Corporate Board Elections and Internal Controls

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Panel remarks by James H. Cheek III, Partner, Bass, Berry & Sims PLC

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It's just not so much fun to be a board member at exciting times. Next, we have James Cheek, a partner from Bass, Berry & Sims and one of the lawyers in America who most shapes our thinking about how corporate boards should operate. Jim.

James H. Cheek: First, as a matter of an information site for you, Bob mentioned the ABA’s Committee on Corporate Laws that has put out a position paper relating to whether to change the plurality vote to a majority vote. That position paper has generated about three inches worth of comment letters and they’re worth reviewing for those of you who want to engage in this debate. You can find them on the ABA’s website at abanet.org/buslaw.

I actually did look at them in connection with these remarks and it reminded me, a little bit, of the current commentary that we read every day about the Iraq war, in that a lot of these letters have a lot of emotional rhetoric. There clearly is no perfect solution being proposed by anybody, and they’re all viewed through the prism of a very politically-combative lens. And I think that having parsed through that, I want to offer five things that I think are factually based and conclusions from those five facts, and a modest proposal for dealing with this for U.S. public companies.

The first fact that both Bob and Marty have mentioned and you’re aware of, is that the U.S. rule clearly is a plurality-default rule; it’s a default rule. It does not prohibit directors from acting to override the default rule, either by charter, bylaw, or corporate-governance principles. As Marty and Bob mentioned, there have been more than 30 boards in 2005 alone that have embraced a variant of majority rule. And that is in part as a result of the increased pressure from activist shareholders directed towards those organizations, in part, due to the 80 shareholder proposals, but in part also for boards that are priding themselves on being on the leading edge of developing corporate practices. So the first conclusion I draw from those facts is that no change in state law is actually required to implement majority voting. State law in the U.S. has generally been an enabling set of statutory provisions, “enabling” meaning that there’s flexibility built into the statutory provisions for the management and the board and the shareholders to exercise judgment and exercise a dynamic that results in decisions in the best interests of the corporate entity. The second conclusion is that voluntary change, without regulation or legislation, is occurring, and more will occur as it evolves into a leading corporate practice; as Marty said, we will have majority voting in a predominant number of public companies in this country. Activist shareholders in organizations are effective advocates for change in the current system and it’s being demonstrated by virtue of the changes occurring in the marketplace.

The next fact – Bob mentioned this as well – is that governance changes in the last three years dramatically have shaped a different set of dynamics in the boardroom and certainly with respect to the board nomination process. The “club” nomination process is no longer the prevalent method of choice. The independence required of boards, of nominating committees, the independent search firms that are being engaged by nominating committees, the disclosure system that now applies to the process that must be used in the nomination situation, and the methods that are now being put into place for direct shareholder communication to independent directors, all play a major role in actually effecting change. I’ve had the occasion...
to observe Chairman Ramo in her nominating-committee-chair role and I think it was very effective and independent in the process. So changes are being effected, and these changes are being effected by a combination of listing standards, federal law, and shareholder action, generally not by state law. The conclusion is that this system is evolving and the trends are clearly supporting a more independent and shareholder-sensitive process that I think can reasonably be expected to react appropriately to adverse shareholder votes. Changes, if needed, may be more quickly effected through listing standards and regulatory disclosure rules rather than state law.

The third fact I’d like to share with you is that the plurality system does provide certainty of election and eliminates most of the horrors that have been trotted out to show the uncertainty of a majority-vote approval. But equally, at the same time, that methodology does not permit effective voting by shareholders to reject a board nominee. It leaves shareholders with the options that Bob outlined, of contested elections, shareholder resolutions, and withhold-vote campaigns. None of those are as cost effective as an effective negative vote and a majority-vote system. The conclusion is that that system is creating an increased public perception that director elections may be illusory, and that the three-legged stool of corporate structure in this country is out of balance. Managers manage, boards oversee, and shareholders are supposed to own and effectively elect the overseers. The question is, are they able to effectively elect the overseers in the system, and if not, does that provide an imbalanced stool? That perception in fact exists, it has a basis in fact, and it’s media appealing. It may lead to regulatory and legislative pressures for more radical surgeries that may be needed.

The fourth fact is that there are multiple reasons, other than director quality of performance, why votes have been withheld within U.S. public-company elections, including general corporate-governance standards that certain activists seek to impose on corporations; issues involving other corporations where a nominee may serve as a director; social-responsibility issues; and strategic alternative decisions serving a unique special interest of a particular activist shareholder. The conclusion I reach from that fact is that the pressure for a majority vote is not all about director accountability or improving corporate operational performance. It really, many times, is simply a power base for shareholders being able to influence board decisions, which may be in the shareholders’ view in the best interest of the corporation, but may not be in the minds of the majority of the board, which is charged with overseeing the basic corporate performance and strategy.

The fifth fact is that there is no one single model for majority-vote provisions that has no negative consequences. There are a number of variants that Marty has mentioned that have been utilized in those that have been adopted today. Many of the proposed variants raise a host of technical issues that you can examine in the comment letters on the website I referred you to. These include the holdover director who was voted so resoundingly against; how to remove a director in the event that that director did not receive the favorable majority; how you fill vacancies; and what shareholder information do you provide for those who are engaged in vote-against campaigns. There’s a whole host of issues related to all of those questions. My conclusion on that is that one size does not fit all here. It’s not likely to be solved satisfactorily by a mandated set of regulations or a mandated change in state statute. It needs to be formed and shaped by a board exercising its business judgment considering all of the circumstances facing that particular corporate entity.

Having thought about those facts and conclusions, I think, as a modest proposal, I will submit for a discussion some minor outpatient surgery, with the hope that it does the least damage. I think that one of the most effective ways governance has been impacted through the last 10, 15, 20 years has been through the adoption of listing standards. The audit committee really finds its progeny in a listing standard that the New York Stock Exchange adopted many years ago. I think that a modest change in the market listing standards, the NASD and New York Stock Exchange standards, to require corporate-governance guidelines, which are already required by the listing standards, to include a provision that requires the board to consider, periodically, if not annually, majority-vote provisions after receiving a recommendation from the independent nominating or corporate-governance committee. The provisions could also require that the public company disclose, via its web page or proxy statement, the decision of the board in respect to that matter and the rationale behind that decision. This could be done through a combination of the listing standard and perhaps a change in the proxy rules. The advantage I see to this proposal is that it deals only with a certain segment of public companies, whereas state law, as you know, would deal with all private and public companies. It leaves the choice of structure within the business judgment of the board. It requires affirmative action by the board and it avoids the parade of horrors that is associated with the mandatory majority rule. The bottom line is that this proposal is a surgical process that is very modest and could have the beneficial effect of providing better sensitivity to the shareholders’ legitimate interest in having a more effective vote.