

## BOARD RESPONSES TO SHAREHOLDER RESOLUTIONS: THE DEVIL IS IN THE DETAILS IN PROXY ADVISOR POLICIES

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'Tis the season of shareholder proposal filings, but the new year may bring additional anxieties for issuers. Proxy advisors Institutional Shareholder Services (ISS) and Glass Lewis have announced in their 2013 policy changes that they are raising the bar on board responsiveness to shareholder resolutions that receive significant support. The potential impact on boards, in the form of future withhold recommendations, could be significant if they fail to respond in the manner outlined by the proxy advisory firms. This article examines the contours of the policy changes and how issuers can prepare for them.

### *ISS Policy*

Beginning in 2014, ISS will recommend against individual directors, committee members, or full boards if a board fails to act on a shareholder proposal that was supported by a majority of *votes cast* in the prior year (i.e., 2013).<sup>1</sup> This is in marked contrast to ISS's longstanding withhold trigger of a majority of shares outstanding in the prior year, or a majority of votes cast in the prior year and one of the two previous years. Historically, only a few categories of shareholder resolutions ever attained those levels of support in the face of board opposition: board declassification, adoption of majority voting in director elections, repeal of supermajority voting, removal of poison pills, and expansion of special meeting or written consent rights. ISS's new policy will substantially broaden the number and types of shareholder resolutions that boards will be expected to act upon (see Table 1).

As an additional update, ISS will consider alternative board actions to fully implementing the shareholder proposal on a case-by-case basis, taking into account the subject matter of the proposal, the level of support it

receives, the degree of recurrence of the proposal, and company disclosures of engagement with investors on the issue and the results of such outreach. While this policy revision appears to accord issuers more flexibility in how they respond to majority-supported shareholder proposals, subsequent guidance from ISS suggests the opposite. In a recent FAQ, ISS outlines what it considers to be satisfactory board responses to common shareholder resolutions to avoid a withhold recommendation in 2014.<sup>2</sup>

- **Board declassification:** Full implementation of the proposal is the only acceptable response. Declassification may be phased-in over several years.
- **Majority vote standard in director elections:** Adoption of majority voting in the charter or bylaws is the only acceptable response. Adopting a director resignation policy ("plurality plus" standard) is not sufficient.
- **Independent chairman:** ISS considers it sufficient for a company to appoint an independent chairman upon the resignation of the current CEO. Other actions, such as appointing or strengthening the role of an independent lead director, may be acceptable depending on the feedback the company receives from engaging with investors, which should be disclosed.
- **Repeal of supermajority voting:** ISS expects full implementation of the proposal, meaning all voting provisions should be reduced to a simple majority of votes cast. ISS will permit the standard to be a

<sup>1</sup> ISS and Glass Lewis are defining majority of votes cast as FOR/FOR+AGAINST votes.

<sup>2</sup> See <http://www.issgovernance.com/files/2013ISSFAQPoliciesandProcedures.pdf>.

majority of shares outstanding if that is the requirement under the company's state laws or if the company consistently uses that standard for other voting items. However, the company should disclose why it is applying a different standard than what was in the shareholder proposal. Reducing the current supermajority threshold to a lower supermajority is not an acceptable response.

- **Special meeting rights:** Granting special meeting rights to shareholders at a higher ownership threshold than what is stipulated in the shareholder proposal (typically 10%) is not sufficient. A higher threshold will only be acceptable to ISS if the company discloses that it was the result of investor outreach and if the higher threshold is reasonable based on the company's ownership structure. Restrictions on agenda items at shareholder-called special meetings are unacceptable.
- **Written consent rights:** Full implementation is expected, but written consent rights may include some reasonable restrictions.<sup>3</sup> ISS considers the following parameters acceptable:
  - An ownership threshold of no more than 10% to initiate a consent.
  - No restrictions on agenda items.
  - A total review and solicitation period of no more than 90 days (including the period of time for the company to set a record date after requested by the shareholder, and no more than 60 days from the record date for the solicitation process).
  - Limits on when written consent may be used of no more than 30 days after a shareholders' meeting or 90 days before a scheduled shareholders' meeting.

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<sup>3</sup>Based on this guidance, granting shareholders more flexible special meeting rights in lieu of written consent will no longer constitute an acceptable response to ISS. For example, a shareholder proposal on written consent received majority support in 2010 and 2011 at R.R. Donnelley & Sons. The company disclosed in its 2012 proxy statement that as a result of discussions with its top holders, it would instead reduce the share ownership threshold for calling special meetings from 25% to 10%. ISS was satisfied with this response and supported the reelection of the R.R. Donnelley board.

- A solicitation requirement to use best efforts to solicit consents from all shareholders.

ISS will accept limitations on written consent that go beyond these levels if the company discloses that they were the result of investor outreach and if they are reasonable based on the company's ownership structure.

On a broader basis, ISS considers it taboo for a company to implement a majority-supported shareholder resolution with a management proposal that is *not* supported by the board. ISS will also not give companies credit for taking alternative actions unrelated to the shareholder resolution (such as adopting other governance reforms), even if they satisfy the proponent.

ISS offers two general exceptions to its board responsiveness policy. Companies are not expected to act on a majority-supported shareholder resolution if it has been invalidated by court rulings or state law, or if adoption of the proposal would be antithetical to shareholder rights (e.g., harmful to minority shareholders at a controlled company).

### *Glass Lewis Policy*

In some respects, Glass Lewis's expectations of board responsiveness to shareholder votes are more onerous than ISS's. Beginning *this year*, Glass Lewis will give additional scrutiny to companies where a shareholder resolution was supported by a mere 25% or more of the votes cast.<sup>4</sup> As evidenced in Table 1, that's a considerable number of shareholder proposals. Although the new policy won't necessarily result in a negative recommendation against directors, Glass Lewis wants companies to demonstrate in their public filings or on their websites that they engaged their shareholders on the matter and have responded to their concerns. Responses may include changes to company policies, business practices, or governing documents; changes to compensation programs; or, at the board level, changes in directorships, committee

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<sup>4</sup>Glass will similarly scrutinize companies where a management proposal or a director election received 25% or more in opposition votes.

memberships, related-party transactions, meeting attendance, or other responsibilities.

Unlike ISS, Glass Lewis doesn't clarify what circumstances would give rise to an adverse opinion against directors. Previously, Glass Lewis would oppose the governance committee members if they failed to implement a shareholder proposal that was supported by a majority of votes cast. Because this policy change takes effect this year, companies have a limited window for conducting any outreach to investors and disclosing the outcome in their 2013 proxy statements.

### *Guidance for Issuers*

Certainly for the most frequently supported shareholder resolutions (see Table 1), the safest approach for issuers is to keep the proposals off their ballots, either through omission or a negotiated withdrawal with the proponent. Already this year, at least 23 companies have acted on shareholder proposal filings on board declassification, supermajority voting, special meetings, and written consent, thereby taking the prospect of a majority vote off the table.

For any shareholder proposals scheduled to go to a vote, companies will need to be particularly attentive this year to their top holders' policies and positions on the issues and monitor any changes to their voting guidelines. A comprehensive solicitation effort can also be a key determinant as to whether or not the vote on the shareholder resolution will cross the majority threshold. Of the 124 shareholder proposals that received majority support in 2012, 22 had support levels of only 51%-55%.

If a shareholder proposal receives significant support this year, issuers should initiate a formal outreach to their largest shareholders early on. A key driver of both proxy advisors' policies is evidence of corporate-shareholder engagement on the issue underlying the shareholder proposal. While many companies are already conducting such dialogues, it will become imperative for issuers to disclose the results of such outreach in their 2014 proxy statements to avoid potential fallout against directors. Longer term,

increased engagement could be beneficial to issuers on a number of levels:

- ***Reducing proxy advisor influence:*** Whether or not the proxy advisors are satisfied with a board's response to a majority-supported shareholder proposal will become less relevant. It only matters that the *shareholders* think it is satisfactory. Notwithstanding their policies, proxy advisors would be hard-pressed to challenge whatever solutions are struck between companies and their shareholders on a given issue. To do so would weaken the proxy advisors' credibility.
- ***Cutting down on nuisance proposals:*** Some commentators have expressed concern that the proxy advisors' policy changes will encourage more shareholder activism. They could actually have the opposite effect. If the company's actions satisfy top holders, a resubmission of the shareholder resolution would not carry any sway with them or receive significant support. Moreover, public disclosure of the company's shareholder engagement and response will only highlight the divide between agenda-driven proponents and shareholders at large.
- ***Eliminating wheel-spinning:*** Companies that have tried to implement a shareholder proposal but could not obtain the requisite voting support (typically a supermajority) may be relieved from revisiting the matter year after year. Dialogue with top holders could result in other types of compromises.

Finally, it should be noted that the proxy advisors have traditionally only penalized boards for inadequate responses to majority-supported shareholder proposals in the year following the vote, not *ad infinitum*. Therefore, any backlash against directors would be short-lived, so long as the shareholder proposal is not resubmitted.<sup>5</sup> Issuers should keep that in mind in

<sup>5</sup>For example, a shareholder proposal to allow 10% holders to call special meetings received majority support in 2009 and 2010 at FirstEnergy and Marathon Oil. Both companies put forward management proposals in 2011 to adopt special meeting rights, though at ownership thresholds of 20%-25%. Because this did not satisfy ISS, it opposed the companies' boards that year. However, opposition votes at both companies only reached the 30% range. In 2012, ISS supported the companies' boards, notwithstanding that they took no further action on the shareholder resolution.



weighing the extent they should follow the proxy advisors' guidelines on acceptable board responses. In the final analysis, there is no one-size-fits-all approach to how boards should respond to votes on shareholder proposals. Such decisions are best left to companies and their own group of shareholders.

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*Table 1: 2012 Shareholder Proposals that Received High Support<sup>1</sup>*

Governance Proposals	# SPs Voted On <sup>2</sup>	# SPs Rec'd Maj. Support <sup>3</sup>	# SPs Rec'd Maj. Support Not Opposed by Board	# SPs Rec'd 50-55% Support	# SPs Rec'd 25-49% Support <sup>2</sup>	Total # SPs Rec'd 25%+ Support	% Total SPs Rec'd 25%+ Support
Declassify board	55	50	8		5	55	100%
Allow shareholders to remove directors with or without cause	1	1				1	100%
Adopt majority voting in director elections	38	24	7	4	13	37	97%
Adopt proxy access	12	2			5	7	58%
Redeem or put poison pill to a shareholder vote	4	4	1	1		4	100%
Redeem NOL pill	2				1	1	50%
Adopt cumulative voting	17				8	8	47%
Eliminate supermajority voting requirements	20	17	2	1	2	19	95%
Eliminate dual-class stock <sup>4</sup>	5	1	1		3	4	80%
Enhance shareholders' ability to call special meetings	18	8	1	3	7	15	83%
Enhance shareholders' ability to act by written consent	21	6		6	15	21	100%
Appoint independent chairman	54	4		4	37	41	76%
Director independence and qualifications <sup>5</sup>	3	1				1	33%
Adopt/disclose a succession planning policy	4				2	2	50%
Reincorporate to Delaware	2	1		1		1	50%
Repeal exclusive venue provision	2				2	2	100%
Maximize value	5	1		1	3	4	80%
Miscellaneous governance <sup>6</sup>	6	1	1			1	17%
<b>Total Governance Proposals</b>	<b>269</b>	<b>121</b>	<b>21</b>	<b>21</b>	<b>103</b>	<b>224</b>	

<b>Compensation Proposals</b>	<b># SPs Voted On<sup>2</sup></b>	<b># SPs Rec'd Maj. Support<sup>3</sup></b>	<b># SPs Rec'd Maj. Support Not Opposed by Board</b>	<b># SPs Rec'd 50-55% Support</b>	<b># SPs Rec'd 25-49% Support<sup>2</sup></b>	<b>Total # SPs Rec'd 25%+ Support</b>	<b>% Total SPs Rec'd 25%+ Support</b>
Allow shareholders to vote on severance pay	1	1				1	100%
Adopt a bonus deferral policy	3				1	1	33%
Limit accelerated vesting of equity awards after a chg. In ctrl.	13				12	12	92%
Eliminate golden coffins	2				2	2	100%
Eliminate tax gross-ups	2				1	1	50%
Allow shareholders to vote on SERPs	2				2	2	100%
Adopt a clawback policy	2				1	1	50%
Adopt an equity retention policy	32				12	12	38%
Use or strengthen performance-based equity awards	7				5	5	71%
Adopt a hedging policy	1				1	1	100%
Miscellaneous compensation <sup>7</sup>	4	1				1	25%
<b>Total Compensation Proposals</b>	<b>69</b>	<b>2</b>	<b>0</b>	<b>0</b>	<b>37</b>	<b>39</b>	

Social & Environmental Proposals	# SPs Voted On <sup>2</sup>	# SPs Rec'd Maj. Support <sup>3</sup>	# SPs Rec'd Maj. Support Not Opposed by Board	# SPs Rec'd 50-55% Support	# SPs Rec'd 25-49% Support <sup>2</sup>	Total # SPs Rec'd 25%+ Support	% Total SPs Rec'd 25%+ Support
Diversify board	2				1	1	50%
Report on reducing hazards from coal	8				3	3	38%
Report on risks of hydraulic fracturing	4				3	3	75%
Report on environmental impacts	3				1	1	33%
Adopt goals for reducing GHG emissions	4				2	2	50%
Report on energy efficiency efforts	1				1	1	100%
Report on worker safety	3				1	1	33%
Report on paper sourcing/deforestation	2				1	1	50%
Adopt a policy on sustainable palm oil sourcing	1				1	1	100%
Report on recycling	5				2	2	40%
Report on sustainability	9				7	7	78%
Nominate a director with environmental expertise	3				1	1	33%
Report on affirmative action policies/discrimination	3				1	1	33%
Add sexual orientation/gender identity to EEO policy	8				6	6	75%
Adopt/amend human rights policy	5				2	2	40%
Disclose lobbying activities	22				10	10	45%
Disclose political contributions	34	1		1	20	21	62%
<b>Total Social &amp; Environmental Proposals</b>	<b>117</b>	<b>1</b>	<b>0</b>	<b>1</b>	<b>63</b>	<b>64</b>	
<b>TOTAL (ALL PROPOSALS)</b>	<b>455</b>	<b>124</b>	<b>21</b>	<b>22</b>	<b>203</b>	<b>327</b>	

**Notes**

1. The table excludes shareholder proposal categories where no proposal received 25% or more in support.
2. Includes floor proposals.
3. Based on For/For+Against votes.
4. The proposal receiving majority support called for eliminating separate classes of directors elected by common and preferred shareholders.
5. The proposal receiving majority support called for nominating a governance expert to the board.
6. The proposal receiving majority support asked that shareholders ratify all board and executive decisions made between April 1, 2011 and March 31, 2012.
7. The proposal receiving majority support called for adopting director and officer stock ownership requirements.