

## Majority Voting For Directors: The Latest Corporate Governance Initiative

### Highlights

- Majority voting for directors will be one of the “hottest” corporate governance initiatives in the 2006 proxy season.
- Implementation of majority voting raises a number of fundamental governance questions dealing with whether, when and how a “failed election” should be resolved.
- As difficult as these questions may be, the activist investor push for majority voting has left the proverbial “station,” and activist investors are not waiting for a consensus on implementation details.
- Boards are being forced to decide whether to fight majority voting shareholder proposals or to adopt either modified, and arguably less radical versions, of majority voting or full-fledged majority voting for directors.
- Many boards have or will adopt a modified version of majority voting to remove the issue as a “flash point” for activist investors. Such a compromise, however, may actually enhance the attractiveness of withhold vote campaigns as a “safe” means to register investor dissatisfaction with a company’s board.
- Other companies may choose to adopt full-fledged majority voting for directors. By creating binding legal significance for an “against” vote those companies will foreclose the governance issue.
- Adoption of majority voting may also deprive activist institutional investors of the relatively effective withhold vote campaign option they possess and implement frequently today and as a practical matter limit activists’ effective protest campaigns against boards and CEO’s to the universally disfavored option of traditional proxy contests in which the activists need to put up a rival slate of directors.

The next battleground in the corporate governance wars between the activist institutional shareholder community and “Corporate America” has been defined. The activists are campaigning hard for companies to change the way in which directors are elected. They are demanding that companies abandon director election by plurality voting, which has been widely accepted in corporate America for many years, in favor of a majority voting regime.

### Background

A few years ago, the SEC undertook an extensive rule making process culminating in a proposal that, under certain circumstances, shareholders

### The Current Situation

With the demise of the direct access proposal, activist investors in 2005 began advocating shareholder proposals recommending that company boards adopt majority voting in place of plurality voting for the

owning 5% or more of a company's stock would have the right to use the company's proxy materials to campaign for their own director nominees running in opposition to board nominees. The so-called "direct access" rule proposal was born out of the corporate governance concerns following the celebrated frauds and corporate collapses in Enron, WorldCom, Adelphia and their progeny. Its articulated rationale was to instill "accountability" of directors by allowing shareholders to sponsor alternative candidates for companies that had suffered governance "lapses."

Needless to say, the SEC rule proposal was highly controversial. It was strongly supported by the entire activist investor community and most corporate governance academics and just as strongly opposed by many corporate governance lawyers and bar associations, as well as by numerous companies and business groups, such as the Business Roundtable and the U.S. Chamber of Commerce. The result was a deeply divided Commission which eventually shelved the proposal after several failed attempts to mediate the differences.

During the course of the debate, several commentators (most notably, Professor Joseph Grundfest, a former SEC Commissioner and a Stanford Law Professor, Ira Millstein, one of the best known corporate governance specialists at the private bar, and Norman Vesey, then Chief Justice of the Supreme Court of Delaware) urged majority voting as an alternative and better solution for advancing accountability of directors to shareholders.

election of directors. The "drumbeat" is growing louder for the 2006 proxy season, as illustrated by the following events.

- 55 majority voting shareholder proposals went to a vote during the 2005 proxy season, with an average 43% affirmative vote. This degree of success has created additional momentum for shareholder proposals for majority voting in the 2006 proxy season.<sup>(1)</sup>
- The Council of Institutional Investors embraced the majority vote initiative and at the end of the 2005 proxy season sent letters to the 1,500 largest U.S. public companies (by market capitalization) requesting that they voluntarily switch to majority voting.
- CalPERS, the largest single institutional investor in the U.S., adopted a multi-pronged plan earlier this year to advocate majority vote election procedures for corporate directors, including sponsoring majority voting proposals and pursuing changes of state laws to implement majority voting.
- Institutional Shareholder Services (ISS), by far the most influential and respected proxy advisory firm in the U.S., has issued a policy statement that it will support majority voting proposals during the 2006 proxy season.<sup>(2)</sup>
- The ABA committee charged with supervision of the Model Business Act has issued a White Paper on majority voting and solicited comment letters for evaluation.
- Activist shareholders from many different backgrounds are submitting proposals for majority voting for inclusion in companies' 2006 proxy materials. Moreover, many of the proposals are framed as binding by-law amendments installing majority voting, rather than as non-binding requests for board action, as was customary in 2005.<sup>(3)</sup> Given the overwhelming support of activist investors and ISS, we anticipate that majority voting proposals will attract even higher affirmative votes in 2006.

## The Policy Issues

The policy debate between majority and plurality voting is relatively simple on the conceptual level. Plurality voting has the significant advantage that no matter how shareholder ballots are cast, directors will be elected. Even if a director receives 1% of the votes cast, he or she will be elected assuming there is no opposition candidate. And where there is an opposition candidate, the candidate receiving the most votes wins, without regard to whether those votes constitute a majority of the votes at the meeting. In short, under a plurality voting regime, there cannot be a "failed" election. Moreover, plurality voting is the standard system for political elections and many of our Presidents, Congressmen and other elected officials would not have been elected under a

majority vote system.

But, the proponents of majority voting argue, plurality voting makes sense only in contested elections. Where only one candidate is running, it takes only a single affirmative vote to elect the candidate. When faced with the rebuttal that shareholders are free to run other candidates if they seek accountability, the activists retort that investors should not be forced to spend what they claim are the huge sums required to wage a full-fledged proxy contest. So, the activist investors reason, only majority voting can bring “true” accountability to the board room.

Whatever the merits of the debate, it's clear today that the activists are winning the battle for the shareholder vote. Companies opposing majority voting on the merits in their proxy materials will not get a meaningful hearing from any of the activists, nor from more traditional institutional investors, nor possibly even from retail holders. Companies just don't have “sound bites” that can effectively compete with the activist mantra of shareholder democracy and director accountability.

## Possible Courses Of Company Action

**The Traditional Company Approach.** Many companies confronting the majority voting movement will be tempted to adopt the same strategy companies have followed historically when confronted with activist shareholder corporate governance campaigns, such as dismantling the poison pill and declassifying the board of directors.

- First, do nothing if you are not the target of a shareholder proposal. After all, there is a practical limit to the number of proposals the activists can mount in any given year and it may be several years, if ever, before you receive a majority voting shareholder proposal.
- If you receive a non-binding majority vote proposal (in contrast to a binding by-law proposal), oppose it, and if it receives a majority vote let the board decide on the merits whether it wishes to retain plurality voting or switch to majority voting or a modified form of majority voting.
- On the other hand, if you receive a proposal to adopt a binding by-law amendment to establish majority voting, try your best to convince the SEC staff that it can properly be excluded under the SEC rules. While precedent suggests this tactic will not succeed in the majority of cases, some number of companies will try it this year and may be successful.<sup>(4)</sup>
- Include the binding by-law proposal in your proxy and ask your shareholders to reject it, even if the odds are strongly against defeating the proposal.

**Pre-emption with a Lesser “Evil.”** A number of companies are taking affirmative action to preempt an actual or possible majority vote proposal by voluntarily adopting what is sometimes called a “modified plurality” system.

- The most common formulation of a modified plurality system is a board policy (although it could also be cast in the form of a by-law amendment) that, while the traditional plurality vote regime governs director elections, nominees must agree in advance that if they do not receive a majority of the votes cast they will submit their resignation to the remainder of the board. The other directors, in turn, are directed to determine whether the nominee(s) not receiving a majority vote should remain as directors (typically within 90 days of the election) or whether their resignation will be accepted.
  - Under this policy the board would have the ability to take into account the perceived reasons for a nominee's failure to receive a majority vote and in “appropriate” circumstances disregard the lack of a majority vote by declining to accept the candidate's resignation.<sup>(5)</sup>
  - The modified plurality structure has several characteristics that make it less threatening than a full-fledged majority vote.
  - It doesn't necessarily lead to a “failed election” since, at least in theory, it allows the board to separate the “sheep” from the “wolves” and decline a resignation because of factors such as the “merits” of the opponents' reasons for rejecting a nominee or the nominee's historic or potential contributions to board knowledge, balance and expertise.
  - It also doesn't create confusion if there is an actual or threatened election contest, which under a majority vote regime would require switching to plurality voting if a contest arises and
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back to majority voting if the contest is abandoned.

- These and other similar considerations have led a number of companies to voluntarily embrace a modified plurality system, including Disney, Pfizer, General Electric, Safeway, Office Depot, Circuit City, Automatic Data Processing, US Bancorp and Best Buy.
- An additional benefit of acting voluntarily, particularly in advance of receipt of a shareholder proposal for majority voting, by implementing a modified plurality policy is that it may discourage activist shareholders from submitting a majority voting proposal and allows the company to seize the corporate governance “high ground.”

There are, however, a number of potential negative considerations in implementing a modified plurality structure.

- A board will be faced with an exquisitely difficult decision if one of its nominees fails to receive the required majority. No matter how important the nominee is perceived to be to a well functioning board and/or how flimsy the perceived reasons for voting the nominee down, it will be a brave board, indeed, that ignores the failed majority vote and continues the director in office. The situation will be exacerbated if the nominee is the CEO or another member of management or if multiple nominees fail to receive a majority.<sup>(6)</sup>
- Under a modified plurality voting system, the failure to obtain a majority of votes will not have a direct legal effect. The decision of dealing with a nominee who does not receive a majority vote will be the board's. This lack of direct impact may make it easier for shareholders to cast a withhold vote than would be the case if the vote had direct legal consequences.
- Finally, it is not clear that voluntary adoption of a modified plurality vote policy will foreclose activist investors from launching shareholder proposals for strict majority voting. Under the SEC proxy rules, companies are allowed to exclude shareholder proposals if they have been substantially implemented by the company.<sup>(7)</sup> However, the parameters of substantial implementation are far from clear. It is not far fetched to worry that the SEC will conclude that the differences between modified plurality and majority voting are sufficiently significant that adoption of the former is not substantial implementation of the latter.<sup>(8)</sup>

**Adoption of Majority Voting.** The arguable weaknesses of modified plurality voting obviously lead to a third possible response — voluntary adoption of a majority voting regime.

- Adoption of majority voting obviously forecloses any continuing debate by activist investors about the inadequacies of a modified plurality system.
- It likewise ensures the company's ability to exclude shareholder proposals for a majority vote regime borne out of ignorance, stubbornness or quarrels about the details of coping with “failed” elections, such as how the board seat should be filled.
- On the other hand, adoption of majority voting raises squarely the possibility of a failure by one or several directors to get a majority, or in worst case scenarios, the entire slate of directors. Another example in the obvious parade of horrors would be a Chairman and CEO who failed to be re-elected.
- The very fact that an “against” vote in a majority vote scheme has direct legal significance — that there is true moral hazard in the vote — may make institutions think long and hard before supporting an “against” vote campaign against a nominee except in the most egregious situations. It is one thing to cast a symbolic vote expressing dissatisfaction with nominees or the board as a whole, it is quite another actually to throw directors or the CEO out of office.
- For example, a withhold campaign based on an audit committee's willingness to approve otherwise permissible non-audit services by the auditor is an interesting but essentially harmless expression of a corporate governance point of view. Similarly, a withhold vote campaign against members of the compensation committee because of “excessive” perks, or too generous stock option grants or the like, is essentially a “no harm, no foul” process. The withhold vote process allows institutions (and ISS) to express a view on auditor services, executive compensation and other governance issues in a safe way that does not affect the company's fundamental governance structure. It is much harder (and some close observers of the institutional voting process would say impossible) to see a significant “against” vote where the institutional investors are not merely sending a message, but directly impacting the

board room.

## Conclusion

We do not recommend that companies faced with a majority voting proposal, binding or non-binding, adopt the traditional approach of trying to defeat the proposal. The odds are too far stacked in favor of the activists, and any victory is likely to be short-lived as the proposal will almost certainly be re-introduced every year until it prevails. Moreover, fighting the proposal will be a negative in the company's "corporate governance rating" and may well lead to a new or re-invigorated withhold vote campaign.

Instead, we recommend that companies faced with a majority voting proposal try to seize the corporate governance "high ground" by either adopting a modified plurality voting policy or a full-fledged majority voting regime.

The situation for companies that have not yet received a majority voting proposal for the 2006 proxy season is somewhat more complicated.

- For companies opting for a modified plurality policy, there is an obvious advantage to acting before a shareholder proposal is received. Not only can the company take credit for embracing "good" corporate governance, but also being pro-active may deter a shareholder proposal and thus fully diffuse the issue.
- On the other hand, there can be no certainty that adoption of a modified plurality standard will avoid a shareholder proposal, and at least some activists have announced they are not satisfied with modified plurality policies. Moreover, it is still uncertain whether the SEC will rule that adoption of a modified plurality policy is substantial implementation allowing a majority vote proposal to be excluded from the company's proxy statement. Additionally, ISS has reserved the right to support a majority voting proposal at companies which have adopted a modified plurality stance for reasons relating to the company's past corporate governance history.
- As a result of considerations such as these, many companies have decided to defer action pending clarification of the issues so that they do not have to address their response to the majority voting campaign until the legal and practical situation becomes clear.
- There is also the other choice: adoption of majority voting in advance of a shareholder proposal. While not without its risks (principally the lack of recourse from a successful against vote campaign), it does have a number of merits, including foreclosing the issue once and for all.

### Endnotes:

- (1) See Georgeson Shareholder, *2005 Annual Corporate Governance Review* (available at [http://www.georgesonshareholder.com/pdf/2005\\_corpgov.pdf](http://www.georgesonshareholder.com/pdf/2005_corpgov.pdf)), Fig. 8, page 16.
- (2) See generally The ISS Institute for Corporate Governance, *ISS U.S. Corporate Governance Policy 2006 updates at 3* (2005); The ISS Institute for Corporate Governance, *Majority Voting in Director Elections: From the Symbolic to the Democratic* (2005); The ISS 2005 Postseason Report, *Corporate Governance at a Crossroads* at 9-12 (2005) and Letter from Stephen Deane on behalf of ISS to The Honorable E. Norman Veasey, Chair, The Committee on Corporate Laws regarding the *Discussion Paper on Voting by Shareholders for the Election of Directors* produced by the Committee on Corporate Laws of the Section of the Business Law of the American Bar Association, August 15, 2005.
- (3) Compare Section 7.28(a) of the Revised Model Business Corporation Act, which requires that companies set forth the voting standard for directors in the charter, with Section 2.16(1) of the Delaware General Corporation Law, which provides that the voting standard be set forth either in the by-laws or articles of incorporation. Because most Delaware corporations have dealt with voting standards in the by-laws, the voting standard can be changed through a by-law amendment which is within the powers of shareholders.
- (4) Last season the SEC Staff denied no-action relief in respect of a number of challenges to the inclusion under Rule 14a-8 of non-binding (commonly called "precatory") proposals calling for adoption of majority voting in the election of directors. See, e.g., American International Group Inc., SEC No-Action Letter (March 14, 2005); Delta Air Lines Inc., SEC No-Action Letter (February 22, 2005) and Citigroup Inc., SEC No-Action Letter



(February 14, 2005). In the Staff's view, such proposals were not excludable under Rule 14a-8(c)(8) as "related to an election for membership on the company's board of directors." The Staff's no-action positions seem to have been based on the view that a proposal to change director election requirements would not directly lead to contested elections. The Staff also took the position that the precatory proposals were not sufficiently vague to be materially misleading so as to permit exclusions under subsection (c)(3) of the Rule. Whether shareholder proposals to amend bylaws would be decided similarly remains to be seen, particularly as to the vagueness of a mandatory proposal which does not deal with the "failed election" issues and other practical problems such as a failure to have the requisite minimum number of independent directors required by the NYSE or NASD rules, as a result of "failed" elections under a majority vote regime.

- (5) Cf. ISS U.S. Corporate Governance Policy 2006 Updates at 3-4 (ISS will support policies for majority voting that articulate the following elements to adequately address each director nominee who fails to receive an affirmative of majority votes cast in an election: established guidelines disclosed annually in the proxy statement concerning the process to follow for nominees who receive majority withhold votes; a clear and reasonable timetable for all decision-making regarding the nominee's status; specification that the process of determining the nominee's status will be managed by independent directors and must exclude the nominee in question; an outline of a range of remedies that can be considered concerning the nominee (e.g. acceptance of the resignation, maintaining the director but curing the underlying causes of the withheld votes, etc.); and prompt disclosure of the decision on the nominees' status in an SEC filing). In October of this year, Pfizer Inc.'s Board of Directors approved amendments to its majority voting policy adopted earlier in the year, to include procedural specifications surrounding the voting policy. These amendments specify that: the board will act on a director's offer to resign within 90 days following certification of the shareholder vote; the board will promptly disclose via a press release its decision to accept the resignation offer, or if applicable the reason(s) for rejecting the offer; the majority voting policy will be limited to uncontested director elections; and any director who tenders his or her resignation shall not participate in any consideration by the board of the resignation offer.
- (6) Also, the NYSE recently convened a committee to review the viability of the so-called broker-vote rule which, if eliminated, could have a significant impact on the outcome of elections under a modified plurality voting system by lowering the number of votes for election of director nominees. Rule 452 of the NYSE currently authorizes brokers to vote shares held in street name in a non-contested election if the broker does not receive voting instructions from the beneficial owner of the stock within a specified period before the shareholder meeting. In the past, these broker votes have generally been cast in support of the board's director nominees.
- (7) Companies soliciting a vote on a modified plurality system in their 2006 proxy when a shareholder has proposed a full-fledged majority vote standard should assert a "direct conflict" exclusion under Rule 14a-8(c)(9) or substantially duplicative exclusion under (c)(11).
- (8) A number of added uncertainties that affect the design and implementation of modified plurality voting further complicate the analysis. For example, there is no guarantee that the modified plurality proposal will result in ISS opposing a full-fledged majority voting standard, particularly if the company has a history of ignoring corporate governance reforms and/or non-binding resolutions that have received majority shareholder support. Furthermore, if broker voting is eliminated, it is possible that retail investors will support majority voting because it sounds good.

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