‘Pay Wars’ Spark Majority Voting Firestorm
Executives and directors feel the heat from shareholders

Shareholder activists have long sought to make companies more socially responsible and environmentally friendly. But recently they’ve taken up a new cause: majority voting.

The reason? A lot of it has to do with executive compensation and the perception (of both investors and the public) that CEOs and Board members are in cahoots when it comes to crafting lavish pay packages for executives.

So they’re fighting back by looking for ways to hold directors more accountable – and that means wresting power away from the Board and putting it in the hands of shareholders via the ability to oust “tainted” directors (or keep them off the Board in the first place) through majority voting.

A recent client commentary by global law firm Latham & Watkins notes that a number of companies (such as Pfizer, Disney and General Electric) have tried to nip majority voting initiatives in the bud by adopting “modified plurality” policies, also known as director resignation policies. These policies preserve plurality voting as the legally effective method for electing directors. But they also provide that if a director fails to receive a majority vote he or she will offer to resign, at which point the Board can decide whether to accept the resignation or take some other action appropriately responsive to the shareholder vote.

However, in the last 60 days or so the bulk of the activist investor community has reached a consensus that it’s not satisfied with director resignation policies and will pursue full-fledged majority voting proposals without regard to whether a company has a director resignation policy in place. Their rationale is that a modified plurality policy leaves plurality voting as the legally effective standard and relies on Board action to deal with nominees who fail to receive a majority vote.

Another thing to consider when weighing the pros and cons of majority voting is that its impact is muted by the existence of state corporate laws requiring that a director hold office until his or her successor is elected. This so-called “holdover” rule is required by statute in most states and cannot be altered in the bylaws. As a result, a majority vote bylaw doesn’t necessarily solve the problem of a “failed election” and is therefore an imperfect tool for achieving one of the key goals of its proponents: simple and direct accountability of directors to shareholders via the election process.

The Real Deal

An irony of the “holdover” rule is that it greatly diminishes the differences between a plurality system with a director resignation and a majority vote rule. The practical effect of adopting a majority vote system for Board elections isn’t very different from adopting a director resignation policy with plurality voting, because the failure of an incumbent nominee to achieve a majority vote under a majority vote bylaw doesn’t end his or her term as a director any more than failure to receive a majority vote does under plurality voting.
In both cases, unless there’s a director resignation policy the failed election won’t effect a change in the boardroom, although in both cases it will erode the legitimacy and credibility of the director and, indirectly, the Board. Given the relative similarity of outcomes under these competing election systems, there’s a legitimate question whether companies should devote political capital to fighting majority voting in favor of a director election policy.

In addition, a majority voting regime has legal consequences that aren’t present in a plurality vote system with a Board resignation policy. Even though the “moral hazard” of majority voting isn’t as strong as it would be if there was no holdover rule, there nonetheless is more psychological and legal consequence in majority voting than in a plurality system coupled with a director resignation policy. As a result, there seems to be a credible argument that adopting majority voting would make a company less vulnerable to campaigns to withhold votes and vote against candidates than would be the case under a director resignation policy.

“In this new, more complex governance environment, companies need to scrutinize their voting regime, weighing the pros and cons of alternate structures,” comments Nathan. “Companies can no longer avoid the debate – the stakes are high, but companies can effectively prepare for the change and claim the corporate governance high ground.”

What To Do

With these issues in mind, companies should consider the following courses of action:

For companies that have received a majority vote proposal for their 2006 annual meeting:

Rather than adopting or reaffirming a director resignation policy with the hope of gaining the support of Institutional Shareholder Services or other proxy analysts against a majority voting proposal, the Board should consider bowing to the inevitable and trying to make majority voting a company sponsored initiative. In doing so, the company could put forward its proposed solution to the issues created by the holdover rule (for example, a director resignation policy) and, to the extent feasible, take corporate governance credit for installing a more shareholder-responsive voting system.

An alternative would be for the company to propose that shareholders adopt a director resignation bylaw in conjunction with retention of plurality voting and to seek no action from the SEC for exclusion of the shareholder’s majority voting proposal as “directly conflicting” with the company’s proposed bylaw amendment. In doing so, the company needs to recognize that the grounds for exclusion of the shareholder majority vote proposal wouldn’t exist in future years, so this solution may only provide a temporary fix.

For companies that haven’t received a majority vote proposal for their 2006 annual meeting:

One obvious course of action would be to seize the high ground and propose majority voting, possibly together with a director resignation policy to deal with incumbents who fail to receive a majority and otherwise would continue to serve under the holdover rule. The rationale here is that the corporate governance contest over director election rules isn’t worth the tension and potential shareholder ill will it may generate, and that (as noted above) a majority voting regime may have the unintended consequence of reducing the company’s vulnerability to “symbolic” withhold votes and against vote campaigns.

The obvious alternative would be for the company to do nothing in 2006, keeping its proverbial powder dry until it actually receives a majority voting proposal. Some might question a “status quo” approach and consider implementing a director resignation policy. It seems clear, however, that a director resignation policy won’t deter a majority vote proposal, nor is it likely to serve as an effective defense against such a proposal.

The issue then becomes whether any purpose is served by a director resignation policy. While some Boards may feel that such a policy is better as a matter of corporate governance than a traditional unadorned plurality vote system, they should take into account that implementing such a policy this year may adversely affect the opportunity to propose a director resignation bylaw in future years as a means of avoiding a majority vote shareholder proposal.

The reasoning here is that proposing a bylaw for shareholder adoption a year or more after a Board has implemented a director resignation policy could easily be attacked in the SEC no-action process as a transparent expedient to create a technical conflict solely for the purpose of precluding a shareholder proposal.

Given the SEC’s strong policy in favor of permitting shareholder proposals and the immense interest of activist investors in promoting majority voting, the odds that the SEC would grant a no-action request under these circumstances are pretty slim.

Gathering Momentum

The events of the last month underline that majority voting is gathering momentum as a key corporate governance reform demanded by activist shareholders. However, absent a radical change in state law making majority voting the mandatory standard for director elections, majority voting can only be implemented on a company-by-company basis. As such, the movement will likely resemble successful activist investor campaigns against poison pill and classified board provisions.

Some companies have already been targeted for the 2006 proxy season, but most will escape the issue this year. Still, escape in 2006 will only postpone the inevitable. For this reason, it’s time for all companies to consider the best course of action to deal with a corporate governance issue that simply isn’t going away.