AN HISTORICAL PERSPECTIVE OF THE CURRENT BALANCE OF POWER BETWEEN SHAREHOLDERS AND BOARDS OF DIRECTORS

Before we turn to a discussion of the appropriate balance of power between boards of directors and shareholders of publicly held corporations, it seems appropriate to take a quick look at the current balance using a historical perspective. I find it helpful to use as a starting point the relationship between boards and shareholders when I started practicing law some 40 years ago. In 1968 the balance of power was heavily weighted in favor of the board - and perhaps more importantly, management. It was common practice for more than one member of management to be on the board and it was often the case that most if not all of the remaining board seats were held by individuals who were either closely connected to the corporation or close friends of the chief executive officer. For example, it was often the case that the outside general counsel served as a member of the board. Little, if any, attention was given to the need for independent oversight. And the board served as the gatekeeper for any extraordinary transaction. For example, if the board was opposed to a sale of the enterprise, shareholders were not well positioned to pressure the board to act. A merger or a sale of substantially all of the assets always required the prior approval of the board of directors and no one had conceived of the possibility of bypassing the board via a cash tender offer for control of the outstanding shares. While a proxy fight was a possibility, the proxy process was generally believed to be stacked in management's favor and there was little likelihood of a contest being successful absent ownership of a very large block of shares.

By any measure, the changes since 1968 have been dramatic. The driving force, without question, has been the substantial shift in share ownership from small retail investors to large institutional funds. In the late 1960s, the shares owned or controlled by individuals typically would constitute a substantial majority; today the retail holdings likely will constitute a small fraction of the outstanding shares.

The earliest significant shift in the balance of power occurred in the early 1970s with the advent of the cash tender offer. Suddenly there was as a vehicle to bypass the board of directors and effect a change in control of the enterprise. From the mid 1970s until the early 1990s much of the focus related to development and use of different tools to retain board control and challenges to those various devices. Included in the litany of protective strategies were the widespread adoption of dead-hand poison pills and the enactment of affiliated transaction statutes. As the percentage of shares owned by institutions steadily increased and shareholders — especially governmental employee funds and union controlled funds — became increasingly aggressive, the effectiveness of these defenses waned and continues to wane.[1]

Sometime in the 90's, the focus shifted from the controlling authority of boards of directors in the special circumstances associated with a potential change in control. A new and broader focus evolved, directed at increasing the separation of the board of directors from management with the objective of reducing management's traditionally strong influence over the board. Shareholders pushed for a substantial increase in the number of board members who were independent of management applying tests of independence that became more and more stringent.

This decade long initiative has been a success by any measure. While the initial objective was to have a majority of the board composed of independent directors, today it is often the case that the only director who is not independent is the chief executive officer. And, as a result of shareholder induced regulatory reform, all of the major board committees now must be

[1] See Exhibit 1.

independent. Related changes to increase the separation between management and the board included the advent of the now standard practice of having a lead director to increase the board's oversight of the CEO, as well as the practice of having regular sessions of the independent directors without any member of management being present. More recently, the push has been to require that the chairman of the board be an independent director rather than the CEO.

With limited exceptions, the foregoing shifts in the balance of power are now accepted as the norm. Some will still advocate that the board should have greater control in the context of a potential change in control, but boards today are much more reluctant to attempt to block an unsolicited offer at a reasonably attractive price. And the ascendancy of the independent board free from management domination is accepted practice.

But we now appear to be entering a new, and significantly different, phase in the campaign to change the relationship between boards and shareholders. In this new phase, the focus is more directly on the ability of the shareholders to limit the board's authority. In simplest terms, this new phase involves, in a variety of different ways, changes that increase the ability of shareholders to influence or direct the board of directors and, in the extreme case, to limit the board's ability to exercise its traditional authority.

Before addressing some of the proposed changes that are a part of this new focus, it seems appropriate to recognize recent organizational, market and regulatory changes and proposed changes that have enhanced in a substantial way the already substantial collective power of institutional and other large shareholders. Perhaps the most important of these developments has been the now widespread practice of certain institutional holders voting shares held in their investment portfolios solely on the basis of the recommendation of one or more shareholder advisory services – with ISS being the principal agent. Many institutions have simply elected to outsource the voting of the many securities included in their portfolios. As a result, for the typical publicly held company the outcome of any contested vote is likely to be influenced significantly, if not controlled, by the position that ISS's staff takes with respect to that matter.[2]

Another major development has been the advent of the advisory shareholder vote. Perhaps the strongest source of support for the power of the board has been the bedrock corporate law concept that the corporation's business is run under the supervision of the board. Based on this concept, it has been standard practice to exclude from consideration at a meeting of shareholders any shareholder proposal that addressed a subject matter within the traditional domain of the board — executive compensation being a good example.[3] By making a proposal only advisory, shareholders no longer can be denied because the matter is within the traditional domain of the board. While a board is free to ignore the results of an advisory vote, it runs a significant risk by doing so, since ISS can be expected to withhold support from directors who fail to adhere to shareholders' wishes even if advisory in nature . As a result, the advisory vote has become an exceptionally effective way for shareholders to pressure boards on aspects of the corporation's business and operations that historically have been the sole province of the board.

Several new practices and investment options in the financial markets also have made it easier for activist shareholders to acquire power. For example, a number of institutional holders have been willing to loan shares in their portfolios for a fee. An activist can borrow those shares for the period during which a target's record date is likely to be established thereby acquiring voting rights that substantially enhance its power with little cost. Similarly, the development of the derivatives market has allowed activists to craft swaps and other similar arrangements in

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[2] See Exhibit 2.

which a bank or investment bank extends credit to the activist with the upside and downside for the activist tied to changes in the stock price of the target. Pursuant to the terms of the swap the lender acquires and hold the shares of the target company that underlie the swap. While the borrower has the right to settle the swap by paying cash and taking title to the target's shares. Until that happens, the right to vote the shares that are the subject of the swap stays with the lender, but it is generally assumed that the lender will be mindful of the borrower's wishes when it comes time to vote.

There also have been a number of regulatory changes that have been adopted or are under active consideration each of which would appear to increase the power of shareholders, and reduce the power of management and the board. For example, the new e-proxy rules[4] are expected to make it much easier for an activist shareholder or group to solicit support in opposition to the board's nominees or proposals and gain support for their own agenda. Proposed regulatory changes under active consideration have the potential of influencing the balance of power in any even more substantive way. For example, the proposed New York Stock Exchange rule change[5] that would eliminate the ability of banks and brokers to vote shares held in street name in an uncontested election of directors absent instructions from the beneficial owner would cut significantly into the vote of the retail holders — a group that traditionally could be counted on to support management and the board. Perhaps of greater significance would be the likely effect if the SEC finally gives large shareholders access to the company's

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[3] See Exhibit 3.
[4] See SEC Release No. 34-56135 (July 27, 2007)
[5] NYSE Rule 452. See Proposed Rule Change Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934 (Oct. 24, 2006).

proxy statement to present their own nominees for the board.[6] Not only would the board lose much of its traditional control over the slate of nominees, but also large holders would be better positioned to push their own agenda with the existing board by using the threat of proposing their own nominees as leverage.

With all of these changes in accepted practices and regulatory requirements, a radical shift in the balance of power appears to be in progress. There is abundant evidence that boards are feeling shareholder pressure with respect to matters in the board's traditional domain, with compensation related issues being the prime example. Of perhaps greater significance, the typical board nominee now must countenance the distinct possibility that he or she may not be elected, or may be removed or replaced. While an attempt to replace a majority of the board would still appear to be difficult absent compelling circumstances, the likelihood that a group of activists can run a short slate and replace a minority of the board is much greater. Even without an election contest, the nominee cannot rest easy. One of the principal indications of the shift in power has been the rapid movement away from the use in the context of an uncontested election of a pro-director plurality vote requirement to a majority vote requirement.[7] If a nominee has to receive a majority of the votes cast as withhold the vote campaign can be a real threat. And more recently, shareholders have been successful in proposing and adopting bylaw amendments to permit a minority of shareholders to call special meetings of shareholders often free of restrictions of any kind.[8] As a result surviving the annual meeting may only represent temporary relief from another election contest.

[6] See Exhibit 4.
[7] See Exhibit 5.
[8] See Exhibit 6.

Shareholders also are looking beyond the shareholder meeting for additional ways to exercise their influence. For example, large shareholders are expecting that members of the board be accessible to them throughout and there may be an emerging trend for boards to establish a policy of having periodic meetings with their largest shareholders.

Until recently the principal activists have been groups controlled by union or governmental employee benefit plans. But in the last two or three years activist hedge funds have aggressively sought to take advantage of the shift in power. These funds often work together to increase their influence. They also have been effective in gaining the support of institutional shareholders and their agents. But the activist hedge funds are fundamentally different from the typical institutional holder in several respects. First and foremost, the traditional institutional holder has the right to vote the target's shares, but the economic interest in the shares resides with the individual or entity on whose behalf the institution serves as agent. In contrast, the hedge fund typically owns the economic interest in the shares, has become highly leveraged in acquiring that interest and both the manager of the fund and the fund's owners have assumed the risks of the highly leveraged position in anticipation of returns that will be realized both quickly and at very high levels. As a result, while traditional institutional investors can be expected to be interested in value creation over the long-term, the activist hedge fund may demand a short term return that likely can only be event-driven. In consequence, the pressure that directors have been feeling from institutional holders has a much softer element to it than is likely to be encountered when a pack of activist hedge funds takes a major position.

With all of these developments we may be approaching the point where there will be a direct challenge to the director-centric corporate model, replacing it with the concept that boards must follow the directives of the shareholders. In any event it seems clear that the shifts in the balance of power over the last forty years have been both substantial and one-directional and appear to be gaining momentum. It seems noteworthy that the substantial shift in the balance of power over the last 40 years has not involved any fundamental changes in the relevant corporate code provisions or in judicial interpretation of those code provisions.[9] The bedrock concept that all corporate power shall be exercised under the authority of the board of directors is still in place. Any amendment of the articles of incorporation, merger or sale of the assets still must start with the board. And Code provisions dealing with annual and special shareholder meetings have undergone no substantive change. As we turn to consider what the proper balance of power should be, a related issue is whether any statutory changes are appropriate.

A.C.G.
February 28, 2008

[9] See General Datacom Industries, Inc. v. State of Wisconsin Investment Board, 713 A.2d 818, 821-822 (Del. Ch. 1999) (the effort to shift the balance of power through the use of stockholder-adopted bylaws has "exposed a critical dearth of precedent.")

2006 & 2007 Shareholder Proposals

Takeover Defenses

	2006		2007	
	Proposals	Avg. Support	Proposals	Avg. Support
Eliminate Classified Board	58	67.0%	36	66.6%
Rescind Poison Pill	15	53.2%	15	44.3%
Eliminate Super Majority Voting Requirement	21	64.5%	19	74.5%

- Rescind Poison Pill:
  - ✓ Bebchuk proposal at Disney requiring 75% vote by independent Directors received 57.3% vote
  - ✓ Disney recently voluntarily adopted a poison pill bylaw

Exhibit 2

Hedge Fund Activism

ISS Continues to Support Hedge Fund Activism

- ISS recommendation is frequently outcome determinative.
- In 33 proxy contests waged by hedge funds, ISS has supported dissidents in 26 (or 78.8%) of cases.
- In the 26 proxy contests waged by hedge funds in which ISS supported dissidents, at least one dissident was elected in 20 of them (or 76.9%).
- In 23 mergers opposed by hedge funds, ISS's initial recommendation has been "Against" 15 times (or 65.2%).
- In the 15 mergers in which ISS recommended "Against", shareholders received a "bump" in 10 of them (or 66.7%)

Exhibit 3

2006 & 2007 Shareholder Proposals

Executive Compensation

	2006		2007	
	Proposals	Avg. Support	Proposals	Avg. Support
Say on Pay	7	40.0%	53	41.8%
Link Pay to Performance	17	30.1%	39	29.9%
Claw Backs	10	25.0%	10	28.8%
Fixed Date Option Grants	0	0.0%	4	47.7%
Golden Parachutes	17	51.7%	12	54.4%

- Fixed Date Option Grants: Longview Funds withdrew most of proposals after discussions with management
- AFSCME is leading a coalition of 70 institutions and individuals who are sponsoring 90 "Say on Pay" proposals in 2008

Innisfree M&A Incorporated

Exhibit 4

2006 & 2007 Shareholder Proposals

Proxy Access

- 3 proposals in 2007

	Support
✓ Hewlett-Packard:	43.0%
✓ United Health	45.3%
✓ Cyro-Cell International	53.4%

- SEC recently changed course and now permits exclusion of proxy access proposals under Rule 14a-8
  - ✓ Will re-examine all alternatives in 2008
- AFSCME has filed proxy access proposals at JPMorgan Chase, Bear Stearns, Countrywide Financial and E*TRADE. AFSCME also filed a proposal to reimburse shareholder expenses related to running a slate of directors if at least one nominee is elected
  - ✓ Prepared to litigate if SEC issues no-action letters
- Comverse Technology recently adopted a proxy access bylaw permitting a holder of 5% or more for at least two years to nominate one candidate in management's proxy materials

Innisfree

Exhibit 5

Exhibit 5

2006 & 2007 Shareholder Proposals

Majority Voting

	2006		2007	
	Proposals	Avg. Support	Proposals	Avg. Support
Majority Voting	93	48.5%	40	50.4%

- 90 shareholder proposals were withdrawn in 2007 after companies voluntary adopted majority voting
- ISS estimates there will be 200 shareholder proposals in 2008, with a high rate of withdrawals
- 66% of S&P 500 companies have adopted majority voting policies
- Approximately 53% of those companies have adopted an Intel-type bylaw, including Pfizer

2006 & 2007 Shareholder Proposals

Shareholder Right to Call a Special Meeting

Right to Call A Special Meeting

Year	Proposals
2007	**18**
2006	1
2005	1
2004	1
Avg. Support	**56.5%**