Holly J. Gregory
PARTNER
WEIL, GOTSHAL & MANGES LLP
Holly specializes in advising companies and boards on corporate governance matters.

Opinion

TRENDS IN DIRECTOR ELECTIONS

Key Results from the 2012 Proxy Season

In her regular column on corporate governance issues, Holly Gregory examines trends in director elections that developed during the 2012 proxy season, including calls for majority voting, negative vote campaigns and proxy access proposals.

Increasingly, shareholders expect to exert a meaningful influence on the composition and functioning of boards of directors through their power to vote in director elections. This expectation has been apparent and growing for the past decade. In the 2012 proxy season, it manifested in the following inter-related trends:

- Expanded efforts to gain majority voting as the election standard for uncontested director elections.
- Targeted and coordinated negative vote campaigns against certain directors.
- The first round of shareholder proposals seeking adoption of proxy access, on a company-by-company basis.

Counsel should take into account these trends in director elections as they prepare to advise boards for the 2013 proxy season. These trends are expected to be a continued focus of active institutional shareholders and their proxy advisors.

MAJORITY VOTING

Shareholder proposals seeking to change the standard for uncontested director elections from plurality voting to majority voting began in 2005. According to data from Alliance Advisors (using FactSet and company filings), about 80% of S&P 500 companies have since adopted some form of majority voting, with many companies adopting it voluntarily to avoid a high vote on a shareholder proposal.

Support for these shareholder proposals has risen steadily each year, averaging over 60% of votes cast on 36 proposals during the 2012 proxy season. Of these 36 proposals, 23 received passing votes. Proponents of majority voting are now expanding their efforts to the next tier of companies, where adoption of majority voting for director elections lags behind the S&P 500 considerably. Only about 31% of the Russell 3000 have adopted a majority voting standard.

HOLDOVER DIRECTORS AND RESIGNATION POLICIES

Under a majority voting standard, a director up for re-election who fails to get a majority of votes cast would not be re-elected but would continue to serve as a holdover director under state law provisions. These provisions provide that, despite expiration of a director's term, the director continues to serve until a qualified successor is elected or until there is a decrease in the number of directors. This holdover rule is designed to ensure that a qualified board is always in place (avoiding a "failed election").

Therefore, even at companies with a true majority voting standard, additional action is required to unseat a holdover director who failed to receive majority support from the shareholders. Boards that adopt majority voting typically also adopt a resignation policy (through a by-law provision or board policy). This requires a director who does not receive majority support from shareholders to tender resignation for consideration by the board. Boards generally retain discretion to allow the director to continue to serve on the board if the board believes that, notwithstanding the vote results, it is in the best interests of the company for the director to continue to serve.

>> For a form of majority voting provision, with explanatory notes and drafting tips, search By-laws or Certificate of Incorporation: Majority Voting Provision on our website.

POSSIBLE COURSES OF ACTION

Companies that have not yet adopted a majority voting standard for uncontested director elections should consider the likelihood of being targeted with a shareholder proposal, given the company's current ownership structure and other circumstances. Boards should be aware of the trend toward majority voting and weigh the potential benefits of:

- **Adopting some form of majority voting now to avoid a shareholder proposal.** This would also avoid negotiations with a proponent about the form that the majority voting provision takes, for example, whether through amendments to the company's articles or by-laws or through a simple director resignation policy.
- **Maintaining the status quo until it becomes an issue for the company's shareholders.** One benefit of the "wait and see" approach is that should shareholders target the company for something else, the company has retained the ability to offer majority voting as an alternative, and this can be a valuable bargaining tool.

If a company receives a shareholder proposal seeking adoption of a majority voting standard for uncontested director elections, assuming there are no procedural or substantive defects in the proposal, the board will need to determine whether to:

- Acquiesce, including by negotiating an approach to majority voting on favorable terms, while hopefully still earning credit for being responsive on this issue.
- Resist and have the shareholder proposal voted on at the annual meeting, with the potential for a high favorable vote.

The trend suggests that for many companies majority voting is inevitable, but boards must be well advised on the potential impact. Depending on the company's shareholders and other issues facing the company, some companies may decide to wait to be pushed.

>> For more information on dealing with shareholder proposals, search How to Handle Shareholder Proposals on our website.

COMMONLY CITED ARGUMENTS AGAINST MAJORITY VOTING

Reasons often cited by management in recommending against a shareholder proposal seeking majority voting in director elections include the following:

- **Plurality voting has long been accepted.** The rules governing plurality voting are well-established and widely understood, whereas majority voting raises complications involving failed elections and holdover directors.
- **Directors with special knowledge or qualifications could fail to be elected.** For example, the audit committee expert or one or more independent directors could fail to receive a majority of votes cast. In this case, the board would no longer meet listing rules or Securities and Exchange Commission (SEC) requirements regarding the number of financial experts or independent directors.
- **There may be increased expense.** There is potential for greater expenditures of time and money on director elections through telephone solicitation campaigns, second mailings of proxy materials and other vote-getting strategies, especially in the face of a negative vote campaign.
- **There may be unintended consequences.** There is potential for undesirable effects, for example, by providing a tool that can be used by special-interest shareholders or proxy advisors to forward a particular agenda or inflexible policy, without regard to the performance and other circumstances of the company or the contributions of the particular director.
- **It is unnecessary.** The current plurality voting standard allows shareholders to register dissatisfaction by means of a withhold vote for one or more directors. In addition, shareholders have a right to submit comments and concerns to the board as described in the company's corporate governance guidelines.
- **It is not mandated by Congress.** The fact that Congress considered but did not mandate majority voting in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 supports the proposition that majority voting is not necessarily appropriate for all companies.
- **There is ongoing debate.** There continues to be debate in the legal community, and among shareholder advocates, corporate governance experts, public companies and others, about the benefits, disadvantages and consequences of majority voting.

Counsel should be aware that, especially given the number of companies that have already gone forward with some form of majority voting, the arguments against adopting it as the voting standard in uncontested director elections are unlikely to be viewed by most institutional shareholders as compelling.

"VOTE NO" CAMPAIGNS

Shareholders view director elections as an opportunity to express dissatisfaction with corporate performance, company policies and board practices and decisions. They are using coordinated campaigns to vote against (or withhold votes for) directors. Widespread adoption of majority voting at S&P 500 companies and elimination of the ability of brokers to vote uninstructed shares has increased the power of these campaigns.

Nevertheless, it remains relatively rare for a director to fail to get a majority of votes cast, and rarer still for such a director to actually step down from the board. Even at companies where majority voting has been adopted, a director who fails to obtain majority support will not necessarily be unseated (see above *Holdover Directors and Resignation Policies*). For 2011, it is estimated that more than 40 directors in Russell 3000 companies failed to win a majority of the votes cast, but most continued to serve as directors. The data is not yet fully in for 2012, but it appears that some directors who failed to receive majority support will continue to serve.

Directors who stay on the board after failing to receive a majority of votes cast have been called "zombie directors." Unless a compelling reason for continued service can be convincingly communicated to shareholders, companies should expect that allowing a director who failed to receive a majority of votes cast to continue to serve will provide a flash point for further shareholder protest and negative vote campaigns.

COORDINATION MECHANISMS

For the last several years, shareholder opposition to director re-election, as indicated by the percentage of withhold and against votes, has declined generally. This is likely due to the relatively new shareholder advisory vote on executive compensation (say on pay), which provides a means of expressing dissatisfaction with board decisions on compensation. In addition, companies are more apt to engage with shareholders on issues of concern.

However, companies should not take false comfort from the decline in negative vote results. The 2012 proxy season saw an increase in negative vote campaigns over 2011. Large institutional shareholders now coordinate their efforts to target directors in these campaigns through the Council of Institutional Investors (CII), an association of public, union and private pension funds and other institutional investors (with combined assets exceeding $3 trillion). In addition, Institutional Shareholder Services (ISS), the most influential proxy advisor, can serve as a coordinating force through negative vote recommendations.

NEGATIVE VOTE RECOMMENDATIONS FROM ISS

A targeted negative vote campaign can be distracting for the company and embarrassing for the targeted director and the board. It is estimated that ISS recommended against at least one director at as many as 15% of S&P 500 companies in the past two years. While a negative vote recommendation from ISS does not guarantee that a director will fail to achieve a majority of the votes cast, such a recommendation is associated with a significantly lower vote.

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The reasons most frequently cited by ISS for recommending against a director appear to be:

- Failure to act on a successful shareholder proposal.
- Compensation concerns.
- Independence issues.

ISS may recommend a negative vote in the election of directors for as many as 50 different reasons. Other factors ISS considers for individual directors include:

- Attending less than 75% of board and committee meetings (unless absences are due to medical or family emergencies and the reasons are disclosed in SEC filings).
- Sitting on more than six public company boards, or being CEO of a public company and sitting on more than three public company boards in total (the negative vote recommendation will apply only to elections for the outside boards).
- Being viewed by ISS as responsible for a material failure of governance, stewardship, risk oversight or fiduciary responsibilities at the company.
- Engaging in egregious actions related to service on other boards that raise substantial doubt about the director's ability to effectively oversee management and serve the best interests of shareholders at any company.
- Being an inside or affiliated outside director and serving on the audit, compensation or nominating committees.

For a detailed list of factors that may give rise to negative vote recommendations, see *ISS Issues Policy Updates for 2012 Proxy Season*, Weil, Gotshal & Manges LLP (Nov. 2011), available at *weil.com*.

STEPS TO PREPARE FOR THE 2013 PROXY SEASON

Shareholders will likely continue to focus on director elections and board composition in 2013 as a means of influencing board behavior. Just as companies will parse through shareholder proposals and vote results from 2012, large institutional shareholders will learn from the experiences of this year.

In particular, companies should expect the next round of proxy access proposals to be more carefully crafted to survive no-action requests to the SEC and to garner broader shareholder support.

Boards should begin to prepare for the upcoming proxy season by taking the following steps:

- **Pay attention to governance trends.** Understand which shareholders are most likely to bring proposals on proxy access or majority voting, or engage in a coordinated campaign to vote against a director. Also consider what circumstances may give rise to shareholder proposals or negative vote campaigns.
- **Review risk exposure.** Assess the issues that are most likely to raise concerns among your shareholders. For example, companies likely to be targeted for proxy access have other perceived governance failings.
- **Engage in shareholder outreach.** Communicate with and be responsive to shareholders generally on governance issues. Identify the concerns of significant shareholders. Sending signals throughout the year that the company cares can serve as a good preventive measure.
- **Consider governance improvements.** Determine whether governance improvements are needed. If so, make changes in a timeframe that allows the company to announce them prior to the deadline for shareholder proposals.
- **Evaluate the performance of directors.** In addition to evaluating the board and its committees, assess the performance and continuing fit of each director. Consider how individuals can improve their contributions to the board and its committees and whether the director should be re-nominated in light of the board's needs and the director's performance.
- **Anticipate shareholder proposals.** Consider how the company would be positioned to respond to a majority voting or proxy access proposal. Some companies may want to adopt majority voting as a defensive measure or be prepared to adopt it if a shareholder approaches. Similarly, some companies may want to consider what form a management proxy access proposal might take. This could serve as grounds for excluding a conflicting shareholder proposal or forestall a potential shareholder proposal.
- **Determine how to handle negative vote recommendations.** Consider the appropriate response if a proxy advisor issues a negative vote recommendation for one or more directors.

>> For a Checklist of steps to prepare for and respond to ISS proxy voting recommendations, search Handling ISS Proxy Voting Recommendations on our website.

PROXY ACCESS

The 2012 proxy season was the first in which shareholder proposals seeking to require future inclusion of shareholder-proposed director nominees in company proxy materials went to a vote. Effective in September 2011, Rule 14a-8(i)(8) under the Securities Exchange Act of 1934 requires companies to include in their proxy materials eligible shareholder proposals seeking the adoption of proxy access procedures.

Shareholders submitted 22 proxy access proposals during the 2012 proxy season. More are expected in 2013, in part because it will be the first year in which those companies with early annual meetings will be subject to Rule 14a-8(i)(8). Of the 22 proposals in 2012:

- Eight were successfully challenged under the SEC's no-action process and found to be excludable for a variety of reasons.
- Three were withdrawn. Of these three, one company (Hewlett-Packard) agreed to put a board-recommended proxy access proposal to a vote at its 2013 annual meeting.
- Nine went to a vote as of the end of July (two were still pending). Of these nine,
  - five were binding proposals, receiving 31% average support; and
  - four were precatory proposals, receiving 40% average support, with two passing (at Chesapeake Energy with 60% and Nabors Industries with 56%).

It is difficult to determine based on this small sample what factors were likely to drive a higher vote. Four of the five binding proposals sought proxy access for shareholders holding 1% of outstanding shares for one year. The two precatory proposals that passed sought a 3%, three-year threshold, the same threshold in the SEC's attempted mandatory proxy access rule. However, both of the proposals that passed also involved fairly unusual circumstances. These companies had been subject to other criticism for governance practices or decisions. It therefore remains unclear whether shareholders are more hesitant to approve binding proposals or to support proposals that fall below the 3%, three-year threshold.

The views stated above are solely attributable to Ms. Gregory and do not reflect the views of Weil, Gotshal & Manges LLP or its clients.