

October 29, 2009

Corporate Governance Update:
2009 Proxy Season Review And a Look Ahead to 2010

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Although 2009 was more notable for legislative and regulatory corporate governance initiatives than for shareholder activism, the recently concluded proxy season produced several potentially significant results. As might be expected, executive compensation issues attracted a large number of shareholder proposals and a significant degree of shareholder support. In the general category of corporate governance, a few topics appeared to be increasingly popular with shareholders: the right to call special meetings, the majority election of directors and independent board chairmanship. Overall, shareholders focused on many of the same issues as did Congress and the Securities and Exchange Commission (SEC) over the last year. In light of the fact that the majority of legislative and regulatory initiatives proposed in 2009 will be pending through the beginning of 2010, a number of important variables remain unknown for next year's proxy season.

Executive Compensation

Say-on-pay shareholder proposals requesting advisory votes on executive compensation were numerous and popular in 2009: 71 say-on-pay resolutions were submitted by shareholders during the proxy season, garnering an average of 46 percent shareholder support.¹ Say-on-pay advisory votes were popular with the federal government as well: In February 2009, the Treasury Department issued a requirement for advisory say-on-pay votes at financial institutions;² in July 2009, the Treasury Department proposed to Congress the Investor Protection Act of 2009, which, if adopted, would mandate nonbinding, advisory say-on-pay votes on executive compensation packages for all public companies at each annual meeting and for "golden parachute"

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¹ RiskMetrics Group Postseason Report, Oct. 2009 ("RMG 2009 Postseason Report") at 5, 6.

² U.S. Department of the Treasury Press Release, Feb. 4, 2009, available at [Treasury Press Release: Say-on-Pay](#). According to RiskMetrics, this prompted more than 300 financial institutions to hold such advisory votes in the spring of 2009. RMG 2009 Postseason Report at 24.

arrangements for executives in the context of a change-in-control transaction.³ The Investor Protection Act also would require disclosure of such arrangements, the conditions under which such arrangements may become payable and the aggregate amount of all such compensation. Regardless of whether the Investor Protection Act becomes law, it appears that say-on-pay activism in one form or another will continue to gain momentum with shareholders in the current environment.

In 2009, Aflac, Alaska Air, Intel and Verizon Communications had voluntary advisory votes on executive compensation, and all four companies received more than 90 percent support on the advisory vote.⁴ With respect to the Troubled Asset Relief Program (TARP) company say-on-pay advisory votes, according to RiskMetrics, most companies received more than 70 percent support on their mandated advisory votes.⁵ In the United Kingdom, where say-on-pay advisory votes originated, the average votes against company remuneration plans doubled in 2009, but still averaged only 14 percent.⁶ A few high-profile companies, such as Apple and Occidental Petroleum, will hold annual advisory votes on compensation in the future, Prudential Financial will hold an advisory vote on executive compensation every other year beginning in 2010, and Microsoft will hold a triennial advisory vote on compensation beginning in November 2009.⁷

While public companies may choose to open the floor to such advisory votes, the complex determinations of executive compensation are firmly, and rightly, within the purview of directors' responsibilities. The board of directors and its compensation committee, advised by an independent compensation consultant and the company's legal counsel, are far better suited than shareholders to the task of structuring executive compensation in a way that encourages long-term performance and discourages undue risk; shareholders should not attempt to micromanage such decisions.

Though elements of executive compensation, such as tax gross-ups and golden parachutes, continue to be favorite activist issues,⁸ there were only a small number of shareholder proposals on these topics in 2009: two shareholder proposals regarding tax gross-ups and seven shareholder proposals regarding golden parachutes.

³ [Investor Protection Act of 2009](#).

⁴ RMG 2009 Postseason Report at 24-25.

⁵ RMG 2009 Postseason Report at 24.

⁶ Financial Times, "Lex: Executive pay" FT.com (Oct. 26, 2009).

⁷ RMG 2009 Postseason Report at 24. See Microsoft Press Release, "[Microsoft Board Authorizes 'Say-on-Pay' Advisory Vote on Executive Compensation](#)" (Sept. 18, 2009); Prudential Financial, Inc. Press Release, "[Prudential Financial, Inc. Board of Directors Adopts Non-Binding 'Say on Pay' Shareholder Vote](#)" (Oct. 13, 2009).

⁸ In 2009, RiskMetrics recommended withhold votes against compensation committee members at over 150 companies based, either solely or in part, on their inclusion of gross-up provisions in new or amended executive contracts. RMG 2009 Postseason Report at 29.

The SEC indicated earlier this month⁹ that it expects to adopt final rules regarding additional compensation disclosure in time for the 2010 proxy season. The proposed rules include new disclosure requirements with respect to overall compensation policies and their impact on risk-taking, stock and option awards for executives and directors, director and nominee qualifications and legal proceedings, company leadership structure, the board of directors' role in the risk management process, and potential conflicts of interest of compensation consultants that advise companies.¹⁰ While a number of issues have been raised with respect to some of these proposed additional disclosure requirements,¹¹ generally there has been broad support for enhanced disclosure on compensation and corporate governance matters.¹²

Corporate Governance

Mechanics of the election of directors was the key issue in corporate governance generally in the 2009 proxy season. The right of shareholders to call special meetings (typically at a proposed 10 percent threshold) was the subject of 56 shareholder proposals, more than any corporate governance issue other than board declassification (proposals relating to which, and shareholder support for which, decreased from 2008 to 2009).¹³ Special meeting shareholder proposals averaged just over 50 percent support, with over half of the proposals receiving majority shareholder support.¹⁴ Moreover, according to RiskMetrics, the number of proxy fights increased in 2009, as it did in 2008 (39 through September 2009, 35 from January to September 2008, and 30 in all of 2007).¹⁵ Though few proxy contests involved board control, dissidents achieved at least partial victories at 22 of the 39 companies.¹⁶ In addition, a number of companies facing potential proxy contests entered into settlements and typically added one mutually agreed individual to the board of directors.

The election of directors by majority vote was the subject of 45 shareholder proposals, up from 27 in 2008.¹⁷ These proposals received an average of 56

⁹ See Elisse B. Walter, "[SEC Rulemaking — 'Advancing the Law' to Protect Investors](#)," Speech at 48th Annual Corporate Counsel Institute, Northwestern University School of Law (Oct. 2, 2009) ("Walter Speech") ("While proxy access may not be in place for the upcoming season, I hope and expect that our proposed proxy and risk disclosure enhancements will be.").

¹⁰ "[Proxy Disclosure and Solicitation Enhancements](#)," SEC Rel. Nos. 33-9052; 34-60280; IC-28817; File No. S7-13-09 (July 10, 2009).

¹¹ See, e.g., [ABA Business Law Section Comments on Proxy Disclosure and Solicitation Enhancements](#), File No. S7-13-09 (Oct. 16, 2009).

¹² Comments on the 2009 SEC proposed disclosure rules can be found at sec.gov/comments/s7-13-09/s71309.shtml.

¹³ RMG 2009 Postseason Report at 5.

¹⁴ RMG 2009 Postseason Report at 15.

¹⁵ RMG 2009 Postseason Report at 19.

¹⁶ RMG 2009 Postseason Report at 19.

¹⁷ RMG 2009 Postseason Report at 5.

percent support, an increase of nearly six percent from last year.¹⁸ At the same time, despite a decrease in the number of organized “Vote No” campaigns against directors in 2009,¹⁹ an increased number of directors failed to receive a majority of votes in uncontested elections. As of September, RiskMetrics counted 91 directors at 49 U.S. companies that did not get above 50 percent support; this is a large increase from the 32 directors at 17 companies that fared similarly in 2008.²⁰ Interestingly, none of the 91 directors has resigned as a result; none of the companies had majority-vote standards, and though two companies had resignation policies, the boards decided to retain the directors that failed to receive majority support.²¹ According to Proxy Governance, a competitor of RiskMetrics, withhold votes for directors increased significantly during the 2009 proxy season:

9.8 percent of unopposed director nominees had at least 20 percent of shares voted against them or withheld, up from 5.5 percent in 2008[,] . . . the percentage of directors having at least 40 percent of shares voted in opposition doubling from 1.0 percent in 2008 to 2.1 percent in 2009, and the percentage of directors failing to attain support from a majority of shares cast tripling from 0.2 percent in 2008 to 0.6 percent in 2009.²²

The other corporate governance issue that became prominent in 2009 was the independence of board chairmen, which can also be viewed as the mandated separation of the chairman of the board and chief executive officer positions. The Millstein Center for Corporate Governance and Performance at the Yale School of Management released a policy briefing paper advocating independent board chairmanships for all public companies in March 2009;²³ the paper was subsequently endorsed by more than 50 individuals and corporate governance organizations, including CalPERS.²⁴ During the 2009 proxy season, there were 31 proposals on independent chairmanship, up from 26 in 2008 but down from 40 in 2007; 2009 proposals averaged 36.3 percent support, almost a seven percent increase from last year.²⁵

¹⁸ RMG 2009 Postseason Report at 6.

¹⁹ Proxy Governance, Inc. News Release “[Shareholder Votes Opposing Director Nominees Show Sharp Increase in 2009 Proxy Season](#)” (Sept. 19, 2009) (“Proxy Governance Survey”).

²⁰ RMG 2009 Postseason Report at 17.

²¹ RMG 2009 Postseason Report at 17.

²² Proxy Governance Survey; *see also* Gretchen Morgenson, “Fair Game: Too May ‘No’ Votes to Be Ignored” N.Y. Times (Sept. 20, 2009).

²³ The Millstein Center for Corporate Governance and Performance at the Yale School of Management, Policy Briefing No. 4, [Charing the Board: The Case for Independent Leadership in Corporate North America \(2009\)](#).

²⁴ Joann S. Lublin, “Chairman-CEO Split Gains Allies,” WSJ, Mar. 30, 2009; [CalPERS Press Release](#), dated Apr. 21, 2009.

²⁵ RMG Postseason 2009 at 5, 6.

Independent board chairmanship would be mandated under both the Shareholder Bill of Rights Act of 2009, a Senate bill sponsored by Senators Charles Schumer and Maria Cantwell,²⁶ and the Shareholder Empowerment Act of 2009, sponsored by a group of Representatives.²⁷ Recently, Senator Schumer commented that companies had objected most strongly to the provision requiring an independent board chairman and indicated that he might drop that requirement from the Shareholder Bill of Rights Act.²⁸

We continue to believe that a universal mandate regarding board structure is a fundamentally misguided approach and that boards of directors function best when they have the latitude to exercise their discretion and business judgment in structural matters as well as substantive matters.²⁹ The key issue remains board independence, and the same end can be served with the appropriate use of an independent lead director in situations where the chief executive officer also serves as chairman of the board.

Broker Discretionary Voting

Under the change to New York Stock Exchange Rule 452 approved by the SEC in July 2009, brokers no longer will be able to vote uninstructed shares in uncontested director elections.³⁰ While broker votes averaged 19 percent of the shareholder votes in 2009,³¹ it is not known how many brokers used proportional voting to vote uninstructed shares, thereby replicating the pattern of client instructions with respect to instructed shares. If that number is small, the rule change could have a significant effect on “Vote No” campaigns. In addition to increasing the proxy solicitation expenses for annual meetings, the rule change is expected to have the even more deleterious effects of significantly empowering activist and institutional shareholders, marginalizing retail shareholders and precipitating more frequent board changes.³²

It is not clear what effect, if any, the elimination of broker discretionary voting will have on “Vote No” campaigns in 2010 for large-cap companies, since most of

²⁶ [Shareholder Bill of Rights Act of 2009 \(S. 1074\)](#).

²⁷ [Shareholder Empowerment Act of 2009 \(H.R. 2861\)](#).

²⁸ RMG Postseason 2009 at 12.

²⁹ See David A. Katz & Laura A. McIntosh, “Corporate Governance Update: Populists’ Wish Lists Offer Legislative Parade of Horribles,” NYLJ, July 23, 2009.

³⁰ “Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors,” [SEC Rel. No. 34-60215; File No. SR-NYSE-2006-92](#), July 1, 2009.

³¹ RMG Postseason 2009 at 10 (citing Broadridge Financial).

³² For an in-depth discussion of the issues raised by this rule, see David A. Katz & Laura A. McIntosh, “[Corporate Governance Update: Activist Shareholders Would Gain Power From Proposed Rule Change](#),” Mar. 26, 2009.

their shares are owned by institutional investors. For small-cap companies and mid-cap companies that tend to have much larger holdings by retail accounts, the impact of eliminating broker discretionary voting in 2010 could be significant. Mid-cap companies tend to have a lower percentage of institutional ownership. Assuming institutional ownership in the range of 30 to 35 percent, mid-cap companies, in certain circumstances, are likely to be unduly influenced by proxy advisory firms such as RiskMetrics and Glass Lewis. For example, in such a company, if RiskMetrics recommended to its institutional clients that they withhold votes in a director election, prior to the elimination of broker discretionary voting, there would be a significant likelihood that, as a result of broker discretionary voting, the withhold vote campaign would fail. However, with the elimination of broker discretionary voting, under those same circumstances, institutional shareholders, which generally follow the recommendations of the proxy advisory firms in uncontested elections, would prevail in a withhold vote campaign. As more and more companies adopt a majority voting standard for the election of directors (which may become mandatory³³), withhold vote campaigns will be increasingly meaningful, as they will give shareholders the ability to block directors from being elected and potentially force the resignation of incumbent directors.³⁴ For a company to prevail in such circumstances, it would need to hire a proxy solicitor and expend significant resources and funds in an effort to communicate with the underlying shareholders and to attempt to convince them to vote.

Small-cap companies will fare the worst as a result of the elimination of broker discretionary voting, since they tend to have the largest percentage of retail shareholders. Therefore, these companies, which are the least able to spend additional funds in any economic environment, will face the greatest need to do so. Unless the small-cap companies can convince their retail shareholders to vote their shares (which will take a concerted effort by these companies and their proxy solicitors), they are unlikely to achieve satisfactory vote levels. Moreover, since public companies need to publicly disclose their voting results, these companies may be viewed as very attractive targets by hedge funds and other activist investors; for a relatively small investment, these activists will be able to exert great influence at a shareholder meeting, in many cases dictating the outcome.³⁵

The SEC has recently proposed amendments to its “notice and access” rules for the electronic distribution of proxy solicitation materials by an issuer as well as other soliciting persons.³⁶ The proposed changes, which the SEC intends to have in

³³ The Bill of Rights Act and the Empowerment Act would require all publicly-traded companies to elect directors under a majority-voting standard.

³⁴ See David A. Katz & Laura A. McIntosh, “[Director Elections and Majority Voting](#),” NYLJ, Dec. 29, 2005.

³⁵ In both the United States and Europe, the median market capitalization of a target company has fallen from \$275 million in 2008 to \$75 million in 2009, while proxy fights have increased by 27 percent. See Sam Jones & Lina Saigol, “Activist Investors Eye Smaller Prey,” FT.com, July 23, 2009.

³⁶ “[Amendments to Rules Requiring Internet Availability of Proxy Materials](#),” SEC Rel. Nos. 33-9073, 34-60825, IC-28946, File No. S7-22-09 (Oct. 14, 2009).

effect before the 2010 proxy season, are intended “to revise [the] notice and access proxy rules to further facilitate informed shareholder participation in the proxy voting process. . . . The notice and access model was intended to establish procedures that would promote use of the Internet as a reliable and cost-efficient means of making proxy materials available to shareholders.”³⁷ Comments on this rules proposal are due by November 20, 2009 in order to facilitate implementation in time for the 2010 proxy season. This should be the first of many revisions to the “proxy plumbing” rules in order to fix a system that was designed for another era and is now out of date.³⁸

2010 Forecast

The 2010 proxy season may be affected by a number of legislative and regulatory proposals, the fate of which is largely uncertain. While there will be new SEC disclosure rules in place regarding compensation and risk management and revised notice-and-access requirements, there also could be new federal legislation regarding compensation practices, advisory votes or corporate governance structures. It is not clear how the elimination of broker voting in uncontested elections will affect voting overall, but it appears that mid-cap and small-cap companies will face the greatest impact given the size of their retail holdings.

Proxy access remains an unknown element. The SEC stated earlier this month that it will not finalize its proposed proxy access rules in time for the beginning of the 2010 season, but it is possible that the rules will become final at some point during the 2010 proxy season.³⁹ Delaware, however, has shown that there is a sensible alternative to the federalization of an important area of state corporate law; in April 2009, Delaware enacted legislation enabling the adoption—via board action or shareholder initiative—by Delaware companies of bylaws permitting shareholder access to company proxy materials.⁴⁰ Delaware’s private-ordering approach, which can be effected by carefully drafted company bylaws, enables companies and their shareholders to tailor proxy access to their own specific circumstances and keeps the issue of proxy access in the proper realm of state law. It is possible that, during the remainder of 2009 and into

³⁷ *Id.* at 4.

³⁸ *See, e.g.*, Melissa Klein Aguilar, “[Enthusiasm for Proposed Notice-and-Access Fixes](#),” Compliance Week (Oct. 27, 2009) (“Commissioners have vowed to undertake a review of the “proxy plumbing” this year, but exactly when that will happen and what reforms might be proposed are still anyone’s guess.”).

³⁹ Sarah N. Lynch, “Activists, Take Note: SEC Delays a Proxy Vote,” *WSJ*, Oct. 3, 2009 at B3; *see also* Walter Speech (“Although I can’t give you a definitive date, I expect we will likely move forward and consider an adopting release sometime in early 2010. This means of course that final rules are not likely to be in place at the beginning of next year’s ‘proxy season.’ To me, that timing is not ideal; however, given the complexity of this issue, I believe it is critical that we take the time we need to produce the best final product. Excellence should triumph over speed.”). The SEC’s proposed rules on proxy access are available at [SEC Release Nos. 33-9046; 34-60089; IC-28765; File No. S7-10-09](#) (June 10, 2009). Over 500 comment letters have been submitted and these are available at sec.gov/comments/s7-10-09/s71009.shtml.

⁴⁰ [Delaware Gen. Corp. L. § 112](#) (effective Aug. 1, 2009).

2010, public companies may utilize Delaware's recently enacted statute to provide process access on their own initiative.

The populist mood of recent proposed federal legislation in response to the financial crisis as well as proposed SEC rules will further encourage shareholder activists toward increased efforts in the 2010 proxy season. With respect to specific issues, proposals regarding say-on-pay and independent board chairmanship likely will continue to gain momentum, and it is expected that many more public companies will be pressured into adopting majority voting if it is not mandated by federal legislation. According to RiskMetrics, labor pension funds and other activists are planning to focus on these issues.⁴¹ Yet, with so many unknown factors, it is hard for companies to predict which reforms, if any, will become the new standard. Boards of directors thus should continue to hold steady to their strategic goals. When the reforms are finalized, the fundamentals will remain. With strong leadership, long-term planning, good advisors and good communication, boards of directors are well-equipped to weather the impact of the proposed changes. Above all else, public companies must remain focused on the long-term best interests of the company and its shareholders and take proactive steps to protect them from being hijacked and sacrificed to the short-term interests of profiteers.

⁴¹ RMG 2009 Postseason Report at 48.