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# Corporate Governance Update: Holding Steady in an Active Market

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Favorable market conditions appear to be producing a substantial increase in shareholder activism and hostile takeover activity this year. Led by pension funds and hedge funds, activist investors have been emboldened by recent changes in corporate governance. As boards of directors and management teams address demands by regulators as well as heightened attacks from shareholder activists, directors need to be fully prepared with state-of-the-art plans ready for immediate use. When facing increased hostile takeover activity, directors should keep in mind that the fundamentals remain unchanged: the business judgment rule still applies, and takeover defenses, especially of the structural variety, are as effective as ever when used appropriately.

## Current Climate

Last month, a prominent and successful activist investor commented that recent changes in corporate governance such as majority voting and other changes to corporate election rules have provided activists with more tools with which to pressure companies, even those with market capitalizations over $50 billion.[1] Previously considered "untouchables," such mega-companies are now seen as potential targets providing even larger profit opportunities.

Similarly, the mandatory say-on-pay advisory vote now in effect for U.S. public companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act has given shareholders a visible platform and an increased sense of their ability to influence boards of directors. High-profile rejections this proxy season of the say-on-pay proposals at major companies such as Hewlett-Packard, Curtiss-Wright and Stanley Black & Decker have emboldened shareholders at public companies across the spectrum.

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[1] Miles Weiss, "Peltz Says Governance Changes Put 'Untouchables' Within Reach," Bloomberg, April 4, 2011 (citing Nelson Peltz, Speech to the Council of Institutional Investors, April 4, 2011) available at www.bloomberg.com/news/2011-04-04/peltz-says-governance-changes-makes-50-billion-companies-easier-targets.html.

While the great majority of say-on-pay proposals have been approved,[2] companies are understandably concerned. In addition, although over 40 percent of the management proxy statements have recommended triennial say-on-pay votes, shareholders have overwhelmingly voted in favor of annual say-on-pay votes.

It is important to note that say-on-pay votes are merely advisory, and a board of directors is not required to change its policy as a result of a negative vote. Indeed, settled law is clear that determining compensation is firmly within the province of the board of directors. It is, moreover, the duty of the board to use its business judgment in formulating and implementing compensation policy, regardless of the views of the shareholders. The Dodd-Frank Act specifically provides that say-on-pay votes do not "create or imply any change to the fiduciary duties" of the board,[3] although this has not stopped shareholder plaintiffs firms from filing lawsuits after several failed say-on-pay votes.[4] Not only do directors face no potential legal liability from taking action contrary to the views expressed by shareholders in advisory votes, but board decisions made after full internal debate are often accorded increased deference. Under the heightened attention brought by a negative vote, a company should take extra care to follow appropriate procedures in determining whether to revise or retain its proposed compensation plan, but once having done so, the board need not fear legal liability.

Directors should also keep in mind that a negative say-on-pay vote may be the result of shareholders automatically following an ISS recommendation. ISS has had a measurable impact on voting results thus far,[5] though it has not been shown that ISS recommendations on compensation are correlated with increased shareholder value, and there is some evidence that the opposite is true.[6] The fact is that compensation

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[2] As of May 6, 2011, all but 15 of the 807 companies that have reported results with respect to their say-on-pay votes received shareholder approval, with over two-thirds of companies receiving more than 90 percent of votes in favor. See Jeremy Goldstein, "Say on Pay So Far," May 11, 2011 available at www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.20251.11.pdf. As of May 20, 2011, 26 companies had lost their advisory say-on-pay proposals during the 201 proxy season.

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec. 951.

[4] *See*, e.g., Professor Stephen Bainbridge, "Say on pay litigation," April 24, 2011, available at www.professorbainbridge.com/professorbainbridgecom/2011/04/say-on-pay-litigation.html#tp.

[5] ISS has recommended against say-on-pay proposals at roughly 12 percent of companies holding such votes; of these companies, 11 out of 60 that reported results as of April 29, 2011 failed to receive majority support. No company receiving a positive recommendation from ISS so far has failed to receive majority approval. See Goldstein, *supra*.

[6] David F. Larcker, Allan L. McCall and Gaizka Ormazabal, "Proxy Advisory Firms and Stock Option Exchanges: The Case of Institutional Shareholder Services," Rock Ctr. for Corporate Governance at Stanford University, April 24, 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1811130 (examining the relationship between firm performance and the recommendations provided by ISS regarding shareholder votes in stock option exchange programs and finding that firms that adopt exchanges that follow the restrictive ISS policies

committees and their independent compensation consultants, if any, are far better positioned to create and establish compensation plans that are well suited to meet a particular company's objectives than ISS or the company's shareholders. ISS uses a "one-size-fits-all" approach that does not accommodate the specific circumstances of any given company. Moreover, ISS has no fiduciary duty to act in the best interests of a company and its shareholders.[7]

## Hostile Bids Increase

After hostile takeover bids doubled from 2009 to 2010,[8] with particularly increased activity near the end of 2010, the expectation of hostile deals has been high for 2011. So far this year there have been a number of large unsolicited acquisition attempts, including Trian Fund Management's $7.6 billion bid for Family Dollar, Valeant's $5.7 billion bid for Cephalon, and NASDAQ's thwarted attempt to acquire NYSE Euronext for over $11 billion. In addition, Carl Icahn recently prevailed in his proxy contest to elect three directors at Mentor Graphics, Oregon's largest company, which had previously rejected an unsolicited offer from Icahn.[9] Shareholder activism has also picked up with hedge funds increasingly putting pressure on companies to sell themselves.[10] The loosening of credit markets and the growing confidence of corporate raiders have combined to create an environment that is increasingly conducive to hostile approaches.

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exhibit statistically lower market reaction at the announcement of this transaction, lower operating performance, and higher executive turnover).

[7] The Securities and Exchange Commission acknowledged concerns about the role of proxy advisors and the potential for conflicts of interest in the proxy advisory relationship in its Concept Release on the U.S. Proxy System, Exchange Act Rel. No. 62495, July 14, 2010, at 114-26 available at www.sec.gov/rules/concept/2010/34-62495.pdf. There are numerous comment letters on the Concept Release that have been filed with the Securities and Exchange Commission and are available at www.sec.gov/comments/s7-14-10/s71410.shtml. *See, e.g.,* Comment Letter from Center on Executive Compensation dated March 29, 2011, available at www.sec.gov/comments/s7-14-10/s71410-297.pdf (attaching white paper prepared by the center entitled "A Call for Change in the Proxy Advisory Industry Status Quo," released on Feb. 8).

[8] According to Thomson Reuters, hostile and unsolicited bids were launched in 2010 for more than $260 billion, more than double the total for 2009. Michael Erman, "DEAL TALK – Hostile bids set to rise again in 2011," Reuters.com, Jan. 6, 2011 available at www.reuters.com/article/2011/01/06/dealtalk-hostiles-idUSN0610526120110106.

[9] Mike Rogaway, "Mentor Graphics puts brave face on Carl Icahn's proxy fight win," *The Oregonian*, May 12, 2011 available at www.oregonlive.com/business/index.ssf/2011/05/mentor_graphics_loses_proxy_fi.html.

[10] *See, e.g.*, Nadia Damouni "Tech boards more 'proactive' over activism," Reuters.com, April 6, 2011 available at www.reuters.com/article/2011/04/06/us-mergers-summit-technology-boards-idUSTRE7351DE20110406.

Fortunately, takeover defenses remain vibrant. In February, the Delaware Court of Chancery rejected the broadest challenge to the poison pill in many years when it reaffirmed the primacy of the board of directors to determine matters of corporate control. The decision in *Air Products & Chemicals Inc. v. Airgas Inc.*[11] upheld the validity of the poison pill to protect a company against a hostile approach and rejected the idea that a poison pill should have an expiration date. So long as directors act in good faith, on an informed basis, and not in their personal interest, their business judgment decisions will continue to be upheld in Delaware, and they may feel confident in acting to protect companies from opportunistic, hostile bids.

Structural defenses, such as a staggered board combined with a poison pill, remain the hardest to overcome by hostile bidders, thus putting the target's board of directors in the strongest position to negotiate on behalf of the target's shareholders. In the period from 2008 to 2010, almost 60 percent of the companies subject to hostile bids remained independent, while in the period 2005 through 2007, only 30 percent of the target companies remained independent. Given the importance of structural defenses, it should come as no surprise that many corporate governance activists have pursued shareholder proposals seeking to de-classify boards or give shareholders the right to call special meetings. It is important that a board focus on the company's potential vulnerability if requested to dismantle a takeover defense. Once a structural defense is removed, it will be virtually impossible to reinstitute. Therefore, boards should get expert advice before dismantling defenses, even if the shareholders have approved precatory shareholder proposals requesting their removal.

## Holding Steady

Companies are finding themselves in an environment of increased activity on all fronts, from capital markets to regulators to shareholder activists to hostile bidders. Good communication and thorough preparation remain essential to managing these challenges as smoothly as possible. Meetings and other contacts with shareholders, whether simply to build good will by hearing and responding to shareholder concerns or to develop relationships with important investors, can be very helpful. In the context of say-on-pay votes—particularly with respect to a negative ISS recommendation—direct engagement with shareholders often can mean the difference between a positive or negative shareholder vote. Proxy solicitors can also be extremely useful in helping management craft an appropriate message for institutional investors and communicate it to the key decision makers at the institutions who make voting determinations. In addition, it is best to engage in a dialogue with key shareholders before there is a controversy such as a proxy contest or say-on-pay controversy.

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[11] C.A. No. 5249--CC (Del. Ch. Feb. 15, 2011) available at courts.delaware.gov/opinions/download.aspx?ID=150850 (Chancellor Chandler).

In times of uncertainty, directors should take comfort in recognizing that nothing has changed in the fundamentals of their duties and powers. American corporate law is founded on the principle that boards of directors are the best qualified to make the business judgments necessary for companies to function effectively and create value for their shareholders. Directors' discretion covers compensation, takeover defense, and everything in between. While directors should no doubt be informed of shareholder views, it is important that directors not cede any of their rightful authority to shareholders; on the contrary, directors must recognize that it is their duty to use their business judgment to further the best interests of the corporation and its shareholders, holding firm, when appropriate, against the protests of corporate raiders and shareholder activists alike.