

Weil, Gotshal & Manges LLP
MEMORANDUM
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Rethinking Board and Shareholder Engagement in 2008

In 2008 we predict – and encourage – increased efforts by boards of directors to engage shareholders in less contentious, more cooperative interaction and communication. We also encourage shareholders to consider how they, in turn, might foster more constructive relationships with corporate boards, including through consideration of the appropriate limits of shareholder power.

Shareholder activism has provided strong stimulus for rebalancing corporate power in the past twenty years. Beginning in the late 1980's and early 1990's and accelerating to the present, we have seen a continuing rebalancing of corporate power in the U.S. from management to the board of directors and the shareholders. To the extent that this shift has brought governance practices more into line with the theoretical accountability of management to the board and of the board to the shareholders, it is a shift that is in the nature of a correction. This rebalancing has been assisted by a host of legislative, regulatory, listing rule and voluntary "best practice" reforms, many of which are still of fairly recent vintage with the full effect not yet wholly known.

We caution, however, that the forces for change should abate once an appropriate balance is achieved, or a new imbalance will result. We are not yet at the point of a new imbalance but one could result if we don't give the multitude of reforms a chance to settle into effect. Activist shareholders – and the proxy advisors they often rely on – need to respect that the corporation, by law, is "managed by or under the direction of" the board. Indeed, this legal empowerment of the board goes hand in hand with the limited liability that shareholders enjoy.

The fundamental role of shareholders in corporate governance is to assure that the board of directors is composed of persons capable of "managing and directing" in the best interests of

company and its shareholders. Boards should expect continuing pressure from shareholders for "rights" designed to provide this assurance. Boards are well-advised to be open to shareholder communications on topics that bear on board quality and attention to shareholder value, communications that are likely to improve mutual understanding and avoid needless confrontation.

Gone are the days when shareholders can broadly claim that boards are inactive, inattentive, and intractable or captives of management. The new reality is that boards are already engaged in an unprecedented level of dialogue with shareholders, and many show real interest in finding ways to further such communication. Certainly, boards and managements have come a long way in recognizing that shareholders have a very legitimate interest in how the company is governed. The quid pro quo on the shareholder side is to act as concerned and rational owners who make decisions based on knowledge of the nuances; who

avoid rigid, box-ticking methods of judging good governance; who

Don't abdicate to proxy advisors their responsibility to use judgment; and who avoid activism for activism's sake.

We are optimistic that good will and common sense will prevail, and cooperative efforts and dialogue between shareholders and boards will aid in reaching consensus about the following issues, all bearing on board quality:

1. Board composition and independent leadership.

Shareholders have a legitimate interest in the make-up and leadership of the board to which control of the corporation is delegated. Yet in many respects the board is better positioned to ensure that the right mix of experience, expertise and independence is at hand. Enhancing opportunities for significant long-term shareholders to provide their views to the nominating and governance committee about desirable characteristics, potential candidates and favored leadership structures should help broaden the committee's perspectives. Efforts to understand shareholder views and to communicate the board's own views on these issues are consistent with, and may even be viewed as necessary in light of, the widespread adoption of majority voting, strong shareholder sentiment in favor of proxy access, the move to electronic proxies that reduce the cost of contested elections, and the pending New York Stock Exchange rule that would bar brokers from voting without customer instructions in even uncontested director elections.

2. Corporate performance disclosures.

Shareholders have a legitimate interest in understanding what they own and how it is performing. They

expect disclosure to accurately reflect the performance and condition of the company. Boards may wish to consider their own role in overseeing how the company communicates material developments to shareholders. Is the board satisfied that it is providing management with appropriate guidance in this area or is this an issue that is largely left to management, investment relations and the lawyers? Also, as advocated by the Aspen Principles (June 2007), boards should consider whether there is benefit to be had in foregoing quarterly earnings guidance and the pressures for short-term focus that it may well bring.

3. Executive performance, compensation and succession.

Shareholders have a legitimate interest in information about the performance and compensation of the senior executive officers and the board's efforts to create an incentive culture designed to promote performance. They also

have a legitimate interest in issues relating to management succession. Shareholders' interests in these matters relate to their ability to make informed buy/sell/hold decisions as well as informed decisions in voting for the fiduciaries that represent them. Shareholders are not well-positioned to make these decisions themselves, and enabling second-guessing is not the role of disclosure. Transparency of compensation and the processes followed to decide compensation (including any conflicts with respect to compensation consultants) should allow shareholders to make a judgment about whether compensation is principled, straightforward, and rational in relation to performance so that shareholders may make educated decisions in board elections and as relates to their investment. Improved communication and dialogue with significant long-term shareholders about executive compensation may provide 2 compensation committees with a broader perspective and balance in relation to the views



provided by management. It may also lessen the push for an advisory vote on executive compensation (“say on pay”).

4. Strategic direction.

Shareholders have a legitimate interest in understanding the strategic direction of the company. Boards and managements have considerable interest in ensuring that their shareholder base – and especially significant long-term shareholders – can evaluate whether corporate direction is aligned with their investment priorities. Efforts to improve communication about strategy are particularly important in relation to (i) long-term strategies that involve disproportionately higher costs over the short-term, such as investments in R&D, and (ii) major transactions that require shareholder action.

5. Societal concerns, including climate change and other issues.

Shareholders have legitimate interests in information about corporate policies and practices with respect to social and environmental issues such as climate change, sustainability, labor relations and political contributions. These issues, many of which do not fall neatly within a line item disclosure requirement, bear on the company’s reputation as a good corporate citizen and consequently, the perceived integrity of management and the board.

Reaching out to shareholders in a concerted fashion will not appeal to every board. However, it is likely to be a prudent approach for companies seeking to avoid confrontation. Setting a positive and constructive tone in shareholder relations not only has the potential to elicit for the board useful insights about shareholder perspectives but also may encourage shareholders to focus on long-term performance and act as



owners making rational investment decisions.

More broadly, it may be time for a dialogue on the limits of shareholder power. Where is the legitimate boundary? Long ago owners gave up rights to control the joint stock company in return for limited liability – and directors took on the fiduciary liability. If shareholders insist on ever-greater say in corporate decision-making, at what point do we need to rethink director liability? We may well miss the opportunity to achieve lasting balance in the corporate power structure if shareholders fail to recognize and respect that there are limits on the issues that are appropriate for shareholder initiatives – limits that

are in keeping with both the duty of the board to direct and manage the affairs of the corporation and the limited liability that has been granted to shareholders. ■

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