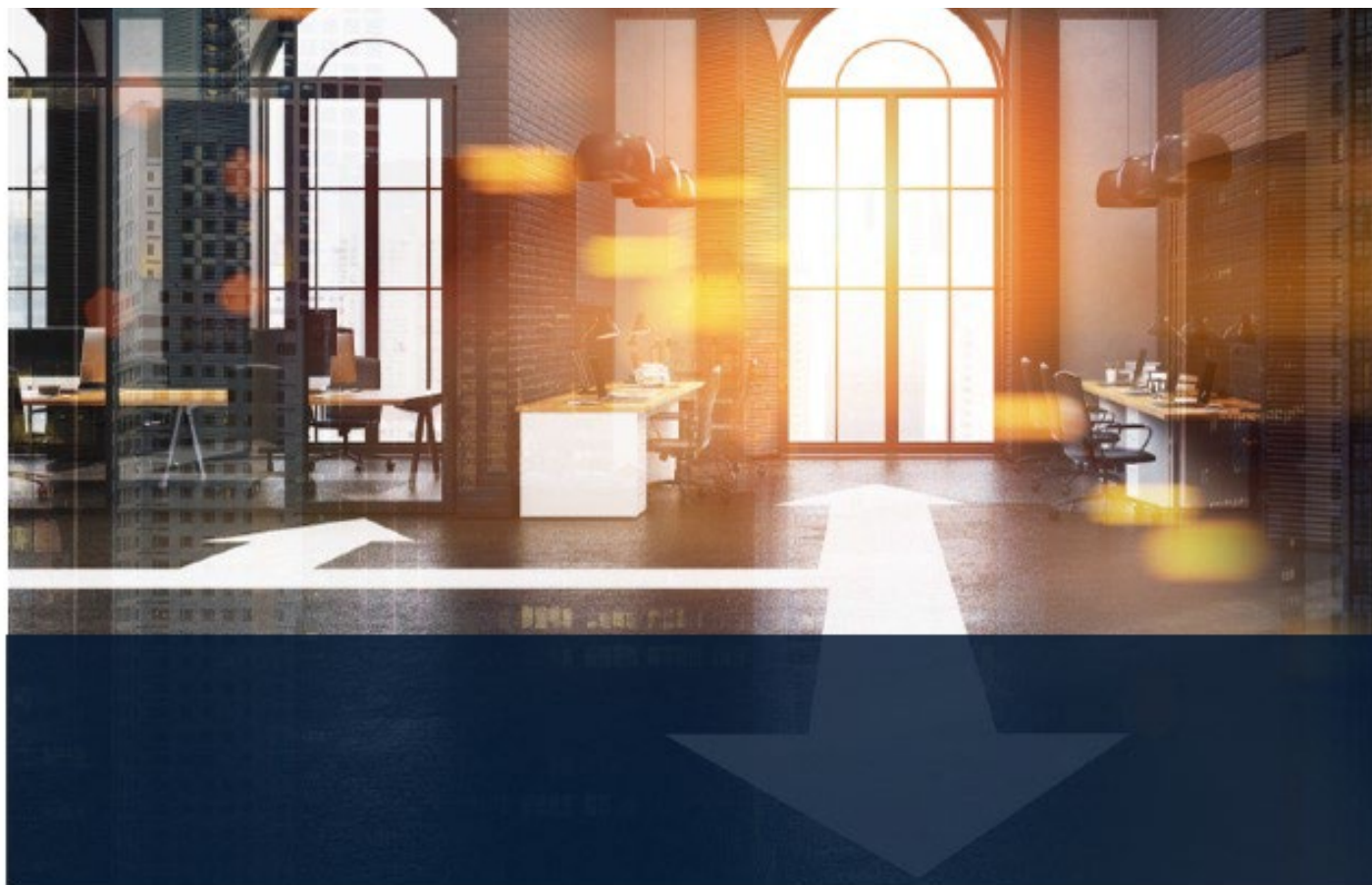


The background of the cover is a photograph of a city skyline at sunrise. A large, dark skyscraper is in the foreground on the right, with the sun rising behind its top, creating a bright glow. Other buildings are visible in the background, partially obscured by a layer of low-lying clouds or fog. The sky is a mix of orange and blue.

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Lessons for Directors from the First Universal Proxy Card Campaigns

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The introduction of the universal proxy card in contested director elections a year ago has altered the shareholder activism landscape, exposing new corporate vulnerabilities as well as reshaping activist and corporate defense strategies. The first activism campaigns under this SEC-mandated regime have also given fresh emphasis to the principles of an effective board, whether or not an activist ever targets the company.

The first universal proxy card campaigns have revealed the following four critical lessons for directors, which are discussed further in this article:

- **Serving as Change Agents:** Boards should embrace the role that their oversight plays in catalyzing change when change is appropriate—or activists will be knocking on the boardroom doors to do so.
- **Thinking Like Your Shareholders:** Boards should understand how the company and the board are perceived by their diverse shareholder body as a part of furthering the best interests of the company and its shareholders.
- **Reviewing Board Composition from First Principles:** Boards should ensure that their composition is “fit for purpose”—that is, closely aligned with the needs of the business such that its members have appropriately diverse experience and other qualifications.

- **Taking Action with Prudent Urgency:** Boards should not wait until an activist approaches the company to make appropriate changes in board composition, strategy, or any other areas of underperformance.

DEBRIEF ON UNIVERSAL PROXY CARDS

Universal proxy cards have been mandatory in contested director elections since September 1, 2022, under new SEC rules. A universal proxy card allows shareholders to vote for any combination of validly nominated director candidates on a single proxy card. All companies (even those without proxy access bylaws) and all nominating shareholders are now required to use a universal proxy card for proxy contests. There is no corporate opt-in mechanism, nor are there any shareholder ownership requirements as seen with the proxy access bylaws adopted by many companies today.

Despite expectations that the universal proxy card would supercharge proxy campaign activity, the actual number of contests during the last year were generally in line with previous levels. Between September 1, 2022, and August 31, 2023, there were 72 proxy fights (as categorized by FactSet) at US-headquartered companies (other than funds), compared to an average of 77.4 per year in the prior five years. Among these proxy contests, there were 32 settlements (average of 25.8 per year in the prior five years), and 18 contested elections that went to a vote (average of 25.2 per year in the prior five years). These levels were arguably a result, at least in part, of the enormous economic uncertainty at the outset of the spring proxy season, when macroeconomic effects such as high inflation and bank failures deterred activists from pursuing contested elections.¹

Presenting both the board's and activist's nominees on one proxy card enables shareholders to vote for any nominee from either slate. This new ability for shareholders to "mix and match" appears to have contributed to a greater number of partial activist slates being elected than in prior years.

The universal proxy card rules have also contributed to increased attention by companies and boards on the state of their structural defenses to activism, including ensuring that their advanced notice bylaws that regulate the contested election process reflect current market practices. In the last two years, we have seen many companies adopt specific bylaws intended to ensure that activists comply with the obligations created by the universal proxy card rules.

SERVING AS CHANGE AGENTS

The increase in support for partial activist slates under the universal proxy card rules has been particularly pronounced in recommendations by influential proxy advisory firm ISS. Since these rules came into effect, ISS has supported one activist nominee at an unusually high rate and full company slates at an unusually low rate in Russell 3000 contests, as compared to the prior five years. In the three Russell 3000 universal proxy card contests where ISS recommended in favor of just one activist nominee, ISS explained its recommendation in part on the grounds that the board would benefit from someone who could create urgency, challenge consensus, or enhance the board's credibility with shareholders.²

These rationales echo a common investor perception that boards can develop an insider mentality at the expense of objectivity. To combat this potential critique, boards should embrace the role of change agent when appropriate for the circumstances. Failure to do so can make the company vulnerable to the election of one or more activist nominees, even if the change advocated for by the activist is unwarranted and not in the best interests of shareholders.

In order for the board to be an effective change agent, directors must challenge themselves and management to take the following steps:

- Consider alternatives and reassess long-held assumptions of management and the board, including by reviewing issues

¹ Source: FactSet.

² Source: FactSet and ISS Voting Analytics.

through the eyes of an outsider and considering the best arguments that a critic could make about the company's strategy, management, and corporate governance.

- Identify additional relevant information, factors, and perspectives that should be considered by the board that may not have been covered by a presentation or discussion.
- Ensure that sufficient time is dedicated to board discussion, that diverse views and perspectives are welcomed and explored, and that challenging questions are raised in a constructive manner in the effort to reach a decision.
- Build an open, respectful, trusting and collegial culture that supports constructive challenge and fosters the foregoing behaviors by working together with the board, board leadership (chairs, lead independent directors, and committee chairs), and the CEO and senior management.

THINKING LIKE YOUR SHAREHOLDERS

Understanding how shareholders think about the company and board is critical for assessing vulnerabilities and successfully defending against an activist.

It is commonly said that boards and companies should “think like an activist” in assessing their vulnerabilities to activism, which means understanding what issues an activist could attack and what actions an activist could demand be taken. The universal proxy card has increased the salience of another analytical lens for directors: thinking like their shareholders.

Understanding how shareholders think about the company and board is critical for assessing vulnerabilities and successfully defending against an activist. While few campaigns go to a contested vote, an activist has leverage over the company to force a settlement only insofar as the company expects shareholders to vote for the activist's nominees. Misunderstanding shareholder sentiment can cause companies to misjudge the appropriate response to an activist, such as by failing to address shareholder concerns during a proxy contest or giving up more in a settlement than the

activist could have achieved at the ballot box.

Thinking like shareholders means understanding and duly considering their views and expectations regarding the company's board, management, strategy, and performance. Doing so not only supports the board in anticipating areas where change may be needed, but also helps the board address vulnerabilities to activism, assess the risk presented if an activist targets the company, and communicate with shareholders during a proxy contest.

Directors should not seek to think like a generic, hypothetical shareholder, or only like one type of shareholder, but rather should engage with their current shareholders' actual views. It is critical to remember that shareholders are not a monolith. Shareholders have different time frames for their investments and may have different views on corporate strategy and key issues facing the company. The various types of investors (actively managed long-only funds, index funds, hedge funds, public pension funds, individual and retail investors, etc.) often have pronounced differences in preferences and viewpoints.

To be clear, this approach is not deference. Ultimately, the board must determine what actions are in the best interests of the company and its shareholders as a whole, and directors do not fulfill their fiduciary obligations by delegating their business judgment to the judgment of one or more shareholders or types of shareholders. But nor should informed fiduciaries simply ignore shareholders' views. Rather, directors should seek to understand the panoply of shareholder perspectives as one factor of many in board decision-making.

Boards should fully utilize their shareholder engagement programs and processes to understand their shareholders' views and expectations. These should include a robust investor relations program reporting to the board about investor sentiment, and might include presentations to the board by select shareholders or participation by directors in regular shareholder engagement activities (especially with more governance-oriented investors).

We wish to emphasize that individual directors should not engage in ad hoc communications with shareholder representatives. Director participation in shareholder engagement requires appropriate coordination and preparation, as well as processes to ensure that material

nonpublic information is not shared in violation of insider trading and tipping prohibitions and the requirements of fair disclosure regulation ([Regulation FD](#)).

REVIEWING BOARD COMPOSITION FROM FIRST PRINCIPLES

The most vulnerable boards have a skills gap related to an area where the company is underperforming or have a number of particularly vulnerable directors up for election.

Some have feared that the ability to “mix and match” between nominee slates on a universal proxy card could empower the proxy advisory firms as “external nominating committees” in proxy contests. We are not aware of any proxy contests in the universal proxy card era that have turned solely on differences in candidate qualifications. Instead, activists have had success where they have been able to link a compelling case for change at the company to their nominees’ qualifications, particularly those qualifications that are missing from, or superior to, the skills on the board.

Going forward, we expect that activists will continue to exploit the universal proxy card to target vulnerabilities in board composition. The most vulnerable boards have a skills gap related to an area where the company is underperforming or have a number of particularly vulnerable directors up for election (particularly based on board leadership positions, tenure, and relevant skills).

To minimize their vulnerability, boards should annually evaluate their composition in light of the company’s strategic and operational priorities, including areas of underperformance that would benefit from enhanced board expertise and oversight. Gone are the days when boards could assume that each director continues to serve based on their own preferred timeline, with age limits or average tenure considerations the driving factor in refreshment efforts. Rather, boards, through their nominating and governance committees, should assess their composition from first principles as if every incumbent director was a prospective candidate and every seat was available to be filled based on the board’s needs in providing effective oversight.

Each director should also reflect on whether he or she is still the right person to serve on the board—and should not hesitate to raise a hand when the answer could be no. Stepping down as a director should not be viewed as a reflection on the director’s talent, performance, commitment, or conduct.

TAKING ACTION WITH PRUDENT URGENCY

While we encourage boards and management teams to regularly evaluate their vulnerabilities to activism, this assessment is only the starting point. Boards that put off addressing their vulnerabilities are leaving the activist door open, and once an activist appears, the board’s options to address issues may become constrained.

While a board can undertake board refreshment or strategy changes after an activist has gone public in an effort to moot the activist’s criticisms, these actions could be viewed as too little and too late by shareholders and proxy advisors. Companies making changes may be able to convince an activist to withdraw or enter into a more favorable settlement, especially if the board’s action leads to a significant increase in stock price or undermines a significant plank from the activist’s platform. However, there is significant risk that proxy advisors and shareholders will discount changes (particularly governance changes) that are made after an activist initiates a campaign or even credit the activist for instigating the changes.

While making governance or strategy changes during an activist campaign should not be taken as a signal that the board was not appropriately attentive or is entrenched, an activist campaign may well cast that shadow for shareholders and proxy advisors. Accordingly, boards are advised to act with prudent urgency to address vulnerabilities to the extent they deem appropriate for the company and its shareholders while they are in a “clear day” prior to an activist approach.

CONCLUSION

As we enter the second year of the universal proxy card era, shareholder activism remains in flux while market participants learn how to best utilize the universal proxy card to advance their particular governance and investment goals. But as much as the universal proxy card rules have changed the activism landscape, they have not changed the critical role of effective boards in sustainable value creation for their companies, shareholders, and other stakeholders.

QUESTIONS FOR DIRECTORS TO CONSIDER

- Does our board consider and periodically assess board culture to ensure we have an open, respectful, trusting, and collegial culture that supports constructive challenge?
- What do our largest shareholders think about the company's performance, strategy, and board composition? Have independent directors spoken to any of these shareholders as part of shareholder engagement efforts in the last year?
- How should our board incorporate shareholder feedback into its decision-making processes?
- List out the main areas that the company plans to prioritize in the next three to five years. Which directors have recent qualifications that line up with those areas? Are there profiles of potential new directors that line up with any of them better than those already on the board?
- If an activist shareholder published an open letter about the company and board tomorrow, what changes in corporate strategy or governance would you like to make to position the company for success in a proxy fight? Why haven't you made them yet?



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The views expressed in this article are those of the authors and do not necessarily reflect the views of Sidley Austin, its other lawyers, or its clients.