

Shareholder Proposals: What You Need to Know Now

In this era of increased focus on corporate governance, there has been a significant rise in the number of shareholder proposals submitted for inclusion in the proxy materials of public companies. This trend is expected to continue in the upcoming proxy season. In addition, under rules proposed by the Securities and Exchange Commission (the "SEC"), if specified triggering events occur, shareholders of the company may be able to include their nominees for director in the company's proxy statement for its subsequent annual meeting. As a result, public companies need to be aware of the current and proposed shareholder proposal and director nomination rules and must be ready to act quickly in the event a shareholder proposal is received.

In this Alert, we discuss the following:

- ▶ recent history of shareholder proposals;
- ▶ actions a company should take if it seeks to exclude a shareholder proposal from its proxy statement;
- ▶ the legal bases that permit a company to exclude a shareholder proposal;
- ▶ actions a company should take if it is unable to exclude a shareholder proposal;
- ▶ implications if shareholders vote to approve a shareholder proposal; and
- ▶ the SEC's proposal to allow shareholders to include their nominees for director in a company's proxy statement.

The Shareholder Proposal Process

When is a Company required to include a shareholder proposal in its Proxy Statement?

Under Rule 14a-8 promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), a public company is generally required to include a shareholder proposal and related supporting statements in its proxy statement and allow shareholders to vote on the proposal unless either the shareholder has not complied with eligibility or procedural requirements or the proposal falls within one of 13 specific substantive bases for exclusion, discussed below.

What is the shareholder proposal process under Rule 14a-8?

Rule 14a-8 generally operates as follows:

The shareholder proposal must be received at the company's principal executive offices not less than 120 calendar days before the one year anniversary of the mailing date of the previous year's annual meeting proxy statement. However, if the company did not hold an annual meeting the previous year, or if the date of the upcoming annual meeting has been changed by more than 30 days from the date of the previous year's meeting, then the deadline is a reasonable time before the company begins to print and mail its proxy materials.

If the company wishes to exclude the proposal from its proxy materials, it must submit to the SEC, at least 80 days before filing its definitive proxy materials, a "no-action" request containing a written explanation of its bases for excluding the proposal. The

company must also simultaneously furnish a copy of its submission to the shareholder proponent.

The shareholder may also submit a letter to the SEC setting forth the reasons why the shareholder disagrees with the company's bases for excluding the proposal.

After review of these submissions, the SEC will issue a response that may or may not concur with the company's view regarding exclusion of the proposal. The company may not exclude the proposal unless it has received a response from the SEC indicating that it will not take any enforcement action against the company if the shareholder proposal is omitted.

Continues on next page

Key Attorney Contacts

Barbara Borden	858/550-6064 bordenbl@cooley.com
Jamie Chung	415/693-2071 jchung@cooley.com
Eric Jensen	650/843-5049 ejensen@cooley.com
Brad Peck	858/550-6012 bpeck@cooley.com
Nancy Wojtas	650/843-5819 nwojtas@cooley.com

This information is a general description of the law and is not intended to provide specific legal advice.

Copyright © 2004 Cooley Godward LLP. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley Godward LLP as the author. All other rights reserved.

If the proposal is not excludable, the company may include in its proxy statement reasons why it believes shareholders should vote against the proposal, provided that such opposition statements are provided to the proposing shareholder at least 30 calendar days prior to the filing of its definitive proxy statement.

If the SEC's no-action response requires that the proposing shareholder make revisions to its proposal or supporting statement as a condition to requiring the company to include the proposal in its proxy materials, then the company must provide the proposing shareholder with a copy of the opposition statements no later than five calendar days after the company receives a copy of the revised proposal.

What topics are appropriate for shareholder proposals?

Other than proposals that pertain to one of the specific substantive bases for exclusion, a shareholder proposal can cover almost any topic. The following are some proposal topics that have gained popularity in recent years:

- ▶ limitations on lucrative compensation packages for executives and severance packages for departing officers;
- ▶ option expensing;
- ▶ executive stock ownership requirements;
- ▶ requirement that the office of the chairman of the board be held by a person other than the CEO;
- ▶ elimination of staggered boards of directors, poison pill and other shareholder protection measures; and
- ▶ prohibitions on the provision of non-audit services by independent auditors.

Do companies seek to exclude shareholder proposals?

According to the SEC, 266 companies submitted no-action requests to the SEC during the 2002-2003 proxy season stating that they intended to exclude shareholder proposals submitted under Rule 14a-8.

How many proposals came to a shareholder vote during the 2002-2003 proxy season?

Over 1,100 shareholder proposals came to a shareholder vote during the 2002-2003 proxy

season, of which a vast majority dealt with corporate governance-related matters, with the leading corporate governance proposal calling for expensing of stock options.

How often are shareholder proposals approved by shareholders?

Of the approximately 1,100 shareholder proposals that came to a shareholder vote during the 2002-2003 proxy season, approximately 155 proposals, or 14%, received at least 50% of the *votes cast*, more than in any previous year. In particular, over 30% of the corporate governance-related proposals received at least 50% of the votes cast.

Are larger companies more likely to receive shareholder proposals under Rule 14a-8?

It does appear that larger companies are more likely to receive shareholder proposals. Of the companies filing periodic reports under the Exchange Act, approximately 20% are "accelerated filers" having a common equity market capitalization of \$75 million or more (excluding shares held by affiliates of the company). Approximately 90% of the 266 companies that submitted no-action requests to the SEC during the 2002-2003 proxy season were accelerated filers.

What are the demographics of shareholders that submit proposals?

Although the demographics of shareholder proponents continue to evolve, special interest group continue to lead the charge. Labor unions overtook individual shareholders as the leading proponent of corporate governance proposals, sponsoring nearly half of all resolutions that came to a vote during the 2002-2003 proxy season.

Actions to Take if a Company Seeks to Exclude a Shareholder Proposal

What should a company do if it wants to exclude a shareholder proposal from its proxy statement?

Determine whether there are any Eligibility or Procedural Bases for Exclusion. A company may exclude a proposal if the proposal does not comply with the SEC's procedural requirements. Under Rule 14a-8, a company must notify the proponent within

14 calendar days of receiving the proposal of the alleged eligibility or procedural defect. This notice is not required if the deficiency cannot be remedied (e.g., the proponent fails to submit its proposal by the company's properly determined deadline). If a notice of deficiency is sent, the shareholder must respond within 14 days. The company may exclude the proposal if the shareholder fails to adequately correct the procedural or eligibility deficiency. If the proposal may be excluded because of a procedural or eligibility defect, the company must still file a no-action request with the SEC explaining its basis(es) for excluding the proposal at least 80 calendar days before the company files its definitive proxy statement with the SEC.

Determine whether there are any Substantive Bases for Exclusion. The substantive bases for exclusion are discussed below under the heading, "Legal Bases for Excluding Shareholder Proposals—What are the substantive bases for excluding a shareholder proposal?" If the company believes that a substantive basis for exclusion exists, it must file a no-action request with the SEC explaining its basis(es) for excluding the proposal within 80 calendar days before the company files its definitive proxy statement with the SEC.

Communicate with the Shareholder. Unless the relationship between company and the shareholder is such that dialog would likely not be fruitful, the most effective way to eliminate a shareholder proposal and to further the company's relationship with the shareholder may be to discuss the proposal with the shareholder. In certain cases, what is expressed by an institutional shareholder in its proposal may be different or broader than its actual concerns. It is possible that the company could agree to take actions that would allay the proponent's concerns and, as a result, the shareholder may withdraw its proposal. Of course, a company must always be mindful of its obligations under Rule 10(b)-5 and Regulation FD regarding selective disclosure when it engages in private discussions with a shareholder.

Legal Bases for Excluding Shareholder Proposals

What are the eligibility and procedural bases for excluding a shareholder proposal?

Deadline for submitting proposals. If the proposal is submitted for regularly scheduled annual meeting, the proposal must be received at the company's principal executive offices at least 120 days before the date on which the company first sent or gave its proxy statement to its shareholders for the previous year's annual meeting. If the meeting is not a regularly scheduled annual meeting, if the company did not hold an annual meeting in the previous year, or if the date of the current year's annual meeting has been changed by more than 30 days from the date of the previous year's meeting, then the deadline is a reasonable time before the company begins to print and mail its proxy materials.

Eligibility. A shareholder would be eligible to submit a proposal only if at the time the proposal is submitted, the shareholder has continuously held, for one year or more, at least the lesser of \$2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting, and the shareholder continues to hold those securities through the date of the meeting.

Number of Proposals. A shareholder may submit only one proposal for a particular meeting. Shareholders often submit proposals containing multiple parts. A company may be able to exclude such a multi-part proposal on the basis that it actually consists of more than one proposal. However, there is no clear guidance as to what constitutes a single proposal. The SEC has stated that a proposal with multiple parts may not be excluded if the several parts relate to a single concept.

Length of Proposals. A shareholder proposal may be excluded if it contains more than 500 words. The 500-word limit applies to the proposal, the supporting statement and any title or heading included with the proposal.

As stated above, a shareholder proposal may not be excluded for procedural reasons if the

shareholder responds to a company's notice of defect within 14 days and adequately cures any eligibility or procedural deficiency.

What are the substantive bases for excluding a shareholder proposal?

If a shareholder has complied with the eligibility and procedural requirements, a company may still be able to exclude a proposal under any one of the 13 substantive bases for exclusion. Many of these substantive bases have been the subject of significant interpretation by the SEC and its Division of Corporation Finance. In seeking to exclude a shareholder proposal on one or more substantive bases, a company should review with counsel relevant SEC no-action letters with respect to each substantive basis to determine how the SEC has interpreted that particular exclusion. Multiple bases for exclusion are permitted. Each of the substantive bases is discussed below:

1. Improper under state law. The proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization. However, a shareholder may circumvent this exclusion if the shareholder casts the proposal as a recommendation or request that the board of directors take a specified action (often referred to as a "precatory" proposal") as opposed to a proposal that would be mandatory or binding if approved by shareholders.

2. Violation of law. A company is not required to include a proposal if the implementation of the proposal would cause the company to violate a state, federal or foreign law.

3. Violation of proxy rules. If the proposal or supporting statement contravenes any provision of the proxy rules, including Rule 14a-9, which prohibits materially false or misleading statements in proxy materials, the proposal may be excluded. Note that even if a proposal cannot be entirely excluded on this basis, a company can in some cases exclude information from the supporting statements on the grounds that it is false or misleading.

4. Personal grievance; special interest. A proposal need not be included if it relates to the redress of a personal claim or grievance or is designed to result in a benefit to the shareholder, or to further a personal interest of the shareholder, that is not shared by the other shareholders.

5. Relevance. A company may exclude a proposal that relates to operations that account for less than 5% of the company's total assets at the end of the most recent fiscal year, and less than 5% of net earnings and gross sales for its most recent fiscal year, so long as the proposal is not otherwise significantly related to the company's business.

6. Absence of power/authority. If the company lacks the power or authority to implement the proposal, the proposal may be omitted.

7. Management functions. If the proposal deals with a matter relating to the company's ordinary business operations, the proposal may be omitted.

8. Relates to election. A company need not include a proposal that relates to an election of directors.

9. Conflicts with company's proposal. When a shareholder proposal directly conflicts with a proposal to be submitted by the company at the same meeting, the company may exclude the shareholder proposal.

10. Substantially implemented. A company may exclude a proposal that it has already substantially implemented.

11. Duplication. A proposal may be omitted if it substantially duplicates another shareholder proposal that will be included in the proxy materials for the same meeting.

12. Resubmissions. If a proposal deals with substantially the same subject matter as another proposal that was included in the company's proxy materials within the previous five calendar years, the company may exclude it from its proxy statement for any meeting held within three calendar years following the last time the proposal was included, if the proposal received:

- ▶ less than 3% of the vote if proposed once during the last five years;
- ▶ less than 6% of the vote on its last submission if proposed twice within the last five years; or
- ▶ less than 10% of the vote on its last submission if proposed three times or more within the last five years.

13. Specific amount of dividends. A company may omit a proposal that relates to specific amounts of cash or stock dividends.

Actions to Take if a Shareholder Proposal Is not Excludable under Rule 14a-8

Is a company permitted to include its reasons for opposing a shareholder proposal and its recommendation that shareholders vote against the proposal in its proxy statement?

Yes. Companies may, and most do, include in their proxy statements their reasons for opposing a shareholder proposal, as well as their boards of directors' recommendation with respect to how shareholders should vote on the proposal. Unlike the shareholder's proposal and supporting statement, which are limited to 500 words, there is no limit on the length of a company's opposition statement. The company must, of course, be careful that its opposition statement is accurate and not misleading and, as discussed above, must provide the shareholders with an advance copy of the opposition statement.

May a company hire a proxy solicitor to solicit votes against a shareholder proposal?

Yes. A company can hire a proxy solicitor to solicit votes against a proposal. Any action by a company in opposing a shareholder proposal, including circulating additional materials or contacting shareholders directly, must be done in compliance with the SEC proxy rules.

Implications if Shareholders Vote to Approve a Shareholder Proposal

Must a board of directors implement a shareholder proposal approved by a company's shareholders?

Not usually. Under the laws of most states, including Delaware and California, a com-

pany's business and affairs are to be managed by or under the direction of the company's board of directors. Therefore, most shareholder proposals must be phrased as recommendations or suggestions or risk exclusion under Rule 14a-8(i)(1), as proposals that are not proper subjects for action by shareholders under the laws of the jurisdiction of the company's organization. While the approval of a precatory shareholder proposal by shareholders may put pressure on the board to implement the proposal, it is still up to the board to determine whether implementing the proposal is in the best interests of shareholders and it may determine not to implement the proposal on the basis of that determination.

However, proposals cast as bylaw amendments are often not excludable under Rule 14a-8(i)(1). Under the laws of many states, including Delaware, shareholders have the authority to amend a corporation's bylaws. Accordingly, where shareholders have this authority, shareholder proposals relating to bylaw amendments may not be excludable under Rule 14a-8(i)(1) unless they also relate to matters that are not a proper subject for shareholders under state law or to another substantive basis for exclusion. A company seeking to exclude a shareholder proposal relating to a bylaw amendment may need to include with its no-action request to the SEC an opinion of legal counsel stating that the bylaw amendment is not a proper subject for shareholder action.

What are the consequences if a board of directors fails to implement a precatory shareholder proposal that received a majority vote?

A board may be subject to criticism from a variety of sources, including shareholder activists. Institutional Shareholder Services ("ISS"), the leading provider of proxy voting and corporate governance services, and other institutional investors may also "withhold" recommendation on the vote to elect directors in situations where a company fails to implement a shareholder proposal approved by the shareholders. In particular, ISS will recommend a withhold votes for directors who fail to implement a share-

holder proposal that was approved by (i) a majority of the votes cast for two consecutive years or (ii) a majority of shares outstanding in one year. Whether or not a "withhold" recommendation would affect the results of a proxy proposal depends on a company's shareholder base. Notwithstanding the effect on the results of a director election, an ISS recommendation to vote "for" a nominee can reaffirm a company's position that they have the right strategy, along with a strong management team and board, to deliver results and to create shareholder value. Conversely, a significant number of "withhold" votes for a particular board nominee could be seen as negative from an investor relations perspective.

The SEC's Proposed Rules Regarding Shareholder Director Nominations

On October 14, 2003, the SEC issued proposed Rule 14a-11 of the Exchange Act. The proposed rule would provide a mechanism for long-term significant shareholders to include nominees for directors in the company's proxy statements. The text of the release can be found at www.sec.gov/rules/proposed/34-48626.htm. Proposed Rule 14a-11 would apply to all companies that are subject to the Exchange Act proxy rules, including investment companies and excluding foreign private issuers. As proposed, a company would become subject to the shareholder nomination procedure unless applicable state law prohibits shareholders from nominating a candidate.

How will the SEC's proposed rule allow shareholders to include director nominations in a company's proxy statement?

Under proposed Rule 14a-11, a shareholder or group of shareholders would be able to have its director nominee(s) included in a company's proxy statement if certain triggering events have occurred, provided such shareholder or group of shareholders has beneficially owned more than 5% of a company's securities that are eligible to vote for the election of directors for at least two years.

Is it possible that the SEC's proposed rules will be significantly modified or not adopted at all?

Yes. In addition to comments received by the SEC in support of the proposed Rule 14a-11, many groups have voiced concerns that the proposal would not aid economic growth or corporate performance but rather would distract corporate boards from their real responsibilities and permit special interest groups, such as unions and state pension funds, to make use of the rules to advance their own agendas rather than that of all shareholders. Accordingly, it is possible that the proposed rules will be significantly modified or not adopted at all. However, it is likely that some form of these rules will be adopted in the near future.

We intend to provide further updates regarding proposed Rule 14a-11 and its implications for public companies as future developments occur. ■