Universal Proxy, Increased Activism and Director Vulnerability

Each fall, Russell Reynolds Associates conducts dozens of meetings with investors, activists, and governance lawyers and professionals, focusing on governance trends. In our most recent meetings, we are hearing that the intersection of the universal proxy,[1] an active environment for traditional shareholder activism, and more assertive institutional investors will bring significant pressure on boards and directors concerning board composition and potential director vulnerabilities. Companies should prepare now, before a proxy contest or a campaign against the election of individual directors. This new and challenging environment will require most boards to greatly enhance their review of board composition and individual director vulnerability in the event of a proxy contest. Even if these campaigns do not garner strong investor support, they can publicly reveal board skill gaps and individual director vulnerabilities. We urge boards to talk with their lawyers, bankers, and firms like Russell Reynolds to understand the implications of these newly converging forces.

In the coming proxy season, public companies should expect to face more challenges from single issue activists/groups (e.g., climate and sustainability) as well as economic activists (e.g., traditional investment funds). We also expect to see an even greater increase in shareholder proposals on a wide range of governance topics. While companies have dealt with many of these issues before, they have not faced them with the added impact of the new universal proxy rules which went into effect in September 2022. The universal proxy gives these activists and cause-related groups the ability not just to propose a slate of directors, but it also allows all shareholders the ability to pick and choose individual directors from both company and activist nominees. As ISS noted, the new rules are a "superior" way for shareholders to vote and it is a "dramatically easier" and "cheap" way for activist shareholders to launch proxy fights. As one major investor noted, even if the activist garners only small support, the case against an individual director serving on a board and his or her perceived skill gaps will be highlighted.

In forthcoming proxy contests, we expect the more aggressive activists and single issue groups to target directors who may appear in public company disclosures to have the weakest case for their continued board service. In our early November interviews, a senior leader at one of the world's largest institutional investors told us that they will be paying much more attention to each director's qualifications, why each director is serving on a board, and their link to long-term value creation or destruction. Large institutional investors are ready to vote for the best board candidates and will pick among candidates from both company directors and activist candidates.

Companies should also be mindful of proxy advisor predictions, ISS noted that activists will "more precisely adjust board composition," targeting directors for removal who are perceived as weaker board members. ISS further noted, "[We] will continue to highlight to clients those nominees from either party who during our engagements appear to be particularly well qualified." ISS provided an example of the type of director investors may target (and they may vote against): [An investor may want to replace] "a long-tenured, over-boarded director who seems disengaged with a new nominee who brings clearly-relevant skills to the board, or perhaps enhances diversity." Glass Lewis noted, "The new rules will potentially make all incumbent directors on a board more vulnerable for replacement, whether they are specifically identified as a targeted director by the activist or not… We also expect there to be a greater emphasis on evaluating the respective skills and qualifications of each individual company and dissident nominee, not only for those nominees who are pitted against each other, but also in terms of the board composition as a whole." In other words, the actual power of the new universal proxy rules may not be in the actual removal of a director, but in its ability to more easily highlight board composition and its strengths and weaknesses.

We want to emphasize the foregoing matters to all companies, whether or not they currently face or expect an activist intervention. As a leader at another large institutional investor recently told us, "The universal proxy creates a new sense of urgency. Boards need to encourage lower performing directors to leave the board before activists do it for them." The right time to take stock of director qualifications, board performance, and related disclosures is prior to an activist contacting the company. If you wait until an activist shows up, it is too often too late.

We have previously written about related topics. Our earlier article ("Activist Investors' Approaches to Targeting Boards," August 2017) outlines how many activists pick directors to target in a proxy fight and settlement. We believe these insights are particularly useful for nominating committees and boards, who may now need to think through the perceived strengths and weaknesses of individual directors before a proxy fight.[2] Another Russell Reynolds article ("Why ExxonMobil's Proxy Contest Loss is a Wakeup Call for all Boards," July 2021) provides insights into Engine Number 1 and ExxonMobil. We talked with numerous institutional investors about why they voted for the Engine Number 1 slate of candidates, and we discovered that their decision was based primarily on board composition and director skills, rather than environmental concerns. Many investors felt that the ExxonMobil Board's experience and skills did not adequately reflect the evolution of the industry and its focus on lower carbon energy sources.[3]

Contested board elections understandably dominate the headlines, but shareholder assertiveness on board composition extends into quiet, uncontested elections as well. This past year, 62 Russell 3000 directors failed to receive at least 50% shareholder support.[4] Significant protest votes occurred at many other companies, with roughly 15% of directors failing to receive 90% vote support this past year.[5] While the number of directors receiving less than 50% of the vote may not increase substantially, we would expect the universal proxy card to result in vulnerable directors receiving significantly less support in a proxy contest or other campaign. Low director support can be an early warning sign—and an invitation for more activist scrutiny—that demands attention.

What should companies do now? First, there should be a clear-eyed assessment of what skills the board needs, and what skills it currently has, with careful attention to skill definitions that would withstand external scrutiny. Second, companies should consider augmented disclosure about board composition, refreshment, and evaluation activities, given the growth in investor interest in these subjects. (We recommend you look at our white paper—Is Your Board Effective, October 2022[6]—for insights into best practices on board and director evaluations). Taking these steps before an activist knocks will be much more valuable than taking them later. Even without the threat of activist interventions, board assessment and augmented disclosure are high-value opportunities to earn or enhance the trust of a company's shareholders and other stakeholders, who expect more and are more willing than ever to penalize those who fail to meet their higher standards.

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References

[1] Fact Sheet: Universal Proxy Rules for Director Elections (sec.gov)

[2] Activist Approaches to Targeting Boards (harvard.edu)

[3] ExxonMobil Proxy Contest Loss is a Wakeup Call for Boards (harvard.edu)

[4] A Look Back at the 2022 Proxy Season (harvard.edu)

[5] A Look Back at the 2022 Proxy Season (harvard.edu)

[6] Is Your Board Effective | Russell Reynolds Associates