

## MAJORITY VOTING

### A DEVELOPING ISSUE IN THE ELECTION OF DIRECTORS

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In the election of directors, majority voting is the hottest topic to hit the corporate governance arena in many years. The issue seems to be evolving by the week and will continue to do so throughout 2006. Everyone, from the labor unions, to the proxy advisory firms, to institutions, to corporations, is formulating a stance on this issue.

The first battles of the 2006 majority vote wars were won by the corporate issuers. In January, three companies - Analog Devices, Ciena, and Hewlett-Packard - all defeated shareholders proposals asking the company to adopt majority voting. However, as the season wore on, many proposals received high shareholder support and many companies adopted some form of a majority vote standard without waiting for the results of a shareholder vote.

As a proxy voting matter, majority voting generally comes in the form of a shareholder proposal asking the company to amend its bylaws to require that a majority of the votes cast at the shareholder meeting be required to elect or re-elect directors. At most corporations, directors are elected by a plurality system. Under this system a director needs just one vote to be re-elected to the board. The majority vote issue stems from the now "dead-in-the-water" equal access to the proxy proposal, which was the big corporate governance issue of 2004. Roughly, the equal access proposal stated if a director received a certain threshold of withhold votes a shareholder group would be allowed to nominate a director on management's proxy card to compete with management's nominees. Equal access was stalled at the SEC, and although a few organizations are trying to revive it, majority voting is the issue going forward.

Although not universal, there is a lot of support for majority voting within the institutional community. In 2005, shareholders voted on over 60 majority vote proposals with an average support level of 44 percent (compared to an average support level of 12 percent in 2004). Proposals at 17 companies received a majority vote from shareholders. In 2006, it is expected that shareholders may vote on over 120 majority vote proposals. The proposal has so far won shareholder support at many companies during the 2006 season. The proposal received less support at companies that have

adopted some variation of majority voting.

In practice there are three variations that companies have been adopting to address the majority vote standard. First, about 25 companies have amended their bylaws to provide for majority voting in director elections (ADP for example). However, companies in this group have not addressed the holdover issue, which addresses the fate of a director who does not get a majority of votes cast in favor. Do they have to drop off the board immediately? Do they have to submit a resignation to the board for their review? Many companies adopted this policy in the early days of the majority vote evolution, and companies now tackling majority voting will not adopt this model.

The second variation is known as the "Pfizer" model, after the pharmaceutical company became the first to adopt it. This is the most common variation and most companies taking a stance on this issue are adopting the Pfizer model. This variation maintains the plurality system but amends the corporate governance guidelines such that a director receiving more Withhold votes than For votes must submit his/her resignation to the board. Once the resignation is submitted, the board will have 90 days to decide whether or not to accept the resignation, addressing the logistics of the holdover issue.

The third, and most recent variation, is sometimes called the "Intel" model, again taking the name of the company first implementing it. Intel amended its bylaws to provide that a director must receive more For votes than Against votes in order to be elected to the board. (Note the addition of the Against vote - rather than just the For and Withhold voting choices that have previously been in place.) A first time nominee who does not meet this requirement will not be appointed to the board. A director up for re-election would be required to submit his/her resignation to the board. The board will then follow a process similar to the holdover logistics of the Pfizer model. The Intel model is considered by majority vote proponents to be much closer to the spirit of majority voting than the Pfizer model, partly because shareholders will be able to actually vote against directors (they feel this sends a much stronger message to the company) and the Intel model is an actual amendment to the company's by-

laws whereas the Pfizer model is an amendment to the company's corporate governance guidelines.

The most vocal proponents of majority voting are the labor unions, particularly the United Brotherhood of Carpenters and Joiners. The Brotherhood also set-up a working group with a dozen corporations to debate and work on the issue. The American Bar Association (ABA), which is responsible for making recommended changes to the Model Business Corporation Act, is also tackling majority voting. The ABA had set-up a task force to work through the issue and in 2005 published an outline of four possible variations for addressing majority voting. However, on January 17, 2006, the ABA issued what many majority vote proponents would call a "damp squib." The ABA did not endorse the majority vote standard but advocated a company-specific solution that strengthens a board's ability to force a director who did not receive a majority of votes at a shareholder meeting to resign and that allows companies to change their bylaws to allow directors who did not receive a majority support to stay on the board for a shortened period of time.

The majority voting issue is also moving into the legislative arena. A state senator from California introduced a bill that would require companies incorporated in the state to provide that directors be elected by the majority of votes cast. Also, the Delaware Bar Association is taking up the issue and may make recommended changes to the state legislature, which is very significant given the number of companies incorporated in Delaware.

As demonstrated by the shareholder support levels, majority voting has the support of many institutions. The California Public Employees' Retirement System (CalPERS) was a main driver in the California bill. The Council of Institutional Investors supports majority voting. The proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis support majority voting. The only exception in 2005 was ISS did not support a majority vote resolution at Paychex Inc, because the proposal was a binding resolution and did not include a carve-out for proxy contests where it is possible the nominees on the winning slate may not meet the majority vote standard. The vast majority of shareholder proposals are precatory in nature, so management is not legally obligated to adopt the proposal even if it gets majority support from shareholders. There have been a few other binding resolutions in 2006; and, thus far, the vote results on these have been similar to the results for the precatory proposals.

In November 2005, ISS released its proxy voting updates for the 2006 proxy season, stating that they will support majority vote proposals, both binding and precatory, provided the proposal includes a carve-out feature as mentioned above. Corporations should keep in mind that ISS supports precatory proposals that do not directly address the carve-out feature. ISS may recommend a vote Against a majority vote proposal where the company has adopted corporate governance principals that meaningfully address a situation where a director does not receive a majority of votes cast. Corporations should expect Glass Lewis to support majority vote resolutions whether they are binding or precatory.

#### **Conclusion:**

For those of our clients who prefer to maintain the plurality vote system, we recommend that if the proxy ballot does not contain a shareholder proposal asking for majority voting then the client should wait and see how the issue evolves during 2006 before adopting majority voting or one of its variations.

For those clients faced with a majority vote proposal, we recommend that a company review its shareholder base to determine how likely its holders are to support a majority vote proposal. Companies should keep in mind that ISS will continue to support a shareholder proposal at companies that have adopted the Pfizer model. It is expected that ISS will not recommend supporting a majority vote proposal at a company that has adopted the Intel model. Those issuers whose shareholder profile does not contain many institutions or institutions that are not influenced by the proxy advisory firms might want to wait until the 2006 season develops before addressing the majority vote issue.

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