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CORPORATE GOVERNANCE ALERT

HOT TOPIC FOR 2006 PROXY SEASON: MAJORITY VOTING IN DIRECTOR ELECTIONS

Majority voting for directors has become a focus of institutional shareholders and is one of the hot issues for the 2006 proxy season. Since it became clear the Securities and Exchange Commission's (SEC's) 2003 proxy access proposal was stalled, which would have let investors with significant stakes in a company nominate candidates for a company's board of directors via the company's proxy statement, institutional shareholders have turned their attention to changing the current plurality voting standard, which is widely prevalent in the United States, to a majority voting standard in uncontested director elections.

PLURALITY AND MAJORITY VOTING STANDARDS COMPARED

Under the plurality voting standard, a director nominee who receives the greatest number of favorable votes wins an election even if the nominee receives less than a majority of all votes cast. With the plurality voting standard, shareholders cannot vote against a director nominee in an uncontested election. Shareholders may only vote for a nominee or withhold, which has only symbolic effect. As an extreme example, a nominee in an uncontested election could win the election with a single favorable vote. The benefit of plurality voting, however, is that it guarantees a full board of directors if there are at least as many nominees as open seats, and it avoids the problems associated with failed elections and the related issue of holdover directors. The plurality voting standard is the default rule under the Delaware General Corporation Law and the Model Business Corporation Act, which serves as a framework for corporate law in more than 30 states.

Under the majority voting standard, a nominee in an uncontested election must receive a majority of all votes cast or a majority of all eligible votes, depending on the particular standard adopted, to be elected to the board of directors. With the majority voting standard, a withhold vote and, under some variations, abstentions have significance. A very few U.S. public companies currently provide for director elections by majority vote in their charters or bylaws. A structural problem with majority voting relates to the implications of a failed election, in which one or more director seats are unfilled because the nominees for such seats do not receive a majority vote. To the extent that director nominees are not already in office, a failed election could result in a variety of unintended consequences, such as:

1. breaching, or triggering severance payments under, the employment agreement of a CEO or other senior executive

2. with respect to the failure to elect a specified percentage of directors, triggering a change of control under credit, lease or other agreement, resulting in consequences such as termination or acceleration of payments, or

3. adversely affecting the corporation's ability to comply with listing standards or other requirements for maintaining independent directors or directors with particular qualifications.

There is a different issue relating to incumbent director nominees who fail to win an election. Under the so-called holdover rule, losing incumbent director nominees continue as directors until replaced, unless such incumbent directors resign. Thus, implementing majority voting would have little effect without a change to the holdover rule. However, simply eliminating the holdover rule would result in the problems listed above.

Cumulative voting should be distinguished from plurality and majority voting. While plurality and majority voting relate to threshold requirements for winning director elections, cumulative voting relates to the number of votes a shareholder may cast in an election. With cumulative voting each share carries as many votes as there are vacancies to be filled, and a shareholder may distribute the votes for all such shares among the director nominees in any way desired. Cumulative voting is generally intended to promote minority shareholder influence, in that a majority shareholder or shareholder group is not assured of being able to fill every director seat with its own nominees. Certain proponents of the majority voting standard think there should be a carve-out — allowing plurality voting — for companies that have cumulative voting.

GROWING MOMENTUM FOR CHANGE

There is growing momentum, primarily driven by institutional investors, to cause public corporations to at least consider majority voting or a form thereof. Here is an overview of the current state of affairs:

- Nonbinding shareholder resolutions calling for majority elections appeared on the ballot in 60 elections for the 2005 proxy season, according to Institutional Shareholder Services. Support for such resolutions averaged 43 percent of votes cast and produced majority votes at 16 companies. In comparison, majority vote proposals appeared on the ballot in 12 elections for the 2004 proxy season, and support averaged 12 percent of votes cast. For the 2006 proxy season, investors have thus far filed more than 100 majority vote proposals.

- In 2005, the Council of Institutional Investors (CII), an association of more than 130 corporate, public and union pension funds, sent letters asking the 1,500 largest U.S. companies to voluntarily adopt a majority vote requirement for director elections. It has been reported that CII has received at least 130 responses, and that at least 24 companies have incorporated this policy into their bylaws.

- In 2005, the California Public Employees' Retirement System, the nation's largest public pension, said it will (i) seek to implement majority vote policies at individual companies through company bylaw and charter amendments and (ii) pursue changes to state laws to implement majority voting where feasible.

- A task force of the Committee on Corporate Laws (the Committee) of the Section of Business Law of the American Bar Association undertook a detailed analysis of possible changes to the Model Business Corporation Act (MBCA) relating to voting for directors. In January 2006 the Committee issued a preliminary report proposing amendments to the MBCA, under which directors would continue to be elected by plurality vote (unless a company's articles of incorporation otherwise provide), but permitting a company's board of directors or shareholders to opt into a form of majority voting through a bylaw amendment. Shareholders of companies that have adopted the bylaw amendment could vote for or against a director nominee (or abstain), and a nominee who is elected by a plurality but receives more against than for votes would serve for only a 90-day period following the election, unless earlier replaced by the board. Upon conclusion of the 90-day period, the board could elect a qualified replacement director or reduce its size. This voting process would apply in both contested and uncontested elections under the proposed amendments to the MBCA. The Committee also proposed amendments to facilitate adoption of voting policies in which a director nominee elected by a plurality vote who receives more withhold than for votes submits a resignation to the board. The Committee is seeking further comment on its proposed amendments to the MBCA.

- The Corporation Law Section of the Delaware State Bar Association has formed a committee to consider whether to propose amendments to the Delaware General Corporation Law with respect to the majority threshold election issue, according to *The New York Times*. The earliest a report is expected is April or May 2006.

- In 2005, 13 major companies agreed to form a working group with the United Brotherhood of Carpenters and Joiners (the Carpenters union) and three other building trades unions to examine how to implement majority elections. In exchange, the unions withdrew their resolutions at the companies calling for majority voting. The working group members have committed to issue a report before the 2006 proxy season that includes findings and outlines areas of agreement and disagreement.

- Institutional Shareholder Services (ISS), the most influential proxy advisory firm, issued an update to its core U.S. corporate governance policies for 2006 that supports majority voting and meaningful alternatives, as described below.

- The New York Stock Exchange (NYSE) has convened a committee to review the continued viability of NYSE Rule 452, the so-called "broker vote rule," which currently authorizes brokers to vote shares held in street name in an uncontested election if the broker does not receive voting instructions from the beneficial owner of the stock within a specified period before the shareholder meeting. Brokers have historically voted in favor of the board's director nominees. Elimination of the broker vote rule could have significant impact on the proportions of for and withhold votes.

ISS POSITION FOR 2006 ON MAJORITY VOTING

ISS advises institutional shareholders on how to vote their shares. Many institutional investors vote their proxies according to ISS' recommendations. Since 2005 ISS has almost uniformly recommended voting in favor of shareholder proposals calling for majority voting thresholds for director elections. Under its updated policy for 2006, ISS will consider recommending against a majority vote threshold proposal if the company has adopted and disclosed formal corporate governance principles that present a meaningful alternative to the majority voting standard containing the following elements:

1. a clear and reasonable timetable for all decision-making regarding the status of a director nominee elected by plurality vote who receives more withhold than for votes
2. a process for determining the nominee's status that is managed by the independent directors and that excludes the nominee in question
3. a limited range of remedies that can be considered concerning the nominee (for example, acceptance of resignation, maintaining the director but curing the underlying causes of the withhold votes, etc.)
4. prompt disclosure (via an SEC filing) of the final decision regarding the nominee's status and a full explanation of how the decision was reached.

In determining whether to recommend against a shareholder majority voting proposal, ISS will review the company's alternative policy, the corporate governance track record of the board and its justification for the alternative approach. ISS cautions that there is not a model one-size-fits-all alternative to a majority voting threshold. A policy that represents a meaningful alternative to majority voting for one company may not pass muster with respect to another company.

EMERGING TRENDS

Approximately three dozen companies, led by pharmaceutical company Pfizer Inc., have voluntarily implemented a form of majority voting, under which the corporate governance policies of such companies require that any director in an uncontested election elected by plurality vote who receives more withhold votes than for votes must tender his or her resignation to the board, which shall consider the resignation. Under the Pfizer approach, the board is required to act on a director's offer to resign within a fixed period of time, such as 90 days, following certification of the shareholder vote. The board is then required to promptly disclose via a press release its decision to accept the resignation offer or, if applicable, the reasons for rejecting the offer. The Pfizer approach gives teeth to withhold votes, but gives the company breathing room to comply with applicable contractual or regulatory requirements relating to the composition of the company's board, if a director were to fail to receive a majority vote.

Some investor activists, however, are not satisfied with the Pfizer approach because a director who wins a plurality vote but fails to receive a majority vote is still technically elected to the board, and the board is not required to accept the resignation of such a director. Consequently, companies that adopt a Pfizer approach will not necessarily escape majority vote proposals from investor activists. For example, of the 66 nonbinding resolutions filed by the Carpenters union for the 2006 proxy season requesting that companies provide for the election of directors by a majority of votes cast, ISS reports that seven such resolutions were filed at companies that have adopted director resignation policies. Also, the Sheet Metal Workers International Association is filing 20 nonbinding resolutions on majority elections in 2006, including at companies that have instituted director resignation policies, according to ISS.

Complicating matters, the SEC staff in January 2006 refused a no-action request by Hewlett-Packard Company, which had adopted a director resignation policy, to exclude from its proxy statement a shareholder proposal to adopt a majority voting standard that was submitted to the company under Exchange Act Rule 14a-8. Hewlett-Packard's request to exclude the proposal was based on the company's position that it substantially implemented the proposal because it had previously adopted a director resignation policy. Although Hewlett-Packard's director resignation policy did not contain certain of the elements recommended by ISS to be considered a meaningful alternative to the majority voting standard, the SEC staff's action suggests that the requests of other companies to exclude majority vote proposals on similar grounds will likely be denied.

Given such considerations, a limited number of companies, most recently Intel Corporation, have adopted a full majority voting standard in their charters or bylaws. Under a typical full majority voting standard a nominee in an uncontested election must receive a majority of all votes cast to be elected to the board, and, in Intel's case, hold-over incumbent directors who fail to win elections must tender their resignation to the board, which has 90 days to decide whether to accept such resignation and then disclose its decision. While adopting a majority voting standard is not without risk (of a failed election), and the risk would increase for NYSE-listed companies should the NYSE eliminate its "broker vote rule," withhold (or against) vote campaigns rarely result in more withhold (or against) votes than for votes. In 2004 director elections at companies in the Russell 3000 index, only 12 nominees at seven companies received a majority of withheld votes, according to ISS. In its 2005 proxy postseason report, ISS reports that three nominees at one company received a majority of withheld votes during the 2005 proxy season.

RECOMMENDATIONS

A company that has not received a shareholder sponsored majority vote proposal may want to wait for a best practice director election standard to develop before taking action. It will be informative to see which policies ISS determines present a meaningful alternative to the majority voting standard this year. Also, it would be useful to wait for further recommendations and reports of law advisory groups considering the issue, including the American Bar Association and the Delaware State Bar Association.

A company that receives a nonbinding or binding shareholder majority vote proposal, depending on facts and circumstances, should carefully consider (i) adopting a Pfizer-like corporate governance policy, requiring an incumbent director in an uncontested election who is elected under a plurality voting standard with more withhold votes than for votes to tender his or her resignation to the board, or (ii) adopting a majority voting bylaw or charter amendment, requiring a director nominee in an uncontested election to receive a majority of all votes cast to be elected to the board. The drive for majority voting is unlikely to recede anytime soon, and the risks of adopting a Pfizer-like corporate governance policy or full majority voting may be bearable based on historical success rates of prior withhold (or against) vote campaigns and the public relations benefit of taking a leading position on a hot corporate governance issue.

CONTACT INFORMATION

If you have questions or would like to learn more about this topic, please contact the partner who represents you, or:

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