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Business Law Section
Committee on Securities Regulation

August 15, 2005

Committee on Corporate Laws
Section of Business Law
American Bar Association

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Attention: Hon. E. Norman Veasey, Chair

Re: Discussion Paper on Voting by Shareholders
for the Election of Directors (June 22, 2005)

Ladies and Gentlemen:

The Committee on Securities Regulation (the "Securities Committee") of the Business Law Section of the New York State Bar Association appreciates the invitation in the Discussion Paper on Voting by Shareholders for the Election of Directors, dated June 22, 2005, of the Committee on Corporate Laws ("ABA Committee") to comment on various issues identified in the Discussion Paper for the ABA Committee to consider in deciding whether to recommend any amendment to the Model Business Corporation Act (the "Model Act")

The Securities Committee is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Securities Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was reviewed by certain members of the Securities Committee, and the views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, are those of the Securities Committee and

do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

Summary

The Securities Committee commends the ABA Committee for the thoughtful and detailed analysis of the Model Act and a variety of alternatives, in light of proposals from various groups to require majority voting for directors, prompted in part by the SEC Security Holder Director Nominations proposal of October 2003. We believe that the Discussion Paper has analyzed and identified important issues and consequences of the alternatives, and would expect that additional issues and insights will be provided through the comment process.

There are a number of independent initiatives in progress addressing majority voting, as discussed below in this letter. While any amendment of the Model Act and adoption of conforming state laws will take a number of years to complete, these independent initiatives may give significant new insights on the subject by the end of the 2006 proxy season. We therefore recommend that the ABA Committee wait to see the results of these initiatives before recommending specific amendments to the Model Act.

In any event, because corporations can adopt majority voting for the election of directors under the Model Act and the corporate laws of states where a majority of publicly-traded corporations are incorporated, we strongly urge the ABA not to recommend any amendment to the Model Act to mandate majority voting at this time, but instead to retain the present flexibility that permits those corporations to adopt majority voting by charter or by-law amendment. If majority voting were mandated for certain corporations by stock exchange listing requirements or otherwise, those corporations could implement required provisions without imposing legislative change on all corporations.

We discuss below in this letter in greater detail the following issues and considerations:

- Corporations currently have the flexibility under the laws of states where a majority of publicly-traded corporations are incorporated to adopt some form of majority vote by amendment to the certificate of incorporation and/ or by-laws, without the need for any change in the states' corporate laws.

- Corporations have demonstrated responsiveness to calls for governance reforms to address shareholder concerns, such as elimination of classified boards, removal of anti-takeover arrangements, and consideration of shareholder input on specific management and/or director positions.
- Any change in legislation to mandate some form of majority voting would involve a substantial amount of time between amendment of the Model Act, which itself could be a lengthy process, to adoption by the various state legislatures, with transition periods or grandfathering of existing corporations possible.
- We encourage the ABA Committee to use the results of its substantial research and analysis to foster a better understanding by the various constituencies of the different election mechanisms that can be implemented under existing laws and to recognize the issues and limitations of majority voting.
- Boards of directors, which have fiduciary duties to shareholders, appear to be in the best position to evaluate a corporation's history to determine if any change in the voting provisions are called for, and to make a determination on whether to adopt policies on resignation of directors who failed to achieve certain voting approval thresholds. Large shareholders, shareholder organizations and governance/rating organizations should examine their policies and criteria for recommending votes or withhold votes for director candidates to consider overall assessment of the qualifications and qualities of directors, as opposed to single-issue campaigns.
- We urge the ABA Committee to encourage the SEC, the New York Stock Exchange and other exchanges and listing institutions to leave the determination of director election provisions to the state corporate laws and the evolution of best practices under existing shareholder communications processes. Even if the SEC or these organizations were to impose majority voting, some transition period of time would be required and the statutory holdover provisions could defeat in practice the majority vote outcome. Furthermore, corporations could be in jeopardy of violating independence and committee membership requirements and confront possible delisting if some directors do not take, or continue in, office as intended by the board in nominating them for election.

Discussion

State corporate laws generally permit corporations to establish majority voting.

Like Model Act Section 7.28, most state corporate laws currently provide substantial flexibility on establishing the vote required for election of directors. To the extent that plurality voting is specified by a state's corporate law, it is generally the default voting method, applicable if no other procedure is adopted. Delaware's General Corporation Law Section 216 provides that the corporation's charter or by-laws may set the standards for quorum and voting, but if they do not specify those standards, then directors are elected by a plurality of the shares present and entitled to vote. Like many other corporate law provisions, the statute is intended to provide flexibility to those forming a corporation to establish higher requirements for election of directors or to rely on the plurality vote which assures all board seats will be filled, even in a contested election. A Delaware corporation may adopt majority voting for election of directors by amending its by-laws or charter, through the board and/or shareholder approval process.

Since nothing more is necessary for a majority of existing publicly-traded companies to provide for majority voting if their shareholders and directors want to do so, it is not clear why the Model Act should be amended unless the purpose of the proposed amendment is to make majority voting mandatory. We strongly urge the ABA Committee not to recommend such an amendment. The state corporate laws provide the framework for all modern state-incorporated corporations – from one shareholder start-ups to multinational corporations. They should continue to provide the kind of flexibility we have noted above, allowing the relationship between shareholder and corporation to be tailored to particular needs of the corporation.

Corporations have demonstrated responsiveness to shareholder governance concerns.

For a number of years, institutional shareholders and interest groups have used the shareholder proposal process to identify issues of importance to them in corporate governance and other areas from executive compensation limits, to redeeming poison pills, to de-classifying boards. Companies receiving shareholder proposals frequently consider the issues raised by the proponent through the board of directors or an appropriate committee. Data from the 2004 proxy season shows that shareholders of 36 companies proposed consideration of de-

classification of the board of directors.¹ Since January 1, 2004, over 20 companies have reported amending their charter and/or by-laws to declassify their board of directors (and this number excludes votes taken at the many April/May 2005 annual meetings which were not reported on Form 10-Q when this information was compiled). The shareholders' message is being heard by the boards and acted upon. When boards have failed to act to the satisfaction of activist shareholders, they publicly announce their intentions to withhold approval of directors.²

Many companies are currently weighing their position on the majority vote issue. Companies have willingly engaged in public debate with union pension plan sponsors of majority voting proposals.³ In fact, in response to recent shareholder proposals by institutional investor groups and other shareholder activists, it has been reported that Lowe's Companies, Inc. and Dillard's Inc. have recently agreed to adopt a majority voting standard for their director elections. It has also been reported that ten other companies, including several in the *Fortune 500*, have agreed to seriously study adopting a majority voting standard in exchange for the withdrawal of shareholder proposals on the subject.

In addition, some companies have modified standards for director elections in more novel ways. For example, Pfizer Inc. has revised its corporate governance principles to require that any director nominee receiving a greater number of "withhold" votes than "for" votes must tender his or her resignation for consideration by the corporate governance committee.⁴ Office Depot, Inc. has also recently announced a majority vote standard providing its governance committee, independent under applicable NYSE requirements, with maximum flexibility, in the event a majority of the outstanding shares entitled to vote withhold or vote against a nominee, to determine whether to accept the tendered resignation.⁵

These voluntary actions are examples of the many changes that have been adopted in the past few years as a result of the changing corporate governance landscape. Mandating a majority

¹ Georgeson Shareholder, *Annual Corporate Governance Review, 2004*.

² Press release of AFSCME, dated May 12, 2004, "AFSCME Employee Pension Fund to "Vote No" on Directors at 10 Companies."

³ Transcript of April 12, 2005 teleconference "Majority Vote for Directors" of the Society of Corporate Secretaries & Governance Professionals.

⁴ Press release of Pfizer Inc., dated June 23, 2005, "Pfizer to Amend Corporate Governance Principles Regarding Election of Directors."

⁵ Press Release of Office Depot, dated August 1, 2005, "Office Depot Announces Adoption of Majority Vote Standard for Director Elections."

vote standard for all companies at a time when we are just beginning to see companies implementing such reforms – especially when the majority voting statutory option already exists for those who choose to implement it – is a step that does not appear to be necessary or appropriate at this time.

Changes to the Model Act would have little immediate effect.

The deliberative process followed by the ABA Committee in considering possible amendments to the Model Act properly includes research and consensus building. The ABA Committee’s Discussion Paper highlights alternatives and unresolved issues around the most appropriate “model” standard for election of directors. It is a time consuming effort but at its conclusion simply starts the process for legislatures in Model Act states to conduct their own analysis of the merits of any change to conform to changes in the Model Act. The time that it would take for a majority of jurisdictions to adopt such provisions could be lengthy. Delaware (not a Model Act state) may act before proper vetting of any Model Act proposal would be possible. The Chairman of the Corporation Law Section of the Delaware State Bar Association has already received direct request from an advocacy group, speaking for its institutional investor client-base, to recommend to the state legislature majority voting as the default rule for director elections.⁶

In addition, if changes mandate election of directors of public companies by at least a majority of the votes cast, state legislators may provide for a period of transition or grandfathering. The implementation is likely to vary by state, with some states imposing a change in the default provision for election of directors from plurality to majority at a date in the future, while other may adopt opt-in provisions to permit corporations formed prior to the enactment of the changes to determine whether to change their election procedure to match new law. In either event, since corporations often detail the election process in either their charter or by-laws, these instruments would require amendment, generally with shareholder approval. Implementing majority voting at any significant number of corporations by amending the Model Act would be a several year process.

⁶ Letter of Ann Yerger, Executive Director, Council of Institutional Investors, dated June 15, 2005, to David C. McBride, Chairman of the Corporate Law Section of the Delaware State Bar Association.

The ABA Committee’s research illuminating the flexibility of existing law and issues arising from majority vote proposals and the comments it receives add to the quality of the debate.

The ABA Committee’s contribution to the understanding of the alternatives and issues has raised the base on which the debate can occur. Additional insights derived from comments it receives should be integrated with its Discussion Paper. Even if the ABA Committee were to decide to recommend an alternative to plurality voting, such change creates many issues requiring further study. A director who fails to receive a majority vote would remain as a holdover director under most states' laws until a successor is elected and qualified. A change in the holdover law could result in a board vacancy. In the 2004 proxy season, one report named 16 public company directors who received at least 50% withhold votes, including four at a single company.⁷ Also, the failure to elect a director-nominee or requiring the resignation of a director who fails to obtain a majority vote could jeopardize a company’s ability to maintain independent audit, nominating and compensation committees as required by law (Section 10A(m)(3) of the Securities Exchange Act of 1934) or stock exchange listing requirements (*e.g.*, NYSE Listed Company Manual Section 303A).

Given the voluntary initiatives being taken by companies today and the issues and potential problems with integrating a majority voting standard with other existing governance requirements, we suggest that the ABA Committee continue to use its research capabilities and resources to further elucidate the alternatives and their relative merits and risks and to educate various constituents including institutional investors, other shareholders and boards of directors with respect to the options that are currently available to companies who want to change their election procedures through voluntary changes to charters, bylaws and governance principles.

The corporation and its constituencies may be the best forum to determine the “right” process for electing directors.

Activist shareholders have been communicating with the investing public, and the boards of directors of the public companies in which they invest, on a number of issues of corporate

⁷ Attachment 2 “Company Directors Receiving at least 50% Withhold Votes (for the 2004 Proxy Season)” to CalPERS Press release, dated March 14, 2005, “CalPERS to Seek Majority Vote for Corporate Directors.”

governance through the proxy proposal process. Rating services advise institutional investors on how to vote, including recommending “withhold” votes on certain director nominees, and providing short-hand or numeric evaluations of the governance of the companies they own. Arbitrary characterizations – such as concluding that a corporation formed in a state with a constituency statute is inherently less well governed than one incorporated where no such statute exists –may lower the governance rating and unfairly penalize a well-run, well-governed company. Unlike members of the board of directors of a company, shareholder and rating services owe no fiduciary duty to the corporation as a whole. As described above, one large union announced its “vote no” campaign against directors of ten companies, generally not because the companies were performing poorly or the directors were engaged in inappropriate activities, but because they did not implement one or more shareholder proposed governance changes approved several times by majority vote. The board of directors of a company may be better able to assess the desires of shareholders as a group, the company’s history and the composition of the board to determine whether to adopt policies or propose charter or by-law amendments to alter the director election process.

In addition, with the possibility of directors resigning or not taking office if insufficient votes are received, large shareholders, shareholder organizations and governance/rating organizations should examine their policies and criteria for recommending votes or withhold votes for director candidates to consider overall assessment of the qualifications and qualities of directors, as opposed to single-issue campaigns.

The Pfizer and Office Depot policies described above are creative majority vote standards that provide the governance committee, independent under applicable NYSE requirements, with maximum flexibility in the event a majority withhold or vote against a nominee to determine whether to accept the tendered resignation in the best interests of the corporation and its shareholders.

Conclusion

There are a number of private initiatives in progress addressing majority voting. Among those initiatives we note the following:

A group of ten companies and unions have been meeting over many months in an effort to find a common ground for an alternative voting process, referred to above. Since this is in process, we cannot tell what concept may emerge. However, any proposal with support from a group of both public companies and shareholders is likely to provide valuable insights.

Pfizer and Office Depot have adopted modified corporate governance principles, as discussed above. Each applies to only one company. However, as voluntary measures, each is already in place. This will allow for prompt observation of their results, and variations on them may be adopted by other public companies.

We understand that the Counsel of Institutional Investors has sent a letter to 1,500 public companies requesting that each recipient adopt some form of majority voting for director elections. The letters recommend that, when permissible under state law, recipients' charters and by-laws be amended to require that directors be elected by a majority of the votes cast or, if state law does not permit majority voting, that board policies be adopted asking directors to tender their resignations if the withheld votes exceed the votes for the director. While the eventual result of these recent letters can not yet be known, the CII website has a tally of each company's response posted, and they demonstrate another initiative being widely proposed without statutory amendment.

It is reasonable to expect that in the 2006 proxy season there will be additional shareholder proposals relating to majority voting for election of directors. The company-union meetings described above grew out of similar shareholder proposals last year. The Council of Institutional Investor letters note past proposals on the subject. More shareholder proposals may result from those letters. It will be instructive to see the results of the 2006 proxy season.

We believe that the efforts of the ABA Committee in its Discussion Paper will prove valuable whether they lead to amendments to the Model Act or not. The various formats described in the Discussion Paper and the pros and cons of each set forth will help in the evaluation of some of

the initiatives described above. We are likely to see a variety of further initiatives over the next year.

Any amendment of the Model Act takes several years, and adoption of conforming state laws will take additional years to complete. The independent initiatives described above may give significant new insights on the subject by the end of the 2006 proxy season. We therefore recommend that the ABA Committee wait to see the results of these initiatives before recommending specific amendments to the Model Act that would mandate majority voting. In any event, we strongly urge the ABA not to recommend any amendment to the Model Act to mandate majority voting at this time, but instead to retain the present flexibility of the corporate laws of the states where a majority of publicly-traded corporations are incorporated that permit corporations to adopt majority voting by charter or by-law amendment.

We hope the ABA Committee finds these comments helpful. We would be happy to discuss these comments further with the Committee or its Task Force studying whether to recommend any change in the Model Act.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION

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