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With Universal Proxy Cards, Director Due Diligence Takes on a More Critical Role

Peter Lagomarsino and Sean Weathersby

Changes implemented by the SEC this past August to rules regarding the way shareholders vote for directors are poised to make it far easier and more attractive for activist shareholders to wage proxy fights. Current management and board directors need to be prepared for an onslaught of such contests.

The SEC's "Universal Proxy" rule that was adopted in November 2021 and went into effect in August 2022 mandates the use of universal proxy cards for contested director elections, significantly altering the shareholder activism landscape. Before the rule change, only shareholders attending the annual meeting were able to cast their votes for a mix of management and dissident directors; shareholders voting remotely or by proxy could only vote for the entire management slate or the entire dissident slate.

How the new rule will affect director elections

Because a single ballot listing both management and director candidates makes it easier for dissident directors to win election, many corporate governance observers expect to see an increase in proxy fights—and even more so given that turbulence in macroeconomic conditions and share price performance provide activists with additional fodder to call for change.

Just as importantly, in addition to becoming more common, we expect the nature of proxy contests to evolve. No longer faced with an all-or-nothing referendum on management, shareholders will now be able to weigh the pros and cons of individual directors, much as they might in elections for public office.

Indeed, activists may focus their efforts on unseating specific incumbent directors that are perceived as

particularly vulnerable, due to, for example, extended tenure that puts their independence in question or poor alignment with the strategic issues facing the company. As proxy fights thus become more "political" in nature, there will be a greater importance placed on the ability to craft compelling messaging regarding your nominees while highlighting weaknesses in your opponent's slate.

Due Diligence Takes on Strategic Value

The Mintz Group has worked with numerous companies and their counsel to conduct due diligence on dissident nominees that can be used in proxy fights to create narratives that shape public and shareholder opinion. While due diligence on an activist slate follows the same general framework as the due diligence customarily conducted by a company on its own nominees, the adversarial context brings a special set of nuances to the task.

For example, when scrutinizing the professional track record of dissident nominees, we examine how the companies where the nominees have served—either as executives, directors, or investors—fared under their leadership, and if there were significant issues that could call into question their ability to serve as a competent director. This assessment calls for casting a wider net than simply checking for controversies naming the nominee; it requires creating a map of current and past associations and researching that larger group of entities. Regulatory and compliance shortcomings, or the effects of ill-conceived business strategies, may emerge only years after the executives responsible have moved on and are no longer mentioned by name in public filings or news reports. Similarly, alleged incidents of workplace misconduct—either by the nominee or under their watch—may not be a matter of public record and require interviews with associates to uncover. Remember as well that it is not uncommon for executives to bury or omit less than flattering job stints entirely.

Given that the activist will almost certainly be invoking improved governance as an argument for the dissident slate, special attention should be directed to the dissident nominees' record on other boards.

How were those board regarded by proxy advisory firms? Have they been targeted by or fallen out of favor with

institutional investors? Were those companies subject to the same criticisms by activists that the activist is now leveling in proposing the dissident slate? The CEO's pay and perks should be examined as well, particularly if the director served on the compensation committee. Due diligence on prior board service should also explore the extent to which the dissident nominees are either overboarded, or conversely, lack adequate public board experience.

It is essential to examine a nominee's relationships to other directors and nominees as well, given that independent directors should represent a range of viewpoints. We regularly find that candidates on activist slates have intertwined histories as executives and investors that may make them more a united bloc beholden to the activists than an independent collection of individuals representing the interests of the larger body of shareholders.

There also may be hidden agendas and undisclosed motives. For example, one recent activist slate included a director nominee who had approached the company with a proposal to acquire a competitor of which he was CEO and a major shareholder. After the proposal was rebuffed, he joined the activist slate. The company was able to disqualify the slate before it ever made it to a vote—in part because the activist failed to include this critical information in its disclosure to the company announcing the slate. Although the slate was disqualified, it provides a cautionary tale underscoring the importance of due diligence.

As scrutiny of individual directors increases, we should expect that a nominee's personal record will be examined for any indication that he or she lacks the judgment and integrity required to serve as a public

company director. This includes a close review of the nominee's social media usage for any inappropriate content, along with searches for litigation, regulatory sanctions and other red flags. Examination of a director's personal background can also identify connections, such as country club memberships, that can put their independence in question.

Think Like An Activist

Finally, management nominating committees should periodically conduct equally extensive due diligence on their own board members. Ideally, this diligence should take place annually, both to ensure that recent events have been included in the review, and to reflect evolving issues and standards that shape the due diligence process. (For example, since the start of the #MeToo movement, screening for sexual harassment allegations has become an essential part of candidate due diligence.) As proxy battles intensify, it will be critical for management to "think like an activist" and to identify potential vulnerabilities that could become issues in a campaign so that counterarguments can be crafted while there is still the luxury of time.

Due diligence on the nominees of dissident slates has long been a standard part of management's toolkit when responding to proxy fights. However, with the introduction of the universal proxy card, nominating committees, general counsel and corporate secretaries need to reexamine their due diligence processes to ensure that they are at the level demanded by the challenges and opportunities of more dynamic director elections.



PETER LAGOMARSINO
[Managing Partner and](#)
[Head of Executive Diligence](#)
San Francisco
plago@mintzgroup.com



SEAN WEATHERSBY
[Managing Director](#)
Washington, DC
sweathersby@mintzgroup.com



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