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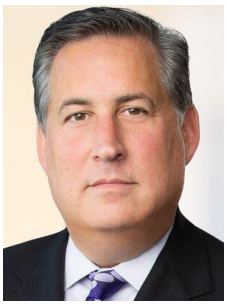
Understanding Advance Notice Bylaws Is Key For All Parties

By **Spencer Klein, Joe Sulzbach and Tyler Miller** (December 18, 2023, 4:41 PM EST)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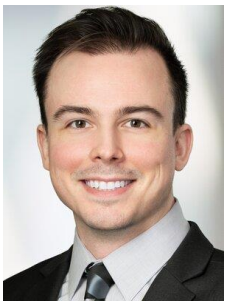
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The 2023 proxy season saw a significant increase in the number of companies rejecting director nominations by dissident stockholders due to purported noncompliance with the company's advance notice bylaws.

Although the reason for the increase is not entirely clear at this time, companies may be emboldened by recent Delaware case law upholding the rejection of nominees at several companies. In any event, the increase underscores the importance of having state-of-the-art advance notice bylaws in place prior to a dissident surfacing. From the nominating stockholders' perspective, compliance with advance notice bylaws cannot be taken lightly.

It will be interesting to see if this increase becomes a new trend or just a one-year blip.

Stockholder Director Nomination Rejections

Advance notice bylaws require stockholders to submit a formal notice of their director nomination, along with detailed information about the stockholder and the nominee, within a specified period before the annual meeting. These provisions provide the board with sufficient time and relevant information to evaluate the candidates, allow board members to knowledgeably make recommendations, and ensure that stockholders cast well-informed votes.

Between January 2022 and September 2023, 19 companies rejected stockholder director nominations for the failure to comply with advance notice bylaws.[1] The most common reasons for the rejections[2] were:

- Failure to make required disclosures under the bylaws: For example, Primo Water Corp. rejected Legion Partners Asset Management LLC's nomination due to its failure to disclose a pending lawsuit for fraud allegations against one of its nominees.

- Failure to correct omissions before the close of the advance notice window: For example, First Foundation Inc. rejected Driver Management Company LLC's director nomination. Despite being notified that its nomination notice was deficient, Driver failed to submit the required information before the close of the advance notice window.

- Misrepresentations: For example, George Norcross, Philip Norcross and Gregory Braca provided the required notice under Republic First Bancorp Inc.'s bylaws to nominate director candidates but, among other things, misrepresented the identity of the record holder of the shares.

One potential reason for the rise in the number of nomination rejections for advance notice bylaw noncompliance is the increase in the number of first-time or occasional activists. These are firms or individuals who do not have significant experience seeking to effect change at a company, including navigating the complexities of the advance notice bylaws.[3] This lack of experience may have led to some of the rejections.[4]

Resulting Lawsuits and Delaware Case Law

Approximately 68% of the rejections resulted in litigation, of which four cases have ended in settlements. Two of these cases settled in favor of the dissident,[5] allowing its nominees to stand for election, while the other two cases resulted in the dissident withdrawing its nominations.[6]

Delaware courts have decided several cases involving noncompliance with advance notice bylaws, including a few recent notable examples: the Delaware Court of Chancery's 2022 cases, Jorgl v. AIM ImmunoTech Inc.[7] and Strategic Investment Opportunities LLC v. Lee Enterprises Inc.,[8] and its 2021 case, Rosenbaum v. Cytodyn Inc.[9]

While the facts and circumstances of each case vary, the courts in each case conducted a similar analysis.

As an initial step, the courts analyzed whether the board was entitled to reject the nomination notice under the bylaws. As the court said in AIM Immunotech, "Clear and unambiguous advance notice bylaw conditions act, in some respects as conditions precedent to companies being contractually obligated to take certain actions."[10]

In each of these cases, the court found that the dissident stockholders had not strictly complied with the unambiguous terms of the advance notice bylaws and, therefore, the boards had been entitled to reject their nominations.

However, as the court in AIM Immunotech went on to say, the board's "technical entitlement to reject the Notice does not necessarily mean that equity will allow [its actions] to stand."[11]

The courts in each case went on to conduct an equitable review of the specific facts and circumstances of the case. In AIM Immunotech, the court upheld the board's rejection of a dissident stockholder's nomination notice because the stockholder failed to disclose "all arrangements or understandings" that the stockholder had with the proposed nominees.

In Lee Enterprises, the court upheld the board's rejection of a dissident stockholder's nomination notice, which was submitted on the eve of the nomination deadline, because the notice was not submitted by a stockholder of record and the stockholder did not use the company's director nominee questionnaire forms.

And in Cytodyn, the court upheld the board's rejection of a dissident stockholder's nomination notice,

which was also submitted on the eve of the nomination deadline, because the stockholder failed to disclose that an entity was in part funding the stockholder nomination and that one of the nominees might seek to facilitate an acquisition by the company of a business in which the nominee was a significant stockholder.

Although these cases show some disagreement among the courts concerning the exact standard of review to be applied to a board's rejection of a stockholder nomination, it has become well settled that compliance with advance notice bylaws should be strictly construed and that Delaware courts will uphold clear, unambiguous advance notice bylaws that were adopted on a clear day — i.e., when the board was not facing an imminent threat — that the board applies reasonably in its decision to reject a stockholder nomination.

Considerations for Companies

The surge in rejections of stockholder director nominations this proxy season and in recent Delaware case law underscores the importance of having state-of-the-art advance notice bylaws. To that end, the following are a few key takeaways that we recommend public company boards take into consideration.

Review the company's bylaws and, in particular, advance notice provisions regularly.

U.S. Securities and Exchange Commission regulations, market practice and Delaware case law are evolving in this area, and companies would do well to stay up to date on recent developments. The recent introduction of the universal proxy card provides a good point of departure for a bylaw review, if one has not been undertaken already.[12]

Adopt any changes to the advance notice bylaws on a "clear day," before any dissident stockholder surfaces.

If the board is aware of an imminent proxy contest before adopting stringent advance notice bylaws, courts may be more stringent in their review of the board's action.

For example, in the 1980 Chancery Court case Lerman v. Diagnostic Data Inc., the board adopted bylaws requiring 70 days' advance notice after the meeting had already been scheduled for 63 days later, and as a result, the court enjoined the enforcement of the advance notice bylaws.[13]

Advance notice bylaws should be clear and unambiguous.

Any ambiguity or lack of clarity in an advance notice bylaw provision will generally be resolved "in favor of the stockholder's electoral rights."[14]

For example, in 2008's Jana Master Fund Ltd. v. CNET Networks, the Chancery Court held that an ambiguous advance notice bylaw provision applied only to stockholder proposals subject to Rule 14a-8 of the Securities Exchange Act, and not to all stockholder proposals more generally, and, as a result, the bylaws' requirements were not applicable to the dissident stockholder's proposal in the face of a legal challenge.

The board must act reasonably when it considers whether a stockholder nomination complied with the advance notice bylaws.

Delaware courts have generally held that advance notice bylaws are valid absent a showing that they unduly restrict the stockholder franchise or are applied inequitably.

Examples of such inequitable or unreasonable conduct may include a "significant change [to the] corporate direction or policy" after the notice deadline had expired, as in 1991's Chancery Court case Hubbard v. Hollywood Park Realty Enterprises Inc.,[15] or amending the date of the stockholder meeting to "obtain an inequitable advantage," as in 1971's Delaware Supreme Court decision in Schnell v. Chris-Craft Industries Inc.,[16] which held that "inequitable action [toward stockholders do] not become permissible simply because it is legally possible."[17]

Advance notice bylaws should be in line with market standards.

Courts see standard advance notice bylaws as commonplace and as serving a legitimate purpose. However, if they are overly aggressive or burdensome compared to market standards, they may be subject to challenge.

For example, in a recent Chancery Court lawsuit brought by a dissident shareholder against Masimo Corp., the dissident shareholder challenged Masimo's very aggressive advance notice bylaws, which required a dissident shareholder to identify, among other things, the names of the dissident shareholder's passive limited partners and their families' investment holdings in the company's competitors or litigation counterparties, as well as any plans the dissident had to nominate directors for other public company boards in the next 12 months.

These requirements went far beyond typical market practice, and Masimo ultimately eliminated the bylaw provisions in question.[18]

Considerations for Stockholders

For stockholders planning to nominate director candidates, these recent developments also suggest several important guidelines.

Be sure to read the bylaws thoroughly, and take note of all timing and information requirements.

Advance notice bylaws can be quite arcane and lengthy, and it may be helpful to prepare a checklist detailing what needs to be collected and prepared, along with any relevant deadlines. Submitting a notice of nomination even one day after the applicable deadline has passed likely gives the board sufficient reason to reject a nomination.[19]

Allow adequate time to collect the necessary information from director nominees and prepare the notice of nomination.

Stockholders should not underestimate how long it takes to collect certain information from multiple parties. All relevant details need to be properly organized and analyzed before the notice of nomination can be submitted to ensure compliance with the bylaws.

Conduct appropriate due diligence to discover any conflicts of interest or other potentially disqualifying factors before submitting the notice.

Many advance notice bylaws require the disclosure of potential conflicts of interest or other factors that

may require a stockholder's due diligence to uncover.

If a board of directors reasonably suspects there may be a conflict of interest, but that conflict is not properly disclosed in the stockholder's notice of nomination, courts are likely to find that the board's rejection of the notice was justified.

For example, in Cytodyn, one of the nominees and one of the stockholders had potential conflicts of interest that were not disclosed in the shareholders' notice, and the court determined that the notice was rejected on reasonable grounds given the nature of the omissions.[20]

Do not assume that any level of noncompliance will be overlooked.

As noted above, compliance with advance notice bylaws will generally be strictly construed, and Delaware courts will uphold clear, unambiguous advance notice bylaws that were adopted on a clear day.

In the absence of certain extenuating circumstances, such as the board's inequitable conduct, stockholders need to comply with advance notice bylaws to the letter.

If possible, submit the notice of nomination well in advance of the deadline to allow sufficient time to cure any defects.

If a notice of nomination is submitted right before the deadline and the board finds it to be deficient, courts are unlikely to toll, or pause, the period of time provided for submissions in the bylaws.

For example, in Cytodyn, the court held that because the plaintiffs had waited until the final day to submit their notice, "they were obliged to submit a compliant notice," and that the bylaws placed the burden for correcting or supplementing the notice on the stockholders. Importantly, however, the court also stated that a board may have a fiduciary duty to inform stockholders of any defects if there is sufficient time to cure such defects before the advance notice deadline.

Conclusion

While the exact reasons for the recent increase in the number of companies rejecting director nominations by dissident stockholders due to purported noncompliance with the company's advance notice bylaws are still unclear, companies and stockholders alike can learn a great deal from recent developments in Delaware case law.

Advance notice bylaws will be strictly construed, and Delaware courts will generally uphold clear, unambiguous advance notice bylaws adopted on a clear day and applied reasonably.

Whether you are a director or a stockholder considering director nominations, a detailed and comprehensive understanding of these bylaws is essential.

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[1] Deal Point Data: (1) Firsthand Technology Value Fund, Inc. rejection of Seven Corners Capital Management, LLC; (2) Avantax (f.k.a. Blucora, Inc.) rejection of Engine Capital Management, LP; (3) Tax Free Fund for Puerto Rico Residents, Inc. rejection of Ocean Capital LLC; (4) AIM ImmunoTech Inc. rejection of Jonathan Jorgl; (5) Republic First Bancorp, Inc. rejection of George E. Norcross, III, Philip A. Norcross, and Gregory B. Braca; (6) Necessity Retail REIT, Inc. rejection of Blackwells Capital, LLC; (7) Global Net Lease, Inc. rejection of Blackwells Capital, LLC; (8) Warner Music Group Corp. rejection of Dorothy Carvello; (9) First Trust Dynamic Europe Equity Income Fund rejection of Bulldog Investors, LLP; (10) First Foundation Inc. rejection of Driver Management Company LLC; (11) CPI Card Group Inc. rejection of Steamboat Capital Partners, LLC; (12) AmeriServ Financial, Inc. rejection of Driver Management Company LLC; (13) Primo Water Corporation rejection of Legion Partners Asset Management, LLC; (14) Genworth Financial, Inc. rejection of Seven Corners Capital Management, LLC; (15) Medalist Diversified REIT, Inc. rejection of Robert V. Wallace and TPG Holdings, LLC; (16) HF Foods Group Inc. rejection of Irrevocable Trust for Raymond Ni, Weihui Kwok, Yuanyuan Wu; (17) Lifeway Foods, Inc. rejection of Edward and Ludmila Smolyansky; (18) Noble Roman's, Inc. rejection of BT Brands, Inc.; and (19) AIM ImmunoTech Inc. rejection of Todd Deutsch and Ted D. Kellner.

[2] It is worth noting that about half of the 19 rejections provided no specific reasoning or justifications for why the notice was deficient.

[3] Out of the 19 rejections, we identified three rejections where the dissident was an occasional or a first-time activist: (1) Warner Music Group Corp's rejection of Dorothy Carvello's nomination; (2) Republic First Bancorp, Inc.'s rejection of George E. Norcross, III, Philip A. Norcross, and Gregory B. Braca's nominations; and (3) Lifeway Foods, Inc. rejection of Edward and Ludmila Smolyansky's nominations.

[4] The Rise of the "Occasional Activist" | Morrison Foerster (mofo.com).

[5] See (1) Driver Opportunity Partners I LP v. Max Briggs et al., 2023-0287 (Del. Ch. Mar. 7, 2023) and (2) Primo Water Corporation's rejection of Legion Partners Asset Management, LLC.

[6] See (1) Global Net Lease, Inc. v.BlackwellsCapital LLC et al., 22-CV-10702 (JPO) (S.D.N.Y. Feb. 6, 2023) and (2) The Necessity Retail REIT, Inc. v. Blackwells Capital LLC, et al., 22-CV-10703 (JPO) (S.D.N.Y. Feb. 22, 2023).

[7] Jorgl v. AIM ImmunoTech Inc., C.A. 2022-0669-LWW (Del. Ch. Oct. 28, 2022).

[8] Strategic Investment Opportunities LLC v. Lee Enterprises Inc., C.A. 2021-1089-LWW (Del. Ch. Feb. 14, 2022).

[9] Rosenbaum v. Cytodyn Inc., C.A. 2021-0728-JRS (Del. Ch. Oct. 13, 2021).

[10] Jorgl v. AIM ImmunoTech Inc., C.A. 2022-0669-LWW (Del. Ch. Oct. 28, 2022), at *11.

[11] Id. at *14.

[12] Preparing for the Mandatory Universal Proxy Card and Its Potential Impacts on Shareholder Activism and Proxy Contests | Morrison Foerster (mofo.com).

[13] Lerman v. Diagnostic Data, Inc., 421 A.2d 906, 911 (Del. Ch. 1980).

[14] BlackRock Credit Allocation Income Tr. v. Saba Cap. Master Fund, Ltd., 224 A.3d 964, 980 (Del. 2020).

[15] Hubbard v. Hollywood Park Realty Enters., Inc., 1991 WL 3151 (Del. Ch. Jan. 14, 1991).

[16] Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971).

[17] Id. at 439.

[18] Politan Capital Management LP, 2022 WL 14813970 (Del. Ch.).

[19] See Bay Capital Finance LLC v. Barnes and Noble Education, Inc., 2020 WL 1527784 (Del. Ch. Mar. 30, 2020).

[20] Rosenbaum v. Cytodyn Inc., C.A. 2021-0728-JRS (Del. Ch. Oct. 13, 2021).