On February 5, 2015, Skadden presented a seminar titled “What Board Members Want to Know This Season” as part of a corporate governance seminar series. Panelists included Susan J. Sutherland, former Skadden partner and current director of Montpelier Re Holdings Ltd.; Peggy M. Foran, chief governance officer, vice president and corporate secretary of Prudential Financial, Inc. and a director of Occidental Petroleum Corporation; Marc S. Gerber and Richard J. Grossman, partners in Skadden’s Mergers and Acquisitions Group; Stuart D. Levi, partner in Skadden’s Cybersecurity and Data Privacy Group; and Regina Olshan, partner in Skadden’s Executive Compensation and Benefits Group.

Shareholder Activism

After a brief introduction by Marc, Rich provided an overview of recent trends and developments in shareholder activism, including increasing numbers of “Son of Activist” funds led by former protégés of well-known activists such as Carl Icahn or Bill Ackman; significant growth in capital allocated to activist funds; increasing targeting of large market cap companies; stealth acquisitions through derivatives and options; and an uptick in targeting even well-performing companies. Activists also are displaying increasing levels of sophistication by running more professional campaigns, hiring top financial and legal advisers, and nominating more qualified candidates to boards.

Perhaps the most significant paradigm shift is the growing amount of support that activists are receiving from traditionally passive institutional investors. Long-term shareholders are increasingly willing to support an activist if they are dissatisfied with a company’s performance. Some are even encouraging activists to initiate campaigns at underperforming companies in their portfolios. Institutional Shareholder Services (ISS) increasingly supports activist shareholders, and activists often collaborate with other activists, public pension funds, corporate acquirers and real estate companies.

The panel also commented on important steps boards can take to get ahead of activists. Rich encouraged companies to conduct vulnerability self-assessments and question whether they have underperforming businesses, underleveraged capital structures, large amounts of excess cash or divestible noncore assets. Thus, when an activist surfaces and raises these issues, the board already has considered them and is prepared to respond thoughtfully. Rich also suggested that companies keep an up-to-date rights plan “on the shelf,” consider stock-watch programs, ensure their investor relations department has a list of activist shareholders, and assemble a defense team that can guide the company in preparation and in response to activism before an activist surfaces. Rich noted that engagement with large shareholders is becoming more important year-round and not just during the proxy season. Finally, companies should recognize the bifurcation between portfolio managers and the governance groups at institutional investors and ensure they communicate with both teams.

Susan added that search firms are paying more attention to directors with skills in dealing with activist constituents. She suggested that companies identify directors who are comfortable meeting with shareholders and train directors in key communications positions, particularly those who serve on compensation committees and are increasingly expected to discuss say-on-pay with shareholders.
Board Composition

Marc shifted the discussion to board composition. Peggy noted that companies are increasingly putting board composition assessments in their proxy statements, including descriptions and matrices of the directors’ experience and skills that indicate how such skills will help achieve the company’s long- and short-term objectives. Peggy mentioned that when companies are recruiting directors, charts of their current directors’ skills help focus on what complementary skills to look for in candidates. Susan added that such skills matrices are particularly valuable when unanticipated board vacancies arise.

Susan highlighted the increasing attention on director diversity as an issue, noting that 39 percent of S&P 500 companies had new directors in the last year and 30 percent of the new directors were female. Peggy said that board diversity is important because boards use consensus to make decisions and diverse views add to a careful evaluation.

Director Tenure

Marc noted the increased attention given to director tenure as an emerging issue, citing State Street’s guideline to vote against long-tenured directors on main board committees and Costco Wholesale’s stockholder proposal to require two-thirds of the board to have a tenure of less than 15 years, though the proposal received only 7 percent of the vote.

Peggy chimed in that refreshment is necessary on any board that has directors with lengthy tenures. She cautioned that, though companies value directors with a history at the company and who have been through financial cycles, too much of a good thing is not a good thing.

Susan compared the director tenure issue in the U.S. to the U.K., where there is a need to justify a director’s independence once a director has served for nine years. Though there are unlikely to be widespread mandatory term limits in the U.S., she noted that some large companies have adopted them. ISS will closely scrutinize a board with an average tenure of over 15 years, and 3 percent of S&P 500 companies have adopted term limits (including Target, Proctor & Gamble and Walt Disney).

Shareholder Engagement

Next, the panel discussed shareholder engagement. Historically, shareholder engagement was only a management and investor relations function, but now directors are becoming more involved in the process, especially with respect to executive compensation. Susan noted the invaluable information that can be provided by services monitoring shareholder sentiment. Watching the activity among a company’s investors will provide early signals to indicate when a board needs to devote time and attention to outreach to shareholders before an emergency arises.

Peggy noted that Prudential has a “tote for vote” program that incentivizes and rewards shareholders who vote in director elections by providing a nominal gift – an eco-friendly tote bag or the planting of a tree in honor of the shareholder. She said this program was successful in engaging shareholders, who are able to include comments when they vote their shares, which enables directors to understand shareholders’ thought processes. Peggy also clarified that the whole board need not (and should not) meet with institutional investors, but that chief governance officers should bring information about shareholders to the boards. Peggy also mentioned that some companies include a digital video in their online proxy statement showcasing the lead director’s message to the shareholders to reinforce the board’s understanding that it represents the shareholders.

Marc asked the panelists whether search firms are looking for “camera ready” directors. Susan said that being able to communicate to shareholders is only one of a mix of many
qualifications being sought in directors, but that strong communication skills are an important characteristic in CEO recruitment. Peggy added that all chairs of board committees should be comfortable talking with shareholders.

**Executive Compensation**

Regina started off a discussion about executive compensation, noting that the issue remains a headline for many companies. Though only a minority of activists raise compensation issues as the motivation for their campaigns, once raised, compensation may play a role in winning the hearts of shareholders in activist campaigns. Furthermore, compensation matters often are raised by ISS and other institutional shareholders.

Regina noted the rising numbers of lawsuits based on proxy disclosures. Shareholders are alleging directors breached their fiduciary duties by filing insufficient proxy statement disclosures. The suits are not brought under SEC rules but rather under state law duties to disclose. Though companies have been prevailing in most of these suits, the threat of an injunction to hold up the company’s annual shareholder meeting and the fact that settlements have generally been small often lead companies to settle. Regina also mentioned other litigation surrounding executive compensation related to the million dollar deductibility cap, where technical violations of the tax rules are alleged to evidence a breach of fiduciary duties.

Regina said that say-on-pay has become normalized in the corporate world and that continuous shareholder engagement continues to be essential for ensuring that shareholders are not just addressed reactively after a bad vote or an ISS negative recommendation.

In terms of say-on-pay votes, companies often aim to receive 90 percent or higher approval ratings and anything below 80 percent approval may be perceived as “losing.” Indeed, if a company is below a 70 percent approval vote, ISS recommends that the company explain any issues in its following year’s proxy statement. Regina recommended that when companies set their performance awards for the end of the year, they carefully consider the performance metrics. She said simpler metrics are usually better, as they are more easily understood by shareholders and institutional investors. Peggy added that complex performance bonuses should be explained simply, with charts and other straightforward graphics. She noted that it is important for companies to show that there is not a lot of discretion in their performance-based bonuses and advised that companies should think in terms of “plain English” when disclosing executive compensation plans.

**Cybersecurity**

Stuart started a discussion about cybersecurity and its growing importance by noting that cybersecurity encompasses more than just data breaches. Companies also are constantly being hit with “denial of service” attacks that take their systems offline, electronic theft of trade secrets and confidential information (including business plans and marketing strategies), and so-called “ransomware” attacks.

Stuart informed the audience that hacking and other cybersecurity problems are not going away, and that regulators are requiring companies to react quickly to attacks. Rapid response also is necessary given the publicity such attacks receive. Companies need to have strong internal governance and reporting over cybersecurity matters, and to develop an incident response plan prior to an attack. Stuart cited a recent Ponemon Institute study that found that in cases where companies had strong governance in this area and a rapid response plan, the costs of responding to a breach dropped significantly. Stuart noted that governance in this area starts at the top, and when boards take cybersecurity seriously, it sets a tone for company employees to treat cybersecurity with the gravity it deserves. He also pointed out that regulators and litigators are very focused on these issues. Marc noted that after Target’s data breach, ISS recommended voting against members of the audit and corporate responsibility committees in director elections.
Though no best practices have been developed yet, Stuart urged boards to be actively involved with cybersecurity issues. He then outlined the range of actions boards should take to ensure appropriate cybersecurity oversight, including receiving regular reports on the issue, understanding what steps are being taken in relation to the company’s risk profile, understanding the criteria used to make cybersecurity decisions and how those decisions are made, and whether staffing and budget are sufficient. Susan mentioned that director search firms are carefully evaluating candidates’ technology and IT skills. Peggy added that companies in certain industries would be well advised to create a cybersecurity committee.

**Proxy Access**

The panel next examined proposals for proxy access, noting that most proxy access proposals get majority shareholder support. Marc surmised that proxy access would be the proposal “topic of the year.” Proxy access is a regime by which a qualifying shareholder can nominate director candidates who will appear in the company’s proxy statement and on its proxy card alongside the company’s nominees. Proposals for proxy access can take several different forms, which vary according to the ownership and holding-period thresholds required for shareholders to enjoy proxy access for nominees of a given percentage of the board. Peggy noted that, though majority (as opposed to plurality) voting for directors was widely accepted by boards across the country, we are unlikely to see a similar reaction to proxy access, as the board-centric model may be resistant to accepting proxy access. However, Peggy suggested that boards eventually may be forced to accept proxy access, as institutional investors recommend voting for such proposals. Rich added that pension funds are likely to use proxy access when and if it is implemented, but that it is unlikely to be used by activist shareholders, who will want to send out their own proxy cards.

Peggy mentioned that the crux of the argument may be whether shareholders are allowed to aggregate their holdings to meet the threshold requirements for proxy access. Marc noted that Vanguard has expressed the view that shareholders should be allowed to aggregate their holdings to meet access thresholds.

**CEO Succession Planning**

Peggy and Susan briefly noted that CEO succession planning is a critical time in the business cycle, and planning in advance is key to avoiding a crisis in case of an emergency vacancy. The panel concluded by taking questions from the audience in New York and over the web.