

**COMMITTEE ON CORPORATE LAWS  
DISCUSSION PAPER ON  
VOTING BY SHAREHOLDERS FOR  
THE ELECTION OF DIRECTORS<sup>1</sup>**

June 22, 2005

The Committee on Corporate Laws (the “Committee”) of the Section of Business Law of the American Bar Association has undertaken a detailed analysis of possible changes to the Model Business Corporation Act (the “Model Act”) relating to voting for directors. The substantive law relating to the election of directors of both public and private corporations is a matter governed by state corporation law. The Committee’s attention to voting for directors is limited to the process governing board elections of public corporations.

This Discussion Paper sets forth various issues identified by the Committee relating to shareholder voting for the election of directors as well as possible changes to the Model Act that could be considered and the potential consequences of those changes. The purpose of the Discussion Paper is to elicit from interested persons focused input and suggestions of alternative courses of action. The Committee intends to consider that input in arriving at a decision whether to recommend any amendment to the Model Act.

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<sup>1</sup> This draft Discussion Paper has been prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association (the “ABA”). It is released by the Committee solely for discussion purposes. It does not set forth a proposal recommended by the Committee. Moreover, it does not purport to set forth ABA policy. It has not been approved by the Section of Business Law, the House of Delegates or the Board of Governors of the ABA. Accordingly, it should not be considered as representing the policy of the ABA.

## *Introduction*

The Model Act was first published in 1950 and is continually reviewed by the Committee. A substantial majority of the states follow the Model Act to a significant extent, either by adoption of the Act substantially in its entirety or by adoption of important parts of it. States that have substantially adopted the Act are known as “Model Act States.” Delaware, the state of incorporation of more than half of all publicly traded companies in the United States, is not a Model Act State, but Delaware lawmakers carefully study the work of the Committee and Model Act developments. Courts and commentators also frequently refer to the Model Act.

Section 7.28(a) of the Model Act provides:

Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present.

This section establishes a plurality vote for directors as the default standard in the absence of a provision in the articles of incorporation specifying a different standard. In the context of election for directors, “plurality vote” is well understood to mean the receipt of the most votes for a nominee or nominees without regard to the number of votes against or not cast.

Section 216 of the Delaware General Corporation Law (the “DGCL”) also provides a plurality standard for election of directors in the absence of a provision in the certificate of incorporation or the bylaws specifying a different standard.<sup>2</sup> Subsection (3) of Section 216 provides that:

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<sup>2</sup> Note that the Model Act uses the term “articles of incorporation,” whereas the DGCL uses the term “certificate of incorporation.” Similarly, the Model Act uses the term “shareholder,” whereas the DGCL uses the term “stockholder.” These respective terms are synonymous.

Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors[.]

According to the Model Business Corporation Act Annotated: “Thirty-five jurisdictions provide expressly that directors are elected by plurality vote.”<sup>3</sup>

A Task Force of the Committee is currently studying the question of whether to recommend to the full Committee any change in the Model Act provisions relating to the election of directors. The Task Force is co-chaired by Margaret M. Foran and A. Gilchrist Sparks, III. Ms. Foran is Vice President-Corporate Governance and Secretary of Pfizer, Inc. Mr. Sparks is a senior partner of the Wilmington, Delaware law firm of Morris, Nichols, Arsht & Tunnell.

The Committee consists of practicing lawyers, academics, in-house counsel and judges, from twenty states. The Committee places great emphasis on the objectivity of its members who “leave their clients at the door” and apply their experience, judgment and drafting skills solely to recommend to the states their views on the correctly articulated expression of proper and balanced corporation law policy.

The process of amending the Model Act is always thorough and deliberative. Any amendment involves consideration by the Committee of a series of submissions of draft amendments with explanatory comment from its task forces that are charged with specific issues to review. Importantly, the process then requires consideration of a proposed amendment at successive meetings of the Committee.

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<sup>3</sup> MOD. BUS. CORP. ACT ANN., § 7.28, Statutory Comparison at 7-191 (3d ed. 2002).

Before making a final decision on any substantive amendment, the Committee publishes the proposal and explanatory material for comment in *The Business Lawyer*. If there is to be any change in the director election provisions of the Model Act, this traditional procedure must be followed. The entire process of considering any possible amendments to the Model Act should take the time necessary to give it the proper care and attention that it deserves. No definitive timetable has been set, but the Committee has been meeting and will continue to meet on this issue.

The next meetings of the full Committee this year will be in September and December. Nevertheless, the Director Election Task Force, like other task forces of the Committee, will meet and consider this matter between meetings of the full Committee. It is too early to predict if or when the full Committee will publish in *The Business Lawyer* a report with a recommendation for amendment to the Model Act relating to the matter of voting for directors.

### ***The History of Plurality Voting***

Plurality voting appears to have its roots in a concern that shareholders presented with a choice among more nominees than there are open positions on the board might fail to elect a director. The annotation to Section 7.28 of the Model Act states that, historically, plurality voting “appears to have received little attention.”<sup>4</sup> The annotation also describes Section 7.28(a) as addressing “the required vote in multifactional elections.”<sup>5</sup> Thus, one may

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<sup>4</sup> MOD. BUS. CORP. ACT ANN., § 7.28 at 7-189 (3d ed. 2002). The plurality voting provision was added to the Model Act in 1983. *Id.*

<sup>5</sup> *Id.*

infer that plurality voting originated as a method of dealing with director elections involving more nominees than directorships.

The evidence of the historical underpinnings of Delaware’s adoption of plurality voting is clearer than the history of its inclusion in the Model Act. The official comment to the 1987 amendment of Section 216 of the DGCL, which introduced the plurality voting provision, states: “The Delaware rule has been that a vote of a majority of those present is required to take stockholder action. However, it was thought that at least in the case of the election of directors, the statute should only require a plurality vote.”<sup>6</sup> Contemporaneous commentary explains that this change was made because the former version of Section 216 did not take into account contested elections of directors and that in such cases it could be possible that none of the candidates would receive a majority of the votes cast.<sup>7</sup>

The legislative history from other states also supports the inference that plurality voting originated primarily due to concerns about failed elections in the event that multiple nominees vied for board positions. For example, in 1981 the Maryland legislature adopted plurality voting for directors of corporations.<sup>8</sup> A document appearing in the bill folder explained the reason for the bill as follows:

The Bill is needed because in some cases it is possible that less than the required number of nominees would receive a majority of the votes cast – when, for instance, there are more

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<sup>6</sup> S. 93, 134<sup>th</sup> Gen. Assembly, 66 Del. Laws ch. 136, § 11 (1987), *reprinted in* 2 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, § 216.

<sup>7</sup> LEWIS S. BLACK, JR. & A. GILCHRIST SPARKS, III, ANALYSIS OF THE 1987 AMENDMENTS TO THE DELAWARE CORPORATION LAW, 314, *reprinted from* The Prentice Hall Corporation (1987).

<sup>8</sup> MD. CODE ANN., Corporations and Associations § 2-404(d) (2005).

nominees than directors. In that event the nominees that received a majority of the votes would fill the remaining directorships, not the stockholders. It is also possible that no nominees would receive a majority of the votes cast, in which case there would be no election and the current directors could continue to serve until the next annual meeting of stockholders. The Bill would essentially eliminate the possibility of these bizarre occurrences.<sup>9</sup>

Experience has shown that the vast majority of elections for the boards of public corporations<sup>10</sup> are non-contested. Where plurality voting applies in a non-contested election, a nominee will be elected if he or she receives very few (or even a single) vote, regardless of how many shareholders withhold their votes for that nominee. This concern is substantially ameliorated in contested elections because the vote, regardless of turnout, will reflect a choice among competing candidates. The focus of this Discussion Paper is therefore on non-contested elections in public corporations, with the intention of not advertently or inadvertently altering present law as it applies to contested elections.

### ***The Failed Election Issue***

As noted, the history of the plurality voting system reflects a concern about the consequences of failed elections – those where a director is not elected. To the extent that directors are not already in office (*i.e.*, they are not incumbent directors), a failed election could result in a variety of practical problems and unintended consequences. These may include, but may not be limited to, the following:

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<sup>9</sup> Explanation of Senate Bill 659 Vote Required to Elect Directors, *quoted in Ideal Federal Sav. Bank v. Murphy*, 663 A.2d 1272, 1277-78 (Md. 1995).

<sup>10</sup> The scope of this paper is limited to addressing the election of directors of public corporations, as defined by Section 1.40(18A) of the Model Act (“Public corporation means a corporation that has shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national securities association.”).

- If a candidate who is the CEO or other senior executive is not elected, it could constitute a breach of that executive's employment agreement, and may trigger an obligation on the part of the corporation to make severance payments to that executive.
- The failure to elect a specified percentage of directors could result in a "change of control," thus accelerating debt or canceling a line of credit provided in a credit agreement, or triggering changes in licenses, franchise agreements or other important corporate arrangements.
- If a fixed number of directors is to be elected by holders of one class of securities, a failure to elect one or more directors could alter the relationship among shareholders of different classes.
- The failure to elect one or more candidates could adversely affect the corporation's ability to comply with listing standards or other requirements for maintaining independent directors or directors with particular qualifications.
- The failure to elect one or more candidates may alter the consequences of having a staggered or classified board.
- A dissident group with minority representation on the board of directors could enlarge its percentage of directors if new nominees to the board are not elected – thereby avoiding the need for a direct proxy contest challenge and altering the existing dynamics of control contests.

With respect to incumbent directors running for re-election, the failure to be elected would raise a different issue. Under current laws, incumbent directors who fail to receive a required vote continue in office as "holdover" directors, without any further action required to

maintain their positions.<sup>11</sup> Were that “holdover” rule left in place, any change in the required default vote could be criticized as ineffective or as discriminating between new and incumbent director nominees. On the other hand, the simple elimination by statute of the “holdover” concept would bring into play with respect to incumbents those problems listed above.

In deliberating upon the various potential director voting rules, it is prudent to consider whether the risk of failed elections is a significant concern. Proponents of majority voting assert that the risk is minimal. For example, in a recent position paper, Institutional Shareholders Services cited examples from the United States and abroad of corporations having majority voting requirements for directors and the wide margins by which their directors continue to be elected under those rules.<sup>12</sup>

On the other hand, when considering the true risk of failed elections in the context of alternatives to plurality voting, it is important to take into account a potential increase in “no vote” activity as a result of state law voting rule changes, as well as the effects of federal laws and regulations and other factors such as possible changes in the rules of the self-regulatory organizations. For example, as noted hereafter, the New York Stock Exchange (the “NYSE”) is

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<sup>11</sup> Model Act § 8.05(e); *see also* DGCL § 141(b).

<sup>12</sup> ISS INSTITUTE FOR CORPORATE GOVERNANCE, MAJORITY VOTING IN DIRECTOR ELECTIONS: FROM THE SYMBOLIC TO THE DEMOCRATIC 4-6 (2005). According to one source, incumbent directors of corporations organized under the laws of the United Kingdom are removed from office if more votes are cast against than in favor of re-election. *See Hermes Corporate Governance Commentary Paper: “Majority Voting: the worldwide orthodoxy,” available at [http://www.hermes.co.uk/pdf/corporate\\_governance/commentary/Majority\\_voting\\_around\\_the\\_world\\_030605.pdf](http://www.hermes.co.uk/pdf/corporate_governance/commentary/Majority_voting_around_the_world_030605.pdf).* The same source notes that an incumbent director of a corporation organized under the laws of France must receive a majority of shareholder votes in favor of election in order to be re-elected, with abstentions counting as votes against a director. *Id.*

currently reviewing the potential elimination of the broker vote rule, which could increase the risk of failed elections under various alternatives to plurality voting.

### *The Impetus for Considering Change*

A change from plurality voting for directors of public corporations has recently become a major focus of shareholder activists, certain academics and others as a means to enhance the accountability of corporate boards.<sup>13</sup> Although the plurality vote default rule has been in place for decades, and has proved useful in avoiding the specter of failed elections, the concern that the plurality voting standard theoretically enables a small number of shareholders to elect directors even in the rare event of substantial (even majority) withheld votes merits attention. Given the intense current interest in, and importance of, corporate board legitimacy and the historic role of state laws in the internal corporate governance arena, the Committee believes it should consider and respond to recently expressed concern with respect to the plurality voting standard.

The Committee is evaluating whether an amendment to the Model Act would be an appropriate response to the concerns of those seeking to give greater effect, in a non-contested director election, to votes cast against or withheld from one or more directors. At the same time,

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<sup>13</sup> This level of attention to majority voting has developed following debate upon the proposal by the Securities and Exchange Commission (“SEC”) in October 2003, to require management to include shareholder nominees for the board in company proxy materials under certain circumstances. *See* Security Holder Director Nominations, Exchange Act Release No. 34-48626 (Oct. 14, 2003). At present, the momentum for adoption of the proposed SEC rule has stalled. *See* Stephen Labaton, *S.E.C. Rebuffs Investors on Board Votes*, N.Y. TIMES, Feb. 8, 2005, at C2 (reporting that the shareholder access proposal appears to be “dead”); *but see* Roel C. Campos, Commissioner of the SEC, “The SEC’s Shareholder’s Access Proposal. It Still Has A Pulse,” Address at the Yale Law School (Jan. 10, 2005).

the Committee is cognizant of the importance of the board's ability to fill board vacancies and to have the flexibility to deal with problems that could occur in the event of a failed election under an altered default voting system.<sup>14</sup> Any proposal to amend the Model Act should avoid the consequences of a voting standard that would create uncertainty in the functioning of the election process or undermine the efficacy of the shareholder franchise.

### *External Rules Affecting Director Voting*

As noted above, this Discussion Paper addresses potential changes to the Model Act. One must bear in mind, however, that federal securities laws and other factors such as stock exchange rules interrelate with and impact the effects of any changes to state laws governing director voting.

Although the election of corporate directors is largely the province of state law, federal regulation of what appears on the proxy cards sent to shareholders affects the mechanics of the voting process. Where plurality voting applies under state law, shareholders receive proxy cards that do not provide for a vote "against" a director nominee. Instead, a shareholder may vote either "for" or "withhold" with respect to a nominee.

The "withhold" choice on proxy cards originated in 1967 when the SEC amended Rule 14a-4(b) to allow shareholders to withhold authority from a proxy holder to vote for an

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<sup>14</sup> The principal focus of this Discussion Paper is the state statutory default rule. Companies are free to change the default rule by private ordering. Such a change may be effected under the Model Act by amending the articles of incorporation, which requires both director action and shareholder approval. Model Act § 10.03. Under the DGCL, the voting system of a Delaware corporation can be changed by amending the certificate of incorporation, which (like the Model Act) requires both a board recommendation and shareholder approval, DGCL § 242(b), or by amending the bylaws. DGCL § 216. Under the DGCL, bylaws may be amended by shareholders without director approval or, if provided in the certificate of incorporation, by the directors. DGCL § 109(a).

entire slate of nominees in the case of a proxy form that contemplated votes on both the election of directors and other matters.<sup>15</sup> Then, in 1979, the SEC proposed another amendment to Rule 14a-4(b) that would have allowed shareholders to vote “for” or “against” a director nominee. Because of the plurality voting system and concerns that shareholders could misunderstand the effects of an “against” vote under such a system, the SEC did not adopt the proposed amendment and continued the withhold vote procedure to allow shareholders to express dissatisfaction.<sup>16</sup> Thus, today most proxy cards provide shareholders with the opportunity to vote only “for” a nominee or to “withhold” authority to vote for a nominee, but they do not provide for an “against” vote.

Some of the alternative director voting rules under consideration would require that proxy cards provide shareholders with the opportunity to vote “against” a nominee, although that option is not currently available on most proxy cards.<sup>17</sup> Those alternatives could nevertheless be implemented without prior action by the SEC to amend its proxy regulations. The instructions to Rule 14a-4 provide that where state law gives effect to a vote “against” a nominee, the proxy card must provide shareholders with an opportunity to vote “against” a

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<sup>15</sup> SEC Rule 14a-4(b)(2), 17 C.F.R. § 240.14a-4(b)(2) (2005); *see also* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 903-04 (1993) (discussing the “withhold” vote and its history).

<sup>16</sup> Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Release No. 34-16356 (Nov. 21, 1979).

<sup>17</sup> Because the SEC developed the concept of a “withhold” vote as a means by which shareholders could express dissent where state law does not permit a vote “against” directors, presumably the “withhold vote” option would not appear on shareholder proxies if shareholders are given the opportunity to vote “against” or abstain with respect to the election of directors.

nominee.<sup>18</sup> Thus, if “against” votes carried weight under state law voting rules, management would be required to issue proxy cards that included an “against” box.

The rules of the national stock exchanges also have important implications for certain of the alternative director voting rules under consideration. For example, Rule 452 of the NYSE currently authorizes brokers to vote shares held in street name in a non-contested election if the broker does not receive voting instructions from the beneficial owner of the stock within a specified period before the shareholder meeting.<sup>19</sup> In the past, these broker votes have generally been cast in support of the board’s director nominees.<sup>20</sup> The NYSE recently convened a committee to review the continued viability of the so-called “broker vote rule.”<sup>21</sup> Elimination of the broker vote rule could significantly alter the proportions of votes for and withheld from director nominees, potentially affecting the outcome of elections under some alternative voting systems.

### *The Alternatives to be Considered*

The Committee is examining various alternative scenarios and their consequences. These alternatives include the following:

- Retain the current plurality vote default rule.
- Change to a majority vote default rule.

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<sup>18</sup> SEC Rule 14a-4, 17 C.F.R. § 240.14a-4 (2005), Instruction 2.

<sup>19</sup> N.Y. STOCK EXCH. CONSTITUTION AND RULES R. 452, *available at* [http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp\\_1\\_5&manual=/nyse\\_rules/nyse-rules](http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_5&manual=/nyse_rules/nyse-rules).

<sup>20</sup> Neal Lipschutz, “*Broker Vote*” at Odds with Majority Rule: A Dow Jones News Analysis, *available at* <http://ap.tbo.com/ap/breaking/MGB34ZXF08E.html> (Apr. 26, 2005).

<sup>21</sup> *Id.*

- Adopt a default plurality rule requiring that a director must be elected by at least a “minimum” plurality vote, such as one-third.
- Leave the plurality vote default rule in place but specifically authorize “against” votes with consequences where a director achieves a plurality vote but more “against” than “for” votes.<sup>22</sup> These consequences could include, for example, shortening the term of that director, unless the board acted within a specified time frame to confirm the director’s election, or giving the board the authority to remove that director.

### ***Retaining The Current Plurality Default Rule***

One option is to retain plurality voting for election of directors. Plurality voting – where all open positions are filled by those nominees with the highest vote tallies – is the prevailing standard in director elections in the American corporate governance system. Supporters of the status quo emphasize the virtues of the current system, question the need for a major overhaul and warn of unintended consequences that may ensue.

As described above, the plurality standard was adopted about twenty years ago as part of the Model Act and the DGCL to avoid the problem of “failed elections” where the desired result of filling all open positions is not achieved. It recognizes the imperatives of achieving a result that is certain and the desirability of maintaining stability in corporate governance. Supporters of the plurality vote system note that it delivers this result in a simple, efficient and

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<sup>22</sup> Alternatively, specified consequences could follow from different voting thresholds, such as “against” votes constituting a majority of the voting power of outstanding shares.

transparent manner, all of which are important criteria in an election system used by thousands of companies and millions of individual voters of varying levels of sophistication.

Undue complexity in a voting system can add a substantial burden to companies, regulators and courts and may discourage shareholder participation. Under the current system, companies and voters know exactly what to do. The SEC is able to oversee proper disclosure to ensure transparency. The law is clear and straightforward; disputes are rare and, by and large, easily dealt with by the courts. Because of the complexity of issues impacting a potential departure from the plurality default rule, moving to a majority vote-based system could jeopardize the simplicity, certainty and efficiency of the current system.

The simplicity of the current system also makes it extremely flexible. Plurality voting works equally well with simple one-share-one-vote structures and with more complex capital structures, such as cumulative voting, different classes of stock with differential voting or the many variations of preferred stock director designation rights. A change from the plurality voting regime could complicate the accommodation of non-standard arrangements like these.

In addition to citing the benefits of plurality voting, its advocates question the need for further reform in this area at this time. The drive toward reforming the corporate election machinery may be guided by a sense that the director election system is not working as a true electoral system and it needs to be changed. But, to the extent that it is a valid concern, it must be considered in the context of changes in recent years, during which substantial reforms and improvements have been implemented.

Those changes include new stock exchange listing standards, the Sarbanes-Oxley Act and related rules, heightened judicial scrutiny of board actions and the increased incidence of voluntarily-implemented best practices. These reforms have tended to bolster the independence

of directors, strengthen audit committees, improve the director nominating process, require annual committee evaluation processes at least for independent committees, enhance communications with directors, encourage and protect whistleblowers, improve disclosures and correct many other governance deficiencies, real or perceived. These changes and enhancements are working their way through the system, and time will tell what impact they have on corporate governance. Thus, a period of absorption of these new rules and developments could be useful in assessing the need for further legislative changes. Among other things, many corporations have embraced different approaches on their own, through changes in their bylaws, in their director nomination procedures or in their corporate governance guidelines.<sup>23</sup> There is a reasonable expectation that this trend would continue.

The rationale most frequently advanced to justify a change from the present voting system is to make directors more “accountable” to shareholders. The voting system typically in place at companies today permits shareholders to register their dissatisfaction by withholding their votes for one or more director nominees, but does not grant any legal significance to the “withhold” vote. Under the prevailing plurality standard, the argument goes, the withholding of support is of no consequence to nominees (at least in a non-contested election) and therefore has no influence on their behavior as directors. Plurality defenders disagree and point out that, in practice, the threat of a high withhold vote is a significant “weapon” at shareholders’ disposal. Directors and the companies they oversee are not

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<sup>23</sup> For example, any board of directors can establish, as an informal corporate governance policy, a voluntary practice that any director receiving more “against” votes than “for” votes would tender his or her resignation.

insensitive to being singled out for criticism, and, as a practical matter, successful “withhold vote” campaigns can lead to real and immediate consequences.

Supporters of the current system note further that the threat of withholding votes in a non-contested election is only one of several techniques available to shareholders to express their views. Dissatisfied shareholders have always had the option of simply selling their shares. Because of regulatory reforms and the increased power of institutional shareholders and hedge funds, they also have a range of other viable tools to register their dissatisfaction. The significant influence of large institutional investors is today wielded in meetings behind closed doors and via the “bully pulpit” of public criticism. Precatory shareholder resolutions are a means for even holders of a small number of shares to have their voices heard.

Proxy contests, although not cost-free, are a viable option, especially in light of rapidly evolving technology. It is also not necessary to launch a full-scale proxy fight as SEC rules allow for “short-slate” solicitations to propose one or more nominees. Indeed, the mere threat of a proxy contest has in some cases been sufficient to cause boards to preemptively nominate shareholder-suggested candidates. Litigation has always been available in cases of abuse. Of course, shareholders also have ultimate resort to the market for corporate control. Thus, supporters of the current system argue, the “withhold” campaign exemplified by a concerted effort to withhold votes in favor of the election of certain nominees is just one technique in the sizable arsenal of tactics already available to shareholders to express their dissatisfaction.

Giving “teeth” to “withhold” campaigns, such as by moving to a majority voting standard, could increase their success rate. This, in turn, presumably would increase the frequency of these campaigns, in part because they are easy, costless and require little or no

commitment on the part of the dissenting shareholders. It is certainly not clear, however, that such a development would lead to improvement in accountability or corporate governance. And it could carry with it the risk of unintended (and sometimes unpredictable) consequences. Indeed, supporters of the current system ask why shareholders wishing to override the judgment of the independent nominating committee of the board should not have the burden of finding one or more better alternative candidates and justifying their position to the rest of the shareholder body by input to the nominating committee or otherwise. Many commentators see one of the greatest threats to corporate governance – and to American industry – in the growing reluctance of talented and experienced business leaders to subject themselves to the increasing demands, risks and criticism associated with being a public company director. To the extent that empowering and encouraging “withhold” campaigns might accelerate that trend, caution may be advisable.

### ***Majority Default Rule Approach***

One possible way of addressing the perceived inadequacies of the plurality rule would be to adopt a form of majority voting requirement for director elections. With respect to this alternative, an amendment to Subsection (a) of Section 7.28 of the Model Act could provide:<sup>24</sup>

7.28(a) Unless otherwise provided in the articles of incorporation, *a director is elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present, provided that a director of a public corporation is elected*

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<sup>24</sup> All of the statutory changes included in this Discussion Paper are for illustrative purposes only. The Committee recognizes that, with respect to each of the illustrative amendments, additional wording and definitional changes would be necessary as part of a definitive drafting process.

*by a favorable majority of the total votes cast for and against the nominee at such meeting unless: (1) the articles of incorporation provide shareholders a right to cumulate their votes for directors; or (2) the number of nominees exceeds the number of directors to be elected and proxies are solicited by or on behalf of a person other than the corporation. With respect to any public corporation the shareholders of which do not have a right to cumulate their votes for directors, shareholders shall have the option to cast their votes for or against the election of a nominee or not vote.*<sup>25</sup>

This Majority Default Rule Approach addresses the concerns associated with directors of public corporations being elected despite significant shareholder opposition by providing that nominees must receive “for” votes representing a majority of the total votes cast “for” and “against” their election. To implement this approach, amended Subsection 7.28(a), where applicable, would provide shareholders of public corporations a new option to vote “against” a director.

The Majority Default Rule Approach is tailored to apply only in circumstances where critics suggest that the existing plurality system is deficient in voting for directors of public corporations. Accordingly, this approach would not apply in contested elections or where cumulative voting rights are applicable.<sup>26</sup> Cumulative voting is in place in relatively few corporations and, where it is in place, provides unique leverage to permit a minority of shareholders to have an influence on board composition. Contested elections do not present the risk of a *de minimis* number of votes resulting in the election of a disfavored candidate because shareholders are afforded the opportunity to choose among rival contestants, each of whom has

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<sup>25</sup> For purposes of this Discussion Paper, the italicized language denotes illustrative changes to existing Model Act provisions.

<sup>26</sup> Regarding contested elections, this approach would have to be refined to address the situation in which there are more nominees than seats to be filled and there is no solicitation of proxies for non-management nominees.

direct access to shareholders.<sup>27</sup> The plurality default rule would remain in place where the Majority Default Rule Approach does not apply.

Requiring a nominee to garner enough “for” votes to constitute a majority of the total votes cast “for” and “against” his or her election should be a sufficient threshold to alleviate the primary concerns suggested by the critics of the plurality voting system. Alternatively, a majority voting rule could be based on a higher threshold, such as a majority of the shares entitled to vote on the election of directors or a majority of the shares entitled to vote and present at the meeting in person or by proxy.<sup>28</sup> By giving effect only to “for” and “against” votes, the Majority Default Rule Approach would lead to a failed election only when a majority of the shares represented at the meeting register their dissent by casting a vote “against” a nominee. A failed election would not occur by virtue of abstentions, shares not present at the meeting or broker non-votes (should they become applicable to non-contested elections) since the holders of those shares have chosen not to record their dissent through a clear “against” vote.<sup>29</sup>

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<sup>27</sup> In a contested election, “against” votes are unnecessary because a vote that would have been cast “against” a director in a non-contested election will be cast “for” another nominee. “Against” votes are also unnecessary where shareholders possess cumulative voting rights in director elections, since “against” votes can be cumulated as additional votes “for” one nominee. Further study may be required on the details of how the limitation to non-contested elections could work in practice. For example, having different election standards for contested and non-contested elections may lead to complexity and uncertainty as, in some cases, there may be uncertainty whether the election will be contested, as well as how and when that determination is made.

<sup>28</sup> These alternatives reduce the chances of a successful election by including in the vote tally shares that were voted neither “for” nor “against” election, which, in turn, decreases the percentage of “for” votes that a director receives.

<sup>29</sup> By excluding abstentions, the proposal avoids the debate regarding whether an abstention is a vote. See *Licht v. Storage Technology Corp.*, 2005 WL 1252355 (Del. Ch. May 6, 2005) at \*5 n.28.

Compared to the current plurality rule, this approach would afford shareholders a more effective means to communicate their dissent regarding existing company policy by establishing the option of casting a vote “against” a nominee. Adoption of the Majority Default Rule Approach, standing alone, would not give much practical effect to an “against” vote, however. Although non-incumbent nominees would not be elected if they do not receive a majority of “for” votes, boards could avoid having non-incumbent nominees by asking that directors who did not intend to run for re-election resign before the meeting and then filling the resulting vacancy before the election. Incumbent directors would continue in office as holdover directors until their successors are elected and qualify.<sup>30</sup> The Majority Default Rule Approach will not result in a change in board membership unless a holdover director resigns and the remaining directors fill the vacancy, the size of the board is reduced to eliminate the directorship or a second shareholder meeting is held to elect another nominee.

If the change in board membership is effected only by director resignation, the Majority Default Rule Approach provides no greater shareholder power with respect to incumbents than the current plurality rule, in which a director may or may not choose to resign after having a significant number of votes “withheld” against his or her election. Although a

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<sup>30</sup> See Model Act § 8.05(e); DGCL § 141(b). In the event of a failed election, holdover directors could remain in office until the next director election. See *Comac Partners, L.P. v. Ghaznavi*, 793 A.2d 372, 380 (Del. Ch. 2001). Notably, failed elections may weaken the anti-takeover effect of a staggered board if the number of holdover directors, combined with the director class facing re-election, constitute a majority of the board. Thus, a hostile acquiror may be able to take control of a board having a significant number of holdover directors at one annual meeting as opposed to being forced to conduct proxy contests for two annual meetings, which would be required if all directors of a staggered board are serving full three-year terms.

holdover director could be removed from office by reducing the size of the board,<sup>31</sup> a reduction in directorships can be accomplished, depending on the circumstances, only by board action, a shareholder-adopted bylaw or, where the number of directors is fixed by or in accordance with the charter, a board-adopted and shareholder-approved charter amendment.<sup>32</sup> Even if board reduction is a readily accessible means to remove a director, such a reduction may disrupt management or alter the balance of power on the board if different classes of stock elect directors by separate voting groups.

The shareholders could also attempt to unseat a holdover director by electing a different candidate at a special meeting called after the annual meeting, but a second election may prove costly, and there is no guarantee that the shareholders will elect the new nominee. Moreover, depending upon the provisions of the articles of incorporation, a group of shareholders willing to call a special meeting may not satisfy the minimum ownership requirement necessary to do so, in which case the board may decline to call a special meeting and simply permit the holdover candidate to remain in office.<sup>33</sup>

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<sup>31</sup> See Model Act § 8.05(e) (holdover directors continue in office until a successor is elected and qualifies or until there is a decrease in the number of directors).

<sup>32</sup> Model Act § 8.03(b) (“The number of directors may be increased or decreased from time to time by amendment to, or in the manner provided in, the articles of incorporation or the bylaws.”). Accord DGCL § 141(b) (providing that the number of directors shall be “fixed by, or in the manner provided in,” the bylaws or the certificate of incorporation).

<sup>33</sup> See Model Act § 7.02(a). Section 7.02(a) provides that the holders of at least 10% of all the votes entitled to be cast on an issue may demand a special meeting regarding that issue. The percentage required to call a meeting may be decreased or increased in the articles of incorporation but cannot be increased to greater than 25% of the votes entitled to be cast. Under Delaware law, special meetings may be called by the board or any other persons authorized in the certificate of incorporation or bylaws. DGCL § 211(d). For some Delaware companies, the certificate or bylaws may not empower the shareholders to call a special meeting. Shareholders of a Delaware corporation may petition the Delaware Court  
(continued . . .)

Under most circumstances, a successful “against” vote campaign would be a hollow victory for shareholders unless Subsection 8.05(e) of the Model Act is also amended to abolish or limit the holdover rule. Complete elimination of the holdover rule seems imprudent, however, since unsuccessful elections could leave the board with a skeleton crew of directors, or perhaps no directors at all, and might cause the types of management crisis, exposure to hostile takeovers and the myriad other negative consequences of failed elections that the plurality rule and the holdover rule are meant to avoid.

### ***Minimum Plurality Approach***

Another alternative would change the default voting rules to provide that a director must receive a “minimum” plurality, such as one-third of the total votes “for” and “withheld,” in order to be elected. With respect to this alternative, Subsection 7.28(a) of the Model Act could be amended as follows:

7.28(a) Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present, *provided that in order to be elected, a nominee for director of a public corporation shall have received at least one-third of the votes cast unless: (1) the number of nominees exceeds the number of directors to be elected at the meeting and proxies are solicited other than by or on behalf of the corporation; or (2) the articles of incorporation provide shareholders a right to cumulate their votes for directors.*

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(. . . continued)

of Chancery to call a meeting to elect replacements for holdover directors, *see* DGCL § 225; *North Fork Bancorporation v. Toal*, 825 A.2d 860, 871 (Del. Ch. 2000), *aff’d*, *Dime Bancorp, Inc. v. North Forth Bancorporation*, 781 A.2d 693 (Del. 2001), but the Court of Chancery may exercise its discretion to deny that request. *See North Fork*, 825 A.2d at 871 (denying a shareholder’s request to order a meeting).

This Minimum Plurality Approach would apply only to public corporations as defined in Section 1.40(18A) of the Model Act. For the reasons already discussed in the Majority Default Rule Approach, this Minimum Plurality Approach also would not apply to corporations that allow cumulative voting for the election of directors, nor would it apply if an election were contested. The plurality vote default rule would continue to apply in those circumstances.

The Minimum Plurality Approach would create a lower risk of the occurrence of a failed election than the Majority Default Rule Approach because fewer votes would be necessary to elect a candidate. Nevertheless, failed elections under this alternative would have the same consequences as those under the Majority Default Rule Approach.

### ***Modified Plurality Approach***

Another alternative is a Modified Plurality Approach that permits a director to be elected by plurality vote, but imposes consequences based on the failure to achieve a majority threshold. This approach could involve a new Subsection 7.28(e) and conforming amendments to Subsection 7.28(a) and Subsection 8.05(e) of the Model Act, as follows:

7.28(a) Unless otherwise provided in the articles of incorporation, *and subject to the provisions of subsection (e)*, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present. . . .

7.28(e) *Unless otherwise provided in the articles of incorporation, with respect to any public corporation the shareholders of which do not have a right to cumulate their votes for directors, shareholders shall have the option to cast their votes for or against the election of a nominee or not vote. A person who receives the vote required for election set forth in subsection (a) or the articles of incorporation but also receives more votes against than votes for that person's election shall cease to be a director 90 days after the voting results are determined pursuant to Section 7.29(b)(5), provided that the board of directors may act within such 90-day period to confirm the election of that person. If a*

*director is elected by a group of shareholders entitled to a special vote by virtue of their group status, only the directors elected by the shareholders of that voting group may participate in a vote to confirm such director pursuant to this subsection. This subsection shall not apply to the election of any class of directors as to which the number of nominees exceeds the number of directors to be elected and proxies are solicited other than by or on behalf of the corporation. . . .*

*8.05 (e) Subject to the provisions of subsection 7.28(e), when applicable, despite the expiration of a director's term, the director continues to serve until the director's successor is elected and qualifies or until there is a decrease in the number of directors.*

The Modified Plurality Approach addresses the concern of those seeking to give effect to votes cast against directors while at the same time respecting the traditional power of the board of directors to fill board vacancies. This approach provides a board with the flexibility, subject to fiduciary restraints, to act to avoid the possible consequences identified earlier of a failed election under a majority vote default rule.<sup>34</sup> It gives meaning to “against” votes by specifically authorizing them and by modifying the holdover rule to truncate the terms of directors who do not receive more “for” votes than “against” votes, unless the board acts affirmatively to confirm their election.

While the Modified Plurality Approach would alter the holdover rule, it does not create the risk presented, if that rule were abrogated, of a management crisis that could occur if an entire board were to fail to receive a required majority or other specified vote. The Modified Plurality Approach should present little utility as a takeover tool because the board can confirm directors in order to prevent multiple vacancies that might otherwise allow a hostile acquiror to

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<sup>34</sup> The Modified Plurality Approach preserves the existing contractual expectations of shareholder classes that have bargained for the right to elect directors as a separate voting group by providing that only the directors elected by such voting group may confirm a director elected by the same voting group.

take control of the board. Further, by specifically authorizing “against” votes, it would give to shareholders an opportunity to express their views on particular directors without ambiguity, as distinguished from the present practice of withholding votes, where a withheld vote can, but does not necessarily, indicate opposition to a candidate.

This approach would permit a board of directors to act to seat a candidate who receives a plurality of votes but also receives more “against” votes than “for” votes. While this feature could be viewed as objectionable, fiduciary restraints and practical pressures may make it unlikely that this will occur except when the continued seating of such a director beyond the ninety-day period specified in the Modified Plurality Approach is in the best interests of the corporation. Moreover, the power of the board to confirm the election of a specific candidate who received a plurality vote but also received more “against” votes than “for” votes is consistent with the existing board power to fill board vacancies between elections.<sup>35</sup>

By triggering director term abridgement with a simple tally of more votes “against” than “for,” this approach seeks to avoid possible unanticipated effects of future external changes in the voting process such as elimination of the broker vote rule and debate over issues such as whether an abstention is a vote.<sup>36</sup> As previously noted, there are possible variants to the triggering vote under this approach, including (i) a failure of a candidate to receive a minimum number of votes; (ii) a majority of shares represented at a meeting and entitled to vote voting “against”; or (iii) a majority of shares entitled to vote voting “against.”

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<sup>35</sup> See Model Act § 8.10.

<sup>36</sup> See, e.g., *Licht v. Storage Technology Corp.*, 2005 WL 1252355 (Del. Ch. May 6, 2005), at \*5 n.28.

Finally, there is a question whether, under this approach, a non-incumbent candidate who receives more “against” than “for” votes should be seated at all. As drafted, the Modified Plurality Approach would apply in the same manner to incumbents and non-incumbents, both of whom would be seated and subject to the shortened ninety-day term unless confirmed by the board. That result is premised upon the view that non-uniform treatment of candidates is not desirable, especially given that most, if not all, of the failed election problems identified earlier would apply equally to incumbents and non-incumbents. In addition, corporations could avoid a rule that did not seat non-incumbents by creating and filling a new directorship or by asking a director who was not going to run to resign before an election and then filling the vacancy before the election, so that all new directors would be incumbents at the time of election.

A variant to the Modified Plurality Approach discussed above could, in lieu of the ninety-day confirmation concept, provide that a director who does not receive more votes “for” than “against” his or her election would hold office, but the board of directors would have authority to remove that director from the board within ninety days of the election. Such a variant could be effected by adopting a new Subsection 7.28(e) to provide:

*7.28(e) Unless otherwise provided in the articles of incorporation, with respect to any public corporation the shareholders of which do not have a right to cumulate their votes for directors, shareholders shall have the option to cast their votes for or against the election of a nominee or not vote. Notwithstanding the election of a person pursuant to subsection (a) of this section or pursuant to the articles of incorporation, if a director receives more votes against than votes for that person’s election, the board of directors may remove that director without cause on or before the 90<sup>th</sup> day after the voting results for such election are determined pursuant to Section 7.29(b)(5), provided that if a director is elected by a group of shareholders entitled to a special vote by virtue of their group status, only the directors elected by the shareholders of that voting group may participate in a vote to remove that director*

*pursuant to this subsection. This subsection shall not apply to the election of any class of directors as to which the number of nominees exceeds the number of directors to be elected and proxies are solicited other than on behalf of the corporation.*

Although cast in terms of “director removal” rather than “director confirmation,” this variant, like the Modified Plurality Approach as first discussed, gives meaning to a successful “against” vote by permitting the removal of a director while affording the board the option of retaining that director, either for part or all of the ninety-day period, or of permitting the director to serve a full term of office. Thus, like the first Modified Plurality Approach, this director-removal variant would permit the board to decline to give effect to a shareholder vote “against” a director.

As compared to the first Modified Plurality Approach, some may prefer a regime in which directors are removed from office because “removal” adds *gravitas* to the consequences of a successful campaign “against” a director. Others, however, may view the removal power as placing an unnecessary strain on the board of directors. The opprobrium associated with director “removal” may cause the board to be reluctant to abide by a shareholder “against” vote to remove a fellow director. Placing the removal power in the hands of fellow directors would also undermine the sense of collegiality among directors, which commentators have recognized as essential to the board’s decision-making process.<sup>37</sup> Moreover, the alternative to removal – simply failing to remove the director during the ninety-day period – may subject directors to less

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<sup>37</sup> See, e.g., 1 DAVID A. DREXLER, LEWIS S. BLACK, JR. & A. GILCHRIST SPARKS, III, DELAWARE CORPORATION LAW AND PRACTICE, § 13.01[6] at 13-9 (“The underlying and overriding policy of Delaware law with respect to exercising the functions of the board of directors is collegiality.”).

scrutiny, and require less justification, than a confirmation decision under the first Modified Plurality Approach.

From a corporate governance perspective, the director-removal variant would alter the current balance of power between shareholders and directors, as well as the authority shared among directors. The common law views the power to remove directors as an integral part of the shareholders' power to determine who will govern the business and affairs of the corporation.<sup>38</sup> Moreover, neither the Model Act nor the DGCL expressly permits directors to remove other directors. The courts that have developed the common law on this subject have declined to engraft onto the corporate law a director-removal power, reasoning that directors, as shareholder-elected officials, should not be permitted to remove other shareholder-elected officials.<sup>39</sup> The variant does, however, place limits on the director-removal power by permitting the board to exercise removal authority only during the ninety-day period following the election.<sup>40</sup> Moreover, the removal authority contemplated by the variant is not completely at

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<sup>38</sup> See, e.g., *Rohe v. Reliance Training Network*, 2000 WL 1038190 (Del. Ch. Jul. 21, 2000) at \*11 (“Like the right to elect directors, Delaware law considers the right to remove directors to be a fundamental element of stockholder authority.”).

<sup>39</sup> See *Bruch v. National Guarantee Credit Corp.*, 116 A. 738, 741 (Del. Ch. 1922) (“If the power of . . . [removal] of a director exists, it is reasonable to hold that it shall be exercised by the power that elected him, viz. by the stockholders. To allow directors to frame charges against one of their fellows and then to try and expel him, would open the door to possibilities of fraud which designing men might use to wrest control of corporate affairs from the stockholders . . . and transfer it to those who might seek to grasp the corporation for their own ends.”).

<sup>40</sup> The ninety-day limit minimizes, to some extent, the danger that the board may remove a director for reasons other than the shareholder vote. If a board were permitted to exercise the removal power at any time during a director's entire term of office, Subsection (e) could effectively produce a two-tiered class of directors, in which some directors serve at the pleasure of other directors.

odds with the concern, identified at common law, that director removal would usurp shareholder authority because the removal authority would arise from a shareholder vote against directors.

Some may find this director-removal variant offensive as it provides the directors of a corporation the ability to remove directors where the articles of incorporation either limit or eliminate the shareholders' power to remove directors without cause.<sup>41</sup> Thus, it would disturb the settled expectations of shareholders who benefit from "for cause only" removal provisions. Moreover, it would be inconsistent with the existing statutory scheme of director removal for classified boards under the DGCL.<sup>42</sup>

On the other hand, if this variant were drafted to afford the board a removal option only where shareholders may remove directors without cause, such an exception could swallow the rule. Because shareholder activism is currently focused on de-classifying staggered boards,<sup>43</sup> and because director-removal issues are often intertwined with the takeover protection afforded by the staggered board structure,<sup>44</sup> a Modified Plurality Approach with a director-removal variant could unnecessarily complicate the issues surrounding staggered boards.<sup>45</sup>

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<sup>41</sup> The Model Act permits corporations to provide in the articles of incorporation that directors may be removed only for cause. Model Act § 8.08(a).

<sup>42</sup> Section 141(k) of the DGCL specifies that, unless otherwise provided in the certificate of incorporation, directors serving on a classified or "staggered" board are removable by the shareholders only for cause.

<sup>43</sup> *See, e.g.*, Georgeson Shareholder "Annual Corporate Governance Review" – 2004 (noting that, in 2004, shareholders of 36 public companies presented proposals to de-classify staggered boards, with an average of 51% of shareholders voting in favor of those proposals).

<sup>44</sup> *See, e.g.*, Lucian Ayre Bebchuk, John C. Coates, IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 912-13 (2002) (noting that the effectiveness of a staggered board as an anti-takeover device depends, in part, on providing that directors may be removed only for cause, because  
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### *Action Required to Vary Plurality Voting Default Rule*

The alternatives for possible change discussed above focus upon revising the default rule establishing the consequences of a director candidate's failure to garner a defined threshold vote as possible ways to respond to efforts to recognize a majority voting principle in the election of directors. Another approach, either alone or in combination with the foregoing, could be to facilitate the ability of shareholders under the Model Act to opt into a majority voting scheme if plurality voting remained the default rule.

Section 7.28 of the Model Act establishes plurality voting for directors as the default rule unless varied in the articles of incorporation. Under Section 10.03, the articles may be amended to vary the plurality voting default rule if the amendment is adopted by the board and approved by the shareholders. Hence, director action as well as shareholder action is required. Unless varied in the articles, a majority of the votes cast at a shareholder meeting at which a quorum consisting of a majority of the votes entitled to be cast is present is necessary to approve the amendment.

This contrasts with Delaware law, where, under Section 216 of the DGCL, the plurality voting default rule can be varied in the certificate of incorporation or the bylaws. Like

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shareholder removal without cause would permit an acquiror to side-step the three-year staggered terms that otherwise can prevent an acquiror from taking control of a board before the occurrence of two annual meetings).

<sup>45</sup> Such an exception could unduly affect the current trend in which shareholders are seeking de-classification of the staggered board structure. By creating an exception to this removal provision that would apply to many companies with staggered boards, this approach might polarize board and shareholder views on de-classification, with some shareholders advocating de-classification even more strongly in order to attain the Subsection (e) removal provision and boards of directors becoming more resistant to de-classification in order to maintain the existing plurality rule for director elections.

the Model Act, Section 242 of the DGCL requires an amendment of the certificate to be adopted by the directors and approved by the shareholders. A favorable vote of a majority of the outstanding stock entitled to vote is necessary under the DGCL for an amendment of the certificate. In contrast, the bylaws, under Section 109 of the DGCL, may be amended by the shareholders, without director action, by the affirmative vote of a majority of the shares entitled to vote and represented at the meeting, as specified in Section 216 of the DGCL (unless a different vote is provided in the certificate or bylaws). The bylaws also can be amended by the directors if the certificate authorizes them to do so.

The Committee recognizes this variance between the Model Act and the DGCL and that arguments can be made for and against each regime. For purposes of this Discussion Paper, however, the Committee has decided to focus only on the statutory default alternatives rather than the method under the Model Act of departing from the statutory default provision. The choice of statutory default rule could affect the analysis of whether to alter the method of varying that default rule. Nevertheless, the Committee invites comment on the pros and cons of changing the method of departing from the default provision of the Model Act.

### ***Conclusion***

In its active consideration of the issues raised in this Discussion Paper, the Committee expects to benefit from the views of interested persons and constituencies. We have identified some benefits of and problems with each of the various alternatives. There may be other benefits and problems that we have not identified. And there may be other alternatives that should be considered, as well. We have reached no conclusions on these issues, and we continue to approach the matter objectively.

The Committee seeks the input of knowledgeable and experienced persons about the optimal course of action to assure a clear, understandable and workable voting system. The goal of this Discussion Paper is to focus and stimulate thought on the issues. It would be most helpful to the Committee if we could receive written comments and suggestions on or before August 15, 2005, addressed to **E. Norman Veasey, Chair, Committee on Corporate Laws, 1201 N. Market Street, Suite 1402, Wilmington, Delaware 19801**, or sent to him by email at **[e.normanveasey@weil.com](mailto:e.normanveasey@weil.com)**.