Majority voting for directors, the latest and one of the most successful activist investor initiatives, is rapidly gathering traction throughout Corporate America. Company announcements of adoption of some type of a majority vote structure are now an almost daily occurrence. Recently, companies such as Intel, Motorola, and Dell have announced they have foregone their plurality standard and adopted a majority vote standard. And many more companies have maintained their plurality standard, but adopted policies that mimic certain aspects of a majority vote standard.

Notwithstanding the growing acceptance of the majority voting concept, there is a large degree of variability in the types and formulations of majority vote structures. Many companies have not acted as they weigh the alternatives available to them. This article examines some of these differences, as well as a number of potentially critical implementation issues.

Modified Plurality Voting or Full-Fledged Majority Voting

Today, most companies elect their directors under a plurality standard. A plurality standard means that the directors with the most “for” votes win, notwithstanding the number of “abstain” or “withhold” votes. Under this standard, a director can be elected with only one “for” vote even though all other votes are “withheld” against the candidate. With the exception of relatively few states that mandate either cumulative voting or majority voting for directors, state corporation laws provide that plurality voting is the default rule, meaning that directors are elected by a plurality vote unless the charter or by-laws otherwise specify.

When deciding whether to change from a plurality voting standard, the initial consideration is whether to implement a modified plurality structure or full-fledged majority voting. A modified plurality system continues to use plurality voting, so that the candidates receiving the highest number of votes are elected. However, the modified plurality system appends to the standard plurality voting a “director resignation policy,” specifying that if an elected candidate does not receive a majority vote he or she is obligated to submit a resignation, which the board can or must act on within a specified period of time. Under this scheme, the candidate, whether an incumbent or a new nominee, is legally elected as a director and the holdover rule of state corporate law (i.e., that a director serves until a successor is duly elected) is not implicated. Rather, the teeth of the scheme is in its director resignation policy.

A full-fledged majority voting structure provides that directors are elected by majority vote. As a consequence, if an incumbent does not receive a majority vote, he or she is not elected...
to another term but continues to serve solely by reason of the holdover rule. A new nominee who fails to receive a majority likewise is not elected but obviously does not serve under the holdover rule. Rather the predecessor director continues to serve and if there is no predecessor (or the predecessor resigns), there is simply a vacancy on the board. Because of the holdover rule, companies implementing a full-fledged majority vote system typically add a director resignation policy, like those used to implement modified plurality voting, to cope with the inappropriate effect of the holdover rule.

As a practical matter, the director resignation policy operates to minimize differences between the two systems. In the case of incumbent director nominees, both systems rely on a director resignation policy to deal with a so-called “failed election,” where the incumbent nominee fails to receive a majority vote but is elected either by virtue of plurality voting or holds over as a director until his successor is duly elected. Likewise, in the case of a new (rather than incumbent) nominee, the director resignation policy would be applicable to the new nominee who is elected by a plurality vote under a modified plurality system, and is frequently made applicable to the holdover incumbent under a full-fledged majority system.

In other words, in all cases under a modified plurality system and most, if not all, cases under full-fledged majority voting, the consequence of a failed election (that is, an election in which a candidate did not receive a majority of votes cast) is that the board is faced with the decision whether to replace the nominee by accepting her resignation or for her to continue in office notwithstanding the lack of a majority vote.

**Current State of Play**

Because the issue of majority voting has been driven by activist institutional investors, a decision between the two prevailing systems presumably should take into account prevailing investor views as to which system is preferable. Unfortunately for a board seeking answers, the institutional investor community has not clearly settled on a single paradigm.

Most activist institutional investors feel strongly that full-fledged majority voting is superior as a matter of corporate governance, and modified plurality voting is not an acceptable substitute. This conclusion is typically premised on the belief that full-fledged majority voting, because of its stronger “legal” effect (failure to achieve a majority means the director has *not* been elected) and consequently its stronger moral effect, will result in greater accountability of directors and the board as a whole to shareholders.

Through its proxy voting guidelines, ISS has reached the same conclusion regarding the superiority of full-fledged majority voting, with the consequence that it ordinarily will recommend the support a full-fledged majority voting proposal, even if the company has previously adopted a modified plurality standard. In addition, the SEC Staff, through its no-action letter process, has accepted the proposition that the two systems are not functional equivalents and will not allow a company to exclude a majority voting proposal on the grounds that its adoption of a modified plurality system is substantially the same under Rule 14a-8, the shareholder proposal rule. This means that a company cannot foreclose shareholder proposals—and a public debate through the annual meeting proxy process—merely by adopting a modified plurality policy.

On the other hand, it is not clear yet that there is a broader consensus among investors in favor of full-fledged majority voting. Several high profile shareholder proposals to install full-fledged majority voting in lieu of company adopted modified plurality systems have failed to achieve a majority vote. Because at this early stage in the 2006 proxy season the die is not yet cast, and proponents of modified plurality voting can hold out hope that it may prove to be an acceptable majority voting standard among the wider investor community.

Assuming investor sentiment continues to be mixed for the balance of the 2006 proxy season, it will leave boards which prefer a modified plurality system in something of a quandary. On the one hand, they can follow their convictions and implement modified plurality voting with the knowledge that the investor community is currently divided on the issue and their company may well prevail if activist shareholders choose to challenge their modified plurality policy in forthcoming proxy seasons. On the other hand, they need to recognize the probability that this policy dispute is not
likely to go away, and they may face continuing challenges to their modified plurality choice for years to come.

**Timing for Implementation of Majority Voting**

The issues surrounding whether—and when—a board should implement majority voting are no simpler than, and in many ways linked to, the issues the board faces in terms of choosing a majority vote system.

First, of course, why do anything? Decision making for the 2006 proxy season is over for companies with calendar fiscal years and fiscal years ending in the first quarter; only those companies with fiscal year-ends later in the year are facing decisions for this proxy season. There is much to be said for a “wait and see” approach. The outcome of the 2006 proxy season should shed light on a number of issues, including:

- Whether proponents of majority vote proposals can muster consistent majority support at companies that have not voluntarily acted.
- Whether proponents of full-fledged majority vote proposals can muster consistent majority support at companies that have adopted modified plurality systems.
- Whether there are other significant ancillary issues (such as implementation through by-laws or board policies) for which an investor consensus emerges.

Recently, the ABA Committee on Corporation Laws issued a proposal that recommends amending the Model Business Corporation Act to permit companies to adopt modified plurality voting, but not full-fledged majority voting, through by-law rather than charter amendment. The Committee also is dealing with other aspects of implementation. Assuming the Committee’s recommendations are adopted following a comment period this Spring, its support for modified plurality voting and its views on other implementation issues may impact investor views and affect the debate over what is the appropriate majority vote system.

More fundamentally, boards may reasonably conclude that plurality voting is—on balance—better for companies and their shareholders than either majority vote systems and may conclude that, unless forced by circumstances beyond their control, inaction is preferable to unwanted and perhaps premature action.

These considerations lead to the conclusion that boards that have not yet acted should wait at least until the Fall of 2006 to consider whether to act. While all of the issues undoubtedly will not be resolved by then, hopefully there will be some additional clarity concerning investor sentiment and the overarching policy debate.

**Defining a “Majority”**

Although seeming self evident, there are several important issues subsumed in the concept of a “majority.” First, a majority of what—all outstanding shares, all shares present at the meeting or all shares voting in the election?

While a number of companies have used all outstanding shares as the denominator, they are in a distinct minority. This is, of course, the hardest majority to obtain and the standard most likely to lead to a failed election. Nor does it have any obvious connection to ordinary concepts of democratic voting, which in most, if not all, manifestations is measured against the actual, not theoretical, voting base. In short, there is nothing obvious to commend this formulation.

Some state laws (Delaware, for example) measure the concept of majority in terms of shares present and eligible to vote at the meeting; not shares actually voting on a proposal. The Delaware formulation has the effect of treating abstentions and failures to vote for any reason as having the same effect as “against” or “withheld” votes. To the extent this formulation is not mandated by statute (and in Delaware, it is not required for director election votes), it seems to be less desirable and arguably less “democratic,” than the third possible standard of a majority of votes cast in the election, which ignores abstentions and failures to vote.

A majority of “for” and “against” votes (or votes cast), in fact, has been the most common formulation of a “majority” for purposes of both a modified plurality and a full-fledged majority vote system. It is the standard we recommend absent state law limitations.
A related, albeit technical, question is what votes should be cast under both a modified plurality system and a full-fledged majority system. The choice under both systems is whether to retain a “withhold” vote or substitute a more natural “against” vote. Assuming no state law issues, switching to an “against” vote seems far better because it eliminates the ambiguity of the “withhold” terminology, which has a strong “abstention” connotation.

Moreover, under the SEC proxy rules, an “against” vote box is permissible for inclusion on a proxy card so long as it is permissible under state law. In addition, use of “for” and “against” vote choices will also mandate an “abstention” (rather than a “withhold” vote alternative) choice on the proxy card. Giving investors the choice to vote “for,” “against” or “abstain,” as well as to not vote, should produce far clearer indications of investor sentiment than the present “for” and “withhold” choices.

Certificate of Incorporation or By-Law or Board Policy?

Unlike the decision between modified plurality and full-fledged majority voting, which is principally one of governance policy, the issue of where to house the voting system is more technical and tactical in nature?

For example, companies wishing to change from plurality to full fledged majority voting must start with state law. In Delaware and many other states, the method of electing directors may be set forth in the by-laws. In these jurisdictions, unless a company’s charter specifies that directors are elected by plurality voting, the change to a majority vote standard may be made by a board adopted by-law. Although, the change could also be implemented by charter amendment, there seems little point in going through the more cumbersome charter amendment process, unless, as noted below, the board wishes to make it more difficult to allow subsequent amendments to the charter provision (compared to a comparable by-law provision).

On the other hand, the Model Business Corporation Act and many state corporate laws specify that the method for electing directors must be set forth in the certificate of incorporation, in which case a charter amendment will be required to implement majority voting. Finally, there are a few states that mandate a voting system for directors, such as majority voting, cumulative voting, or plurality voting. Companies incorporated in these states will need to follow their state’s mandated standard and hope for the state legislature to change the law to allow for a choice.

The interplay of the holdover rule and director resignation policies is likewise a combination of state law and board choice. Every state has a statutory holdover rule, which is not subject to variation by charter or by-law. However, in the wake of the activist institutional campaign to foster majority voting, at least one state has legislation pending that would alter the director holdover rule to provide that an incumbent who did not receive a majority would be required to resign within 90 days of the failed election.

Moreover, the ABA Committee on Corporation Laws has issued a report proposing amendment of the Model Business Corporation Act to permit companies to amend their certificate of incorporation to modify the holdover rule to provide for no or only a limited term in office following a failed election. Given the often confusing interplay between state corporation law and the company’s existing charter and by-laws, as well the variations in state corporation laws, there is no simple one-size-fits-all analysis.

There are, however, several key issues that should be addressed by companies wishing to modify their existing director election standard. First, a decision to implement full-fledged majority voting cannot be made by board policy. It must be embedded in a by-law or certificate of incorporation, depending on the jurisdiction. Second, where companies are able to choose between a charter amendment, by-law amendment, or board policy (for example, adoption of a director resignation policy to deal with holdover issues or modification of plurality voting to implement a modified plurality system), the key distinctions are the method of adoption and the method of future change.

As a general matter, a board policy is not subject to shareholder approval nor is it considered “binding.” As a result, a board policy is subject to amendment or deletion by the board at any time. For this reason, a board policy is the most flexible vehicle for change. By the same token, however, it is most subject to criticism on these very grounds.
This is the principal reason that some activist institutional shareholders have begun agitating against director resignation policies in favor of more “formal” by-laws.

Under most state laws, by-laws may be adopted either by the board or by shareholders. Board adopted by-laws usually can be amended or repealed by the board without shareholder approval. Thus, as a pure legal matter, a board adopted by-law may be altered by a board just as easily as a board policy. However, the more formal nature of a by-law means that it will probably be psychologically, if not legally, more challenging for a board to change it.

Under some state laws (including Delaware), a shareholder adopted by-law may also be amended or repealed by a board without shareholder approval unless the by-law specifically provides that it may only be amended by shareholders. For obvious reasons, however, the optics of a board invoking its power to amend a shareholder adopted by-law make such an exercise of board power rare. Moreover, board amendment of a shareholder adopted by-law would not be permissible in a number of states, and the ABA Committee on Corporation Laws has proposed this concept for shareholder (as opposed to board) adopted by-law implementing modified plurality voting.

Consequently, activist institutional shareholders do have potential leverage if they are dissatisfied with the company’s implementation of majority voting or if they wish to overrule a company’s choice of a modified plurality system. In either case, they can propose a by-law for shareholder approval that will overrule the board adopted program. Moreover, shareholder approved by-laws can provide that they are subject to amendment only by shareholders in states where that is not already a statutory rule. These considerations may provoke activist shareholders to seek shareholder approval of by-law amendments to create majority voting regimes that are not subject to further board modification.

The only practical antidote to the shareholders’ ability to impose, or overrule a board adopted, majority vote system is to embed the board’s majority vote system in a charter amendment. Utilization of a charter amendment for implementation of majority voting is the hardest to accomplish and the hardest to change. Unlike by-laws, which can typically be amended unilaterally either by the board or by shareholders, a charter amendment requires two steps in a prescribed order. First, the board must propose a charter amendment and then the shareholders must approve it. Neither body has the legal right to compel the other to act.

For this reason, a charter amendment is the most permanent form of implementation for a director election system. This very feature, of course, is both its benefit and its curse. A company would have to be quite sure of its governance policy and of its ability to achieve a favorable shareholder vote before deciding to go the charter route (unless it was forced to do so by its corporate statute or its existing charter).

**Dealing with the Holdover Rule—Director Resignation Policies**

Like so many other issues in the majority vote debate, the method of dealing with the holdover rule and the structure of the corresponding director resignation policy involve a number of difficult policy and practical decisions.

The overriding issue is whether a board should have the ability to allow a director to stay in office in the face of failure to achieve a majority vote and, if so, under what circumstances. This is probably the single most difficult question in the entire debate. It involves judgments about whether—and why—shareholders might use their new found majority voting power to “defeat” a candidate who is not the subject of an election contest, as well as concerns about governance crises that could result from such votes, such as the loss of the requisite number of independent directors necessary to meet SEC or exchange listing standards. As a result of the complexity of these governance issues, there are no easy answers.

To date, the prevailing solution has been to leave the decision to the board. That is to say, both in a modified plurality structure and in full-fledged majority voting, the board is given the discretion to decline the resignation from an incumbent nominee who has failed to receive a majority vote or, in the case of a new nominee under majority voting, to appoint the subject of the failed election to the vacancy on the board created by the failed
The distinction between accepting or rejecting a resignation and filling a vacancy has been further blurred under the ABA Committee on Corporation Law’s proposal to amend the Model Business Corporation Act which provides that under a modified plurality system, the resignation of the “failed” candidate is binding (i.e., not subject to rejection by the board) and the board can only act by filling the vacancy created by the resignation either with the “failed” candidate or another qualified candidate.

It remains to be seen whether the activist investor community will continue to accede to the board having such broad discretion. It is not farfetched to worry that a consensus will emerge among activists that “defeated” candidates cannot continue in office, at least where there is no crisis, such as a failure to meet SRO listing standards.

A hidden issue in the paradigm of giving the board the responsibility of dealing with a failed election is the process and standards which should govern the board’s discharge of its responsibility. ISS, for one, has suggested minimum procedural standards. These include:

- **A clear, reasonable timetable for making the determination.** 90 days is fast becoming the universal norm. However, it may be dangerous to make 90 days an absolute deadline, at least in cases where the failed election relates to all (or most) directors on a board. It is one thing for a board to deal with the consequence of one or two failed elections in a 90 day period, and another if the acceptance of resignations from all those who failed election will decimate the board or leave no continuing directors. To address this issue, a company implementing a majority voting structure should consider providing for up to a 90-day extension to allow the board to cope with extreme situations. An alternative would be to build into the director resignation policy, either as a required or permissive solution, that the three independent directors receiving the highest vote totals (whether or not a majority of the votes cast) should remain on the board for an additional term in order to preserve continuity, institutional memory, and coherence.

- **A process for determining the “failed” nominee’s status that is managed by independent directors**

This standard seems fair and easily achieved, except that it does not deal with a widespread failed election that leaves no independent directors on the board or so few as to raise the question of the desirability of having only one or two directors deciding the fate of the vast majority of the board. A possible solution would be to allow failed independent nominees to participate in decisions with regard to other failed nominees, but not the decision as to their own fate. Although the specter of blatant or subtle “back-scratching” makes this alternative seem no better, and perhaps worse, than leaving the fate of the board in the hands of only one or two directors, it has the commanding advantage that it is the only practicable course if all independent nominees fail to be elected.

- **Prompt disclosure via an SEC filing of the final decisions on new directors.** This procedural principle seems unobjectionable.

- **Specifying remedies or factors that will be considered by the board.** So long as the list of remedies available for a failed election or the factors to be considered by the board in making a determination as to remedy are not exclusive, elucidation may be helpful to the directors in their deliberations and give comfort to investors as to the types of considerations the board will take into account. However, exclusive lists should be avoided because of their lack of flexibility, especially in the context of unforeseen circumstances.

- **A full explanation of how the board’s decision was reached.** This is, perhaps, the most dangerous of ISS’ recommended minimum procedures. For example, if a resignation is not accepted, how can and why should the board explain it is because the director has better leadership qualities or is smarter and more astute than other directors, or is one of the few directors who will stand up to the CEO? Even a summary explanation, let alone a full one, is rife with obvious difficulties and problems. Absent compulsion, a board should not adopt this ISS recommended disclosure standard.

For companies with classified boards, another potentially important aspect of a director resignation policy is whether the term of a successor director appointed by the board to fill a vacancy
created by acceptance of a “failed” nominee’s resignation should extend until the next annual meeting or for three years to maintain the staggered board election cycle. The former seems more in keeping with notions of shareholder democracy and director accountability, but could raise important change of control issues, particularly if more than one nominee in the class fails to receive a majority and is replaced by the board. Absent a three year term for the directors appointed by the board to fill the vacancies, the company could become subject to a change in a majority of directors at its next annual meeting, creating the very opportunity for a potential hostile bidder that the classified board was intended to prevent.

Finally, a board adopting a director resignation policy should make sure that implementation of the policy through resignation and appointment of new directors, even as to a majority of sitting board members, does not inadvertently trigger any change of control provisions applicable to the company, whether in loan agreements, severance contracts, joint venture agreements, regulatory licenses or the like.

Contested Elections

One issue on which nearly all participants in the majority election debate agree is that plurality, not majority, voting should govern election contests. The reason is that with “for” and “against” votes possible for each candidate under both a majority vote and a modified plurality vote system, the possibility of shareholders voting against disfavored candidates—rather than for favored candidates—raises the specter that some election contests will result in few or no candidates receiving the requisite majority vote. But a consensus on this point doesn’t make implementation simple.

First, there is the question of how to define a contested election. Most commentators have settled on the principle that plurality voting should apply to any election in which there are more candidates than seats to be filled. This definition conveniently deals with election contests where some, as well as all, seats are contested for both classified and unclassified boards. Although some commentators have raised the specter of management manipulating this standard by nominating an “extra” candidate to avoid application of majority voting, the obvious manipulative effects of such a tactic, as well as the relatively simple drafting that could be employed to prevent it, suggest that it is not a valid objection to the proffered definition.

However, there remains the issue of an election that starts as contested, but ends as uncontested—or that starts as uncontested or one that starts as uncontested and ends as contested. For example, if a company’s proxy statement specifies that a plurality voting standard applies (because there are more candidates than seats): does plurality voting continue to govern if the contest is dropped, or does a new proxy statement implementing majority voting have to be delivered when the contest ends, even if that means as a legal or practical matter that the meeting must be postponed? To date very few majority or modified plurality systems have tried to grapple with these very real issues. Of the possible solutions, none of which is perfect, two emerge as the most practical.

First, is to have the voting system reflect reality, so that plurality voting only applies if at the actual time of election there are more candidates than seats. This solution implies that a new proxy statement or proxy supplement will have to be circulated when an election contest ends and if the belated nature of the change results in a new meeting date, so be it.

The converse situation, where at the time of mailing there were no contested seats but a contest emerges prior to the meeting, could be dealt with in the same manner. Far better, however, would be for companies to avoid this theoretical problem through adoption of an advance notice by-law (for companies that don’t already have one) or coordination of the proxy mailing with an existing advance notice by-law (for companies that do have one). In either case, the advance notice by-law should preclude the possibility of a proxy contest commencing after the initial distribution of the proxy material.

A second possible solution would be to have the voting system reflect the reality up to some predetermined date prior to the meeting, at which point the voting system would be frozen so that the meeting would not have to be adjourned or postponed. Because advance notice by-laws should eliminate the theoretical problem of an uncontested election becoming contested after the initial proxy mailing, the “freeze and hold” solution would only apply to
settlements of election contests at the end of the proxy solicitation period. In such circumstances, where by hypothesis the proponents of the contest have withdrawn, a plurality rather than a majority vote does not seem to be deviate much from a more general majority election standard. While not as conceptually pure as the first alternative, the second solution does seem to be a more practical alternative to costly resolicitations and postponed annual meetings.

Conclusion

As of the writing of this article, there are as many, if not more, questions about implementation of a majority vote system (modified plurality or full fledged majority) as there are clear-cut answers. Over time, many of these issues will be sorted out by companies and investors. Prevailing standards and best practices will emerge. In the meantime, boards and their legal advisors will have to grapple with the intricacies and difficulties of implementation making the choices they think best for the company and its constituencies.

Notes

1. For example, California law does not recognize “against” and “withheld” votes and hence, they do not have any legal effect.