

Are Routine Director Elections A Thing Of The Past?

by Kevin H. Douglas

For decades, the re-election of management's slate of board members has been a routine certainty at most corporations. Now, the onset of proxy access and the loss of broker discretionary voting promise to permanently alter the landscape of public company board elections. How should your company prepare for this new era of proxy politics?

We are in the midst of a dynamic and rapidly evolving time for shareholder activism. Now, developments like proxy access change and the elimination of broker voting in uncontested director elections will have a profound impact on U.S. public companies and their boards. These trends will further increase the influence of activist shareholders and proxy advisory services such as RiskMetrics. Moreover, pending legislation in the U.S. House and Senate would, among other things, require the Securities and Exchange Commission to adopt proxy access rules and mandate majority voting for listed companies.

Activists and institutions have shown increased willingness to challenge management. 2009 witnessed a continued increase in "withhold" or "against" votes received by directors.

These legislative and regulatory developments occur in the midst of a surge in shareholder activism and the influence of proxy advisory firms. Activist and institutional shareholders have shown an increasing willingness to challenge management, and 2009 witnessed a continued increase in the percentage of "withhold" or "against" votes received by directors of U.S. public companies.

According to RiskMetrics data, the average level of dissent through September 2009 against directors of U.S. public companies was 7.2 percent, up from 5.1

percent in 2008. In addition, proxy fight activity in 2009 remained high, both in terms of the number of proxy fights that ultimately went to a vote and those that settled earlier. Hostile and unsolicited takeover activity was also at historically high levels in 2009 and is expected to remain robust during 2010.

In June 2009, the SEC proposed rules that would mandate proxy access for U.S. public companies (the SEC commissioners voted 3-2 in favor of the rules, with the three Democratic commissioners voting in favor and the two Republican commissioners dissenting). Following the release of these proposed rules, it was initially anticipated that final rules would be adopted in time for the 2010 proxy season. The SEC received over 500 comment letters in response to the proposals, some supportive of the SEC's approach and others arguing that mandatory proxy access represented an unwise and premature intrusion into matters that should be left to state corporate law.

In October 2009, the SEC announced that it would defer adoption of any final rules until early 2010. This will delay implementation of any final rules until after the 2010 proxy season for companies with a fiscal year ending at calendar year end.

The SEC's proposed Rule 14a-11 would require public companies to include shareholder director nominations in their proxy statements. The nominating shareholder or shareholder group would need to meet certain threshold criteria and followed specific procedures, including:

- Ownership threshold.* Nominating shareholders would be required to meet a specified threshold ownership percentage, which would vary by company

Kevin H. Douglas is a member of the law firm *Bass Berry & Sims PLC* in Nashville, TN. His focus is on corporate and securities law, mergers and acquisitions, securities offerings, and representation of public and private companies. {www.bassberry.com}

Board Election Campaigning Ten Tips For Management

It is generally *not* advisable to adopt proxy access bylaw amendments in advance of the adoption of final SEC rules.

Management should consider how to react in 2010 to various scenarios based on the final proxy access rules.

Take a wait-and-see approach before taking any steps to respond to the legislation currently pending in Congress.

Attempt to gauge the anticipated impact that the elimination of broker discretionary voting will have on director election results.

Companies with a significant retail vote that have *not* switched to a majority voting system should be cautious about doing so in the current environment.

Companies should work with their proxy solicitor to consider what solicitation efforts could stem the anticipated decline in the retail vote.

Closely monitor your shareholder base and maintain a dialogue with significant shareholders (subject to Regulation FD).

Gain an understanding of the voting practices and hot-button issues of significant shareholders.

Management should be mindful of the influence of proxy advisory services, such as RiskMetrics, while not allowing the influence of such services to unduly interfere with decisions that are in the best interests of the company.

Remain vigilant and monitor your vulnerabilities and defensive profile on an ongoing basis in this active hostile takeover climate.

size. This starts at one percent for large accelerated filers (generally, companies with a public float of at least \$700 million), three percent for accelerated filers (a public float between \$75 million and \$700 million) and five percent for non-accelerated filers (public float below \$75 million). Nominating shareholders would be required to have held this stock for at least one year, and could aggregate their holdings to meet this threshold.

Number of nominees. Shareholders, in the aggregate, could nominate no more than 25 percent of a company's board of directors or one candidate, whichever is greater. Shareholder director nominees elected to serve on a classified board under this rule would count toward this limit during the term of their service.

A "first submitted" clause in SEC proxy access proposals has faced heavy criticism for driving a potential race to submit nominees.

"First submitted" rule. If more shareholder board nominations were submitted than could be included in a company's proxy statement, a company would include nominee(s) from the first shareholder or shareholders who provided timely notice under the rules. This "first submitted" clause has been the source of heavy criticism during the comment process because of perceived unfairness and potential for a race to submit nominees.

If the proxy access rules are adopted, it is expected that an alternative framework (such as giving larger shareholders priority if multiple shareholders make nominations) may be used for determining which shareholders will have priority in nominating directors.

Certification. A nominating shareholder would be required to certify, among other things, that they have no current intent to effect a change of control of the company and that its nominee(s) would be independent under the independence standards of the company's stock exchange. The nominee would not, however, be required to be independent from the nominating shareholder.

If a valid nomination were made by a shareholder under Rule 14a-11, the company would be required to include disclosure regarding the nominee(s) in its proxy statement, and include the name(s) on the proxy card. The proposed rules would not interfere with the ability of shareholders to nominate directors within the scope of the current proxy regime (that is, a traditional proxy contest through the use of the shareholder's own proxy statement).

The proposed rules also include an amendment to Rule 14a-8 that would allow stockholders to include shareholder proxy proposals aimed at altering the company's bylaws to permit proxy access. Under current SEC rules, companies are not required to include such proposals in their proxy statements.

Reaction to the SEC proposals has been mixed. Shareholder activists, proxy advisory services and some institutional shareholders express general support for mandatory proxy access. Business constituencies (and their law firms) and some institutional shareholders oppose mandatory proxy access.

Opponents generally accept the proposed modification of Rule 14a-8 to allow shareholders to include access bylaw proposals in company proxy materials. They argue that companies should have the flexibility under state law, through board or shareholder-approved bylaw amendments, to determine whether proxy access is appropriate for their company and what rules will govern such access.

Supporters of proxy access rules argue that mandatory access is necessary to promote shareholder participation and democracy.

In contrast, supporters of proxy access argue that the cost barriers to shareholder participation in the director election process under the current regime are too high. In their view, mandatory proxy access is a necessary reform that would promote shareholder participation and democracy.

Since the proposed rules were adopted, the SEC has signaled a willingness to allow companies greater flexibility to implement proxy access than was provided in the proposed rules. In a speech in October 2009, Commissioner Elisse Walter (one of the three SEC commissioners who voted in favor of the proposals) suggested that she may be open to allowing companies to adopt bylaw amendments providing for more restrictive proxy access rules than those mandated by SEC rules. However, she was skeptical of permitting companies to take such action without shareholder approval.

Opponents of the SEC's proposed proxy changes

argue that the SEC's mandatory approach undermines ongoing state law developments, which would nurture proxy access on a company-by-company basis. Under pressure to adapt to shifting sentiment on proxy access, Delaware adopted legislation (effective in August 2009) clarifying that Delaware corporations may adopt bylaw provisions setting proxy access rules and conditions regarding shareholder board nominees.

The American Bar Association is currently considering similar amendments to the Model Business Corporations Act (which has been adopted in whole or in part in over 30 states). These amendments would sanction the adoption of bylaws setting forth terms and conditions related to proxy access.

The elimination of broker discretionary voting is a game changer. Companies with a sizable retail shareholder base will likely see a big drop in votes for management's board slate unless countervailing measures are taken.

The impact of these state developments will depend upon what is included in final SEC rules. As described above, the proposed SEC rules would preclude companies from adopting more restrictive proxy access rules than those set forth by the SEC. This would limit the relevance of the Delaware legislation and Model Business Corporations Act proposed amendments. To date, few Delaware or other public corporations have adopted bylaws providing for proxy access, in part because of the uncertainty surrounding what will be included in final SEC rules.

Another "game changer" has been the elimination of broker discretionary voting. In July 2009, the SEC, by a 3-2 vote of its commissioners, approved an amendment to New York Stock Exchange Rule 452 eliminating broker discretionary voting for uncontested elections of directors. The amendment designates an uncontested director election as a "non-routine" matter, removing brokers' ability to vote without specific instructions from beneficial owners. The amended Rule 452 applies to all shareholder meetings held after January 1, 2010.

Because this applies specifically to securities brokers, virtually all of whom are governed by New York Stock Exchange rules, this amendment will affect all companies listed on a national stock exchange, including those listed on NASDAQ. Previously, brokers could cast discretionary votes in uncontested elections of directors if a beneficial owner had not given the broker voting instructions at least 10 days before a scheduled meeting.

Historically, most shares held by retail holders (who tend to vote in favor of management) are not voted unless prompted by active solicitation efforts. Therefore, companies with a sizeable retail shareholder base (more often, mid-cap or small-cap companies) are likely to see a significant drop in the percentage of shares voted in uncontested director elections (and those cast in favor of management's slate of directors) unless countervailing measures are taken.

There is also federal legislation pending in the U.S. House and Senate that would, if adopted, markedly change the current landscape with respect to shareholder activism. In the Senate, Senator Charles Schumer (D-NY) introduced the Shareholder Bill of Rights Act of 2009 in May 2009. Among other things, this would require exchange-listed companies to abolish classified boards, implement majority voting, and have an independent chairman. The act would allow the SEC to exempt certain companies from its provisions based on the market capitalization of the company or other criteria the SEC deems appropriate.

Similar legislation (the Shareholder Empowerment Act of 2009) was introduced in the U.S. House in June 2009, although the House legislation would not abolish classified boards or provide the SEC with authority to exempt companies. Both the Shareholder Bill of Rights Act and Shareholder Empowerment Act also would require the SEC to adopt proxy access rules.

More recently, in November 2009, Senator Christopher Dodd (D-CT) introduced a financial reform bill (the Restoring American Financial Stability Act of 2009) which included similar provisions to the Shareholder Bill of Rights Act and Shareholder

Empowerment Act. Senator Dodd's bill would mandate majority voting, prohibit classified boards unless approved by shareholders, require companies to provide disclosure if a company's CEO serves as chairman, and require the SEC to adopt proxy access rules.

Certain aspects of this legislation represent a sweeping federalization of corporate law, which have drawn opposition from a variety of sources (including defenders of Delaware's traditional role as a primary source of corporate law). However, in the current pro-regulatory environment, the outcome of this legislation remains uncertain, and difficult to predict. In addition, in the case of Senator Dodd's bill, the fact that these corporate governance provisions are only a small part of a comprehensive financial reform bill rather than stand-alone legislation increases the challenge of forecasting the ultimate outcome of these corporate governance provisions.

Any endeavor to amend bylaws in advance of final SEC rules runs a significant risk that company time and expense will be wasted.

In the current environment, boards should take action to deal with these regulatory and legislative developments:

□ *Proxy access.* Because of the uncertainty regarding final SEC rules, it is *not* advisable for most companies to adopt proxy access-related amendments to their bylaws prior to the adoption of final rules. Any endeavor to amend bylaws in advance of final SEC rules runs a significant risk that company time and expense will be wasted. The bylaw amendments might need to be materially revised again based on what is included in final rules. Companies should, however, consider how to respond to what is included in the final rules, including the following possible scenarios:

Scenario 1: The SEC adopts Rule 14a-11 substantially as proposed, with proxy access mandatory for all U.S. public companies, and offering little or no flexibility to opt out of the proxy access regime. In this event, boards will likely need to amend their

bylaws to take into account the SEC's proxy access rules, but will have little or no flexibility to refine access for their company.

Scenario 2: In what may be the likeliest scenario, the SEC adopts final rules which implement proxy access, but provides a mechanism by which companies (perhaps solely through shareholder action) can opt out of the proxy access regime, or provide for more restrictive proxy access rules and procedures than those set by the SEC. In this event, boards should consider the advisability of opting out of the SEC regime or modifying the terms of proxy access applicable to their companies, and whether there is sufficient shareholder support for such action.

Scenario 3: The SEC final rules do not prescribe proxy access. However, they amend Rule 14a-8 to require inclusion of shareholder proposals in company proxy materials that would amend bylaws to provide for proxy access. In this scenario, boards will want to consider amending their company's bylaws to preempt shareholders from proposing their own bylaw amendments that may be less company-friendly than those approved by the board.

Legislative initiatives: Wait and see. Adoption of the federal legislation described above would have far-reaching effects on U.S. public companies. Still, these companies should generally wait to see what, if any, of this legislation is adopted before taking any action. Much uncertainty remains on what will be included in any final legislation, and whether any of this legislation will become law.

Companies that have not already switched to a director majority-vote policy should be cautious about doing so now.

Assess the impact of eliminating broker discretionary voting. The elimination of broker voting in uncontested elections will be a significant issue for companies with a sizeable percentage of retail votes. Companies are advised to gauge the estimated impact this change will have on their director election results through examining past results and reviewing their shareholder base.

While companies with plurality voting may be more vulnerable to withhold vote campaigns following this change, companies with majority (or plurality-plus-resignation) voting will be particularly susceptible. The anticipated reduction in the size of the retail vote will increase the difficulty of incumbent directors receiving a majority vote.

For this reason, companies with a significant retail vote that have not switched to a majority (or plurality-plus-resignation) voting regime should be cautious about doing so in the current environment. Moreover, companies that are vulnerable to this change should work with their proxy solicitor to consider what solicitation efforts (such as phone solicitations or multiple mailings to retail holders) may help stem the anticipated decline in the retail vote.

Monitor your shareholder base and maintain dialogue with significant shareholders. Companies should closely monitor the composition of their shareholder base. In addition, engage in dialogue with significant shareholders and proactively communicate management's vision regarding the company. When engaging in this dialogue, be mindful of the restrictions under Regulation FD with respect to communicating material non-public information.

Understand the voting practices of significant shareholders. Work to gain an understanding of the voting practices of significant shareholders, including their historical voting practices, issues of particular concern, and whether (and how closely) they follow the recommendations of a particular proxy advisory firm.

Influence of proxy advisory services. Proxy advisory firms, particularly RiskMetrics, are extremely influential in the current environment, and have a far-reaching impact on the public company landscape. Nevertheless, companies should not assume that a negative recommendation by RiskMetrics against a management-supported proposal must inevitably doom that proposal.

The 2009 Target/Pershing proxy fight shows that management can overcome an adverse RiskMetrics recommendation by communicating management's position in an early and consistent manner, and by effectively using multiple media outlets.

Hostile takeover activity will likely be high in 2010. Boards and management should be vigilant in watching for vulnerabilities.

□ *Remain vigilant for hostile takeover attempts.* A confluence of factors is expected to result in a continued high level of hostile and unsolicited takeover activity during 2010. These include improved financing conditions compared to the height of the credit crisis, weakened takeover defenses as the result of pressure from shareholder activists and institutional shareholders, depressed market capitalizations of U.S. companies (resulting in companies being perceived as undervalued by potential hostile acquirers), and the increased acceptability of hostile bids as a legitimate tactic. Managers, in consultation with outside advisors, should remain vigilant

and monitor their company's vulnerabilities and defensive profile on an ongoing basis.

Although it remains unclear what regulatory and legislative changes will be enacted in 2010, it is likely that the era of routine director elections is over for many U.S. companies. In one form or another, it is apparent that proxy access will become part of the landscape for U.S. corporations, a development that is likely to increase the number facing contested director elections, including multi-shareholder contests.

In addition, the SEC's elimination of broker discretionary voting is likely to diminish the influence of retail voters and further empower institutional and activist shareholders and proxy advisory firms. In this environment, boards should closely monitor the regulatory and legislative landscape and confront the challenges posed by shareholder activism. ■

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