The 2009 Proxy Season and the Year of Investor Anger

Financial crisis expected to unleash tsunami of shareholder proposals.

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As the mortgage crisis has turned into a full-blown financial crisis, and with the broader economy faltering as consumers clamp down on their spending, investors are taking it on the chin. Since its peak in 2007, the S&P 500 has been down by as much as 46 percent, while the Dow has dropped as much as 45 percent from its 2007 high. Shareholders of companies that were white-knuckle rescued, like Bear Stearns, American International Group, and Wachovia, have suffered far greater losses. And the pain has been absolute for shareholders of the high-profile implosions, like Lehman Brothers and Washington Mutual.

Many attribute the financial crisis principally, if not exclusively, to the compensation practices of Wall Street. They argue that by focusing on short-term trading profits, Wall Street's bonus system encouraged bankers to trade in and bet on increasingly exotic and risky securities that in the end proved catastrophic for their firms and for the global economy. To make matters worse, as companies making these bets fell one by one, the public was bombarded with headlines about jaw-dropping sums of money being owed to the departing heads of the fallen companies. Investors were outraged that the CEOs they believed responsible for running their companies into the ground were walking away, not only unscathed, but enriched. So while executive compensation has sparked investor push-back over the past several years, the financial crisis, in the eyes of investors, the financial press and politicians, has had the effect of pouring gasoline onto a fire.

But it is not just executive compensation. Boards of financial institutions have also come in for a large share of the blame for abysmally failing in their oversight function and allowing, if not actively encouraging, the search for excess profit that is popularly believed to be the crux of the financial catastrophe now besetting the world.

After the pop of the telecom bubble at roughly the same time as Enron and other corporate scandals surfaced at the beginning of the decade, there was a surge in shareholder proposals related to corporate governance, from 88 in 2000 to 427 in 2003. The financial crisis of 2008 will almost certainly lead to a similar tsunami of shareholder proposals in the 2009 proxy season.

Executive Compensation

In the coming proxy season, companies will be faced by an onslaught of executive compensation proposals like Say on Pay, linking pay to company performance, limiting or eliminating golden parachutes, and clawing back "excess" pay. Say on Pay has been the darling of the corporate governance protest movement for the most recent two proxy seasons. It essentially gives shareholders the opportunity to voice their approval or rejection of the company's pay practices. It shot to prominence in 2007 when 39 proposals went to a shareholder vote, after just four proposals were voted in 2006. The trend continued in 2008, as a total of 67 Say on Pay proposals were voted.

While the number of Say on Pay proposals taken to shareholders has increased dramatically, the average support for the proposals remained flat at around 40 percent. A recent survey of the largest institutional investors published by the Center on Executive Compensation found that about half of the survey group were strongly opposed to Say on Pay, with only a quarter in favor. This opposition among many institutional investors may help explain why Say on Pay has not become the stunning success many expected. It is probable, if not inevitable, that the seething anger over "excessive" executive pay among retail investors, Congress and the press will spill over to institutional investors, which dominate the ownership rolls of public companies, causing many to reconsider their stance on Say on Pay.

Another critical arena for Say on Pay will be Congress. The leaders of the House of Representatives reportedly tacked a Say on Pay provision onto one of their versions of the financial rescue bill, although it did not make its way into the final law. House Financial Services Committee Chairman, Representative Barney Frank, D-Mass., has made clear that Congress intends to focus closely on executive compensation next year. Last year, the House passed Say on Pay legislation, and Senator Barack Obama, D-Ill., introduced a similar measure in the Senate. As a result many observers predict that Say on Pay will become federal law in 2009.

The bigger question is whether shareholders pounce on other, potentially more punitive, executive compensation proposals. For instance:

• Dramatically limiting or prohibiting severance payments to departing executives;

• Clawing back pay, not only after a restatement of a company's financials reveals that performance awards had been mistakenly made, but in other, more subjective situations, such as where performance makes clear that the previous payments were not deserved or were too rich;

• Eliminating compensation practices characterized as encouraging "excessive" risk-taking; and/or

• Placing absolute caps on executive pay.

Proxy Access: Lite and Heavy

Corporate governance activists will also probably turn to various adaptations of "proxy access" to discipline boards and achieve a higher level of director "accountability." "Proxy access" refers to shareholder proposals that attempt to circumvent the current proxy system that limits nominees for director in the company's proxy statement to board-approved candidates. Under the existing regime, if shareholders wish to nominate their own candidates for director in opposition to the board's, they must spend the time and money to prepare their own proxy statement and proxy card. Under a proxy access system, shareholders would be able to include an opposition slate of directors in the company's proxy materials.

After a long-running debate, the Securities and Exchange Commission in 2007 declined for a second time to amend its rules to permit proxy access proposals to be included in a company's

proxy statement. At that time, the SEC announced it would revisit the issue in 2008 in an attempt to bring the controversy to a consensus-driven solution. However, the financial crisis apparently overtook SEC reconsideration of the issue, and it seems clear that no new SEC proposal will be forthcoming for the 2009 proxy season. As a result, corporate governance activists will turn their attention to two alternative ways to reduce the burdens of shareholders who wish to nominate directors, which could be dubbed "proxy access lite" and "proxy access heavy."

Proxy access lite refers to a shareholder adopted bylaw that would require a board to reimburse the reasonable costs of shareholders who seek to elect directors. While not giving shareholders full access to the company's proxy card, a reimbursement bylaw would partly achieve the result of proxy access by mitigating the costs of a proxy contest to shareholders.

A version of such a bylaw (which was limited to nominations for less than a majority of a board where at least one nominee was elected) was challenged during the 2008 proxy season as impermissibly preventing a board from exercising its fiduciary judgment regarding the expenditure of company funds. The Delaware Supreme Court in CA Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. July 17, 2008), ruled that proposals regarding shareholder reimbursement and proposals involving director elections generally are proper subjects for action by shareholders but must be drafted to permit the board to exercise its fiduciary duties in deciding whether reimbursement is appropriate under the circumstances. This ruling paves the way for a wave of shareholder reimbursement proposals in the upcoming proxy season.

If shareholder reimbursement is proxy access lite, a recent proposal by Harvard law professor Lucian Bebchuk can best be described as proxy access "heavy." During the 2008 proxy season, Mr. Bebchuk submitted a proposed bylaw at Electronic Arts that would require the company to include any shareholder proposal in the company's proxy materials so long as the proposal was permissible as a matter of state law and met certain minimal criteria, even if the same proposal, absent the bylaw, would otherwise be excludable under the SEC's Rule 14a-8.

If a company adopted Mr. Bebchuk's proposed bylaw, the consequence would be that the company's shareholders would be able to utilize it to campaign for adoption of proxy access without regard to the provisions of Rule 14a-8. Mr. Bebchuk's proposal is currently being litigated in the Southern District of New York. Bebchuk v. Electronic Arts Inc., No. CV 08-3716 (SDNY filed April 18, 2008). If Mr. Bebchuk wins, companies are likely to see a good deal more of this type of proposal, which effectively end-runs the entire Rule 14a-8 process and creates an open door for any and all shareholder proposals, including proxy access proposals.

While proxy access sits at the SEC and shareholders turn to proxy access lite and potentially proxy access heavy, Congress may decide to settle this longstanding debate through legislation. Proxy access is often mentioned, along with executive compensation, as one target of a heavily Democratic Congress in 2009.

Right to Call Special Meeting

There were more proposals to give shareholders the right to call a special meeting in 2008 than there were in the previous four years combined. The vast majority of the proposals in 2008 were submitted by a handful of individual activists. While many of these proposals called for permitting shareholders with ownership of at least 10 percent of the company's stock to call a special meeting of shareholders for any reason, some did not specifically name any ownership requirement, and instead called for the company to amend its governing documents so that "there is no restriction on the shareholder right to call a special meeting, compared to the standard allowed by applicable law on calling a special meeting." The proposals with a specified ownership threshold tended to attract much higher support in 2008 than the "no-trigger" proposals.

Activists of all stripes support the rights of shareholders to call special meetings. Armed with this right, shareholders pose a constant threat to wage a proxy contest against the company. Without this right, shareholders typically have only a 30-day window under advance notice bylaws to launch a proxy fight. The question for 2009 is whether more corporate governance activists and hedge funds will push for the right to call a special meeting. Moreover, while the "no-trigger" proposals did not attract widespread support in 2008, we should not be surprised to see more proposals with triggers as low as 10 percent or even 5 percent ownership for calling special meetings.

Traditional Proxy Contests

Traditional proxy contests have been on the rise in the past three years and have become more successful.

• There were an average of 61 proxy fights from 2001 to 2005 with a 45 percent average success rate.

• In 2006, there were 100 proxy fights with a 57 percent success rate.

• In 2007, there were 107 proxy fights with a 50 percent success rate.

• So far in 2008, there have been 53 proxy fights with a 71 percent success rate.

Moreover, these statistics understate both the prevalence of proxy contests and their success rate because many contests are settled at an early stage favorably to the dissidents before they ripen into a formal contest.

So-called "event driven" hedge funds have been particularly active and successful in actual and threatened proxy contests due to:

• Their discretion over large pools of capital, which allows for rapid accumulations of stock positions.

• The declining returns from financial engineering, which have reverted to the mean.

• "Wolf Pack" coordination among hedge funds and other activists, including leveraging of voting power, information sharing and cooperation, which often results in rapid and dramatic changes in a company's shareholder profile.

• Ready access to and use of derivatives that, among other things, permit undisclosed accumulations of economic interests that can readily be converted into traditional share ownership.

• "Record date capture" and other forms of so-called "empty voting."

• The impact of "Good Governance" campaigns on takeover defenses, such as poison pills and classified boards.

These factors have helped hedge funds to succeed in two-thirds of their proxy fights from 2001 to 2006. In normal times, these successes and the need by hedge funds for exit strategies could be expected to drive the 2009 proxy season to even higher numbers of contests. Nowadays, however, hedge funds are under tremendous pressure as investors are pulling out and margin calls are increasing. The question is whether this pressure will cause hedge funds to pull in their horns in 2009, or whether depressed stock prices will spur them to even more activism.

Advance Notice Bylaws

In light of the increased activism expected during the 2009 proxy season from emboldened corporate governance activists, angry investors and alpha-seeking hedge funds, companies should prepare for the storm by reviewing and, if appropriate, updating their advance notice bylaws to reflect the current state-of-the-art.

Two cases decided in early 2008 by the Delaware Chancery Court1 have highlighted the need for companies to get the basics right in their advance notice provisions.

• First, expressly state that the provisions providing for advance notice of nominations or proposals do not apply to proposals submitted pursuant to Rule 14a-8.

• Second, tie the deadlines for shareholders to submit nominations and proposals to a period of time in advance of the anniversary of the preceding year's shareholder meeting, and not the mailing of the prior year's annual meeting proxy statement, which is a Rule 14a-8 concept.

• Third, minimum deadlines for nominations or submission of proposals of more than 90 days before the annual meeting anniversary may be viewed with suspicion by the Delaware courts, so companies with minimum notice periods longer than 90 days may want to consider shortening them.

• Finally, advance notice bylaws should be carefully reviewed to avoid drafting ambiguities that the Delaware courts will interpret against restricting the exercise of the shareholder franchise.

Another closely followed case in the Southern District of New York2 highlights the need for companies to consider requiring that shareholders who seek to nominate directors or present other proposals at a shareholders' meeting provide the company with more information than that required by conventional advance notice provisions. Among other things, companies should consider:

• Requiring expanded disclosures about any person making proposals or nominations, including (i) any derivative, swap or other transaction that results in a disparity between the person's economic and voting interests, positive and negative; (ii) identity and background information on the persons making the investment and other decisions for the proponent of the shareholder proposal or nomination; (iii) historical information concerning the proposing person's relationships to the company and other significant shareholders; (iv) any other information relating to the proposing persons that would be required to be disclosed in a proxy statement; and (v) information concerning all parties who are acting in concert with the proposing person, including those who are acting with conscious parallelism, which would be defined similarly to the antitrust concept of conscious parallelism.

• Requiring expanded disclosure about director nominees, including certain financial and other relationships between the proponent and its nominees.

• Requiring an update of all of this information from the proposing person shortly before the record date and within 10 days preceding the meeting.

None of these and other recommended updates to advance notice bylaws are a magic bullet against hedge fund driven proxy contests, but they would at least provide the company and its shareholders with more information about the insurgent's motives and methods, and therefore help them to evaluate and respond to the proposal.

Final Comment

For many public companies, angry shareholders will be just one of the many challenges 2009 will bring, and it may be tempting for many companies to capitulate against the crescendo of outrage. Executive suites and boardrooms should remember, however, that the products of this outrage, whether in the form of non-binding shareholder proposals, binding bylaw provisions or sweeping new federal laws, like the burdens of Sarbanes-Oxley, will be with them well after the current crisis abates.

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Endnotes:

1. JANA Master Fund, Ltd. v. CNET Networks Inc., 2008 WL 660556 (Del. Ch. March 13, 2008), aff'd 947 A.2d 1120 (Del. S. Ct. May 13, 2008) and Levitt Corp. v. Office Depot, 2008 WL 1724244 (Del. Ch. April 14, 2008).

2. CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al., 562 F.Supp.2d 511 (SDNY June 11, 2008) aff'd 2008 U.S. App. LEXIS 19788 (2d Cir. Sept 15, 2008).