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An Excess of Access

Bryn R. Vaaler

The ability of dissident shareholders to include director nominees in the company's proxy materials and put them to a vote at company expense – dubbed "shareholder access" – is the Holy Grail in the activist shareholder quest for parity in corporate governance. The rules of the Securities and Exchange Commission have, to date, prevented shareholder access, requiring shareholders to run their own independent proxy solicitations at their own expense to support dissident nominees. But, over the next year, it is almost certain shareholders will find their Holy Grail.

On May 20, by a three-to-two vote, the SEC proposed a new rule that would give shareholders owning as little as 1% of the shares of a large public company the right to include in the company's proxy materials nominees for up to one quarter of the board. For smaller companies, the ownership thresholds would be 3% or 5%, depending on size. If multiple groups seek inclusion of nominees, proposed Rule 14a-11 operates on a first-come, first-served basis. The SEC also proposed changes to its existing shareholder proposal rule (Rule 14a-8) that would permit shareholders to include bylaw proposals in the company's proxy materials governing director nomination procedures and disclosures so long as they are not in conflict with the access requirements of Rule 14a-11.

This is not the first time the SEC has proposed shareholder access. A similar 2003 proposal died in the face of opposition by pro-management groups, who claimed it went beyond the SEC's statutory authority, was an unwise federal incursion into the state-law domain of corporate governance and would damage board effectiveness by replacing efficient collegiality with a balkanized rabble.

Disappointed activists kept pressing for access, but turned their efforts in another direction. They began a campaign to require director election by majority vote instead of the then prevailing plurality-voting system in which negative votes by dissidents had no real effect. After several years of campaigning, two-thirds of S&P 500 companies have today adopted some form of majority voting for election of directors (according to lawyer Claudia Allen's Study of Majority Voting in Director Elections).

Shareholder access again came up in 2006 and 2007, when a federal appeals court ruled AIG could not exclude from its proxy materials under Rule 14a-8 an AFSCME-sponsored proposal to amend AIG's bylaws to require shareholder access. After proposing two alternative revisions of Rule 14a-8 – one clearly permitting such proposals, the other clearly permitting exclusion of them – the SEC (by a three-to-two vote) adopted the one permitting exclusion.

Once again, disappointed activists turned their efforts to another approach: if they could not include nominees in the company's proxy materials, then the company ought to reimburse them for running their own independent solicitations. In 2008, AFSCME submitted a proposed bylaw requiring proxy expense reimbursement for inclusion in the proxy materials of CA, Inc. When CA attempted to exclude the proposal, the SEC referred the question of state-law validity of proxy-reimbursement bylaws to the Delaware Supreme Court. The Court ruled that shareholder-adopted bylaws governing process and procedural matters relating to election of directors were generally valid under Delaware corporate law.

In response to *CA v. AFSCME*, Delaware's legislature adopted amendments to its corporation statute earlier this year making it absolutely clear that bylaws requiring shareholder access or proxy reimbursement are valid under Delaware law. Similar amendments are in the works for the Model Business Corporation Act, which serves as the template for corporation statutes in most other states.

The SEC's May 20 proposal on shareholder access would override development of shareholder access on the state-law level by imposing a mandatory, one-size-fits-all federal rule on all public companies. The full text of the proposed rule has not yet been published. Once published, there will be a 60-day comment period that will likely stimulate further heated debate. If the proposed mandatory rule is adopted after that, it will almost certainly be challenged in court. The U.S. Chamber of Commerce has already notified SEC Chair Mary Schapiro it will sue claiming the rule exceeds the SEC's statutory power.

In the meantime, Senator Charles Schumer has announced he will introduce a "Shareholder Bill of Rights Act" in Congress. In addition to requiring an annual say-on-pay shareholder vote, eliminating classified boards and mandating independent board chairs and majority election of directors, Schumer's legislation would explicitly buttress the SEC's statutory authority to adopt a mandatory shareholder-access rule.

And, far from the Beltway, American Railcar Inc. (majority-controlled by Carl Icahn) recently became the first U.S. public company to re-incorporate in North Dakota in order to opt into the pro-shareholder governance provisions of that state's Publicly Traded Corporation Act. The North Dakota Act requires shareholder access and proxy reimbursement in addition to an annual say-on-pay vote, independent board chairs and majority election of directors. Eleven other public companies received shareholder proposals to re-incorporate in North Dakota during the 2009 proxy season.

Shareholder access is coming. The case for self-perpetuating, collegial boards made up solely of management nominees has been undermined by economic crisis, a depressed stock market, high-profile corporate scandals and excessive executive compensation. A recent study published by IRRC Institute and Proxy Governance makes the case that boards with at least one dissident member may, under certain conditions, actually produce greater shareholder value than boards made up entirely of management nominees.

Shareholder access may be inevitable, but Congress and the SEC should be wary of imposing a mandatory federal rule and overriding development of a more nuanced approach on a company-by-company basis by consensus between management and shareholders. Instead of imposing a new mandatory rule, the SEC should simply amend its rules so they are no longer an impediment to private ordering with respect to shareholder access. The SEC should amend Rule 14a-8 to permit shareholder-access bylaw proposals. Shareholders and management will then be able to work out new standards through development of shareholder-access bylaws – as now clearly permitted under Delaware law. The recent experience with the majority-election movement shows how quickly and effectively this private-ordering approach can change corporate governance standards.

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