Corporate Governance Reform & Director Elections

*By Daniel I. Fisher**

The beginning of this decade featured a number of high-profile corporate scandals which have led to a sea change in the way public companies operate—best exemplified by the disclosure and controls requirements of the Sarbanes-Oxley Act of 2002. However, those scandals have also led to a greater focus on the roles and responsibilities of Boards of Directors, and to a search by stockholder activists for reforms that would increase what they describe as "director accountability." While no single reform has had a significant impact to date, a number of changes that are currently in various stages of implementation could significantly alter the way directors are elected at public companies, and thus the way such companies operate. These changes could both make it more difficult for incumbent directors to win re-election, and encourage, simplify and lower the cost of proxy contests by stockholder activists.

The Trend Towards Majority Voting

Perhaps the most significant potential change is the sweeping reform movement to change the voting standard directors must meet to be elected. Traditionally, directors of most U.S. public companies have been elected by plurality voting. Under plurality voting, assuming that a quorum is present at the stockholders' meeting, nominees with the greatest number of votes are elected as directors, up to the total number of directorships up for election. As a result, unless dissident stockholders run a competing "slate" of nominees (a difficult and expensive process), under plurality voting the Board's own nominees are essentially guaranteed a successful election. While stockholders have the option to "withhold" votes from some or all of the board's nominees, absent competing candidates such "withhold" votes are merely symbolic and do not affect the actual election of directors; as a result, the only alternative for stockholders seeking to change the composition of the board is to run an expensive proxy contest.

The majority-voting movement, which has been led by certain activist stockholders (primarily the United Brotherhood of Carpenters and Joiners and other labor unions), seeks to change the legal standard for director elections from a plurality—which provides only a symbolic opportunity to oppose a board's nominees—to a majority. To implement a majority-voting standard, companies must amend their constituent documents (generally in the form of bylaw amendments for Delaware corporations and charter amendments in the case of corporations organized under other jurisdictions) to provide that director nominees must receive a majority of the votes cast to be elected to the board.[1] As a result, a campaign by stockholders against a director's election held under the majority-voting standard can have the very real result of denying the director's election. However, in situations where the unsuccessful director is an incumbent director, under the corporate laws of nearly all states, that incumbent continues to serve on the board as a director until resignation, removal or the election of a successor at the next stockholders meeting. This is referred to as the "holdover" problem, since an unsuccessful director is "held over" and remains on the board despite the apparent expressed wishes of the voting stockholders. As a result of the holdover problem, companies adopting majority voting generally couple these provisions with resignation mechanisms similar to those described in the next paragraph.

The initial response of much of corporate America to the rise of majority voting was not to change the legal standard for director election to a majority. Instead, many corporations adopted stand-alone "director-resignation policies" as part of their corporate governance guidelines, which attempted to address the underlying theme—that stockholders' opposition to director candidates in uncontested elections should be given weight. Under these policies, the first prominent example of which was adopted by Pfizer in June 2005, director nominees for whom more votes are withheld than cast are legally elected (since the underlying election standard is not changed), but are required to submit their resignation to the Board, which in turn must consider and act upon the recommendation. Proponents of these policies argue that they give clear effect to the expressed will of stockholders (by requiring a resignation if a nominee does not receive a majority vote), while at the same time providing for corporate continuity and flexibility in the Board's actions (since the Board's nominees will be elected absent a competing slate, and the Board is allowed procedural and substantive flexibility in its decision-making). Generally, director-resignation policies set forth guidelines for consideration of such resignations, including the standards the board (or designated committee) will apply, requirements for disclosure and provisions that the director or directors whose resignations are being considered are not to participate in the deliberations.[2]

Although many public companies followed Pfizer's lead and adopted director-resignation policies, activist stockholders were not satisfied with this approach and continued to pressure companies to adopt the majority-voting standard throughout the 2006 proxy season, principally by means of stockholder proposals to adopt majority voting. Many companies opposed these efforts, on the grounds that the stockholders' goals were essentially achieved by the adoption of stand-alone director-resignation policies. To be sure, the only technical difference in application between majority voting and a stand-alone director-resignation policy is that new director nominees (not incumbents) in companies adopting the former reform are not elected (creating a vacancy to be filled by the Board), while such nominees are elected in companies adopting the latter reform (though required to submit a resignation). However, the unspoken feeling among stockholder activists who have campaigned for majority voting even in companies which have adopted director-resignation policies is that the change in legal standard for election makes clear the seriousness of stockholder opposition and reduces the chance that a resignation submitted by a director will be rejected.[3]

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The 2006 proxy season featured hundreds of stockholder proposals to implement majority voting: a general trend emerged. These proposals received approximately 41% of the vote at companies with pre-existing stand-alone director-resignation policies and approximately 57% of the vote at companies without policies, clearly showing that not all stockholders agreed that a stand-alone policy needed to be replaced. However, even companies that successfully resisted shareholder proposals to implement majority voting did so in the midst of a shift by a number of large public companies towards the voluntary adoption of majority voting. Beginning with Intel's adoption of a majority-voting bylaw in January 2006, there has been significant increase in the number of companies (including some of America's best known corporate giants) that have adopted majority voting bylaws, including some that had previously adopted stand-alone policies.

Many companies that have accepted the seeming inevitability of majority voting are still trying to determine the most advisable method of implementation—in particular, the manner in which majority-voting bylaw amendments may be amended in the future, especially in light of recent amendments to the Delaware General Corporation Law (DGCL). In response to the majority-voting movement, the DGCL was recently amended to provide that, where stockholders adopt bylaw amendments specifying the vote for election of directors (i.e., adopting majority voting), these amendments may not be subsequently modified or deleted by the Board of Directors, as would otherwise be the case with a Delaware corporation's bylaws (§216 of the DGCL).[4] Unsurprisingly, activist stockholders have argued that it is crucial that Boards not have the power to amend or delete majority-voting bylaw amendments, while companies have argued that Boards need to retain the flexibility to alter the voting standard in the face of possible unforeseen circumstances. As a result, future stockholder proposals may be submitted even when companies have adopted majority-voting bylaws that could be amended by the board, and the issue of boards' power to amend a majority-voting bylaw has developed into a key point of negotiation between stockholders considering submitting proposals and companies seeking a negotiated solution (typically involving companies adopting some form of majority voting) to avoid such proposals. Regardless of the form or individual features, and despite the debate over their appropriateness, the concept of majority voting has gained a strong and increasing level of support. According to one recent study, as of October 2006, approximately 36% of the companies in the S&P 500, and 31% of the Fortune 500, have adopted some form of the majority-voting principle.

The Elimination of Broker Discretionary Voting for the Election of Directors

An additional development that affects director election contests is the elimination of broker discretionary voting. Shares of public companies beneficially owned by individuals are often legally held in the name of a bank, broker or similar intermediary. As a result, when a stockholders' meeting is called, brokers will request instructions as to how the beneficial owners would like their shares to be voted. If the individuals have not responded within ten days of the stockholders' meeting, NYSE rules permit brokers to cast the votes at the broker's discretion on matters deemed "routine."[5] Traditionally, the election of directors in uncontested elections has been deemed routine, and brokers have generally tended to vote for the Board's candidates, and thus companies could count on a significant reservoir of votes in an uncontested election.[6]

However, in light of developments in director elections and corporate governance activism—including majority voting and the rise of organized "withhold" and "just vote no" campaigns—the NYSE formed a proxy working group in April 2005 to consider and recommend possible reforms to proxy voting. In June 2006, the proxy working group issued a recommendation that the uncontested election of directors be classified as "non-routine" and thus not eligible to be voted on at the discretion of brokers when those brokers' clients, the individual beneficial owners, do not give the brokers voting instructions. Though this change will not be implemented until the 2008 proxy season, there have already been signs of significant consternation among public companies—especially those governed by a majority-voting standard or that are the target of a concentrated withhold or other similar campaign.[7]

The Uncertainty Surrounding Proxy Access

In 2003, the Securities & Exchange Commission (SEC) proposed rules that would have established what came to be referred to as "proxy access;" providing that, in certain situations, long-term stockholders of public companies would be able to nominate director candidates to be included on the company's proxy card and other proxy materials. This reform would likely have greatly reduced the logistical and financial burdens on stockholder activists seeking to nominate director candidates, and seemed likely to increase the number of contested director elections and the possibility that the nominees of stockholder activists could be elected to boards with increased frequency. The proposal was met with significant debate in the corporate community and, for a variety of reasons, in 2004, the SEC declined to adopt final rules implementing proxy access, making it essentially a dormant issue.

That year, however, the American Federation of State, County and Municipal Employees (AFSCME) submitted a stockholder proposal for inclusion in the proxy materials for the American International Group (AIG) at their 2005 annual meeting which would have amended AIG's bylaws to include proxy-access provisions generally similar to those that had been proposed by the SEC. SEC rules allow the exclusion of stockholder proposals from a company's proxy materials when the proposals relate to "an election" of directors, and traditionally the SEC has permitted companies to exclude stockholder proposals implementing proxy access on these grounds.[8] However, when AIG excluded the AFSCME's proposal, the labor union sued, and the U.S. Court of Appeals for the Second Circuit ruled that the SEC had not properly determined that stockholder proposals on proxy access were excludable. The Second Circuit ruling—which can be interpreted as requiring companies under the Second

Circuit's jurisdiction to include proxy access proposals similar to AFSCME's in their proxy materials—was met with dismay by many corporate commentators as well as by the SEC. The Commission immediately indicated that it was prepared to amend the proxy rules, in response to the court's ruling, in a manner that would presumably allow companies to exclude proxy-access proposals. However, while the SEC was expected to address the issue at its December meeting, it did not do so, and gave no public explanation as to why it was silent, or when new rules might be forthcoming.[9] Moreover, in January the SEC declined to either agree or disagree with the request for no-action relief sought by Hewlett-Packard to exclude a proxy access proposal from its proxy materials, adding to the lack of clarity on the issue.

Internet Delivery of Proxy Materials

The SEC has recently adopted final rules that take significant steps toward allowing anyone soliciting proxies for a public company stockholders' meeting (i.e., both the company and stockholders soliciting in opposition) to satisfy the proxy requirements by delivering solicitation materials electronically. The new rules require parties soliciting proxies to notify stockholders of the internet availability of proxy materials, but not (as previously had been the case) physically to print and mail the proxy materials to stockholders. This process could yield cost savings for public companies. However, this benefit may well be offset by the advantage it gives to stockholder activists seeking to contest company solicitations, for whom the cost reduction will be far more significant. At a minimum, the "e-proxy" rules should lead to an increase (possibly a large one) in the number of proxy contests for the election of directors and in other situations, such as the approval of significant business transactions, where a stockholder vote is required.

The final impact of the rise of majority voting and the elimination of broker-discretionary voting in director elections may take a number of proxy seasons to be fully appreciated. However, public company directors and their advisors will surely need to be mindful of these reforms in approaching stockholder relations and future director elections, and should have well-considered plans in place for dealing with the subject. The possibility that proxy-access proposals will be allowed (or even that the proxy-access rules themselves will be revived), coupled with the possible advent of proxy material e-delivery, could foretell an increased level of proxy contests and dissident stockholder activism, as well as the next wave of reform.

Endnotes

1 Generally, majority-voting only applies to uncontested elections, on the theory that, where there is a competing slate of nominees, stockholders' votes have an actual impact, as stockholders are presented with a choice. In elections held under the majority voting standard, stockholders are able to vote "for" or "against" a candidate; and only candidates with more for than against votes are elected.

It is also unclear how a contested election under a majority voting standard would work in practice; confusing disclosure, improper votes and the election of no directors could result. In recognition of this, Institutional Stockholder Services ("ISS"), a leading proxy advisory firm, has stated that, while in general strongly supporting majority voting, it opposes majority voting that does not include an exclusion for contested elections. ISS will generally recommend against voting to elect directors who approve implementation of majority voting without a provision that contested elections be held under the plurality standard.

2 As described above, companies which adopt majority-voting bylaw or charter amendments (changing the legal standard for election) generally also adopt some form of a director resignation policy, either within the bylaw or charter amendment or separately, to address the issue of holdover directors.

3 For the 2006 proxy season, ISS' policy was to recommend that its clients vote for stockholder proposals on the adoption of majority voting, even when the company in question had adopted a stand-alone director-resignation policy, unless the stand-alone policy was sufficiently strong, the company made valid arguments against adoption of majority voting and the company had a history of strong governance features and corporate accountability. ISS only recommended against one majority-voting proposal under this framework, in the case of General Electric (which recently announced that it would proceed to adopt a charter amendment implementing a majority-voting standard in 2007). For the 2007 proxy season, ISS has announced it will recommend "for" standard majority-voting proposals without the previous exception.

4 The DGCL was also amended to permit directors to submit irrevocable resignations contingent on the occurrence of future events (§141(b) of the DGCL)—in other words, resignations that spring into effect if the director fails to receive the required vote under a majority-voting bylaw or director-resignation policy. This avoids the potentially problematic issue of directors refusing to submit resignations, and has enabled companies to make director nominations contingent on the submission of such resignations.

5 For technical reasons relating to the structure of broker-dealer regulation, the NYSE rules apply to elections at public companies listed on both the NYSE and NASDAQ.

6 For example, the well-known "withhold" campaign run against Michael Eisner at the Walt Disney Company's 2004 annual meeting resulted in Mr. Eisner receiving 55% of the votes, with 44% withheld. If the election of directors had not been deemed a routine matter, Mr. Eisner would have received 45% of the votes, with 54% withheld.

7 Broker discretionary voting for the election of directors often helps achieve a quorum; the elimination of such voting increases the chance that companies will lack a quorum at stockholders' meetings—and thus will be unable to conduct any business at all. Automatic Data Processing has estimated that if broker discretionary voting had been eliminated for the 2004 proxy season, as many as 20% of companies would have failed to achieve a quorum. Since, in general, if a quorum is achieved for one proposal that quorum carries over to other proposals to be voted on at the same meeting (even if some shares are not voted on the other proposals), it seems likely that there will be an increase in the number of "routine" proposals (principally, ratification of auditor selection) voted on at stockholders meetings, as companies seek to ensure broker discretionary votes are present for quorum purposes.

8 The reason stockholder proposals on majority voting have generally been allowed while stockholder proposals to implement proxy access have not been permitted is the SEC's policy position that the stockholder proposal process should not be used to promote proxy contests for the election of directors.

9 At least one of the Democratic appointees to the SEC has indicated general support for the proxy-access concept and it is possible that SEC Chairman Christopher Cox was unable to achieve a political consensus to address the issue.