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Delaware's Flexible Approach to Majority Voting for Directors

By David C. McBride and Rolin P. Bissell

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Introduction

Currently pending before the Delaware General Assembly are two amendments to the Delaware General Corporation Law (the "DGCL") that were designed to make it easier for stockholders to require majority voting in the election of a corporation's directors (the "Proposed Amendments").[1] The current default standard under the DGCL is plurality voting: the director who receives the greatest number of votes is elected. Majority voting, on the other hand, requires a director to receive a majority of the votes cast or present and entitled to vote, depending upon how the provision is drafted.

Proponents argue that majority voting would give stockholders greater power to unseat directors on underperforming boards, and thus may help cure a variety of corporate governance ailments such as excessive executive compensation, entrenchment, and board indifference to lackluster management performance. However, there are significant questions about the severity and pervasiveness of these ailments, their true causes, whether majority voting would help cure them, and what unwanted side effects majority voting might trigger.

Consistent with Delaware's historic approach of enacting permissive enabling statutes that give corporations flexibility in their basic governance arrangements, the Proposed Amendments would not create a default rule that mandates majority voting. Instead, the Proposed Amendments would strengthen the hand of stockholders, but leave it up to each corporation to decide whether it would benefit from majority voting. Thus, if the Proposed Amendments are adopted, Delaware will have resisted the temptation to make a premature judgment that either declares majority voting a new wonder drug or bans it as useless nostrum.

Identifying the Disease and the Quest for the Cure

In the wake of the corporate scandals of the past several years, many argue that one way to avoid future scandals and improve corporate governance is for state corporation law and federal securities law to give stockholders more power to discipline and motivate boards of directors.[2] The source of woe, so the theory goes, is that too many

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directors are ill-informed and lackadaisical time-servers at best, and management cronies with divided loyalties at worst. If the true owners of corporations—the stockholders—were empowered to bring wayward directors to heel, it would invigorate anemic directors and restore corporate health. Under this theory, the key to strengthening the stockholders' hand is to give them greater power to replace errant directors.

The first remedy to make its way out of the corporate law laboratory was the "shareholder access" proposals the Securities and Exchange Commission considered in 2003 and 2004.[3] The proposed "shareholder access" rules would require corporations, under certain circumstances, to include in their proxy materials stockholder nominees for election as director. The SEC may yet adopt these rules, but that appears increasingly unlikely. As a result, stockholder empowerment advocates have shifted their focus to changing the state laws governing the vote required to elect directors.

Until recently, director vote requirements were a sleepy and largely uncontroversial area of corporate law. The laws in thirty-five states currently provide for the election of directors by a plurality vote.[4] That is, directors are elected by a plurality vote unless a majority vote is mandated in the certificate of incorporation, or, in some states (including Delaware), the bylaws. But the issue has gained prominence in the last year and a half. The International Corporate Governance Network made majority voting one of its key advocacy initiatives, and the Council of Institutional Investors ("CII") also decided to support majority voting. In February 2005, the American Bar Association created a task force to consider the issue of majority voting, and soon a working group of corporate and labor pension fund representatives also was examining the issue. Around the same time, CII wrote to 1,500 corporations requesting that they adopt majority voting,[5] and Pfizer amended its corporate governance guidelines to require that any director who receives a majority of withheld votes must submit his or her resignation to the board, with the board to then decide what to do.[6]

The Majority Voting Issue Comes to Delaware

Current Delaware law already permits stockholders to establish a majority vote requirement for the election of directors and to establish this change through stockholder action without the approval of the board of directors.[7] Even though the stockholders of Delaware corporations have long had this power and have generally opted not to use it, on June 15 and 22, 2005, CII and the California Public Employees Retirement System wrote nearly identical letters requesting that the DGCL be amended to provide majority voting as the default rule for the election of directors.

After considering this proposal for months, the Council of the Section of Corporation Law of the Delaware State Bar Association, which is the body that typically recommends amendments of the DGCL to the General Assembly, determined not to recommend a change to the statutory vote provision. Instead, the Council recommended two amendments that will have the effect of making it easier for stockholders and boards of directors to implement majority voting or governance structures of comparable operation if they determine to do so. In essence, the Proposed Amendments eliminate some (but not all) of the legal issues that may arise in implementing a majority vote requirement for the election of directors. It is expected that the Delaware General Assembly will act on the amendments before its current session ends on June 30, 2006.[8]

If the Delaware General Assembly enacts the Proposed Amendments, Section 216 will be amended to provide as follows:

> A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.

As explained in the Synopsis to this amendment, the change to Section 216 protects stockholder-adopted bylaws that specify the vote needed to elect directors from being amended or repealed by the board. It is not limited to protecting "majority votes"; rather, it protects any vote requirement established in a stockholder-adopted bylaw, including a plurality vote. Most Delaware corporations provide concurrent power to stockholders and directors to adopt bylaws, but the Delaware courts have not resolved the issue of whether a board of directors may use its power to adopt and amend bylaws to alter a bylaw the corporation's stockholders have previously adopted. This proposed amendment makes it clear that the stockholders have the last word on the vote requirement for election of directors.

This amendment also potentially protects more than the specified vote from being changed. It states that the "bylaw amendment" that specifies the vote may not be further amended by the board. Thus, an amendment by which majority voting is instituted may do more than specify the necessary vote; it also may resolve other issues implicated in the adoption of a majority vote, such as how the vote will be computed or what the effect of the vote shall be. Whether subsidiary terms of the bylaw amendment are protected from later modification by the board of directors may depend upon how integral those terms are to the vote itself, the extent to which those terms impact matters other than the implementation of the vote, and the structure of the amendment (whether it is one amendment or two).

The Proposed Amendments also would change Section 141(b) to provide the following with respect to director resignations:

> A resignation is effective when the resignation is delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events. A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable.

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As explained in the Synopsis to this proposed amendment, the revision allows for the creation of an irrevocable resignation that is conditioned upon the "director failing to receive a specified vote for reelection." To be irrevocable, the resignation need not be effective upon the failure to receive a specified vote, only "conditioned" upon such a failure. Such a resignation may provide that it is not effective unless and until accepted by the board of directors. Under current law, there is some doubt whether a director's resignation can be made irrevocable before it is submitted to the corporation or whether a resignation effective at a future time is permissible.[9] Thus, the ability of stockholders or directors to compel a director to submit a resignation upon the director's failure to receive a majority vote also is uncertain. The amendment to Section 141(b) eliminates a potential challenge to the resignation of a director after a failed vote on the basis that the agreement to resign in the future was impermissible.

The Flexible Approach is Sensible as a Matter of Both Doctrine and Policy

By facilitating stockholder implementation of majority voting, but not imposing a new default rule of majority voting, the Proposed Amendments maintain the flexibility and balance that have been the hallmarks of the Delaware corporation law. This flexibility is warranted on the majority voting issue for at least three reasons. *First*, majority voting will not be a benefit for some corporations, and those corporations should have the freedom to retain plurality voting. *Second*, it is far from clear that majority voting will have any curative effects on the corporate ills it seeks to palliate. *Third*, it is not clear that this remedy is necessary in light of other actions dissatisfied stockholders could take.

Majority voting may not actually empower stockholders

Plurality and majority vote requirements both have advantages and disadvantages. The major advantage of the plurality vote requirement is that an election never fails to elect a director; someone always receives the greatest number of votes.[10] The major disadvantage of a plurality vote is that in an uncontested election—as most corporate elections are—a single vote elects a director, even if the vast majority of stockholders are opposed to the directors' election. The primary advantage of the majority vote is that it guarantees that a director will not be elected unless a majority of the shares voting or entitled to vote support election. The primary disadvantage of a majority vote is that it can make it more difficult to elect directors: a majority vote requirement may result in the failure to elect a director or, possibly, the entire board of directors, if no candidate receives a majority vote.

The risk of a failed election is particularly acute if the non-voting and abstaining shares present in person or by proxy count in the computation of the majority vote needed, which is how CII and other institutional stockholder groups want the majority vote to operate. Again, under a majority vote requirement, it is possible, even in an uncontested election, that no candidate will receive a majority of the votes actually cast. It becomes increasingly difficult to obtain a majority of the votes present when the shares present in person or by proxy either abstain or withhold their vote, and thus essentially count as "no" votes.

The key premise behind majority voting is that it is difficult for stockholders in most widely-held corporations to nominate and elect directors. But the effect of an incumbent director's failing to receive a majority vote is that the incumbent will either "hold over" or voluntarily resign, and the vacancy created will then be filled by the board of directors. Thus, ironically, under a majority vote requirement, it is the director who fails to receive the necessary vote and the other directors who nominated that director who will decide what should be done after a director fails to receive a majority vote. If a majority vote requirement simply gives the board an opportunity to find a replacement for an unpopular candidate, the process does little to increase stockholder power.

Section 141(k) currently allows the removal of a director by a stockholder vote or written consent on the specific proposal that the director be removed by a "majority of the shares then entitled to vote at an election of directors." Thus, the stockholders already can vote to remove the director after the director has failed to receive the necessary majority vote. This option does not become more potent under majority voting. If the stockholders are prepared to conduct a proxy contest to remove a director, they can run a candidate against that director in the original election, when a lesser vote would be needed to elect a new director than the vote necessary to remove a holdover director.

If a director were to resign following the failure to achieve a majority vote, Section 223 of the DGCL would govern the filling of vacancies. Unless the certificate or bylaws provide otherwise, vacancies may be filled by a majority of the directors remaining in office, although less than a quorum of the board, or by the sole remaining director. Also, unless the certificate or bylaws provide otherwise, a director who resigns effective at a future date may participate in the selection of his or her successor.

The provisions granting the power to directors to fill vacancies are not exclusive; the stockholders have the inherent power to fill vacancies unless that power has been unmistakably limited by a certificate provision[11] or, possibly, a bylaw provision.[12] However, it seems pointless for stockholders to attempt to exercise such power. Replacing an incumbent director by voting not to re-elect and, if successful, then voting again to fill the vacancy requires two steps by the stockholders to accomplish what could have been done in one step in the initial election. In addition, if the election of directors required a majority vote, the vote necessary to elect a replacement would be greater than the vote required simply to elect the candidate under a plurality structure.

If the effect of an incumbent's failure to receive a majority vote is simply to require the board to find a replacement, it

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seems the majority vote process will add little to the existing influence that institutional stockholders already have either by lobbying the board to find a new nominee before the election or by lobbying the board to replace the director who receives fewer votes in favor of election than withheld. Both of these options are available without majority voting. Simply put, if stockholders had the wherewithal to act to elect a nominee after a failed election, it would be easier and quicker to exercise that electoral power in the original election and under a plurality vote standard.[13]

From the perspective of incumbent boards, all of the reasons that limit the utility of majority voting for stockholders suggest that its adoption is, at most, a minor shift in the "balance of power" that currently exists between boards and stockholders. To those who believe the current balance is correct, majority voting is not a significant threat, and it offers to stockholders a way to express discontent in a more meaningful manner.

However, whatever added influence the majority vote requirement provides to stockholders in demonstrating their dissatisfaction is potentially offset because majority voting makes a proxy contest more difficult to win. The higher vote threshold under majority voting applies to both stockholder-nominated and board-nominated candidates. In a proxy contest, a majority vote requirement creates two possible outcomes that stockholders should find unpalatable: if none of the nominees, including the stockholder nominee, obtains a majority, either a second proxy contest must be conducted or the incumbent director remains in office as a "holdover." By making a proxy contest more difficult and more expensive, the majority vote provision may lessen whatever leverage the threat of a proxy contest confers on institutional shareholders. Even the advocates of majority voting realize that majority voting will be rarely used. Given this, one might also question whether majority voting will materially assist stockholders in holding directors accountable.

On balance, it is difficult to say that majority voting enhances the stockholders' ability to influence boards. For that reason, it is unclear whether boards of directors should fear it or stockholders should covet it.

Majority voting may not improve corporate governance

The fundamental premise of the policy arguments in favor of majority voting is that additional power in stockholder hands will constrain "corporate abuses." Even if it were clear that majority voting gave stockholders more power, there still would be the question of whether the majority voting medicine has counter-productive side effects that exceed its benefits.[14] Potential negative side effects include:

- Majority voting might create board vacancies that would be difficult and time-consuming to fill, and the existence of such vacancies could disrupt board-governance structures mandated by exchange rules (including independence requirements).[15]
- Majority voting might increase the already considerable disincentives for capable business people to serve on the boards of public companies. ISS notes that "the embarrassing possibility of a director losing a majority-vote election—even while running unopposed . . . could further lower the pool of qualified candidates."[16]
- Majority voting might operate to reduce director accountability and undermine the ability of stockholders to elect directors. Under the current "symbolic" system, the failure of a director to receive a majority vote, particularly if the director is also a prominent officer, is an embarrassment. Majority voting would make the consequences, and thus the embarrassment, more severe, causing institutional stockholders to be less inclined to withhold votes. For example, a stockholder might withhold a vote for a director with a poor attendance record, believing this "mild" rebuke is appropriate, but might not withhold a vote for that reason if removal were the consequence. Thus, the net effect of this "stockholder empowerment" may be to lessen the use of "withhold" votes as a rebuke to directors.[17]

Majority voting is not necessary to address stockholder concerns

Even judging from the perspective of facilitating stockholder activism, the case for majority voting seems less than compelling. If, as discussed above, majority voting makes it more difficult to elect directors—those nominated by the board of directors and those nominated by stockholders—why is it endorsed so enthusiastically by institutional investors and stockholder empowerment groups? The reason institutional stockholders support the majority vote is that they, and maybe all stockholders, have abandoned nominating their own candidates. The reason for that is simple: proxy contests cost money. Presumably, the costs of a proxy contest are so significant that it makes attempting to elect directors economically impractical.

There is much truth to the proposition that proxy contests are too expensive and are impractical as a means of electing directors, but the institutional stockholders may be premature in abandoning the prospect of electing directors nominated by stockholders. Certainly, if the legislature is to impose a majority vote default rule on all corporations organized under Delaware law and all stockholders of those corporations, the case must be compelling that this device actually enhances—and doesn't detract from—stockholder power. That judgment turns upon whether the prospects of stockholders actually nominating and electing directors are so slim that they should be abandoned. That case has not been made, and there is reason to believe that stockholder democracy may be better advanced by other means.

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If the problem is that proxy contest are too expensive, the solution may be to make them less expensive. For example, a pending SEC proposal would permit issuers and other persons to furnish proxy materials to stockholders by posting them on an Internet Web site.[18] The Commission states that:

> The proposed amendments may reduce the costs of persons other than the issuer conducting their own proxy solicitations . . . We expect that the flexibility afforded to persons other than the issuer under the proposed amendments would substantially reduce what has traditionally been viewed as the high cost of engaging in proxy contests, thereby increasing the effectiveness and efficiency of proxy contests as a corporate control mechanism."[19]

This proposal has obvious benefits for both issuers and stockholders because it would reduce the costs of proxy solicitations. If adopted, it would cause the proxy contest to become a more economical means of electing directors. Indeed, the Internet already has demonstrated its remarkable ability to reduce the cost of communications. Given the potential of this technology, it would seem to be a particularly inauspicious time to consign the proxy contest to the "dustbin of history" and adopt a default majority voting requirement that seems likely to raise the cost and difficulty of stockholders electing directors.

The invigoration of stockholders' ability to elect directors is not dependent upon rule changes by the SEC. Again, under the DGCL, the stockholders have the ability to adopt bylaws without the necessity of any action by the board of directors. Bylaws regulating the process by which stockholders conduct their own business, such as electing directors, would have a similar permissible scope. The governance changes that stockholders may accomplish in a bylaw to facilitate their ability to elect directors has never been explored, but such bylaws offer an opportunity to invigorate proxy contests.

Conclusion

Given the substantial questions about majority voting's efficacy and side effects, the balanced and flexible approach of the Proposed Amendments seems wise and warranted. This approach leaves Delaware corporations and their stockholders free to experiment with majority voting, and those corporations that retain plurality voting may serve as a "control" in this ongoing experiment. Over time, the results of this experimentation will tell whether majority voting is a useful corrective or merely a placebo in search of a disease.

Notes

1. The proposed amendments are to 8 Del. C. § 216 and 8 Del. C. §141(b).
2. This short article can provide little more than a cartoon version of the ongoing debate about the proper limits of stockholder and director power and their relationship to each other. A recent, highly readable and fuller description of all sides of that debate can be found in Stephen M. Bainbridge, "Director Primacy and Shareholder Disempowerment," 119 Harv. L. Rev. 1735 (2006); Vice Chancellor Leo E. Strine, Jr., "Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution For Improving Corporate America," 119 Harv. L. Rev. 1759 (2006); and Lucian Ayre Bebchuk, "The Case for Increasing Shareholder Power," 118 Harv. L. Rev. 833 (2005).
3. SEC Release No. 34-48626 (Oct. 14, 2003), *available at* <www.sec.gov/rules/proposed/34-48626.htm>.
4. Mod. Bus. Corp. Act Ann., § 7.28 at 7-191 (Statutory Comparison).
5. The letter, dated May 24, 2005, is available on the ICI's Web site at <www.cii.org/library/correspondence/061705_mvfordirectors.htm>.
6. Pfizer, Corporate Governance: Principles, Item 7, *available at* <www.pfizer.com/pfizer/are/mn_investors_corporate_principles.jsp#voting>.
7. *See* 8 Del. C. § 216 (providing for a plurality vote unless a different vote is specified in the certificate of incorporation or bylaws) and 8 Del. C. § 109(a) (allowing stockholders to amend bylaws without board approval).
8. Delaware Senate Bill No. 322 was introduced May 16, 2006, reported out of the Judiciary Committee on May 30, 2006, and passed by the Senate on June 7, 2006. It is now before the House Judiciary Committee. S.B. 322, 143rd De. Gen Ass. (2006). A copy of the text of Senate Bill No. 322 can be found, and its progress in the legislature can be tracked, through the Delaware General Assembly's Web site, <www.legis.state.de.us>.
9. *See* Dillon v. Berg, 326 F. Supp. 1214, 1225, (D. Del.), *aff'd*, 453 F.2d 1876 (3d Cir. 1971) (a secret, undated resignation letter executed by one director and given to the CEO of the corporation was ineffective under Delaware law because it would effectively permit the CEO to remove a director).
10. Indeed, the prospect of "failed" elections prompted the Delaware Assembly to specifically adopt plurality voting as the default rule in 1987. *See* Lewis S. Black, Jr. & A. Gilchrist Sparks, III, Analysis of the 1987 Amendments to the Delaware Corporation Law, 314 (1987); and David A. Drexler, Lewis S. Black, Jr. & A. Gilchrist Sparks, III, Delaware Corporate Law and Practice § 25.06.
11. *See* Siegman v. Tri-Star Pictures, Inc., 1989 Del. Ch. LEXIS 56 (Del. Ch. May 30, 1989).
12. 1 Rodman Ward, Edward P. Welch & Andrew S. Turezyn, Folk on the Delaware General Corporation Law, § 223.3.
13. A recent example of successful lobbying efforts include an agreement by Wendy's International Inc. to expand its board of directors to include three directors nominated by a significant stockholder, Trian Partners General Partnership, L.P.
14. A full discussion of the potential negative side effects, as well as the reasons that they may be overstated, can be found in ISS, "Majority Voting in Director Elections, from the Symbolic to the Democratic" (Dec. 2005), *available at* <http://www.issproxy.com/pdf/MVwhitepaper.pdf>.
15. *Id.* at 12.
16. *Id.* at 13.
17. *Id.* at 14-15.
18. SEC Release No. 34-52926 (Dec. 8, 2005), *available at* <www.sec.gov/rules/proposed/34-52926fr.pdf>.
19. *Id.* at 67.

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