Unbundling Proposals After the Holidays

By Jim Moloney, Cem Surmeli and Erin Cho of Gibson Dunn & Crutcher LLP

On October 27th, the SEC's Division of Corporation Finance issued two new Compliance and Disclosure Interpretations ("CDIs") clarifying what proposals must be "unbundled" in the context of mergers and acquisitions under Rule 14a-4(a)(3) of the Securities Exchange Act of 1934.[4] Whereas previous guidance from the SEC on unbundling set forth somewhat vague standards as to when U.S. public companies are

[4] 17 CFR § 240.14a-4(a)(3).

permitted to combine separate matters into a single proposal for shareholder approval, the most recent CDIs provide more precise standards on when acquirors, target companies, and acquisition vehicles must unbundle proposals related to mergers and acquisitions.[5]

Background

In 1992, the SEC adopted Rule 14a-4(a)(3), along with its companion rule, Rule 14a-4(b)(1) (collectively, the "unbundling rules"). Rule 14a-4(a)(3) addresses the *substance* of proxy solicitations, requiring a form of proxy to "identify clearly and impartially each separate matter intended to be acted upon, whether or not related to or conditioned on the approval of other matters."[6] Whereas Rule 14a-4(b)(1) addresses the specific *form* of proxy solicitations, requiring that shareholders be "afforded an opportunity to specify by boxes a choice between approval or disapproval of, or abstention with respect to each separate matter" submitted for shareholder approval.[7] The SEC initially adopted the unbundling rules to permit shareholders to "communicate to the board of directors their views on each of the matters put to a vote, and not be forced to approve or disapprove a package of items and thus approve matters they might not if presented independently."[8]

Subsequently, in 2004, the SEC issued guidance on the application of Rule 14a-4(a)(3) to certain factual situations in its Manual of Publicly Available Telephone Interpretations (the "2004 Guidance").[9] The 2004 Guidance explains that in the context of mergers, acquisitions, and similar transactions, *material* changes to the surviving company's "charter, bylaw[,] or similar provisions that [would] become applicable as a result of [such] transaction," must be presented as separate proposals if *all* of the following conditions are met:

- "the provisions in question were not previously part of the company's charter or bylaws;
- the provisions in question were not previously part of the charter or bylaws of a public acquiring company; and
- state law, securities exchange listing standards, or the company's charter or by-laws [*sic*] would require shareholder approval of the proposed changes if they were presented on their own."[10]

Nearly a decade later, in 2013, the federal courts sought to further clarify the application of the unbundling rules. In *Greenlight Capital, L.P. v. Apple, Inc.*, the U.S. District Court for the Southern District of New York granted a preliminary injunction against Apple, finding that it was probable the company had improperly bundled four separate matters together, submitting the items as a single proposal.[11] The Court rejected the company's arguments that the proposal complied with the SEC's unbundling rules because: (1) the proposal offered only a single matter for consideration, whether to amend the company's articles of incorporation; (2) the proposal was consistent with common proxy disclosure practice; (3) the proposal was not challenged by the SEC; (4) the proposal grouped only matters that were immaterial in nature; and (5) the proposal did not combine pro-shareholder amendments with those harming shareholder interest.[12]

In its decision, the Court held that although the company's proposal was limited to amending its articles of incorporation, the proposal still presented four separate matters "that, unless ministerial or technical, [would] require separate shareholder votes."[13] Additionally, the Court found that common proxy practice was irrelevant to deciding the case. While other companies had bundled similar proposals in their proxy statements, such similar instances cited by the company were never held to comply with SEC rules—thus they were "non-compliant but unchallenged proxies."[14]

---

[5] It should be noted, however, the SEC Staff's long-standing position has been to allow persons soliciting proxies to cross-condition their proposals, effectively rendering them a package of proposals put to a vote as a group.

[6] *17 CFR § 240.14a-4(a)(3).*

[7] 17 CFR § 240.14a-4(b)(1).

[8] Exchange Act Release No. 34-30849 (June 23, 1992).

[9] *SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Fifth Supplement*, SEC.GOV (Sept. 2004), *available at* https://www.sec.gov/interps/telephone/phonesupplement5.htm.

[10] *Id.*

[11] *See Greenlight Capital, L.P. v. Apple, Inc.*, No. 13 CIV. 900 (RJS) (S.D.N.Y. Feb. 22, 2013), *available at* http://www.nysd.uscourts.gov/cases/show.php?db=special&id=273. The proposal sought the following changes to the company's articles of incorporation: (1) eliminate certain language relating to the term of office of directors to facilitate majority voting for incumbent members of the board; (2) eliminate "blank check" preferred stock; (3) establish a nominal par value for the company's common stock; and (4) eliminate certain obsolete provisions, such as stray references to preferred stock. *See id.* at 2-3.

[12] *Id.* at 7.

[13] *Id.*

[14] *Id.*

Third, the Court ruled that the SEC's failure to object to the bundled proposal when reviewing the company's preliminary proxy statement did not render the proposal accurate or complete. Regardless of the SEC's inaction, the Court opted to exercise its "independent judgment" on whether the proposal complied with the SEC's unbundling rules.[15] Moreover, the Court did not accept the company's argument that each of the bundled matters proposed was immaterial, for three of the four matters were likely material to the company's shareholders.[16] The Court further stated in dicta that even combining multiple immaterial matters along with a single material matter would appear to violate the SEC's unbundling rules.[17] Lastly, the Court was not persuaded by the company's argument that the proposal complied with the unbundling rules because all of the proposed matters were beneficial to shareholders. The Court explained that the application of the unbundling rules does not turn on *management's* view of the benefits of an amendment—rather the *shareholders* hold the exclusive right to decide what is truly beneficial to them.[18]

The *Greenlight Capital* decision essentially put companies on notice that bundling multiple matters into a single proposal to amend provisions in the articles of incorporation—and likely, by extension, other organizational documents—could still potentially violate the unbundling rules if any of the changes were material.

Shortly after the *Greenlight Capital* decision, shareholders of Groupon filed a class action suit against the company, similarly alleging a violation of the unbundling rules and seeking injunctive relief.[19] The shareholders claimed that Groupon had improperly tied together three separate matters by submitting them as a single proposal to amend the company's equity compensation incentive plan.[20] Plaintiffs argued that each of Groupon's proposed changes to its equity compensation incentive plan constituted a separate matter and thus should be voted on separately by shareholders. Although the Groupon class action suit ultimately ended in a settlement,[21] both the *Greenlight Capital* decision and the Groupon case likely drew the SEC's attention to the practice of bundling proposals in proxy materials.

In 2014, in the wake of the *Greenlight Capital* decision and the Groupon settlement, the SEC issued three CDIs (the "2014 CDIs") to further clarify the application of Rule 14a-4(a)(3). In the 2014 CDIs, the SEC reaffirmed the 2004 Guidance and provided specific examples of when bundling would be permissible, stating that:

- matters that are "inextricably intertwined" may be bundled, even if they are material;
- the SEC staff would not ordinarily object to the bundling of any number of immaterial matters with a single material matter; and
- multiple changes to an equity incentive plan could be bundled together if the individual matters would require shareholder approval under state law, the rules of a national securities exchange, or the registrant's organizational documents if presented on a standalone basis.[22]

The SEC's Modified Guidance

Nevertheless, the 2004 Guidance and 2014 CDIs did not dispel all of the ambiguity surrounding the SEC's unbundling rules. In recent years it seems that the practice of bundling proposals has become a matter of increasing concern for the SEC. In this regard we note the number of SEC comments requesting companies to revise their proxy materials in accordance with unbundling rules has dramatically increased. In 2013 and 2014, the SEC issued a total of 71 comment letters referencing unbundling. In contrast, the SEC issued

[15] *Id.* at 7-8.

[16] The Court found the proposal's "blank check" amendment to be "indeed material" and found the director term and par value amendments to be possibly material to Apple's shareholders. *See id.* at 8.

[17] *Id.* at 9.

[18] *Id.*

[19] *See MacCormack v. Groupon, Inc.*, Verified Class Action Compl., Case 1:13-cv-00940-GMS, ECF No. 4 (D. Del. May 24, 2013), *available at* http://securities.stanford.edu/filings-documents/1050/GRPN00_03/2013524_f01c_13CV00940.pdf.

[20] Specifically, the shareholders claimed that Groupon had improperly bundled into one proposal the following amendments to the company's equity compensation incentive plan: (1) an increase in the total number of shares allowed under the plan; (2) an increase of the share limit for each individual recipient under the plan; and (3) ratification of an existing award already made to the company's COO in excess of the plan's then current limit. *Id.* at 10.

[21] *See MacCormack v. Groupon, Inc.*, Stipulation and [Proposed] Order Regarding Dismissal of Action with Prejudice and Setting Briefing Schedule on Plaintiffs' Motion for Fees and Costs, Case 1:13-cv-00940-GMS, ECF No. 18, 2013 WL 5467440 (D. Del. Sept. 16, 2013); *see also* Letter to The Honorable Gregory M. Sleet from Brian E. Farnan Regarding Settlement of *MacCormack et al. v. Groupon, Inc.* (Aug. 16, 2013); *available at* http://www.law.du.edu/documents/corporate-governance/takeovers/maccormick/Letter-Apprising-Court-of-Settlement-MacCormack-v-Groupon-1-13-cv-00940-D-Del-August-16-2013.pdf.

[22] *Exchange Act Rule 14a-4(a)(3): Division of Corporation Finance Compliance and Disclosure Interpretations*, SEC.GOV (Jan. 24, 2014), *available at* https://www.sec.gov/divisions/corpfin/guidance/14a-interps.htm.

only 27 such letters in 2011 and 2012. In addition, a study to be published in a forthcoming issue of the *Southern California Law Review* has observed that improper bundling appears to be pervasive in the U.S. and may cause shareholders to vote for proposals that they otherwise would not support.[23] The authors of the study advocate for the creation of a simple standard on unbundling to replace those that are rather vague and easily abused, such as the "inextricably intertwined" standard articulated in the 2014 CDIs.[24]

Perhaps recognizing a need for clearer guidelines, on October 27, 2015, the SEC released two new CDIs (the "2015 CDIs") to supersede the 2004 Guidance, concerning the unbundling of proposals in the context of mergers and acquisitions. First, the SEC clarified that an amendment to an acquiror's organizational document embedded within a transaction agreement, such as a merger agreement, must be unbundled and submitted separately if it constitutes a *material* amendment that would require shareholder approval under state law, the rules of a national securities exchange, or the acquiror's organizational documents on a standalone basis.[25] While the SEC did not explicitly define "materiality" in the 2015 CDIs, it advised acquirors to "consider whether the [amendment] in question substantively affect[s] shareholder rights." The SEC then provided concrete examples of material amendments, including those regarding:

- Classified or staggered boards;
- Limitations on the removal of directors;
- Supermajority voting provisions;
- Delaying the annual meeting for more than a year;
- Eliminating the ability to act by written consent; and
- Changes in minimum quorum requirements.[26]

Interestingly, the SEC went on to explain in the 2015 CDIs that if an acquiror would be required to unbundle proposals on its form of proxy under the unbundling rules, then the target company in the transaction, if subject to Regulation 14A, would similarly be required to present such matters to its shareholder in separate proposals.[27] This would be the case even if the target company was not required to present such amendments for approval under applicable state law, the listing rules of a securities exchange or the target company's organizational documents.

However, to the extent such approval is not required by applicable laws or rules, the results of a shareholder vote would only be advisory, like the SEC-mandated shareholder votes on "golden parachute" arrangements in connection with certain mergers. Lastly, the SEC clarified that the aforementioned guidance pertaining to acquirors and target companies would apply equally to transactions where the parties form a new entity to act as an acquisition vehicle.[28]

Practical Implications

The 2015 CDIs shed new light on the application of unbundling rules in the M&A context. In contrast to the 2004 Guidance and 2014 CDIs, the new 2015 CDIs outline clearer standards as to when acquirors, target companies, and acquisition vehicles will need to unbundle certain changes resulting from their transactions and present those changes as separate matters. This modified guidance will likely prompt U.S. public companies to carefully consider each specific amendment to the organizational documents of the parties to such transactions, including any acquisition vehicles used in the context of an M&A transaction.

Moreover, it is possible that the 2015 CDIs will likely be seen to have their most prominent impact in the area of inversion transactions. In a typical inversion transaction, a U.S. company merges with a foreign company and is effectively reincorporated into a non-U.S. jurisdiction where it can usually benefit from a lower corporate tax rate.

Under the SEC's new interpretation, any material amendment to an acquiror's organizational documents resulting from a change in jurisdiction of incorporation must be separated out on the form of proxy and submitted separately for shareholder approval.[29] Since transactions seeking to redomicile a company under the laws of another country often involve significant changes to corporate governance and control-related

[23] *See* James D. Cox, et al., *Quieting the Shareholders' Voice: Empirical Evidence of Pervasive Bundling in Proxy Solicitations*, Southern California Law Review (forthcoming); Vanderbilt Law & Economics Working Paper No. 15-10 (Sept. 28, 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2602827.

[24] *Id.* at 56.

[25] *Exchange Act Rule 14a-4(a)(3): Division of Corporation Finance Compliance and Disclosure Interpretations*, SEC.gov (Oct. 27, 2015), *available at* http://www.sec.gov/divisions/corpfin/guidance/exchange-act-rule-14a-4a3.htm.

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *See id.*

provisions of organizational documents, such inversion transactions will likely entail the need for the unbundling of proposals that may have been tied together prior to this new guidance.

Thus, future inversion transactions—such as the planned merger between Pfizer Inc. and Allergan plc—may be more complicated under the 2015 CDIs. They may require that multiple proposals be presented separately for shareholder approval—changes that could potentially have been bundled together and perhaps overlooked under the 2004 Guidance and 2014 CDIs.

However, it is unlikely the 2015 CDIs will introduce any material impediments to inversion transactions (as speculated in the media[30]) that would dissuade U.S. public companies from seeking a lower tax regime in another jurisdiction. This type of dissuasion may instead come from recently proposed legislation designed to reduce the financial attractiveness of such inversion transactions.[31]