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Dissident Uses Disclosure Litigation as an Offensive Tactic in Successful Proxy Contest

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Editor's note: Steven M. Haas is a partner and Charles Brewer is an associate at Hunton & Williams LLP. This post is based on a Hunton & Williams publication by Mr. Haas and Mr. Brewer, and is part of the Delaware law series; links to other posts in the series are available here. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

In a recent proxy contest, a dissident stockholder brought a lawsuit against the company claiming that the company's disclosures about certain incumbent directors were deficient. The court agreed, and enjoined the company's annual stockholders meeting until at least 10 days after the company supplemented its disclosures. As a result of the court's ruling, Institutional Shareholder Services ("ISS") reevaluated its support for the company's nominees and changed its voting recommendation in favor of the dissident, who ultimately prevailed at the stockholders meeting. Although litigation in proxy contests—whether actual or threatened—is not new, this ruling illustrates how dissident stockholders can use offensive disclosure litigation to influence proxy advisors' recommendations and win a stockholder vote.

Background

In February 2017, the founder, former CEO, and largest stockholder of Cypress Semiconductor Corporation (the "Company") announced a proxy contest to replace the Company's executive chairman and lead independent director with two new independent directors. As part of that campaign, the dissident argued that the executive chairman had an irreconcilable conflict of interest due to his affiliation with a private equity firm (the "Affiliated PE Firm"), which allegedly competes with the Company for acquisitions and might be a potential acquirer of the Company. The dissident also targeted the Company's lead independent director, claiming he should be held accountable for the Company's alleged corporate governance failures. The dissident believed the Company had failed to disclose material information that would demonstrate the need to replace the executive chairman and lead independent director. To compel disclosure of that information, the dissident filed a lawsuit in the Court of Chancery.

Despite the Company having filed two supplemental proxy statements in an apparent attempt to moot the lawsuit, the court agreed with several of the dissident's claims.[1] It explained that "[u]nder Delaware law, directors have an affirmative duty to disclose fully and fairly all material information in the board's control when stockholder action is sought." Most importantly, "once directors have traveled down the road of partial disclosure, they must provide the stockholders with an accurate, full, and fair characterization of the disclosed events." In this case, the Company's second supplemental proxy statement disclosed that an investment banker told the Company that the Affiliated PE Firm "might be one of 30" potential acquirers of the Company. In fact, however, the investment banker's presentation identified the Affiliated PE Firm as one of the four most likely acquirers of the Company. The court held that "having traveled down the path of partial disclosure," full and fair disclosure required the Company to disclose the Affiliated PE Firm's apparent status as one of the Company's four most likely acquirers.

The court also ordered additional disclosure with regard to certain other information concerning the executive chairman's activities with the Affiliated PE Firm, but notably did not require the Company to disclose that the executive chairman had recently resigned from the board of another public company due to concerns over his role with the Affiliated PE Firm. The court found that the circumstances surrounding that resignation would not be material to the Company's stockholders.

When the annual stockholders meeting was finally convened, both of the dissident's nominees were elected to the Company's board of directors. Of particular importance, before the court's ruling, ISS had recommended that stockholders vote management's proxy card but withhold support from the Company's lead independent director. After the ruling, however, ISS issued a new recommendation that stockholders vote the dissident's proxy card to replace both the lead independent director and the Company's executive chairman. Moreover, it appears that the executive chairman's resignation from the other public company troubled ISS more than the court. In its updated report, ISS wrote that it was "harder to accept" the board's assertion that the executive chairman's role with the Affiliated PE Firm was an "easily manageable situation that poses no threat" to the Company given the other public company's response to that potential conflict.[2] Overall, ISS believed that the Company's "piecemeal, selective disclosure [was] more consistent with a board intent on sanitizing the information provided to shareholders than with one willing to allow shareholders to make fully-informed decisions" and, as a result, changed its voting recommendation in favor of the dissident.[3]

Conclusion

Although it is not clear whether ISS's change in recommendation affected the outcome of the vote, the dissident's offensive disclosure litigation caused ISS to reevaluate—and ultimately withdraw—its support for the executive chairman. Litigation in proxy contests is not new, but this case shows how a dissident can use offensive litigation strategically to bolster the dissident's arguments and influence stockholders and proxy advisors.

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[1] *See Rodgers v. Bingham*, C.A. No. 2017-0314-AGB (Del. Ch. June 1, 2017) (TRANSCRIPT).

[2] Press Release, CypressFirst, *ISS Changes Recommendation—Now Recommends Cypress Stockholders Vote The Gold Proxy To Elect CypressFirst Nominees Martino And McCranie To Replace Bingham And Benhamou On Cypress Board* (June 6, 2017), available at http://www.prnewswire.com/news-releases/iss-changes-recommendation—-now-recommends-cypress-stockholders-vote-the-gold-proxy-to-elect-cypressfirst-nominees-martino-and-mccranie-to-replace-bingham-and-benhamou-on-cypress-board-300469686.html (quoting ISS report titled "Cypress Semiconductor Corp. (CY): Further Down the Rabbit Hole").

[3] *Id.*