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SECURITIES ALERT

COMPANIES SHOULD EXPECT ACTIVE 2008 PROXY SEASON

RESULTS OF 2007 PROXY SEASON AND RECENT AND PROPOSED RULE CHANGES SIGNAL INCREASE IN PROXY ACTIVITY IN 2008

If the results of the 2007 proxy season are any indication, companies should expect a high level of proxy activity in 2008. The number of shareholder proposals submitted to public companies in 2007 increased over the prior year, as did shareholder support for such proposals. Corporate governance issues received the most attention this season, with majority voting in director elections and executive compensation issues leading the charge. Now that the 2007 proxy season is winding down, we take a look at the major proposals that shaped this season and at new and proposed rule changes that will likely have a major impact on next year's proxy season.

Majority Voting in Director Elections

Majority voting sustained significant momentum over the past year.[1] More than 180 companies adopted new majority voting policies or bylaws in 2006, and this movement has remained strong in 2007.[2] As of July 16, 2007, investors had filed 140 proposals on this topic, although 90 of these proposals were subsequently withdrawn as more and more companies are agreeing to either change their election policies to provide for majority voting or to introduce the measure at the next shareholder meeting.[3] According to ISS, the average level of support for majority voting proposals this year has been 49.4 percent for the 29 meetings where results are known to date, which is up from 47.7 percent for the first half of 2006.[4]

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1 Until recently, most directors were elected by a plurality voting standard, whereby a director nominee who receives the greatest number of favorable votes wins the election. Under the majority voting standard, a nominee in an uncontested election must typically receive a majority of all votes cast to be elected to the board of directors.

2 Posting of Rosanna Landis Weaver, "ISS 2007 Preview: Board Elections," to ISS Blog, January 17, 2007. Available at http://blog.issproxy.com/2007/01/2007_preview_board_electionssu.html.

3 Institutional Shareholder Services, "Knowledge Center – 2007 Proxy Season Watchlist," July 2007. Available at http://www.issproxy.com/knowledge_center/proxy_season_watchlist/.

4 L. Reed Walton, Institutional Shareholder Services, "Preliminary Postseason Report," July 13, 2007. Available at http://www.issproxy.com/governance_weekly/2007/077.html.

Many companies are taking action on the majority voting issue even before receipt of a shareholder proposal. Over 52 percent of the companies in the S&P 500 and over 45 percent of the companies in the Fortune 500 have adopted some form of majority voting policy, bylaw and/or charter provision.[5] The issue facing companies this year is not so much whether to provide for majority voting, but rather what form of majority voting to adopt. The majority vote model that is proving popular with many companies is referred to as the "Intel" model, which includes both a majority voting and director resignation policy. Under this standard, the charter or bylaws provide that a nominee in an uncontested election must receive a majority of all votes cast to be elected to the board. In addition, incumbent directors who fail to win elections must tender their resignation to the board, which has 90 days to decide whether to accept such resignation and then disclose its decision. In response to recent changes in Delaware law (as discussed below), Intel further refined its model by amending its corporate governance guidelines in January 2007 to provide that director nominees must annually submit a contingent resignation that becomes effective if they do not receive the required majority vote and the board of directors accepts the resignation.

Recent changes in state laws have also fueled the majority vote movement. Prior to these changes, even if stockholders proposed and succeeded in adopting a bylaw requiring majority voting, the board of directors would often have the power to unilaterally amend the bylaw back to the plurality voting standard. Further, a corporate governance policy requiring a director to resign if he or she did not receive the requisite votes in an election was non-binding and unenforceable. Effective August 1, 2006, Delaware adopted changes to the Delaware General Corporation Law (DGCL) to address these concerns. Section 216 of the DGCL was amended to prohibit repeal by the board of directors through unilateral action of any stockholder-adopted bylaw that addresses the requisite vote for election of directors, and Section141(b) was amended to allow a resignation conditioned upon the director failing to receive a specified vote for reelection to be irrevocable.[6] In June 2006 the American Bar Association also took action by adopting amendments to the Model Business Corporation Act that focus in part on enabling majority voting through a modified plurality standard by which directors continue to be elected by a plurality of votes cast, but any director who receives more "withhold" votes than "for" votes in an uncontested election must submit his or her resignation.[7]

In addition to the legislative amendments discussed above, a new law in California took effect January 1, 2007, allowing California corporations that are listed companies that have eliminated cumulative voting to amend their bylaws or charters to require that directors be elected by "approval of the shareholders"[8] in uncontested elections. If a director fails to receive the required approval, the director's term will end at the earlier of (1) 90 days after the vote is determined or (2) the date the successor is appointed by the board.

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[5] Claudia H. Allen, Neal, Gerber & Eisenberg LLP, "Study of Majority Voting in Director Elections," February 5, 2007.

[6] Del. Gen. Corp. L. §§ 141(b) and 216.

[7] Pursuant to these amendments, either directors or shareholders may adopt a new voting standard through modification of bylaws that may not be reversed except by a vote of the shareholders or, if enacted solely by directors, by a vote of the directors or shareholders. In addition, any director receiving more votes "against" than "for" must resign within 90 days or as soon as the board of directors finds a replacement, if earlier. Failure of the board of directors to find a replacement within 90 days would allow shareholders to find a replacement, unless provided otherwise in the articles of incorporation. Furthermore, similar to the Delaware amendments, the MBCA amendments allow corporations to adopt resignation policies tied to the occurrence of an event, such as failing to collect a majority of votes, that are binding and enforceable.

[8] Under California law, "approval of the shareholders" requires the affirmative vote of a majority of the shares represented and voting at a duly held meeting at which a quorum is present. California law also includes an additional requirement that the shares voting affirmatively must also constitute at least a majority of the required quorum. Cal. Corp. Code § 153.

Executive Pay Issues

With the new SEC disclosure rules requiring companies to disclose significantly more information on their executive pay practices, pay-related shareholder proposals are also making headlines this proxy season. In an effort to curb excessive compensation practices and promote increased communication between shareholders and boards of directors, pay-for-performance proposals and proposals permitting shareholder advisory votes on executive compensation, commonly known as "say on pay" proposals, are receiving the most press.

Pay-for-Performance. "Pay-for-performance" proposals have been one of the most frequently filed proposals during the 2007 proxy season. So far, 64 pay-for-performance or similar type proposals have been filed.[9] These proposals have received an average of 36.2 percent support at 22 meetings where results are available, which is a slight decrease from last year's average support of 36.1 percent.[10] Under the typical pay-for-performance proposal, companies would not be allowed to pay annual bonuses unless the company's performance exceeds the median or mean performance of a disclosed peer group of companies with respect to specified financial performance criteria, and stock-based and non-equity compensation would not be paid unless the company's performance exceeds the peers' median or mean performance on selected financial and stock price performance criteria. These proposals reflect shareholders' attempt to align executive pay more closely with company performance and the performance of peer companies.

Say on Pay. "Say on pay" proposals have also been a hot topic during the 2007 proxy season, with approximately 66 such proposals filed to date. As of July 16, 2007, say on pay proposals have received support averaging 42.9 percent at 29 meetings where results are available, compared to an average of 40 percent at seven meetings in the first half of 2006.[11] Four say on pay proposals have received majority votes this proxy season and at least 10 proposals have received more than 45 percent support.[12] With such strong support, companies can expect to see more of these types of proposals in the future. Aflac Incorporated decided not to wait on a shareholder vote on this matter and in February 2007 became the first major U.S. company to agree to give shareholders an advisory vote on executive compensation.[13]

Say on pay proposals ask that shareholders be given the opportunity at each annual meeting to ratify the compensation of the named executive officers set forth in the summary compensation table and related narrative disclosure (excluding Compensation Discussion and Analysis).[14] Although such a vote would be nonbinding on the board, shareholders believe it would make boards more accountable for executive compensation and increase the boards' communication with the shareholders.

Congress has recently joined the say on pay movement with the House of Representatives passing the Shareholder Vote on Executive Compensation Act on April 20, 2007. This act would give shareholders an annual, nonbinding vote on executive compensation packages disclosed in proxy statements, as well as a nonbinding advisory vote on golden

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[9] Institutional Shareholder Services, "Knowledge Center – 2007 Proxy Season Watchlist," July 2007. Available at http://www.issproxy.com/knowledge_center/proxy_season_watchlist/.

[10] Institutional Shareholder Services Corporate Governance Bulletin, "Support for Pay Proposals Marks 2007 Proxy Season," June 2007. Available at http://www.issproxy.com/pdf/CGB_June_2007_Article1.pdf.

[11] L. Reed Walton, Institutional Shareholder Services, "Preliminary Postseason Report," July 13, 2007. Available at http://www.issproxy.com/governance_weekly/2007/077.html.

[12] Id.

[13] Press Release, Aflac Incorporated, Aflac Adopts Non-Binding "Say on Pay" Shareholder Vote (February 14, 2007). The vote will be effective beginning in 2009, which will be the first year that executive compensation tables in the proxy statement will contain three years of data that reflect the SEC's new executive compensation disclosure rules.

[14] Rosanna Landis Weaver, Institutional Shareholder Services, "2007 Preview: Executive Pay." Available at http://www.issproxy.com/governance_weekly/2007/006.html.

parachute packages in certain circumstances involving negotiations to buy or sell a company. Similar legislation is pending in the Senate, although it has not received much attention to date.

Antitakeover Measures

Although the primary issues facing companies during the 2007 proxy season relate to majority voting and executive compensation, shareholders have expressed strong support for proposals that target takeover defenses, including poison pills, classified boards and supermajority requirements. So far this season there have been 25 proposals asking companies to either redeem their poison pills or put these plans to a shareholder vote.[15] These proposals have received an average of 47.8 percent support at nine meetings where results are available.[16]

Shareholders are also strongly supporting proposals requesting companies to repeal classified boards of directors and instead hold annual elections for all directors. There have been 64 such proposals this season, receiving an average of 67.2 percent support at 17 meetings where results are available.[17]

Elimination of supermajority requirements is another antitakeover issue that shareholders are targeting this season. Shareholders have submitted 34 proposals asking companies to eliminate supermajority requirements on bylaw changes and other matters. These resolutions have received average support of 74.6 percent over 16 meetings where results are available.[18]

Recent Developments in the Proxy Solicitation Process

The following recent developments have the potential of dramatically changing the landscape of proxy solicitation, particularly with respect to director elections. Although these issues did not have a significant impact on the 2007 proxy season, companies need to be focused on the impact these developments will have on their annual meeting process going forward.

E-Proxy. The SEC's new e-proxy rules became effective on July 1, 2007. This "notice and access" method allows companies and other soliciting persons to disseminate proxy materials by posting such materials on an Internet Web site and sending shareholders a notice of the availability of the materials. Although companies utilizing this notice and access method will likely benefit from a reduction in printing and mailing costs for distribution of proxy materials, this method also will significantly reduce the costs of proxy solicitations by activist shareholders, creating the potential for an increase in proxy contests.

Proxy Access. Although companies have not faced many shareholder proposals related to proxy access this season, the corporate world has been anxiously awaiting the SEC's response to a 2006 court decision that effectively allows shareholders to require companies to include shareholder nominees on management's proxy. In September 2006 the 2nd Circuit held that an SEC rule that permits companies to exclude from their proxy statements shareholder proposals that relate to an election of directors does not allow a company to exclude proposals relating to general procedures concerning director elections.[19] Thus, the company in question, AIG, was required to include in its proxy statement a

[15] Institutional Shareholder Services, "Knowledge Center – 2007 Proxy Season Watchlist," July 2007. Available at http://www.issproxy.com/knowledge_center/proxy_season_watchlist/.

[16] Id.

[17] Id.

[18] Id.

[19] *Am. Fed'n of State, County and Mun. Employees v. Am. Int'l Group, Inc.*, 462 F.3d 121 (2d Cir. 2006).

shareholder proposal to amend the company's bylaws to require the company to include in the AIG proxy statement and proxy card shareholder-nominated candidates for director.

On July 27, 2007, the SEC issued two competing proposals in response to the shareholder proxy access issue. The first proposal would require shareholders to own at least 5 percent of a company's shares to be able to propose bylaw changes that would give shareholders a greater hand in nominating director candidates. The other proposal is similar to the SEC's current position, which is to allow companies to keep shareholder proposals related to the election of directors off their proxies. The contentious issues raised by these proposals stirred a debate among the commissioners, with neither proposal receiving a unanimous vote. Business interests obviously prefer the second proposal. Investors obviously favor the proposal allowing them access, but concern has been raised that the 5 percent threshold is too high to actually be meaningful for the majority of shareholders other than hedge funds. Although there is likely to be significant debate over these proposals, SEC Chairman Christopher Cox has stated that the SEC intends to act in time for the 2008 proxy season.

Three shareholder proxy access proposals have made it to the ballot so far this proxy season.[20] A shareholder proxy access proposal that would have permitted shareholders who held 3 percent of the company's stock for at least two years to nominate director candidates received support from approximately 39 percent of the shares at Hewlett-Packard Co.'s annual meeting in March 2007.[21] A similar proposal at UnitedHealth Group, which would have allowed shareholders who held 3 percent of the company's stock for over two years to nominate two directors to management's election ballots, received approximately 42 percent support at the company's annual meeting in May 2007.[22] With a move that may pressure other companies to follow, Comverse Technology recently became the first company since the 2nd Circuit's ruling to adopt a proxy access provision in its bylaws. Under Comverse's bylaws, an investor that owns a 5 percent stake in the company for at least two years may nominate one director to appear in the company's proxy statement.

Elimination of Broker Discretionary Voting. The New York Stock Exchange (NYSE) is proposing to eliminate broker discretionary voting in the election of directors commencing in 2008. Under current NYSE rules, brokers are permitted to vote shares held in client accounts on "routine" matters at their discretion absent voting instructions from the client. Under the proposed rule change, an uncontested director election would no longer be considered "routine." Because brokers historically have used their discretion to vote in favor of management candidates, the rule change will make it more difficult to achieve a majority vote in companies that have adopted some form of majority voting policy. The NYSE has submitted this proposed rule change to the SEC for its approval, but the SEC has been slow to take any action, possibly signaling a delay to give the Commission time to absorb the effects that majority voting, e-proxy and proxy access will have on director elections.

Conclusion

The 2007 proxy season reflected shareholders' continued focus on corporate governance issues, primarily director elections, executive compensation and takeover defenses. Shareholder proposals to dismantle takeover defenses

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[20] Institutional Shareholder Services, "Knowledge Center – 2007 Proxy Season Watchlist," July 2007. Available at http://www.issproxy.com/knowledge_center/proxy_season_watchlist/.

[21] According to Hewlett Packard's quarterly report on Form 10-Q filed June 8, 2007, there were 800,838,964 votes cast for the proposal, 1,063,381,341 votes cast against and 171,785,398 abstentions.

[22] Posting of L. Reed Walton, "Proxy Access Receives 42% at United Health, CalPERS Says," to ISS Blog, May 30, 2007. Available at http://blog.issproxy.com/2007/05/proxy_access_receives_42_at_un.html.

received overwhelming support. The average level of support for majority voting in director elections is nearing 50 percent, and executive compensation proposals made a strong showing. With the arrival of e-proxy, we can expect to see continued, if not increased, shareholder activism on these matters. Furthermore, if the SEC approves a proxy access rule and/or the NYSE's requested rule change to eliminate discretionary voting in director elections, companies can expect a dramatic increase in shareholder say in the director election process.

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