The next committee in the spotlight

Why the focus will be on nominating/corporate governance committees in 2007.

By Richard Koppes, Lizanne Thomas, and William Zawrotny

Since the beginning of the new era in corporate governance that began with the passage of the Sarbanes-Oxley Act (SOX) in 2002, the focus of governance activity has shifted among the various required standing committees of the board of directors: the audit, compensation, and nominating/corporate governance committees. The first few years after SOX were highlighted by an emphasis on audit committee functions. In 2005, and with more intensity in 2006, institutional shareholders and the SEC shifted their focus to executive compensation, resulting in a corresponding shift in governance focus from audit committees to compensation committees. As a result of three significant issues in corporate governance discussed below that will continue to gain momentum in 2007, it is likely that the focus this year will turn next to nominating/corporate governance committees.

1. Majority voting

Plurality voting in the election of directors is the default standard in most state corporate statutes, as well as under the Model Business Corporation 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, whether or not the director received a majority of the votes cast. Under a majority voting standard, however, a director would be required to receive a majority of votes cast to be elected to the board of directors, and the failure of a nominee to receive majority support would necessitate some subsequent action by the board. Generally, the director would not be automatically unseated; rather, the board would have to make an affirmative determination to keep the director on the board, notwithstanding the vote.

By the end of 2006, 36 percent of S&P 500 companies and 31 percent of Fortune 500 companies had adopted some form of majority voting. The number of Fortune 500 companies with majority voting policies doubled during the 2006 proxy season. This trend is expected to continue through the 2007 proxy season and beyond. Accordingly, boards will be faced with the challenge of dealing with a variety of issues related to majority voting. This task will be placed on the collective shoulders of the nominating/corporate governance committee.

Among the most significant challenges that nominating/corporate governance committees will have to address is the likely increase in "vote no" campaigns by institutional shareholders. Historically, such campaigns had little effect on companies, but the advent of majority voting will give "vote no" campaigns greater teeth. Boards will have a difficult time justifying the continued service of a director who has been successfully targeted by such a campaign.

2. Shareholder access to the proxy statement

On September 5, 2006, the United States Court of Appeals for the Second Circuit brought back to life the issue of shareholder proxy access in its decision in *American Fed'n of State, County & Mun. Employees* v. *American Intern. Group, Inc.* In this case, AFSCME, a shareholder of AIG, attempted to put a binding bylaw amendment proposal on AIG's 2005 annual proxy statement. The proposed bylaw amendment would allow large, long-term shareholders access to the AIG proxy in subsequent years for the purpose of nominating director candidates. AIG excluded the proposal on the basis that it "related to an election" in accordance with the long-

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time position of the SEC staff. The Second Circuit held that the proposal was not properly excludable because it did not relate to a specific election, but to elections generally.

This holding has, in effect, led the SEC to consider amending Rule 14a-8 of the proxy rules and to review the issue. If, ultimately, the rule is amended and companies adopt binding bylaws that would permit dissident access to the proxy statement, the cost of conducting a proxy contest would drop precipitously, and one could expect the number of such proxy contests to increase significantly.

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The Second Circuit decision, coupled with a renewed push by institutional shareholders, is forcing boards (and possibly the SEC) to address the shareholder access issue in a variety of ways. In some instances, boards are asking major shareholders for director nominee suggestions. When there has been a preexisting dialogue among boards and major shareholders, such shareholders are proactively offering names for consideration. In both instances, nominating/corporate governance committees will be faced with additional tasks such as vetting and considering these additional director nominees. This process will put into bold relief what the company has highlighted in its corporate governance documents as important attributes of director candidates and may lead to a further review of such attributes, all of which will fall to the nominating/corporate governance committees.

3. Direct shareholder communication with directors

Institutional shareholders continue to push for direct communications with directors. As required by exchange listing standards, companies now disclose how shareholders may contact board members directly. Considerations related to Regulation FD, however, have continued to minimize the contact between directors and shareholders. Many shareholder advocates feel that current methods are inadequate to support a substantive exchange of information and ideas between boards and shareholders. As this is a significant corporate governance matter that boards will have to address in the foreseeable future, it is likely that nominating/corporate governance committees will also be asked to take the lead in finding an acceptable solution to meet the demands of these shareholders and shareholder advocates.

Preparing for the shift

Boards should take the time now to evaluate the membership of their various standing committees to ensure that they are appropriately staffed to deal with the additional burdens that will be placed upon them in the year ahead. Corporate governance is no longer just about ensuring that the various documents and procedures are correct and in place; it is about developing a substantive approach to the governance issues that face companies in 2007 and beyond.

There is no single approach that works for all companies. A company that is underperforming may be compelled to deal with shareholders in a different way from a company that is performing well. In addition to being prepared for an expanded time commitment, members of nominating/corporate governance committees should also have an appetite for direct contact with shareholders.

It is unlikely that the issues discussed above will lose momentum any time in the near future, so nominating/corporate governance committees can expect to have greater contact with shareholders and to bear more direct responsibility for good shareholder relations as the year passes. ■

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