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OHIO OPENS THE DOOR FOR MAJORITY VOTING IN DIRECTOR ELECTIONS

As a result of a recent amendment to Ohio law,[1] effective January 1, 2008, shareholders of Ohio corporations may require that director candidates receive a majority vote in order to be elected. Under the current plurality voting standard of Ohio Revised Code § 1701.55(B), it takes only a single vote to elect a candidate as a corporate director in an uncontested election, and thus management's director nominees are nearly always elected or reelected to the board. As amended, O.R.C. § 1701.55(B) will permit the articles of incorporation of an Ohio corporation to set forth alternative standards for the election of corporate directors, including majority voting. Under a majority voting standard, there is a real possibility that a board-supported director nominee may not be elected, even in an uncontested election.

This amendment to Ohio law is a response to a populist movement that seeks to give shareholders a stronger voice in corporate affairs through greater power in director elections. The amendment will allow a fundamental shift in how directors of Ohio corporations are elected, and accordingly Ohio's public companies should consider how they will approach director elections in light of the new statute.

THE MAJORITY VOTING MOVEMENT

Plurality voting in the election of directors is a long tradition of American corporations and, until recently, was the nearly universal norm. The majority voting movement began in the wake of the corporate scandals of the early '00s, when the SEC proposed but failed to adopt rules that would have increased shareholders' ability to nominate director candidates in the corporation's proxy statement. After the SEC rulemaking effort stalled, activist shareholders began to pressure U.S. corporations to adopt majority voting standards intended to make boards of directors more accountable to shareholders and thereby promote share-

1. See text of House Bill 134, as enrolled, at http://www.legislature.state.oh.us/bills.cfm?ID=127_HB_134.

holder democracy. These standards were typically proposed in the form of shareholder proposals to be included in the company's proxy statement and submitted to a nonbinding vote of shareholders.

In response to the majority voting movement, the boards of many public U.S. companies took action to implement some form of majority voting system. Many of the early corporate responses were in the form of so-called "Pfizer policies," after the policy adopted by Pfizer Corporation in 2005, which require a nominee who fails to receive a majority of the votes cast in his or her election to tender his or her resignation to the board. The boards of other companies adopted bylaws that require nominees to receive a majority of votes cast in order to be elected to the board, following the model adopted by Intel Corporation in 2006.

Currently, shareholder activists generally consider a majority vote requirement, coupled with a director resignation policy, to be the state-of-the-art majority voting standard for uncontested director elections. Moreover, in the past few years, activist shareholders have lobbied for the inclusion of these election standards in the corporate articles of incorporation (the "certificate of incorporation" for most non-Ohio corporations), rather than in board-adopted policies or bylaws, because provisions in the corporate charter documents are generally more binding. Accordingly, in recent years, even companies that have taken board action to adopt a director resignation policy or majority voting bylaw have been subject to investor pressure to adopt additional measures to make these voting standards less susceptible to change. The strength of the majority voting movement continued to be evident in the 2007 proxy season, in which more than 140 shareholder proposals relating to majority voting were filed, and those proposals submitted to a shareholder vote received, on average, the support of more than 49 percent of the votes cast.

MAJORITY VOTING FOR OHIO CORPORATIONS

Until now, the situation for Ohio corporations has been somewhat different than for those companies incorporated elsewhere, since the Ohio statutes did not clearly permit adoption of voting standards other than plurality voting. Directors of Ohio corporations could voluntarily adopt Pfizer-type director resignation policies that would work in tandem with plurality voting, but under Ohio's statutory framework, they could not adopt standards that would require a majority vote for a director's election.

Ohio's statutory system did not dissuade shareholders of Ohio corporations from submitting shareholder proposals to seek the adoption of majority voting standards. A few years ago, however, two Ohio corporations won SEC no-action relief for the exclusion of those proposals from their proxy materials on the grounds that those proposals violate Ohio law. Specifically, the SEC accepted the legal opinions of counsel to those corporations that the implementation of a majority voting standard in director elections would violate O.R.C. § 1701.55(B).

Undaunted, shareholder activists found another route to bring majority voting to Ohio corporations, in the form of shareholder proposals to reincorporate out of Ohio and into other states whose statutes permitted majority voting. In total, more than a dozen Ohio companies received nonbinding reincorporation proposals in the 2006 and 2007 proxy seasons. Ultimately, only a few Ohio public companies faced a shareholder vote on a reincorporation proposal, because many of the subject companies were able to secure the proposal's withdrawal based on the commitment of the Corporation Law Committee of the Ohio State Bar Association to support an amendment to Ohio law to enable majority voting in director elections.

In September 2006, the Corporation Law Committee approved a proposed amendment to O.R.C. § 1701.55(B) that would permit nonplurality voting standards in director elections. In the spring of 2007, the amendment was submitted to the Ohio legislature as part of House Bill 134, and was passed without opposition by the House and the Senate. Governor Strickland signed the bill into law on July 19, 2007.

RESPONDING TO THE NEW O.R.C. § 1701.55(B)

House Bill 134 amended O.R.C. § 1701.55(B) to provide for plurality voting in director elections "[u]nless the articles set forth alternative election standards." This amendment to Ohio law should bring an end to the majority-voting-related reincorporation proposals submitted to Ohio companies in the past few

years. It is very likely, however, that in light of the new Ohio statutory framework, Ohio public corporations will now face shareholder pressure to amend their articles of incorporation to require majority voting in uncontested director elections.

Directors of Ohio corporations have several possible responses to consider in light of the amendments to O.R.C. § 1701.55(B): the board may determine to take no responsive action, may adopt a director resignation policy, or may submit to a shareholder vote an articles amendment to adopt a majority voting standard. As with most corporate governance decisions, there is no "one-size-fits-all" approach.

Wait-and-See Approach. Directors of an Ohio corporation may choose to reserve action until the board can better assess the shareholders' views on majority voting in light of the new statutory framework. This may be a particularly attractive option for companies that have not received shareholder proposals relating to majority voting or are otherwise unable to gauge the sentiment of their shareholder base on the issue. As with many corporate governance decisions, majority voting is not without costs to the corporation, and directors should evaluate those potential costs in light of the potential benefits of majority voting before undertaking a course of action.

Specifically, the implementation of a majority vote requirement will increase the possibility of failed director elections, especially in light of the pending amendments to the NYSE rules that, when effective, will prohibit brokers from voting shares in favor of management's director candidates without express instructions. The possibility of failed director elections could have dire consequences for a corporation, ranging from increased difficulty in finding qualified candidates willing to serve as directors, to the failure to meet applicable exchange listing requirements, or other potential consequences of changes in board composition.

While the wait-and-see approach may be an appropriate response for some companies, it should be noted that inaction on this issue could also cede control of the issue to activist shareholders. Ohio law, unlike the laws of Delaware and other states, does not require director approval of shareholder-proposed amendments to the articles of incorporation. Accordingly, a shareholder may propose a binding amendment to an Ohio corporation's articles of incorporation, and that amendment would be adopted—notwithstanding director opposition—if approved by the requisite proportion of the corporation's voting power (generally two-thirds, or the greater or lesser proportion, but not less than a majority, required by the corporation's articles). If a binding articles amendment is proposed by shareholders, the corporation might be placed at a disadvantage by having to defend against the proposal or seek support for its own form of articles amendment (or resignation policy) instead of the shareholder proposal. Accordingly, if a board chooses inaction, it will wish to be prepared to act or react quickly if shareholder support for an articles amendment becomes evident.

The Pfizer Approach. If the directors wish to act, changing the articles of incorporation to adopt majority voting is not the only alternative. Just as they could before the adoption of House Bill 134, directors may voluntarily adopt a Pfizer-style corporate governance policy that would be applicable in uncontested director elections. The policy would typically provide that any director who fails to receive a majority of the votes cast in his or her election would be expected to submit his or her resignation to the board promptly after the certification of the election results. The board and its nominating and corporate governance committee would then consider each resignation in light of any factors they consider appropriate, including the director's qualifications and service record, as well as any reasons given by shareholders as to why they voted against (or withheld votes from) the director. The board would be required to determine whether to accept the tendered resignation within 90 to 120 days following the election, and to disclose its decision, as well as the reasons for rejecting any tendered resignation.

The adoption of a director resignation policy is appealing because it is responsive to the majority voting movement while preserving the traditional plurality voting system. In addition, for many companies, this step may be enough to discourage shareholder activists from seeking more. The results of majority voting proposals in past proxy seasons appear to support the premise that shareholders may be less likely to support a shareholder-sponsored majority voting proposal if the corporation has already adopted a Pfizer-type resignation policy. Of course, activist investors may successfully argue that such a Pfizer-style approach is weak or inadequate, especially in light of the availability of true majority voting standards under the amended Ohio statutes.

Management-Sponsored Articles Amendment. As amended, O.R.C. § 1701.55(B) will permit a board to sponsor and propose for shareholder approval an amendment to the corporation's articles to provide for majority voting in director elections. Seeking shareholder approval of an amendment to the articles reflecting the board's own majority voting proposal is the alternative that is most likely to forestall further shareholder action on the issue and to be deemed by investors to be an adequate response to shareholder activism on the issue. (Because amended O.R.C. § 1701.55(B) allows adoption of a majority vote standard only through an articles amendment, Ohio corporations will not have the choice, available to corporations in states such as Delaware, to adopt Intel-type majority voting bylaws or regulations through board action.)

NEXT STEPS

The Ohio statutory amendments have the potential to promote a trend in the elections of directors of Ohio corporations toward majority voting systems designed to foster greater shareholder power over corporate elections. In light of this statutory change, the practical decision now facing boards of most Ohio public companies is not whether to support majority voting, but how to incorporate a majority voting standard into the corporate articles or a board policy, or how to otherwise address shareholder activism on the issue once it arises.

If the board of directors determines that a director resignation policy or an articles amendment is the appropriate response, it should work closely with counsel to ensure that the policy or provision is carefully formulated to work with the corporation's existing election structure and avoid potential pitfalls. For example, in drafting the majority voting provisions, careful attention should be given to the following issues, among others:

- whether director elections are annual or staggered;
- whether cumulative voting is available;
- typical voter turnout for routine shareholder meetings, especially in light of the changing NYSE broker voting rules;
- the board's ability to decrease the number of directors, and to fill board vacancies, in light of possible director resignations;
- applicable board composition requirements under SEC and stock exchange rules and contractual covenants; and
- applicable disclosure requirements.

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