THE ADVISOR

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2011 PROXY SEASON REVIEW: GOVERNANCE PROPOSALS

By Shirley Westcott **September 2011**

This month's newsletter continues Alliance Advisors' review of the 2011 proxy season with a look at governance proposals. Our July and August newsletters covered say on pay and compensation issues, and upcoming articles will address some of the environmental and social (E&S) proposals.

Overview

With the first wave of regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act underway, executive compensation and say on pay overshadowed all other issues this proxy season. The result has been a decline in shareholder proposals overall, both in terms of filings (below the 1,000 level of previous years) and the number appearing on ballots. There has also been less diversity of shareholder resolutions this year as proponents largely brought back tried-and-true issues rather than craft new types of proposals. The one exception has been in the E&S universe where resolutions relating to corporate political spending topped the shareholder proposal list both in number (54 voted on through early August) and variation.

While compensation will likely remain the central focus of investors and issuers alike in coming years, this year's governance trends and shareholder initiatives offer insight as to what lies ahead for 2012:

Fewer Shareholder Resolutions, More Dialogue

Ballot items pertaining to governance (board structure and shareholder rights) receded from 273 in 2010 to 220 through early August 2011 (see Table 1), with only a few remaining in the pipeline for the remainder of the year. The biggest reduction was in proposals calling for an independent chairman—primarily sponsored by organized labor—which were down by almost half from last year's count. Labor funds appeared more preoccupied this year with say-on-pay votes, supplanting compensation-related shareholder resolutions with "vote no" campaigns against companies' pay programs (see our July newsletter), a trend that is likely to continue.

Public pension funds concentrated their efforts on improving board accountability (annual director elections and majority voting) through a combination of letter-writing campaigns, engagement, and shareholder proposals. Their behind-the-scenes dialogue paid off, with far more of their proposals withdrawn than on ballots. Indeed, beginning this year, the California Public Employees' Retirement System (CalPERS) eschewed its public "name and shame" annual focus list in favor of privately engaging underperforming companies after a study by Wilshire Consulting found that privately contacted firms outperformed those named to CalPERS' focus list over the past two decades.

As in the past, one-third of the governance proposals on ballots this year were sponsored by John Chevedden and his network of retail activists. However, this season they shifted their proposal mix by cutting back on those relating to special meetings and supermajority voting in favor of written consent. While gadfly proponents aren't usually amenable to negotiating withdrawals with issuers, the popularity of their proposals with other investors has encouraged companies to adopt them.

Proxy Access Lite?

The SEC's adoption of a final proxy access rule in August 2010 pursuant to the Dodd-Frank Act, although stayed through proxy season, heartened some activists to lay groundwork for its implementation in 2012. In April, CalPERS and the California State Teachers' Retirement System (CalSTRS), in conjunction with The Corporate Library, launched the Diverse Director DataSource (3D), a database of potential director candidates to increase board diversity, reduce group think in the boardroom, and improve corporate performance. Meanwhile, labor unions switched out their five-year campaign on proxy solicitation expense reimbursement for proposals to adopt cumulative voting in contested elections.

The July decision of a U.S. Court of Appeals to void the rule due to an inadequate cost/benefit analysis leaves proxy access in disarray. Given the SEC's backlog of Dodd-Frank rulemaking, the Commission is unlikely to revisit proxy access in time for the 2012 proxy season, while the outcome of the 2012 presidential elections could result in an overhaul or repeal of Dodd-Frank itself. Absent a federal proxy access rule, private ordering is the default and activists may resort to the traditional means of enforcing their will. Unlike Rule 14a-11, the SEC's amendments to Rule 14a-8, which would permit shareholders to file proxy access bylaw proposals, was not challenged by business groups although it was also stayed last fall. Whether or not the SEC lifts the stay ahead of next proxy season, companies should remain vigilant about issues of concern to their investors in order to preempt activist challenges.

What follows are some of the highlights of this year's shareholder campaigns and company responses regarding governance issues.

Board Declassification

This season board declassification got an added lift by campaigns coordinated by the American Corporate Governance Institute (headed by Harvard professor Lucian Bebchuk), the Florida State Board of Administration (Florida SBA) and Nathan Cummings Foundation, which resulted in commitments by 16 companies to propose declassification of their boards at this year's annual meetings or in 2012. Their nine proposals which proceeded to a vote averaged 82.2% support, which is noteworthy since this was reportedly the first time in 20 years that Florida SBA has submitted a declassification resolution, while Nathan Cummings was a first-time filer of such proposals.

Overall, 40 shareholder proposals and 55 management proposals to declassify boards had gone to a vote through early August. While these are similar proportions as last year, this year's shareholder proposals garnered higher average support levels (71.3% versus 60.4% in 2010), and in some cases over 90% support even in the face of board opposition (MEMC Electronics and Pioneer Natural Resources). This reflects shareholders' near universal preference for annually elected boards, which they feel improves board accountability.

The higher support for declassification resolutions also reflects the shift in proponents and targets between 2010 and 2011. Last year, over half of the declassification resolutions were sponsored by retail activist Gerald Armstrong, who mostly targeted small and mid-size financial institutions, which generally have relatively low institutional ownership. This year a majority were sponsored by institutional investors (labor funds, public pension funds and foundations), and over half of the proposals were directed at S&P 500 firms. Aside from cleanup at the remaining 25% of S&P 500 firms that maintain staggered boards, future shareholder campaigns will likely drill down to small and mid-cap firms where classified boards are still fairly commonplace (46% of the S&P 400 and 49% of the S&P 600, according to SharkRepellent).

In view of the high degree of investor support these proposals historically achieve, companies targeted with shareholder proposals to declassify their boards inevitably concede the issue rather than fight it. Of the 33 companies where shareholder declassification resolutions received majority support in 2010, 18 complied in 2011. Seven of the companies that did not comply faced the shareholder proposal again in 2011 and, invariably, saw it receive majority support again. Because boards run the risk of withhold votes if they fail to implement a majority-supported shareholder resolution, few will attempt to stand down a successful shareholder campaign after two consecutive years (one notable exception being Neurocrine Biosciences which has resisted a declassification proposal from the New York City Pension Funds after five consecutive years of majority support). Even companies that begrudgingly comply with a shareholder referendum by opposing their own management resolution (Barnes Group) are still likely to see it pass.

Impediments to Declassification

Recent changes to state laws have shielded some companies from shareholder challenges to their staggered boards. Indiana and Oklahoma now require most of their public companies to have classified boards by default, though Indiana companies were able to opt out before mid-2009 and Oklahoma companies can opt out beginning in 2015. This has prompted some shareholder activists to switch course from declassification proposals to reincorporation proposals in cases where the former can be omitted for conflicting with state law.

For a second year the American Federation of State, County and Municipal Employees (AFSCME) took aim at Indiana companies to reincorporate in Delaware, but with limited success. A second-year proposal at Wellpoint received lower support in 2011 (34.5%) than in 2010 (38.4% in 2010). A reincorporation proposal at Ball this year fared better (43.4% support), mainly due to the company's intransigence with respect to adopting majority-supported shareholder resolutions to declassify the board in 2008 and 2009. (A 2010 declassification proposal sponsored by CalPERS was excluded by Ball for violating Indiana state law.)

Other Indiana companies have been more amenable to governance reforms. For the past four years, Eli Lilly has tried to declassify its board, but each time failed to obtain the requisite 80% shareholder approval. Lincoln National, which had been an AFSCME target for reincorporation, agreed to adopt majority voting in 2010 and to amend its articles in 2011 to allow shareholders to propose bylaw changes, which is not allowed by default in Indiana.

The 2010 Oklahoma law similarly relieves Chesapeake Energy from shareholder declassification campaigns (which had received majority support in 2008 and 2009), but poses a quandary for two other Oklahoma companies: Oneok, which unwound its staggered board in 2009, and OGE Energy, which is phasing in annual elections to 2013 in response to majority-supported shareholder proposals in 2008 and 2009. Because of the lengthy delay before opt-outs are permitted, companies domiciled in Oklahoma could become future candidates for shareholder-sponsored reincorporation proposals.

State of Incorporation and Forum Exclusivity

Companies seeking to reincorporate in states with strong takeover protections have met resistance from proxy advisors and institutional investors unless they opted out of statutory provisions or made other charter amendments to equalize shareholder rights. This year, shareholders sank efforts by Abercrombie & Fitch and Camden Property Trust to redomicile in Ohio and Maryland, respectively, but approved TF Financial's move to Pennsylvania because it bowed out of anti-takeover statutes. Although the bulk of corporate migrations are typically to Delaware (14 out of 22 companies this year), these, too, can occasionally fall flat (Triangle Petroleum and Zix) if shareholder rights are ultimately diminished.

One provision that has featured in some of this year's company-sponsored reincorporation proposals (PURE Bioscience, Williams-Sonoma and Zix), as well as in separate charter and bylaw resolutions, is the designation of Delaware as the exclusive forum for resolving intra-corporate disputes, such as shareholder class action and derivative suits. Endorsed by the Chancery Court's 2010 opinion in In Re Revlon, Inc. Shareholders Litigation, such provisions can eliminate duplicative litigation in multiple jurisdictions, while Delaware's well-developed body of case law provides for faster dispute resolution and greater certainty of outcome. Given the number of shareholder derivative suits against directors and officers of companies with failed say-on-pay votes, these measures may be particularly timely since the Delaware Chancery Court has a high threshold for demonstrating breach of fiduciary duty (which may explain why derivative suits against Beazer Homes USA, Jacobs Engineering, Hercules Offshore and Occidental Petroleum were not brought in Delaware even though these companies are incorporated there).

Because board-approved bylaws mandating exclusive jurisdiction may not be enforceable (e.g., the 2011 federal court ruling in Galavitz v. Berg), a number of companies this year have sought shareholder approval of charter and bylaw provisions designating Delaware as the exclusive venue for state corporate law disputes. While all but one (Allstate) have passed so far, companies should be aware that proxy advisor Institutional Shareholder Services (ISS) is opposing these resolutions until it can further study the issue from a shareholder perspective.

Majority Voting in Director Elections

With a majority vote standard omitted from the final Dodd-Frank legislation, activist shareholders ramped up their efforts over the past year to increase its adoption company by company. In addition to the longstanding advocacy by the United Brotherhood of Carpenters, Florida SBA and CalPERS obtained company commitments to adopt majority voting through extensive letter-writing campaigns in 2010. Successful company engagement similarly prompted CalSTRS to withdraw 21 of its 26 majority voting proposals and the New York City Pension Funds to withdraw eight of their 11 proposals.

Now that a critical mass of large-cap companies have adopted majority voting (77% of the S&P 500), proponents are extending their campaigns to mid- and small-cap firms. Of the companies targeted this year with majority voting proposals, 54% were outside of the S&P 500 universe, compared to 19% of the companies targeted in 2010. According to SharkRepellent, 57% of S&P 400 companies and 74% of S&P 600 companies have neither a majority voting standard nor plurality voting with a director resignation policy.

Through early August, 39 shareholder proposals to adopt majority voting had gone to a vote, of which 25 received majority support. These are roughly the same proportions as in 2010 (32 proposals with 19 receiving majority approval). Although the average support level has been higher this year (61.3% versus 56.4% in 2010), this is attributable to exceptionally high support (over 80%) at five companies that either made no recommendation on the shareholder proposal (Gentex, Lorillard and Spark Networks) or that adopted majority voting prior to or at the annual meeting (Selectica and Wilshire Bancorp). Excluding these situations, average support on the shareholder resolutions that were opposed by the target companies was 57.4%—only a single point increase from 2010.

As in past years, most of the shareholder proposals that failed or drew only marginal majority support were at companies that had plurality voting with a director resignation policy. A number of institutional investors, such as BlackRock, Fidelity and Capital Research, consider this structure to be as effective as a majority vote standard.

Failed Elections

Companies that switch from plurality to majority voting need to be attentive to factors which could lead to a failed election. This year, of the 38 firms where directors received less than majority approval, two were recent adopters of majority voting: Annaly Capital Management, which adopted majority voting two months before its annual meeting in response to a CalPERS' proposal, and IRIS International, which adopted majority voting in January 2010.

The most prevalent cause for a director failing election is poor attendance (less than 75%) at board and committee meetings in the prior year, as occurred with one director at Annaly Capital Management. Companies can deflect opposition votes of this kind by disclosing a satisfactory reason for the director's absences in the proxy statement, as well as pointing out the director's strong attendance record from previous years.

While poor attendance is a one-off situation, other factors resulting in a failed election may be more difficult to cure. IRIS International's entire nine-member board was rejected by shareholders for having adopted a 10-year poison pill in September 2010 without obtaining shareholder approval (or committing to do so within a year). Although the directors understandably did not accept the resignation of the full board, they face a double jeopardy situation going forward. If they put the pill to a shareholder vote, it is unlikely to pass because it not only lacks the shareholder-friendly features advocated by proxy advisors and many institutional investors, it contains a negative provision (an adverse person clause for acquisitions of 10% or more of the shares). But short of restructuring or redeeming the pill, the board members may face failed elections in future years.

Other factors which commonly trigger high withhold votes are failure to adopt a majority-supported shareholder proposal, inadequate board or committee independence, and excessive outside board service.

This year even some companies with plurality voting are acting promptly to redress majority withhold votes by rolling "non-independent" directors off key committees (Synovis Life Technologies) or encouraging "overboarded" directors to cut back on outside board seats (HSN).

Cumulative Voting

This year organized labor co-opted cumulative voting, which had heretofore been a recurring theme of gadfly investor Evelyn Davis. However, unlike Davis's proposals, the eight labor resolutions—primarily sponsored by the Trowel Trades S&P 500 Index Fund and the International Brotherhood of Electrical Workers (IBEW)—asked companies to adopt cumulative voting only for contested elections, which could facilitate the election of dissident candidates by shareholders accumulating their votes for them. Cumulative voting has little utility in uncontested elections where there are as many nominees as board seats. At companies with plurality voting, all of the nominees invariably get elected. At companies with majority voting, voting against unwanted directors has the same effect as cumulating votes for desired directors.

Ultimately, the labor-sponsored resolutions got only slightly more traction than those offered by Davis and other individual investors, with average support of 31.1% and 29.4% on their respective proposals. Historically, most institutional investors have shown little interest in cumulative voting, notwithstanding Davis's persistent resubmissions (the longest-running being at WGL Holdings which has received Davis' resolutions every year since 1986). Although support levels for her proposals have inched up in recent years, this is most likely due to ISS tightening its policy so that it will support shareholder resolutions to adopt cumulative voting unless the company has both majority voting and proxy access—essentially an insurmountable hurdle.

Many institutional investors remain leery of cumulative voting because it could further the candidacy of minority and special interest shareholders. Indeed, companies that have had cumulative voting have largely been successful at eliminating it, often times by offering shareholders a trade-off for other governance enhancements, such as declassifying the board or, more often, adopting majority voting, which is viewed as incompatible with cumulative voting. This year, eight companies scrapped their cumulative voting provisions, albeit in some cases with dissent from ISS, which seems to only accept the removal of cumulative voting when bundled with other governance reforms.

Board and Executive Leadership

Shareholder proposals seeking the appointment of an independent chairman have been less numerous than last year, but they have garnered higher average support and more majority votes. Through early August, 23 resolutions had been voted on (versus 44 in 2010) with average support of 35.8% (versus 28.7% in 2010). Four have received majority support, compared to only one in 2010. While this is still a small subset of the targeted firms, companies should be watchful of increasing support levels. Of the 10 proposals that were resubmissions from 2010, support levels crept up in virtually all cases, and made it over the majority mark at Aetna, Moody's and Vornado Realty Trust after receiving support in the 30%-40% range last year. (The fourth majority-supported proposal this year—at Cedar Fair—was part of a proxy fight.)

The higher support may be partly attributable to ISS which only opposed five of this year's 23 independent chairman proposals, while last year it opposed over one-third of the resolutions (16 out of 44). While many targeted companies with a non-independent chairman are able to satisfy ISS's policy of having a countervailing leadership and independence structure (a lead director with comprehensive duties, two-thirds independent board and fully independent key committees), they can fall short on other criteria that will sway ISS toward supporting an independent chairman, such as poor financial performance (in the bottom half of peers' one- and three-year total shareholder returns) or problematic pay or governance practices.

Under most circumstances, institutional investors consider a lead director to be an acceptable counterbalance to a combined chairman/CEO, and lead directors have become fairly commonplace (at 66% of companies, according to the National Association of Corporate Directors). However, the effectiveness of this structure has as much to do with the person who is the chairman/CEO of the corporation, the composition of the board, and overall governance of the firm. This October, News Corp. will face off with investors on these issues at its annual meeting in the wake of the phone hacking scandal at its British tabloid. Although Rupert Murdoch has announced that he will not be stepping down, Christian Brothers Investment Services plans to introduce a floor proposal calling for an independent chairman. Other shareholders may raise concerns over board independence, CEO succession, and the company's dual-class stock which gives the Murdoch family outsized voting power (38%) relative to its economic ownership in the firm (12%).

The influence and role of company founders has featured at other annual meetings this season where shareholders filed resolutions to eliminate dual-class capital structures or to disclose the process for CEO succession. Six companies were targeted by various individual investors to recapitalize classes of stock with unequal voting rights, including two that have been longstanding resubmissions (Astronics and Ford Motor). As in the past, average support on the proposals was thin at 21.1%.

For a second year, the Laborers International Union of North America (LIUNA) and affiliates brought back resolutions on CEO succession planning, which had previously been excludable as ordinary business. Most companies complied with the requested disclosure, prompting a withdrawal of all but two proposals, at Kohl's (which disclosed its succession planning policies and practices in its proxy statement) and Apple (where Steve Jobs recently stepped down as CEO and was succeeded by COO Tim Cook). Average support for the resolutions was 29.5%, a slight uptick from the 27.7% received for last year's five proposals. News Corp. shareholders may similarly revisit CEO succession at the company's fall meeting, given its current turmoil, despite the withdrawal of a succession planning proposal in June by Hermes Equity Ownership Services Ltd.

Supermajority Voting

As in 2010, retail activist John Chevedden, along with affiliates William and Kenneth Steiner, the Rossi family and others, sponsored one third of this year's governance resolutions on ballots. While their hit-or-miss approach to proposals and targets can sometimes fizzle (such as their revival this year of their 2009 lead director proposals), several of their campaigns have resonated well with proxy advisors and other investors, including repealing supermajority voting provisions and giving shareholders greater ability to call special meetings and act by written consent.

Like board declassification, shareholder resolutions to rescind supermajority voting requirements, which typically apply to business combinations, charter and bylaw amendments, and director removal, have historically received high levels of support, often exceeding a majority of outstanding shares. Because of this, companies have been aggressive in responding to them to avoid votes against directors in the following year.

So far this year, only 15 shareholder proposals to repeal supermajority voting have appeared on ballots, compared to 32 in 2010. In addition to the drop in number, this year's shareholder resolutions have also received proportionately fewer majority votes (10 out of 15, versus 28 out of 32 last year) and lower average support (52.7% versus 74.1% last year), with the highest support at Prudential Financial (98%) where the board backed the proposal. This shift, however, may simply be due to the companies targeted this year. Of the five companies where the shareholder proposal failed, four had a significant shareholder, often a founder. In such cases, minority shareholders may be reluctant to reduce the voting threshold from a supermajority to simple majority because it would give the major shareholder greater influence over corporate actions.

Corporate efforts to revoke supermajority vote requirements have been far more widespread this year. Through early August, 44 companies put forward management proposals to adopt a simple majority vote, and an additional company (Cognizant Technology Solutions) reduced its supermajority threshold from 80% to 67%. Of these, 18 were in response to majority-supported shareholder proposals from 2010 and another 13 were in response to submissions of shareholder proposals for 2011.

Despite good intentions, even company initiatives to eliminate supermajority voting or amend other lockedin charter provisions can fail. For a second year, Eli Lilly and Alcoa could not obtain the necessary 80% approval to repeal their supermajority voting provisions, which also impeded their respective attempts to declassify the board and rescind fair price provisions. Supermajority approval requirements similarly blocked efforts this year by Baxter International, Cleco, Comverge and Principal Financial to declassify their boards, by Walgreen to abandon its fair price provision, and by Herley Industries to repeal its supermajority provisions.

Special Meetings and Written Consent

Now in its fourth year, Chevedden's campaign to enhance shareholders' right to call special meetings continued to lose momentum after many companies complied with earlier versions of his resolutions by granting this right for holders of 25% or more of their shares. However, his efforts to ratchet down the ownership requirement to 10% have met with resistance from other shareholders. This year, only four of the 29 special meeting proposals on ballots received majority support (compared to 12 out of 43 last year), notwithstanding that he proposed somewhat higher ownership thresholds (15% or 20%) at nine of the targeted companies and that all of the resolutions this year were endorsed by ISS.

Fifteen companies omitted the shareholder proposals this year by offering competing management resolutions, though at higher ownership thresholds than the 10% ideally sought by Chevedden. Of the 21 company resolutions to expand shareholders' ability to call special meetings, the lowest share requirement was 15% (at Mattel) while most others were between 20% and 25%.

With waning shareholder interest in special meeting proposals, Chevedden doubled up on his written consent resolutions, which last year won majority support at 13 out of 18 companies. However, this endeavor also appears to be stalling out. This year the proportion of majority votes dropped (12 out of 33 proposals) and average support declined to 48.1% from 54.4% in 2010, despite receiving nearly across-the-board approval from ISS. Although 11 of the proposals were resubmissions from 2010, only three received majority support in both years (Amgen, Allstate and Staples). The vast majority of this year's targeted companies already accorded shareholders the right to call special meetings, which many investors consider a preferable mechanism for shareholder action between annual meetings. Without procedural safeguards, a consent solicitation could be initiated by any size shareholder and disenfranchise some shareholders from being informed about and voting on the proposed business.

Several companies were able to skirt Chevedden's written consent resolutions this year by taking alternative actions. Alaska Air Group re-canvassed its shareholders' desire to have written consent via a non-binding management proposal, while Omnicom Group and Home Depot agreed to adopt written consent but with restrictions, such as an advance notice period, a minimum ownership requirement for requesting a record date, and a requirement that consents be solicited from all shareholders. Separately, the shareholder proposal was dropped at Southwest Airlines, presumably because the company gives holders of 10% of the shares an unabridged right to call special meetings, which ISS now accepts as a suitable alternative to written consent. ISS opposed shareholder written consent proposals at two other companies this year (Kohl's and Sempra Energy) on the same basis.

Looking Ahead

As in 2011, most of the dissonance in next year's proxy season will likely revolve around executive compensation. With proxy access in flux, shareholder activists will continue to strive for other reforms to improve board accountability, such as board declassification and majority voting, but with more emphasis on engagement than on shareholder resolutions. For issuers, this portends a busier off-season, but fewer contentious annual meetings.

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Table 1: 2011 and 2010 Shareholder Governance Proposals

Proposal	Number of Proposals in 2011	Number of Majority Votes in 2011	Average Support in 2011	Number of Proposals in 2010	Number of Majority Votes in 2010	Average Support in 2010
Declassify board	40	34	71.3%	49	34	60.4%
Majority voting	39	25	61.3%	32	19	56.4%
Written consent	33	12	48.1%	18	13	54.4%
Special meetings	29	4	40.9%	43	12	43.1%
Cumulative voting	26	-	29.9%	20	-	27.2%
Independent chairman	23	4	35.8%	44	1	28.7%
Supermajority voting	15	10	57.2%	32	28	74.1%
Dual-class stock	6	-	21.1%	2	-	28.1%
Reincorporate from Indiana to Delaware	2	-	39.0%	1	-	38.4%
Succession planning	2	-	29.5%	5	-	27.7%
Disclose prior government service of executives and advisors	2	-	8.1%	2	-	7.8%
Poison pill	1	1	69.1%	4	2	54.9%
Lead director	1	1	12.2%	-	-	-
Permit removal of directors with or without cause	1	1	49.4%	1	1	53.4%
Proxy solicitation expense reimbursement	-	-	-	8	-	36.7%
Board committee independence	-	-	-	5	-	6.7%
Reincorporate in North Dakota	-	-	-	4	-	11.7%
Majority vote shareholder committee	-	-	-	3	-	32.0%
TOTAL	**220**	**92**		**273**	**110**	

Vote results are based on FOR + AGAINST votes.