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2007 PROXY SEASON

More Smoke Than Fire

By H. Bryan Brewer 3rd

GOVERNANCE

Results of the 2007 proxy season are indicative of the changing landscape and drive for transparency and corporate accountability.

Activist shareholders, private equity funds, public pension funds and others have continued challenging companies at the feverish pitch that was apparent during last year's proxy season. Shareholders have had a difficult time discerning the total compensation for executives, and that continued to drive many investor proposals this year. Shareholder proposals also continued to reflect disdain for excessive compensation at U.S. companies.

Activist shareholders continued to play an important role in the proxy process, but the expected number of contentious high-profile proxy contests did not materialize, largely a result of the willingness by many companies to make compromises and to avoid such public proxy fights.

Three shareholder proposals of note during this past season were "say on pay," majority vote for directors and pay for performance; early in the season, the most interesting development was compromise.

■ *Say on Pay*. Proposals seeking an annual advisory shareholder vote on executive pay debuted with the 2006 proxy season, and it's no surprise that say on pay proposals emerged as one of the bellwether issues this past season. The proposals require an annual, albeit "non-binding" or advisory shareholder vote. Based on an independent review of shareholder proposals and review of Institutional Shareholder Services (ISS) tracking of proxy proposals, the say on pay proposal was the second-most popular proposal, with approximately 66 proposals being tracked.

The first clear victory of the 2007 proxy season on the say on pay proposals came with New York City Employees' Retirement System proposal at the annual Blockbuster Inc. shareholder meeting on May 9.

The proposal seeking an annual advisory shareholder vote on executive pay received approximately 57 percent support. Again, while the vote was non-binding, the message sent by shareholders to the board was clear.

Another example of activist shareholders pushing the say on pay proposals came at the Verizon Communications Inc. annual meeting on May 3. Verizon shareholders voted on a proposal that would give them an annual vote on pay packages for top executives. The proposal received 50.18 percent of the vote, and the Verizon board will now need to analyze and react, especially if a higher number of votes are received on this say on pay resolution in the future.

Critics of the say on pay proposal argue that the amount of executive compensation should be determined by the marketplace for executives' services, and that a non-binding up or down vote does not provide a meaningful mechanism for shareholders to express their opinion.

At other companies where shareholders have voted on similar say on pay measures, the proposals have not garnered overwhelming approval, although several came close to receiving a majority vote. At Merck & Co. Inc., the measure received 49.2 percent support; at Occidental Petroleum Corp., it received 48.4 percent; and at Bank of New York Co. Inc., 47.3 percent.

■ *Majority Vote for Election of Directors.* The most frequently proposed shareholder resolution during the 2007 season — based on an independent review and ISS tracking information — was the proposal requiring a majority vote of the shareholders to elect directors. The debate and focus over this issue has continued to evolve over the past few years as companies have adopted new election policies and amended their governing documents. Most companies put into place director resignation policies while still maintaining a plurality vote standard.

■ *Pay for Performance.* Investors have sought to continue to link executive pay to performance. These proposals set up various performance metrics for calculating executive compensation. According to the latest ISS 2007 watch list, 62 proposals are being tracked this season relating to pay for performance. ISS notes that there are 29 such proposals, compared to 17 that came to a vote in the 2006 proxy season and 18 that were withdrawn this year.

■ *Compromise.* While shareholder activism is at an all-time high, this has not necessarily translated into high-profile proxy fights. Many companies have tried to address activists and shareholder proposals outside the proxy process. Computer maker Gateway Inc. is one example. Gateway avoided a contentious proxy fight by entering into an agreement with Harbinger Capital Partners and Firebrand, two institutional investor firms.

The agreement calls for Gateway to seek approval from shareholders to modify the timing of its board elections from being staggered to being held on an annual basis. Most commentary on this move saw this action as helping investors demonstrate any displeasure with the present board and permit the potential nomination of an alternative slate of directors. This could lead to election of a new board, given that the right forces are in place.

Last fall, Firebrand and Harbinger called on Gateway to add three board members and remove several obstacles that could deter unsolicited buyout offers. As a result of Gateway's concessions, the investor group agreed to abide by certain standstill provisions that would run through the end of 2007, presumably keeping a proxy contest on hold — at least for the time being.

Other companies faced similar institutional pressure and reacted in kind. For example, in February, The Home Depot Inc. provided a seat on its board to David H. Batchelder of Relational Investors LLC. Relational Investors has advocated that Home Depot consider alternative strategies — including a leveraged buyout — as a way to boost shareholder value. Relational had threatened a proxy battle over the company's strategic direction and was undoubtedly part of the underpinnings that led to former chief executive Robert Nardelli's resignation.

One notable exception to this trend was activist investor Carl Icahn's failed bid for a seat on Motorola Inc.'s board at its May 7 annual meeting. Through various entities, Icahn owns approximately 2.9 percent of Motorola. It was reported that Icahn's attempt to win a seat on Motorola's board garnered approximately 40 percent of the shareholder vote.

Additional Proxy Issues

Several other issues have surfaced this season. Among them:

■ *Proxy Access* — This has been the subject of much media and commentary. Proxy access proposals seek to establish procedures to allow shareholders to nominate directors. Although a favorite of governance proponents, only three proposals were advanced during the 2007 proxy season.

In addition, on Jan. 22, the staff of the U.S. Securities and Exchange Commission (SEC) issued a statement express-

THE 2007 PROXY SEASON SAW A SLEW OF CHALLENGES FROM ACTIVIST SHAREHOLDERS, PRIVATE EQUITY FUNDS, PUBLIC PENSION FUNDS AND OTHERS. MANY HIGH-PROFILE PROXY CONTESTS DID NOT MATERIALIZE, AS COMPANIES COMPROMISED TO KEEP RESOLUTIONS FROM BEING VOTED ON.

ing "no view" in its highly anticipated response to Hewlett-Packard Co.'s request to exclude a shareholder proxy access proposal from its 2007 proxy statement. The proposal was submitted by four pension funds, led by the American Federation of State, County and Municipal Employees (AFSCME).

This was the first shareholder proposal seeking access to proxy materials following the September 2006 decision by the U.S. Court of Appeals for the Second Circuit in *AFSCME v. American International Group Inc*. (granting shareholders the right to place proxy access proposals on company proxy statements).

The proposal seeks to amend the corporation's bylaws to require it to include the names of director candidates nominated by certain shareholders in its annual meeting proxy materials. Approximately 43 percent of the HP shareholders voted in favor of this proxy access proposal at the March 14 meeting.

There remains one proposal to be voted on at UnitedHealth Group Inc. at the end of May (past press time). A proxy access proposal at Reliant Energy Inc. was withdrawn.

The SEC has grappled with this issue for a number of years, and in recent media statements, Chairman Christopher Cox has indicated that it will likely release a proposal this summer to address controversy over so-called shareholder democracy that will aim to have new rules in place for the 2008 proxy season.

The SEC proposal is expected to address shareholders' ability to nominate corporate directors and place those names on the company's proxy ballots. In early May, the SEC conducted the first in a series of three public roundtable meetings on the proxy access topic in an effort to conduct a "top-to-bottom review" of shareholder proxy-voting issues before proposing the new rules.

■ *Social Responsibility* — The ISS watchlist notes an increasing number of proposals on social responsibility issues, including 40 calling for a report on sustainability; 8 on reporting on energy efficiency; and 56 on reporting on political contributions. Shareholder activism and the media attention that it garners for these issues — associated with the green movement, in general — are all contributing to an increase in these types of proposals.

■ *Notice and Access Method (Internet Delivery)* — The SEC has adopted a voluntary system that will allow issuers and other soliciting persons to satisfy proxy delivery requirements by posting proxy materials on an Internet website and sending shareholders notice of their availability. This proposal is seen as addressing the rising costs of soliciting proxies and taking advantage of technological developments. The rules went into effect on July 1; companies will need to carefully consider various timing and technical requirements of the new rules.

The 2008 Proxy Season And Beyond

The stage for the 2008 proxy season is already being populated with interesting dramas. Several areas should continue to develop during the year and ultimately play out — with shareholders and in the media — for next year and beyond.

Say on pay proposals should continue to garner interest from a variety of sources and will further develop over the coming year. This issue is also gaining momentum in Congress. Federal legislation giving shareholders a non-binding say on executive compensation passed the House of Representatives in April. The bill, introduced by the chairman of the House Financial Services Committee, Rep. Barney Frank (D-Mass.), passed by a 269-134 vote.

The bill permits shareholders to approve or disapprove a company's executive compensation plans but doesn't set mandates or limits on pay. It also affords company shareholders an advisory vote on any previously undisclosed "golden parachutes" that a company provides to executives in connection with merger and acquisition activity. While a companion bill has been introduced in the Senate, it does not have a strong champion at the present time — and without Senate passage, Congressional say on pay legislation would die.

Coupled with the increased disclosure requirement under the SEC rules on executive compensation in the Compensation Discussion and Analysis (CD&A) section, investors are closer to realizing transparency, but also are facing an increasingly complex stew of information that must be reviewed and analyzed.

The New York Stock Exchange (NYSE) continues to pursue its proposal to eliminate discretionary broker voting — a proposal subject to approval by the SEC — which calls for the amendment of NYSE Rule 452 to be effective for all shareholder meetings held on or after Jan. 1, 2008. The proposal stipulates that broker-dealers holding shares in "street name" will not be able to vote with management unless the investors specifically direct the broker-dealers to vote in such manner.

To sum up, shareholder activism continues, and the importance of integrity in the voting process will likely continue as a developing issue for the upcoming season and beyond. Issues that attract attention and bear watching include: use of the company's proxy statement for competing director slates; the green movement and social responsibility; and the lack of shareholder proposals without binding effect, such as on say on pay.

Indeed, the stage is set for another interesting year — and beyond. Expect to see continued investor scrutiny driving shareholder proposals in the future, in what can only be described as a new era of company compromise and ongoing shareholder drive for transparency.

Currently a partner in the Washington, D.C. office of Crowell and Moring LLP and member of the firm's Corporate Group, H. Bryan Brewer, Esq., was a partner with the law office of Nixon Peabody LLP at the time of publication. He can be reached at bbrewer@crowell.com.

EDITOR's NOTE: Updates on specific proxy results will be included with this article online at *www.financialexecutive-magazine.com*.

TAKEAWAYS

>> Proxy season 2007 saw three proposals of note: majority vote for directors (leading proposal), "say on pay" (second most popular proposal) and pay for performance.

>> Activist shareholders continued to play an important role, but the expected number of high-profile proxy contents did not materialize, largely due to the willingness of companies to compromise and avoid public proxy fights.

>> Next year, expect more proposals on say on pay, eliminating discretionary broker voting and issues related to social responsibility.