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Corporate Governance Update: Shareholder Activists Risk Destroying Board Effectiveness

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Although stockholder meetings for the most part have been quieter this year,<sup>1</sup> the two corporate governance issues receiving the most attention during the 2007 proxy season were stockholder proxy access and stockholder voting on executive compensation.

Proxy access emerged as a high-profile issue at the Hewlett-Packard Co. (H-P) annual meeting in March 2007. A non-binding stockholder access proposal, which was publicly supported by two large California pension funds and Institutional Shareholder Services (ISS), was voted down by holders of 52 percent of the company's shares. Thirty-nine percent of the shares voted in favor of the measure. Despite the failure of the proposal, stockholder activists, such as the pension funds that sponsored the measure, are claiming to be emboldened by the relatively strong showing of support among H-P stockholders.<sup>2</sup> In light of this showing, absent action in this area by the Securities and Exchange Commission (SEC), it is likely that many more stockholder access proposals will be filed next year, particularly if a similar result is achieved at UnitedHealth Group annual meeting being held at the end of May 2007.

The landscape of the proxy access battle may be about to change, however: SEC Chairman Cox stated in March that the SEC will propose an investor-friendly rule on proxy access prior to the 2008 proxy season. Chairman Cox apparently indicated that electronic delivery of proxy materials would be a factor in the proposed rule.<sup>3</sup> As we have noted previously, this technological advance, along with the elimination of broker voting in uncontested director elections, would give stockholders

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<sup>1</sup> See Gretchen Morgenson, "Proxy Fights More Muted, For Most Part," N.Y. Times, May 16, 2007 (citing the general counsel of Georgeson, Inc. for the observation that "meetings have been quieter this year because companies and shareholder activists were working out their differences in advance of the gatherings").

<sup>2</sup> The co-sponsors of the proposal were the American Federation of State, County and Municipal Employees (AFSCME) and the state pension funds of New York, Connecticut and North Carolina.

<sup>3</sup> See Judith Burns, "Making 'Great Deal of Progress,' on Proxy Access, SEC's Cox Says," Wall St. J., Mar. 8, 2007.

(especially institutions) greater ability to influence the outcome and the process of annual elections than ever before, even without the implementation of proxy access.<sup>4</sup>

We continue to believe that stockholder proxy access would impose an undue burden on public companies. The H-P proposal, for example, would permit stockholders who held 3 percent of the company's stock for at least two years to nominate director candidates; as the H-P board noted in its opposition statement, this could potentially result in the election of "special interest directors" who have an incentive to influence the board in ways that disproportionately benefit the stockholders that nominated them.<sup>5</sup> Particularly in light of the sweeping trend toward majority voting for directors, proxy access and the resultant proxy contests would be a source of conflict and expense, and, in our view, would provide no significant countervailing benefits to stockholders.

### *Executive Compensation*

Another issue making headlines this proxy season is stockholder voting on executive compensation. In March 2007, U.S. Representative Barney Frank (D., Mass.) introduced legislation that would require stockholder advisory votes on executive compensation packages.<sup>6</sup> Representative Frank's bill also would require that stockholders approve any compensation arrangements entered into in connection with business combination transactions. The bill states that the stockholder votes would not be binding on a board and would not be construed as overruling a decision by a board. Similar laws have been implemented in the United Kingdom, Australia and the Netherlands.

Meanwhile, activist stockholders have filed precatory proposals to permit stockholder advisory votes on executive compensation packages at approximately 60 companies this year.<sup>7</sup> These activists argue that such a vote, albeit nonbinding on a board, would prompt increased communication between stockholders and boards and curb excessive compensation practices. According to ISS, in 2006, such proposals averaged stockholder support of around 40 percent.<sup>8</sup> A group of companies and activist stockholders, including AFSCME, CalPERS, Pfizer Inc. and Schering-Plough Corp., has organized to discuss the issue.

Aflac Inc. has become the first company to implement an advisory stockholder vote on executive compensation. In February 2007, Aflac's board approved

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<sup>4</sup> See David A. Katz & Laura A. McIntosh, "Corporate Governance Update: Proxy Access—Not Then, Not Now," N.Y.L.J., Sept. 28, 2006.

<sup>5</sup> Hewlett-Packard Co., Schedule 14A, at 23 (filed with the Securities & Exchange Commission on Mar. 7, 2007).

<sup>6</sup> H.R. 1257, the "Shareholder Vote on Executive Compensation Act," was introduced March 2, 2007.

<sup>7</sup> See ISS 2007 Proxy Season Watchlist, available at [http://www.issproxy.com/knowledge\\_center/proxy\\_season\\_watchlist/](http://www.issproxy.com/knowledge_center/proxy_season_watchlist/).

<sup>8</sup> See White & Patrick, *supra*.

a resolution that will give stockholders an advisory vote starting in 2009, when three years of compensation information under the new disclosure rules will be available.<sup>9</sup> It is rumored that at least several other significant companies are considering similar resolutions.<sup>10</sup>

Companies that are opposing proposals for stockholder advisory votes, such as Wells Fargo & Co., typically—and rightly—argue that a simple yes-or-no vote is too blunt an instrument to convey stockholders’ opinions of complex pay packages and that there are other, better ways for stockholders to communicate with a board.<sup>11</sup> Assembling a chief executive’s pay package involves strategic and sophisticated calculations that take into account the company, the individual, and industry and market conditions. This decision is precisely the sort of decision that should be in the hands of a board, not in the hands of a large, unfocused group of relatively uninformed stockholders. At least one company, WellPoint Inc., succeeded in excluding from this year’s proxy a proposal for advisory stockholder voting on executive compensation,<sup>12</sup> and, in our view, such exclusion is appropriate.

In a targeted effort to shape the contours of executive compensation, precatory pay-for-performance stockholder resolutions have been filed at numerous public companies this season. According to ISS, over 40 such proposals are pending or have been voted upon in 2007, a significant increase from the 17 that came to a vote in 2006.<sup>13</sup> These proposals aim to align executive pay with company performance, often using data from peer companies and broad market benchmarks. One such proposal

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<sup>9</sup> Aflac Press Release, “Aflac Adopts Non-Binding ‘Say On Pay’ Shareholder Vote,” available at <http://www.aflac.com/us/en/aboutaflac/PressReleaseStory.aspx?rid=962932>.

<sup>10</sup> See Erin White & Aaron O. Patrick, “Shareholders Push for Vote on Executive Pay,” Wall St. J., Feb. 26, 2007.

<sup>11</sup> The statement of the Wells Fargo board in opposition to the proposal reads, in part:

The Proponent believes that the requested advisory vote would “give stockholders a clear voice that could help shape senior executive compensation.” The Board does not agree. The proposed advisory vote would not provide useful guidance to the HRC [Human Resources Committee] in considering its compensation philosophy and program or in making specific compensation decisions because of the “up-or-down” nature of the vote. Such a vote would provide no clear or meaningful guidance to the members of the HRC on specific components of the Company’s executive compensation program, nor would it allow for constructive feedback about the program generally. The members of the HRC would be forced to speculate about which component of executive compensation—salary, bonus, stock options, or retirement programs—is of particular concern to the stockholders.

Wells Fargo & Co., Schedule 14A, at 94 (filed with the Securities & Exchange Commission on Mar. 16, 2007).

<sup>12</sup> See White & Patrick, *supra*.

<sup>13</sup> See ISS 2007 Proxy Season Watchlist, available at [http://www.issproxy.com/knowledge\\_center/proxy\\_season\\_watchlist/](http://www.issproxy.com/knowledge_center/proxy_season_watchlist/).

passed at H-P's annual meeting in March.<sup>14</sup> These proposals are misguided because they would narrowly constrain compensation decisions, eliding the many other variables that must be considered both in constructing a complex pay package and in recognizing superior performance by a top executive. The use of pay-for-performance benchmarks, like other aspects of executive compensation, is properly the subject of board consideration and discretion.

### *Governance by Proxy?*

The 2007 proxy season has amplified the trend toward ever more intrusive stockholder involvement in the management of public companies. Executive compensation proposals are proliferating and the proxy access movement is gaining steam. These developments are unfortunate and could prove to be destructive in the long term. It is neither practical nor sensible for companies to be run by stockholders via referenda, though this appears to be the direction in which some activists are heading. At American Airlines last week, 54 percent of stockholders approved a precatory stockholder proposal that would allow holders of 10 percent or more of the outstanding stock to call a special meeting of stockholders. Similar proposals also have passed at Electronic Data Systems, Citigroup and JP Morgan Chase.<sup>15</sup> Stockholder voting on executive compensation packages, even if merely advisory, would tend to undermine a board's fundamental authority to supervise the affairs of a company by hiring and compensating its top executives. This kind of interference could have the direct, though unintended, consequence of pushing the best executives to private firms where they would presumably be paid more; at the least, it would be yet another reason, on top of the onerous corporate governance requirements imposed in recent years, why sensible boards may prefer to keep or take their companies private.

Stockholder activists, in their constant quest for greater stockholder involvement in the key decisions taken in the life of a company, run the risk of destroying the effectiveness of the board. Moreover, the specific interventions that are the subject of recent stockholder proposals are becoming less justified as more companies move toward a majority-voting standard in the election of directors. Stockholder activists have been emboldened by the success in recent years of initiatives such as majority voting and the dismantling of takeover defenses. They would be wise, in our view, to let the current round of reforms play out rather than attempting to accelerate the pace of reform still further. Public company boards that are elected by and answerable to stockholders long have done the work that has made the U.S. capital markets prosper, and market

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<sup>14</sup> The proposal read as follows:

RESOLVED: Shareholders request the Board of Directors adopt a long-term policy that a significant portion of future long-term equity compensation to senior executives shall be performance-based, i.e., linked to demonstrable performance criteria, measured by challenging performance targets, and using as benchmarks such criteria as Hewlett-Packards' [sic] performance compared to its peers and a broader market standard.

Hewlett-Packard Co., Schedule 14A, at 28 (filed with the Securities & Exchange Commission on Mar. 7, 2007).

<sup>15</sup> See Eric O'Keefe, "Executive Pay Proposals Rejected at AMR," N.Y. Times, May 17, 2007.

participants should make sure that the consequences of recent, significant changes to public company governance structures are clear before implementing additional changes that could possibly do irreparable harm to a fundamentally sound and successful system.