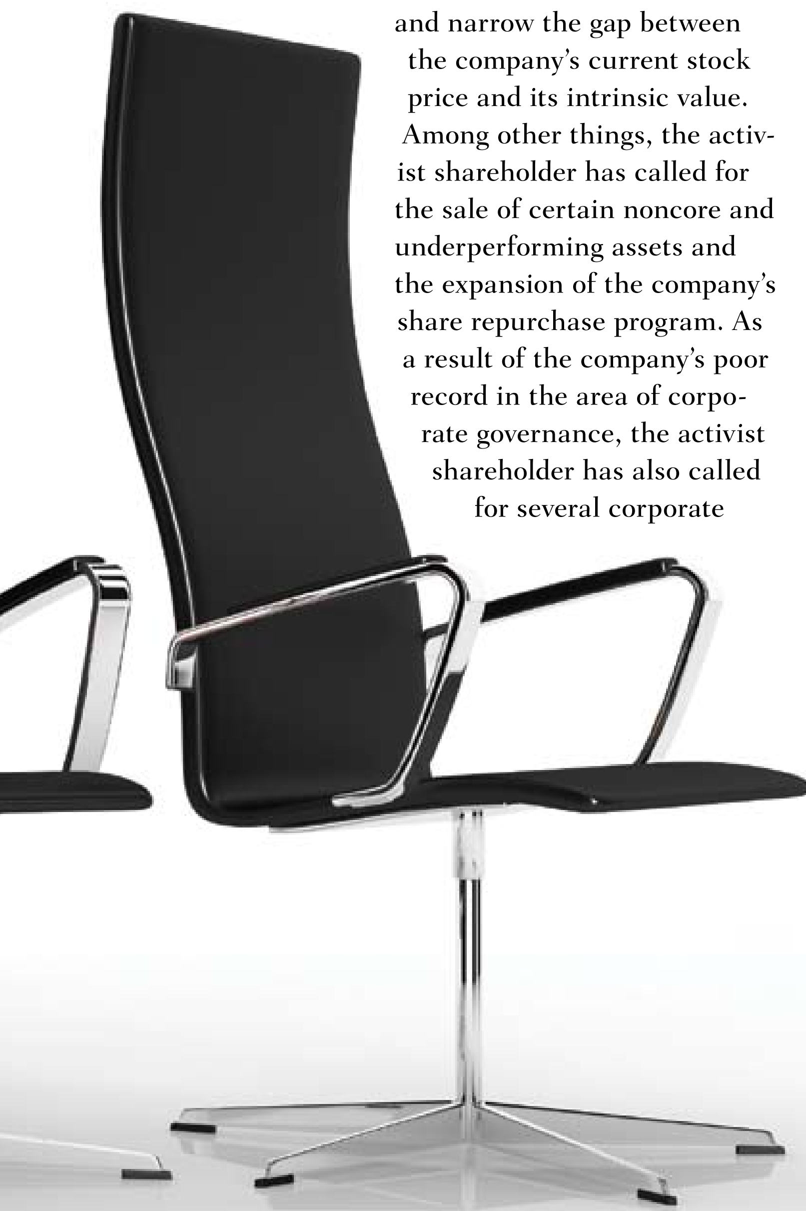
The Ten Elements of a PROXY CONTEST SETTLEMENT

BY JARED L. LANDAW, KEITH E. GOTTFRIED, AND BARRY H. GENKIN

THE past few years have been extremely challenging for your company. Following a prolonged period of poor financial and share price performance, extensive turnover in the executive suite, and internal accounting issues which have necessitated the restatement of the company's historical financial statements, your company now finds itself facing a proxy contest brought by an activist shareholder. Prior to launching the proxy contest, the activist shareholder released a "white paper" calling for the company to undertake a number of initiatives to enhance shareholder value and narrow the gap between the company's current stock price and its intrinsic value. Among other things, the activist shareholder has called for the sale of certain noncore and underperforming assets and the expansion of the company's share repurchase program. As a result of the company's poor record in the area of corporate governance, the activist shareholder has also called for several corporate governance reforms. After six months had elapsed without any response from the company regarding the "white paper," the activist shareholder, in compliance with the advance notice provisions contained in the company's bylaws, notified the corporate secretary of the company that he intends to conduct a proxy contest to have four of his nominees elected to the company's board of directors at the next annual meeting of shareholders.



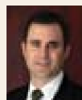
Over the past three months, a significant amount of management's time and attention has been consumed with defending itself against the proxy contest, engaging in a "war of words" with the activist shareholder as to the best way to turn around the company's business and create value for shareholders. As each day passes, legal fees and other expenses related to the proxy contest toll higher and higher. Furthermore, pressure has been mounting on the company's management team by many of the company's largest institutional holders to find a way to quickly resolve the proxy contest and get back to focusing on how to turn the company's business around. While the company is not prepared to concede to all of the demands of the activist shareholder, it would be willing to offer him some level of minority board representation, perhaps one or two board seats, assuming it can get them to agree to a reasonable standstill. It is also willing to consider implementing some of the suggestions made by the activist shareholder in his "white paper" to enhance shareholder value, many of which management privately concedes would be helpful. As the company begins to move forward in pursuing a settlement, you are asked as the company's in-house counsel to draft a form of settlement agreement for use in settling the proxy contest.

If your proxy contest does end up being settled, your company's experience would be far from unique as many proxy contests waged by activist shareholders against public companies settle without going to a vote. The table on page 82 shows a sampling of contested solicitations in 2007 where a settlement agreement was entered into and filed with the Securities and Exchange Commission (SEC).

This article will review some of the more significant issues that should be considered when drafting a settlement agreement, both from the point of view of the company as well as the activist shareholder. Proxy contest settlement agreements frequently contain some combination of the following 10 elements:

- representation on the company's board of directors for the activist's nominees or the agreement by the company to add additional independent directors that are acceptable to the activist shareholder;
- the agreement of the activist shareholder to vote his shares in support of the company's slate of nominees and against any shareholder nominations for directors that have not been approved and recommended by the board for election at the company's annual meeting of shareholders;
- termination of the proxy contest;
- standstill covenants preventing the activist from initiating or participating in any further proxy contests or other activist campaigns with respect to the company for a designated time period;
- the procedure for making public announcements regarding the settlement, including the content of a joint press release;
- reimbursement by the company of the activist shareholder's expenses incurred in connection with the proxy contest;
- commitment by the company to implement one or more initiatives intended to enhance shareholder value;
- commitment by the company to implement one or more corporate governance enhancements;
- mutual releases and covenants not to litigate against the other party; and
- mutual nondisparagement provisions.

Like many other contracts, the settlement agreement will also typically contain recitals, representations, and warranties of the parties with respect to matters including due authorization, due execution, due delivery, valid and binding obligations, enforceability, and the absence of conflicts. Settlement agreements also typically include a variety of miscellaneous provisions addressing such issues as governing law, jurisdiction, specific performance, the absence of third party beneficiaries, severability, and the ability to execute the agreement in counterparts. As we assume that most readers are already well versed in these areas, we will focus our discussion on the provisions that are unique to the settlement of a proxy contest.



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To Settle or Not to Settle

There are numerous reasons for both the company and the activist shareholder to consider a settlement. For the company, the reasons include:

- the ability to save face by not officially losing the proxy contest;
- the ability to extract concessions from the activist shareholder that might not be granted if the proxy contest went to a shareholder vote;
- the desire to minimize public scrutiny or criticism of the performance of the company and its management team;
- the alleviation of pressure from institutional shareholders;
- the ability to minimize the costs of engaging in, or continuing, the proxy contest;
- the ability to have the activist shareholder agree to comply with reasonable standstill provisions; and
- the desire to establish a more positive working relationship with its shareholders.

There is no doubt that proxy contests can be a significant distraction for a company's management team. A company could easily conclude that the cost of settling (e.g., one or two board seats) may not be nearly as great as the cost of not being able to focus management's time and attention on operating and growing the business. Remember, typically a proxy contest is commenced because the activist shareholder believes that a company is not only undervalued and underperforming, but also managed without appropriate attention to the interests of shareholders. While reality may be different from the perception of shareholders, if most of management's time and attention is focused on attacking one of its shareholders in a proxy contest rather than running the business, it is not too difficult to see how that perception, however inaccurate, can evolve into reality.

Furthermore, in some instances what a company may be asked by an activist shareholder to "give up" in a settlement

may not be much of a capitulation at all. For example, the measures that the activist is proposing that the company take may actually be beneficial and along the lines of initiatives that the company was already considering implementing in the future. In addition, board nominees proposed by the activist may have strong and relevant backgrounds in the industry that the company operates in, and could be more qualified to join the company's board than other candidates currently being considered by the board's nominating committee. When this is the case, it may make sense for the company to consider settling, even if it believes that it would likely win the proxy contest. By doing so, the company may gain a significant ally in its efforts to affect a company turnaround and forge stronger relationships with its shareholders.

There are also many reasons why the company may not want to agree to a settlement. These may include:

- not wanting to provide the activist shareholder with representation on the board of directors;
- not wanting to be perceived as capitulating;
- not wanting to encourage other activist shareholders to target the company;
- having an unrealistic perception of the level of support that the company will receive from its shareholders; and
- having the possibility of actually winning the proxy contest.

For the activist shareholder, the reasons to settle a proxy contest include:

- the risk of losing the contest;
- the costs of continuing the proxy contest, which must be borne by the activist, as opposed to the management team, which often has virtually unlimited access to the financial resources of the company;
- the possibility of being guaranteed some board representation through the settlement or the ability to have input into the selection of additional independent board members;
- the possibility of the company agreeing in the settlement agreement to undertake one or more initiatives intended to enhance shareholder value;
- the possibility of the company agreeing in the settlement agreement to implement one or more corporate governance enhancements;
- the possibility of the company agreeing in the settlement agreement to reimburse the activist shareholder for its fees and expenses incurred in conducting the proxy contest;
- the potential boost to the activist shareholder's reputation by being able to spin the settlement as a victory; and
- the opportunity to build a constructive working relationship with the company's management team that may allow the activist to effect positive change at the company.

There are also a number of reasons why an activist shareholder may not agree to a settlement. These may include instances where the activist shareholder is seeking majority representation on the company's board of directors, control of the company, or facilitation a sale of the company to the activist shareholder. In some situations, the activist shareholder may believe that the company's board or management team is so recalcitrant that nothing less than going through the process of losing a proxy contest will compel a more "shareholder focused" attitude at the company. In other situations, the proxy contest may have become so vitriolic that it might be impossible for the activist shareholder and the company's management team to hammer out a settlement.

1. Board Representation

Board representation is the dominant issue to be addressed in most proxy contest settlements. The activist shareholder will typically either be seeking direct representation on the board by having himself or a colleague appointed to the board, or indirect representation through the appointment of one or more nominees who are not affiliated with the activist shareholder or the company and who would be deemed independent members of the board. In the latter case, the company can avoid being perceived as having capitulated to the activist shareholder since he is not being given direct board representation. From the activist shareholder's perspective, the new directors can be expected to be more independent than the company's incumbent directors since they were not "handpicked" by the company's management. Furthermore, such directors may bring new perspectives into the boardroom and be more receptive to initiatives proposed by the activist shareholder to enhance shareholder value.

If the settlement entails the company providing the activist shareholder with direct or indirect board representation, there are numerous questions to be resolved, including the following:

- How many board seats will the company make available to the activist shareholder?
- How will vacancies on the company's board be created to accommodate the activist shareholder's nominees?
- Will the size of the board increase or will incumbent directors be asked to resign?
- Will the activist shareholder's nominees be appointed concurrently with the execution of the settlement agreement or will they have to wait until they are elected at the next annual meeting of shareholders?
- Will the size of the company's board be increased temporarily to allow the appointment of the nominees and then, after they are elected at the annual meeting to replace incumbent directors, reduced back to its original size?

- How will the activist shareholder ensure that the annual meeting, and consequently the election of its nominees, is not unduly delayed?
- What kind of support do the nominees expect to receive from the company?
- How long will the company agree to support the election of the activist shareholder's nominees (e.g., for one annual meeting or longer)?
- In addition to board seats, will the activist shareholder's nominees be given membership on any of the company's standing committees?
- Will any of the activist shareholder's nominees receive board leadership positions?
- How does the activist shareholder ensure that its nominees are treated like other directors and not "frozen out" or excluded from board or committee meetings?
- If any of the activist shareholder's nominees are unable to serve on the company's board, should the activist shareholder have the right to nominate replacement nominees?

Recent Proxy Contest Settlement Fee Reimbursement Caps

Company	Activist shareholder	Date of settlement	Fee Reimbursement Cap
The Topps Company, Inc.	Crescendo Advisors LLC/Pembridge Capital Management LLC	July 28, 2006	$350,000
The Pep Boys – Manny, Moe & Jack	Barington Companies Equity Partners LP	August 2, 2006	$200,000
The Home Depot, Inc.	Relational Investors LLC	February 5, 2007	No expense reimbursement
The Brink's Company	Pirate Capital LLC	February 8, 2007	No cap
Applebee's International, Inc.	Breeden Capital Management LLC	April 25, 2007	$500,000
Comverse Technology, Inc.	Oliver Press Partners LLC	May 22, 2007	No expense reimbursement
Intervoice, Inc.	David W. Brandenburg	June 22, 2007	$500,000
Pomeroy IT Solutions, Inc.	Flagg Street Capital LLC	July 12, 2007	$350,000
WCI Communities, Inc.	Icahn Partners LP	August 20, 2007	No expense reimbursement
Ceridian Corporation	Pershing Square LP	September 7, 2007	No expense reimbursement
Lancaster Colony Corporation	Barington Companies Equity Partners, LP	October 9, 2007	$150,000
Adaptec, Inc.	Steel Partners LLC	October 26, 2007	$50,000
Tandy Brands Accessories, Inc.	Golconda Capital Management LLC	October 29, 2007	$175,000
Kraft Foods, Inc.	Trian Partners LP	November 7, 2007	No expense reimbursement
A. Schulman, Inc.	Barington Companies Equity Partners LP	November 15, 2007	$200,000

** Source: Filings made with the Securities and Exchange Commission.*

- During the "board representation period," will the company be permitted to increase or decrease the size of the board and/or otherwise change the composition of the board?

How will the requisite number of vacancies on the board be created?

Once the number of directors is agreed upon, the parties need to decide how to create the requisite number of vacancies on the board. Vacancies can be created by the company in two ways: by either increasing the size of the board or by removing incumbent directors. Where the activist shareholder had been conducting a proxy contest to replace an entire board of directors, and having already conceded to having a minority presence on the board, he may not want his potential influence on the board eroded even further by an expansion of the board. Accordingly, the activist shareholder may prefer that the necessary number of incumbent directors resign to make room on the board for him. This could be a potential issue for the company since there may not be enough incumbent directors who are ready to give up not only their board seats, but also the annual fees each receives for serving as a director of the company. As a compromise, both sides may be agreeable to temporarily increasing the size of the board to accommodate the activist shareholder's nominees until the term of certain incumbent directors ends, at which point such directors would not stand for reelection and the board would then return to its original size.

When will the activist shareholder's nominees join the company's board?

The activist shareholder may desire to have his nominees join the company's board as soon as possible. However, the annual meeting may not take place until four to six weeks following the execution of the settlement agreement. Among other things, the company will need to revise its annual meeting proxy statement to include the necessary biographical, beneficial ownership, and other information about the activist shareholder's nominees. The company will also need to summarize in the proxy statement the terms of the settlement agreement, which obviously cannot happen until the settlement agreement is finalized. In addition, the company may have received comments from the staff of the SEC that need to be addressed prior to being able to file its revised proxy statement in definitive form.

Accordingly, many settlement agreements provide that, concurrently with the execution of the settlement agreement, the company shall appoint to its board of directors the agreed upon nominees to serve as additional independent directors. In the case of a company that does not have a classified board, the term of office for such directors would generally not be until the next annual meeting of shareholders, at which time they would stand for reelection. In the case of a company with a classified board, the term of office would depend on which class such nominees were assigned to, and when such class of directors is scheduled to stand for reelection.

Are the activist shareholder's nominees, independent and otherwise, qualified to serve as directors?

Before agreeing to appoint or support the election of the activist shareholder's nominees to the company's board of directors, the company should establish that the proposed nominees are qualified and meet the requisite "independent" standard dictated by the stock exchange the company's shares are traded on. To address this issue, the company's nominating committee would typically review and approve the qualifications of the activist shareholder's nominees and determine that each of them are independent and qualified to serve on the company's board. If such review takes place prior to the execution of the settlement agreement, the activist shareholder will likely want the company to acknowledge in the settlement agreement that it has determined that each of the activist shareholder's proposed nominees are qualified and independent. If the review takes place after the execution of the settlement agreement, the agreement would need to contain a mechanic for the activist shareholder to propose additional nominees should his initial nominees be rejected by the nominating committee in good faith.

Accordingly, the activist shareholder **may prefer that** the necessary number of incumbent directors **resign** to make room on **the board for him.**

How will the company's management support the election of the activist shareholder's nominees to the board?

The company would be expected to include the activist shareholder's nominees in the company's revised slate of nominees for election as directors at the next annual meeting of shareholders, and to use its reasonable best efforts to cause the election of each of the activist shareholder's nominees. Typically, that would mean giving each of the activist shareholder's nominees no less than the same degree of support, and using the same efforts with respect to the activist shareholder's nominees, as it gives and uses

with respect to the other members of its slate of nominees. To support the election of the activist shareholder's nominees, the activist would typically expect the company to do the following:

- recommend that its shareholders vote in favor of the election of these nominees;
- include such recommendation in its annual meeting proxy statement;
- vote all proxies granted by shareholders in favor of the activist shareholder's nominees (except for such proxies that specifically indicate a vote to withhold authority with respect to any of such nominees);
- not take any position, make any statements, or take any action inconsistent with its recommendation of the activist shareholder's nominees; and
- not nominate any additional persons to the board other than the agreed-upon revised slate of nominees.

How long should the company agree to support the election of the activist shareholder's nominees?

How long the company agrees to keep an activist shareholder's nominees on the board is a frequent point of negotiation between the company and the activist. A related issue for both the company and the activist shareholder to consider is how long of a standstill period is contemplated. While we will discuss standstill provisions in more detail later, typically the standstill period will be coterminous, or close to coterminous, with the board representation period. The settlement agreement may provide that the standstill period continues only so long as at least one of the activist shareholder's nominees is serving as a member of the company's board. In other cases, such as where the activist shareholder's nominees are only being supported for election at one annual meeting, the settlement agreement may provide that the standstill period expires on or immediately prior to the date of the following year's annual meeting. In such instance, the activist shareholder may seek to negotiate provisions into the settlement agreement that provide him with the ability to bring a proxy contest immediately after the standstill period expires. Depending on the advance notice provisions contained in the company's bylaws, this may require that the standstill contain a carve-out to permit the activist shareholder to provide such notice during the standstill period.

Should the activist shareholder's board representation be dependent on maintaining any fixed level of stock ownership in the company?

It may be the case that the company is agreeable to giving the activist shareholder board representation because of the level of his stock ownership in the company. What happens if he significantly reduces his stock ownership? Should the activist shareholder's right to board representation be dependent on maintaining at least a threshold level of ownership in the company? In one recent settlement, the agreement provided that if the activist shareholder ceases to own, in the aggregate, at least 50 percent of the number of shares of the company's common stock that he owned as of the date of the settlement agreement, the activist shareholder would be required to resign from the board "with a view toward having the board fill the vacancy created with an individual affiliated with more significant shareholdings."[1] In another relatively recent settlement, the activist shareholder was not required to resign if his beneficial ownership fell below a certain level, but his right to fill a vacancy in the board caused by the resignation of one of his nominees would automatically terminate if his ownership in the company fell below an amount equal to 5 percent of the shares of the company's common stock outstanding as of the date of the settlement agreement.[2]

Will the activist shareholder have the right to propose a replacement nominee if someone is unable to serve?

The activist shareholder will typically want the right to fill vacancies on the board of directors caused by the resignation, removal, death, or incapacity of any of the activist shareholder's nominees. The company's major concern here would be to ensure that such a "replacement nominee" satisfies the requisite definition of an "independent" director, and meets the qualifications for membership of the board then in effect as established by its nominating committee. If the replacement nominee was determined in good faith not to be independent or not to be qualified for membership on the board, then the activist shareholder could be given the right to propose another nominee. This situation can also be addressed by having the company approve a list of replacement nominees prior to the execution of the settlement agreement, acknowledging that each of those nominees meets the definition of an independent director and qualifies for membership on the board of directors. For example, the company may agree that any of the individuals nominated by the activist shareholder in the nomination letter that was previously sent to the company during the course of the proxy contest are acceptable.

When should the company be required to hold the annual meeting?

If the company is not going to be appointing the activist shareholder's nominees to the company's board concurrently with the execution of the settlement agreement, the activist shareholder may want the annual meeting to be held as soon as possible so that his nominees can be elected to the board at the earliest possible time. However, even if the activist shareholder's nominees are appointed

to the company's board of directors prior to the annual meeting, the activist shareholder may still have an interest in causing the company to hold the annual meeting as soon as possible or, at a minimum, by at least an agreed to date. This is likely to be acceptable to the company's management team as the proxy contest is now behind them and therefore they no longer have the need to have the flexibility to delay the annual meeting for strategic reasons. Since the annual meeting cannot be held before the revised preliminary proxy statement is filed with the SEC, the activist may want a commitment from the company to file its revised proxy statement by a certain date and to respond to any comments from the staff of the SEC as expeditiously as possible. The activist shareholder may also want the company to be prevented from adjourning, postponing, rescheduling, or continuing the annual meeting without his prior written consent.

What kind of committee membership should be given to the activist shareholder's nominees?

In addition to serving as members of the company's board of directors, the activist shareholder may desire to seek membership on one or more of the key standing committees of the board, including the executive, audit, compensation, nominating, and governance and strategic planning committees. In addition, the activist may desire for the settlement agreement to provide that if a new standing or special committee is created during a time when the activist shareholder's nominees are serving on the board, the company would appoint one of them to the membership of such committee. Such provisions limit the ability of the board to exclude the activist shareholder's nominees from substantive formal discussions conducted by a subset of the board (such as in a meeting of the company's executive committee). Any agreement by the company to appoint one of the activist

Sampling of Proxy Contest Settlement Agreements Executed in 2007*

Company	Activist shareholder	Date of settlement
The Home Depot, Inc.	Relational Investors, LLC	February 5, 2007
The Brink's Company	Pirate Capital LLC	February 8, 2007
Applebee's International, Inc.	Breeden Capital Management LLC	April 25, 2007
Comverse Technology, Inc.	Oliver Press Partners LLC	May 22, 2007
Intervoice, Inc.	David W. Brandenburg	June 22, 2007
Pomeroy IT Solutions, Inc.	Flagg Street Capital, LLC	July 12, 2007
WCI Communities, Inc.	Icahn Partners LP	August 20, 2007
Ceridian Corporation	Pershing Square, LP	September 7, 2007
Lancaster Colony Corporation	Barington Companies Equity Partners, LP	October 9, 2007
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Tandy Brands Accessories, Inc.	Golconda Capital Management, LLC	October 29, 2007
Kraft Foods, Inc.	Trian Partners, LP	November 7, 2007
A. Schulman, Inc.	Barington Companies Equity Partners, LP	November 15, 2007

** Source: Filings made with the Securities and Exchange Commission.*

shareholder's nominees to any standing or special committee of the board should be conditioned on such nominees being qualified to serve on such committee under applicable legal requirements and listing standards. The activist shareholder may also want to consider seeking observer rights that would permit his nominees, regardless of committee membership, to attend as observers of all committee meetings.

Will the activist shareholder's nominees be given any board leadership positions?

In some cases, the activist shareholder may seek one or more board leadership positions for its nominees. Such positions would include chairman of the board, vice chairman of the board, or lead independent director. This may particularly be the case where the activist shareholder had earlier sought to replace the entire board with a complete slate of nominees. In return for the activist shareholder agreeing to accept minority representation on the board, the company may agree to give one or more of the activist shareholder's nominees a board leadership position. If that were the case, such an appointment would likely be made concurrently with the appointment of the activist's nominees to the board. Depending on how important such an appointment is to the activist shareholder, he may want to ensure in the settlement agreement that the incumbent directors are not permitted to amend the company's certificate of incorporation or bylaws, or take any other action to diminish the authority of the position, or to assign to another person any of the powers or duties of such leadership position.

How does the activist shareholder prevent his nominees from being removed from the board or otherwise having their terms curtailed?

Having just conducted a proxy contest against the company, an activist shareholder may be somewhat untrusting of the board's incumbent directors and concerned that they may seek to remove his nominees from the board after their appointment or election. Under Delaware law, if the company has a nonclassified board, shareholders have the right to remove directors without cause. If the company's certificate of incorporation does not specifically deny shareholders the right to act by written consent, they would also have the right to conduct a consent solicitation to remove and replace some or all of the members of the company's board. In the absence of the right to act by written consent, the shareholders may also be able to remove and replace directors by calling a special meeting.

In order for the activist shareholder to prevent the removal of his nominees from the board or the otherwise curtailment of their terms, he may want the company to agree to refrain from calling any special meetings of shareholders for the purpose of removing any of the activist shareholder's nominee, or taking any action which would have the effect of curtailing any of the terms of such nominees. The activist shareholder may also want the settlement agreement to provide that the company and the board will recommend against any proposal or consent solicitation that might be brought to remove or curtail the term of any of the activist's nominees serving as a director, and that the company will use its reasonable best efforts to solicit proxies against any such action.

Following the execution of the settlement agreement, are there actions of the company that should require the consent of the activist shareholder?

While the company may not want to give the activist shareholder a special veto right on most company actions, the activist shareholder may want to prevent the company from taking certain actions, such as amendments to the company's certificate of incorporation or bylaws, that would be inconsistent with the intent of the settlement agreement, or would have the effect of frustrating the objectives of the agreement or any of the obligations or covenants contained therein. In addition, the activist shareholder may want the company to agree not to increase the size of the board without first obtaining the written consent of the activist.

How does the activist shareholder ensure that its nominees, once appointed or elected to the board, are treated no different than other directors?

The activist shareholder may want to ensure that his nominees, once appointed or elected to the board, are not discriminated against or relegated to an unofficial "second tier" of directors. To address this, the settlement agreement could provide that the activist shareholder's nominees would have the same rights, privileges, powers, and duties as all other nonemployee directors and receive the same compensation and benefits as all other nonemployee directors, including, but not limited to, indemnification rights, exculpation protections associated with service on the board, and directors' and officers' liability insurance to the extent set forth in existing or future policies for directors generally. In addition, the settlement agreement could provide that the activist's nominees would be entitled to separate counsel, at the company's expense, if the activist's nominees determine that such counsel is reasonably necessary, including to enforce any of the provisions of the settlement agreement.

How does the activist shareholder prevent the company from excluding his nominees from board proceedings?

An activist shareholder may be concerned that board or committee meetings may be scheduled or held without properly informing the activist's nominees so that they

can prepare for, attend, and participate in such meetings. To avoid this, the company could be asked to agree in the settlement agreement to require each of the incumbent directors and each member of the company's senior management team to refrain from scheduling board and committee meetings without first conferring in advance with, and providing reasonable notice to, the activist shareholder. In addition, the activist shareholder may want the company to agree to make reasonable efforts in scheduling and noticing board and committee meetings to accommodate the schedule of each board and committee member.

2. Voting Agreements by the Activist Shareholder

As part of a settlement, the company would typically seek the agreement of the activist shareholder to support the company at the annual meeting of shareholders. In particular, the company would ask the activist shareholder to commit to cause all shares of common stock, which he has the right to vote as of the record date for any meeting of shareholders to be present for quorum purposes, and to be voted at any such meeting or adjournments or postponements thereof:

- in favor of each director nominated and recommended by the board for election at any such meeting (provided, of course, that such slate of nominees includes the activist's nominees);
- in favor of any other proposals that are supported by the company's board of directors, whether that be the approval of a new stock option plan or the ratification of the selection of the company's auditors for the next fiscal year;
- against any shareholder nominations for director which are not approved and recommended by the board for election at any such meeting; and
- against any shareholder proposals which are not recommended by the board for approval at any such meeting.

Whether the voting agreement obtained from the activist shareholder applies just to the election of directors, or includes other proposals as well, is often the subject of negotiation between the parties.

3. Termination of the Proxy Contest

A fundamental part of any settlement agreement from the point of view of the company is the agreement of the activist shareholder to terminate the proxy contest. Technically, there is nothing to do to terminate a proxy contest. What the company is really seeking is a commitment from the activist shareholder not to continue the proxy contest. The company may therefore ask the activist shareholder to commit to do the following as evidence of his agreement not to continue the proxy contest:

- withdraw his letter informing the company of his intent to propose nominees for election to the company's board of directors at the next annual meeting of shareholders;
- notify the SEC in writing of the termination of the proxy contest;
- withdraw any demands that have been made to inspect shareholder records; and
- amend his Schedule 13D to indicate the termination of the proxy contest and the execution of the settlement agreement.

4. The Standstill Covenants

The company will typically desire to obtain the broadest standstill covenants possible in order to limit the activist shareholder's ability to take public action that the company might find disruptive during the standstill period. Depending on what is negotiated, the standstill may prohibit the activist shareholder and his affiliates from, directly or indirectly, doing any of the following without prior board approval:

- making, engaging, or in any way participating in, directly or indirectly, any solicitation of proxies or written consents of the company's shareholders;
- seeking to advise, encourage, or influence any person with respect to the voting of any common stock;
- seeking, alone or in concert with others, the election or appointment to, or representation on, or the nomination of any candidate to, the company's board of directors;
- seeking to call or requesting the call of a special meeting of the shareholders of the company;
- seeking the removal of any director from the company's board of directors;
- initiating, proposing, or otherwise soliciting shareholders of the company for the approval of shareholder proposals, or causing, encouraging, or attempting to cause or encourage any other person to initiate any shareholder proposal;
- effecting or seeking to effect any merger, acquisition, or other business combination involving the company or any of its subsidiaries; or
- seeking to control or influence the management, the board of directors, or policies of the company.

The foregoing list is not exhaustive and the settlement agreement could specify other prohibited actions. The company may also seek to prevent the activist shareholder from increasing his ownership of the company's stock above a certain threshold. While the standstill period in settlement agreements can vary, where the activist shareholder has been given representation on the company's board of directors, the standstill period is often set to be at least coterminous with the board representation period. That is, for as long as the activist shareholder is represented on the company's board of directors, the standstill covenants would apply to the activist shareholder. The activist shareholder may seek certain carve-outs from the standstill, such

as a provision that would allow it to discuss any matter confidentially with the company or any member of its board of directors. To the extent that the activist shareholder himself is to serve as a director, he is advised to ensure that the settlement agreement specifies that the standstill provisions will not limit the actions of any director of the company in his capacity as a director, recognizing that such actions are subject to such director's fiduciary duties to the company and its stockholders. The standstill agreement may provide that it is subject to early termination if:

- the company announces or enters into a definitive agreement providing for, or recommends that its shareholders support, a sale, merger, or other business combination transaction involving the company;
- the company breaches its obligation to include the activist shareholder's nominees in the slate of nominees that it recommends to its shareholders for election to the board of directors; or
- the company otherwise materially breaches any of its commitments or obligations contained in the settlement agreement and such breach is not cured with a fixed period of time.

A fundamental part of any settlement agreement from the **point of view** of the company is the agreement of the **activist** shareholder to **terminate** the proxy contest.

5. The Press Release

The press release announcing the settlement of the proxy contest will be of significant interest to both the company and the activist shareholder. Among other things, both parties will likely want to avoid being depicted as capitulating to the other, even if that is not the case. Typically, the press release will be a joint release. If not a joint release, it will be issued by the company with significant input from the activist shareholder. In any case, the actual text of the press release will typically be negotiated as part of the settlement and included as an exhibit to the settlement agreement. The press release would typically announce, among other things:

- that a settlement has been reached between the company and the activist shareholder;
- that the activist shareholder and one or more of his nominees have been appointed to the company's board of directors;
- that the activist shareholder and one or more of his nominees have been added to the revised slate of board nominees being recommended by the company's management; and
- the complete list of such revised slate of board nominees.

The press release may also include statements from the company:

- indicating that it is pleased to have reached a settlement with the activist shareholder;
- welcoming the activist shareholder and his nominees to the company's board of directors;
- possibly validating one or more of the concerns raised by the activist shareholder during the course of the proxy contest and welcoming his input;
- expressing management's belief that the activist shareholder and his nominees will be joining the board as supportive and productive members; and
- suggesting that management and the activist shareholder are now of a like mind or desire to strengthen and improve the company.

In addition, the press release may include a statement from the activist shareholder indicating:

- that she is pleased he is to have reached a settlement with the company;
- that she believes that the settlement provides significant value for the company's shareholders;
- that she is very excited to be joining the company's board of directors;
- that she appreciates the commitment of the board to make changes to improve the company's operations, profitability, and corporate governance; and
- that she is looking forward to working constructively with the company and its board to continue to create additional value for the shareholders of the company.

Often the press release is drafted to convey to the marketplace that the risk of a proxy contest is over, that management and the activist shareholder have joined forces, and that both management and the activist shareholder can be expected to work together constructively. The settlement agreement will typically also contain a provision preventing the parties from making any additional public statements that are inconsistent with, or are otherwise contrary to, the statements in the agreed-upon press release.

In addition to being referenced in the press release, the company will discuss the settlement agreement in its proxy statement and current report on Form 8-K and by the activist shareholder in a Schedule 13D filing. All of the foregoing will be made publicly available when filed with the SEC. To ensure that the messaging in each of these documents is consistent with that in the press release, the settlement

agreement can be drafted to provide each party with the reasonable opportunity for it and its counsel to review and comment on the filings of the other party.

6. Reimbursement of Expenses

Not every settlement provides for the activist shareholder to be reimbursed for his expenses. Whether expense reimbursement is included in the settlement agreement may depend on how far along the activist shareholder was in pursuing his proxy contest at the time of settlement. Typically, the activist shareholder's most significant expenses will be derived from the legal fees related to preparing and filing preliminary and revised proxy statements with the SEC. Where the proxy contest was just threatened but no proxy statement was ever prepared and filed with the SEC, the activist shareholder may not be as concerned with being reimbursed for his expenses. However, where the activist shareholder had already prepared and filed preliminary and revised proxy statements with the SEC, he could easily have incurred a few hundred thousand dollars in legal fees and other expenses and may be seeking reimbursement.

Where expense reimbursement is included in the settlement, the activist shareholder will likely want the company to reimburse him for all of his expenses incurred in connection with the following activities:

- the threatened or initiated proxy contest;
- the preparation of the related proxy statement and Schedule 13D;
- the preparation, negotiation, and execution of the settlement agreement;
- the review of the company's revised proxy statement, the company's Form 8-K related to the settlement agreement, and any other disclosure documents prepared by the company; and
- the preparation and filing of a Schedule 13D amendment related to the settlement agreement.

In addition to clarifying the types of activities that are covered by the expense reimbursement, the agreement may also clarify the types of expenses that are covered. The types of expenses typically reimbursed include expenditures for attorneys, public relations advisors, investor relation advisors, proxy solicitors, advertising, printing, postage, and travel.

The company may desire to establish a cap for such expenses. While the caps that are agreed to vary from settlement to settlement and will depend to some extent on how far along the activist shareholder was at the time of settlement, they generally range from a few hundred thousand to a half a million dollars. The table on page 82 shows a sampling of the reimbursement caps that were agreed to in a number of recent settlement agreements.

In addition, the activist may want to establish certain exceptions to the cap. For example, if the activist shareholder's nominees would be entitled to reimbursement for their out-of-pocket legal fees and other expenses incurred as members of the company's board, or if legal fees are incurred to enforce the terms of the settlement agreement, those fees and expenses may be negotiated as being outside of the expense reimbursement cap.

7. Initiatives to Enhance Shareholder Value

A major inducement for the activist shareholder to enter into a settlement agreement with the company and end the proxy contest is often to obtain the company's agreement to pursue one or more initiatives that are intended to enhance shareholder value. These could include any of the following:

- the initiation or expansion of a previously authorized stock buyback program;
- the declaration of a cash dividend;
- the reduction of corporate overhead and other costs;
- the alignment of costs with the long-term needs of the business;
- an expansion of the company's sales force or other initiatives to enhance revenues;
- the sale of noncore assets or underperforming businesses;
- the monetization of intellectual property such as patents through the implementation of a royalty generating licensing program;
- the formation of a special task force or the hiring of a management consulting firm to explore ways to improve the company's margins, enhance operating efficiencies, reduce expenses, and otherwise improve the company's operating and financial performance;
- the formation of a special committee and/or the retention of a financial advisor to explore strategic alternatives to maximize and improve shareholder value, including, without limitation, a strategic acquisition, merger, or sale of the company;
- the hiring of an executive search firm to identify candidates to replace a member of the company's executive management team; or
- the hiring of a compensation consultant to more closely align the compensation of management with the enhancement of shareholder value.

While the activist will typically want the company to make hard commitments in the settlement agreement, the company may seek to "soften" the commitment that it is making in writing with respect to these initiatives. For instance, rather than commit to a fixed reduction in corporate overhead and other expenses, the company might seek to have the agreement provide that it will "conduct a review of the company's selling, general, and administrative expenses to identify potential actions that would eliminate corporate overhead without sacrificing the company's ability to generate revenue or service customers." Rather

than commit to hiring a fixed number of additional sales representatives to increase product sales revenue, the company might seek to agree to "explore opportunities to increase product sales revenue, including, but not limited to, expanding the sales force."

8. Corporate Governance Enhancements

During the course of the proxy contest, the activist shareholder may have criticized a number of corporate governance practices of the company. The activist may desire to improve the company's corporate governance for a number of reasons, including increasing board responsiveness to shareholder concerns, minimizing management entrenchment. A number of studies have demonstrated that companies with better corporate governance tend to outperform those with poorer corporate governance.[3] Accordingly, the activist shareholder may ask the company to agree in the settlement agreement to implement certain corporate governance enhancements, including:

- The separation of the roles of chairman of the board and chief executive officer, or designating one of the independent directors as the "lead director."
- The adoption of majority voting for directors except in contested elections.
- The formation of additional board committees such as a strategic planning committee.
- The compensation committee review of the compensation structure for senior management with a view to providing more equity-based incentives and better aligning the economic interests of senior management with those of the company's shareholders.
- The adoption of a bylaw to provide that the board of directors cannot adopt any shareholder rights plan, commonly known as a "poison pill," without the approval of the company's shareholders. If the company already has a shareholder rights plan, the activist shareholder may ask the company to agree to amend it to add a "TIDE" provision, which requires a committee of independent directors to meet at least once every three years to review the terms and conditions of the rights plan to determine whether the plan remains in the shareholders' best interests or if such a plan should be modified or terminated.[4] If the company's rights plan includes a "dead hand" provision, the company may be asked to amend the plan to remove such a provision.
- The employment of a nationally recognized consulting or law firm with no relationship with the company or the activist shareholder to study the company's policies regarding related party transactions (e.g., transactions with directors, officers, and similar insiders), public disclosure, and corporate governance against the policies and practices of a relevant peer group. The agreement would also provide that such a study would need to be completed by a fixed period of time following the retention of such firm, and the board of directors would have a fixed period of time thereafter to take action with respect to the implementation of the findings or recommendations of such a study as is determined by a majority of the members of the board of directors (at a meeting at which one or more of the activist shareholder's nominees are present) to be in the best interests of the company.

Frequently, companies find that improving their corporate governance is well received by institutional shareholders and helps minimize the risk of the company being targeted by corporate governance watchdog groups and

ACC Extras on…Settlement Agreements

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> **While not always the case, there have been a number of recent threatened or actual proxy contests where the settlement appeared to be a win-win for both sides.**

other activist organizations as the subject of a shareholder proposal to improve its governance in the future. Improved governance may also enhance the company's standing with independent proxy advisory service providers, such as RiskMetrics Group and Glass, Lewis & Co., and prevent the company's directors from receiving withhold recommendations from these organizations at future annual meetings.

9. Mutual Releases and Covenants Against Litigation

Not every proxy contest settlement will include mutual releases. Among the factors that may be determinative of whether the settlement will include releases are:

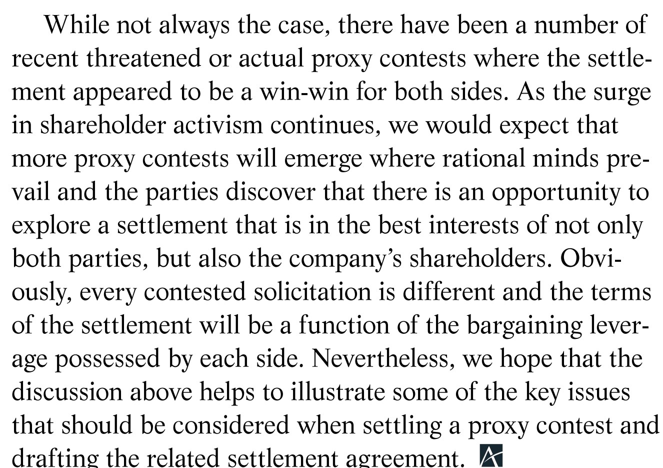
- if the proxy contest was one that involved litigation between the parties;
- if there is a history of an acrimonious relationship between the parties; and
- if the proxy contest involved a significant amount of negative messaging targeted toward the other side.

In addition to comprehensive mutual releases, the parties may also agree to covenants that prohibit each from initiating litigation against the other except with respect to commercial matters that have nothing to do with the proxy contest or issues of corporate control. For example, if the company were a bank, among the claims that might be excluded from the releases and the covenants against litigation would be claims arising out of banking or lending relationships with the company. In addition, any rights with respect to dividends or other incidents of stock ownership could be excluded from the releases and litigation covenants.

10. Nondisparagement

To the extent that proxy contest settlement agreements include nondisparagement clauses, it is often for the same reasons that mutual releases are included. In such instance, each party would typically seek an agreement from the other not to engage in any conduct, make any statement, or communicate any information (whether oral or written) that is calculated to or is likely to have the effect of undermining, impugning, disparaging, or otherwise reflecting adversely or detrimentally on the other party, its affiliates, and their respective directors and officers. Of course, if well negotiated, the nondisparagement might have a number of carve-outs. Among others, the nondisparagement provision might not apply to (a) nonpublic oral statements made by either party directly to the other or to its directors, officers, employees, or representatives, or (b) any compelled testimony, either by legal process, subpoena, or otherwise.

A Win-Win Is Possible



While not always the case, there have been a number of recent threatened or actual proxy contests where the settlement appeared to be a win-win for both sides. As the surge in shareholder activism continues, we would expect that more proxy contests will emerge where rational minds prevail and the parties discover that there is an opportunity to explore a settlement that is in the best interests of not only both parties, but also the company's shareholders. Obviously, every contested solicitation is different and the terms of the settlement will be a function of the bargaining leverage possessed by each side. Nevertheless, we hope that the discussion above helps to illustrate some of the key issues that should be considered when settling a proxy contest and drafting the related settlement agreement.

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NOTES

1. See Settlement Agreement, dated May 22, 2007, by and between Comverse Technology, Inc. and Oliver Press Partners, LLC, filed as Exhibit 10.1 to the Current Report on Form 8-K filed by Comverse Technology, Inc., with the Securities and Exchange Commission on May 29, 2007.
2. See Settlement Agreement, dated as of August 2, 2006, by and between the Barrington Group and The Pep Boys—Manny, Moe & Jack, filed as Exhibit 10.1 to the Current Report on Form 8-K filed with the Securities and Exchange Commission on August 3, 2006.
3. See, e.g., Bebchuk, Cohen and Ferrell, *What Matters in Corporate Governance?,* Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper No. 491 (September 2004)(identifying a statistically significant correlation between stock performance and the degree to which boards are accountable to their shareholders); Institutional Shareholder Services, *Better Corporate Governance Results in Higher Profit and Lower Risk* (2005 "Companies with better corporate governance have lower risk better profitability and higher valuation. More specifically, these well-run companies outperform poorly governed firms in return on investment, annual dividend yield, net profit margin, and price-to-earnings ratio." See also Eisenhofer and Levin, *Investment Returns: Does Corporate Governance Matter to Investment Returns?* Corporate Accountability Report, Vol. 3, No. 57 (September 23, 2005) ("[E]mpirical evidence suggests what common sense tells us is correct—those corporate boards that are more concerned about shareholder rights are also better guardians of shareholder money)."
4. An example of a settlement agreement where such an amendment to a rights agreement was sought is the Settlement Agreement, dated as of August 2, 2006, by and between the Barrington Group and The Pep Boys—Manny, Moe & Jack.