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Shareholder Proposals, Proxy Access and the Current Proxy Season

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While the current global financial crisis may result in slightly fewer shareholder proposals being submitted in the 2008-2009 proxy season, hundreds of shareholder proposals will undoubtedly be submitted to U.S. corporations during the current proxy season. As a result, companies should be aware of the rules governing shareholder proposals and be prepared to respond if a shareholder proposal is received. In addition, there have been several recent developments with respect to "proxy access," which is industry jargon for regulatory changes that would expressly allow shareholders access to a company's proxy statement for the purpose of electing directors not nominated by the company's board. Accordingly, this client alert provides an overview of the following:

- the general process for responding to shareholder proposals under Rule 14a-8;
- actions to be taken if a company wants to exclude a shareholder proposal;
- actions to be taken if a shareholder proposal is not excludable under Rule 14a-8;
- implications if shareholders approve a shareholder proposal;
- hot subjects for shareholder proposals; and
- proxy access and reimbursement for proxy soliciting expenses.

The General Process for Responding to Shareholder Proposals Under Rule 14a-8

Rule 14a-8 promulgated under the Securities Exchange Act of 1934 ("Rule 14a-8") generally requires public companies to include shareholder proposals (along with corresponding supporting statements) in their proxy statements, unless the shareholder has failed to comply with certain eligibility or procedural requirements or if the proposal falls within one of 13 substantive bases for exclusion. The following outlines the SEC rules relating to the operation of Rule 14a-8.

- *Deadline by Which Proposal Must be Received*. The shareholder proposal must be received at the company's principal executive offices not less than 120 calendar days before the one year anniversary of the date on which the previous year's annual meeting proxy statement was first sent or given to shareholders. If the company did not hold an annual meeting the previous year, or if the date of the upcoming annual meeting has been changed by more than 30 days from the date of the previous year's meeting, then the deadline is a reasonable time before the company begins to print and mail its proxy materials.
- *Procedure if there is an Eligibility or Procedural Flaw with the Proposal*. If the company wishes to exclude the proposal

because the shareholder has not complied with an eligibility or procedural requirement of Rule 14a-8, it first must notify the shareholder of the alleged defect(s) within 14 calendar days of receiving the proposal (unless the defect cannot be remedied). The shareholder has 14 calendar days from the date it receives the deficiency notification to respond. Failure to cure the defect(s) or to respond to the company's notice in a timely manner may result in exclusion of the proposal.

- *Procedure for Seeking Exclusion*. If the company believes that it may exclude the proposal from its proxy materials because of the proponent's failure to comply with eligibility or procedural requirements or there is a substantive basis for excluding the proposal, the company must submit a "no-action" request to the staff of the SEC at least 80 days before filing its definitive proxy materials with the SEC (unless it demonstrates "good cause" for missing the deadline). The "no-action" request must contain a written explanation of the company's bases for excluding the proposal. The company must also furnish a copy of its "no-action" request to the shareholder proponent.

- *Right of Shareholder Proponent to Submit Materials to the SEC*. The shareholder proponent may also submit a letter to the staff of the SEC setting forth the reasons why the shareholder disagrees with the company's bases for excluding the proposal.

- *Response of the SEC and Ability to Obtain a Judicial Resolution*. After review of these submissions, the SEC will generally provide a written response stating whether it agrees with the company's view that the shareholder proposal may be excluded from the company's proxy materials. The company may only exclude the shareholder proposal if it has received a response from the staff of the SEC indicating that it will not recommend enforcement action against the company if the shareholder proposal is omitted. A shareholder proponent is always free to pursue a judicial resolution of the matter, however.

- *Right of Company to include a "Statement of Opposition" if Proposal Included in its Proxy Statement*. If the shareholder proposal is not excludable, the company must include the proposal in its proxy materials, but may also include the reasons why it believes that shareholders should vote against the proposal. This "statement of opposition" usually must be provided to the proposing shareholder at least 30 calendar days prior to the filing of the company's definitive proxy statement. However, if the SEC's "no-action" response requires a proposing shareholder to make revisions to its proposal before the company is required to include the proposal in its proxy materials, then the company must provide the proposing shareholder with a copy of its "statement of opposition" no later than five calendar days after the company receives a copy of the revised proposal.

Actions to be Taken if a Company Wants to Exclude a Shareholder Proposal

A company seeking to exclude a shareholder proposal can try to negotiate with the proponent of the proposal to have the proposal withdrawn. As noted above, the company may also seek to have the proposal excluded from its proxy materials based on an eligibility, procedural or substantive defect with the proposal.

Negotiate a Mutually Agreeable Resolution with the Shareholder Proponent

While filing a "no-action" request with the SEC is always an option, many of the organizations that submit shareholder proposals are quite sophisticated and will usually craft their proposals in a manner that will not permit exclusion under SEC rules. Accordingly, a company may be better off communicating directly with the shareholder in an effort to negotiate a resolution that satisfies

the company and the shareholder.

A company must, of course, be aware of its obligations under Rule 10b-5 and Regulation FD regarding selective disclosure when it engages in private discussions with a shareholder.

Determine Whether There are any Eligibility or Procedural Bases for Exclusion

The following are the eligibility and procedural bases for exclusion of a shareholder proposal:

- *Failure to Meet the Deadline for Submitting a Proposal*.
    - *Regularly Scheduled Annual Meetings.* If the proposal is submitted for a regularly scheduled annual meeting, the proposal must be received at the company's principal executive offices at least 120 days before the date on which the company first sent or gave its proxy statement to its shareholders for the previous year's annual meeting.
    - *Other Meetings.* If the meeting is not a regularly scheduled annual meeting, if the company did not hold an annual meeting in the previous year, or if the date of the current year's annual meeting has been changed by more than 30 days from the date of the previous year's meeting, then the deadline is a reasonable time before the company begins to print and send its proxy materials.
- *Eligibility*. Shareholder proposals may only be submitted by shareholders that, at the time the proposal is submitted, have continuously held for one year or more at least the lesser of $2,000 in market value, or 1%, of the company's securities entitled to vote on the proposal at the meeting, and continue to hold those securities through the date of the shareholder meeting.
- *Number of Proposals*. A shareholder is only permitted to submit one proposal for a particular meeting. Notwithstanding this limitation, shareholders often submit proposals containing multiple parts. Sometimes these proposals may be excluded on the grounds that they actually consist of more than one proposal. However, there is no clear guidance as to what constitutes a single proposal, and the SEC has stated that a proposal with multiple parts may not be excluded if the several parts relate to a single concept.
- *Length of Proposals*. A company may exclude a shareholder proposal if it contains more than 500 words. This 500-word limit applies to the proposal, the supporting statement and any title or heading included with the proposal.

As noted above, a company must notify the proponent within 14 calendar days of receiving the proposal of any alleged eligibility or procedural defect and the steps the proponent must take to remedy the defect. This notice is not required, however, if the deficiency cannot be remedied (*e.g.*, if the proponent indicates in the proposal that he or she does not own at least $2,000 in market value, or 1%, of the company's securities).

If a company plans to exclude a proposal because of a procedural or eligibility defect, it must file a "no-action" request with the SEC as noted above.

Determine Whether There are any Substantive Bases for Exclusion

If a shareholder has complied with the SEC's eligibility and procedural requirements, a company may still attempt to exclude a proposal under one or more of the 13 substantive bases for exclusion by filing a "no-action" request with the SEC explaining its basis(es) for excluding the proposal at least 80 calendar days before the company files its definitive proxy statement with the SEC.

The following are the 13 substantive bases for excluding a shareholder proposal under Rule 14a-8:

1. *Improper Under State Law*. A proposal may be excluded from a company's proxy statement if it is not a proper subject for action by shareholders. As discussed further below, a shareholder can often circumvent this exclusion if the shareholder casts the proposal as a "precatory" proposal, *i.e.*, a proposal that recommends or requests that the board of directors take a specified action as opposed to a proposal that would be mandatory or binding if approved by shareholders.

2. *Violation of Law*. If the implementation of the proposal would cause the company to violate any state, federal or foreign law to which it is subject, it may be excluded.

3. *Violation of Proxy Rules*. A company may exclude a proposal if it or its supporting statement is contrary to any of the SEC's proxy rules (including the prohibition on materially false or misleading statements in proxy materials set forth in Rule 14a-9).

4. *Personal Grievance; Special Interest*. A company may exclude a proposal if it relates to the redress of a personal claim or grievance or if it is designed to advance a personal interest that is not shared by other shareholders.

5. *Relevance*. A proposal may be excluded if it relates to operations that account for less than 5% of the company's total assets at the end of the company's most recent fiscal year, and for less than 5% of its net earnings during the most recent fiscal year and is not otherwise significantly related to the company's business.

6. *Absence of Power/Authority*. A company may omit a proposal if it lacks the power or authority to implement the proposal. This exclusion may apply if carrying out the proposal would cause the company to breach an existing contractual obligation.

7. *Management Functions*. A proposal may be excluded if it deals with a matter relating to a company's ordinary business operations.

8. *Relates to a Board Election*. A company may exclude a proposal that relates to a nomination or an election for membership on the company's board or a procedure for such nomination or election.

9. *Conflicts with Company's Proposal*. If a proposal directly conflicts with a proposal to be submitted by the company for the same meeting, it may be excluded.

10. *Substantially Implemented*. A proposal may be excluded if it has already been substantially implemented.

11. *Duplication*. A proposal may be excluded if it substantially duplicates another shareholder proposal that will be included in the company's proxy materials for the same meeting.

12. *Resubmissions*. A proposal may be excluded if it deals with substantially the same subject matter as a proposal that has been previously included in the company's proxy materials within the last five years and the previously submitted proposal failed to receive specified vote percentages.

13. *Specific Amount of Dividends*. If a proposal relates to specific amounts of cash dividends, it may be excluded.

Most of these substantive bases for exclusion have been the subject of significant interpretation by the SEC and its Division of Corporation Finance. In seeking exclusion of a shareholder

proposal, a company should review with counsel the relevant SEC "no-action" letters with respect to each substantive basis to determine how the SEC has interpreted that particular provision.

Actions to be Taken if a Shareholder Proposal is Not Excludable Under Rule 14a-8

If a shareholder proposal is not excludable under Rule 14a-8, a company may include the reasons for its opposition to the proposal in its proxy statement, and may also include its board of directors' recommendation for how shareholders should vote on the proposal. Unlike the limitations placed on the length of the shareholder's proposal and supporting statement (500 words), there is no limit on the length of a company's "statement of opposition." The company must ensure that its statement of opposition is accurate and not misleading, and, as noted above, must provide an advance copy of its statement of opposition to the shareholder proponent.

A company may also hire a proxy solicitor to solicit votes against the proposal. However, it should be noted that a company's efforts to oppose a shareholder proposal, including circulating additional materials or contacting shareholders directly, must comply with the SEC proxy rules.

Implications if Shareholders Approve a Shareholder Proposal

Under the laws of most states, including Delaware, New York and California, a company's business and affairs are generally to be managed by or under the direction of the company's board of directors. Therefore, shareholder proposals generally must be phrased as recommendations or suggestions or otherwise they risk exclusion under Rule 14a-8(i)(1), the provision which allows exclusion of shareholder proposals that are not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization. In certain circumstances, shareholder approval of a precatory shareholder proposal may put pressure on the board to implement the proposal. Nevertheless, a board may appropriately determine not to implement the proposal if it in good faith believes that its implementation is not in the best interests of the company and its shareholders.

However, mandatory (as opposed to precatory) proposals cast as bylaw amendments are sometimes not excludable under Rule 14a-8(i)(1). Under the laws of many states, including Delaware, New York and California, shareholders generally have the authority to amend a corporation's bylaws. Accordingly, where shareholders have this authority, mandatory shareholder proposals relating to bylaw amendments may not be excludable, unless they are invalid under state law or are excludable on some other basis. In the recent *CA, Inc. v. AFSCME Employees Pension Plan* case discussed below, the Delaware Supreme Court ruled that a mandatory shareholder proposal relating to a bylaw amendment would unduly infringe on a board's exercise of its fiduciary duties providing a basis for its exclusion. To exclude a shareholder proposal relating to a bylaw amendment from its proxy materials, a company may need to provide the SEC with an opinion of legal counsel stating that the bylaw amendment is not a proper subject for shareholder action.

If a board of directors does not implement a shareholder proposal that has been approved by shareholders, it may be subject to criticism from a variety of sources, including shareholder activists. In addition, RiskMetrics Group ("RiskMetrics") and other proxy advisory services may recommend that shareholders cast "withhold" votes with respect to the election of directors in situations where a company fails to implement a shareholder-approved shareholder proposal. In particular, RiskMetrics will recommend that shareholders vote against or withhold their votes from all nominees for directors (other than new nominees) where a company's "board failed to act on a shareholder proposal that received approval by a majority of the shares outstanding the previous year [or] failed to act on a shareholder proposal that

received approval of the majority of shares cast for the previous two consecutive years. . . ."[1] A significant number of "withhold" votes for a particular board nominee could be seen as negative from an investor relations perspective.

Hot Subjects for Shareholder Proposals

"Say on Pay"

"Say on pay" proposals seek to provide shareholders with an annual advisory vote on executive pay. In the wake of the global financial crisis and complaints by shareholders regarding significant compensation paid to executives on profits that turned out to be illusory, "say on pay" proposals may garner much support this year. These proposals received support from an average of 42.1% of votes cast (excluding abstentions) in 2008,[2] and there are a significant number of "say on pay" shareholder proposals expected in the 2008-2009 proxy season. Moreover, many predict that Congress may preempt such proposals by passing legislation mandating advisory votes on executive pay at public companies during the 2009 legislative session. President-elect Obama introduced "say on pay" legislation in the Senate after it had passed in the House in 2007. However, the legislation stalled in the Senate. Nevertheless, Barney Frank, Chairman of the Financial Services Committee of the U.S. House of Representatives and an ardent supporter of "say on pay" legislation, and many others believe that "say on pay" legislation will be passed in early 2009.

Majority Voting for Election of Directors

In the past, nearly all directors of U.S. public companies were elected under a plurality voting standard. Under plurality voting, in an uncontested election, a director nominee merely needs to receive one vote to be elected. Now, more than half of the S&P 500 and Fortune 500 companies have adopted some form of majority voting,[3] which generally requires a director nominee to receive more votes "for" his or her election than votes that are withheld from the nominee. These proposals received support from an average of 50.2% of votes cast (excluding abstentions) in 2008.[4] Moreover, during the 2007-2008 proxy season, more than half of the approximately 90 majority voting proposals submitted were ultimately withdrawn,[5] suggesting these target companies agreed to implement majority voting on their own. A significant number of majority voting proposals are again expected to be submitted in the 2008-2009 proxy season.

Independent Board Chairs

Shareholder proposals requesting the appointment of an independent board chairman received an average of 29.8% of votes cast (excluding abstentions) during 2008.[6] A significant number of these proposals are expected to be submitted in the current proxy season.

Other Proposals that Have Gained Popularity in Recent Years

Additional shareholder proposals that have gained popularity in recent years include proposals relating to: the establishment of a shareholder right to call special meetings; the elimination of tax gross-ups for senior executives; the placement of limitations on severance payments to departing executives; and the elimination of classified boards.

Proxy Access and Reimbursement for Proxy Soliciting Expenses

The SEC Proposes, but Never Adopts, Rules Regarding Proxy Access in 2003

"Proxy access" generally describes a system where shareholders are permitted access to the company's proxy statement for the purpose of electing directors not nominated by the company's board. This contrasts with the current regime, where only the board's nominees are included in the company's proxy materials, and shareholders are required to pay for the preparation and distribution of their own proxy materials if they want to attempt to elect an

opposing slate of directors. The SEC proposed proxy access rules in 2003, which were heavily debated. Ultimately, however, the SEC declined to adopt these proposed proxy access rules.

Shareholder Efforts to Obtain Proxy Access

AFSCME v. AIG

In December 2004, AFSCME Employees Pension Plan ("AFSCME") submitted a shareholder proposal for inclusion in the 2005 proxy statement of American International Group, Inc. ("AIG") that, if adopted, would amend AIG's bylaws to require AIG, under specified circumstances, to publish in its proxy materials the names of shareholder-nominated candidates for director positions together with any candidates nominated by AIG's board of directors and to allow shareholders to vote on the shareholder-nominated candidates using management's proxy card. AIG sought to exclude AFSCME's proposal, and the SEC's Division of Corporation Finance issued AIG a "no-action" letter indicating that the Division of Corporation Finance would not recommend enforcement action against AIG if it excluded the proposal based on Rule 14a-8(i)(8). At the time, Rule 14a-8(i)(8) permitted companies to exclude a shareholder proposals that related "to an election for membership on the company's board of directors . . ." (the "Election Exclusion"). In reliance on its "no-action" letter, AIG determined to exclude AFSCME's proposal. AFSCME then brought suit in the United States District Court for the Southern District of New York seeking a court order compelling AIG to include the proposal in its next proxy statement. In denying AFSCME's application for a preliminary injunction, the district court concluded that AFSCME's proposal "on its face 'relates to an election.' Indeed it relates to nothing else."[7] AFSCME appealed to the United States Court of Appeals for the Second Circuit.

On September 5, 2006, the Second Circuit in *AFSCME, Employees Pension Plan vs. American International Group, Inc.* (hereinafter "*AFSCME v. AIG*") overturned the district court's decision and ruled that a shareholder proposal seeking to amend corporate bylaws to establish a procedure by which shareholder-nominated candidates may be included in management's proxy materials does not "relate . . . to an election" and therefore may not be excluded from management's proxy materials under the Election Exclusion.[8] This interpretation was at odds with the amicus brief submitted to the court by the SEC. In reaching its decision, the court concluded that the SEC had impermissibly changed its interpretation of the Election Exclusion, and thus based its decision on the interpretation of the Election Exclusion that, according to the court, was adopted by the SEC in 1976 and followed by the SEC's Division of Corporation Finance from 1976 to 1990. The court, however, left open the possibility for the SEC to explain the reasons for the departure from its 1976 interpretation, in which case it appears that the court would defer to the SEC's interpretation.

SEC Response to AFSCME v. AIG

In response to the Second Circuit's decision in *AFSCME v. AIG*, the SEC issued two alternative proposing releases in July 2007. The first, if adopted, would have modified the Election Exclusion to allow shareholders to propose proxy access bylaw amendments under specified conditions.[9] The second proposing release (i) clarified that the SEC's interpretation of the Election Exclusion would allow companies to exclude shareholder proposals similar to proposal at issue in *AFSCME v. AIG* and (ii) proposed amendments to the Election Exclusion to make clear that it applies to proposals that relate "to a nomination or an election for membership on the company's board . . . or a procedure for such nomination or election."[10] The second proposing release was designed to nullify *AFSCME v. AIG*. In December 2007, the SEC voted 3-1 to adopt the second proposing release, again declining to allow proxy access.[11] While SEC Chairman Cox left open the possibility of the SEC revisiting proxy access in 2008, no action was taken in 2008, most likely because the SEC had its hands full with the

current global financial crisis.

Bebchuck v. Electronic Arts, Inc

On February 20, 2008, Harvard law professor Lucian Bebchuck submitted a shareholder proposal to Electronic Arts, Inc. ("EA") recommending that the EA board of directors submit to EA's shareholders for approval an amendment to EA's certificate of incorporation or bylaws to allow certain significant shareholders direct access to EA's proxy statement for specified proposals relating to the amendment of EA's bylaws (the "Bebchuck Amendment"). To the extent a future shareholder proposal complied with the requirements of the Bebchuck Amendment, it would not be excludable under Rule 14a-8. In April 2008, after EA submitted a "no-action" request to the SEC to exclude Mr. Bebchuck's proposal from its proxy statement, Mr. Bebchuck filed a complaint against EA in the United States District Court for the Southern District of New York seeking a declaratory judgment and injunctive relief to require EA to include his proposal in EA's 2008 proxy statement. The district court issued a one-page opinion granting EA's motion for summary judgment without explanation.[12] It has been reported that the judge did not issue a written opinion because he expected Mr. Bebchuck to appeal the case. Mr. Bebchuck has in fact appealed, but a decision is not expected to be rendered in time for the current proxy season.

Shareholder Efforts to Obtain Reimbursement of Proxy Soliciting Expenses

The developments in the *CA, Inc. v. AFSCME Employees Pension Plan* case provide guidance to companies that seek to oppose bylaw amendment proposals. In response to the SEC's inaction on proxy access, AFSCME submitted a shareholder proposal that, if adopted by shareholders, would require CA, Inc., a Delaware corporation ("CA"), to include a provision in its bylaws that would require CA to reimburse any shareholder for the shareholder's reasonable expenses of soliciting shareholders, where the shareholder engages in a proxy contest for the election of fewer than 50% of the CA board, one or more of the shareholder's candidates is elected and certain other requirements are met. CA submitted a "no-action" request to the SEC to exclude the proposal and AFSCME submitted arguments as to why it believed the proposal should not be excluded. Because the SEC had received conflicting opinions from counsel to CA and AFSCME as to the validity of the shareholder proposal under Delaware law, the SEC availed itself of a recently adopted rule of the Delaware Supreme court and certified the following questions to the Delaware Supreme Court:

> "(1) Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law? and (2) would the AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?"[13]

On July 17, 2008, the Delaware Supreme Court answered the SEC's questions, concluding that, while the proposed bylaw is a proper subject for shareholder action, the bylaw would violate Delaware's "prohibition . . . against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders."[14] The Delaware Supreme Court suggested, however, that such a bylaw would be permissible if it contained a "fiduciary out" provision. Accordingly, some commentators believe that proposals similar to AFSCME's proposals but containing a "fiduciary out" clause will be put forth in the current proxy season. However, we are not aware of any such proposals being submitted by shareholders as of yet, and, given that a board of directors is already obligated to consider its fiduciary duties in connection with a request for reimbursement by an insurgent director (or insurgent directors) that has (have) been elected by shareholders, we do not believe such a bylaw amendment would be particularly advantageous to a dissident shareholder.

Possible Legislation of Proxy Access

While attempts to grant shareholders access to a company's proxy statement have so far been unsuccessful, proxy access may in fact be on the way. Congressman Barney Frank has been pushing for proxy access legislation for years. In the current economic and political climate, such legislation may be forthcoming. We will keep you informed of developments relating to proxy access as they occur.

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[1] RiskMetrics Group, *2009 U.S. Proxy Voting Guidelines Summary* page 8 (December 24, 2008).
[2] RiskMetrics Group, *2008 Postseason Report Summary, Weathering the Storm: Investors Respond to the Global Credit Crisis* page 3 (updated as of October 10, 2008).
[3] Neal Gerber Eisenberg, *Majority Voting in Director Elections—An Activist Success Story* page 1 (November 13, 2007).
[4] RiskMetrics Group, *2008 Postseason Report Summary, Weathering the Storm: Investors Respond to the Global Credit Crisis* page 3 (updated as of October 10, 2008).
[5] *Id.* at 7.
[6] *Id. at 3*.
[7] *Am. Fed'n of State, County and Mun. Employees Pension Plan v. Am. Int'l Group*, 361 F.Supp. 2d. 344, 346 (S.D.N.Y. 2005)
[8] *AFSCME vs. AIG*, 462 F.3d 121 (2d. Cir. 2006).
[9] Shareholder Proposals, Release No. 34-56160 (July 27, 2007).
[10] Shareholder Proposals Relating to the Election of Directors, Release No. 34-56161 (July 27, 2007).
[11] Shareholder Proposals Relating to the Election of Directors, Release No. 34- 56914 (December 6, 2007).
[12] *Bebchuck v. Electronic Arts, Inc.*, No. CV 08-3716 (S.D.N.Y. November 13, 2008).
[13] *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 231 (Del. 2008).
[14] *Id.* at 236 and 238.