

Electing Directors with Consequences — Methods for Board of Directors Elections Matter

08.21.17

The system your company uses to elect directors can significantly affect whether the board is truly responsive to the shareholders it represents. Recently, the Council of Institutional Investors (CII) reviewed the various voting methods and concluded that the only approach with “teeth” is “consequential majority voting.” What is it and should your company be using this method? Let’s take a look.

Plurality or majority voting

Generally, corporate boards elect directors in one of two ways: by a plurality of votes cast or a majority of votes cast. A small number of companies use cumulative (or “proportional”) voting, in which each shareholder casts one vote per share multiplied by the number of directors to be elected. Cumulative voting helps minority shareholders gain board representation by allowing them to apply all their votes to one candidate.

According to the CII, nearly 90% of S&P 500 companies — as well as most foreign companies — use some type of majority voting. Among Russell 2000 companies, however, only 29% use majority voting in uncontested elections, with most mid-cap and small-cap companies opting for plurality voting. Currently, only a small number of U.S. companies, including Microsoft, use consequential majority voting.

Four voting regimes

The CII has identified four voting regimes within plurality and majority voting categories:

1. Strict plurality. Nominees who receive the most “for” votes are elected until all board seats are filled. The CII believes this is the best approach for contested elections and for companies that use cumulative voting. But in uncontested elections without cumulative voting, a strict plurality approach is essentially a “rubber stamp” process that can sometimes result in the election of directors who lack the confidence of a majority of shareholders. Why? Because in an uncontested election — that is, one in which the number of nominees is equal to the number of available board seats — a nominee only needs one “for” vote to be elected, regardless of how many shareholders oppose the candidate.

Most companies that use plurality voting give shareholders a ballot option to “withhold” their votes. Contrary to the belief of some shareholders, however, withholding one’s vote is strictly symbolic; it has no more legal impact on the election’s outcome than abstention.

2. Plurality plus. In recent years, companies concerned about the plurality approach’s inherent lack of accountability have adopted “plurality plus” voting. This requires nominees who receive more “withhold” votes than “for” votes to tender their resignations. Nevertheless, these “majority-opposed” directors are legally elected for another term, subject to the board’s acceptance of their resignations. Typically, however, these resignations aren’t accepted, so while plurality plus is an improvement over strict plurality voting, it still lacks the “teeth” the CII is looking for.

3. Majority voting with board-rejectable resignation. Majority voting means that, to win election, a nominee must receive a majority of the votes cast. In other words, he or she must receive more “for” votes than “against” votes. Most companies that use majority voting, however, require losing directors to tender their resignations, which the board would accept or reject — so the ultimate decision as to whether a director steps down rests with the board rather than the shareholders.

4. Consequential majority voting. Under this approach, an uncontested nominee must receive more “for” votes than “against” votes to be elected to the board. Uncontested nominees who receive more “against” votes than “for” votes must leave the board at a “reasonable point.” To avoid situations in which a company must scramble to fill a vacancy, a consequential majority voting system should include a “holdover” provision under which defeated directors continue to serve during a transition period. Typically, a 90-day period is appropriate, although the CII says a period of up to 180 days is appropriate under certain circumstances.

The preferred approach

In uncontested elections with no cumulative voting, the CII recommends consequential majority voting, finding it to be “the only approach that places ultimate authority in the hands of the company’s owners.” For more information, including sample bylaw language for consequential majority voting, go to http://www.cii.org/majority_voting_directors for more information, including sample bylaw language for consequential majority voting.

Do professional directors improve board quality?

It's widely believed that electing professional directors results in higher quality, more rigorous corporate governance. This leads most public companies to have at least one professional director on their boards. A professional director is an independent director whose only employment is as a director on one or more corporate boards. But do professional directors really add value? Probably not, according to a recent study, titled *Does the Market Value Professional Directors?*

The authors examined empirical evidence reflecting the effectiveness of professional directors, specifically the cumulative abnormal returns around their appointment. They found that companies that appoint professional directors experience negative and significantly lower cumulative abnormal returns on the announcement date compared to companies that appoint nonprofessional directors. They also found that this negative market reaction occurs primarily at companies identified as requiring stricter monitoring.

There are several possible explanations for these results. For example, professional directors may actually be *less* independent because their livelihood depends on retaining their board seats. And even though professional directors hold no other full-time employment, it doesn't necessarily follow that they devote their additional time to more rigorous monitoring. "Overall," the authors concluded, "our results do not lend support for the calls to professionalize corporate boards."