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Shareholders Ready for Battle

Second Circuit ruling, along with other changes, portends a wave of proxy fights.

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A RECENT Second Circuit decision grants shareholders access to the corporate ballot to adopt bylaws permitting the shareholders to nominate directors. Together with other developments designed to encourage shareholder democracy, such as majority voting, a new era of activist investing may be only a few months off, in time for the 2007 proxy season.

In *American Federation of State, County and Municipal Employees Pension Plan v. American International Group, Inc.* (*AFSCME v. AIG*), the U.S. Court of Appeals for the Second Circuit considered a shareholder proposal to amend corporate bylaws to require a company to include shareholder-nominated candidates for the board in the company's proxy materials.[1] The company contended that the proposal could be excluded because it "relates to an election for membership on the company's board" within the meaning of Rule 14a-8(i)(8).[2] The Second Circuit disagreed, holding that the proposal could not be excluded.

Rule 14a-8 governs the inclusion of shareholder proposals in a public company's proxy material. The Second Circuit concluded that while the nomination of a specific person to the board might be excludable under Rule 14a-8(i)(8), as relating to an election for directors, a bylaw proposal permitting shareholders to submit such nominations could not.

The consequence of the Second Circuit's ruling is that shareholders can do, in two steps, what Rule 14a-8(i)(8) prohibits them from doing in one. Shareholders may not be able to nominate directors directly, but they can pass a bylaw amendment in one year permitting shareholder nominations and then nominate directors the next, for the company's next annual meeting.

The Securities and Exchange Commission is slated to consider this matter at its meeting on Dec. 13, 2006,[3] which may not give it enough time to implement changes prior to the 2007 proxy season. As a result, issuers and investors must assume that the Second Circuit's decision will control when proxy materials have to be mailed next winter and spring.

The Second Circuit's ruling, coupled with other changes, portends a wave of proxy fights and voting challenges. The SEC is considering permitting electronic delivery of proxy materials, which will make proxy fights cheaper. More companies are requiring an affirmative majority vote to elect directors, and the New York Stock Exchange has proposed changes to its rules to prohibit brokers from voting shares held by their customers in street name in favor of management without an express instruction from the customers. Taken together, these changes will substantially tip the balance from a proxy process largely controlled by management to one where shareholders have a much greater voice.

In *AFSCME v. AIG*, a union proposed a bylaw amendment that would allow shareholders to nominate directors for inclusion in the company's proxy statement. If adopted, the bylaw would permit shareholders to nominate directors, and force the company to cooperate in the nomination and balloting process, without any of the shareholders having to prepare, file and mail proxy material for an insurgent slate of directors, as a full-blown proxy fight might require.

The company sought to exclude the proposed bylaw amendment under Rule 14a-8(i)(8), on the rationale that "the proposal relates to an election for membership on the company's board of directors."[4] Rule 14a-8, the so-called "town meeting" rule, sets forth when a company may and may not exclude shareholder proposals from the company's proxy material. That a proposal relates to an election to the board is one of the traditional grounds to exclude a shareholder proposal, along with others such as matters of illegality (Rule 14a-8(i)(2)), personal grievances (Rule 14a-8(i)(4)) and matters relating to the company's ordinary course of business (Rule 14a-8(i)(7)).

The problem the Second Circuit faced in *AFSCME* is that the phrase "relates to an election" is ambiguous. The shareholder bylaw proposal did not propose a specific nominee for election to the board, but it arguably related to the manner in which future elections would be conducted.

Complicating the analysis is the fact that the SEC has itself changed its interpretation of Rule 14a-8(i)(8). As the Second Circuit pointed out, in 1976, when the rule was last revised, the SEC took the view that what Rule 14a-8(i)(8) barred were specific shareholder nominations for specific board seats. The rationale was that if a non-management shareholder wanted to propose nominees, his suggestions should be accompanied by a proxy statement and all the filings one would expect in a proxy fight, and this requirement should not be evaded through the device of a direct shareholder nomination to the corporate ballot.

The Second Circuit noted that starting in 1990, the SEC's position had evolved, in a series of sometimes contrary and arguably inconsistent no-action letters dealing with various shareholder proposal issues, to the point where the SEC permitted the exclusion not only of specific board nominees, but also proposals concerning the method of nomination of directors, or the conduct of shareholder meetings and election contests. In *AFSCME*, the company and the SEC both took the position that any shareholder proposal "may be excluded under Rule 14a-8(i)(8) if it would… establish a process for shareholders to wage a future election contest."[5]

Measured by this standard, AFSCME's proposal plainly would have been excludable. The union's bylaw amendment proposed that shareholders be permitted to nominate board candidates directly, which certainly is a process for waging future elections. But the Second Circuit concluded that "[t]he election exclusion [applies] to shareholder proposals that relate to a particular election and not to proposals that, like AFSCME's, would establish the procedural rules governing elections generally."[6] Thus, a nomination for a specific director would fall within Rule 14a-8(i)(8) and be excludable, but not a bylaw proposal permitting such nominations.

The Second Circuit's decision threatens to open the corporate ballot box, potentially unleashing a wave of proxy fights, hostile corporate takeovers and contested director elections. The Second Circuit said, "we take no side in the policy debate regarding shareholder access to the corporate ballot," because such policy judgments "are appropriately the province of the SEC, not the judiciary."[7]

Ballot Access

The Second Circuit was arguably being disingenuous in stating that it was leaving ballot

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access policy entirely to the SEC. The Second Circuit's decision plainly affects that policy, putting a proverbial thumb on the scale. And, the SEC's 1976 interpretation was never as clear and complete as the Second Circuit suggested. There is little in legal life which is as difficult and confusing as attempting to reconcile all of the various SEC "no-action" letters determining which shareholder proposals must be included in management's proxy statement each year.

In effect, the Second Circuit in *AFSCME* implemented a form of the SEC's aborted 2003 proxy proposal, which proposed to liberalize shareholder access to the ballot.[8] The essence of the SEC's proposal was to permit larger, longer-term shareholders to nominate directors for inclusion in the company's proxy materials. The Second Circuit's decision arguably is more pro-investor and anti-management because it contains no numerical or temporal limitations.

The Second Circuit handed down *AFSCME* on Sept. 5, 2006. Immediately thereafter, the SEC placed proxy access on its agenda for an open meeting on Oct. 18, 2006.[9] The SEC then adjourned the matter until Dec. 13, 2006.[10] Given the time required for rule-making proposals and associated comment periods, it is unlikely as a practical matter that the SEC can issue a rule in time for the 2007 proxy season. Management must assume that the Second Circuit's decision will control, at least in the short term, and that there will be at least a small flood of bylaw amendment proposals permitting shareholders to nominate directors in the next several months.

Related Developments

The Second Circuit's decision was not issued in isolation. The year 2006 was already an active proxy season, with a number of companies such as Heinz and ImClone forced to replace management-appointed directors with insurgents. There are also a number of other recent developments designed to foster shareholder democracy and activism.

First, many companies have agreed, voluntarily or under pressure, that directors shall be elected only by an affirmative majority of the votes cast, as opposed to a mere plurality. According to Institutional Shareholder Services, the proxy advisory firm, almost 50 companies have voluntarily adopted majority voting, and more than 150 have faced majority voting proposals, which enjoyed an overall 47 percent level of support.

Pfizer and Intel represent the two most common approaches. In 2005, Pfizer adopted a governance policy in which a nominee who receives more "withhold" than "for" votes in an uncontested election must offer his resignation immediately, after which a committee recommends whether the board accepts or rejects the resignation. Within 90 days from certification of the shareholders' vote, the board must act upon the committee's recommendation and disclose its decision in a Form 8-K filing. In 2006, Intel adopted a majority vote requirement through a bylaw amendment. Intel's policy requires an actual vote against a director, instead of merely withheld votes.

Since many investors often withhold votes for some or all nominees as a way to express dissatisfaction, majority voting makes it harder for management and its slate to prevail.

Second, recent proposed amendments to the Model Business Corporation Act, adopted by the Committee on Corporate Laws of the ABA's Business Law Section in June 2006, and amendments to the Delaware General Corporation Law which were enacted effective Aug. 1, 2006, also aim to encourage majority voting. The ABA proposal would add a new Section 10.22 to the Model Act, to permit corporations or their shareholders to adopt bylaws requiring majority voting. It would also prohibit boards from repealing shareholder-adopted bylaws.[11]

An amendment to §141(b) of the Delaware General Corporation Law permits a director to agree in advance to resign if he fails to win a majority of the votes cast, thereby precluding that director from continuing in a holdover capacity until a successor is elected. This amendment facilitates the Pfizer approach. The Delaware amendments also revise §216 to prohibit management from amending or repealing shareholder-adopted bylaws that establish majority voting or otherwise set thresholds for the election of directors.[12]

Third, on Oct. 24, 2006, the New York Stock Exchange proposed its own rule changes to limit so-called "broker 'no' votes." For shares held in "street" name, proxy materials are sent to brokers, who forward them by mail to the beneficial owners with requests for voting instructions. Currently, if no instructions are delivered, the broker is free to vote the shares at the broker's discretion as to all "routine" matters.[13] Normally, uncontested elections are considered "routine," and as a practical matter brokers always vote for management's slate. Even for companies which have adopted majority voting, this provides a good number of votes for director slates proposed by management, and broker "no" votes by themselves can frustrate a "withhold" campaign.

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The NYSE has proposed to the SEC that it be allowed to amend NYSE Rule 452 to ban such "no" votes, eliminating broker discretionary voting on the election of directors.[14] If a broker "no" vote cannot be cast or counted, the arithmetic of corporate voting will be substantially altered, giving more leverage to activist shareholders whose votes, whether cast or withheld, will have more weight. The NYSE has proposed that its rules take effect on Jan. 1, 2008, for the 2008 proxy season.

Fourth, in addition to forcing majority voting, shareholders at some companies have been acting to limit the board's ability to adopt anti-takeover defenses, also by bylaw amendment. In one such case, Harvard Law Professor Lucian Bebchuk proposed a bylaw amendment to limit a board's ability to adopt and extend a poison pill unless the shareholders had ratified the measure. The purpose of the amendment was to enable shareholders to decide whether they wanted long-term takeover defenses permanently in place. The company claimed the proposal places an illegal restriction on the board's fiduciary duty as a matter of Delaware corporate law, and thus could be excluded under Rule 14a-8(i)(2), but the SEC declined to issue a "no action" letter to permit the proposal to be excluded.

To resolve the issue of illegality, Mr. Bebchuk brought a declaratory judgment action in Delaware Chancery Court. In June 2006 that court declined to rule, saying that until the shareholders had voted to adopt the proposal, the matter was not ripe.[15]

According to Institutional Shareholder Services, shareholder proposals were up by more than 20 percent from 2004 to 2006. Topics included not only anti-takeover defenses, but also capping executive pay, linking pay to performance, requiring an independent chair and declassifying the board. These proposals often enjoyed substantial shareholder support. If the SEC declines to issue "no action" letters, and if the *Bebchuk* decision is followed elsewhere, the decision will effectively permit more shareholder proposals to be put to a vote. In this fashion, a seemingly procedural ruling may have a significant practical effect.

Finally, on Dec. 13, 2006, at the same time it is to consider *AFSCME v. AIG*, the SEC will also consider electronic delivery of proxy material.[16] If adopted, this would substantially diminish the cost of a proxy fight.

All of these developments, taken together, portend a new era of shareholder activism. In the short term, many shareholder-proposed bylaw amendments dealing with election of directors can be expected for 2007. Assuming their adoption, by 2008 shareholders will be nominating directors without having to go through the exercise of a full-blown proxy fight. Board-adopted anti-takeover devices may also be disfavored, and, since a favorite tactic of corporate raiders is to threaten to replace the board, more hostile takeover activity may result.

Whether all of this shareholder democracy is a good thing is open to question. As with political elections, corporate voter turnout can be low, and oftentimes activist investors, such as hedge funds, have a short time-horizon. If such investors come to dominate either the bylaw amendment process or majority voting, management and other investors hoping for the success of longer-term strategies may suffer.

1. 462 F.3d 121 (2d Cir. 2006).
2. 17. C.F.R. §240.14a-8.
3. SEC Press Release No. 2006-172, Oct. 11, 2006.
4. 17 C.F.R. §240.14a-8.
5. *AFSCME*, 462 F.3d 121, 128.
6. Id. at 130.
7. Id. at 131.
8. SEC Release No. 34-48626, Oct. 23, 2003.
9. SEC Press Release No. 2006-150, Sept. 7, 2006.
10. SEC Press Release No. 2006-172, Oct. 11, 2006.
11. American Bar Association Committee on Corporate Laws Press Release, June 20, 2006.
12. Delaware General Corporation Law, §216.
13. NYSE Rule 452.
14. NYSE Group Press Release, Oct. 24, 2006.
15. *Lucian A. Bebchuk v. CA, Inc.*, 902 A.2d 737, 738 (Del. Ch., 2006).
16. SEC Press Release No. 2006-172, Oct. 11, 2006.