

Storming the Ramparts: The Ongoing Shift in the Balance of Power Between Shareholders and Incumbent Boards of Directors

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Executive Summary

American corporations are currently witnessing a sea change in their corporate governance. Over the past several years institutional and activist shareholders have pursued and partially achieved significant alterations in the balance of power between shareholders and incumbent boards of directors, with further potentially fundamental changes yet to come. Taken together, these developments are ushering in a new era in which institutional shareholders will enjoy far greater power to challenge and remove incumbent directors whom they do not believe are sufficiently responsive to shareholder concerns.

Majority Voting and the Elimination of Broker Discretionary Votes

Led by labor union pension funds, a handful of prolific individual activists and, more recently, hedge funds, and with backing from proxy advisory service Institutional Shareholder Services (ISS), these shareholder groups have already succeeded in triggering a wholesale shift from plurality to majority voting in uncontested director elections. This new voting standard will attain even greater impact with the expected elimination of broker discretionary voting in director elections. No longer able to count on the historically predictable “street” vote in favor of the incumbent slate, directors will find themselves substantially dependent on institutional shareholders for their reelection. This direct and immediate accountability can be expected to markedly affect the degree to which directors look to major shareholders and their advocates for guidance on how those shareholders wish a company to be managed.

Insurgent Election Campaigns

Simultaneously, the rise in so-called “short slate” election campaigns and the potential of the SEC’s new electronic proxy delivery rules to reduce the cost of conducting election contests make it increasingly likely that institutional shareholders may actively seek to substitute their own nominees in place of specific incumbent directors whose performance or responsiveness they consider unsatisfactory.

Further potential developments are waiting in the wings.

Shareholder Access to Corporate Proxy Statements

The Second Circuit’s recent decision in *AFSCME v. AIG* has brought back to life the possibility that the SEC might at some point mandate direct shareholder access to corporate proxy statements for their own nominees. If such a rule is adopted, director elections might lose the character of an up-or-down vote of confidence in the incumbent board and come more to resemble general elections in the political sphere, with multiple slates contending for office side by side in a single proxy statement.

Mandatory Bylaw Amendments

Shareholders have also discovered what may prove to be the keys to the governance kingdom, namely direct shareholder amendment of corporate bylaws to alter governance structures or even mandate specific shareholder roles or aspects of managing a corporation’s business. The rising use of this technique may ultimately bring to a head in the Delaware courts the tension between two equally broad and unambiguous statutory grants of authority: the power of the board to manage the business and affairs of the corporation, versus the power of the shareholders to directly amend the bylaws, which in turn may contain any provision not inconsistent with law or the corporate charter relating to the business of the corporation, the

conduct of its affairs, and the rights and powers of shareholders, directors, officers and employees. Which power will trump the other remains to be seen.

Targeting Executive Compensation

One of the near term battlegrounds in which shareholders can be expected to flex their newfound muscle is executive compensation. Against the backdrop of the SEC's new executive compensation disclosure rules, a number of large institutional shareholders have announced their intention to focus heavily on compensation matters. In recent weeks, moreover, Congressional leaders introduced a bill which would require nonbinding shareholder votes as to executive compensation. Meanwhile, numerous shareholder proposals calling for such advisory votes on compensation have been submitted to companies during the current proxy season. Compensation practices appear headed for change.

The days when academics could describe a corporate landscape in which shareholders no longer exercised effective control over the managers of major enterprises may soon be drawing to a close.

Victory of the Majority Vote Movement

With astonishing speed, a new voting standard for the election of corporate directors is sweeping the Fortune 500. Gone or rapidly vanishing is the former "plurality" voting standard which was and is the default provision under state corporation laws. Into its place is stepping the new "majority" voting standard for uncontested elections.

Response to Initial Failure of Proxy Access Proposal

The initial trigger for this sudden shift in the voting landscape actually lay elsewhere, namely in the frustration of institutional shareholders' attempts to gain access to corporate proxy statements through SEC regulation. In 2003, the SEC had proposed a new rule under which large shareholders under certain circumstances could require an issuer to include shareholder nominees in the corporation's own proxy statement, often referred to as "shareholder access."

This was a significant regulatory move, as state corporation laws do not require a board to include in the company's proxy statement any nominees other than its own. Up until

now, an insurgent seeking to conduct an election contest has always had to prepare, file and distribute their own proxy statement in competition with the one circulated by the issuer. This is an expensive proposition, and the cost had long served as a deterrent to conducting election campaigns. Hence the vast majority of all nominee slates proposed by incumbent boards have historically run unopposed. Many large shareholders have long been dissatisfied with this result—without the whip of an effective and inexpensive power to remove directors from office, they have not felt incumbent boards to be sufficiently responsive to their wishes and concerns.

In the resulting storm of controversy the proposed rule was placed on the back burner—it remained outstanding, but no immediate action appeared likely.

Shareholders Turn to Majority Voting

As the SEC's shareholder access proposal had hit political turbulence, activist shareholders, led by the Carpenters' pension fund, turned to the majority voting standard as an alternative way to affect the composition of corporate boards.

Under the majority voting standard as proposed by these shareholders, in an uncontested election no director who fails to receive at least a majority of the votes cast in his or her favor is permitted to take a seat on the board. Such a result lends real teeth to a "just vote no" campaign.

This contrasts with the default rule under state law, plurality voting. Plurality voting simply means that those nominees receiving the highest number of votes are elected. On its face this rule appears unobjectionable. When, however, the incumbent board's slate runs unopposed, this means theoretically that even a director receiving a single vote can be elected to the board. Although in actual practice board slates have as a historical matter routinely received favorable votes significantly in excess of a majority, a number of institutional shareholders had recognized the potential power of just vote no campaigns, intended to use them as an important tool for disciplining boards going forward, and did not wish for corporations to be able to disregard the results of a majority withhold vote. These shareholders wanted the result of such a vote to be legally binding, and accordingly began introducing shareholder proposals urging corporate boards to change companies' bylaws to this effect. The proposals call for majority voting only in uncontested elections while the plurality standard would continue to apply in con-

tested elections, in order not to lead to situations where no directors receive enough votes to be seated.

The Central Role of Shareholder Proposals

Many boards would have preferred not to present such proposals as part of their proxy statements leading up to the wave of annual shareholder meetings in late spring of 2006. Again, under state law, they would not be required to do so. But here federal law comes into play as well. SEC Rule 14a-8 mandates that shareholder proposals be included in corporate proxy statements unless one or more of certain enumerated criteria for exclusion by the company are satisfied.

One of these criteria for exclusion is Rule 14a-8(i)(10), which permits a company to decline to include a shareholder proposal in the company's proxy statement where the company has already "substantially implemented" the proposal.

Many boards seized upon this as a means to potentially alter the form of majority vote standard which might ultimately come to govern their corporations. In a preemptive move, the board of Pfizer and other like-minded boards adopted director resignation policies (as distinct from bylaw amendments) pursuant to which a director who did not receive at least a majority of votes cast in their favor would submit their resignation for consideration by the board. Under many such policies, the board generally would have retained the ability to reject the resignation. These companies argued to the SEC during the 2006 proxy season that they should now be permitted to exclude majority vote bylaw proposals as having been substantially implemented by the resignation policies. Beginning with Hewlett-Packard's request to exclude, however, the Division of Corporation Finance did not concur, and the bylaw amendment proposals went before shareholders.

Tidal Wave of Reform

This burst the dam. In its 2006 postseason report, ISS indicated that more than 180 U.S. companies had adopted majority voting, of which at least 40 followed Intel's lead and did so in the form of an amendment to the bylaws rather than merely a resignation policy. And the wave of reform continues unabated, with a multitude of majority vote proposals again having been submitted for the current proxy season and ISS generally recommending a vote in favor of such proposals. Companies such as General Electric, Exxon Mobil, General Motors and Wal-Mart have all adopted the new standard.

State Law Changes

To facilitate the adoption of majority voting, Delaware has even undertaken certain modifications to its corporation law. During 2006, the state added a provision making explicit that a bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors (such as a majority vote bylaw) shall not be further amended or repealed by the board. In addition, to address the issue of what happens if a director fails to receive a majority vote in favor, but then refuses to tender a resignation despite the board's resignation policy, the state added a provision that a resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable. This makes it possible to collect irrevocable resignation letters from all directors before they are seated on the board, which can then later be used to enforce the majority vote bylaw. In October 2006, Bank of America adopted a majority vote bylaw based on this new provision, where the bylaw indicated that the board would only nominate persons who agree to tender such irrevocable resignation letters following their election or appointment to the board. California's corporation law and the Model Business Corporations Act have also been amended to accommodate majority voting.

The Coming New Paradigm

With the momentum among large publicly traded corporations now clearly in the direction majority voting, more companies can be expected to follow this lead. As for the stragglers, certain institutional shareholders have indicated that they intend to continue to pursue companies which do not voluntarily make the switch. Indeed, a representative of AFSCME has publicly indicated an intent to use mandatory bylaw amendments, discussed at greater length below, to force the switch in cases where a board remains recalcitrant in the face of merely precatory resolutions urging such a course of action. It appears likely that majority voting will soon be the dominant paradigm among major American corporations.

Elimination of Broker Discretionary Voting

Sharply increasing the impact of the shift to majority voting will be the widely anticipated elimination of broker discretionary voting in director elections.

Reliance on Broker Discretionary Votes

Up until now, each year incumbent boards have been able to face the prospect of the annual meeting of shareholders with the comfortable knowledge that the board would have a large block of broker discretionary votes in favor of the incumbent slate in their back pocket. Unless there were overwhelming opposition to the company's slate or a vigorous election contest by an insurgent, reelection was thus often a foregone conclusion.

NYSE Rule 452

Broker discretionary voting is permitted under existing NYSE Rule 452, which provides that if the underlying beneficial owner of shares held in street name has not indicated how those shares should be voted, the relevant broker is allowed to vote the shares in its discretion. Furthermore, by virtue of NASD Rule 2260(c)(2), if a broker is permitted to cast a proxy under NYSE rules, it is also permitted to cast a proxy under the rules applicable to Nasdaq listed companies. The NYSE rule thus permits discretionary voting across effectively all major listed issuers in the U.S. And brokers typically exercise that discretion to vote in favor of the company's recommended slate of directors.

This discretionary voting is only permitted, however, as to so-called "routine matters." The NYSE has now proposed to the SEC a rule change pursuant to which director elections would no longer be considered routine. Pursuant to the NASD coordinating rule mentioned above, such an NYSE rule change would likewise impact voting with respect to Nasdaq listed companies.

If, as expected, this rule change is approved by the SEC, the incumbent board will no longer have any votes cast in favor of its slate unless the beneficial owner has in fact affirmatively cast such a vote or expressly authorized its broker to do so. And the rate of affirmative voting participation by shares held by individuals is markedly lower than the rate among institutional holders and hedge funds. The large pool

of broker discretionary votes upon which incumbent directors have traditionally been able to rely is about to disappear. This will, in effect, dilute the importance of the retail shareholder whose votes were cast discretionarily by brokers and thereby emphasize the importance of institutional shareholders, who typically vote their shares, in a manner disproportionate to their actual shareholdings.

Face to Face with Institutional Shareholders

For a company which has adopted a majority voting standard, this translates into a situation where incumbent directors will need to garner significant support among institutional holders in order not to face removal from the board. This in turn means that those directors will face powerful incentives to be responsive, and to be seen as being responsive, to the concerns and wishes of those holders. The balance of power will have shifted tangibly.

The Rise in Insurgent Election Campaigns

The shift to majority voting is occurring against the backdrop of a general rise in activism by institutional shareholders and hedge funds. The number of hedge and other investment funds, as well as capital committed to these strategies, has more than tripled in recent years and fund managers have not been shy in making their wishes known to the companies in which they invest. Where the incumbent board does not accede to their view of how to maximize value, funds have been willing to mount proxy contests to place their own representatives on the board. According to ShareRepellent.net, 2006 witnessed 98 proxy fights, a notable increase over prior years.

Many of these challenges involve hedge funds' desire to see management divest assets, cut costs, increase dividends, undertake stock repurchases or sell the company. Such a proxy fight which attracted significant media attention last year was the attempt by Nelson Peltz' Trian to capture 5 of 12 seats on the board of Heinz (in the end, Peltz won 2 seats).

There has also emerged the concept of a "governance fund." At the current time Breeden Capital, led by former SEC chairman Richard Breeden, is engaged in a fight to gain 4 seats on the board of Applebee's. In addition to criticizing a number of specific business decisions by management,

Breeden Capital stated that a “variety of poor governance practices have also contributed to a lack of accountability for performance and other weaknesses that should be corrected. For example, Breeden Partners believes that Applebee’s should eliminate its staggered board and replace this system that harms shareholder interests with majority voting for all members of the board on an annual basis.”

Reimbursement for Short Slate Campaigns

A type of shareholder proposal which has recently seen its way into corporate proxy statements and may serve to increase the frequency of proxy fights yet further are resolutions calling for reimbursement to shareholder insurgents for the cost of “short-slate” opposition campaigns to a subset of the incumbent slate.

These proposals target the fundamental issue which has historically hindered institutional shareholders from conducting campaigns to oust the incumbents: the cost of waging a proxy contest. The typical proposal has urged the board to adopt a policy pursuant to which a shareholder who proposes an opposition slate garnering a certain level of support will be reimbursed for the costs of having conducted the campaign, even where the total number of opposition nominees is less than the total number of seats open for election (a short slate).

Companies have sought to exclude these proposals under Rule 14a-8, but again the Division of Corporation Finance has generally not concurred and such proposals have been brought before shareholders. To the extent such proposals find widespread support, they pose an alternative mechanism for shareholders to reduce the cost of insurgency and thus facilitate the removal of incumbent directors.

E-Proxy

An entirely different manner of reducing the costs of insurgency has also recently emerged, namely the SEC’s change to the proxy rules which now permits electronic delivery of proxy statements. Costly paper delivery will only be required where specifically requested by a shareholder.

It has yet to be seen how great the impact of this new rule will be. Significant proxy preparation and filing efforts and other legal compliance costs in waging an election contest will remain, and some paper delivery will presumably be requested. Nonetheless, over time, and particularly as more shareholders consent to electronic delivery as a general matter, the costs of election contests may drop markedly. Shareholder activists will be able to reduce their costs and accelerate their campaigns by simply filing a proxy statement and proxy card with the SEC, web-posting the same, and mailing out a paper notice of the meeting solely to the handful of largest institutional shareholders (whose relative voting power will be amplified by the anticipated elimination of broker discretionary voting). Paper copies of the proxy statement and card would only be required for those shareholders who specifically request paper. As to those shareholders which have previously consented to electronic delivery of such materials, even the notice could be provided in electronic rather than paper form. If and when institutional shareholders have all delivered to each other such consents to electronic delivery, printing costs in connection with opposition proxy solicitations by shareholders will as a practical matter have been eliminated. The trigger pull for opposition campaigns will be commensurately quicker and easier.

Shareholder Access to Corporate Proxy Statements

Perhaps the final and most decisive way for shareholders to reduce the cost of conducting an opposition campaign would be to gain access to the corporate proxy statement for shareholder nominees.

Historically No Requirement to Include Opposition Candidates in Company’s Proxy Statement

State law does not require such a result. Instead, boards of directors have the power to decide which nominees are featured in a company’s proxy statement. This has meant in practice that solely the board’s own nominees have appeared.

Heretofore, federal law has not interfered. Rule 14a-8 has required the inclusion of many shareholder proposals as to various substantive matters, but has not required the inclusion in company proxy statements of shareholder nominees. Specifically, Rule 14a-8(i)(8) permits a proposal to be ex-

cluded if it “relates to an election for membership on a company’s board....” Thus corporate proxy statements have traditionally included management proposals, and for some companies certain shareholder proposals (typically precatory), but only a single slate of candidates for the board.

As mentioned earlier, in 2003 the SEC proposed to change this result and require public companies under specified circumstances to include a handful of nominees of major shareholders in corporate proxy statements. This controversial proposal ran into political headwind and initially stalled out. Shareholder interest in this matter, however, never died.

Pursuit of Proxy Access Through Shareholder Proposals

Again riding point, AFSCME decided to push the issue in a somewhat different manner. It submitted to AIG a proposal that would have directly amended the company’s bylaws to provide that in future a shareholder or group holding 3% of the outstanding shares for at least a year would be able to place one of their own nominees in the company’s proxy statement along with a statement supporting the candidacy. In effect, AFSCME was attempting to obtain shareholder access to the corporate proxy statement through direct bylaw amendment by the shareholders rather than through SEC regulation.

AIG, however, obtained a letter from the Division of Corporation Finance indicating that inclusion of the proposal was not required. The Division of Corporation Finance stated that there “appears to be some basis for your view that AIG may exclude the proposal under rule 14a-8(i)(8), as relating to an election for membership on its board of directors.” AFSCME then sued.

Second Circuit Decision Changes the Landscape

The Second Circuit disagreed with the SEC staff, ruling that the Division’s understanding of the rule did not deserve deference and that exclusion of such a shareholder access proposal was not permitted under Rule 14a-8. AFSCME’s proposal would now go before shareholders in the company’s own proxy statement.

Moreover, although the decision as a technical matter is only binding in the Second Circuit, New York City and thus both the NYSE and Nasdaq fall within its jurisdiction. Practically all major American issuers are listed on one or the other of those exchanges. The national impact of the deci-

sion soon made itself felt with Hewlett-Packard’s attempt to block another shareholder access proposal by AFSCME substantially similar to the one earlier submitted to AIG, though permitting each 3% holder or group to place two candidates in the company’s proxy statement. HP argued that it should be permitted to exclude the proposal on grounds that the company is headquartered and would hold its annual meeting in California, and that therefore Ninth Circuit rather than Second Circuit law would apply. In denying the company’s request in January 2007, the Division of Corporation Finance noted that HP’s letter “assumes that the Ninth Circuit is the applicable jurisdiction for purposes of this request. Since we are unable to dispute or concur in this assumption, we express no view concerning whether HP may exclude the proposal under rule 14a-8(i)(8) as relating to an election for membership on its board of directors.”

In the event, at HP’s annual meeting on March 14, 2007 the proxy access proposal received significant support with close to 40% in favor, but did not pass. Nonetheless, the fate of HP’s request to the SEC to exclude the proposal in the first place means that companies will now either have to include such shareholder access proposals in their proxy statements or face the cost of litigating the matter in court.

Will the SEC Repropose Proxy Access?

The Second Circuit’s decision has put the SEC’s feet to the fire. The difference of opinion between the court and the agency’s own Division of Corporation Finance, and the potential for differing treatment of the matter in different circuits, has created an undesirable state of legal uncertainty. To date, the SEC has not acted to either issue definitive guidance more likely to receive judicial deference in support of the Division of Corporation Finance’s interpretive position or, in the alternative, revise its rules to mandate shareholder proxy access. However, a recent report in the media indicates that Chairman Cox has stated the SEC is in fact working on a shareholder access rule proposal at the current time.

Implications of Proxy Access for Contested Elections

If ultimately the SEC does decide to mandate shareholder proxy access, the ramifications could be significant. Depending on the final form of such a rule, shareholders might no longer face inhibitory costs in connection with mounting an insurgency, as their nominees would mandatorily be included in the company’s own proxy statement. Again depending on how such a rule is drafted, there might arise situations in

which two or more competing slates of candidates vie for office side by side in a single proxy statement. In such a case, gone would be the days of near-certain approval of the incumbent slate, and gone would be the up-or-down vote of confidence posed under the current form of majority vote regime. Free-for-all election battles for corporate control could potentially ensue.

Mandatory Bylaw Amendments

To this point the discussion has turned on shareholder attempts to affect the management of enterprises by altering, or wielding the deterrent capability to alter, board composition. There is, however, an entirely alternative means of pursuing control, namely direct amendment by shareholders of the corporate bylaws, often referred to in SEC circles as a “mandatory bylaw amendment.” This would constitute management by shareholders not via the board but instead bypassing the board altogether.

The Overwhelming Historical Dominance of Precatory Proposals

Until very recently, this alternative tool for shareholder control had not been utilized in any widespread manner. Indeed, it was so uncommon that for many decades it has not been widely recognized in the shareholder or corporate communities as a possibility at all.

This has led to the still typical precatory form of shareholder proposal under Rule 14a-8, i.e. a resolution which urges or requests the board to take specified action but ultimately lacks any legally compulsory effect should the board choose to ignore it. In cases where shareholders submitted proposals purporting to mandate and require corporate action (not through an amendment to the bylaws but simply through a resolution purporting to direct the company or its officers to follow a certain course, e.g. “resolved that the company shall discontinue its mining operations in Indonesia”), corporations have submitted to the SEC opinions of counsel asserting that such proposals are excludable under Rule 14a-8(i)(1) as not a proper subject for shareholder action under state law. Such requests to exclude have generally received the concurrence of the Division of Corporation Finance. Indeed, an instruction to Rule 14a-8(i)(1) states explicitly that: “... some proposals are not considered proper under state law if they would be bind-

ing on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law.”

Representative Democracy in Corporate Law

The reason for this result is that existing state corporation laws typically provide for a form of corporate governance broadly comparable to that of representative democracy in the political sphere. Just as voters periodically have the right to elect a government, but once the election has occurred have no right to dictate to the government or its officers any specific course of action to be followed, shareholders periodically have the right to elect a board but then generally enjoy no power to dictate any specific course of action to the board. This comparison is complicated somewhat by the fact that certain major corporate actions (such as an amendment of the charter, or most mergers) require approval not solely by the board but also by the shareholders (roughly comparable to a plebiscite in the political sphere), and by the fact that under certain circumstances shareholders might be able to remove directors before their terms of office expire. But at a fundamental structural level, the analogy holds.

This principle is enshrined under Delaware law in DGCL Section 141(a): “The business and affairs of every corporation...shall be managed by or under the director of a board of directors....”

The Practical Impact of Precatory Proposals

Despite the nonbinding character of precatory proposals and the frustration felt among many shareholders at not having sharper legal teeth, precatory proposals have in fact served as the vehicle for significant governance reforms at many companies, from board declassifications to the elimination or limitation of poison pills and restrictions on severance pay. An outstanding example of the impact of precatory proposals is the majority vote movement discussed earlier. This is in large part because boards of directors, who have been elected by the shareholders and stand under a fiduciary duty to serve the interests of those shareholders, feel distinctly uncomfortable declining to implement or at least to respond to an expressed wish of a majority of those shareholders in the form of a successful shareholder resolution. There is an ill-defined sense under such circumstances of being somewhat more exposed and vulnerable to attack than one might otherwise wish.

New Weapon in the Arsenal

Nonetheless, certain activist shareholders, notably AFSCME and Harvard Professor Lucian Bebchuk, do not believe that shareholders need restrict themselves to merely precatory proposals and have begun to wield mandatory bylaw amendments as a hammer to smash through the restrictions of Rule 14a-8(i)(1) and pound recalcitrant boards into submission. It was precisely a mandatory bylaw amendment to implement shareholder access which was at issue in the Second Circuit case *AFSCME v. AIG*. And a representative of AFSCME has publicly declared an intent to use mandatory bylaw amendments to impose a majority voting standard where a company has chosen to disregard an earlier and successful precatory proposal requesting such a change.

Shareholder Power to Rewrite the Bylaws

The reason a mandatory bylaw amendment under Delaware law is immune to attack as an improper subject for shareholder action is that DGCL Section 109 specifically empowers the shareholders to adopt, amend and repeal bylaws. In fact, directors only have such power themselves if so authorized in the corporate charter, and even then such a power in the directors cannot divest or limit shareholders' power to adopt, amend or repeal. Moreover, under DGCL 109 "the bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and...the rights and powers of its stockholders, directors, officers or employees." This is on its face easily as broad a grant of authority to shareholders as the grant of authority to directors to manage the corporation under DGCL 141(a).

The Coming Clash in Delaware

How the tension between these two provisions will ultimately be decided in the Delaware courts remains to be seen. It may be that the principal/agent relationship between shareholders and directors will be viewed as paramount, and that directors will not be permitted to disregard or block a direct order given to them by the owners of the enterprise through a mandatory bylaw amendment. On the other hand, Delaware might believe that as a matter of policy it is vital that corporations continue to have governing structures capable of rapid and effective action, flexible enough to adapt to changing circumstances (not necessarily the case with a fixed rule in the form of a bylaw), with a core of experienced and knowledgeable individuals at the helm who follow the

corporation's affairs closely. For the same reason that representative rather than direct democracy is generally the rule in the American political sphere, Delaware may believe that it should remain the rule in the corporate sphere and that frequent use of mandatory bylaw amendments might at some threshold interfere with the desired function of the board. The courts might accordingly find that certain shareholder bylaw amendments are contrary to the grant of authority to the board under DGCL 141(a) and thus "inconsistent with law."

So far Delaware has managed to duck the issue. In *Bebchuk v. CA*, the company had managed to obtain an opinion of counsel asserting that a mandatory bylaw amendment from Professor Bebchuk would improperly limit the management function of the board in violation of state law, and the Division of Corporation Finance issued a no-action response permitting exclusion of the proposal from the company's proxy statement. Bebchuk sued to compel inclusion. The court ruled that the matter was not ripe for adjudication, as the bylaw had not yet been approved by the shareholders. As events transpired, the company then voluntarily proceeded to include the resolution, which failed to pass at the meeting.

This will not, however, be the last time the issue is presented to the courts. Given the rising use of this technique, the matter will ultimately need to be addressed. The resolution of this tension has the potential to tangibly affect the structure of American corporate governance.

Targeting Executive Compensation

The first application of shareholders' ever-increasing power will be to restrict certain forms and amounts of executive compensation viewed by many in the shareholder community as excessive, particularly personal perquisites and deferred compensation and severance arrangements which permit executives leaving a company's employ to walk away with significant termination payments. As reported in the *Wall Street Journal*, according to ISS through March 9, 2007, "investors had submitted 266 shareholder proposals related to executive pay, almost double the year-earlier period...."

Impact of the New Disclosure Rules

With the SEC's new executive compensation disclosure requirements, shareholders are expecting compensation

arrangements to be revealed which they then intend to target. Under the new rules as initially adopted, shareholders were expecting eye-popping “holy cow” compensation numbers, driven in part by a requirement to disclose as income in year one the entire value of an equity award, irrespective of the fact that an executive might have to remain employed over a number of years to vest in the award. In December 2006 the SEC moved to modify the rule such that time-based vesting would be taken into account, requiring disclosure of the value of equity awards as the employee completes the service necessary to vest in the award. This will have the effect of smoothing what otherwise might have been highly variable compensation disclosure exhibiting sharp one-time spikes.

Although certain shareholders would have preferred the SEC to remain with the original version of the rule, the transparency of disclosure will still illuminate numerous arrangements to which many shareholders may be expected object. As indicated by a representative of a major institutional shareholder, in circumstances where investors believe board members have approved inappropriate compensation packages, those directors may be removed from office using shareholders’ newfound power under the majority voting standard. A new day is dawning for members of compensation committees.

Shareholder Advisory Votes

Beyond working to influence compensation via the board, certain shareholders are again striving to affect management of the enterprise in a more direct manner by requiring a shareholder vote on executive compensation. ISS reported on February 8, 2007, that “so far this proxy season, labor pension funds and other U.S. investors have filed more than 60 proposals seeking advisory votes on pay practices.” On February 14, insurance company Aflac announced that its board had “approved a resolution giving shareholders a non-binding vote on executive compensation.”

There are significant political players in Washington who see matters the same way. On March 1, 2007, Barney Frank and certain other representatives introduced in the House a bill which would require an annual nonbinding shareholder advisory vote to approve executive compensation, as well as a separate advisory vote in the acquisition context with respect to any acquisition-related compensation which has not previously been subject to such a vote. This proposed requirement that shareholders be provided a vote on executive compensation is modeled on similar rules already existing in the U.K. and Australia.

Regardless of whether the bill passes, shareholders interested in instituting such an advisory vote mechanism have open to them the possibility of using their expanded deterrent power over board members to cause such arrangements to be adopted. Or to use mandatory bylaw amendments to achieve the result. It is even imaginable that certain shareholders might seek not solely to establish a nonbinding advisory vote, but instead to affirmatively require that executive compensation be approved by shareholders each year as a prerequisite to corporate action.

The Dawn of a New Era

Executive compensation will only be the first of many management issues upon which the shareholder community will focus over time. A wide array of social, political and business matters can be expected to be pursued. Directors who fail to respond to shareholder wishes will face opposition proxy contests or simply be removed from the board. A new era of shareholder involvement with and control over American corporations appears to be dawning.

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