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By Lindsay Frost

The close and contested proxy fight at **Procter & Gamble** is still being scrutinized by experts and companies alike for its unusual costs and the unique strategies used by both sides. One item of interest to emerge from the battle has been to what degree employee investors, who hold the power to sway proxy votes in some cases, can be influenced by activists' arguments, experts say.

As hedge fund giants continue to take on companies with more diverse shareholder bases, boards need to consider targeting messages to company employees who may not automatically be on management's side during proxy contests, sources say.

"At the beginning of a contest, every vote counts," says **Steve Balet**, managing director and activism expert in the strategic communications practice at **FTI Consulting**. "Companies need to understand that they have a significant advantage with regards to their employee shareholders, and they need to maintain that advantage by consistently communicating with them, not just as employees, but as investors."

ESOPs and Proxy Voting

Employee stock ownership plans (ESOPs) allow company employees to hold stock within their retirement plans. At one point a popular option in 401(k)s, ESOPs have decreased largely because many of the tax advantages in these plans for public companies have been eliminated. According to **Callan**, an investment consulting firm, 38.5% of U.S. defined contribution retirement plans hold company stock now, down from almost 50% in 2009.

"[If a company decides to liquidate an ESOP], management wouldn't just be liquidating ... from an economic point of view, but also liquidating management-friendly votes from a campaign perspective," writes **Kai Liekefett**, head of law firm **Vinson & Elkins**'s shareholder activism response team, in an e-mail.

Fewer Companies Offer Stock in Employee Retirement Plans



Source: Callan survey of 165 plan sponsors

From a technical standpoint, many ESOPs include terms allowing trustees to use their discretion to vote the shares of employees who failed to specify how they wanted their ESOP shares cast. Typically, most of these votes go to management, as the trustees tend to be management-friendly, Liekefett says. This is also known as proportional voting. For example, if an ESOP carries 100,000 votes and only 50,000 of those votes were submitted, and the majority of those 50,000 went for management, the 100,000 would be split 60,000 for management and 40,000 against management.

“This is a bit of a controversial issue,” says **Ele Klein**, partner and co-chair of the global shareholder activism group at **Schulte Roth & Zabel**. “This is heavily putting the vote on the side of [management], which is not really there. [In some cases], 90% of the shares were not directed at all, so they probably shouldn’t be voted at all when thinking about being fair.”

Balet adds that some plans offer pass-through voting, which allows for one vote per employee active in the plan — giving the employees more of a direct say.

Experts say employees are usually a company’s saving grace in proxy fights, as they tend to side with management for a number of reasons. The biggest reason tends to be that activists often call for job cuts and selling off parts of the business within their plans.

“Most activists are not highly regarded by employees whose jobs may be cut or ‘synergized’ out of existence as a result of an activist’s plans,” Liekefett says. “Employees and management that are at each other’s throats tend to have a ‘kumbaya’ moment after an activist launches a campaign.”

For example, Liekefett says, when activists say, “We are concerned about shareholder value,” employees hear, “We can’t wait to fire folks.” Employees tend to be single-issue voters, Liekefett says, and that issue is “jobs, jobs, jobs.”

Matteo Tonello, managing director of corporate leadership at **The Conference Board**, writes in an e-mail that large and established corporations that have a long history of dividend distributions typically have large numbers of employee and retail investors, and therefore their vote is important. This was the case at P&G.

According to shareholder service **Optimizer**, P&G's ESOP accounts for about 7.5%, or about \$16 billion, of outstanding shares at the company. Public filings show that a little more than 58,000 employees participate in the plan, and the trustee votes the shares proportionally, which Optimizer says gave P&G's management an additional edge.

Those employee votes no doubt played a role in the recount of ballots from P&G's recent proxy fight with **Trian Fund Management's Nelson Peltz** conducted by independent inspector **IVS Associates**, which determined that Peltz actually won his bid for a board seat by 43,000 votes, reversing the original ruling that P&G shareholders had rejected his effort to join their board by just over 6.1 million votes. At press time, P&G was challenging the results of the recount.

"Employee stock funds can make the difference when a company has a large retail base as compared to their institutional ownership," Tonello says.

Employees at **United Airlines** last year rallied in support of CEO **Oscar Munoz** during a proxy contest between United and **Altimeter Capital Management** and **PAR Capital Management**. Pilots and flight attendants picketed Par and Altimeter headquarters at the time, calling the fight an unnecessary distraction.

On the other hand, an activist contest may call attention to problems employees have had with the company — thus driving them to support the activists. ESOP votes are reflective of how employees are feeling, and sometimes they are worried about the stability of the business, Liekefett says.

Additionally, Tonello says that if the stock of the company is severely underperforming, this can be motivation for an employee to vote for an activist slate.

"Employees who are heavily invested in an ESOP could view the proxy fight as an opportunity to prompt the change in the company's leadership that is needed to revive the stock," Tonello says. "Activists that want to win employees' votes would have to persuade them of their ability to change the trajectory of the stock."

Employee and Retail Communication in Proxy Fights

Each company's message should be specific depending on who your shareholder base is, experts say. Retail investors in general have played a bigger role in many campaigns during the past year, Klein says. Klein's team worked with dissident **venBio** to obtain board seats at **Immunomedics** during a contest earlier this year. He says the large retail base at the company was "surprisingly engaged" and led to four board seats for venBio.

Although it can be costly, FTI's Balet says, phone calls, mailings and social media campaigns draw support from individual investors.

"If employees cover a significant number of votes, both sides are trying to direct the message to them to get those shares," Klein says. "Management has easier access, so they can reach out in ordinary course to employees, so if you're an activist, you are going to try to reach out to them through social media and letter-writing."

Trian's Peltz went with a letter-writing campaign to P&G employees, writing that employees and retirees are suffering because the company's shares have underperformed for so long. He also emphasized that he was not aiming to cut jobs, but rather that current management and the board were.

"We believe in organizing the company in a way that clarifies reporting lines and reduces matrices so that P&G's many talented employees are empowered to unleash their skills and creativity rather than being stifled by endless layers of bureaucracy," Peltz said in the letter. "Contrary to what the company's materials would have you think, our proposals will not derail the progress that comes from your hard work at P&G. Rather, they will help make P&G better, holding management and the board accountable for success and failure and empowering you."

Elliott Management also sent a letter to **Arconic** employees earlier this year during the proxy fight there, criticizing then-CEO **Klaus Kleinfeld** for a secret vote-buying agreement back in 2014 when Arconic was still Alcoa. Elliott also sent individual video players to retail voters, including employees, arguing their case. The two sides ended up settling.

Companies should understand that if they choose to communicate to employees, say via e-mail, about the proxy contest, they have to file these communications with the **SEC** and give the activist access to that contact information as well, experts say. Activists also need to have access to the trustee, Balet says. Back in 2010 before the recent rise of activism, private equity firm **Yucaipa Companies** accused **Barnes & Noble** of refusing access to company resources used to urge employee support of their chairman during a proxy contest. The company ultimately won the contest.

Some companies have provided incentives for individual investors to vote not only in proxy contests, but on general proxy issues as well. For example, at **Bank of America**, retail voters account for a third of the company's outstanding shares. Earlier this year, the company announced a plan to donate \$1 to the Special Olympics on behalf of every individual investor who returned a voted proxy. The company says the total accounts voted this year went up by 8%.