Georgeson LATHAM & WATKINS LLP

Corporate Governance Commentary

Proxy Access Analysis No. 2 June 22, 2009

Latham& Watkins LLP and Georgeson Inc. are pleased to publish the next in our series of *Proxy Access Bulletins and Analyses*. By combining thoughtful legal analysis from Latham & Watkins with Georgeson's expertise on trends related to corporate governance, the shareholder voting process and other shareholder matters, we hope to provide you with timely, useful and practical guidance as you navigate the issues created by proxy access.

The Latham & Watkins-Georgeson *Proxy Access Bulletins and Analyses* are designed to:

- Facilitate your understanding of the various proposals being made on multiple fronts to enable shareholder proxy access
- Support your efforts to shape the outcome of these proposals on the legislative and regulatory fronts
- Assist you in taking concrete action in response to the final rules as a matter of both procedure and best practices as they emerge

Our *Proxy Access Bulletins* will be brief updates on "breaking" events related to proxy access, to be delivered quickly following material new developments. They will be short, fact-specific alerts intended to keep our clients and friends up-to-date on a real time basis.

Our *Proxy Access Analyses* will focus on in-depth analysis of the relevant legal and practical issues of proxy access as they develop and will suggest concrete actions we think companies should consider in response to proxy access developments.

For additional resources regarding this topic, please **click here** and **here**.

Delaware Law Changes to Facilitate Voluntary Adoption of Proxy Access and Reimbursement Policy for Proxy Contests

Changes are effective August 1, 2009

On April 10, 2009, Delaware's governor signed into law legislation that has the potential to impact significantly the election of directors. These changes are effective August 1, 2009, but generally would not affect companies until the 2010 proxy season.

This *Commentary* describes the legislative changes and their practical impact, as well certain questions raised by them. Their practical impact is identified throughout this *Commentary* under the headings "How Could This Impact You?"

Highlights

The Delaware General Corporation Law (the DGCL) was amended exactly as proposed by the Delaware State Bar Association earlier this year, with respect to, among other things, proxy access, reimbursement of shareholder expenses, and separate record dates for notice and voting at shareholder meetings. (*See* the earlier *Georgeson Report*, dated March 2, 2009, on this topic, as well at the Latham & Watkins/Georgeson Corporate Governance Commentary, dated June 15, 2009.)

Three amendments to the DGCL concern director elections and shareholder voting and are discussed below. Click here to view all of the recent amendments to the DGCL.

Delaware companies will not be required to take any action as a result of the three amendments, which are referred to as "enabling" legislation. The first two amendments will permit, but not require, companies to include the applicable provisions in their bylaws. The third amendment does not depend on revision of a company's bylaws to become effective, but rather will become a choice that a company's board will be entitled to make each year.

Proxy Access

Under new Section 112 of the DGCL, companies are specifically given the option to adopt bylaw provisions permitting shareholder access to a company's proxy statement for the purpose of nominating candidates for election as directors. This DGCL amendment will permit the company to impose any lawful conditions on proxy access, such as:

- requiring minimum stock ownership by the nominating shareholder (in terms of the number of shares and related derivative rights, as well as how long the shares have been held),
- requiring the disclosure of specified information about the nominating shareholder and its nominees (including their ownership interests in the company),
- conditioning the shareholder's right to nominate directors on the number or proportion of directors being nominated by shareholders and whether that shareholder has sought such proxy access in the past,
- precluding nominations if the nominating shareholder, its nominee(s), or any affiliate(s) of either, has purchased or intends to purchase a specified percentage of the company's voting shares within a specified time before the director election, and
- requiring the nominating shareholder to agree to indemnify the company for any loss resulting from false or misleading statements made by the shareholder in connection with its nomination of director(s).

How Could This Impact You?

This amendment will directly impact only companies incorporated in Delaware and only those that "elect" to amend their bylaws pursuant to the amendment. This amendment highlights the rapidly evolving issue of proxy access on company, state and federal levels.

- One critical issue is whether a new federal law will be enacted on proxy access, as has been recently proposed in the House and Senate, and/or whether the proxy access rule proposal published by the SEC on June 10, 2009, will be adopted in some form. The new federal law or proxy rules, which are very controversial and can be expected to be hotly debated over the next several months, could be similar to the Delaware law and merely "enabling." They could supersede the Delaware law only in part by mandating certain aspects of proxy access that could not be made more company-friendly, while leaving other aspects up to state law and a company's governing documents. Or, as both the proposed legislation and SEC proxy access Rule 14a-11 contemplate, they could establish an exclusive proxy access regime and oust, virtually in their entirety, state corporate laws and the "private ordering" of proxy access by companies and their shareholders.
- There is speculation that Delaware adopted this amendment to maintain its importance as the pre-eminent state for company incorporation and corporate law. Under most state laws, boards and shareholders generally already have the right to approve procedural amendments to their bylaws. Nevertheless, the Delaware General Assembly may have thought that by enacting a specific proxy access bylaw before a federal proxy access law or rule was enacted, the federal legislators and regulators would find it, legally and politically, more difficult to supersede the new Delaware law. As the debate over the Congressional bills and the SEC's proposed proxy

access rules play out, we will eventually learn whether the Delaware and other state proxy access regimes of private ordering will be permitted to co-exist with a federal one and, if so, to what extent.

- A related question is whether the SEC will continue to permit companies to exclude shareholder proposals on proxy access from their proxy statements under SEC Rule 14a-8 of the Securities Exchange Act of 1934, as the SEC has done in the past. In its June 10th Release proposing proxy access rules, the SEC proposed to amend Rule 14a-8 to permit explicitly proxy access shareholder proposals. Given the highly complex review process expected to result from the SEC's Release, it is possible that the SEC may amend Rule 14a-8 to permit shareholder access proposals for the 2010, while it continues to work on its substantive access proposal. In this scenario, companies may want to consider whether they want to pre-emptively enact their own proxy access regime or propose a management proxy access proposal for shareholder approval, as discussed in more detail below.

- Another set of complications arise from the fact that Delaware companies (as well as companies incorporated in many other but not all states) may amend their bylaws by either board or shareholder action. Each amendment route has a further set of issues.

- If a board elects to adopt its own form of proxy access, it may head off or defeat shareholder proposals that seek to do the same in a more shareholder-friendly form. Boards could adopt a bylaw that puts more conditions on their shareholders' right to proxy access than corporate governance activists might want (which, depending on whether a new federal law or rule allowed for unrestricted private ordering, could also be more restrictive than the new federal regime), such as higher share ownership and holding period thresholds for the nominating shareholder. On the other hand, shareholder activists would surely encourage Delaware boards to negotiate with them on the terms of the proxy access, so that it is more shareholder-friendly than or, at a minimum neutral with regard to, any non-binding federal regime.

- Assuming that the SEC amends Rule 14a-8 as proposed to permit shareholder proposals regarding proxy access, shareholders may decide to submit for inclusion in a company's proxy statement a binding shareholder proposal to amend a company's bylaws to provide for proxy access. We expect that such shareholder proposals would be very shareholder-friendly.

- Companies would, nevertheless, still have at least two options if they receive a shareholder proposal to amend their bylaws to provide for proxy access. If they regularly communicate with their shareholders and generally have good governance practices, they may be able to negotiate with the shareholder proponent to come up with a more neutral version of proxy access. Alternatively, boards may adopt or ask their shareholders to adopt a more "neutral" proxy access bylaw, in which case the SEC may permit exclusion of the shareholder proposal—at least for the year of that shareholders meeting.

- There are very few examples to date for companies or shareholders to consider when proposing a proxy access bylaw provision.

    - RiskMetrics Group, Inc. has bylaws that, in addition to having certain procedural requirements, limit the proxy access to: (i) one candidate per nominator per meeting and (ii) nominators who have owned 4 percent or more of the company's stock for at least two years. In addition, any nominator whose candidate did not receive at least 25 percent of the votes cast in the corresponding shareholders meeting may not nominate further candidates for four years from the date of the shareholders meeting in question.

    - Before it was acquired, Apria Healthcare Group Inc. had adopted a policy on proxy access, which was specifically permitted under its bylaws. The policy was somewhat similar to RiskMetrics' bylaw provisions, except that (i) each eligible nominator could nominate up to two candidates per election, (ii) a maximum of two shareholder nominations were permitted for each individual board seat and (iii) the share ownership threshold was 5 percent.

- The best example of a proxy access bylaw, however, is almost certainly the exposure draft of an Illustrative Proxy Access Bylaw posted this week on the ABA Web site at ABA Committee Task Force on Shareholder Proposals. The Illustrative Bylaw was prepared by the Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities of the ABA before publication of the SEC's proposed proxy access rules. As such, it assumes that companies will have the freedom to adopt proxy access bylaws under state laws, such as Delaware's. The Illustrative Bylaw is quite comprehensive and includes a commentary. It is intended to identify and suggest balanced answers to the myriad issues that should be dealt with in a proxy access regime.

- Until we see how the federal action on proxy access plays out, Delaware (and other) companies would be well advised to follow good governance practices and to continue to engage their shareholders, so that they are well-positioned to have a constructive dialogue with them if it turns out that it is necessary and there is room to negotiate a form of proxy access for their companies. They should also keep abreast of proxy access developments on the Congressional, SEC and state levels, keeping particular watch for any emerging trend such as pre-emptive adoption of proxy access bylaws.

Reimbursement of Shareholder Proxy Contest Expenses

Under new Section 113 of the DGCL, companies will be permitted to adopt bylaw provisions to reimburse shareholders who have incurred expenses in connection with their solicitation of proxies for director elections. Again, a company will be permitted to impose lawful conditions on this right to reimbursement, such as:

- conditioning it upon the number or proportion of directors nominated by the shareholder seeking reimbursement and whether the shareholder has sought similar reimbursement in the past;

- limiting the amount of reimbursement based upon (a) the proportion of votes cast in favor of one or more of the directors nominated by the shareholder or (b) the amount spent by the company soliciting proxies for the director election; and

- limiting it for reasons relating to cumulative voting of directors.

How Could This Impact You?

This amendment will again directly impact only companies incorporated in Delaware and only those that elect to take advantage of the amendment. The amendment raises some of the same issues raised by the new Delaware law on proxy access, such as (i) whether a company's board should pre-emptively adopt a bylaw provision (perhaps with some shareholder engagement) to avoid adoption of a binding shareholder bylaw amendment on proxy expense reimbursement and (ii) whether other state corporate laws already give boards and shareholders the ability to amend company bylaws to provide for such expense reimbursement.

Many commentators consider proxy contest expense reimbursement bylaws a form of proxy access, since they provide a way for shareholders to nominate directors without incurring the costs otherwise associated with having a proxy statement separate from the company's proxy statement. For that reason (subject, of course, to events with respect to the currently proposed federal proxy access regime), companies should consider their response to shareholder proposals for expense reimbursement.

Separate Notice and Record Dates for Shareholders Meetings.

Under amendments to existing DGCL sections concerning shareholder meetings, a company's board will be given the option of selecting both (a) an initial "notice" record date for the purpose of giving notice of the meeting to those shareholders owning shares on the initial date (which would be a date currently considered the "record date") and then (b) a later "voting" record date (which

could be any date on or before the date of the meeting) for the purpose of determining which shareholders would actually be entitled to vote at the meeting. Both dates would need to be identified in the initial notice of the meeting.

How Could This Impact You?

These DGCL amendments will impact only those companies incorporated in Delaware and only those companies whose boards elect to take advantage of these amendments. There appears to be no ability for shareholders to take advantage of these amendments. The purpose of these amendments is to deal with the reality that buyers of shares after a record date do not have a practical means for voting at the meeting, notwithstanding their economic ownership of the stock. On the other hand, sellers after the record date as a practical matter retain the voting rights even though they no longer have a corresponding economic interest in the company. Utilization of these amendments would permit companies to better match voting interests with economic interests by permitting a company to select a later record date for voting purposes and thereby reduce the period during which buyers are effectively disenfranchised.

At first glance, these amendments appear to make it easier for Delaware company boards to work toward the elimination of one source of so-called “empty voting” (a term generically describing situations in which the party possessing the right to vote shares has less than full economic exposure to share ownership).

On closer review, however, a number of problems and uncertainties would arise if a company board were to take advantage of the amendments. For example, obtaining votes from the shareholders owning shares on the later “voting” record date could be quite cumbersome and costly. At this point in time, neither Broadridge nor the transfer agent community has figured out exactly how proxy solicitation materials would be provided to the shareholders who acquired company shares between the two record dates. In addition, “Notice & Access” (which has reduced the costs of mailing proxy materials for many companies) would likely not be available for shareholder meetings with two such record dates, unless the SEC further amends its “Notice & Access” rules to provide later dates for sending the required notice to the voting shareholders. A later “voting” record date also raises a number of logistical issues concerning distribution to the new beneficial owners of voting instructions, tabulating the late arriving voting instructions and converting the data to legal proxies. “Overvoting” and “undervoting” issues that have been of concern in recent years would also be exacerbated if there were a much shorter time period between the “voting” record date and the meeting date, in which to reconcile actual share ownership and to determine which shareholders have the right to vote the shares in question.

In light of the complexities and extra expense entailed in using (or at least pioneering) a dual record date process for shareholder meetings, we suggest that companies consider a two record date structure only for meetings where approval of extraordinary transactions (such as a company merger) is being sought. In such cases, there is frequently a significant amount of trading among institutional shareholders (particularly arbitrageurs) between the record date and the meeting date. It would be easier to send sets of proxy materials to these types of shareholders, because they have generally already consented to receive their proxy materials electronically. Therefore, the timing concerns about last minute delivery of proxy materials could be minimized, if not eliminated. Moreover, keeping track of post-record date institutional buyers would be simpler, as would the voting instruction delivery and recovery process. On the other hand, even when seeking approval of extraordinary transactions, companies may achieve better voting outcomes by early identification of the shareholders they need to solicit for votes. Accordingly, it remains to be seen whether and when, if at all, Delaware company boards would benefit from electing to take advantage of the dual record date amendments.

If you have any questions regarding this *Commentary* or dealing with the new Delaware corporate law changes, please contact the Latham & Watkins LLP representatives or the Georgeson Inc. representatives listed below or the representative of such firm with whom you normally consult.

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