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August 2, 2006

Recent Securities Law Developments on: <u>Majority Voting in Director Elections</u>

Prior to 2005, virtually all directors of public companies were elected by a "plurality" voting system whereby a director nominee who received the highest number of votes cast for an open director's seat would be elected to that position, regardless of the number of votes "withheld," voted "against" or not cast. Because "withhold" and "against" votes have no effect under this standard, a director could be elected by a single "for" vote. Over the last few years, however, there has been a continuing trend towards adopting some form of a "majority" vote standard, whereby a director would only be elected if he or she receives affirmative votes from a majority of the votes cast or the shares eligible to be voted at a meeting.

Although initially driven by shareholder advocacy groups, several other groups, such as the American Bar Association ("ABA"), have joined in the effort to support majority voting. The Delaware state legislature also recently passed an amendment to encourage majority voting, and in California legislation has been proposed that, if adopted, would authorize corporations in that state to amend their bylaws or charter to provide for majority voting in director elections.

This firm memorandum highlights some of the recent significant events and includes some of the implications of these trends in the years to come.

I. Recent Significant Actions

A. Un-adopted SEC Proposal on Shareholder Action

On October 8, 2003, the Securities and Exchange Commission ("SEC") proposed new rules that would require companies to allow certain shareholders to nominate directors using company proxy materials.[1] Despite the support by many shareholder advocacy groups who supported a greater role for shareholders in the director election process, the proposal met substantial opposition and ultimately was not adopted. Its failure, though, is significant in that it spawned a new area in shareholder advocacy to empower shareholders in the director election process. In particular, shareholder activists began initiating campaigns to change the election of directors from a plurality voting standard to a majority voting standard.

B. Company Action

As a result of these efforts and a desire to preempt potentially binding shareholder proposals, companies began to adopt varying forms of modified plurality standard that gave shareholders more say over board elections without adopting a majority vote standard. In June 2005, Pfizer, Inc. ("Pfizer") was the first to adopt such a standard in its corporate governance guidelines. Although Pfizer's policy retained the plurality standard, it required a director who did not receive a majority of the votes cast to tender his or her resignation to the board. The board was then given the opportunity to review the reasons for the failed election and decide whether to accept the resignation. Pfizer further fine-tuned its policy by requiring that the board act within 90 days; and that their action be made public in a press release addressing the status of "holdover directors" — those board members who receive less than a majority of votes but who must serve, under Delaware law, until a new candidate is found. Initially, Pfizer was lauded for its proactive approach and a number of companies followed its lead by adopting a similar standard in their corporate governance policies.

In November 2005, Institutional Shareholder Services ("ISS") announced that it would "continue to support well-crafted precatory and binding shareholder proposals calling for a majority voting standard."[2] ISS also affirmed its strong belief that "majority threshold voting represents a more accountable structure than a plurality system." Although its support of such proposals was unequivocal, it did suggest that shareholder proposals at companies with a governance policy in place may not receive support from ISS if the policy provides a "meaningful alternative" to majority voting. Some of the factors ISS would consider include:

- A clear and reasonable timetable for all decision-making regarding the nominee's status;
- A process for determining the nominee's status that is managed by the independent directors and that excludes the nominee in question;
- A range of remedies that can be considered concerning the nominee (for example, acceptance of the resignation, maintaining the director but curing the underlying causes of the withheld votes, etc.); and

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1 *See* Securities and Exchange Commission, Press Release 2003-133, "SEC Proposes to Increase Proxy Access by Shareholders", *available at* http://www.sec.gov/news/press/2003-133.htm (Oct. 8, 2003).

2 *See* Institutional Shareholder Services Press Release, "ISS Releases 2005 Corporate Governance Policy Updates," *available at* http://www.issproxy.com/pdf/2006Policy112105.pdf (Nov. 21, 2005).

- 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.[3]

In January 2006, Intel Corporation ("Intel") took the Pfizer model a step further and amended its *bylaws* to replace its plurality voting standard with a modified plurality model. Under this system, shareholders vote either "for" or "against" a director and any nominee who receives more "against" than "for" votes is required to tender their resignation. Similar to the Pfizer model, the company's corporate governance and nominating committee then reviews the resignation and makes a recommendation to the board. Although shareholders are given the opportunity to cast meaningful votes, the board retains the power to rescind the bylaw amendment at any time without shareholder approval. Since January, a number of companies have followed Intel's lead and adopted similar bylaws.

To date at least 28% of the companies in the S&P 500 and over 25% of the companies in the Fortune 500 have adopted a majority vote policy, bylaw or charter provision.[4] The majority of these companies retain a plurality vote standard, with a discretionary policy, like Pfizer's that addresses the status of a director nominee who fails to receive the majority of votes cast. Proponents argue that this is a healthy compromise, taking into account the views of the shareholders, while giving the board the flexibility it needs to handle situations that can result from a failed election. Opponents, however, argue that the approach is not sufficient since the final authority rests with the board of directors.

C. ABA Final Amendments to Model Business Corporation Act

On June 20, 2006, the Committee on Corporate Laws of the Business Law Section of the ABA (the "Committee") released its finally adopted amendments to the Model Business Corporation Act (the "Model Act") relating to the voting standard for the election of directors.[5] The Model Act, which is the basis for a majority of state corporate statutes, provides for plurality voting as a default standard in director elections. A corporation can opt-out of the plurality standard by amending its articles of incorporation, but the ability to do so requires action from both the board of directors and the shareholders.

Although the amendments to the Model Act do not change this statutory default system, the Committee has sought to encourage individual corporate action by introducing a majority voting bylaw that can be adopted unilaterally by either the board of directors or the shareholders. If adopted, the bylaw provides that any director in an uncontested election who does not receive a majority of the votes cast must resign no later than 90 days after the election. The choice of a new director during this time is

3 *See* Institutional Shareholder Services "Majority Elections: Questions and Answers," *available at:* http://www.issproxy.com/majorityvote/index.jsp.

4 *See* The Conglomerate, "The Rise in Majority Voting Proposals", *available at* http://www.theconglomerate.org/2006/06/the_rise_in_maj.html (Jun. 6, 2006).

5 *See* American Bar Association Press Release, "Committee on Corporate Laws Adopts Amendments to the Model Business Corporation Act Relating to Voting By Shareholders For the Election of Directors" (Jun. 20, 2006).

left to the discretion of the board, making it possible for the board to re-elect the resigning director. The amendment also provides that if the bylaw is adopted by the shareholders, it can only be repealed by the shareholders, and if adopted by the board of directors, both the board of directors and the shareholders have the ability to repeal the bylaw. Because the amendments retain the plurality voting default rule and permit the board to fill any resulting vacancy with the resigning director, they are considered a "modified plurality" standard, rather than a true majority voting system.

D. State Legislation

Like the ABA's Model Business Corporation Act, Delaware's General Corporation Law provides for plurality voting as the default standard in director elections, with an option to opt-out of the plurality requirement through a charter or bylaw amendment. Under Delaware law, an amendment to a corporation's charter requires action by both the directors and the shareholders. A bylaw, on the other hand, can be amended by either the directors or the shareholders acting alone unless the bylaws provide otherwise. As a result, any bylaw amended by the shareholders to provide for majority voting could be repealed by the board.

Effective August 1, 2006, however, Delaware's corporate law has been amended to encourage the adoption of majority voting by Delaware corporations.[6] Without changing the plurality default standard, the amendment accomplishes this in two ways. First, a provision has been added which allows corporations to make a director resignation effective and irrevocable upon the failure to achieve a majority vote for election. Second, the new law prohibits the board of directors from repealing or amending a bylaw adopted by the shareholders to provide for majority voting, an important incentive that shareholders may consider in determining whether to make majority voting proposals.

California's legislature is also reviewing the majority voting issue. California's corporate law mandates plurality voting in all director elections, with no ability to opt-out. On January 26, 2006, Senator Richard Alarcon introduced a bill ("Senate Bill 1207") that, if adopted, would require a majority vote for all directors running in an uncontested election.[7] On June 28, 2006, the bill was amended. Under the new version, companies are authorized, not required, to amend their bylaws or articles of incorporation to provide for majority voting in director elections. Existing law requires a majority vote of all shareholders or approval by the board of directors to change bylaws and articles, but under Senate Bill 1207, only a majority of those shareholders *voting* is required — a far lower threshold. Under the proposed bill any director who does not receive a majority vote must resign within 90 days, and unlike the modified plurality standards, the board of directors would not have the ability to reject the resignation — leaving the office of that director declared vacant.

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[6] *See* S. 322, 143rd Gen. Assem., Reg. Sess. (Del. 2006).

[7] *See* S. 1207, 2006 Leg. (Cal. 2006).

E. NYSE Proposed Amendments on Broker Voting Rules

On June 5, 2006, the Proxy Working Group of the New York Stock Exchange ("NYSE") recommended the adoption of an amendment to NYSE Rule 452 that could ultimately give activist shareholders more control over board composition. Currently under Rule 452, brokers can vote the shares they hold on behalf of "street" holders with regard to "routine" matters (which includes uncontested director elections) if the broker does not receive voting instructions from the beneficial owner of the stock within a certain period of time prior to the shareholder vote. Under the proposed amendments, this type of discretionary voting by brokers would be eliminated for all director elections. Because this would significantly reduce the large block of "for" votes that directors usually receive from brokers (who are traditionally in favor of management), the amendment could have a substantial impact.

II. Current Implications

Proponents of a majority voting system continue to advocate that majority voting is a simple, swift and effective way to make directors more accountable for their actions and provide shareholders with a more meaningful role in director elections. Opponents cite a number of concerns with a pure majority system: that it will make it more difficult to recruit suitable directors; that a failed election could result in long-term vacancies on the board that could affect a company's ability to maintain the requisite number of independent directors; that it could result in a company having no directors at all on the board, which could trigger a change in control under a company's material agreements; or that it could lead to contractual breaches if a CEO's or other officer's employment contract requires that they remain part of the board.

Many companies have been proactive in addressing the issue, most commonly by adopting policies that implement a modified plurality system. Adopting such a standard is an effective way for companies, not yet subject to a shareholder proposal, to demonstrate that their governance practices are reasonable without adopting the full standard. In the 2006 proxy season, approximately 80% of majority voting proposals (all non-binding) passed at companies which had no Pfizer-type policy in place, as opposed to the 20% that were passed at companies which did,[8] indicating that a company's efforts to adjust to the new trend are taken into account by its shareholders.

Shareholders have also begun to turn to the judicial system to seek court support for binding shareholder proposals. In *Bebchuk v. CA, Inc.*,[9] a shareholder submitted a proposal that, if adopted, would have limited the power of the board of directors to adopt a "poison pill." When the company refused to include his proposal in its proxy statement, Bebchuk filed suit. Although the court ultimately declined to rule on the issue, the opinion is relevant to majority voting because it does not foreclose the

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8 *See* "Majority Voting Picking Up Steam," *available at* http://www.cfo.com/article.cfm/6966762?f=related (May 19, 2006).

9 No. 2145-N., 2006 WL 1805545 (Del. Ch. Jun. 22, 2006).

possibility of enforceable shareholder adopted bylaws that restrict the power of the board of directors. Although the ability of shareholders to adopt this type of bylaw in Delaware remains an open question after *Bebchuk*, it is likely that shareholder activists will use the ruling to show that a resolution favorable to them is not impossible.

Whether through a corporate governance policy, bylaw or charter amendment, it is clear that majority voting has gained significant shareholder support and it is likely that this trend will continue to build momentum in the 2007 proxy season. Particularly with the adoption of the Delaware amendment, companies can expect further pressure from shareholders to adopt some form of majority voting. Companies that have adopted a modified plurality policy may still be subject to proposals that incorporate majority voting into their bylaws in line with the ABA's amendments. Companies that have not addressed the issue at all may likely be scrutinized more closely by activist shareholders. Although there is no universal standard, it is advisable that companies assess their current voting standards.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com; or Boji Wong at (212) 701-3011 or bwong@cahill.com.