



## SECURITIES & CORPORATE GOVERNANCE

### Update

July 2008

### Reviewing the 2008 Proxy Season and a Look Ahead

With this year's proxy season largely over, public companies and their advisors are taking stock of a contentious 2008 and looking ahead to an uncertain 2009. Difficult economic headwinds this season left many shareholders disappointed with management and more inclined toward shareholder proposals. In response, boards of directors deployed a range of countervailing strategies, some public and some behind the scenes, with mixed results. Overall, 2008 saw more shareholder engagement, more management push-back, and hints that the investor activity will only increase in coming years.

Companies sought to omit shareholder proposals more frequently this year and with some success. RiskMetrics' Institutional Shareholder Services (ISS) charted an increase in proposals omitted with Commission staff approval to 20 percent this season, up from 13 percent in 2007. This gain coincided with new rules issued in December 2007 permitting companies to exclude most shareholder access proposals this year.

ISS also reported that, with more corporations having moved to some form of majority election of directors, there was a resurgence of board declassification proposals. ISS indicated that 60 percent of the boards of the S&P 500 are declassified and counted 96 shareholder proposals submitted on classified boards, with support averaging nearly two-thirds of votes cast. The trend has moved increasingly towards small- and mid-cap companies, and towards particular industries. Large banks, for example, have widely

adopted annual elections, with investors now targeting other sectors.

Executive compensation remained a hot topic, especially as executive pay packages are increasingly highlighted against non-executive compensation in a sluggish economy. There was a decline in so-called "pay for performance" proposals, which explicitly tie executives' salaries more closely to performance. This decline was possibly a result of shareholders opting for say-on-pay advisory vote proposals instead, which would allow for a non-binding vote on executive compensation at every annual meeting. Another factor for the shift may be greater transparency brought about by the SEC disclosure requirements, which have allowed greater shareholder monitoring and encouraged directors to become more involved in active compensation oversight.

Shareholder access to the ballot (which involves opening up the management ballot to dissident nominees) and wide-scale election of dissident directors remained on hold for 2008, but that may soon change. In 2009, we may see the SEC revisit its 2007 shareholder access rule following the swearing in of the new SEC commissioners. In addition, pending changes to the broker non-vote policy (which currently favors management) and continued development of the electronic notice-and-access system for proxy contests will lower barriers to investors seeking to put their own directors on the board. By ISS's recent count, there are approximately 100 dissidents on various public company boards. While wholesale ouster of incumbent directors will



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likely remain rare, substantial representation of activist shareholder groups – in the range of one to three seats – may become more common.

In addition, even bigger changes may await. Patrick McGurn, ISS's special counsel for governance services, believes a bill of shareholder rights is virtually guaranteed to be passed early in the next president's term, regardless of which candidate wins in November. As a result, "say on pay" and shareholder access may eventually be federalized.

In retrospect, the 2008 proxy season saw only incremental movement along well-known fault lines in investor-management relations. Increasingly, however, signs point to continuing significant influence from shareholders in coming years.

#### **Advancement Rights Denied to Former Delaware Director**

In *Schoon v. Troy Corporation*, a Delaware Chancery Court recently denied advancement rights to a former director even though the bylaws provided for the advancement of legal fees at the time the director retired from the board. The court determined that the former director's right to advancement vested based on the bylaws in effect when litigation is actually commenced and not based on the bylaws in effect when the director retired. Therefore, the bylaw amendment that eliminated advancement rights, which was approved by the directors before the commencement of litigation, governed the former director's advancement rights.

Such a result, however, is not possible under the Virginia Stock Corporation Act, which provides that

no right may be reduced or eliminated by any amendment of the articles of incorporation or bylaws with respect to any act or omission occurring before such amendment.

The North Carolina Business Corporation Act, on the other hand, does not contain such a provision and North Carolina courts may follow Delaware's lead.

#### **FASB Proposes Expansion of FAS 5 Disclosures**

The FASB recently issued an Exposure Draft that proposes to significantly expand the disclosures required about loss contingencies such as pending or threatened litigation. According to the FASB, the proposed amendments to SFAS 5 set forth in the Exposure Draft will:

- expand the population of loss contingencies that are required to be disclosed;
- require disclosure of specific quantitative and qualitative information about those loss contingencies;
- require a tabular reconciliation of recognized loss contingencies; and
- provide an exemption from disclosing certain required information if disclosing that information would be prejudicial to an entity's position in a dispute.

If adopted, the proposed statement would be effective for annual financial statements issued for fiscal years ending after Dec. 15, 2008, and interim and annual periods thereafter.

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