# The Proxy Edge: Exercising Your Shareholder Rights

By John Deysher

**Within the next few months, investors' mailboxes will be groaning under the weight of annual reports and proxy statements.**

While the annual report often looks nicer, with glossy pages and color photos, the proxy can be just as important, detailing everything from executive pay to policies on corporate governance.

Indeed, corporate governance has been a hot button issue since the collapse of Adelphia, Enron, Worldcom (now MCI) and others. The Securities and Exchange Commission (SEC) is keeping the heat on public companies by requiring broader and deeper disclosure on how corporations are actually governed—most of which can be found in the proxy. If you wanted to find a company that was "ideally" governed in line with shareholders' interests, it would be the proxy statement that you would turn to for most of the information (see accompanying box).

Unfortunately, many individual investors don't know what to do with the proxy statement—they don't know how to vote on certain issues, or feel that their votes do not count for much. Many shareholders simply toss their proxies in a file or, worse, the trash. But with it, they are throwing away their votes—and their shareholder right to keep management's interest in line with their own.

As a portfolio manager for a mutual fund, I read proxy statements carefully during my initial company analysis and on a regular basis once a position is taken. And, needless to say, I always want my votes counted.

Although proxies are written by attorneys and can make for some dry reading, they are generally arranged in sections that lead to organized analysis. Here are some tips on getting the most out of a proxy, sequentially organized according to a typical proxy's format.

### Annual Meeting Specifics

The SEC requires that shareholders receive a proxy statement prior to any shareholder meeting. The statements must disclose all important facts about issues on which shareholders are asked to vote, including the election of directors and the approval of other corporate action, or even solicitations by other shareholders. The information contained in these statements must be filed with the SEC *before* any shareholder votes are solicited.

That's why the proxy statement will start with information on when and where the annual meeting is to be held. It will also provide a detailed outline, in the form of a Q&A, of the proposals that are to be voted on.

If you can get to the annual meeting—go! Even if you're not a shareholder and are checking the company out, most firms will allow you to attend their annual meeting, although you won't be able to vote unless you're a shareholder. You'll meet management, hear about the firm's prospects and get to ask questions. It's the one time of year when you'll have management's undivided attention, so take advantage of it. You'll probably meet like-minded investors whom you may wish to exchange information or stay in contact with. Berkshire Hathaway's meeting draws thousands of intelligent shareholders who look forward to their marathon Q&A with Warren Buffett each year.

### Election of Directors

Proposal One in most proxies is the election of directors. Who you vote for is critical, since they are your representatives who oversee management, making sure outside shareholders are treated fairly.

Here's how to proceed with this section.

- First, read the backgrounds of each nominee. Are they insiders affiliated with management or outsiders with no ties (business or otherwise) to management? Ideally, you want the majority of directors to be outsiders representing your interests, not management's. Be aware that someone who appears to be an outsider may actually be an insider even though they aren't part of management. For example, a relative of a key executive, a recently retired former employee or someone who provides services to the firm like accounting, legal or consulting. Such relationships are riddled with conflicts of interest.
- Next, see what committees the various nominees sit on. There should be no insiders sitting on the audit, compensation, governance or nominating committees. Vote against any that do—you don't want insiders determining policies and procedures or making key decisions in any of these areas. This should be left to objective outside directors.
- Third, review the Security Ownership table showing how many shares the insiders own, both individually and as a group. The higher the better—as an investor, you want their money on the line along with your own. There's usually a footnote to the table showing how many of the shares shown are restricted stock or subject to options exercisable within 60 days. Subtract those shares from the amounts shown to provide a better idea of true share ownership. Often what appears to be a high degree of ownership is actually quite minimal.
- Finally, votes or board seats should be commensurate with share ownership. For example, on a seven-person board where the insiders hold two seats and have 28.6% of the votes (2 divided by 7), make sure those directors own at least 28.6% of shares. If not, withhold your vote from as many insiders as appropriate. I once withheld votes from most of the nominees who were all insiders but owned no shares; all my votes were cast for the largest inside owner nominees. In a firm where the insiders own few or no shares, there should be only one insider on the board, typically the president or chief executive officer.

### Ratification of Accountants

The external auditors play an important role in today's financial scene. More than one firm has been sunk by "accounting irregularities," which sometimes mask outright fraud.

For most public companies, I generally like to see a "Big 4" accounting firm—Deloitte & Touche, KPMG, PricewaterhouseCoopers and Ernst & Young—or a strong regional firm doing the audit. They tend to have higher-quality people and a better knowledge of accounting systems and regulatory issues.

Many audit clients have switched in recent years from Big 4 firms to regional firms for cost and other considerations. This is acceptable as long as there are no accounting controversies triggering the change. Any time a firm changes auditors, the reason behind it is required to be disclosed in an 8-K filing.

Firms are now required to separately list fees paid for audit, tax and consulting services for the last two years. *Beware of companies that pay more for consulting services than audit services.* Major consulting assignments should not be handled by the audit firm or any other outside firm with financial responsibilities, to avoid potential conflicts of interest.

### Executive Compensation

This section of the proxy will contain a Compensation Committee Report. Read this section and try to understand the committee's compensation philosophy and how executives are actually rewarded.

Compensation is usually some combination of cash (salary/bonus) and equity (options and/or restricted stock). Together they are intended to attract, motivate and reward executives who are expected to manage for short- and long-term success.

From a shareholder's standpoint, salaries should be reasonable and commensurate with others holding similar positions in the same or a comparable industry. The best way to get information to compare executive compensation is to check out other proxies on SEC's EDGAR Web site (www.sec.gov/edgar.shtml) for this data.

Bonus programs should be disclosed in writing and be tied to a company's performance, ideally its return on assets or capital rather than its return on equity. [Return on assets is calculated by taking net income and dividing it by total assets; return on capital takes net income and divides it by the sum of shareholder's equity plus net debt (total debt less cash and cash equivalents). The return on equity calculation takes net income and divides it by shareholder's equity. In these calculations, you should use averages (average total assets, average shareholder's equity and average net debt) to eliminate distortions occurring when a company issues equity or debt during the year—using beginning shareholder's equity or capital doesn't address this.] Return on equity can be easily manipulated upward by adding financial lever-

# Corporate Governance: The Shareholder Score

We've all heard of credit scoring—the process by which a lender evaluates the creditworthiness of the potential borrower. In that system, the higher the score, the better the terms of the loan.

A similar system could be used on various corporate governance criteria, to provide a rough measure of the degree to which a company actually follows the courses of action that are most in line with those of outside shareholders—call it a Shareholder Score.

One possible system, outlined below, contains 10 categories with a maximum of 10 points each, for a possible perfect score of 100. Points are deducted within each category to reflect the extent to which a company deviates from the ideal. The higher the total score, the better. Most of the information you would need to derive a Shareholder Score can be found in the corporation's annual proxy statement, and in 10-K filings, including exhibits and footnotes.

### 1) Capital Structure

Score a full 10 points for a company with one class of stock—1 share, 1 vote.

Deduct 2 points for each of the following:

- There is a non-transferable super-voting common class of stock;
- There is a widely held class of stock that gets 0 votes;
- There are additional classes of shares owned by insiders only;
- There is non-cumulative voting of directors.

### 2) Management Salary Compensation

Score a full 10 points if salaries are reasonable and reflect company performance.

Deduct 2 points for each of the following:

- There is minimal disclosure in the proxy statement of how salaries are determined;
- Salaries are higher than for executives running similar-sized public companies in similar industries;
- Past increases in salary are not in line with company performance.

### 3) Compensation: Bonuses & Cash Incentives

Score a full 10 points for compensation incentives based on corporation's return on assets or return on capital.

Deduct 2 points for each of the following:

- Short (less than three years) vesting periods;
- Incentives based on non-return measures like earnings per share, sales levels or stock price;
- There is no disclosure of how bonuses are determined.

Deduct 4 points if there are Golden Parachute agreements.

### 4) Compensation: Stock Options/Restricted Stock

Score a full 10 points if there is no stock option or restricted stock incentive plan.

If there is a stock option/restricted stock plan, add 2 points each if:

- It is issued in modest quantities (the "overhang"* is less than 10% for non-technology companies and less than 20% for technology companies);
- The company treats option exercise as a compensation expense;
- The option strike price is at or above the stock's price at the time of grant;
- The vesting period is greater than three years;
- The option exercise is "funded" with shares repurchased on the open market.

Deduct 4 points if options are "repriced" lower to reflect sagging stock prices.

**overhang = (options + restricted stock awarded or to be awarded) ÷ shares outstanding*

### 5) Insider Ownership of Shares Outstanding

Score: 10 points if insider (management and the board of directors) ownership is greater than 40%

8 points if insider ownership is 30% to 39%

6 points if insider ownership is 20% to 29%

4 points if insider ownership is 10% to 19%

2 points if insider ownership is 5% to 9%

*(continued on next page)*

## Corporate Governance: The Shareholder Score (con't)

**6) Board Composition & Board Committees**

Score 2 points each if:

- At least 2/3 of the board are outside directors;
- Each outside director is truly an outsider—no relations with insiders and no business dealings with the company;
- Chairman of the board is an outside director with no ties to management;
- No insiders are on the audit, compensation, governance or nominating committees;
- Votes/seats held by insiders are commensurate with shareholdings—e.g. on a seven-person board where insiders hold two seats and therefore hold 28.6% (2 divided by 7) of votes, insiders hold at least 28.6% of shares.

**7) Conflicts of Interest & Related-Party Transactions**

Score a full 10 points if there are no conflicts of interest.

Deduct 2 points for each of the following:

- The company occupies a building leased from management or an affiliate;
- The company engages in business with another company owned or controlled by management;
- The company buys real estate or business from management or an affiliate;
- The company makes loans to management on generous terms (i.e., interest free);
- Management receives excessive perks (apartment, aircraft, country club memberships, life insurance, etc.).

**8) Takeover Defenses**

Score a full 10 points if there are no takeover defenses.

Deduct 2 points for each of the following:

- Staggered board of directors;
- Poison pills ("shareholder rights" plan);
- Prohibitions or restrictions on shareholders' ability to call special meetings;
- Blank-check preferred stock;
- Super-majority voting requirements.

**9) Governance Statement**

Score a full 10 points if the corporation provides full disclosure in the proxy statement of governance guidelines laying out structures, policies, and programs of governance—including committee charters and the responsibilities of board members.

**10) Re-Incorporation Strategies**

Score a full 10 points if the corporation has had no re-incorporation strategies.

Deduct 2 points for each of the following:

- The company has or is proposing to re-incorporate in another state (Delaware or Pennsylvania) or country (Bermuda or the Cayman Islands);
- The company has or is proposing a merger resulting in new, less-shareholder-friendly corporate charter.

age, which may not be in the company's long-term interest. Likewise, tying a bonus to earnings or cash flow growth encourages executives to ignore the assets and capital necessary to generate them. A company may add product lines or distribution channels or accept new customers that increase earnings and cash flow but the capital requirements may be so high the return on capital actually declines!

A bonus tied to share price appreciation may also lead to unintended results. I know of several companies that bought back large amounts of stock using borrowed money in an attempt to keep the share price high. Their balance sheets became leveraged and liquidity became an issue, causing the share price to ultimately decline. Beware of "show up" bonuses where the bonus is "determined at the discretion of the board of directors." These lucky executives need only "show up" to earn their bonus!

Finally, make sure the combined cash compensation matches the company's financial performance. If executive compensation marches continually upward while results go sideways or down, something is definitely wrong. One of the most effective programs I've ever seen requires executives to earn high returns on capital *and* beat the returns on capital of the peer companies—by doing so, they can earn substantial compensation!

Most companies now have some type of option or restricted stock plan to reward long-term performance. Like Warren Buffett, I prefer that there be no options/restricted stock incentives but instead cash incentives where executives can do very well if performance is extraordinary. However, if a firm has an options/restricted stock program, it should contain the following elements:

- Stock options/restricted stock should be issued in modest quantities with minimal "overhang." Overhang is the sum of options and restricted stock awarded or to be awarded, divided by the number of shares outstanding. For a non-technology firm, overhang should be less than 10%; for a technology or biotech firm, overhang should be less than 20%. Generally, I'll vote against option proposals that violate these thresholds;
- A company should treat option exercise as a compensation expense;
- The strike price should be at or above stock's price at time of grant;
- The vesting period should be at least three years, ideally five years;
- The option exercise should be "funded" with shares repurchased on the open market;
- Options should never be re-priced to a lower exercise price if the shares decline.

## Related-Party Transactions & Conflicts of Interest

This section is normally buried toward the back of the proxy—for good reason. It highlights transactions and relationships that, while not illegal, should be examined carefully for unethical behavior. If there are too many of these transactions, it can indicate the firm is being run as a personal piggy bank for management.

The most common examples include:

- The company occupies building leased from management or an affiliate.
- The company engages in business with another firm owned or controlled by management.
- The company buys real estate or business from management or affiliate.
- The company makes loans to management on generous terms (i.e., interest free).

## Anti-Takeover Measures

Shareholders are sometimes asked in the proxy to approve various anti-takeover measures that primarily serve to entrench management. Generally, I vote against these. The most common include:

- ***Poison pills (shareholder rights plans):*** This takeover defense is normally triggered when an outsider purchases a certain percentage of shares, usually 10% to 30%. Once activated, the plan gives all other shareholders the right to acquire additional shares at a set price, thereby diluting the interests of the outsider and making a takeover more difficult.
- ***Staggered board structure:*** This defense involves dividing directors into separate classes that have overlapping terms. For example, one-third of the board would have its term expiring in 2005, one-third expiring in 2006 and one-third expiring in 2007. This staggering will usually delay outsiders seeking to quickly gain voting control of the board.
- ***Non-cumulative voting:*** Cumulative voting has been present in corporate voting for centuries. It allows investors to accumulate and cast all their votes for one or two directors, as opposed to spreading the votes across all directors. For example, suppose you owned 1,000 shares of IBM and there are three nominees running for three board seats. You would thus have 3,000 votes to cast (3 × 1,000). Under cumulative voting, you could cast all 3,000 for one director. Under non-cumulative voting, the most votes you could cast for a single director would be 1,000. Cumulative voting thus increases the chance that a minority investor(s) can impact the election results by targeting all votes to one or two directors.
- ***Re-incorporation strategies:*** A company will sometimes ask for shareholder approval to re-incorporate in another state or offshore location to take advantage of management-friendly courts, strong anti-takeover statutes and other shareholder restrictions. If approved, governance documents may be rewritten to favor management at the expense of shareholders with important changes buried in thick legal documents.

## Conclusion

Don't throw those proxies in the circular file!

Remember, you as a shareholder own the company and management works for *you.*

Exercise your rights carefully—and do not vote for any director or proposal that would limit those rights.

If you don't understand a proposal, don't vote for it.

And make sure you *DO* vote for those that align management's interests with your interests—you'll never be sorry. ➤

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