



# 2013 Proxy Season Review and Corporate Governance Update

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## Webinar Presenters



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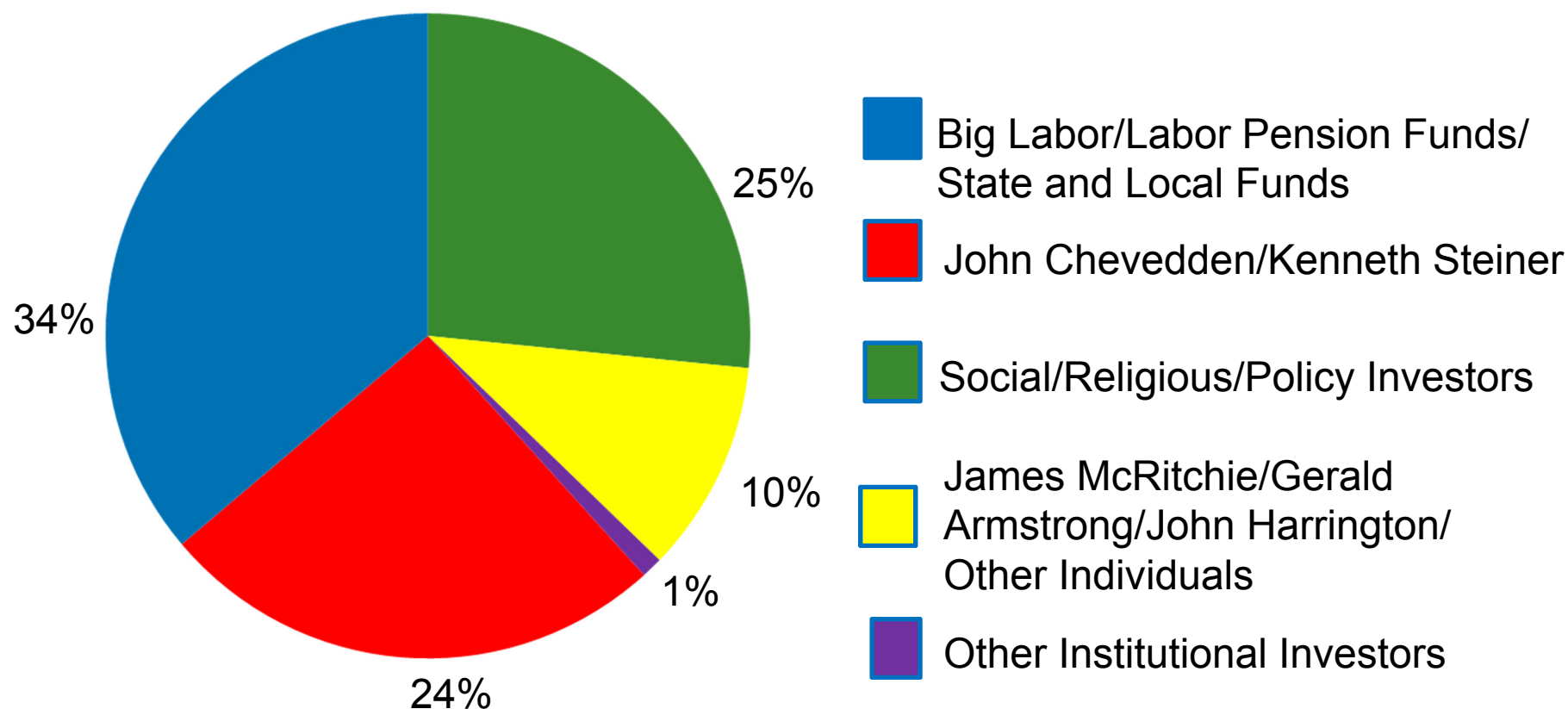
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# Today's Agenda

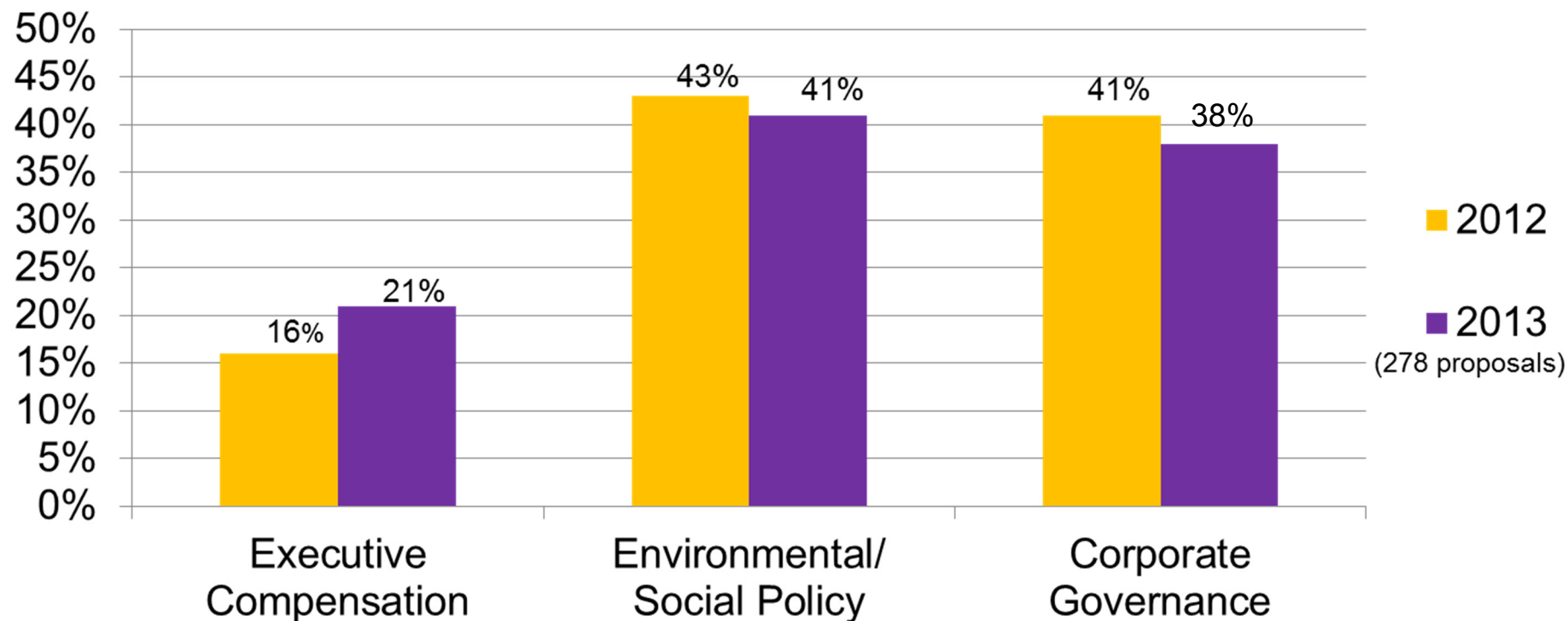
1. Shareholder Proposals
2. Corporate Governance Update
3. SEC Pay Ratio Disclosures
4. Looking Forward to 2014

# Part I. Shareholder Proposals

## Overview of Proponents at Fortune 250 (2013)



## General Categories of Shareholder Proposals (Fortune 250)



Source: Proxymonitor.org

## Corporate Governance Proposals

- Separate Chairman & CEO – 13% of all shareholder proposals at Fortune 250 in 2013\* [1 of 33 passed]
- Shareholder right to call meetings/act by written consent – 9%\* [1 of 19 passed]
- Majority voting for directors/other voting – 7%\* [7 of 12 passed]
- Declassify board – 3%\* [6 of 7 passed]
- Statistics do not capture instances where Company voluntarily implemented change in exchange for shareholder withdrawing proposal

\* Source: Proxymonitor.org

## Proxy Access Update

- Proposals broadly intend to give shareholders the right to include director nominees in Company's proxy statement
- 2% of all shareholder proposals at Fortune 250 in 2013\*
- US Proxy Exchange Model – Either (i) holders of between 1% and 5% for at least 2 years or (ii) 50 holders of \$2,000 holding between 0.5% and 5% for 1 year [Received 4-9% support at four Fortune 500 companies]
- Norges Bank model – 1% holder for 1 year [Received 32-37% support at 3 Fortune 500 companies]
- SEC model – 3% holder for 3 years [Received 40-72% support at 3 Fortune 500 companies]

\* Source: Proxymonitor.org



## Executive Compensation

- 21% of all shareholder proposals at Fortune 250 in 2013\*
- Variety of topics; the most common were limits on golden parachutes and stock retention awards
- Limits on golden parachutes (prohibit single-trigger accelerated vesting of awards) – average about 33% support
- Limits on stock retention awards (external vesting past retirement) – average about 25% support
- No proposals on these topics received majority support at Fortune 250

\* Source: Proxymonitor.org

## Environmental and Social Policy

- 41% of all shareholder proposals at Fortune 250 in 2013\*
- Includes topics such as environmental stewardship, sustainability reporting, human rights, global labor conditions, employment rights, animal rights
- Range from average of 3% support (animal rights) to 40% support (sustainability reporting)
- No proposals on these topics received majority support at Fortune 250

\* Source: Proxymonitor.org

## Political Disclosure and Spending

- 20% of all shareholder proposals at Fortune 250 in 2013\*
- Run spectrum from requiring disclosure of contributions to trade associations to outright ban on political spending and lobbying
- 34% of those introduced in 2013 were sponsored by organized labor
- Total spend immaterial at companies; generally portrayed as “good governance” or “transparency” by proponents
- Part of broader plan by special interest groups to silence and intimidate business
- In 2013, averaged 18% support at Fortune 250 (down from 25% in 2009)

\* Source: Proxymonitor.org

## Political Disclosure and Spending (cont'd)

- Proponents usually claim that political efforts harm shareholder value, but at least one economic study has found that corporate political activity actually improves shareholder value\*
- More fundamentally, these proposals can be used to attack companies and silence an entire side of various policy debates
- From a governance perspective, issues presented are no different than others that are managed with appropriate board oversight
- Appeasement could hamstring the company and open it to future attack
- Strategies for responding to proposals:
  - SEC Staff has permitted exclusion of certain proposals via no-action process
  - Broader engagement than other proposals; involvement of PR and IR functions
  - Direct outreach to shareholders (esp. institutional investors)
  - Emphasize that board oversight/appropriate policies and procedures are in place to manage expenditures

\* See Shapiro & Dowson, "Corporate Political Spending: Why the New Critics are Wrong"

## Proponents' Strategies to Evade 500-Word Limit

- Use of external websites
  - Several shareholders now reference website in 500-word statement
  - SEC Staff has not objected to this practice
  - Staff Legal Bulletin 14G (Oct. 2012) permits website reference as long as information there only supplements information in proposal and is not misleading to third parties
- Increase in Rule 14a-6(g) filings
  - Notice of Exempt Solicitation (Form PX14A6G) required to be filed if holder of more than \$5 million in stock engages in certain non-exempt proxy solicitations
  - Proponents making increased use of the filing (even when holding less than \$5 million) to provide expanded narrative around disclosure statement
  - SEC has not taken any action to prevent this practice

# Part II.

## Corporate Governance Update

## Proxy Contests

- Several high-profile contests
  - Starboard proxy contest at Office Depot
  - Icahn/Southeastern at Dell
- Many resulted in negotiated settlements in which some—but not all—dissident nominees were added to board
- New Bebchuk study on activist hedge funds
  - Argues that activist hedge funds do not harm corporations in the long-term
    - “We find no evidence that long-term shareholders experience negative stock returns during the three years following the partial or full cashing out of an activist’s stake.”
      - See Lucian A. Bebchuk et al, *The Long-Term Effects of Hedge Fund Activism* (draft July 9, 2013)

## Consent Solicitation

- Health Management Associates, Inc.
  - Activist Glenview Capital Management successfully replaced entire board through consent solicitation
    - Glenview owned 14.6% of HMA and wanted to raise its share
    - HMA had adopted a shareholders rights plan (poison pill)
    - Glenview also opposed M&A deal
  - ISS backed Glenview's slate
    - Note: ISS is less likely to back proxy contests where board control is at stake
- Result: In August, a majority of HMA's shareholders elected the 8 nominees, forming a new board
  - Note: Consent solicitations are unusual, but not unheard of (recall Wet Seal in 2012)



## Compensatory Arrangements with Dissident Nominees

- Two proxy contests in 2013 involved compensatory arrangements between activist hedge funds and their director nominees
  - Arrangements were disclosed
  - If elected, directors would be entitled to cash bonuses payable by the hedge funds based on companies' stock performance
  - Hedge funds argued these arrangements aligned interests with all stockholders – gave directors incentive to maximize shareholder wealth

## Compensatory Arrangements: Hess Corp.

- Activist: Elliott Management (4.9%)
  - Proposed splitting Hess Corp. into 2 companies
  - Nominated 5 individuals to Hess's 14-member board
  - Entered into compensatory arrangements with each of its nominees:
    - One \$50,000 fee for standing for election
    - \$30,000 for each percentage point Hess's stock outperformed a peer-group over a three-year period
    - Bonuses capped at \$300,000

## Hess Corp. (cont'd)

Despite these side-arrangements, ISS and Glass Lewis recommended voting “FOR” the dissidents

- But, faced with significant criticism, the nominees waived the compensatory arrangements
- Outcome: Settlement of Proxy Fight
  - Hess seated three dissident nominees
    - Also agreed to separate its chairman/CEO roles
  - Note: Reports indicated Hess was going to lose proxy contest

## Compensatory Arrangements: Agrium

- Similar to situation at Hess, JANA Partners initiated a short-slate contest at Agrium and offered bonuses to its nominees based on profit JANA earned on its Agrium shares
- Proxy advisors split on recommendation
  - Glass Lewis recommended “for” dissidents; ISS recommended against
- Outcome: Dissident slate defeated

## Implications of Compensatory Arrangements

- Significant controversy
  - “*If this nonsense is not illegal, it ought to be.*” Professor Stephen Bainbridge, UCLA School of Law
- Were dissidents’ interest aligned with long-term interests of shareholders?
  - What does it mean to say “long-term” interests?
- Beginning of a trend?
- Prohibit through bylaws?

# DISRUPTIVE DIRECTORS

## Dissident Directors

- *Kalisman v. Friedman* (Del. Ch. Apr. 17, 2013)
  - Dissident director was excluded from consideration of significant transaction
    - Was also a member of special committee, but excluded from its deliberations
  - Objected to last minute notice of meeting to approve transaction
  - Sued to challenge transaction and sought access to privileged communications

## *Kalisman* (cont'd)

- Held: Dissident director was entitled to most of the attorney-client communications with the board and special committee
  - A director's right to information is "essentially unfettered in nature"
  - Access to information necessary to discharge duties
  - Directors treated as "joint client" when legal advice is given to corporation



## *Kalisman* – Key Quotes

“A director’s right to information is ‘**essentially unfettered in nature**’” (emphasis added).

...

“A company ‘cannot pick and choose which directors will receive [which] information.’”

“The director’s right to information extends to privileged material. As a general rule, ‘a corporation cannot assert the privilege to deny a director access to legal advice furnished to the board during the director’s tenure.’”

“Under Delaware law, each director has a right to information that is ‘**correlative with his duty to protect and preserve the corporation**’” (emphasis added).

## *Kalisman* (cont'd)

- Exceptions:
  - Pre-existing agreement with dissident
    - None in *Kalisman*
  - When “sufficient adversity exists” such that director “could no longer have a reasonable expectation that he was a client of the board’s counsel”
- Concerns about misuse of information
  - Use of information subject to fiduciary duties, but fear of misuse not sufficient reason to deny access

## *Kalisman* (cont'd)

- Court also indicated that dissident director could share information with the stockholder that designated him
  - “When a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder’s representative, then the stockholder is generally entitled to the same information as the director.”

## *Kalisman* (cont'd)

- Dicta on sharing information surprised many practitioners
  - Directors owe duties to all stockholders, not just those who elected/designated them
  - But duty of confidentiality is unclear
  - Concerns over lack of confidentiality
    - Reg FD
    - Insider trading liability
    - Boardroom collegiality

## Disruptive Director at JCPenney

- Pershing Square Management held nearly 18% of JCP
  - Ackman urged the board to remove both JCP's CEO and its chairman
- Ackman went public with his concerns:
  - Called for removal of CEO as well as Interim Chairman
  - Claimed “material information [was] not being properly shared with the board, and the board [did] not have access to independent advice”
  - Also claimed that board was not meeting to discuss his concerns

## JCPenney/Ackman: Dealing with Disruptive Director under *Kalisman* (cont'd)

- **Uncertain whether Ackman breached fiduciary duties by “going public”**
  - **But note that *Kalisman* suggests he could have shared board-level information with his investment fund**
- **Unable to resolve conflicts, Ackman resigned from the board**
  - **And Pershing Square sold its 18% interest in JCP at significant loss**

## Dealing with Disruptive Directors

- Revisit confidentiality policies
- Educate directors on importance of confidentiality
- Agreements with large stockholders with board representation
- More aggressive:
  - Form committees, initiate litigation, etc.

# WITHHOLD/AGAINST VOTES IN DIRECTOR ELECTIONS



## Majority Withholds Against Directors

- In 2013, ISS issued negative recommendations against approximately 10% of the directors (~3000 negative recommendations in total)
  - Only 50 directors (less than 1.5%) received more negative votes (both “against” and “withheld”) than “for” votes
- Less of an issue among larger companies
  - Within the S&P 500, ISS recommended against approximately 3% of directors
    - Only 9 directors received less-than-majority support

## ISS's Reasons for Negative Recommendations

- Independence issues:
  - Non-independent directors on key committees or
  - Failure to maintain a majority independent board
- Excessive non-audit fees paid to auditors, or failure to disclose a breakdown of fees
- Absence of a formal nominating or compensation committee
- Compensation issues
- **Poison pill issues (e.g., maintaining a pill with dead-hand provisions or failing to put a pill up for a shareholder vote)**
  - Average of only 73% of votes cast voted “for” the directors
  - 10 directors received less than 50% of the vote

## ISS's Rationale for Negative Recommendations (cont'd)

- Poor attendance at board and committee meetings
- Failure to address material weakness in internal controls
- Failure of risk oversight due to pledging of shares by executives
- Over-boarding
- Lack of responsiveness to shareholder concerns (e.g., failure to implement a successful shareholder proposal)
  - Average of only 60% of votes cast voted “for” the directors
  - 8 directors received less than 50% of the vote

## Say-on-Pay

- 2013: Three-year anniversary of mandatory say-on-pay proposals under Dodd-Frank
- 2013 results: Overwhelming majority of companies received strong support for executive pay programs
  - Only 2% had failing say-on-pay votes
  - Average level of shareholder support: 90%
  - 92% of Russell 3000 companies received over 70% shareholder support
- Companies receiving negative ISS recommendations received 29% less support, on average

## Say-on-Pay (cont'd)

- Company responses to low shareholder support (less than 80% shareholder approval):
  - 72% of companies reached out to shareholders to discuss concerns
  - 68% of companies made changes to pay programs, including, among other things:
    - More rigorous plan metrics (23%)
    - Adjusted compensation mix (23%)
    - Granted new long-term performance awards (21%)
    - Eliminated excise tax gross ups (20%)

Source: TowersWatson

## Say-on-Pay (cont'd)

- Proxy Advisory Firms
  - ISS and Glass Lewis have made efforts to consider input from companies regarding the companies' peer groups
  - Typically, advisory firms chose comparable peer groups
    - Sometimes, but not always, proxy advisory firms' peer groups overlapped with the companies' selections

## Say-on-Pay (cont'd)

- Glass Lewis
  - Glass Lewis' data provider, Equilar, now allows Russell 3000 companies to submit their peer groups via a web portal
  - Peer groups are expected to be updated semi-annually in January and July
- ISS
  - Intends to reach out to companies to ascertain whether companies have changed their peer group since their last proxy statement

## Reflections on Say-on-Pay

- Say-on-pay: neither bark nor bite?
- Increased stockholder engagement
- Growing alignment between executive compensation and stock performance
- Concerns over homogenization of pay packages
- Next move by plaintiffs' bar



## NYSE Informal Guidance

- *LAMPERS v. Bergstein* (Del. Ch. May 30, 2013)
  - Company sought informal guidance from NYSE staff on whether stockholder approval to comp plan amendment was required
    - Staff indicated no approval was required
  - DE court disagreed
    - Complaint sufficiently alleged the change was a material amendment requiring stockholder approval, particularly based on prior disclosures

## ***Bergstein* (cont'd)**

- Little deference to company's defense that it relied on informal NYSE guidance
- Court characterized NYSE's email as "off the cuff"

"I'm not saying that people don't give you comfort, but you sort of get what you ask for, which is it might be a second nod, but, ultimately, it's an email."

- Court contrasted NYSE informal guidance with more "formal" SEC no-action letters

## **Broadridge Will Stop Providing Preliminary Vote Tallies to Shareholder Proponents**

- Broadridge provides real-time voting tabulations to companies
  - Historically, Broadridge provided the same information to the sponsors of shareholder proposals
- In Spring 2013, at the request of a client, Broadridge cut off proposal sponsors' access to the voting tabulations
- Result: More difficult for shareholder proposal sponsors to assess voting turnover/support
  - Already led to calls for regulatory reform

## Status of Pay Ratio Disclosure Rules

- Section 953(b) of Dodd-Frank requires issuers to disclose ratio of median annual total compensation of all employees to CEO
- Must do full-blown S-K Item 402 calculation to derive median pay
- Highlights of rules proposed on September 18
- Section 953(b) not an amendment to 1934 Act so SEC limited in ability to use exemptive authority and other rule-writing shortcuts
- Expect about one-year process to get to final rules with disclosure required for 2016 proxy season (assuming no legal challenge to rules)

# **Part III. Final Thoughts**

## **The 2014 Proxy Season**

## Looking forward to 2014: ISS Proxy Voting Policy Survey

- Comment period closed September 13
- Overview of topics for which input sought
  - Whether ISS should differentiate by size or type of company
  - Board responsiveness with respect to majority votes on non-binding shareholder proposals, high levels of dissent on say-on-pay resolutions and significant against or withhold votes in director elections
  - Impact of a director's current or prior service on boards of other public companies in assessing a director's performance
  - Director tenure (and its impact on independence) and board leadership rotation
  - Role of company performance in ISS's evaluation of directors

## Predictions for 2014

- What's Hot ?
  - Hedge fund activism
  - Disclosure of political spending
  - Majority voting and declassification of boards (smaller companies)
- What's Not?
  - Proxy access
  - Say-on-pay litigation
- What to Watch?
  - Separate Chairman/CEO
  - Board “responsiveness”

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