US Corporate Governance: Have We Crossed the Rubicon?

Skadden

January 2016

This article is from Skadden's *2016 Insights* and is available at skadden.com/insights/2016-insights.

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The general themes on the corporate governance front — shareholder activism, governance activism, scrutiny of board composition, concerns regarding board oversight of risk management, director-shareholder engagement — remain ever-present. Debate continues as to whether the paradigm shift from a more deferential, board-centric corporate governance model to a more skeptical, shareholder-centric model ultimately will damage the ability of U.S. public companies to invest in the future, innovate, and create jobs and economic growth. Boards of directors must assess how to navigate their companies through this turbulence as well as through the challenges presented by evolving marketplaces, economic events and disruptive technological changes.

Shareholder Activism. Shareholder activism remains a significant presence on the corporate landscape, with no signs of abating. Shareholder activists have taken ownership positions in companies and agitated for changes in business strategy, operations, structure, capital allocation, management and board composition. In 2015, following DuPont's successful proxy fight against Trian Partners and Nelson Peltz, some commentators suggested that shareholder activism had peaked and the tide was about to turn. These predictions proved premature. Following the retirement of DuPont's then-CEO, Trian remained an active and engaged shareholder, even consulting with DuPont (under a confidentiality agreement) in connection with the announced transaction in which DuPont and Dow Chemical — a large chemical company in which shareholder activist Third Point has a significant stake — would merge with the intention to eventually split the combined company into three independent, publicly traded companies.

While every activist situation must be assessed on its own facts and circumstances — for example, Ethan Allen successfully defended itself in a proxy contest with activist Sandell Asset Management — companies nevertheless are settling with activists at a faster pace than ever before, sometimes entering into agreements to appoint activists as directors in as little as days or weeks following the initial public disclosure of the activist's position in the company's stock. In fact, well-established activists such as Carl Icahn, Pershing Square and Starboard were able to secure board seats without running a proxy contest in 2015. The end result is that activists increasingly are transitioning from outside agitators to influential insiders.

Governance Activism and Proxy Access. Governance activism — often spearheaded by state, local and union pension funds and other individual investors — already has changed the framework of director elections and eliminated many so-called anti-takeover protections. As a result, at most large-cap companies and even many mid-cap companies, all directors are elected annually to one-year terms and must submit their resignations if they fail to receive the support of a majority of votes cast at the annual meeting. But until recently, the goal of "proxy access" — allowing certain shareholders or shareholder groups to nominate a limited number of candidates for election to the board and have those candidates appear in the company's proxy materials in side-by-side competition with the board's nominees — had remained elusive.

Following the Securities and Exchange Commission's (SEC) adoption of a proxy access rule in 2010, the judicial vacating of that rule in 2011, and the early but limited success of proxy access shareholder proposals in 2012-14, the New York City comptroller, on behalf of various New York City pension funds, launched its "Boardroom Accountability Project" proxy access campaign, which has significantly transformed the dialogue around proxy access. (See "Proxy Access: Latest Developments" from the September 17, 2015, Skadden webinar.) In 2015, at least 116 companies received a shareholder proposal seeking a proxy access bylaw along the parameters of the vacated SEC rule: requiring ownership of 3 percent of a company's shares for three years to gain access

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Approximately

125

companies had a proxy access bylaw by the end of 2015

Parameters of the SEC's vacated proxy access rule require ownership of

3%

of a company's shares for

3 years

to gain access to the proxy statement to nominate up to

25%

of the directors

to the company's proxy statement for nominees for up to 25 percent of the number of directors. Company responses varied from opposing proxy access on principle, to expressing openness to the idea and pledging further shareholder engagement on the topic, to adopting or agreeing to adopt proxy access on the terms proposed by shareholders or on terms the board believed were more appropriate for the company — typically a 5 percent ownership threshold — to putting competing management and shareholder proxy access proposals in the company's proxy statement. When the dust settled, approximately three-fourths of these companies either saw the shareholder proposal receive majority support, making adoption of proxy access likely, or had adopted, agreed to adopt or expressed a willingness to adopt proxy access.

As a result of this campaign, together with companies proactively adopting proxy access or adopting access in response to shareholder proposals submitted for 2016 annual meetings, approximately 125 companies had a proxy access bylaw by the end of 2015, with more companies expected to follow before the start of the 2016 proxy season. Most of these are large-cap companies; at the current pace, it is likely that a majority of S&P 500 companies will have a proxy access bylaw in place within the next year or two.

During the 2015 proxy season, the debate centered on whether to have proxy access at all and, if so, whether the appropriate ownership threshold was 3 percent or 5 percent. Shareholders do not possess uniform views on either of those questions, and a board should assess its particular shareholders when considering action on this topic. Nevertheless, for many corporate governance participants, the discussion has moved on to more nuanced questions, such as whether and for how long an access candidate elected to the board and renominated by the board should count against the limit on the number of access candidates, and whether a company should be subject to an access election contest while simultaneously engaged in a traditional proxy contest.

While no proxy access contest has occurred to date, and there is some debate over which shareholders are likely users of the proxy access mechanism, the turbulence boards face will only increase when the first access nominations are submitted and access contests undertaken.

Board Composition. Investors continue to question whether boards have the right personnel to effectively oversee management. These questions range from skill sets and expertise, to gender and racial diversity, to whether long-tenured directors are sufficiently independent of management. Related questions include whether board self-assessments are robust enough to help boards identify the need to replace directors and whether director succession planning is being done to ensure necessary board "refreshment."

The issue of director tenure, and whether tenure impedes independence, has been the topic of continuing discussions among investors and companies. The California Public Employees' Retirement System (CalPERS) is considering a change to its governance principles, which would call for companies in which it invests to undertake "rigorous evaluations" of directors after 12 years of board service and either classify them as nonindependent or provide detailed disclosure explaining their continued independence. Recently, even though a 2013 shareholder proposal seeking director term limits failed to attract much support, General Electric adopted term limits of 15 years for directors. While term limits remain an uncommon governance feature among U.S. public companies — and create the risk of losing valuable and experienced directors at inopportune times — investors are likely to continue to focus on the question of director tenure and its impact on independence.

In addition to concerns about tenure and whether boards lack the diversity of a company's employees or customers and the diversity to avoid "group think," the critical concern regarding board composition remains whether the right skills are present in the boardroom. Companies continue to expand and refine their proxy disclosure concerning the use of skill matrices, and that trend is likely to continue. Nevertheless, boards need to be sensitive to having members knowledgeable enough to ask the right questions and understand the implications of the answers without becoming a balkanized board made up of numerous single-area subject matter experts.

In this regard, the recently introduced Cybersecurity Disclosure Act of 2015 is troubling. This bill would require public companies to disclose whether any board member has cybersecurity expertise or experience (based on standards to be established by the SEC and National Institute of Standards and Technology) and, if not, to describe the cybersecurity measures taken by the company that were considered by the board or nominating committee in lieu of having a director with that background. While cybersecurity is unquestionably a significant issue for most companies, a high-functioning board can utilize the necessary advisers and subject matter expert consultants and, depending on the business, should not need a cybersecurity expert on the board to understand how those issues may interact with the company's business model and methods, industry and regulatory developments, and other strategic opportunities and risks. (See "Emerging Trends in Privacy and Cybersecurity.")

Shareholder Engagement. Shareholders continue to seek more robust engagement from the companies in which they invest. Recently, the Council of Institutional Investors published an investor-company roundtable on effective engagement and a paper highlighting good examples of company disclosures about shareholder engagement efforts. Clearly communicating the company's long-term strategy, and explaining how that strategy is reflected in the board's composition, may help companies establish credibility with their long-term shareholders and reduce the risk of activists or others claiming that certain board members are ineffective or irrelevant, or should be replaced. This clarity and focus of message should be part of the company's disclosure to all investors and incorporated into investor meetings and other forms of engagement.

In addition, certain investors continue to seek and encourage engagement directly with company directors. While so far only a handful of companies have adopted policies describing when and how directors may be available to meet with shareholders, as the practice continues to evolve, more companies are likely to adopt and disclose formal guidelines governing director-shareholder engagement. Directors need not always be part of a company's engagement efforts, but there is no doubt that directors engage with shareholders to a much greater extent than they did a few years ago. Doing so can provide a board of directors with valuable insights and unfiltered feedback, potentially allowing the board to address a small issue before it becomes a larger problem. Some boards have begun to factor in the "camera readiness" of director candidates as they consider new nominees or who should serve as the lead independent director.

The turbulence wrought by shareholder activism, governance activism and other scrutiny of boards cannot be eliminated, but shareholder engagement efforts are an important component of any effort to mitigate the effects.