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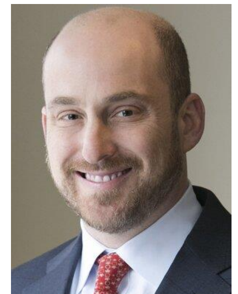
2nd Circ. Case Reinforces Need For Advance Notice Bylaws

By **Michael Blanchard, Justin Chairman and Christopher Wasil** (August 7, 2024, 4:30 PM EDT)

The U.S. Court of Appeals for the Second Circuit recently affirmed the U.S. District Court for the Southern District of New York's denial of a company's request to sterilize the voting securities of stockholders who allegedly violated the disclosure requirements of Section 13(d) of the Securities Exchange Act, as amended. In so holding, it highlighted the importance of advance notice bylaws in protecting against undisclosed coordination among activist shareholders.

Michael Blanchard

In Nano Dimension Ltd. v. Murchinson Ltd., the Second Circuit on May 20 affirmed the dismissal of Nano Dimension's complaint that alleged that certain investors had violated Section 13(d) of the Exchange Act, which was added to the Exchange Act by the Williams Act, by failing to disclose in public filings that they were acting as a group when acquiring more than 5% of Nano Dimension's outstanding stock, holding that the investors had mooted the company's claims by amending their public filings to disclose, not that the investors were a group, but that the investors were alleged to be a group.


Justin Chairman

This case reinforces the limitations of the federal securities laws in general, and the Williams Act in particular, when invoked to provide meaningful protections against allegedly inequitable or even fraudulent conduct in the modern era of shareholder activism, and the importance of adopting effective advance notice bylaws to compensate for those federal securities law limitations.

Section 13(d) of the Exchange Act

Christopher Wasil

Section 13(d) of the Exchange Act was adopted by Congress in 1968 as part of the Williams Act, in an effort to legislate transparency in a then-rapidly growing phenomenon — the hostile takeover. Section 13(d) requires any person who acquires more than 5% of a registered issuer's equity securities to file with the U.S. Securities and Exchange Commission a Schedule 13D disclosing, among other things, whether the person's purpose in acquiring the securities is to take control of the business or make major changes in its corporate policy or governance.[1]

Under Section 13(d), a "person" includes two or more persons acting as a group for the purpose of acquiring or holding securities.[2] Speaking generally about the Williams Act as a whole, its author, former New Jersey Sen. Harrison Williams, stated that disclosure of a person's accumulation of shares was "the only way that corporations, their stockholders, and employees can be adequately

prepared in advance to meet the threat of the takeover specialist."[3]

In enacting Section 13(d), Congress expressed its view that a company and its shareholders are entitled to know when an investor, or group of investors, accumulates or aggregates a significant percentage of a company's securities with the intent to change the direction, governance or control of the company.

While Section 13(d) served its purpose during the hostile takeover boom of the 1970s and 1980s, it has been proven to have little impact in the modern world of activist shareholders.

Most recently, in the Nano Dimension case, the plaintiff company alleged that the defendant investors had violated Section 13(d) by failing to disclose that they acted as a group in acquiring more than 5% of the company's American depository shares. The company sought two forms of relief: (1) an order directing the defendants to file amended Schedule 13Ds disclosing the existence of an alleged group, and (2) an injunction preventing the defendants from acquiring additional American depository shares or voting their existing ones until they filed the amended Schedule 13Ds.

After the complaint was filed, the investors voluntarily filed an amended Schedule 13D, attaching the company's complaint and otherwise disputing its allegations. The Southern District of New York dismissed the action with prejudice, ruling that the amended Schedule 13Ds cured any alleged violation of Section 13(d), and that the company's claims were thus moot.

The Second Circuit affirmed the dismissal for two reasons. First, it rejected the company's argument that the amended Schedule 13Ds were deficient because they merely disclosed — and denied — the company's allegations that the investors were acting as a group, rather than disclosing the alleged "actual truth." Relying on decades-old case law, the court held that Section 13(d) was satisfied because the amended Schedule 13Ds had disclosed a "genuine and vigorous dispute" regarding the investors' group status.

Second, the court rejected the company's request for retroactive relief, holding that "injunctive share sterilization," i.e., negating votes cast by disputed shares, was unavailable because corrective disclosures had been made, and the investors' disputed votes — which were cast at a special meeting held before the filing of the amended Schedule 13Ds — had not resulted in a change in control.

This second holding is particularly significant. Because activist shareholders often seek to gain control of a board of directors incrementally — in part a function of staggered boards — the Nano Dimension decision confirms that Section 13(d) provides little to no meaningful injunctive relief until those efforts culminate in a change in control of the board.

The Nano Dimension case serves as a cautionary reminder that Section 13(d) — and the narrow remedies available for violations thereof — may prove ineffective in mitigating against activist shareholders' alleged undisclosed coordination, potentially to the detriment of the company and its other shareholders.

Advance Notice Bylaws

Demonstrating the limits of Section 13(d), the Nano Dimension decision gives occasion to trumpet the potential effectiveness of newer, more pragmatic corporate governance mechanisms that have developed in the interests of promoting both transparency by activist shareholders and fairness in elections through the imposition of real-world consequences when actors choose not to play by the

rules: advance notice bylaws.

Advance notice bylaws operate as governance mechanisms requiring shareholders to submit formal notice of, and detailed information concerning, director nominees or business that will be discussed at a stockholder meeting, typically including requirements to disclose coordination among those stockholders in support thereof. As discussed below, the advantages of adopting robust advance notice bylaws, particularly in contrast to Section 13(d), are significant.

While advance notice bylaws differ from one company to another, they commonly require stockholders who seek to nominate an individual for election to the board or propose other business at an annual stockholder meeting to notify the company of the stockholder's intentions 90 to 120 days before the one-year anniversary of the prior annual meeting.

When the stockholder seeks to nominate directors for election to the board, the notification typically must include, among other things:

- Specific information about the nominee;
- Material relationships between the nominee and equity owners supporting the nomination, including the nominating stockholder;
- Potential conflicts of interest;
- Coordination among stockholders and other actors in support of the nominee's election — i.e., the existence and composition of any voting agreements between the stockholder and associated persons, and whether the stockholder is part of a group that intends to issue a proxy statement in support of its director nominee or proposed business; and
- Any other information required to be furnished with proxy statements under Section 14(a) of the Exchange Act.

Like the federal securities laws and Section 13(d), these bylaws serve the interests of all shareholders by ensuring that board elections and stockholder meetings are conducted with transparency and in an orderly fashion. As the Delaware Court of Chancery explained in its December 2023 decision in Kellner v. AIM ImmunoTech Inc.:

Modern advance notice bylaws have two primary functions: timing and disclosure. Regarding the former, advance notice bylaws set a deadline by which stockholders must give notice of their intention to nominate director candidates in advance of an annual meeting. In furtherance of the latter, advance notice bylaws may require stockholders to provide information allowing boards of directors to knowledgably make recommendations about nominees and ensuring that stockholders cast well-informed votes.[4]

Critically, however, and in sharp contrast with Section 13(d) and the jurisprudence that has evolved around it, advance notice bylaws have teeth. Namely, advance notice bylaws often permit the company to reject director nominations or other proposals that do not comply with the disclosure requirements. And critically, the Delaware courts have demonstrated a willingness to enforce exclusionary consequences for failure to comply with a company's advance notice bylaws.

For example, in Rosenbaum v. CytoDyn Inc., the Court of Chancery in 2021 upheld a company's rejection of a stockholder's nomination notice for failure to include required information regarding the identity of those supporting the nomination and potential conflicts of interest.

These are particularly significant consequences in the context of activist shareholder campaigns where proponents of competing slates of director nominees invest significant resources into their election campaign for less than a controlling block of director seats. Whereas the federal securities laws have long eschewed any meaningful relief by way of voting sterilization, absent a change in control, advance notice bylaws offer the possibility of meaningful consequences even when the proxy fight's objective is limited to putting directors on the board as mere dissenters.

As the Nano Dimension case demonstrates, the remedy for violating Section 13(d)'s requirements is to require a relatively inexpensive supplemental disclosure of questionable, if not negligible, value — violating an advance notice bylaw, by contrast, can have the costly result of "game over."

Given these high stakes, it is unsurprising that advance notice bylaws have become the subject of several stockholder lawsuits brought in the Court of Chancery, seeking to invalidate, or otherwise enjoin the company from enforcing, their provisions. From these cases, certain legal principles have developed regarding the enforceability of advance notice bylaws.

Generally speaking, advance notice bylaws that legitimately promote disclosure and orderly meetings will be enforced; bylaws that are unreasonably interposed to defeat activist challenges will not be enforced.

In Kellner, for instance, the Delaware Supreme Court recently affirmed, in pertinent part, the rejection of a company's advance notice bylaws that were deemed improperly motivated to defeat an activist campaign. Kellner notwithstanding, where improper motives of interfering with the stockholder franchise are not demonstrated, the majority of cases challenging advance notice bylaws have found them to be valid and enforceable.[5]

Given their functional utility, boards of directors are well advised to consider the benefits of adopting advance notice bylaws as a means of promoting transparency and orderly annual meetings via the threat of bona fide consequences for noncompliance, especially given the shortcomings of Section 13(d). Critically, in the modern era of shareholder activism, where the dissident's objectives often fall short — at least initially — of a change in control, advance notice bylaws hold out the threat of meaningful consequences for noncompliance that otherwise do not exist under the federal securities law regime.

Conclusion

The Second Circuit's decision in Nano Dimension reinforces that, in the context of a dispute with activist shareholders who seek something less than a change in control, Section 13(d) is a square peg for a round hole. Boards of directors concerned with promoting transparency in corporate governance are therefore well advised to review their company's bylaws to ensure that appropriate measures are in place to promote transparency at the corporate ballot box. Failing to do so increases the risks of clandestine coordination and undisclosed agendas by those seeking to affect the governance of the corporation.

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[1] 15 U.S.C. § 78m(d)(1)(C).

[2] 15 U.S.C. § 78m(d)(3).

[3] 111 Cong. Rec. 28, 259 (1965) (remarks of Senator Williams).

[4] Kellner v. AIM ImmunoTech Inc., 307 A.3d 998, 1022 (Del. Ch. 2023), aff'd in part, rev'd in part, 2024 WL 33770273 (July 11, 2024) (internal quotation marks and citations omitted).

[5] See, e.g., BlackRock Credit Allocation Income Tr. v. Saba Cap. Master Fund, Ltd., 224 A.3d 964, 981 (Del. 2020) (upholding exclusion of stockholder's director nominee for failure to comply with deadline set by advance notice bylaw); Strategic Inv. Opportunities LLC v. Lee Enterprises, Inc., No. CV 2021-1089-LWW, 2022 WL 453607, at **16–17 (Del. Ch. Feb. 14, 2022) (upholding a corporation's rejection of a stockholder's nomination notice for failure to comply with advance notice bylaws that were adopted on a clear day, were reasonable "as a matter of policy," and where there was no "manipulative conduct" or bad faith by the board).