Activist Investors Get More Respect

Boards are listening, and shareholder proposals are making headway

BusinessWeek
Jena McGregor
June 11, 2007

When Harvard Law School professor Lucian A. Bebchuk filed a shareholder proposal with Home Depot Inc. (HD) on Dec. 12, his expectations were low. It asked the company to require that two-thirds of its board approve executive compensation plans--a novel concept that hadn't been tested in prior proxy seasons. Bebchuk also sought to have the change written into Home Depot's corporate bylaws, something most companies are loath to do. "I did not expect [they] would be willing to make changes in the bylaws in response to a proposal by someone who really is an individual shareholder," says Bebchuk, who owns just 90 shares.

But Home Depot surprised him. The company, smarting from the thrashing it took for its controversial annual meeting last year and fresh from the ouster of excessive executive-pay poster-boy Robert L. Nardelli, held its first discussions with Bebchuk the same day new Chief Executive Officer Francis S. Blake took over in January. After a couple of conversations and e-mails with Bebchuk and a discussion with outside counsel, the home-improvement retailer adopted the proposal outright. In exchange, Bebchuk agreed to withdraw the resolution.

It may come as little surprise that Home Depot is offering up a few olive branches. Its 2006 annual meeting, a 37-minute session that was attended by none of the company's directors and where shareholders were not allowed to ask Nardelli questions, was one of the low points in the history of corporate governance. But Home Depot's agreement with Bebchuk also demonstrates the new mood of this year's proxy season. While plenty of investor resolutions are still prompting heated contention, shareholders and boards are negotiating away a near-record number of proposals ahead of meetings. So far this year, 22% of corporate governance proposals have been withdrawn by investors, up from 15% at this point last year. New resolutions that make it to the ballot are winning soaring vote tallies. And activists and directors are having more dialogue than ever.

Such trends have led some proxy watchers to call this season a breakthrough year. "I think there's no doubt this will be the most successful proxy season ever," says Patrick McGurn, executive vice-president and special counsel of proxy adviser Institutional Shareholder Services. "The wave of constructive engagements between boards, management, and the proponents of these proposals has led to a boatload of reforms being adopted."

'MERCY'

While CEOs used to be able to shrug off shareholder activists, now they do so at their own risk. It is yet another sign that in the battle between owners and managers--the most fundamental governance struggle in business--investors are gaining power. "Shareholders have a right to say we don't think this is working," says Harvey J. Goldschmid, a professor at Columbia University

School of Law and a former commissioner at the Securities & Exchange Commission, "and [corporations] just haven't been able to hold back the pressures."

The most widely adopted reform this year has been majority voting. First introduced three years ago, the new rule means directors must be elected by more than 50% of shareholder votes rather than just by a plurality. For meetings so far this year, 57% of the proposals on this topic have been withdrawn after shareholders either negotiated deals or companies agreed to adopt the new rule--up from 25% this time last year. "On the issue of majority voting, boards are just rolling over and saying, 'Mercy,'" says Jennifer O'Dell, assistant director for corporate affairs at the Laborer's International Union of North America.

But majority voting isn't the only issue that has quickly gained steam. "Say on pay" proposals, which would give shareholders the right to make a nonbinding vote on executive compensation packages, were filed at 66 companies this year after first finding their way to the ballot in 2006. Although only three companies, Blockbuster Inc. (BBI), Verizon Communications Inc. (VZ), and Motorola Inc. (MOT) have seen the idea win more than 50% of votes, many votes came flirted with a majority. The average vote on the issue so far this year is 43%, up from 40% last year. Stephen M. Davis, president of independent governance consulting firm Davis Global Advisors Inc., says he has never seen a new issue be embraced so quickly. "It's taken off like a rocket," he says. "To have the first year of a widespread campaign producing votes with 30% to 50% outcomes is unheard of."

In one sign of how willing companies are to engage with investors on this new issue, insurer Aflac Inc. (AFL) became the first company to commit to giving shareholders a nonbinding vote on executive pay after social investor Boston Common Asset Management filed a proposal in November. Aflac Chairman and CEO Daniel P. Amos placed calls to his largest institutional investors and longtime individual shareholders before adopting the idea.

Some shareholder activists have bargained for other outcomes. The American Federation of State, County & Municipal Employees (AFSCME) filed a say-on-pay proposal at drugmaker Bristol-Myers Squibb Co. (BMY), but withdrew it following the company's agreement to join AFSCME's new working group on the topic. The latest sign of an armistice: The working group is bringing together more than 20 other corporations, unions, and investors to explore how giving shareholders the chance to vote on pay might be adopted by U.S. companies. (The vote is standard practice in Britain, Australia, and the Netherlands.)

Such hand-holding would have been unthinkable not long ago. Until Enron and Sarbanes-Oxley forced boards to tighten their grip on management, even shareholder proposals that won respectable votes were often ignored by companies. A 30% vote for a resolution would have been enormous. Labor unions didn't have the sophisticated relationships they now have with boards. "A lot of people who made proposals were kind of fringe players," says Goldschmid.

Until recently, says Richard Ferlauto, the director of pension and benefits policy for AFSCME, discussing proposals with the board rather than senior staffers would have been unimaginable. "Five years ago we would have never gotten in a corporate boardroom," Ferlauto says. "Now we're regularly meeting with corporate directors about substantive issues."

SWING VOTES

Activists such as Ferlauto could have even more leverage next year on director elections. That's because the SEC is expected to vote on a New York Stock Exchange (NYX) proposal to bar brokers from voting on behalf of investors who don't submit their votes on uncontested director elections within 10 days of the annual meeting. According to Broadridge Financial, these "broker votes" average about 20% of votes cast at U.S. corporate meetings. Because they usually side with management, removing them from the tally at companies where a majority vote rule is in place could swing the vote in shareholders' favor. Some of the narrow margins now being seen in director elections, such as the 56% majority received by one board member at CVS Caremark Corp. (CVS), might not hold.

The change in the rule on broker votes is just one reason proxy watchers believe the 2008 season could be turbulent. Outsize executive pay revealed in this year's new compensation disclosures could prompt more resolutions on pay levels next year. In addition, there may finally be a ruling this summer on whether to give large shareholders "proxy access," or the right to nominate their own candidates to the company's slate of directors. "Next year is being set up as the proverbial 'perfect storm' season," says ISS's McGurn. "But I think boards have become good at sensing changes in the weather, and so it could be that before then boards will take steps to try and diffuse any potential controversies."