# Majority Board Election: Where Do We Stand?

**By Bryn R. Vaaler**

**The past several years have seen accelerating change in the ways corporations nominate and elect board members. While the SEC battles over rules to allow shareholder access to the proxy nomination ballot, a majority of large U.S. companies have made it easier for shareholders to vote out unwanted board members through majority voting reforms. What is the status of this revolution in progress?**

One of the hottest issues in U.S. corporate governance over the last several years has been majority election of directors. Those advising public companies on governance issues must have a firm grasp on the basics of majority election, and how it relates to other significant current developments that may change the way U.S. corporate directors are elected.

"Plurality" voting for directors has been, and continues to be, the prevailing legal rule throughout the United States. Nearly all state corporate statutes, including the Delaware General Corporation Law (DGCL), provide that, unless stated otherwise in a corporation's charter, nominees receiving the most votes, up to the full number of seats open, are elected, even if such nominees do not receive a majority of votes cast in their favor. Plurality voting is intended to ensure continuity of the board.

**If directors must be elected by a majority of shareholder votes cast, then withheld or negative votes will have real meaning.**

Shareholder activists maintain that plurality voting does not adequately permit shareholders to express disapproval. They argue that votes withheld have no real effect. In an uncontested election, each nominee in the board's slate will still be elected so long as he or she receives just one affirmative vote—even if a majority of votes is withheld. If directors must be elected by a majority of votes cast, then withheld or negative votes will have real meaning.

In 2003, the SEC proposed a new rule that would have given five percent shareholders of U.S. public companies the power to nominate their own director candidates in the company's proxy materials under certain circumstances. As it became clear that the SEC was not going to move forward with its 2003 "shareholder-access" proposal, activists turned their attention to majority election as a means of expressing their influence and giving shareholder disapproval real teeth.

In 2005, shareholder activists, led by the Council of Institutional Investors and labor union pension funds, began flooding larger public companies with letters and formal shareholder proposals requesting that boards amend their charters to implement a majority-voting regime for directors. In 2005, 54 formal shareholder proposals calling for majority election were voted on. They received an average of 44 percent of votes cast in favor (with 13 garnering majority favorable votes).

In June 2005, Pfizer Corporation announced that its board of directors had taken a different approach. Rather than adopt majority voting by charter amendment, Pfizer simply adopted a corporate governance principle requiring any nominee who receives more votes withheld than in favor to submit his or her resignation. Pfizer's board governance committee would then decide whether to accept the resignation.

The principle was later amended to apply only to uncontested elections. Further, the director in question could not participate in the decision on accepting the resignation. A decision had to be made within 90 days, and the reasons for the decision had to be published in a press release.

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In the face of increasing pressure from activists, dozens of other large public companies followed the Pfizer example and began adopting director-resignation governance principles.

Some shareholder activists, most notably the United Brotherhood of Carpenters and Joiners pension fund, maintained that Pfizer-type governance principles did not go far enough. They argued (among other things) that the principle did not really adopt majority voting, and that boards may choose not to accept the tendered resignations or may simply rescind the principle without consulting shareholders.

Nevertheless, in November 2005, Institutional Shareholder Services (now RiskMetrics Group) announced that it "generally supported" proposals calling for majority voting in uncontested elections. However, it would consider opposing such proposals in the future if a company had adopted formal governance principles offering a "meaningful alternative" along the lines of the Pfizer approach.

There was, however, no assurance that any particular policy would suffice. ISS has supported majority-election proposals since such announcement in nearly every case, whether or not the company had a Pfizer-type principle in place.

In January 2006, the SEC staff refused to let Hewlett-Packard and Gannett Co. omit majority-election bylaw proposals from their proxies. The companies had claimed that the proposals had been "substantially implemented" within the meaning of the exclusion in Exchange Act Rule 14a-8(i)(10) by previous adoption of Pfizer-type governance policies. The SEC staff disagreed.

As a result, Intel announced in January 2006 that it had adopted a new bylaw provision requiring election of directors by a majority of votes cast, except in contested elections. Under the Intel bylaw, a new director nominee (in an uncontested election) who fails to receive a majority of votes cast in his or her favor is not elected. An incumbent nominee who fails to get the required vote remains in place under the DGCL's so-called "holdover" rule, but must tender his or her resignation. Intel's governance committee must decide whether to accept or reject the resignation within 90 days.

The Intel bylaw rapidly became the gold standard for shareholder activists promoting the cause of majority election. This is because it actually adopts a majority-vote standard (instead of just a resignation policy). Also, it is part of the company's charter documents, and may be more difficult to change or eliminate without shareholder consent than a mere board-adopted governance principle.

**Activists have called on states to change their default corporate statutes from plurality to majority board voting, and make other changes to accommodate majority voting.**

A Delaware corporation, like Intel, may adopt a majority-election standard through a bylaw amendment, which may be approved by either the board or the shareholders. Most other state corporate statutes require that a change to the default plurality-voting rule be made in the articles of incorporation, not the bylaws. Here, adoption of an Intel-type bylaw is not an option, and corporations incorporated in those states would have to amend their articles (usually requiring both board and shareholder approval).

Activists have also called for states to change the default rule in their corporate statutes from plurality to majority, and make other changes to accommodate majority-voting bylaws and policies.

In response, the American Bar Association Committee on Corporate Laws, which is responsible for the Model Business Corporation Act (the basis for the corporate statute in more than half the states), studied the question. In 2006, it finalized amendments to the Model Act.

The amendments did not change the Model Act's plurality-vote default rule. They did, however, permit either the shareholders or the board to amend the bylaws to provide that, in uncontested elections, a director nominee receiving more votes withheld than in favor would generally serve no more than a 90-day transitional term. If adopted by shareholders, such a bylaw amendment may not be rescinded or modified by the board.

The Model Act amendments also confirm the va-

lidity of director resignations made conditional on a future event (such as failure to receive the favorable vote of a majority of those cast). They also permit opting out of the "holdover" rule by amendment to the articles of incorporation.

**Since 2006, Delaware, California, Virginia, Washington, Ohio and North Dakota have all reformed their board election laws.**

Delaware has also retained its plurality default rule. In 2006, however, the Delaware legislature amended the DGCL to provide that a shareholder-adopted bylaw requiring a greater vote for election of directors could not be rescinded or modified by the board and to affirm the validity of conditional director resignations.

In 2006 and 2007, California, Virginia and Washington adopted amendments to their corporate statutes retaining plurality default rules but allowing companies to adopt majority-election regimes through bylaw amendment under some conditions.

Ohio amended its corporate statute to permit companies to opt out of plurality voting by amendment to the articles of incorporation. This came after a Delaware re-incorporation shareholder proposal campaign directed at Ohio public companies by the Carpenters and the Sheet Metal Workers. North Dakota adopted a new Publicly Traded Corporations Act, which has a majority-election default in uncontested elections for corporations that do not have cumulative voting.

Other recent developments also promise to have an important impact on director elections and must be considered in conjunction with majority election.

☐ *Shareholder access.* In 2006, a Second Circuit Court of Appeals panel held that American International Group (AIG) could not omit a binding shareholder-access bylaw proposal submitted by the AFSCME pension fund under the Rule 14a-8(i)(8) exclusion for matters that "relate to an election." The court so ruled despite the SEC Staff's long-standing interpretation that such exclusion covers *both* proposals that would result in a contest in the immediate election *and* proposals that would set up a process for contested elections in the future.

In part as a response to this opinion, the SEC made two contradictory proposals in July 2007. The first proposal explained the staff's interpretation and clarified that the exclusion covers both proposals resulting in immediate election contests and those that would set up a process for contested elections in the future, in effect overturning *AFSCME v. AIG.* The second proposal would have instead amended Rule 14a-8(i)(8) to permit shareholders who hold five percent or more of a company's shares for a year to propose a binding shareholder-access bylaw in the company's proxy if certain additional disclosure requirements were met.

The SEC received over 34,000 comments on the proposals. Management commentary generally favored the proposal reversing *AFSCME v. AIG* and clairifying that shareholder-access proposals could be excluded. Comments from institutional investors and shareholder activists generally criticized the five-percent threshold and other limitations of the second proposal and encouraged the SEC to leave *AFSCME v. AIG* in place until a broader access rule could be devised.

On November 28, 2007, by a contentious 3-1 vote along party lines, the SEC adopted the proposal reversing *AFSCME v. AIG* and clarifying that shareholder-access proposals could be excluded under the 14a-8(i)(8) exception. Although Chairman Cox indicated he remained committed to considering development of a new rule affording greater shareholder access for director nominations in the near future, perhaps as early as for 2009, the 14a-8 amendment does not contain a "sunset" provision. For the 2008 proxy season, the issue of shareholder-access proposals under Rule 14a-8 appears to have been clarified. Where shareholder-access proposals go beyond 2008, however, is far from clear.

**A pending rule change would mean brokers could no longer routinely vote for management's slate. This could have a significant effect on director elections.**

☐ *Street-name voting.* In 2006, the New York Stock Exchange approved and submitted to the SEC an amendment to NYSE Rule 452. This rule governs discretionary voting by brokers of shares held in street names when owners have not instructed how such shares should be voted.

The amendment would make uncontested director elections (except those at registered investment companies) non-routine matters under the rule. Brokers could no longer vote in favor of management's slate without instruction from customers.

If approved by the SEC, this amendment could have a significant effect on director elections. "Vote no" or "withhold" campaigns would no longer be "diluted" by a block (often in excess of 20 percent of votes cast) of broker votes in favor of management's slate. Companies with majority-voting bylaws or policies may have to work much harder to ensure election of management's slate.

NYSE Rule 452 governs all brokers. Consequently, this proposed amendment would affect all public companies that have shares held in street name, not just NYSE-listed companies. In September 2007, the NYSE announced that the SEC intended to consider approval of the NYSE Rule 452 amendment "as part of a broad range of issues relating to shareholder communications and proxy access." If adopted, the amendment would not be effective for the 2008 proxy season.

☐ *E-proxies.* In December 2006, the SEC approved rules permitting public companies (and others soliciting proxies), beginning July 1, 2007, to satisfy their proxy information delivery requirements by posting materials on a public internet site (other than EDGAR) and sending a prescribed notice to shareholders at least 40 days before the meeting. Shareholders who wish to receive paper or e-mailed proxy materials may continue to do so by so informing the company or other soliciting party.

In June, the SEC adopted additional amendments to the proxy rules making internet posting of proxy materials mandatory. Under the mandatory e-proxy rules, public companies and other soliciting persons may comply with proxy delivery requirements by the notice-and-access method or may continue full-set delivery. The mandatory e-proxy rules go into effect for large accelerated filers (other than mutual funds) on January 1, 2008 and for all other public companies and soliciting persons on January 1, 2009.

The e-proxy rules are intended to cut the cost of proxy solicitations and make it more cost-effective for persons other than the company to launch solicitations. The rules permit dissident solicitations to avoid printing costs by sending materials only to those shareholders who have not previously asked for paper or e-mail delivery. It is, however, too early to tell whether the e-proxy rules will result in substantial cost savings, whether significant numbers of companies will elect notice-and-access solicitation and whether cost reductions will translate into more contested director elections.

**The number of majority-election proposals voted on dropped sharply from 2006 to 2007. More companies simply gave up and adopted the change to avoid a vote.**

Majority-election proposals have remained high on shareholder activist agendas through the 2006 and 2007 proxy seasons. Such proposals received average support of over 47 percent of votes cast in 2006 and over 50 percent in 2007 according to RiskMetrics Group.

Proponents have generally not refrained from making a proposal just because a company has a Pfizer-type governance principle in place, but shareholder support for such proposals has generally been lower at companies with such a policy. Faced with majority-election shareholder proposals, many companies have adopted Intel-type bylaws.

In fact, the total number of majority-election proposals put to a vote decreased sharply from 2006 to 2007, not because there were fewer proposals, but because more and more companies agreed to adopt provisions preemptively to head off a vote.

By August 2007, Claudia Allen of Neal Gerber & Eisenberg LLP reports, in her *Study of Majority Voting in Director Elections,* that over 60 percent of the S&P 500 companies had adopted some type of election

reform. More than a third of those companies have retained plurality voting, but adopted a Pfizer-type resignation policy. A little less than two-thirds have adopted actual majority voting through an Intel-type bylaw or an articles amendment.

In a sign that majority election is here to stay, prominent corporate law firms in Delaware and elsewhere have circulated recommended forms of majority-election policies and bylaws to their clients. This suggests that the question, at least for larger public companies, is more "when" than "whether."

Companies that have not already adopted a majority-election bylaw or policy should consider several points:

☐ *No reason to rush.* For companies that have not received a shareholder proposal and are not otherwise under pressure from activists to adopt a majority-election measure, there is no compelling reason to rush into doing so.

This is especially true given the uncertainties posed by the proposed amendment to NYSE Rule 452 and the lack of practical experience with the new e-proxy rules. As companies watch and wait to see how these developments play out, boards must be kept thoroughly advised on the majority-election options and their relationship to these other issues.

☐ *Plurality default rule.* It appears unlikely that many state legislatures will change the plurality default rule in their corporate statutes to a majority default rule. It remains to be seen how many states will follow the Model Act amendments or those recently adopted in California, Virginia and Washington permitting adoption of majority voting by bylaw amendment (as is already permitted in Delaware).

Until that happens, boards of companies incorporated in most states outside Delaware cannot adopt Intel-type bylaws, and will have to seek shareholder approval to amend the articles of incorporation in order to adopt majority voting or be satisfied with a Pfizer-type policy.

☐ *Work with activists.* Once approached by activists, a company may be much better off working with the proponent and adopting changes, rather than permitting the proposal (especially a binding bylaw proposal) to go to a vote. By acting preemptively, the company retains more control over the process and the actual wording. A bylaw proposal, once approved by shareholders, may be impossible to change without another shareholder vote.

☐ *Only uncontested elections.* Majority-voting requirements should apply only to uncontested elections. It is crucially important to have an appropriate advance notice requirement in place before a majority-election provision is adopted so the applicable voting regime can be determined well before the meeting.

The practical realities of majority voting may not be a significant departure from those of the plurality-voting past for most public companies. Successful "withhold" or "vote no" campaigns in uncontested elections will be rare, even if broker discretionary voting blocks disappear.

Yet the cumulative effect of majority voting, absence of broker discretionary voting, possible shareholder-access changes, lower-cost e-proxy solicitation and the next wave of reforms to emerge may have a more profound impact on how corporate directors are elected. It remains to be seen whether any of these reforms will advance the real business of our public corporations. ■

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