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Corporate Governance Update: Populists' Wish Lists Offer Legislative Parade of Horribles

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In recent weeks, regulators and lawmakers have proposed a dizzying array of reforms that, if implemented, would exacerbate short-termism, undercut directorial discretion, further empower shareholder activists, and impose unnecessary and potentially costly burdens on public companies. Few of the proposed reforms are truly new and nearly all are ill-conceived. They appear to proceed in part from a misguided impulse on the part of regulators and lawmakers to be seen as “doing something” about the current recession—though hardly any of the proposed reforms have even a remote connection to the origins of the credit crisis that precipitated the economic downturn—and in part from an opportunistic desire to use the financial crisis as an excuse to enact an activist “wish list” of reforms.

Overview

Members of Congress, the Department of the Treasury and the Securities and Exchange Commission (SEC) are all currently engaged in putting forth corporate governance initiatives. The proposed reforms include shareholder proxy access rules, corporate governance proxy disclosure requirements, executive compensation proxy disclosure requirements, requirements as to the structure, composition and election of the board of directors, executive compensation clawbacks, say-on-pay and independence requirements for compensation committees and their outside consultants, and mandatory majority voting. Pending federal legislation includes the Shareholder Bill of Rights Act of 2009 (Bill of Rights Act),¹ sponsored by Senators Charles Schumer and Maria Cantwell, the Shareholder Empowerment Act of 2009 (Empowerment Act),² sponsored by a group of Representatives, the Excessive Pay Shareholder Approval Act (Excessive Pay Approval Act),³ sponsored by Senator Richard Durbin, and the Treasury's Investor Protection Act of 2009 (Investor Protection Act).⁴

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¹ [Shareholder Bill of Rights Act of 2009 \(S. 1074\)](#).

² [Shareholder Empowerment Act of 2009 \(H.R. 2861\)](#).

³ [Excessive Pay Shareholder Approval Act \(S. 1006\)](#).

⁴ [Investor Protection Act of 2009](#); *see also* [U.S. Department of the Treasury Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: New Independence for Compensation Committees](#), TG-218 (July 16, 2009); [U.S. Department of the Treasury Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: Say-On-Pay](#), TG-219 (July 16, 2009). The Investor Protection Act addresses say-on-pay and compensation committee independence; Representative Barney Frank also circulated similar say-on-pay legislation in mid-July

Amidst this veritable avalanche of reform, the SEC has already approved the New York Stock Exchange's (NYSE) proposal to eliminate broker discretionary voting in uncontested elections beginning next year.⁵ The key features of the proposed initiatives are discussed below.

Shareholder Proxy Access

The latest chapter in the continuing saga of proxy access began in June 2009 as the SEC released proposed proxy access rules for the third time this decade.⁶ The first proposal, in 2003, was the subject of fierce debate—the SEC received a record number of comment letters on the proposal—and was shelved in 2004.⁷ The prevailing sentiment at that time was that the issue of proxy access was highly complex and carried many hidden consequences. For a time, it appeared that the issue had been largely superseded by the widespread adoption of a majority voting standard for the election of directors. In 2007, in response to a court ruling that unsettled the SEC's long-held position that shareholder proposals on proxy access could be excluded from the proxy statement,⁸ the SEC took the unusual step of issuing two conflicting alternative proposals on shareholder access, each approved by votes of 3-2 among the SEC Commissioners.⁹ Later that year, the SEC voted to continue its policy of permitting companies to exclude shareholder proposals relating to board nominations or director elections from the company proxy statement. Now comes the latest installment, and, under the new leadership of SEC Chair Mary Schapiro, the SEC seems poised to take definitive action.¹⁰ The SEC comment period ends August 17, 2009, and the SEC has announced its intention to adopt final rules by November 2009 so that they will be in place for the 2010 proxy season. As part of its proposal, the SEC raised more than 500 questions that it asked be addressed in the comment process.

This most recent proposal, like the previous iterations, requires issuers to include in their proxy materials director nominees proposed by shareholders who satisfy ownership and other requirements. Any shareholder or group of shareholders that has held at least one percent of the stock of a public company (with larger thresholds for small-cap companies) for at least a year would be entitled to have their proposed nominees for up to 25 percent of the entire board

(though this proposed legislation includes a provision giving shareholders a non-binding vote on the compensation of top corporate executives), which itself is substantially similar to the say-on-pay legislation approved by the House of Representatives in 2007. See [Corporate and Financial Institution Compensation Fairness Act of 2009](#) (draft bill).

⁵ [SEC Release No. 34-60215; File No. SR-NYSE-2006-92 \(July 1, 2009\)](#). See also David A. Katz and Laura A. McIntosh, "[Corporate Governance Update: SEC Revisits Shareholder Access to Director Nominations](#)," NYLJ, Aug. 30, 2007; David A. Katz and Laura A. McIntosh, "[Corporate Governance Update: Proxy Access—Not Then, Not Now](#)," NYLJ, Sept. 28, 2006.

⁶ [SEC Release Nos. 33-9046; 34-60089; IC-28765; File No. S7-10-09](#) (June 10, 2009).

⁷ [SEC Release No. IC-26206](#) (Oct. 14, 2003).

⁸ [AFSCME v. AIG](#), 462 F.3d121 (2nd Cir. 2006).

⁹ [SEC Release No. 34-56160](#) (Aug. 3, 2007) and [SEC Release No. 34-56161](#) (Aug. 3, 2007).

¹⁰ Separately, proxy access is an element of the proposed Bill of Rights Act.

included in the company's proxy statement and on its proxy card, on a first-come, first-served basis. Under this proposed rule, exclusion of proposals related to elections and nominations would be permitted only in very narrowly defined circumstances.

The SEC's proposed approach is both unwise and unnecessary. The one percent threshold is extremely low¹¹ and will further empower activists to manipulate the corporate process in pursuit of their own agenda. The first-come, first-served procedure proposed by the SEC will give shareholders a perverse incentive to rush to nominate directors to ensure their place in line. Moreover, the SEC proposed rule does not require a nominating shareholder to hold, or even to state a commitment to hold, stock in the company for any period of time if it succeeds in electing a nominee to the board. It would be detrimental to provide increased rights to shareholders who are free to seek short-term gain through the manipulation of board composition (and perhaps corresponding movements in stock price) without requiring such shareholders to continue to have an economic stake in the company. If the point of requiring a nominating shareholder to hold a substantial number of shares is to be sure the shareholder has real "skin in the game," that shareholder ought to be obliged to maintain its "skin" for some period should its nominee be elected.

Overall, the proposal raises issues of enormous complexity, as the SEC evidently recognizes in the large number of questions on which it seeks comment. As has been true from the beginning of the proxy access debate, opening shareholder access is a step that could have the negative effects of causing corporate disruption and waste, deterring qualified candidates from standing for election and undermining the effectiveness of board processes. Shareholders have always had the ability to nominate directors for election and have had great success in placing directors on many boards. It is highly debatable whether the barriers to such nomination need be lowered even further by providing shareholders with access to the company's own proxy statement, especially at a time when shareholders increasingly follow regimented, one-size-fits-all voting recommendations from proxy advisory services. While it is difficult to predict, many observers believe that adoption of anything like the SEC proposed proxy access regime would result in a very significant increase in shareholder nominations and proxy contests.

Delaware has shown that there is a sensible alternative to the federalization of an important area of state corporate law; in April 2009, Delaware enacted legislation enabling the adoption—via board action or shareholder initiative—by Delaware companies of bylaws permitting shareholder access to company proxy materials.¹² Delaware's private-ordering

¹¹ Note that RiskMetrics Group, a public company formerly known as Institutional Shareholder Services or ISS, generally has a four percent threshold for shareholder nominations to be included in the proxy statement: "Our bylaws set forth the provisions by which we will include in our proxy materials the name of a person nominated by one of our shareholders, or group of our shareholders, who meets specified requirements for election as a director. Generally, a nominating shareholder must have owned at least 4% of our outstanding common stock continuously for at least 2 years and must provide notice to us in accordance with our bylaws." See RiskMetrics Group Proxy Statement dated Apr. 29, 2009 p. 6, available at <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NDI2NXxDaGlsZEIEPS0xfFR5cGU9Mw==&t=1>.

¹² [Delaware General Corporation Law § 112](#) (effective Aug. 1, 2009).

approach, which can be effected by carefully drafted company bylaws, enables companies and their shareholders to tailor proxy access to their own specific circumstances and keeps the issue of proxy access in the proper realm of state law. Federalizing proxy access on a one-size-fits-all basis was a terrible idea in 2003 and again in 2007. It is no better now. The financial crisis does not provide any rationale for the federal government to overrule state corporate law statutes and private ordering that it has not even given a chance to be applied in practice.

Executive Compensation

Proposed legislation concerning executive compensation addresses both disclosure requirements and specific corporate practices. The Empowerment Act would require all publicly-traded companies to disclose specific performance targets used to determine senior executive officers' eligibility for bonus, equity and incentive compensation. Furthermore, the Empowerment Act would require all publicly-traded companies to develop and disclose a policy for reviewing any unearned bonus, incentive or equity payments that were awarded to executive officers owing to fraud, financial statements that require restatement or some other cause. This mandatory "clawback" obligation would require recovery or cancellation of such unearned payments to the extent feasible or practical.

The Investor Protection Act, recently delivered to Congress by the Department of the Treasury, would mandate non-binding, advisory say-on-pay votes on executive compensation packages for each annual meeting and for "golden parachute" arrangements for executives in the context of a change-in-control transaction. The Investor Protection Act also would require disclosure of such arrangements, the conditions upon which they may become payable and the aggregate amount of all such compensation.

The Excessive Pay Approval Act would require an annual supermajority shareholder vote to approve "excessive compensation" of any employee of a public company. "Excessive compensation" is defined as compensation (broadly defined to include fringe benefits, bonuses and any other form of remuneration) to an employee of a public company in any year exceeding an amount equal to 100 times the average compensation for services performed by all employees of that company during such year. The proxy statement seeking the supermajority shareholder approval would need to disclose the compensation paid to the lowest paid employee, the highest paid employee, the average compensation paid to all employees, the number of employees who are paid more than 100 times the average compensation for all employees and the aggregate compensation paid to employees who are paid more than 100 times the average compensation.

Further, the Investor Protection Act would require all public company compensation committee members and their advisors to be independent (using new, stricter independence standards than those currently in place at the NYSE) and, if a compensation committee did not hire an independent compensation consultant, the Investor Protection Act would require disclosure as to why it did not.

Executive pay has long been a touchstone for debate and an easy target for populist-minded reformers. Disclosure and communication are key elements in the process of

harmonizing company goals and shareholder interests. Say-on-pay legislation may have superficial appeal to certain groups, but there is no reason to believe that it would increase communication between companies and their shareholders or precipitate any changes in executive compensation practices. There is not even a shareholder consensus in favor of say-on-pay proposals. Some chief executive officers have raised concerns that say-on-pay could lead to further government intervention and shareholder micromanagement with the result that talented executives could leave public companies for privately-held firms. Other chief executive officers have expressed concerns that institutional shareholders or hedge funds could use a say-on-pay policy to attempt to coerce management into making certain short-term decisions that would not be in the company's best long-term interests.¹³

The fact is that the directors, and not the shareholders, are charged with the responsibility of determining executive compensation. Indeed, despite the furor that has raged in activist circles for years over executive compensation, directors should be confident in following normal procedures, with the advice of an independent consultant and the company's legal counsel, as they make decisions on executive pay—decisions that must take into account complex concerns of not only aligning incentives and risks but also of retention. Case law is clear that courts will protect decisions on executive pay made by directors on an informed basis, in good faith, and without a taint of self-interest. In the current environment, directors would be well-advised to structure compensation that links pay with the long-term performance of the company and to avoid compensation that might encourage undue risk.¹⁴ It is properly the province of the directors to determine executive compensation, and it would be a mistake for shareholders to attempt to usurp or undermine the proper functioning of the board in this very important and highly visible task.

Broker Discretionary Votes

Earlier this month, the SEC approved the NYSE's proposal to eliminate broker discretionary voting in uncontested elections.¹⁵ As a result, effective in the 2010 proxy season, brokers will not be able to vote on behalf of clients who fail to provide voting instructions in uncontested director elections at NYSE-listed companies.

This is a significant change, as broker votes accounted for approximately 19.1 percent of votes cast during the 2009 proxy season. In addition to increasing the proxy solicitation expenses for annual meetings, the rule change is expected to have the even more

¹³ See Del Jones, "[CEOs openly oppose push for say-on-pay by shareholders](#)," USA Today, July 15, 2009 ("For example, certain investors could threaten to vote "no" on the CEO's pay to coerce the CEO into making decisions for short-term gain, such as delaying capital investment or taking on unnecessary debt. Such tactics could temporarily boost the stock price to the detriment of the company's long-term health").

¹⁴ See Martin Lipton and Jeremy L. Goldstein, "[Executive Pay and Directors' Duties](#)," July 20, 2009.

¹⁵ Separately, the Empowerment Act also includes a prohibition on broker discretionary voting for all publicly-traded companies.

deleterious effects of significantly empowering activist and institutional shareholders, marginalizing retail shareholders, and precipitating more frequent board changes.¹⁶

Board Requirements

Nowhere is the usurpation of board discretion more egregious than in the numerous proposed reforms directed at the composition and structure of the board of directors. The Bill of Rights Act and the Empowerment Act would require all publicly-traded companies to split the role of board chairman and chief executive officer. The chairmanship would be required to be held by an “independent” director. The proposed legislation offers varying definitions of “independence” and could result in a more stringent definition than the one currently used by the NYSE.¹⁷

Director independence became a touchstone of corporate governance via regulatory and legislative reforms in the wake of the Enron, WorldCom and Adelphia scandals. Standards of independence now are firmly ingrained in corporate culture and, disturbingly, appear to be on a one-way ratchet, ever increasing to the point at which, perhaps, directors will be considered fit for election only if they have never heard of the company on whose board they would serve. Though many independent directors do bring needed objectivity and outside expertise to board deliberations, there can be a downside to “excessive” independence. As Judge Frank Easterbrook recently noted:

Independent directors tend to be ignorant directors. Independence means that they don’t know what’s going on, except what managers tell them. Professors of all people should know this. Universities’ boards of trustees are almost completely “independent” but are also kept in the dark, and hence under the thumb of the president and faculty.¹⁸

¹⁶ For an in-depth discussion of the issues raised by this rule, see David A. Katz and Laura A. McIntosh, “[Corporate Governance Update: Activist Shareholders Would Gain Power from Proposed Rule Change](#),” NYLJ, Mar. 27, 2009.

¹⁷ One example is the potential independence of former executives of an issuer. The Bill of Rights Act would exclude any former executive officer of the issuer from being an independent director, while the Empowerment Act excludes anyone who has been an executive of the issuer in the preceding five years and the NYSE excludes anyone who has been an executive officer within the preceding three years. See Shareholder Bill of Rights Act of 2009 (S. 1074), Sec. 5(e)(2); Shareholder Empowerment Act of 2009 (H.R. 2861), Sec. 2(d)(2); NYSE Listed Company Manual Sec. 303A.02(a) and (b). With respect to other categorical bars to independence, the Bill of Rights Act defers to the rules of the exchange on which an issuer is listed, while the Empowerment Act spells out specific criteria that, in many cases, are more stringent than those of the NYSE.

¹⁸ Frank H. Easterbrook, “[The Race for the Bottom in Corporate Governance](#),” 95 Va. Law Rev. 685, 693 (2009). See also Leo Strine, “Toward Common Sense and Common Ground? Reflections On The Shared Interests Of Managers And Labor In A More Rational System Of Corporate Governance” (Keynote Address to The Journal of Corporation Law), Mar. 1, 2007 (“Increasingly, boards are comprised of one person who knows everything about the company and who has an intense interest in its future — the CEO — and nine or ten other people selected precisely because they have no possible interest in or connection to the company that might cause them to be perceived as conflicted — or that might cause them to have any genuine concern for the corporation’s future.”) available at <http://www.law.upenn.edu/academics/institutes/ile/CCPapers/040507/Strine%20Speech.pdf>.

In addition, the Bill of Rights Act would require each public company board to establish a risk committee, comprised entirely of independent directors, which would be responsible for establishment and evaluation of risk management practices.

In perhaps its most far-reaching feature, the Bill of Rights Act would require boards of directors of publicly-traded companies to be declassified. As a result, all public company directors would be subject to annual election; staggered boards, which have been an available option since the dawn of the corporate form, would become illegal as a matter of federal law. This proposed legislation also ignores the dramatic changes in the prevalence of staggered boards that has taken place over the last nine years by private ordering without any federal intervention; for example, the percentage of S&P 500 companies with staggered boards has declined from 61 percent in 1999 to 34 percent at the end of 2008.¹⁹ Moreover, the Bill of Rights Act and the Empowerment Act would require all publicly-traded companies to elect directors under a majority-voting standard. The proposed standard would apply only to uncontested elections and would require that the number of shares voted “for” a director’s election exceed 50 percent of the votes cast with respect to that director’s election. Incumbent directors who are not reelected by a majority vote would be required to tender their resignation to the board of directors (with the Bill of Rights Act mandating that the board accept such resignations). The elimination of staggered boards would increase the vulnerability of public companies to unsolicited takeovers and would further encroach on territory properly governed by state corporate laws.

Governance Disclosure

In early July, the SEC proposed a package of new proxy disclosures, generally to be effective for the 2010 proxy season, concerning a wide variety of corporate governance and compensation issues.²⁰

Among other things, the proposed rules would require a description of, and justification for, a company’s leadership structure, including whether and why a company has chosen to combine or separate the positions of chief executive officer and chairman of the board, and whether and why a company has a lead independent director. The proposed rules also would require a description in proxy statements of the board’s role in risk management as well as a discussion in the Compensation Discussion & Analysis section addressing the relationship between a company’s overall employee compensation policies and risk management practices and/or risk-taking incentives (to the extent material). Required information about directors, board nominees and executives would be significantly expanded, with longer look-back periods for disclosures. The proposed rules also would require detailed disclosures regarding compensation consultants who advise on executive and director compensation and provide other services to a company, including potential conflicts of interest and, significantly, quantification of the fees paid for each type of service.

¹⁹ Classified Boards Year Over Year, www.SharkRepellent.net (from 302 at year-end 1999 to 172 at year-end 2008).

²⁰ [SEC Release Nos. 33-9052; 34-60280; IC-28817; File No. S7-13-09](#) (July 10, 2009).

These proposals, if implemented, would impose a significant burden on companies that, in our view, is not justified by the benefit provided to shareholders. That said, a disclosure regime, which recognizes that companies may have excellent reasons for adopting a variety of corporate governance structures, is far preferable to the sweeping, uniformly applicable legislative approach currently being considered by Congress.

Conclusion

A number of the proposed reforms described above individually would be harmful to American companies and to our economy, and, in combination, could fundamentally change the nature of the public company and its role in our society. A major consequence of the proposed reforms, if enacted, would be to destabilize the board of directors. The combination of mandatory federal one-size-fits-all proxy access, the elimination of broker votes, mandatory board declassification and majority voting, together with the electronic distribution of proxy materials, would have the effect of increasing board turnover, balkanizing the board with factions representing different groups and deterring qualified candidates from standing for nomination. From a takeover defense standpoint, the combination of these proposed reforms would greatly weaken the board's ability to resist a determined suitor. A stable, secure board brings enormous leverage to the negotiating table; without that strength, it is the company's shareholders—the very group these reforms ostensibly are intended to protect—who are the ultimate losers.

Many of the reforms proposed by Congress and the Department of the Treasury represent misguided attempts to assert federal control over areas that have traditionally, and successfully, been governed by state law.²¹ The benefits of the state law model have been demonstrated time and again by states' useful regulatory innovations, timely responsive actions and individualized regimes that help companies to maximize efficiency and minimize unnecessary burdens. Especially with respect to the minutiae of corporate governance (such as whether a company splits the roles of chief executive officer and board chairman), a one-size-fits-all, top-down approach would have the effect of forcing conformity where it does not belong and serves no useful purpose. State lawmakers and companies are addressing many of the topics covered in the proposed reforms, but they are doing so in thoughtful, individualized ways that permit flexibility and promote productivity. Federal lawmakers should not commandeer this healthy and constructive process.

A number of the misguided initiatives that have been proposed would undermine directors' authority to determine the structure and functioning of the board itself. Directorial discretion and business judgment form a fundamental bedrock of American corporate success; weakening it serves neither shareholders nor anyone else (other than activists and opportunistic acquirors). The proposed reforms in the Bill of Rights Act and Empowerment Act represent an

²¹ For a thorough discussion of this issue and other related points, see Martin Lipton, Jay W. Lorsch and Theodore N. Mirvis, "[A Crisis Is a Terrible Thing To Waste: The Proposed 'Shareholder Bill of Rights Act of 2009' Is a Serious Mistake](#)," May 12, 2009.

ill-considered attempt to substitute broad activist doctrines for carefully considered individual decisions.

Worst of all, most of the reforms discussed above would, in one way or another, have the effect of increasing unhealthy pressure on companies to focus on short-term stock price results.²² Hedge funds and professional institutional investment managers control more than 75 percent of the shares of most major companies; in recent years, we have seen how these shareholders have demanded that companies produce unsustainable quarterly earnings results at the expense of long-term stability and growth.²³ President Obama in February decried the “reckless culture and quarter-by-quarter mentality that in turn have wrought havoc in our financial system.”²⁴ As one commentator succinctly put it, these large and active shareholders are not investors, they are traders. Share turnover numbers are nothing less than shocking: annual turnover on the NYSE in recent years has been greater than 120 percent, mutual fund turnover has been as high as 110 percent, and pension fund turnover has been more than 90 percent; by comparison, historical rates averaged in the 10-20 percent range before 1980.²⁵

As Vice Chancellor Strine stated in a 2007 speech:

As much as corporate law scholars fetishize the agency costs that flow from the separation of ownership and control in operating companies, they have been amazingly quiet about the “separation of ownership from ownership.” What I mean by that is that the equity of public corporations is often owned, not by the end-user investors, but by another form of agency, a mutual fund or other institutional investor. It is these intermediaries who vote corporate stock and apply pressure to public company operating boards. . . . Most corporate law scholars have not burdened their minds with the fact that undifferentiated empowerment of these so-called stockholders may disproportionately strengthen the hand of activist institutions who have short-term or non-financial objecti[ve]s that are at odds with the interests of individual index fund investors. That proxy fights and derivative suits against money management boards are virtually unheard of under the “Business Trust” statutes that are prevalent in the governance of mutual funds is accepted by corporate law scholars with equanimity. But these same scholars claim the much greater number of such fights and suits against the board of operating companies is grossly insufficient and a justification for reforms in the corporation law governing operating corporations.²⁶

²² See *id.* And Lawrence Mitchell, “[Protect Industry from Predatory Speculators](#),” FT.com, July 8, 2009.

²³ See Lipton, Lorsch and Mirvis, *supra*.

²⁴ President Barack Obama, [Speech on Executive Compensation, Feb. 4, 2009](#).

²⁵ See Mitchell, *supra*.

²⁶ Strine, *supra*.

Inexplicably, it is these very traders that Congress proposes to empower further through its purportedly populist reforms. Providing stock price profiteers with greater voting rights, reducing the ability of companies to defend themselves from takeovers and undermining the stability and cohesion of the board of directors is a recipe not for recovery but for relapse. Many of the proposed reforms would exacerbate the short-termism that played a role in creating many of the economic problems we are experiencing today, and these “reforms” should not be adopted as proposed.