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SHAREHOLDER ACCESS

A "Common Sense" Approach to Shareholder Access: A Modest Proposal for an Access Bylaw

By John C. Wilcox

For more than five years issuers and investors have been debating whether shareholders should have the right to nominate board candidates for inclusion in the company's proxy. This so-called "access" right is rooted in a longstanding concern that, short of a proxy contest, procedures for nominating directors at US companies are not sufficiently accessible to shareholders. Since corporate legitimacy rests squarely on the integrity of the director selection process and a meaningful shareholder vote, the validity of an access right is difficult to challenge.

The Securities and Exchange Commission attempted to find a workable approach to access in 2003 with proposed Rule 14a-11, a fine-tuned but complicated concept that failed to attract support from either investors or corporations. Efforts to define and implement an access right later shifted to the shareholder proposal process, further polarizing the views of companies and investors. Following a controversial interpretation of Rule 14a-8(i)(8) by

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the SEC earlier this year, the fight over access has been suspended for at least the duration of the current proxy season. The issue will probably not be taken up again until after the Presidential election.

This intermission may turn out to be a blessing in disguise, provided that companies and investors are willing to use the time to cool down, reevaluate the pros and cons and seek constructive ways to develop a moderate and flexible form of access acceptable to both sides. Based on past experience with Rule 14a-11 and subsequent SEC initiatives, federal rule-making is probably not the most effective way to establish an access right. Following the path that led to acceptance of the majority vote standard in director elections, access might be more easily derived through a careful analysis of its implications under state corporate law.

Start with a Dispassionate Analysis of Shareholder Access

A dispassionate analysis of access should start with an understanding of the preferences and limited goals of long-term institutional investors. Their agenda does not include election of special-interest directors, back-door proxy contests or advocacy for causes unrelated to performance enhancement and long-term value creation. They envision access as a new engagement tool—a new step on the ladder of shareholder rights—that is more aggressive than precatory shareholder proposals or votes against directors, but less aggressive than a short-slate election, control contest or takeover bid.

Access, as conceived for use by long-term investors, would function as a potent but narrowly defined accountability mechanism applicable primarily to companies with serious strategic, governance or performance problems. The need for such a tool has become urgent in recent years, as shareholders have confronted deep-rooted governance and performance problems at US companies. Abusive compensation practices, ill-conceived mergers and acquisitions, improper accounting, neglect of succession planning, self-dealing, conflicts of interest and ethical lapses have occurred at many companies. The three remedies currently available—divesting stock, waging a proxy contest, or developing an engagement program—have in many cases failed to provide efficient or timely means for institutional investors to respond to these crises.

Selling or divesting shares of troubled companies is usually not an option for large, indexed long-term investors whose performance is measured against market benchmarks. From an economic viewpoint, divestment can be particularly inappropriate when a portfolio company's stock price is depressed by the very problems the investor seeks to remedy.

Proxy contests present numerous obstacles and potential conflicts for institutional investors. Because of the economic and fiduciary constraints involved in managing large portfolios, institutions may not be in a position to take on the organizational demands, costs, exposure, time commitment, legal complications, disclosure requirements, liability concerns and other risks and obligations associated with waging a proxy fight. For economic reasons investment managers are often rationally reluctant to further disrupt an already troubled company with a discounted stock value. The free-rider problem is often perceived as an obstacle. In addition, institutions may not support the goals of short-term activists willing to initiate proxy contests.

Active engagement with the boards and managers of targeted companies has always been the remedy of choice for long-term investors. Engagement has proven extremely effective as a means to promote shareholder rights, improve governance practices, increase director accountability and promote policy changes. But the slow pace of traditional engagement campaigns makes them less useful to "jump-start" companies that are languishing or ignoring their problems.

A Proposed Shareholder Access Bylaw

Conceptually, an access right would provide shareholders with a stepped-up form of engagement—a new accountability mechanism for dealing with seriously troubled companies. By bringing shareholder concerns directly into the boardroom, access would inject a note of heightened urgency and promote the kind of "director-centric" solution needed to deal effectively with serious governance or performance crises.

Access will work in practice, however, only if the right is properly structured so as to encourage change without opening the door to abuses or excessive disruption.

The following proposed access bylaw suggests how such a balance might be achieved:

Shareholder Nomination of Directors

In connection with the election of directors at the company's annual meeting, a shareholder-nominated candidate for the board of directors shall be included in the company's proxy statement and on the company's proxy card, provided that all the following conditions are satisfied:

1. The shareholder or group of shareholders sponsoring the candidate (the sponsor) shall (i) own at least [three percent] of the company's outstanding shares of common stock, (ii) shall have maintained this level of ownership for no less than [two years] and (iii) shall agree to maintain this level of ownership through the annual meeting. In a case where two or more sponsors nominate different candidates, the sponsor representing the largest ownership position will prevail.

2. The sponsor shall submit the nomination and supporting documents no later than [six months] prior to the anniversary of the previous year's annual meeting, or in accordance with the company's advance notice requirements.

3. No more than [one] shareholder-nominated candidate may be included on the company proxy in a given year.

4. No shareholder-nominated candidate may be submitted if a shareholder-nominated candidate was elected to the board in the previous year and is currently a member of the company's board of directors. [No shareholder-nominated candidate may be submitted if the number of shareholder-nominated members of the board of directors would exceed the following limits: 25 percent of the board when the size of the board is 10 or fewer directors or 20 percent when the size of the board is greater than 10 directors.]

5. The shareholder-nominated candidate shall be "independent" with respect to both the company and the sponsor, using the definition of independence set forth in the company's corporate governance policies and in the listing standards of the New York Stock Exchange.

6. The sponsor shall submit a statement of no more than 500 words in support of the shareholder-nominated candidate for inclusion in the company's proxy statement. The 500-word limit shall not apply to biographical information and other disclosures about the candidate and the sponsor required by this provision or by regulation.

7. The sponsor shall file the disclosures and provide background information about the sponsor as required under SEC Rule 14a-12, and shall affirmatively state and make appropriate SEC filings indicating that it has no intention to seek control of the company.

8. The sponsor shall not seek reimbursement from the company for any solicitation expenses. [However, if the company engages in a solicitation in opposition to the shareholder-nominated candidate, the sponsor will be entitled to reimbursement for its expenses incurred in conducting a comparable solicitation.]

9. If the company currently requires a majority vote to elect directors, the majority vote requirement

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will be maintained if (i) the size of the board is expanded to accommodate the shareholder-nominated candidate, or (ii) the company agrees to replace one of the company's nominees with the shareholder-nominated candidate, thereby resulting in an election where the number of candidates for election does not exceed the number of seats to be filled. A plurality vote will be required if the inclusion of the shareholder-nominated candidate results in more candidates for election than seats to be filled.

10. The sponsor shall agree to meet with the nominating committee of the company's board of directors for the purpose of discussing the reasons for the submission of the shareholder-nominated candidate, the candidate's qualifications and independence, and any other matters relating to the nomination and election of directors. Such a meeting shall be convened by the company no later than 60 days following the sponsor's submission of the nomination.

Analysis of the Proposed Shareholder Access Bylaw

Like SEC Rule 14a-11, this proposed access bylaw is detailed and prescriptive. By its terms, access would be subject to the following limitations:

- The access right would be available only to substantial long-term shareholders;
- The right would be exercisable only at the annual meeting;
- The number of shareholder-nominated candidates and board members would be limited;
- Special-interest, non-independent candidates would not be eligible;
- Notice and full disclosure would be required;
- Reimbursement of costs would be prohibited or subject to limits;
- Dialogue between the board and the sponsor would be mandated.

From the viewpoint of long-term investors, paragraph 10 is arguably the most important provision of the proposed bylaw. The requirement for a meeting between the sponsor and the board's nominating committee is intended to promote the traditional engagement goals of dialogue, negotiation and board-sponsored change. This requirement reflects sensitivity to the importance of board collegiality. Mandated dialogue could lead to a variety of negotiated outcomes. Paragraph 9 suggests a few: selecting a compromise candidate acceptable to both sides; adding a new board seat rather than sacrificing an incumbent director; seating a well-qualified candidate as a replacement for an underperforming director. All these outcomes fall short of the feared "mini proxy contest" that many critics assume would result from access.

The independence requirement in paragraph 5 is intended to eliminate special-interest directors. It reinforces the important principle that all directors, including those sponsored by shareholders, should represent the interests of the corporation as a whole.

The access right's level of aggressiveness could be varied by modifying or eliminating some of the proposed terms, particularly those set forth in brackets in paragraphs 1, 2, 3, 4 and 8. Some shareholder activists have suggested an approach (not taken in this proposed bylaw) in which access would be accompanied by the right to call a special meeting.

Unlike Rule 14a-11, this proposed access bylaw would not be activated by pre-established "triggers." Access should not be viewed as a form of punishment inflicted only when companies have transgressed in specific ways. Shareholders should have broad discretion to decide if and when access is the appropriate method to deal with an underperforming or poorly governed company.

Other questions—many of them central to the ongoing debate over shareholder rights and governance reform—would have to be analyzed in the context of access:

- Could the sponsor's qualifying ownership position be hedged or based on derivatives that might give rise to "empty voting"?
- What would be the impact, if any, on a shareholder-nominated "access" candidate if a third party unaffiliated with the sponsor were to wage an independent election contest?

- Under state law, could shareholders create or modify an access right by unilaterally submitting a binding bylaw amendment without board approval?

- If the federal courts or the SEC were to reopen Rule 14a-8 to access proposals, what would be the impact of multiple access models?

The goal of access is not to enable a proxy contest at every annual meeting. With the exception of a small coterie of committed activists, institutional investors generally agree that conflict resolution is preferable to conflict. They would rather find constructive solutions to the problems of underperforming portfolio companies than pick fights with boards and managers. From their perspective, access should be viewed as an extension of their active engagement programs. It would provide the means to send a strong message of concern and bring a new voice into the boardroom, thereby encouraging internal changes that would improve the behavior, policies and performance of troubled companies.