Shareholders at the gate

Boards bow to activist pressure as proxy season looms

MarketWatch
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March 3, 2006

SAN FRANCISCO -- Settlement fever is breaking out in board rooms and corner offices across America as this year's proxy season draws near.

Determined to avoid embarrassing and potentially damaging votes at annual shareholder meetings, more companies are bowing to pressure from activist investors. Corporate governance experts say the trend highlights a major shift in the balance of power toward shareholders and away from corporate executives and directors.

Household-name companies from Intel Corp. to 3M Co. to fast-food chains like McDonald's Corp. and Wendy's International Inc. are just a few of the corporate titans that have shaken things up this year in response to increasingly assertive investors.

Activist hedge funds like William Ackman's Pershing Square Capital and powerful financiers such as Nelson Pelz and Carl Icahn are cutting deals to get all or some of what they want from companies. Other types of activists are also succeeding, including pension giants like CalPers.

"Companies that used to disdain what shareholders had to say are realizing that if they continue to do that, investors will become active through the ballot," said Robert McCormick, vice president of proxy research and operations at Glass Lewis & Co., an independent firm that advises large institutions on how to vote at annual meetings.

And the growth in settlements could shrink the volume of votes being held.

In each of the past three years, more than 1,000 shareholder proposals were put forward at the start of proxy season, but this year will likely fall well short of that, according to Patrick McGurn of Institutional Shareholder Services, another proxy advisory firm.

That's not because investors have stopped making demands. It's because more companies are cutting deals to kill off ballot proposals deemed unacceptable before they go before the broader body of voting shareholders, McGurn said.

Over the next few weeks, companies will mail out proxy statements to shareholders to give them time to read about issues that will be up for a vote at the annual meeting.

"If companies are going to get irksome and potentially damaging proposals off their proxy, they need to strike deals with dissident shareholders pretty quickly," McGurn said. "If they miss the deadline and the issues get on the proxy, the damage is already done."

Settlements like this have been rising in the past couple of years and 2006 will see deal-cutting at unprecedented levels, McGurn added.

‘Terrifying’

On Thursday, Wendy’s announced a new strategy and changes to its board structure to head off a possible proxy fight at its annual meeting later this year. As part of the deal, Wendy’s will add three board members nominated by Pelz’s Trian Fund Management. See full story.

McDonald’s, the world’s biggest restaurant chain, fended off Pershing Square’s Ackman in January by agreeing to step up plans to turn some of its international stores over to franchisees. The company also said it would accelerate a stock-buyback plan by purchasing $1 billion worth of shares during the first quarter. See full story.

“Hedge funds are terrifying to corporate management,” Nell Minow, editor at proxy firm The Corporate Library, said. “The fact that McDonald’s negotiated with Ackman even though he was unable to get much shareholder support, shows you how skittish management is.”

Last month, Time Warner Inc. avoided a proxy battle with Icahn by agreeing to increase its share buyback program to $20 billion from $5 billion, cut costs and bring in new directors. See full story.

That pact was struck even though Icahn failed to get much support for his broader plan to break Time Warner into four companies.

Similarly, billionaire activist Kirk Kerkorian got aide Jerry York onto the board of General Motors Corp. in February without having to file any official shareholder proposals, Glass Lewis’s McCormick noted. See full story.

Pension clout

Other types of activist investors are winning more concessions from companies this year too.

The American Federation of State, County and Municipal Employees, which claims its member organizations own at least 3% of the largest U.S. companies, has been filing shareholder proposals and pressuring firms to change for years.

But 2006 is already turning into a banner year for the group, which counts pension giants CalPers and the New York State Common Retirement Fund among its members, according to Director of Pension and Benefit Policy Richard Ferlauto. “Settlements with companies are up significantly on last year,” he said.

Jet engine and elevator maker United Technologies Corp. agreed to adopt majority voting standards for its board of directors after an AFSCME shareholder proposal earlier this year, Ferlauto said.

3M and bank Wachovia Corp. agreed to have annual elections for all their directors, rather than staggering votes over multiple years.

Raytheon Co. agreed to a stronger cap on severance payments for executives in response to an AFSCME proposal this year, Ferlauto added.

AFSCME withdrew all these proposals after the companies agreed to play along, Ferlauto said.

“It’s been a great proxy season so far,” he said. “We’re also in discussions with three or four other companies about improving executive pay.”

Board accountability

One of the biggest concessions companies are making this year is a move to majority voting for directors.

After Intel, the world’s largest semiconductor maker, introduced such a plan in January, lots of other companies followed.

By late February, 16% of companies in the Standard & Poor’s 500 index had adopted some form of majority voting for directors, according to a study by Chicago law firm Neal, Gerber & Eisenberg LLP. Most of these plans have been introduced within the past year, the firm added.

Minow, who has spent two decades focusing on corporate governance, calls the trend “the single most important shareholder initiative of my lifetime.”

In the past, directors were elected based on a “plurality,” meaning they only had to get one shareholder vote to be on the board.

“Your mother could vote for you and you would get re-elected,” explains ISS’s McGurn.

That meant that when shareholders voted in favor of other issues and changes at annual meetings, directors could ignore the decisions.

Now, with majority voting, directors will be much more worried about being voted off the board in future proxy seasons if they disregard shareholder votes on other issues.

“This relatively recent phenomenon signals a fundamental shift in the balance of power between stockholders and corporate boards of directors which could play out in the 2006 proxy season and beyond,” said Claudia Allen, a partner at Neal, Gerber & Eisenberg, who oversaw the study.

Next target: executive pay

Armed with the extra leverage that majority voting will give them, many activist shareholders will probably push companies on other issues in future proxy seasons, knowing that directors have to listen to them more.

One of the main targets will probably be executive compensation. Institutional investors in a recent ISS survey cited that issue as their number-one concern over the next three years.

At least one activist group is already planning an assault on executive pay in future proxy seasons.

“We’re linking all shareholder activism to executive compensation and targeting companies that have egregious pay practices that we’d like to reform,” AFSCME’s Ferlauto said.

“If majority voting becomes standard, companies won’t want to have directors vulnerable to losing their jobs if they haven’t been responsive to shareholders,” he added.

Fighting back

Still, some companies will continue to fight back against activist shareholders, often by proposing solutions that don’t go as far as investors want.

The AFL-CIO’s Office of Investment filed a proposal this year aimed at reducing the controversial retirement package of Pfizer Inc. Chief Executive Henry McKinnell.

The present value of McKinnell’s pension is between $71.5 million and $83 million, according to a study by Harvard Law School Professor Lucian Bebchuk that the AFL-CIO cited in its proposal. That exceeds the $67 million that McKinnell has earned while working at Pfizer.

The AFL-CIO is demanding that Pfizer seek shareholder approval for any senior executive retirement package that exceeds what they earned while working for the company.

Pfizer introduced a “watered-down” version of the AFL-CIO’s proposal in January and argued that the issue should be dropped before a vote at the annual meeting, claims Daniel Pedrotty, an attorney at the union organization.

After taking the dispute to the Securities and Exchange Commission, the agency ruled against Pfizer, allowing the vote to proceed, Pedrotty added.

Pfizer spokesman Bryant Haskins declined to comment beyond what the company said in its proxy statement.

Pfizer argued in the filing that compensation agreements that have been fully disclosed shouldn’t be rescinded and doing so in McKinnell’s case may break Federal law. The company also noted that the executive’s pension package was earned during a period when Pfizer outperformed its rivals.

Other companies are going even further to reject shareholder activists.

Sovereign Bancorp has been battling with two of its biggest shareholders -- Relational Investors and Franklin Mutual Advisers -- over a plan to sell a chunk of itself to Spain’s Banco Santander.

Sovereign has gone as far as persuading legislators in its home state of Pennsylvania to pass a law that makes it easier for the bank to block attempts by Relational and Franklin to oust executives and directors.

Unintended consequences

Indeed, some experts warned of unintended consequences if too much power swings from executives and boards to shareholders.

“This may not always work out the way everyone would like,” Allen of law firm Neal, Gerber & Eisenberg said, citing some potential consequences of majority voting for boards.

A majority vote against a CEO's re-election to the board could, in theory, inadvertently trigger a big severance payout, she said.

Such votes could also trigger change-of-control clauses that affect companies' credit agreements with lenders.

If a company unexpectedly loses its independent directors in a shareholder vote, it could automatically violate listing standards, she warned.