked state, not federal, law.

Another Delaware poison pill case involved several institutional shareholders challenging a News Corp. board decision. The shareholders alleged that the board had agreed it would adopt a poison pill for a single year's duration and extend it only with shareholder approval. After the board extended the pill without the promised consultation, shareholders sued for breach of contract. *Unisuper Ltd. v. News Corp.*, No. 1699-N (Del. Ch. Ct.). Representing shareholders, the Eisenhofer firm helped negotiate a pretrial settlement in April. News Corp. agreed to put the poison pill provision to a shareholder vote during the annual meeting.

Ballot-proposal lawsuits have been few because litigation involving SEC rule-making is thought to be a dead end, said Smith, the University of Wisconsin law professor.

Yet Eisenhofer, the shareholders' lawyer, said that going to court can work. The cases are somewhat similar to corporate takeover litigation, said Eisenhofer, a former corporate defender at Skadden, Arps, Slate, Meagher & Flom.

Said Eisenhofer, whose partners published the *Shareholder Activism Handbook* last year: 'You do everything possible to avoid litigation, but file suit if nothing else works.'