



JONES DAY
COMMENTARY

MAJORITY VOTING FOR DIRECTORS

The campaign to prompt U.S. companies to adopt majority voting standards in director elections continues to gain momentum. In 2006 alone, more than 150 stockholder proposals relating to majority voting were filed, and more than 25 percent of the companies in the S&P 500 currently have some form of majority voting policy in place. In addition, the Model Business Corporation Act (the "Model Act") and the Delaware General Corporation Law (the "DGCL") were amended in 2006 to facilitate majority voting, and leading proponents of majority voting have indicated that they intend to continue to push the issue in the 2007 proxy season and beyond. SEC Chairman Cox has also voiced his support for majority voting in director elections. In this regard, even companies that already have acted to address the issue could find themselves under pressure from activist stockholders if those companies have adopted a lesser form of majority voting than what certain activists are seeking.

OPTIONS TO CONSIDER

Depending on your company's specific circumstances, your board should consider the following:

- If your company has already been targeted by activist stockholders on this issue, consider adopting some form of majority voting now in an effort to maintain control over the process, but understand that your chosen course of action may not completely satisfy activists;
- If your company has not yet been targeted, review the issue with your board now and understand all available options, including the potential benefit of being proactive by adopting a majority voting bylaw now;
- If your company has already reviewed majority voting but has opted to defer action, prepare your board for increased stockholder focus on the issue; and
- Regardless of your company's decision, your board should be prepared to revisit this issue due to the likelihood of increased pressure to adopt majority voting standards that cannot be unwound by board action alone.

BACKGROUND OF THE MAJORITY VOTING MOVEMENT

Plurality voting in the election of directors is the default standard in most state corporate statutes, including

Delaware's, as well as under the Model Act. In short, plurality voting means that a director is elected to office by virtue of having received the most votes in his or her election. In uncontested elections, a single vote "for" a director theoretically would be sufficient to secure his or her election. As a result, while withholding authority to vote for the election of a director may be an effective way to communicate dissatisfaction or stockholder unrest, no amount of withheld votes can defeat a director under the plurality standard. Under majority voting, however, a director would be required to receive a majority of votes cast in his or her election to be elected to a board, and the failure of a nominee to receive majority support would necessitate some subsequent action by the board. Accordingly, the rationale most frequently given behind the push for majority voting is to make boards of directors more "accountable" to stockholders.

After failing to push through various stockholder access proposals in 2003 and 2004, activist stockholders began to focus on majority voting. The momentum behind the majority voting movement increased dramatically in 2005 when the Council of Institutional Investors ("CII") launched a letter-writing campaign to 1,500 of the largest U.S. corporations, urging them to consider adopting majority voting to elect their boards of directors, and ISS published a policy statement regarding majority voting, indicating that it would support nonbinding stockholder proposals calling for majority voting. During the 2006 proxy season, ISS continued to generally recommend "for" reasonably crafted stockholder proposals calling for directors to be elected with an affirmative majority of votes cast in the director's election or the elimination of the plurality standard for electing directors (including binding resolutions requesting that the board amend the company's bylaws), provided the proposal included a carve-out for contested elections (*i.e.*, elections in which there are more nominees than board seats).¹ ISS also indicated that it would consider recommending a vote against a stockholder proposal requiring that directors be elected by an affirmative majority of votes cast if the company has already adopted a formal corporate governance guideline that contained certain elements. However, during the 2006 proxy season, ISS only once recommended a vote against a stockholder proposal where the company had already adopted a corporate governance guideline.²

Majority voting in director elections is not without its share of potential issues, primarily the possibility of a "failed election." A failed election occurs when one or more directors are not seated on the board for any reason, including the failure to receive the requisite vote. The possible consequences of a failed election range from potential breaches of material contracts and the triggering of change-of-control provisions in various agreements, to potential stock exchange delisting if insufficient independent directors are elected. Another potential issue raised by stockholder-preferred majority voting standards is the required resignation of each director who does not receive a majority vote. Under many state corporate statutes, including the DGCL, director resignations must be voluntary and cannot be compelled. As discussed below, however, solutions to these and other issues have been proffered by advocates of majority voting, and more recently, amendments to the Model Act and the DGCL sought to address these issues.

PFIZER APPROACH

In June 2005, Pfizer Inc continued its leadership in corporate governance by adopting an amendment to its corporate governance principles providing that any director who fails to receive the affirmative majority of votes cast in his or her election must submit his or her resignation to the Corporate Governance Committee of the Pfizer board. The Corporate Governance Committee would, in turn, consider the resignation and make a recommendation to the full Pfizer board whether to accept or reject the proffered resignation. In October 2005, Pfizer announced amendments to its voting policy to further clarify how the policy would be applied. The amended corporate governance principles state that:

- The Pfizer board will act on a director's offer to resign within 90 days of the certification of the stockholder vote at issue;
- The board will promptly disclose through 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 will not participate in any consideration by the board of the resignation offer.

Although more than 150 companies, including Microsoft Corp., Bristol-Myers Squibb, and Johnson & Johnson, have since followed suit with similar policies, some activist stockholders assert that it is inadequate. The United Brotherhood of Carpenters and Joiners of America (the “UBCJA”), for example, has said of companies that adopted the Pfizer model: “[t]he companies have not adopted a majority vote standard; rather they’ve adopted legally unenforceable resignation policies to cover the situation when directors get elected under the company’s plurality vote standard, but the level of symbolic ‘withheld’ votes exceeds a certain level.”³ The Pfizer approach also utilizes a corporate governance guideline that can be amended or removed by the board more readily than a bylaw.

INTEL APPROACH

Intel has advanced an alternative approach. In January 2006, Intel announced that its board had amended the company’s bylaws to adopt a majority voting standard for the election of directors in uncontested elections. The Intel approach requires that each director receive the affirmative majority of votes cast in his or her election. Moreover, a nominee standing for election for the first time would not be elected to the board if he or she did not receive a majority of the votes cast in his or her election.

To address the director holdover issue (*i.e.*, the requirement under the DGCL – and most other state corporate laws – that a director remain on the board until his or her successor is elected and qualified), the Intel board also adopted a director resignation policy in the company’s bylaws implementing the following procedures:

- If an incumbent director is not elected by a majority of the votes cast in his or her election, the director would be obligated to offer his or her resignation to the Intel board;
- The corporate governance and nominating committee of the board would then make a recommendation to the board on whether to accept or reject the resignation, or whether other action should be taken; and
- The board would then publicly disclose its decision and the rationale behind it within 90 days of the certification of the election results.

The principal distinctions between the Intel director resignation policy and the Pfizer model are that the Intel policy is reflected in the company’s bylaws and is not a corporate governance policy that can be changed somewhat easily, and the bylaw requirement that, to be elected, a nominee must receive a majority of the votes cast. However, because the Intel board could change its policy by amending the bylaws without stockholder approval, the most outspoken stockholder activists have advocated bylaws that can be changed only with stockholder approval and under which a director who fails to receive a majority of the vote must resign immediately. Nonetheless, the Intel model has been endorsed by a number of stockholder activists, including ISS, which referred to it as the “gold standard.”⁴ At least 45 companies have adopted the Intel model in 2006, including Home Depot, Clear Channel, and Dell, and others have indicated their intention to do the same in the near future.

CALIFORNIA APPROACH

Another alternative approach, which has been supported by CalPERS and CalSTRS, is reflected in California legislation that was signed into law on September 30, 2006.⁵ Under this new law, effective January 1, 2007, certain California-based corporations that also are listed corporations may amend their bylaws or charters to require that directors be elected by “approval of the shareholders” in uncontested elections.⁶ Under this standard, if a director fails to receive the required approval, his or her term will end at the earlier of (1) 90 days after the vote is determined or (2) the date on which a successor is appointed by the board.⁷ This approach has not yet been adopted by any company, though the action, if any, that companies covered by the new law may take in this regard in 2007 obviously remains to be seen.

AMENDMENTS TO THE MODEL BUSINESS CORPORATION ACT

Recently, the Committee on Corporate Laws of the Section of Business Law of the American Bar Association (the “ABA Committee”) adopted amendments to the Model Act that facilitate majority voting in director elections. The ABA Committee recognized the widespread impact that would result from a wholesale change to the current plurality voting

default rules and chose to leave the plurality voting rules intact, focusing instead on facilitating individual corporate action by permitting the adoption of bylaws mandating majority voting. Through adoption of these bylaw amendments, publicly held companies could elect to apply a specified plurality voting system for the election of directors, unless, of course, the company's charter already provides for cumulative voting in the election of directors, provides for director election by other means, or specifically prohibits the adoption of such a system.

In this regard, the amendments to the Model Act continue to provide for election by a plurality vote, but with the qualification that a nominee who is so elected but fails to receive a majority of the votes cast in the director's election would serve as a director only for a term ending on the earlier of (1) 90 days from the date on which the voting results are determined or (2) the date on which an individual is selected by the board to fill the office held by such director, which selection would be deemed to constitute the filling of the vacancy by the board.

The ABA Committee also adopted procedures by which corporations could repeal the bylaw provisions of the Model Act. If originally adopted by stockholders, the bylaw provisions could be repealed only by stockholders, unless the bylaw provides otherwise. If adopted by the board, the bylaw provisions of the Model Act could be repealed by the board or the stockholders.⁹ While these amendments do not impose any mandatory requirements on public companies, they do provide additional momentum for the trend towards majority voting. The Model Act is the foundation of corporate statutes in many jurisdictions, but not in Delaware, which is discussed below.

RECENT DEVELOPMENTS

Delaware Adopts Majority Voting Amendments. The Delaware legislature recently adopted amendments to the DGCL that facilitate majority voting in the election of directors. Among other changes, the amendments to the DGCL provide that a resignation may be made effective upon the occurrence of a future event or events, coupled with authority granted in the same section to make certain resignations irrevocable (*i.e.*, a corporation is permitted to enforce a director's resignation

conditioned upon the failure of the director to achieve a specified vote for reelection). This amendment also addresses the potential fiduciary duty issue surrounding director resignations by allowing a director to agree to resign prior to the occurrence of a specific event (*e.g.*, failure to receive a majority vote).

Additional amendments to the DGCL provide that a bylaw adopted by a vote of stockholders that prescribes the required vote for the election of directors may not be altered or repealed by the board. When coupled with board acceptance of director resignation, these provisions permit corporations and individual directors to agree voluntarily to voting standards for the election of directors that differ from the DGCL plurality default standard. These recent amendments to the DGCL increase the momentum of the majority voting movement.

2006 Proxy Season. ISS has reported that more than 150 majority vote proposals were filed for the 2006 proxy season, including more than 70 by the UBCJA. As of late September 2006, stockholder support for majority vote proposals averaged 47 percent.⁹ In 2005, those proposals averaged approximately 44 percent.¹⁰ During the 2006 proxy season, however, proposals targeting companies that had previously adopted some version of majority voting received less stockholder support (42 percent at 47 meetings) than proposals targeting companies that had not previously taken action on this issue (54 percent at 33 meetings).¹¹

According to ISS, more than 200 companies now elect directors by majority vote or require them to tender their resignations if a majority of stockholders withhold their support. This number shows an extraordinary increase, as it is up from just 30 companies at the beginning of 2005. This number will undoubtedly rise in 2007, as the UBCJA has indicated that it intends to file at least as many majority vote proposals in 2007 as were filed in 2006 (70), including against companies that have already adopted the Pfizer model.¹² Of greater importance than the sheer number of proposals to be filed is the fact that stockholder activists, emboldened by the recent changes to the Model Act and the DGCL, may move to submit stockholder proposals to adopt binding bylaws amendments as opposed to traditional nonbinding resolutions that have been proposed in the past including, to a limited degree, during the 2006 proxy season. This change

puts pressure on boards to consider preemptive changes to director voting policies in the hope of heading off more draconian stockholder proposals.

Proposed Amendments to NYSE Broker Voting Rules. In June 2006, the Proxy Working Group of the New York Stock Exchange (“NYSE”) recommended that NYSE Rule 452 be amended to prohibit discretionary voting by brokers on all director elections. Currently, Rule 452 permits brokers to vote shares held by them on behalf of “street name” holders of those shares on “routine” matters, including uncontested director elections, if the broker does not receive instructions from the beneficial owner a specified period of time prior to a stockholder vote. If the proposed amendments to Rule 452 are adopted, the effects on board elections for companies that have implemented majority voting systems could be substantial, since brokers historically have voted discretionary shares in accordance with the board’s recommendation. If, however, the traditional large block of votes in favor of the board’s recommended slate of directors is not received, some directors may not receive the requisite stockholder approval, which ultimately could result in stockholder activists or hedge funds gaining greater control over board composition. This shift in power to institutional stockholders could dramatically reshape the landscape of future proxy contests.

The NYSE’s comment period relating to the Rule 452 amendments expired near the end of June 2006. After reviewing the comments, the NYSE Proxy Working Group in August 2006 recommended moving ahead with the amendments but to delay the rule change until the 2008 proxy season. Further revisions to these amendments are possible, however. The NYSE may propose other changes itself, and of course, the SEC will have the opportunity to review the proposed NYSE amendments and solicit additional public comment before the changes would be implemented.

THE PATH FORWARD

In light of the developments that occurred during the 2006 proxy season, it appears that majority voting is well on its way to becoming a corporate governance standard. The decision facing public companies today is whether to act on this issue now or to await further settling of the issue. ISS recently announced that it is reviewing its majority voting policy for

2007, a pronouncement that weighs in favor of companies adopting a “wait and see” approach. Note, however, that with ISS, it is only a question of the type of majority voting standard it will support in the 2007 season, not whether it will support one. On the other hand, if your company has received a letter regarding majority voting from the CII or has otherwise been targeted on this or other corporate governance issues, then being proactive with regard to majority voting may enable you to maintain control over this agenda item.

While some activists disfavor the Intel model because it continues to provide the board with flexibility to amend the bylaw at issue, others believe it to be the “right formulation for what majority voting should look like.”¹³ Accordingly, the Intel model currently may provide the most insulation from activist stockholders if a company does not wish to adopt a bylaw that can be amended only by stockholders (an approach that should provide complete insulation at this point in time).¹⁴ However, whether to adopt a policy and, if so, what specific action to take depends upon numerous factors, including applicable state law and the company’s charter, oversight profile, and prior activist history, and therefore we believe a one-size-fits-all approach is inadvisable. Rather, each company should consider the adoption of majority voting in light of its particular circumstances.

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NOTES

1. Most proponents of majority voting recognize the potential for uncertainty and confusion that could be created if majority voting were mandated in contested elections (e.g., the possibility of a “failed election”) and, accordingly, do not insist on majority voting in such situations.
2. This likely is a result of companies adopting policies that do not address the particular issues raised in the stockholder proposals. For example, Hewlett-Packard Company filed a “no-action” request to exclude from its 2006 proxy materials a stockholder proposal on the grounds that Hewlett-Packard “substantially implemented” the stockholder proposal by adopting the “Pfizer model.” The SEC denied the request in light of the fact that Hewlett-Packard’s policy lacked a number of the features sought by the proponent. Hewlett-Packard’s policy did not include a timetable for decision making regarding the nominee’s status or a requirement for independent director oversight of the process. The proposal was defeated at the March 15, 2006, Hewlett-Packard annual meeting but received 44 percent of the votes cast.
3. ISS *Governance Weekly*, January 2006.
4. ISS *Majority Elections: Questions and Answers*, available at <http://www.issproxy.com/majorityvote/index.jsp>.
5. California Senate Bill No. 1207, available at http://info.sen.ca.gov/cgi-bin/postquery?bill_number=sb_1207&sess=CUR&house=B&site=sen.
6. Because California law mandates cumulative voting for all California corporations (and even corporations incorporated in other states that meet specified conditions), companies covered by the new law must first eliminate cumulative voting prior to adopting the “approval of the shareholders” standard in their articles of incorporation or bylaws. In this regard, the new California law does not provide for a true majority vote standard; rather, the “approval of the shareholders” formulation requires the affirmative vote of a majority of the shares represented and voting at a duly held meeting at which a quorum is present. This requirement is similar to a majority of the votes (i.e., abstentions would not have a negative effect); however, California adds an additional requirement that the shares voting affirmatively must also constitute at least a majority of the quorum required for the meeting.
7. The new law leaves some ambiguity, as it does not expressly limit the right of the board to appoint a candidate who fails to be reelected due to special circumstances.
8. Of course, state laws vary – in some states, stockholder action is required for bylaw amendments. For example, a company’s chairman may require both director and stockholder action in these circumstances. Accordingly, the specific circumstances of each company must be considered before action is proposed.
9. *ISS 2006 Proxy Season Review*, available at <http://www.issproxy.com/proxyseasonreview/2006/index.jsp>.
10. *Id.*
11. ISS *Growing Support for Majority Vote Proposals*, available at http://blog.issproxy.com/2006/06/growing_support_for_majority_v.html.
12. ISS *Banner Year for Majority Elections*, available at <http://www.issproxy.com/governance/publications/2006archived/175.jsp>.
13. Ed Durkin, director of corporate affairs at the UBCJA, in ISS *Governance Weekly*, January 2006.
14. In this regard, however, there are increasing calls for a majority voting standard that cannot be unwound by the board. It would not be surprising if the end result of the majority voting movement is a standard that cannot be changed by the board.

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