Corporate Board Elections and Internal Controls
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Briefing: Board elections in the United States by Robert Mundheim, Of Counsel to Shearman & Sterling

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Ladies and gentlemen, my name is Roberta Ramo. I’m from The American Law Institute. I’m a lawyer from New Mexico, but I’m really very enthusiastic about being here this morning, especially for this panel. I chair a nominating committee for the board of a publicly-held company, and now I’m going to see if we did the right thing. We’ll begin with a briefing from Robert Mundheim, who’s of counsel to Shearman & Sterling and one of the most distinguished speakers about these matters in the United States. Bob.

Robert Mundheim: I’ve been asked to talk to you a little bit on legal background relating to the election of boards of U.S. public companies. Now, the substantive law on election of directors is governed by state law. And under state law, directors are typically elected by shareholders, although the board also normally has the right to fill vacancies. It’s a common practice for boards, acting on the recommendation of a nominating committee, to propose a slate of directors. The company then solicits proxies for the slate, and bears the expenses of drafting the proxy statement and soliciting votes.

Unless the charter of the company or its bylaws provide otherwise, state law then provides, as a default rule, that directors nominated will be elected if they win more affirmative votes than any other candidate properly standing for election. That is the plurality rule, which is the default rule in all our states.

Thus, in an uncontested election, if a candidate wins 10,000 votes out of a possible million, that director will be elected. That’s true, even if the 10,000-share vote for that director is balanced against 100,000 shares that are marked “withhold” or voted “against.” And that’s because the plurality-vote rule counts only the votes for a candidate. That example suggests that even directors in whom shareholders may have lost confidence could be elected under present law. Although that’s a pretty rare occurrence, there are examples of that happening. So the question is, how can the shareholders’ role in the election of directors be enhanced?

There are a number of ways. First, under state law, dissatisfied shareholders can always present their own slate for election. And they, of course, will win if they can get more affirmative votes than any other candidate properly standing for election. That is the plurality rule, which is the default rule in all our states.

A second method, under the rules of the New York Stock Exchange and NASDAQ, is that listed companies now must have nominating committees composed exclusively of directors, independent of management. Those committees are expected in the proxy to describe their processes, and it is hoped that they would be more open to shareholder suggestions than in the past and generally to address, in a thoughtful fashion, the whole nomination process. I think it’s a little early to make any judgments about the extent to which this new nominating process works.
A third approach, of course, is that the state law on plurality voting could be changed, and indeed, that is a question that the American Bar Association’s Committee on Corporate Laws is analyzing now. That Committee is the custodian of the Model Business Corporation Act, which has set a pattern for state legislatures to follow. The plurality-vote rule appears to have been adopted in response to a concern that, in a contested election – let’s say you have three candidates for one post – no one might win a majority of the affirmative votes cast. That, I think, is not the concern which the Committee is addressing. The Committee is focusing on the uncontested election, where the shareholders are dissatisfied with one or more, or the whole slate of candidates. And the shareholders want to find a way to signal their dissatisfaction in a way that matters.

Moving to a different rule is actually not quite as simple as it sounds, because if a candidate or slate in a noncontested election is not elected, there are a number of questions. Let me give you a few. If the candidate who fails to be elected is an incumbent director, does she serve until a successor is elected? If she does, have we made a lot of progress? If a slate or a number of candidates are not elected, you then have the question whether enough directors remain in office to do the business of the board. If the failure to elect an incumbent leaves a vacancy and the board can fill the vacancy, what kind of guarantee is there that that process will be more responsive to shareholders? And a little broader issue, would management or boards, reacting to a system in which it’s easier to prevent the election of a director, try to roll back the recent trend towards eliminating staggered or classified boards?

Now the Committee on Corporate Laws is examining a number of alternatives to the present plurality-vote rule. One is a plurality of a minimum number of votes cast, say a third. A second would be to require a candidate to win a majority of the votes cast or alternatively, of the votes entitled to vote, a much bigger required majority. Both of those approaches require you to address the issues that I laid out a minute ago. And a third alternative that they are looking at is to allow a director to be elected by a plurality of the votes cast, just as you have now, but provide that if there’s a failure to get a majority, either of the votes cast or of those entitled to vote, then the term of that elected director ends after 90 days, or some shorter period, unless the directors vote to confirm the election for the full term. So that’s a much more flexible approach to the problem.

Now fourth, and in a way most important, is that we’ve been talking about a default rule, and companies can, on their own, adopt in their charters or bylaws any of the alternatives that the Committee has looked at as changes in state law. And companies can adopt, and have adopted, their own responses. Amending the charter or bylaws to require nominees to win a majority of the votes cast actually has gained a good deal of currency. In 2005, there were 80 shareholder proposals supporting this approach, typically in terms of precatory resolutions. In 13 corporations, more than 50 percent of the votes cast favored the shareholder proposal; in an additional 15, 40 percent of the votes cast favored the proposal. So you can see there is some momentum building in this direction. The Pfizer Corporation has adopted a rule requiring a director who has received “withhold” votes that constitute a majority of the votes cast to submit her resignation to the corporate governance committee, which will consider the resignation and make a recommendation to the board. The board could then say, “Well, no, we want you to stay, we don’t accept the resignation,” or say, “You’re out.” Other companies are following Pfizer’s lead, and it’s very likely that more will do so. Office Depot, I think, has a similar procedure, when the “withhold” or “against” votes constitute a majority of the shares entitled to vote, and that, I think, was the Lipton suggestion of a while ago. That gives you a kind of framework, at least of the law governing this area.