FENWICK & WEST LLP

Corporate and Securities Law Update

Recent Developments in Majority Voting for Directors

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Over the past year, the concept that majority votes should be required for the election of corporate directors has emerged as one of the top issues being focused upon by investors, public company boards and shareholder advisory firms. Three recent events are likely to accelerate further development of this issue:

- ISS signaled that the "plurality plus" solution does not adequately address shareholder concerns;
- The SEC refused to block a majority vote shareholder proposal at Hewlett Packard, which had already adopted a plurality plus governance provision; and
- Intel announced today that it has amended its bylaws to require majority votes for the election of directors.

Background. The majority vote concept has arisen out of investor concern with the fact that, in an uncontested election, all nominees are virtually assured of election. This is due to state laws governing the election of directors which generally provide that directors are elected by a plurality of votes cast. In accordance with the SEC's proxy rules, shareholders have the right to vote "for" a nominee or to "withhold" their votes with respect to the nominee. Because the approval threshold is a plurality of the votes cast, a nominee in an uncontested election will be elected if he or she receives any positive votes. This will be the case even if the number of withheld votes exceeds the number of affirmative votes.

As concern with this process, undoubtedly spurred by SEC initiatives to increase shareholder access to the director nomination process, was voiced, several large companies responded with new corporate governance policies. Called "plurality plus" provisions, and adopted by technology notables Hewlett Packard and Microsoft, these provisions require that an elected nominee would tender his or her resignation to the company if the votes "withheld" exceed the votes "for" in an uncontested election. The board would then decide within a prescribed time period whether to accept the resignation. Other companies adopted similar provisions but would require the resignation if the number of votes withheld exceed 50% of the outstanding shares.

ISS is closely monitoring developments in this area. In 2005, it supported all but one of the 60 plus shareholder majority vote proposals (the one exception being a proposal that did not contain a carve-out for contested elections). However, in none of these cases did the company have a meaningful alternative structure—such as plurality plus—in place. In November 2005, ISS issued a substantial white paper on its commitment to majority voting to enhance shareholder participation in the election of directors.

Companies that adopted plurality plus provisions undoubtedly expected that those provisions would be regarded as providing shareholders with a sufficient level of control over the election process. Attendant to this expectation were implicit expectations, or at least hopes, that advisory services such as ISS would concur and that the SEC would view the plurality plus approach as substantially implementing majority voting in deciding whether shareholder majority vote proposals could be excluded from proxy statements.

Recent Developments. Three recent events make it clear that the adoption of plurality plus provisions will not end debate on majority voting for directors. These events are:

- In December 2005, ISS stated that "the burden of proof is on a board to explain" how its plurality plus, or other, provision "promotes greater boardroom accountability" than majority voting. This statement strongly suggests that ISS will generally support majority vote proposals, even at companies with plurality plus provisions in place.
- On January 5, 2006, the SEC staff issued a no action letter to Hewlett Packard disagreeing with HP's position that a majority vote proposal could be excluded from the proxy statement on the grounds that HP's plurality plus provision had substantially implemented the proposal.
- Today's announcement by Intel that it has amended its bylaws to provide for a majority vote standard for election of directors in uncontested elections and has adopted a governance policy requiring incumbent

directors who do not receive a majority of the votes cast in an uncontested election to tender their resignation (to prevent the "holdover director" problem further discussed below).

Some Complications. Majority vote provisions involve complications under state corporate law and typical charter provisions that are of concern to all participants in the discussion. Most prominent among these is the problem of the "holdover director." State law generally provides that a sitting director holds office until a successor is duly elected. If a sitting nominee does not receive a majority of favorable votes, preventing election in a majority voting scheme, that director would remain in office until a replacement is elected or, of course, until he or she resigned. Intel's approach addressed this issue by requiring such a failed sitting nominee to submit a resignation.

Another potential problem arising from the failed election of a nominee is the impact on the makeup of the board. Nasdaq and stock exchange listing requirements require independent boards, audit committees with super-independent and financially sophisticated members and compensation committees with independent directors. Governance provisions adopted by many companies also contain specifications about board composition. The failed election, and removal, of a sitting nominee could prevent compliance with one or more of these provisions. ISS has acknowledged that this situation needs to be addressed to give effect to shareholder votes while allowing boards to continue to operate free from potential significant business disruptions.

As withheld votes become significant and if majority vote provisions become more common, voting by street name holders will come under increased focus. Currently under New York Stock Exchange rules, brokers who receive no specific voting instructions from the beneficial owners of the shares are allowed to vote for board nominees in an uncontested election. Investor activist seem likely to question the application of such a default voting mechanic in favor of the board's nominees.

Looking Ahead. The recent actions described above by ISS and the SEC pave the way for a robust proxy season of shareholder proposals on majority voting. It remains to be seen whether shareholders will approve majority vote proposals, particularly where a company has already implemented a plurality plus arrangement. It also remains to be seen how many companies follow Intel's lead and preempt the issue by adopting majority voting on their own initiative.

If you have any questions about the issues addressed in this update, please contact any member of your Fenwick & West team, or Dan Winnike (650.335.7657 - dwinnike@fenwick.com), Horace Nash (650.335.7934 - hnash@fenwick.com) or Gordon Davidson (650.335.7237 - gdavidson@fenwick.com).