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Majority Voting Update, Shareholder Democracy, and How Boards Should Respond to Hedge Funds and Activist Shareholders

2007 NATIONAL DIRECTORS INSTITUTE

MAJORITY VOTING UPDATE, SHAREHOLDER DEMOCRACY AND HOW BOARDS SHOULD RESPOND TO HEDGE FUNDS AND ACTIVIST SHAREHOLDERS

Because activist shareholders and hedge funds have proven effective at advancing corporate governance reform proposals and affecting corporate decision-making with their increasing power and influence, boards of directors have been forced to significantly alter the way in which they react to shareholders who are seeking a greater influence on what happens in the boardroom.

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, "Majority Voting Update, Shareholder Democracy and How Boards Should Respond to Hedge Funds and Activist Shareholders," was a featured breakout session jointly moderated by Patrick Quick, partner, Foley & Lardner; Richard Grubaugh, senior vice president, D.F. King & Co., Inc.; and Justin Friesen, executive director — mergers & acquisitions, UBS Securities, LLC. Panelists included Jeffrey Brown, senior corporate counsel, Motorola, Inc.; James Duffy, executive vice president and general counsel, New York Stock Exchange; and Patrick McGurn, executive vice president and special counsel, Institutional Shareholder Services.

Majority Voting Movement Update

A *plurality voting standard* is used in the election of directors under most state corporate laws and is the default rule under the Model Business Corporation Act. Under this standard, a nominee is elected as a director by receiving the highest number of votes cast for a open seat, even if this number is less than a majority. This means that only votes "for" a candidate have any legal significance, and only a single affirmative vote is needed for a nominee to be elected in an uncontested election.

A *majority voting standard* allows a director nominee to be elected only if he or she receives a favorable majority vote, typically expressed as an affirmative vote of the holders of a majority of the shares present and voted. Under this standard, "withhold" votes (which may be expressed as "against" votes) have legal significance.

The two principal model majority voting models that companies have implemented have been the Pfizer approach and the Intel approach.

- *Pfizer*: Under the Pfizer approach, a corporate governance policy provides that a director who receives more votes withheld than in favor of his or her election (*i.e.*, if a majority of votes are withheld) is required to submit his or her resignation to the board, although such director is still technically elected. If this happens, then the company's corporate governance or similar committee will consider, but is not required to accept, such resignation. A Pfizer-style proxy card has two voting options: "for" and "withhold." The policy generally does not apply to contested elections. The Pfizer model was the first model developed, but the Intel model has now replaced it as the preferred majority voting approach.
- *Intel*: The Intel approach takes the form of a bylaw amendment that requires that, in uncontested elections, a director must receive a majority of the votes cast to be elected. Contested elections will continue to use the plurality vote standard. If the

director does not receive a majority of the votes cast, then he or she is not elected. But, under the law of many states, any such director who is an incumbent would still continue in his or her position under holdover rules because a successor to the director has not been elected. However, a director who is not elected must offer his or her resignation to the board. An Intel-style proxy card should have three voting options: "for," "against," and "abstain." To the advocates of this approach, the fact that majority voting is required by a company's bylaws, and not merely by corporate governance principles, provides a more permanent and formal means of ensuring majority voting.

The push toward majority voting for directors has reached full steam and shows no signs of letting up. Although it appears inevitable that all companies will at some point be compelled to adopt a majority vote bylaw, the panel was divided as to whether a company should adopt a majority vote bylaw absent pressure to adopt it. Patrick McGurn stated that a company may gain a tactical and strategic advantage by adopting a majority vote bylaw before receiving a shareholder proposal. Richard Grubaugh disagreed, noting that voluntarily opening the door to the boardroom in such a manner is not necessary. Instead, he recommended that companies be prepared to adopt the Intel approach (as opposed to a "half-step measure" like the Pfizer approach) only after shareholders actively campaign in favor of a majority voting standard.

The panel also considered the likely impact of the impending effectiveness of the rule change that will eliminate broker discretionary voting in the election of directors of shares held in client accounts, as is currently acceptable, in situations where the client has not given the broker specific voting instructions. Because it has been estimated that 70-80 percent of votes are held through brokers, banks and depositories, disallowing a large percentage of those votes would make it more difficult to obtain a majority affirmative vote, which would place even more power in the hands of institutional shareholders. Additionally, those companies with large percentages of shares held by retail shareholders — who are less likely to vote their shares — will face increased costs and may have greater difficulty convincing shareholders to vote in uncontested elections. There was a consensus among the panel members that this development could be the single largest factor affecting the mechanics of voting during the 2008 proxy season.

The panel discussed whether ISS differentiates among companies based on their voting policies when issuing its voting recommendations and how a company should explain its standard in its proxy statement. Mr. McGurn noted that ISS does not yet differentiate. The panel concluded that over time there is likely to be a clear bifurcation on the issue of majority voting – companies will either have a well-defined majority vote bylaw or will not have confronted the issue at all. Until that time, because it is often difficult to differentiate between the varying types of majority voting policies, the panel agreed that each company must educate its shareholders about its particular standard.

Understanding Hedge Funds

Hedge funds are becoming the most aggressive proponent of the "shareholders in the boardroom" theme. Patrick Quick began a discussion regarding the nature of hedge funds by asking the panel to clarify how companies can identify an activist hedge fund. Mr.

McGurn noted half in jest that the name of a fund in itself may be a giveaway – funds named after an animal or bird of prey often prove to be aggressive, activist hedge funds. Generally, however, the panel agreed that it is difficult to know the intentions of any type of investor without engaging that investor in dialogue.

The panel then generally discussed the importance of effective communication with shareholders, including hedge funds. Mr. Grubaugh stated that such communication is often difficult in light of Regulation FD, which imposes limits on what can and cannot be privately disclosed. Others agreed and added that a company can discuss what appears in the MD&A section of its Form 10-K or Form 10-Q, but that disclosure of any additional information should be carefully considered after seeking legal advice. Simply listening to the concerns and suggestions of the hedge fund or activist shareholder, noted Jeffrey Brown, has value in itself and can often satisfy investors or prevent a hotly contested proxy battle.

While it is impossible to control hedge funds, it is possible to prepare for them. Mr. Brown stated that companies should anticipate the issues on which hedge funds are likely to focus and prepare to explain how the company is addressing those issues when confronted by a hedge fund.

But, are they counterproductive to long-term investing? Jim Duffy noted that hedge funds aggressively seek an immediate return on their investment and that the goals of a hedge fund often conflict with the company's goal of providing long-term shareholder value. Notwithstanding this apparent dichotomy of interests, Mr. McGurn stated that some long-term institutional investors, such as pension funds, have generally given the green light to hedge funds that are attempting to effectuate corporate change. The panel concluded that because hedge funds are relatively new investment vehicles, the long-term impact of their influence on management and boards of directors cannot yet be determined. Further, long-term institutional investors may turn against hedge funds if the policies adopted by a company in response to pressure from hedge funds adversely affect the investors' long-term returns on investment.

Before a hedge fund has gone public with its concerns about a company, Mr. Grubaugh noted, the company should respond quickly and politely and should consider implementation of a shareholder rights plan to avoid a "takeover without a premium." Mr. McGurn cautioned that an appropriate balance between takeover defenses and shareholder accommodation is necessary due to the fact that certain hedge funds may deliberately target a company with high defenses and assert that its management and the board of directors are inappropriately entrenched. Additionally, Justin Friesen pointed out that proper communication with the market when dealing with an activist shareholder or hedge fund is vital. He also indicated that companies should constantly be considering ways to maximize shareholder value, noting that it is important to keep in mind that hedge funds are usually operated by former investment bankers who want to enact those actions they advocated while full-time investment bankers.

Responding to Activist Shareholder Proposals

Responding to shareholder proposals is more of an art than a science, depending heavily on the shareholder and the proposal being advocated. In some circumstances, a "wait and see" approach is most advisable when a shareholder approaches a company with a proposal, while under other conditions it may be more appropriate to take immediate action on the proposal. Mr. McGurn noted that conflict between management and shareholders in the context of a shareholder proposal is greatest when the company, as a matter of course, immediately resists shareholder proposals and when the shareholder activist refuses to negotiate a resolution to the issue it is presenting to management. Additionally, some proposals, such as majority voting proposals, are almost guaranteed to pass and should not be steadfastly opposed, while other proposals, such as "say on pay" proposals, as discussed below, have not yet become so prevalent that management and boards of directors should immediately acquiesce.

Communication is Key

The panel agreed that effective communication is a critical component of dealing with activist shareholders and hedge funds. Mr. Friesen noted that the mantra of a public company dealing with a hedge fund or other activist shareholder should be, "We're always interested in what our shareholders have to say." He added that successful companies find ways to maintain communications with hedge funds and large institutional investors so that those investors will generally be supportive of management and the board of directors. The company's investor relations department or outside public relations consultants can be invaluable resources in responding to activist shareholders. They can also be effective in identifying the most immediate shareholder concerns and the most powerful and influential shareholders and in communicating such information to management and the board of directors.

Say on Pay – The Next Corporate Governance Battlefront?

Executive and director compensation is the most significant issue affecting public companies in the 2007 proxy season, and the focus of shareholder activists has naturally turned to this topic. Currently, shareholders may object to a company's compensation practices by seeking to remove the members of the compensation committee, replacing them in a proxy contest, or withholding votes for them. Each of these options is often difficult, if not impossible. In response to this challenge, the newest trend among shareholders seeking a more prominent voice in the boardroom comes in the form of proposals seeking to grant shareholders the right to cast an advisory vote on a company's executive pay practices. The concept of a "say on pay" proposal places another arrow in the quiver of shareholder activists, offering them an alternative to attempting to remove, replace or withhold votes for compensation committee members.

The panel was in agreement that although the "say on pay" movement is in its early stages, it is trending similarly to the manner in which the majority voting movement has progressed to date. The panel noted, however, that a variety of questions must be addressed in connection with this issue before it becomes as widespread as majority voting. For example:

- If the shareholder advisory vote results in disapproval of a company's compensation practices, how should the company react?

- How will shareholders judge whether a company responded adequately to the shareholder advisory vote, and what remedy would shareholders pursue if the company fails to respond adequately? For example, under what circumstances would a negative “say on pay” vote in one year lead to withholding votes for directors in the next year?

Since the issue of “say on pay” is still relatively new, Mr. McGurn noted that a company may want to consider adoption of a carefully crafted “say on pay” proposal because those companies who take a position at the forefront of shareholder movements often “get a pass” from shareholder activists.

Going Private as a Way of Stemming Shareholder Activism

The panel discussion concluded with consideration of whether going private can offer a suitable alternative for a company to the prospect of having to deal with more active shareholders and hedge funds. While certain situations may make going private an attractive alternative to coping with pressure from hedge funds or activist shareholders, the consensus was that going private was not necessarily a panacea. The panel noted that control in the boardroom can quickly be lost in this type of a situation. For example, the duties imposed on a board of directors by *Revlon* to seek the best possible value for shareholders can require the board to accept a transaction other than the going private transaction that management initiated. Additionally, equity investors in a private company often have a loud and more direct voice in the boardroom.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the moderators and panelists directly.

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.