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Corporate Governance Update: Shareholders Focused on Stability in Proxy Votes

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The 2008 proxy season, forecasted last winter to be a season of increased activism,[1] now appears to have been the season in which shareholders began to put governance reform proposals back into perspective. As the credit crisis worsened and market turbulence became increasingly worrisome, shareholders appeared less concerned with governance issues and instead focused on corporate stability: directors generally were reelected with 90-plus percent support, backing for governance proposals fell from 2007 levels in many cases, and the number of governance proposals brought to a vote by shareholders decreased as some prominent activist investors dropped planned lawsuits and "vote no" campaigns. The declining number of shareholder proposals brought to a vote can be attributed to improved communication between companies and shareholders as well as, to a lesser extent, a decreased interest in pursuing (or ability to carry out) a governance agenda in the face of economic upheavals. The 2008 proxy season also brought a high number of proxy contests,[2] although most of these contests involved campaigns to elect "short slates"[3] of directors as opposed to proxy contests for control.

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[1] *See, e.g.*, Subodh Mishra, "Contentious Proxy Season Ahead As Debate Flares Over Elections, Pay," RiskMetrics Risk & Governance Blog, Dec. 26, 2007, available at http://blog.riskmetrics.com/2007/12/contentious_proxy_season_ahead.html (last visited Oct. 28, 2008).

[2] According to RiskMetrics, there were 36 announced proxy fights (defined as contests in which a dissident filed a definitive proxy statement), representing a 57 percent increase over the number at the same point in 2007; at this rate, there would be 40 this year as compared to 30 in 2007. *See* RiskMetrics 2008 U.S. Proxy Postseason Review at 28 (updated Oct. 10, 2008).

[3] Only 10 of the 36 proxy fights announced as of August 2008 contemplated a change in control of the board, a percentage comparable to 2007's. The term "short slate" indicates that the number of seats at issue in the proxy contest is less than the number of open seats on the board. *See* Securities and Exchange Commission Division of Corporate Finance, "Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors," July 15, 2003. Under Exchange Act Rule 14a-4(d), a shareholder

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Results of the 2008 Proxy Season

At the start of the 2008 proxy season it was anticipated that executive compensation would continue to be a major issue for governance activism. In fact, though a few directors were targeted because of compensation concerns,[4] overall, the success of compensation-related proposals was mixed. "Say-on-pay" proposals increased in number from 41 in 2007 to 69 in 2008, but support for say-on-pay proposals stayed the same at roughly 42 percent.[5] Notably, at seven financial companies that faced similar proposals last year, support for say-on-pay proposals dropped in 2008.[6] Pay-for-performance proposals decreased in number from 38 in 2007 to 20 in 2008 and on average these proposals received less shareholder support than in 2007.[7] Proposals regarding claw-backs of executive bonuses in the event of restatement, shareholder approval of golden parachutes, and SERP policies also declined in number.[8] Overall, companies responded to the SEC's enhanced disclosure rules regarding executive compensation by disclosing (in increasing numbers) the goals in their executive compensation plans, using plain English in the descriptions of their pay programs, adopting claw-backs of incentive compensation in the event of misstatements, adopting share-ownership requirements, and generally implementing more shareholder-friendly compensation practices.

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seeking minority board representation through a short slate contest may seek proxies that vote for some of the management's nominees to fill out the board slate.

[4] The most notable example was at Washington Mutual (WaMu), where certain directors were targeted by labor-affiliated Change to Win Investment Group (CtW) and AFSCME. AFSCME objected to the decision of the human resources committee (the committee which oversees compensation) decision to protect 2008 executive bonuses from the company's subprime losses. WaMu ended up appointing an independent chairman of the board, adopting majority voting, and naming new chairs to its finance and human resources committees. Separately, CtW blamed the chair of WaMu's finance committee for the company's failure to properly manage its risk; she resigned after receiving 49.9 percent opposition. *See* L. Reed Walton, "RiskMetrics Preliminary U.S. Postseason Report," July 21, 2008.

[5] This includes only proposals that were voted upon. RiskMetrics 2008 U.S. Proxy Postseason Review at 5.

[6] *Id.* at 13. The seven firms are Merrill Lynch, JPMorgan, Wachovia, Citigroup, Morgan Stanley, Capital One, and Wells Fargo.

[7] *Id.* at 5. Pay-for-performance proposals were voted upon at 38 companies in 2007 with an average of 29.5 percent support; in 2008, 20 proposals were voted upon and, of the nine meetings where RiskMetrics had voting results, the average support was 24.9 percent.

[8] Between 2007 and 2008, proposals on claw-backs declined from 9 to 5; proposals on shareholder approval of golden parachutes declined from 11 to 5, and proposals on SERP policies declined from 14 to 3. Data includes only proposals that came to a vote. *Id.* at 4.

Outside of the executive compensation arena, other governance proposals also declined in number. As more companies adopted majority voting,[9] majority voting proposals declined to only 27 voted upon in 2008, as compared to 38 in 2007 and 84 in 2006. The average support was 50 percent in 2008, the same level of support as in 2007.[10] Proposals on independent board chairs declined from 40 in 2007 to 26 in 2008, with support increasing slightly from 25 percent to 30 percent.[11] Proposals to rescind supermajority voting requirements declined from 20 to 12 in 2008, and support dropped from 68 percent to 59 percent.[12]

One of the primary lessons to emerge from the 2008 proxy season is that effective company-shareholder communication does make a difference. This season saw the practical impact of effective and improved communication in reducing the number of proposals that were brought to a vote and the amount of support that proposals received. The United Brotherhood of Carpenters and Joiners withdrew more than half of its pay-for-performance proposals after negotiations with targeted companies.[13] Carpenters and other investors withdrew more than 30 pay-for-performance resolutions after discussions with targeted companies, compared to 17 in 2007.[14] At all six financial firms targeted by labor funds, directors met with shareholder representatives.[15] At ExxonMobil, proponents of an independent chairman position claimed that their proposal would have done better if the company had not engaged in an "'unprecedented outreach effort … to solicit votes from institutional and retail investors.'"[16] At Verizon, a say-on-pay resolution was withdrawn as the company had committed to holding an investor pay vote in 2009.[17]

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[9] According to one study, the number of companies in the S&P 500 that had adopted a majority vote policy, bylaw and/or charter provisions increased from 16 percent in February 2006 to 66 percent in November 2007. *See* Claudia H. Allen, "Study of Majority Voting in Director Elections," Nov. 12, 2007, available at http://blogs.law.harvard.edu/corpgov/2007/11/23/study-of-majority-voting-in-director-elections/#more-312 (last visited Oct. 28, 2008). This number further increased in 2008.

[10] RiskMetrics 2008 U.S. Proxy Postseason Review at 4, 5.

[11] *Id.*

[12] *Id.*

[13] *See* Walton, *supra*.

[14] *Id.*

[15] RiskMetrics 2008 U.S. Proxy Postseason Review at 8.

[16] Walton, *supra*.

[17] *See id*.

Drawing on the experience of 2008, the 2009 proxy season is likely to bring even more examples of successful communication among companies and their shareholders, particularly as all parties concentrate on the important issues of stability, strategic direction, and long-term share value. In this context, boards of directors need to be careful that, in negotiating with shareholder activists, they do not give up too much to obtain withdrawal of a shareholder proposal. Especially in regard to executive compensation, management teams may find themselves with limited flexibility to retain senior executives if the company has unduly limited its options. Similarly, as discussed below, in the context of takeover defenses, companies need to consider carefully how an agreement with a shareholder activist may make them more vulnerable to opportunistic raiders in the future.

For the 2009 proxy season, executive compensation is expected to remain in the spotlight. In addition to say-on-pay proposals, the recent TARP legislation,[18] as well as renewed calls for regulation of executive compensation, is expected to bolster governance activists in the upcoming proxy season. Even absent increased regulation, executive compensation remains a hot button issue.[19] ISS/RiskMetrics withhold vote recommendations against compensation committee members are likely to increase significantly in light of the number of underperforming companies. CD&A disclosure is likely to have increased prominence during the 2009 proxy season as investors look to hold boards of directors accountable for what they perceive to be excessive executive compensation. Compensation committees should use the CD&A as an opportunity to highlight the key aspects of pay-for-performance policies as well as adding in discussions about avoidance of undue risk in the design of bonus and compensation structures.

Takeover Defenses Important

We cannot emphasize enough the importance of takeover defenses in a down market. It appears that shareholders may agree, as support for eliminating takeover defenses appears to be on the wane. Support for proposals to end staggered boards and to eliminate supermajority requirements for bylaw changes and other matters declined compared to last year. Proposals to give shareholders the right to call special meetings also received less support this year than last year, although the number of such proposals more than doubled from 22 in 2007 to 51 in 2008. The number of proposals to eliminate

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[18] Troubled Asset Relief Program under the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343.

[19] *See, e.g.*, Robert Kropp, "Executive Pay Comes Under Fire From Activist Shareholders for Contributing to Financial Crisis," Institutional Shareowner, Oct. 28, 2008.

poison pills also continues to decline; only 4 were voted upon this year as compared to 14 in 2007.[20]

As share prices fall in the troubled market and hostile and unsolicited takeover offers increase,[21] companies are recognizing that takeover defenses play an important role in their strategic plan. In fact, 2008 appears that it will bring a recent high in the number of poison pill adoptions; SharkRepellent reports that as of September, 40 U.S. public companies have adopted their first-ever poison pill, as compared to 42 first-time pill adoptions in 2007. Most of these companies had relatively small market capitalizations: eight belonged in the S&P 1500 Index, but the average market capitalization of the other 32 companies was $438 million.[22] Companies also have started to recognize that activist hedge funds have been using derivative positions to obtain large holdings without disclosing their ownership levels or intentions;[23] as a result, companies have begun to include derivative transactions and the resulting synthetic positions in the language of their poison pill triggers.[24]

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[20] RiskMetrics 2008 U.S. Proxy Postseason Review at 4.

[21] In 2008, through September 16, there were 52 hostile or unsolicited takeover bids as opposed to 42 in 2007 for the same time period; the number is expected to rise in the last quarter of 2008. *See* John Laide, "Rethinking the Role of the Poison Pill?" SharkRepellent.net, Sept. 17, 2008.

[22] *See id.*

[23] CSX Corp. fought a highly publicized battle earlier this year against a pair of activist hedge funds, one of which accumulated large positions in CSX stock by entering into total return swaps and accompanying agreements with the counterparties to obtain and vote the stock in accordance with their wishes. The U.S. district court found that the fund had deliberately violated its disclosure obligations; nonetheless, the court was powerless to prevent it from voting its shares at the annual meeting. *CSX Corp. v. The Children's Investment Fund (UK) LLP, et al.,* 562 F. Supp. 2d 511 (S.D.N.Y. June 11, 2008); aff'd in part, 2008 WL 4222848 (2d Cir. Sept. 15, 2008). Despite the clear finding of wrongdoing, RiskMetrics continued to support the dissident slate in the proxy contest. *See* "RiskMetrics Group-ISS Governance Services (ISS) Recommends CSX Shareholders Elect Four TCI/3G Board Nominees," June 18, 2008 press release, available at http://www.pr-inside.com/riskmetrics-group-iss-governance-services-r649311.htm (last visited Oct. 28, 2008).

[24] In 2008 to date, 16 companies have adopted or amended pill language that includes derivative transactions in calculating an investor's ownership stake for the purposes of triggering the poison pill. *See* Laide, *supra*. We have recommended that companies include broad language in their advance notice bylaws as well, requiring a shareholder proponent to disclose fully all ownership interests, including derivatives, hedged positions and other economic and voting interests. *See* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: Advance Notice Bylaws: Lessons From Recent Cases," NYLJ, May 22, 2008. However, with respect to poison pill triggers, careful consideration needs to be given to including derivative transactions in the beneficial ownership definition in light of the lack of a true reporting mechanism for such derivative positions. While the inclusion of such a trigger would be appropriate in certain circumstances, this is a rapidly developing area and provisions need to be carefully tailored to the specific circumstances that a company faces.

The threat of takeover is very real. It is worth noting that 24 percent of all pill adoptions and renewals in 2008 were undertaken while the company was "in play," as compared to 16 percent in 2007 and only 2 percent in 2001. Moreover, all but seven of the pill-adopting companies have done so without seeking shareholder approval, despite the fact that ISS recommends that its clients withhold votes for directors at companies who adopt or renew a poison pill without requiring shareholder ratification.[25] Though the total number of U.S. companies with poison pills continues to decline, as it has since 2001, the decline is slowing, and fewer companies are proactively terminating their poison pills before their expiration dates.[26] It appears that the ISS voting policy has led a number of companies to decide to let their poison pills expire with boards of directors determining that they can adopt a new poison pill in the face of a threat, as opposed to having a poison pill in place as a deterrent. Boards will be much better off with an effective poison pill that works in the face of a real threat than adopting a watered-down version of a poison pill that will meet the standards generally necessary to achieve shareholder approval.[27]

Interestingly, management proposals to declassify boards increased to 79 proposals in 2008 from 54 in 2007 (there were 72 management proposals in 2006). It may be that management has felt pressure to take this step in order to improve the company's corporate governance ratings, a concern which, as we have noted previously, would be misplaced.[28] If so, one would expect this number to decline significantly in 2009 as companies and shareholders properly shift their focus back to company fundamentals and away from superficial and frequently counterproductive governance metrics. The fact that there was an increase in proxy fights during the 2008 proxy season may also discourage companies from declassifying their boards.

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[25] *See* ISS US Corporate Governance Policy 2008 Updates at 5 ("ISS will recommend to withhold from or vote against the entire board of directors (except for new nominees, who should be considered on a case-by-case basis) if: The board adopts or renews a poison pill without shareholder approval, does not commit to putting it to shareholder vote within 12 months of adoption (or in the case of a newly public company, does not commit to put the pill to a shareholder vote within 12 months following the IPO), or reneges on a commitment to put the pill to a vote, and has not yet received a withhold recommendation for this issue.")

[26] *See* Laide, *supra*.

[27] ISS's U.S. proxy voting guidelines state that "[i]deally, [rights] plans should embody the following attributes: 20 percent or higher flip-in or flip-over; two-to-three-year sunset provision; no dead-hand, slow-hand, no hand or similar features; and shareholder redemption feature – if the board refuses to redeem the pill 90 days after an offer is announced, ten percent of the shares may call a special meeting or seek a written consent to vote on rescinding the pill." ISS U.S. Proxy Voting Manual, Chapter 6.

[28] David A. Katz and Laura A. McIntosh, "Corporate Governance Update: Do Ratings Fail To Make the Grade?" NYLJ, Jan. 24, 2008.

Conclusion

The lesson of the recent proxy season is that in troubled financial times, the fundamentals are more important than ever. Companies and their shareholders must take the long-term view toward increasing share value through strong leadership and sound strategic direction. Good communication and effective takeover defenses are crucial to ensuring that executives, directors and shareholders are on the same page with respect to a company's future. In a down market particularly, takeover defenses are extremely important: they enable a company to determine its own destiny and to protect shareholder value in the event of a negotiated sale or through continued independence. Moreover, effective takeover defenses empower a board of directors to negotiate from a position of strength when faced with an opportunistic takeover bid, thus promoting the long-term best interest of the corporation and its shareholders.