Proxy Battles Ahead For 2007

by Richard P. Swanson

The 2006 proxy season was one of the most contentious in memory, but now appears to have been only an overture for the proxy battles coming this spring. "Majority vote" and "shareholder access" issues have become a corporate reality. Legal rulings are making it easier for shareholders to change board bylaws. With several major SEC decisions pending, this will be a season like no other.

What can corporate directors, senior management and general counsels expect for the 2007 proxy season? The days when the only issues you had to worry about were activist shareholder proposals on social topics such as divestment or animal testing are long gone. Fueled by oceans of capital sloshing into hedge funds and other institutional investors, shareholder activists today are demanding a greater voice in corporate affairs. This includes the election of directors, senior executive compensation, anti-takeover defenses, and similar matters.

Proxy fights are on the increase, but lesser means of shareholder muscle flexing are also increasingly prevalent. The best way for a corporate board to avoid becoming enmeshed in such controversies is to have vigorous and effective corporate governance processes in place, and to pay attention to shareholder value.

By far the most significant theme for the 2007 proxy season will be the continuation of the 2006 movement toward majority voting for the election of directors. Many more companies are adopting, voluntarily or under pressure, a requirement that all directors be elected by an affirmative majority of the votes cast.

Gone are the days where a plurality would suffice. Some activist shareholders are pressing "withhold" campaigns, where other shareholders are encouraged not to vote for or against one or more directors nominated by management. Others are encouraging outright "no" votes against certain nominees. They are also encouraging corporations to adopt a "majority vote" policy, with shareholder proposals to that effect.

In response, some companies have voluntarily adopted "majority vote" policies. Pfizer and Intel represent the most common approach. Pfizer's policy requires directors to offer their resignation if a director receives more "withhold" than "yes" votes. Intel requires an affirmative vote against a director, not simply withheld votes.

More than 200 companies have adopted some form of majority voting proposal, with most following some form of the Pfizer or Intel models. More than 150 companies in 2006 faced shareholder proposals designed to force majority voting. These proposals received an average support rate of 47 percent. Many more can be expected in 2007.

The Delaware General Corporation Law and the Model Business Corporation Act have both been amended to address the problem involving directors who have been voted down. Previously, these directors may have been entitled to continue serving until a successor was duly appointed or elected if an alternative slate was not proposed.

That a director would suffer a vote of "no confidence" but still be entitled to serve seems to fly in the face of common sense. The fact that the Delaware Legislature and the drafters of the Model Act are both willing to try altering this result proves that majority voting is here to stay.

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Majority voting represents a significant shift in the balance of power away from management and in favor of institutional shareholders.

In addition to majority voting proposals, companies can expect more actual "withhold" vote campaigns this season. These are often pushed by proxy advisory firms, to whom institutional shareholders are often all too willing to delegate their newfound authority.

"Withhold" campaigns directed at one or more directors can be a powerful indicator of shareholder discontent. This is true even when votes are withheld for a company that has not formally adopted majority voting. What company would want to seat a director whom shareholders have refused to endorse?

"Withhold" campaigns can often force a company to engage in its own "get out the vote" counter-solicitation even without the proposal of a formal insurgent slate. Since "withhold" campaigns do not solicit someone's proxy—they ask that a proxy for the election of one or more directors be withheld from the company—the SEC's proxy solicitation rules do not generally apply.

Relatedly, the NYSE in late 2006 adopted rule changes designed to limit so-called "broker 'no' votes." For shares held in "street" name, proxy materials are sent to brokers, who forward them to beneficial holders with requests for voting instructions. Currently, if no instructions are delivered, the broker is free to vote the shares at the broker's discretion on all "routine" matters.

Normally, uncontested elections are considered "routine," and as a practical matter, brokers always vote for management's slate. Even for companies with majority voting, this brokerage block voting provides a good number of votes for director slates proposed by management, and broker "no" votes by themselves can frustrate a "withhold" campaign.

The NYSE has proposed amending its Rule 452 to ban such "no" votes, eliminating broker discretionary voting for directors. If broker "no" votes cannot be cast or counted, the arithmetic of corporate voting will be substantially altered. This gives additional leverage to activist and institutional shareholders whose votes, whether cast or withheld, will have more weight.

While the NYSE's proposed rule changes will not take effect until 2008, even in 2007 companies will want to analyze what their voting would have looked like if broker "no" votes were eliminated. Depending on the count, some companies may want to take steps after the 2007 proxy season to placate investors and deal preemptively with the underlying reasons for shareholder dissatisfaction.

In its *AFSCME v. AIG* decision, the U.S. Court of Appeals has now permitted shareholders to propose bylaws allowing them to directly nominate directors.

Another topic that bears careful monitoring by directors in 2007 is proxy access. The United States Court of Appeals for the Second Circuit in 2006 handed down a decision, in *AFSCME v. AIG,* which permitted shareholders to propose bylaw amendments allowing shareholders to nominate directors directly, without having to go through a formal proxy solicitation process.

Historically, the SEC has not permitted shareholders to nominate directors directly, or to propose bylaw or charter amendments to permit them to do so. The SEC's position was based on its Rule 14a-8, the so-called "town meeting" rule, which set forth when a company may or may not exclude shareholder proposals from the company's proxy materials. That rule permitted companies to exclude proposals that, for example, would be illegal; or which related to personal grievances; or which related to the company's ordinary course of business.

Every year a wave of "no-action" letter requests would be filed with the SEC in the winter and spring by companies seeking to exclude specific shareholder proposals on these grounds. The SEC was asked to declare that it would not commence an enforcement proceeding if the proposals were excluded by the company from its corporate ballot.

In the case of shareholder nominations for directors, the SEC permitted companies to exclude such proposals under Rule 14a-8(i)(8), because "the proposal relates to an election for membership on the company's board of directors," one of the many grounds for exclusion in Rule 14a-8. The nominating process was the exclusive prerogative of management and the board. The only way for shareholders to seek the election of specific directors was to mount a full-blown proxy contest, which was expensive and often resulted in litigation.

In the case of AIG, the American Federation of State, County and Municipal Employees tried to get around the ban on shareholder nominations by proposing a corporate bylaw amendment. This would expressly authorize shareholders to submit board nominees to a shareholder vote through the company's proxy statement.

In effect, AFSCME sought to do in two steps what Rule 14a-8(i)(8) prohibited them from doing in one. Shareholders may not be able to nominate directors directly, but they could pass a bylaw amendment in one year to permit shareholder nominations, and then nominate directors the next year.

AIG contended that AFSCME's proposal also "relates to an election" for directors. While the proposal did not suggest specific nominees for the board, it arguably related to how future elections for directors would be conducted.

Historically, the SEC had supported AIG's interpretation of the Rule. In 2006, however the Second Circuit disagreed, stating "[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." Thus, a nomination for a specific director would be excludable under Rule 14a-8(i)(8)—but not a bylaw proposal permitting such nominations in the future.

The Second Circuit's decision threatens to open access to the corporate ballot, potentially unleashing a new wave of shareholder activism. More immediately, the decision may place some companies in a quandary for 2007. The SEC may still believe that proposals like AFSCME's should be excludable, but the Second Circuit's decision is different.

Whose guidelines should a company follow? What will the other Courts of Appeals say? Does a company incorporated in Delaware, in the Third Circuit, and headquartered in California, in the Ninth Circuit, have to pay attention to *AFSCME v. AIG* because it has shares traded on the NYSE or shareholders in New York where the Second Circuit is situated? At the moment, these are unanswered questions, and they will not be answered before the start of the 2007 proxy season.

The SEC may have dropped the proxy access issue from its December agenda because the topic is so controversial. The proposal drew more than 10,000 comment letters.

The SEC was originally scheduled to take up the issue of proxy access at an open meeting on December 13, 2006, when it had a long list of other items on its agenda, including internal accounting controls. This offered some hope that companies might gain some guidance on how to implement the AFSCME decision prior to the start of the 2007 proxy season. The Commission took the proxy access item off its agenda at the last moment, however, leaving a state of confusion.

The SEC probably removed proxy access from its December agenda because the entire topic is highly controversial. In 2003, the SEC proposed to liberalize shareholder access to the corporate ballot. 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 proposal was so charged that it generated more than 10,000 comment letters. The Second Circuit's decision is arguably even more radical because it imposed no size or temporal restrictions.

Proxy access will continue to be controversial. In December, the Business Roundtable reiterated its opposition to giving shareholders access to the company's ballot. The Second Circuit has put its proverbial thumb on the proxy access scale, potentially altering the balance. While the Second Circuit denied taking a substantive position on that important policy, of course that is precisely what it had done. Further, the SEC has not taken steps to clear up the resulting confusion. In fact, the SEC has taken proxy access off its early 2007 agenda, but it will have to deal with it before 2007 is over.

What the SEC has done, since the Second Circuit's decision, is to create even more confusion. AFSCME submitted to Hewlett-Packard (HP) the same director nomination bylaw proposal it submitted to AIG. HP asked the SEC for a no-action letter, permitting it to exclude the proposal from HP's proxy material without threat of being subject to an enforcement action. On January 22, 2007, the SEC declined to grant "no-action" relief.

What is a company to do in response to the SEC's decision? The only safe course is to include the shareholder proposal in the company's proxy material. If that is the result, the SEC will in effect have forced through proxy access, without ever taking formal action, and the Second Circuit's decision will have nationwide effect.

In light of corporate America's hostility to granting shareholder access to the corporate ballot, all companies may not want to take the "safe" approach; some may simply refuse to accept the proposal and take their chances with the SEC and the courts. Given that the Second Circuit's *AIG v. AFSCME* decision announced a change in the law, and in the SEC's prior policy, it is hard to see the SEC commencing an enforcement case against a company who continues to follow prior SEC policy—but the possibility does exist.

One proxy change, which the SEC did make at its December meeting, was to require electronic delivery and voting of proxies. Since one of the major expenses of a proxy fight is the printing and mailing of proxy solicitations, this change will make proxy fights considerably cheaper, easier—and therefore more prevalent.

If shareholders have access to both your proxy machinery and can electronically deliver solicitations, more activism can be expected.

This change, like the NYSE's "broker 'no' vote" change, will not take effect until the 2008 proxy season. Still, be forewarned—if shareholders have access to the corporation's proxy machinery, and electronically deliver solicitation material besides, more activism can be expected.

In addition to majority voting and proxy access, institutional shareholders can be expected to pursue a number of other corporate ballot proposals during the 2007 proxy season. Many institutional holders will attempt to force limits on traditional takeover defenses. These will include repeal of poison pills; requiring shareholder approval before adoption of new poison pills and other anti-takeover devices; elimination of classified boards; elimination of super-majority voting requirements; and requiring an independent board chair.

Shareholder proposals can also be expected to focus on executive pay, especially with the SEC's adoption of major changes to disclosure on compensation, as well as options backdating controversies. One popular executive pay proposal would require "clawbacks" of bonuses after a restatement.

Increasing pressure on mutual funds to disclose and justify the fiduciary value of their votes will also continue in 2007. Most mutual funds have routinely voted in favor of management. If they voted against the company, it was more often with their feet, by selling their shares. Now, there are many more shareholder proposals, and much more transparency about how mutual funds have cast their ballots. Automatic votes in favor of management can no longer be assured. Mutual funds will more often support activist campaigns in 2007 than they typically have in the past; indeed, they may even lead some campaigns.

What can management and the board do to try to protect themselves against activist investors? The best answer is to focus on high-quality corporate governance processes, and deliver shareholder value.

Data suggests that large shareholder "no" or "withhold" votes correlate to poor corporate governance practices, especially regarding compensation. Companies perceived as offering unduly generous pay packages to their CEOs have earned significant "no" or "withhold" votes, as have companies with questionable options practices, including re-pricing, spring-loading and general excess.

Since 2007 will be the first proxy season after the options backdating controversies came into full bloom, companies with backdating problems can also expect to come under shareholder attack. Conversely, companies who clearly tie CEO pay to corporate performance have generally not been targeted by shareholders for attack.

Companies with separate chairs and vigorous, independent committees are more likely to avoid "no" or "withhold" vote campaigns.

Other corporate governance practices associated with large shareholder "no" or "withhold" votes relate to director independence. Obvious board conflicts, affiliated outsiders serving on board committees, related-party transactions and just about any other kind of director independence issue often result in "no" or "withhold" vote campaigns. Other drivers of "no" or "withhold" vote and other activist campaigns include adoption of anti-takeover devices and even attendance at board meetings. However, companies with an independent chair separate from the CEO, and with vigorous and independent compensation, audit and other key committees, are more likely to remain unscathed.

It is hard to generalize about the impact of shareholder value on activist campaigns, except to say that obviously shareholder satisfaction with the economic terms of their investment is key. How to go about creating shareholder value depends upon your individual enterprise. Directors must constantly ask themselves if they are being sufficiently vigilant concerning the performance of the business, its future and growth, the health of its key financial metrics and the responsiveness of management to all of those challenges.

The best mechanism to avoid shareholder activists is for boards to focus on discharging their fiduciary duties of care and loyalty, and on sound corporate governance practices and processes. There are no "checklists" or single black-and-white rules. What is required is sound judgment and extensive effort.

When contested votes do occur (and they will), a close vote may bring a test of the global proxy voting process, just like the Presidential election in Florida in 2000 produced evidence of flaws in the system of political voting. To date, inspectors of elections have not often had their findings challenged. However, there is room for substantial dispute over who cast what proxy vote.

This could include the system of proxy distribution, shares held widely in "street" name, clearing houses and custodians who hold shares for institutions worldwide and other forms of separation of beneficial from record ownership. The practice of loaning shares for short selling compounds the problem of the separation of ownership and right to vote, as do options, hedges, equity swaps and other derivatives. The possibility of electronic vote fraud cannot be discounted. We did not know until Election Day 2000 how badly the political voting system might be broken, and it may only take one contested corporate contest to demonstrate the same problems with corporate voting.

One thing that senior management might consider, and boards could insist upon, is greater tracking of the specific institutional character of a company's shareholder base. By tracking Forms 13F, required to be filed by institutional investors managing more than $100 million, companies can identify who their shareholders actually are. It is also possible to construct a database of which institutional shareholders typically vote for or against specific shareholder proposals. You can therefore estimate, well in advance, what the likely support for different kinds of shareholder proposals may be, and try to deal with the possibility of such proposals preemptively.

Whether all of this shareholder democracy is a good thing is open to question. Shareholder activism is unquestionably fueled by large pools of capital available to hedge funds, which often have a relentless short-term orientation. The interests of shareholders and management who favor longer-term value-building strategies may suffer as a result. However, there is no question that our legal and institutional structure has driven greater levels of shareholder activism and participation in corporate voting, and the changes are likely permanent. ■

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