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In this issue … Shareholder Power: New Dawn or Just a Break in the Clouds?

Striking a balance between the demands of shareholding owners and the pragmatic actions of executives and directors who run those companies is a challenge inherent in the public company structure. Recent events may mean an increase in shareholder influence; we review what is happening in this area of corporate governance.

BACKGROUND

Historically, the power of outside shareholders to effect change at the companies in which they own stock has been constrained by various legal and regulatory factors:

The Delaware Business Judgment Rule

The Delaware business judgment rule generally describes the belief held by the Delaware courts that public companies are run by people who are doing the best they can and are utilizing their business judgment as they see fit by acting in good faith and with the best of intentions for the company and its stockholders. Under this basic premise, judges in the Delaware Court of Chancery have been reluctant to allow shareholder lawsuits to proceed against public company executives and directors. This business-friendly rule helps explain why so many American public companies choose to incorporate in the state of Delaware.

Recently in Delaware, Citigroup, Inc. stockholders attempted to pursue a derivative suit on behalf of the company against the directors. The suit bumped up against the Delaware principle. In dismissing the suit, Chancellor Chandler observed (PDF) that "business decision-makers must operate in the real world, with imperfect information, limited resources and an uncertain future. To impose liability on directors for making a "wrong" business decision would cripple their ability to earn returns for investors by taking business risks."

New York Stock Exchange (NYSE) Rule 452

This rule, which dates back to 1937, permits stockbrokers that hold shares on behalf of their clients to vote those shares at the discretion of the stockbroker, in the absence of any specific instructions from the owner of the shares at least ten days before a scheduled shareholder meeting. This powerful proxy, abetted by the general inertia of small "retail" stockholders, almost always results in the brokerage voting in accordance with management's proposals, on the premise that if their clients had wanted otherwise they would have told them so. While the broker vote is limited to "routine" matters, the election of directors is included under the "routine" designation.

Proxy Access and the Costs of Proxy Contests

Currently, outside investor recourse to challenging management's proxy statement (the document sent to shareholders containing details of an upcoming vote) is through a proxy contest. Rules for proxy contests are laid down by the Securities and Exchange Commission (SEC), and generally involve the outside investor obtaining a list of shareholders and sending them a competing set of proxy materials for shareholders to vote on. Even though the SEC now permits electronic distribution of these materials, the cost and logistical challenges posed by marshalling support from a large shareholder base are still a significant deterrent to these shareholder-led initiatives.

The hurdles raised by proxy contests lead naturally to discussions of "proxy access," the phrase given to facilitating the ability of outside shareholders to submit their own nominees for director, which would then be included in the "official" proxy materials distributed by the company to the shareholders for voting. The issue has been debated for several years; in 2003 and 2007 the SEC proposed affording proxy access to qualified outside shareholders, but both times the proposals were ultimately defeated.

A GENTLE BREEZE OF CHANGE

As far as the Delaware business judgment rule is concerned, this protection seems to be as strong as ever. But the legislative and regulatory landscape in Washington, D.C. appears to be shifting in favor of outside investors.

Amendment of NYSE Rule 452

On February 26, 2009 the SEC announced its intent [PDF] to place director elections outside the scope of the broker voting proxy. This change to Rule 452 is planned to take effect for proxy voting at all shareholder meetings held on or after January 1, 2010.

The impact could be significant; those with most to gain will probably be large institutional investors, which typically are the most active voters in proxy elections. Hitherto, the passive non-voting by small retail investors was typically translated into a pro-management vote through brokers' application of Rule 452. In the future these pro-management broker votes will not be cast in director elections, almost certainly leaving the institutional investor block with greater influence.

There is a concern that while not ideal, the current broker discretionary vote exercised under Rule 452 was a reasonable reflection of the retail investors' wishes, as these investors could, had they wished, provided their brokers with specific voting instructions up to ten days before the vote. Failure to provide instructions could therefore be taken as implied assent with the management position.

However, the retail investor will still have the right to vote as she wishes, and there is the question of whether retail investors even know Rule 452 exists. Retail investors perhaps believed erroneously that a failure to vote would simply result in an abstention being recorded. Not surprisingly the Council for Institutional Investors is thrilled [PDF]: "This is a huge victory for the investor community," commented its executive director.

Proxy Access: The SEC reopens the box

In a speech given on April 6, 2009, SEC Chairman Mary Schapiro stated that "proxy access is about making boards more accountable for the risks undertaken by the companies they manage." Chairman Schapiro said that the Commission staff would shortly be considering a proposal to "ensure that a company's owners have a meaningful opportunity to nominate directors."

The formal proposals on proxy access were announced by Chairman Schapiro on May 20, 2009, and offered two approaches: first, to permit director nominations from shareholders with holdings over a certain threshold and for more than a certain length of time; and second, amending a federal rule setting guidelines for what proposals can be contained or excluded from the official proxy sent to investors. The public will have sixty days to comment, and a final decision will be made later in the year. The SEC was split 3-to-2 along party lines, with Republican commissioners opposing the measures.

Congressional Maneuvers

In tandem with regulatory actions is a bill (the U.S. Shareholder Bill of Rights Bill 2009) introduced by Senator Charles Schumer (D- New York) and Senator Mary Cantwell (D- Washington). The proposed measure would 1) give investors a "say on pay" through an advisory, or non-binding vote; 2) a require that public companies separate the role of chairman from that of CEO; 3) mandate annual elections to the board of directors; and 4) facilitate investors nominating their own directors, a reflection of the SEC's proxy access initiative. Simultaneously, the Chairman of the House Financial Services Committee, Representative Barney Frank (D-Massachusetts), is working on significant financial services reform legislation that will almost certainly include a "say on pay" provision.

Reaction from the corporate community has not been supportive. The Business Roundtable, an organization that represents CEOs from 160 of the largest corporations, believes a measure such as Sen. Schumer's would overturn "…200 years of state corporate law…" and "…initiate a process of federalization." While the parallel SEC initiative might make federal legislation on proxy access seem redundant, there is a possibility that the SEC's proposal could face a legal challenge from the business lobby, and a federal act could help settle the issue.

Activism in Action

Even before any SEC or Congressional measures have been implemented, there have been signs that the culture of passive shareholder acquiescence is under attack. At the annual meeting of Bank of America Corporation in April 2009, shareholders voted [PDF] to strip CEO Kenneth Lewis of his additional role of Chairman. According to the RiskMetrics Group, this clear reduction in Mr. Lewis's power, and an equally clear statement of censure, was the first time ever this had happened at a Fortune 500 company

Shareholder activism is also being demonstrated in Europe. At the May 19, 2009 annual meeting of Royal Dutch Shell, one of the world's largest oil producers, a majority of investors —some 59 percent— voted down the company's executive pay plan. The proposed compensation, which was relatively modest by U.S. standards, included bonuses to be paid to executives in spite of performance targets having been missed. While the vote is non-binding, it is a clear rebuff to the Shell board, which will have grimly noted the presence of institutional investors from around the world, determined to voice their dissatisfaction.

SUMMARY

Shareholders may be the owners of public companies, but as a practical matter it is impossible for these owners, who typically number in the thousands, to be directly involved in the running of the company they own. To that extent, the structure of employed managing executives complemented by independent directors representing the shareholder provides a generally workable model for both running the company and answering to its owners. The Delaware business judgment rule recognizes this reality and permits managers and the board to operate on a daily basis as they see best, short of blatant, egregious malfeasance.

However, for investors that have substantial holdings in a company, often with millions of dollars committed to that investment, it might not be unreasonable to allow their voices to be more easily heard and voted on by their fellow owners.

The amended NYSE Rule 452 will remove a built-in bias that tends to skew voting in favor of the incumbent management and board. If proxy access is ultimately confirmed, it will almost certainly allow the emergence of qualified outside nominees and create a real contest. Even if Sen. Schumer's bill is watered down by subsequent compromises, the mood of the public is demanding some change to the status quo, and so between that bill and Rep. Barney Frank's, it is likely something will be enacted.

Traditionally, investors' discontent with a company's operation had a simple remedy: Sell the stock. While that remedy remains, the option of voting with their feet is no longer enough for money managers with significant amounts of money at stake. Regulatory and legislative initiatives may help give activist investors at least some of what they have been looking for. But while shareholder power appears to be on the rise, it is probable that business interests will not surrender their protections without a fight. It will be interesting to see what effect these changes will have on shareholder class action litigation.

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