LAW OFFICES

SILVER, FREEDMAN & TAFF, L.L.P.

A LIMITED LIABILITY PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

3299 K STREET, N.W., SUITE 100
WASHINGTON, D.C. 20007
PHONE: (202) 295-4500
FAX: (202) 337-5502 or (202) 337-5503
WWW.SFTLAW.COM

MAJORITY VOTING AND OTHER DIRECTOR ELECTION DEVELOPMENTS

What is majority voting?

Historically, nearly all corporations utilized a plurality standard for the election of their directors. Under a plurality standard, the candidate who receives the most votes for a directorship position is elected. Thus, if the board's nominees are unopposed, then each nominee will be elected if he or she receives only a single vote, even if a substantial portion of the shareholders register their disaffection with the nominees by marking their proxy cards to withhold authority or by not voting at all. For this reason, there has been a significant push in recent years by corporate governance advocates for public companies to replace the plurality vote standard with a majority vote requirement for the election of directors, at least where the election is uncontested. While there can be different formulations, most companies that have adopted a majority vote system provide that to be elected as a director, the number of votes cast for a nominee must exceed the number of votes withheld from (or, in some cases, votes cast against) the nominee's election.

Have many companies moved to a majority vote standard?

This is certainly the case among the largest public companies, as over half of the companies in the S&P 500 have made this move. By being in the spotlight of the financial press and the corporate governance reform community, these companies have also obviously faced the most pressure to abandon the plurality system. While some smaller public companies have followed suit, in our estimation they have not done so to the same extent as the largest companies. Companies with a mostly institutional shareholder base clearly face greater pressure to move to a majority vote system than those with a mostly retail shareholder base (as the latter are less beholden to ISS and the like).

How does a company implement a majority vote system?

It can be done through a number of means, subject to the laws of the company's state of incorporation: a non-binding policy adopted by the board; a bylaw amendment, which in most cases can be adopted by the board without shareholder approval and in some cases by shareholders themselves; or a charter amendment, which in nearly all cases would require shareholder approval. Amendments to the Delaware General Corporation Law in 2006 provide that a bylaw amendment approved by shareholders which specifies the requisite vote for director elections may not be amended or repealed by the board of directors.

What happens if a nominee doesn't receive the requisite majority vote?

Because a director generally serves until his or her successor is elected and qualified, until he or she is removed from office (a rare occurrence) or until he or she resigns, to avoid a "holdover director" situation, most majority vote standards provide that a director who

does not receive the requisite majority must offer his or her resignation to the board.

This scenario initially created a legal sticking point that has been overcome – at least for Delaware corporations. Delaware law provides that directors cannot be removed unless the shareholders vote for removal, and that for corporations with staggered boards, such removal can only be for cause. Requiring directors to offer their resignations is inconsistent with these baseline rules. It has also been questioned whether this requirement can be enforced against a director who asserts that his or her fiduciary duties require him or her to refuse to resign. Some companies have dealt with this problem by providing (generally in their bylaws) that as a condition to any director's nomination, he or she must submit an irrevocable resignation letter in advance that will become effective if he or she does not receive the requisite majority vote. The Delaware General Corporation Law was amended in 2006 to specifically permit this approach.

Putting aside the potential legal issues, a board whose nominees are not elected may face a difficult decision from a practical standpoint. Even if the board may legally be entitled to not accept the resignations, a board which does not accept the resignations and allows its nominees to remain in office will likely anger shareholders. Depending who the nominees are, a company may be out of compliance with its stock exchange listing requirements (which require that a majority of the directors be independent and that the audit, compensation and nominating committees be comprised entirely of independent directors) if the resignations are accepted. And what is a board which is not classified (meaning that all directors face re-election annually) to do if *none* of the directors receive the requisite majority vote? While a majority vote standard clearly puts teeth into a "withhold vote" or "no vote" campaign, this may not necessarily be in shareholders' best interests because of the potentially de-stabilizing effect on the board.

What are some of the other issues or problems that can arise with a majority vote system and what are some of the other developments in the director election area that should be considered before moving to this system?

Most companies that have adopted a majority vote standard provide that a plurality standard applies instead if the election is contested. While a plurality voting standard certainly makes sense where shareholders have a choice between rival nominees, a company will need to decide what exactly will be considered a contested election. Although an election technically is contested if there is one more nominee than the number of directorships to be filled in the election, what standard should apply if a dissident shareholder submits nominations in opposition to some, but not all, of management's nominees (often referred to as a "short slate")? In theory, a plurality standard could apply to the election for the positions where there are opposition candidates and a majority standard could apply with respect to the positions that are unopposed. This would be complex to administer, however, and would likely cause shareholder confusion. There is also the question as to when a determination will be made that an election is contested and that therefore a plurality, as opposed to a majority, standard applies. The best way to handle this issue may be to provide that a plurality standard applies if a shareholder has given the company notice of an opposition candidate in accordance with the company's advance notice bylaw provision and if the nomination of the opposition candidate is not withdrawn as of a specified number of days before the company mails its proxy materials.

Under existing New York Stock Exchange rules (which apply to nearly all brokers regardless of whether the company involved is listed on the NYSE), if a broker does not receive instructions from its customer on how the customer's shares should be voted in an uncontested election of directors, the broker may vote such shares in its discretion. The NYSE has proposed to eliminate this discretionary authority in uncontested director elections. If approved by the SEC, this change in the NYSE rules could have a profound effect on companies with majority vote standards because brokers have traditionally voted discretionary shares in favor of the board-recommended candidates. If the traditional large block of votes in favor of the board's nominees is not received, some or all of the board's nominees could have trouble receiving the requisite majority vote. Thus, apathy by retail shareholders could result in activist and institutional holders gaining greater control over director elections.

The primary reason that most director elections are uncontested is because of the expense involved in running a proxy contest against the board's nominees. This expense can be reduced significantly as a result of the SEC's new e-proxy rules, which now allow companies and dissident shareholders to deliver proxy materials by posting them on a website and sending shareholders notice of the availability of the materials. Running a campaign against the board's nominees could also get easier and less expensive, depending on what happens when, as it has promised to do, the SEC revisits the "shareholder access" question. This issue arose following a 2006 court decision which effectively held that shareholders may require public companies to include shareholder nominees in management's proxy materials. In that case, the U.S. Court of Appeals for the Second Circuit held that AIG was required to include in its proxy statement a shareholder proposal to amend AIG's bylaws to require AIG to include in its proxy statement and proxy card the opposition nominees of a dissident shareholder. In 2007, in response to the Second Circuit's decision in the AIG case, the SEC proposed two competing rule changes. One proposal was to effectively supersede the Second Circuit's decision by providing specifically that companies may exclude such shareholder proposals from their proxy materials. The other proposal was to expressly permit certain greater than 5% shareholders (including a group) to propose binding bylaw provisions that would govern the director nomination and election process, including a provision like the one proposed by the shareholder in the AIG case. In November 2007, the SEC adopted the first of the two proposed rule changes, clarifying that shareholder access proposals can be excluded from company proxy materials. Many shareholder activist groups were disappointed in the SEC's decision. The shareholder access issue is far from over, as SEC Chairman Christopher Cox has indicated that it plans to revisit the issue.

From a corporate governance policy standpoint, the fact that election contests could be easier to wage in the future cuts against the notion that a majority vote standard is the only way to make director elections meaningful. This fact, coupled with the strong possibility that broker voting discretion for uncontested elections will soon be eliminated, means that boards should think long and hard before moving to a majority vote system and may want to wait and see how things evolve.

Are many companies moving to de-classify their boards of directors in connection with adopting a majority vote standard?

Many public companies have a classified board of directors, meaning that only a portion (typically one-third) of the directors are up for election at each annual meeting of

shareholders. While de-classification of the board need not be considered part and parcel with the adoption of a majority vote standard, there is definitely a movement, particularly among the largest public companies, to have all directors elected annually. De-classifying the board usually requires shareholder approval of an amendment to the company's charter. A number of companies have faced non-binding shareholder proposals to de-classify their boards.

As with majority voting, a board should think twice before proposing to de-classify. A classified board is perhaps the most important takeover defense a company can have, as it prevents a dissident shareholder who wages a proxy contest from gaining majority control of the board at a single annual shareholders' meeting. As discussed above, this process is expected to only get easier for dissident shareholders, with the SEC's new e-proxy rules and the SEC's inaction (thus far) on the issue of shareholder access to management's proxy materials. The classification of the board has benefits aside from its value as a takeover defense, including board continuity.

In addition to board de-classification, there has recently been a push by corporate governance activists for companies to eliminate other takeover defenses in their charters, such as a supermajority shareholder vote requirement for business combination transactions with persons acquiring more than a specified percentage of the company's voting stock, absent approval of the transaction by a majority of the disinterested directors. As with board de-classification, a board should not be quick to propose the elimination of these provisions. Notwithstanding the activists' arguments, the purpose of these provisions is usually not to entrench the existing board and management, but to protect the long-term interests of shareholders and other constituents by encouraging a potential acquiror of the company to negotiate directly with the company's board and management. There is a common theme to the activists' movements in this area – an effort to transfer more control of the company away from the board and into the hands of shareholders. The problem is that the "shareholders" to whom this greater control is effectively transferred are often not the shareholders at large, but a small group or a single person sometimes not having the long-term best interests of all shareholders at heart.

* * *

For further information, please contact Dave M. Muchnikoff at (202) 295-4513 or dmm@sftlaw.com, or Craig M. Scheer at (202) 295-4525 or cscheer@sftlaw.com.

For over 30 years, Silver, Freedman & Taff, L.L.P. has represented financial institutions and other companies nationwide in connection with initial public offerings and other capital raising transactions, mergers and acquisitions, regulatory and enforcement issues, tax and compensation matters, and corporate governance matters. With attorneys who previously served with the federal banking and thrift regulators as well as the Securities and Exchange Commission, Silver, Freedman & Taff, L.L.P. provides a full array of legal services to financial institutions and other companies.

This document provides general information and should not be used or taken as legal advice. Such advice requires a detailed analysis of applicable requirements and an evaluation of precise factual information.

© 2010 Silver, Freedman & Taff, L.L.P.