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Empowering Shareholders in Directors' Elections: A Revolution in the Making

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Abstract

In the last few years, also in the light of the financial crisis in which the world has plummeted, the concern for self-referential and unaccountable boards has gained momentum and prompted several important reforms aimed at enhancing shareholders' democracy. The reforms recently implemented or currently under consideration both at the state and federal levels, focusing on proxy access, might however prove to be too timid to exorcise this specter. This Article discusses the limits of the latest legislative and regulatory initiatives and advances a new, bold if not heterodox, proposal to empower shareholders and better align the composition of the board to the interests of all the owners of the corporation. The core of the proposal is a proportional voting system called "list voting." Building also on a brief comparative analysis, the Article advocates that "list voting" is superior to the traditional U.S. "cumulative voting" both from the point of view of directors, managers and controlling shareholders, and of minority shareholders.

Keywords: unaccontable boards, shareholders' democracy, proxy access, list voting, cumulative voting

JEL Classifications: G38

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EMPOWERING SHAREHOLDERS IN DIRECTORS' ELECTIONS: A REVOLUTION IN THE MAKING

MARCO VENTORUZZO*

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I. INTRODUCTION

A specter is haunting Corporate America – the specter of Directors' Dictatorship.[1] In the last few years, also in the light of the financial crisis in which the world has plummeted, the concern for self-referential and unaccountable boards has gained momentum and prompted several important reforms aimed at enhancing shareholders' democracy. The reforms recently implemented or currently under consideration both at the state and federal levels might however prove to be too timid to exorcise this specter. This Article discusses the limits of the latest legislative and regulatory initiatives and advances a new, bold if not heterodox, proposal to empower shareholders and better align the composition of the board to the interests of all the owners of the corporation.

Directors' elections are at the core of corporate governance. The extensive powers that directors enjoy as fiduciaries of the shareholders can only be justified, from an economic and legal point of view, to the extent that shareholders, acting as principals, retain control on the selection and removal of their agents. But do shareholders actually have, in the American system of corporate law, this power? According to many, the answer to this question is a resounding "No." Several statutory, regulatory and contractual provisions grant sitting directors effective control over the election of new directors. As a consequence, the board of directors can become a largely self-perpetrating body. This emasculation of the most fundamental right of shareholders would cripple the very base on which the corporate law system is founded.

In the past two years the rules concerning directors' elections have witnessed a revitalization of regulatory competition among states and possible federal intervention. Both state-level reforms and federal initiatives seek to strengthen the role of shareholders in the election of boards of directors. Delaware, the undisputed front-runner state in the chartering race, has recently been challenged by North Dakota. In 2007, the state passed the North Dakota Publicly Traded Corporation Act of 2007 (NDPTCA), a decidedly "shareholders friendly" statute designed to facilitate a more active role for stockholders in selecting the directors. In 2009, Delaware responded by amending its corporate law in order to explicitly allow a corporation to adopt shareholder-empowering rules analogous to those available under the NDPTCA. Despite all this tangible evidence of regulatory competition, state law might end up being pre-empted by rules proposed by the Securities and Exchange Commission (SEC). Also in 2009, the SEC finalized a proposal that, if adopted, would allow shareholders' to add their own candidates to the corporation's proxy statement, giving them a louder voice in the directors' election process. In addition, federal law may explicitly regulate the issue. Two different bills have been proposed by senators Schumer and Dodd, which among other things included provisions

[1] In a sort of *contrappasso*, it seems apt to paraphrase the famous incipit of one of the nemesis of Capitalism, the Manifest of the Communist Party by Karl Marx and Friedrich Engels. The German version of the manuscript, firstly published in London in the fatal year 1848, begins with the sentence: "Ein Gespenst geht um in Europa – das Gespenst des Kommunismus" or, "A specter is haunting Europe – the specter of Communism", Karl Marx and Frederick Engles, COLLECTED WORKS Volume 6 476, New York, International Publishersm 1976 (1888).

aimed at facilitating shareholders' access to corporate proxies. In December, the House approved a bill regulating different aspects of financial markets regulation and investors protection that explicitly attributes the SEC the authority to regulate proxy access. In theory, these innovations might profoundly change the very structure of the American managerial model of capitalism.

These reforms are important from a substantive point of view, but they also offer an insight into the rule-making process and, in particular, the dynamics of regulatory competition in U.S. corporate law. A common assumption of the scholarly debate is that notwithstanding its dominant position, Delaware must maintain a corporate regime that maximizes the interests of directors and managers, on the one hand, and shareholders, on the other hand, because it faces potential horizontal competition from other states, and potential vertical competition from the federal government. The idea is that if Delaware engages in a regulatory race-to-the-bottom that is detrimental to the interests of shareholders and solely advantageous to corporate executives and directors, other states might size a slice of the chartering market offering a different regulatory regime, better tuned to shareholders' preferences. In this case, the argument runs, shareholders and investors would be able to force corporations to reincorporate outside of Delaware.[2] In addition, if Delaware law is perceived to be sub-optimal in terms of shareholders' protection, the Federal government and its agencies might step in, introducing mandatory rules capable of trumping existing differences at the state level.[3] The recent reform proposals on directors' election envisioned at the federal level offer an excellent illustration of this possible dynamic of the "market for corporate charters."

This Article is organized as follows. Part I examines both the prevailing rules on directors' elections and the most recent implemented or proposed reforms, explaining the reasons why, as a matter of fact, shareholders' role in selecting the members of the board is usually quite limited. More specifically, Paragraph I.1 offers an overview of the traditional approach to directors' elections, Paragraphs I.2 and I.3 discuss the major

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[2] Few issues have received much attention in corporate law as the role of state competition. To cite just some of the most important contribution, *see William L. Cary, Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974), arguing that regulatory competition among states leads to a race to the bottom in terms of shareholders' protection; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977), favoring regulatory competition; Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle* 1 L.J. ECON. & ORG. 225 (1985); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 711-13, 752-53 (1987); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role,* 89 COLUM. L. REV. 1618 (1989), discussing the effects of mandatory legislation and specifying standards courts should use in determining whether to accept deviations from traditional rules of corporate governance; Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1437 (1992), in favor of an expansion of the role of federal law in corporate law. *See* also, in a similar vein, Lucian A. Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers* 99 COLUM. L. REV. 1168 (1999)The economic theoretical framework illustrating the conditions under which regulatory competition can lead to efficient rule-making has been laid down by Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

[3] The potential threat of displacement of Delaware corporate law by the Federal legislature has been analyzed in depth in a seminal and recent article by Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005).

innovations of the NDPTCA of 2007, Paragraph I.4 illustrates the 2009 amendments to the General Delaware Corporation Law, and paragraphs I.5 and I.6 will be devoted to the most controversial reform of all, the proposed SEC's rules on proxy access. Part I also identifies other pending federal legislative initiatives on the issue of proxy access. Part II is dedicated to an analysis of why the recent reforms might be heading in the right direction, but fall short of really addressing the core issue of board's accountability to shareholders. In this Part, also in the light of some empirical evidence (Paragraph II.1), I examine the reasons supporting minority shareholders representation on the board, and advance a voting system that I will call "list voting" (Paragraphs II.2 and II.3). I argue that this system could be superior to cumulative voting, notwithstanding the longer history of the latter in the United States, and why minority directors can be useful also in a system with widespread ownership structure, like the U.S. (Paragraphs II.3 and II.4). Part IV concludes.

II. THE CURRENT REGULATORY FRAMEWORK AND RECENT REFORMS

1. *Directors: By the Grace of God, or by the Will of the Shareholders?*

During the *Ancien Régime*, absolute European monarchs were said to be entitled to the throne solely by the grace of God. More moderate sovereigns, or sovereigns aspiring (or forced) to appeal to democratic tendencies, expanded their style to include a reference to their subjects. Oliver Cromwell, for example, was "Lord Protector" by the Grace of God, *and the Republic*.[4] The king of Italy, after the reunification of the country in 1861, was such by the Grace of God, *and the Will of the Nation.*[5] And today Elizabeth the Second is Queen not only by the Grace of God, but also "of the United Kingdom of Great Britain and Northern Ireland and of Her other Realms and Territories." Do American directors reign over their corporate empires by the will of the shareholders? Can their tenure really be challenged by disgruntled equity investors? Does their legitimization come from the shareholders' meeting, or from a quasi-divine investiture granted by the board itself?

There are several reasons why sitting directors can easily coagulate enough consensuses to obtain the election of either themselves or their favorite candidates over candidates advanced by shareholders. In fact, under the traditional U.S. regulatory framework, the ability of shareholders to propose nominees to the board is severely constrained.

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[4] Oliver Cromwell, English military and political leader best known for his involvement in making England into a republican Commonwealth and for his later role as Lord Protector of England, Scotland, and Ireland. For more information, *see* http://www.british-civil-wars.co.uk/biog/oliver-cromwell.htm and John Morley, Oliver Cromwell, Adamant Media Corporation (2005).

[5] Referring to the title of the Crown of Italy, Victor Emmanuel II, (14 March 1820—9 January, 1878), the King of Piedmont, Savoy, and Sardinia from 1849 to 1861 and later assumed the title King of Italy. For more information, *see* F. COGNASSO, ED. LE LETTERE DI VITTORIO EMANUELE II (Turin, 1966), DENIS MACK SMITH, VICTOR EMANUEL, CAVOUR AND THE RISORGIMENTO (New York, 1971) and DENIS MACK SMITH, ITALY AND ITS MONARCHY (New Haven, 1989).

A first factual explanation might be found in the widespread ownership structure of listed corporations in the U.S. It is quite difficult for a multitude of minority shareholders, who are unrelated and hold relatively small participation, to identify specific candidates and coordinate to concentrate their votes on those candidates. Collective action problems, information asymmetries and transactional costs discourage even institutional investors from following this strategy. In case of disagreement with the way in which the corporation is managed, stockholders can more easily sell their shares and thus "vote with their feet."

In this respect, however, the last decades have seen a peculiar evolution of the ownership structure of American corporations. Institutional investors have acquired a more central position and become some of the most important equity holders. For an institutional investor, it is not always possible without facing potential significant losses, to quickly liquidate its investment. A mutual fund holding four percent of a large listed corporation, for example, can hardly dump its shares without causing a little earthquake both in the value of its portfolio and in the market price of the shares. These economic limitations are sometimes coupled with even stronger constraints. For example, index funds that replicate a particular market index with a passive investment strategy, holding the shares of the issuers that compose the index, simply cannot alter their portfolio. For these investors in particular, to actively participate in the life of the corporation and have a say in the selection of directors is often the only viable course of action to protect their investment against board's decisions that are perceived as contrary to shareholders' interests. The legal system has not, however, developed as to harmoniously respond to the change in the ownership structure.

Even ignoring the specific needs of large institutional investors, the rules currently applicable to most listed corporations raise serious doubts on directors' accountability to shareholders.[6] Several legal hurdles stand in the way of shareholders seeking to influence the composition of the board.

The first of these hurdles concerns the majority required to appoint a director. Under Delaware law, as well as in most other states, directors are voted one-by-one, and not bundled together. Each individual nominee does not need to receive the positive vote of the majority of the shares represented at the shareholders' meeting to be appointed. Like in political elections, to be elected a plurality of the votes cast is usually sufficient; votes against a specific candidate are not possible and abstentions are not relevant. Simply, the nominees that receive the highest number of positive votes are elected. For example, if 300,000 voting shares are represented at the meeting, nominee John Doe might be elected with as little as 60 votes, if no other individual receives a higher number of positive votes. Under this rule it is easy for sitting directors to obtain the relative highest number of votes for their candidates.

In recent years, largely under the pressure of institutional investors, there has been a shift toward majority voting. In a majority voting system, nominees need to receive the majority of the votes represented at the shareholders' meeting to be elected, and therefore

[6] On the link between board accountability to the shareholders and corporate performance *see* Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors – A Decision-Making Analysis*, 5 BERKELY BUS. L.J. 131 (2008).

"no" votes or abstentions can affect the outcome of the election. According to a recent study, as of February 2007, roughly 52% of S&P 500 companies had adopted some form of majority voting in their charter or bylaws.[7] The same study, however, demonstrates that the specific provisions implemented in the governing documents of the corporations often water down significantly the intended effects of majority voting in terms of shareholders' empowerment.[8] The reason is that in most cases it is not provided that directors are appointed only if they receive a majority of the votes, but it is simply required that candidates to the board prepare, before their election, a resignation letter renouncing to the position if they are elected but do not obtain the absolute majority of the votes cast. The resignation, however, is subject to approval by the old board. Consequently, the board enjoys a great deal of discretion in overriding the shareholders' meeting outcome by simply rejecting the anticipated resignation.[9]

The traditional regulation of proxy voting provides for another legal basis for the extensive control that current directors hold on the elections of the board. Directors send out proxies using corporate resources and information. Shareholders cannot easily piggy-back on the proxy solicitation conducted by the corporation because, pursuant to federal law, directors can exclude shareholders' proposals concerning the election of directors from the corporate proxies.[10] Adding nominees to the slot of candidates advanced by the board of directors is considered a matter regarding directors' election, and therefore shareholders can be denied access to corporate proxies in this regard. On the other hand, shareholders could independently solicit their own proxies, but this is unlikely to happen because proxy solicitation can be extremely expensive (also in terms of potential liability for misstatements in the proxy documents). In addition, the corporation is not mandated to reimburse proxy expenses, even in case of complete or partial victory of the dissenting shareholders.[11] On top of that, shareholders might face other procedural obstacles in their proxy fight, such as obtaining an updated lodger of shareholders of record in a timely manner.[12]

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[7] William K. Sjostrom & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459 (2007).

[8] *Id. at* 486.

[9] *Id. at* 487.

[10] For an account on the limitations to shareholders' access to the corporate ballot *see* Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475, according to which (481): "One "red line" that the SEC has maintained throughout various formulations of the access conditions has been that the shareholder proposal cannot relate to a particular election of directors."

[11] Proxy solicitations are terribly expensive. Generally, advertising costs per vote are between $5 to $10, not including fees paid to solicitation firms, for preparation and the like. For example, in the proxy battle on the HP purchase of Compaq, the expenses incurred until shareholders finally cast their votes topped $100 million. See e.g.: http://news.cnet.com/Costs-mount-in-HP-proxy-fight/2100-1003_3-859261.html. As insightfully pointed out by Gordon, *supra* note 10, costs are not only related to the drafting and dissemination of the proxies, but more importantly, and notably not included in the above named figures, to the risks of liability connected with the proxy statement. Thus in reality, the costs are even higher.

[12] While shareholders have a general right to access to the corporation's documents, the board can refuse to hand them over, arguing that it needs room to operate. In order to balance the interests of the board and of shareholders, and to limit "fishing expeditions", courts have held in this regard, that shareholders must

For these reasons, directors' elections are often uncontested, which means that the number of nominees is not greater than the number of available slots on the board, and the only nominees are the ones selected by the existing board. But there is more. Until a recent amendment of NYSE regulation, effective for meetings held on or after January 1, 2010, in uncontested directors elections brokers could vote uninstructed shares. Uncontested elections, more precisely, were considered "routine" matters, and brokers had the discretion to vote the shares in the absence of specific instructions from the beneficial holders of the securities. In these instances, brokers would usually cast their votes according to managers' proposals.[13] Brokers' discretionary voting had two important and powerful effects on directors' elections. On the one hand, it ensured the presence of the required quorum. On the other hand, it made it easier for boards' nominees to receive a majority or a plurality of the votes, and be elected.

As mentioned, however, NYSE Rule 452 has been amended in 2009.[14] According to the new provision, directors' elections will no longer be considered "routine" matters, even when uncontested. Consequently, from January 2010, brokers will no longer be permitted to vote in the absence of specific instructions from the stockholders. The scope of the rule is broad because it applies to all NYSE-registered brokers, independently from the market on which the corporation holding the election is listed.[15]

This innovation will clearly make it somehow more difficult for directors to attract votes under either a plurality or a majority voting system. While institutional investors' campaigns against board nominees are likely to have more chances of success, the concrete effect of new NYSE Rule 452 is not completely clear, especially when plurality vote still applies.

In sum, plurality vote or the "weak" forms of majority vote adopted by some states or companies, limitations to proxy access, the cost of an independent proxy solicitation, and brokers' discretionary vote in uncontested elections have traditionally made it very difficult, for shareholders, to have a strong and independent voice in the appointment of directors. In most situations, with the exclusions of successful hostile takeovers waged either through proxy fights or through the acquisition of a controlling block of shares, directors are *de facto* selected by the existing board and simply "ratified" by a rather passive shareholders' meeting.

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show "proper purpose" in requesting documents, and at least to some extent be able to support their allegations. See for example: Seinfeld v. Verizon Commnc Inc. 909 A.2d 117, 118 (Del. 2006). This can result in either lack of information or at least delay in obtaining it.

[13] As the SEC itself recognizes and uses as a reason for the amendment. See: http://www.sec.gov/rules/sro/nyse/2009/34-59464.pdf *at* 5.

[14] *See* http://law.lexisnexis.com/practiceareas/Insights--Analysis/Emerging-Issues/The-New-Amendment-to-NYSE-Rule-452-. For SEC issued notice of amendment, *see* http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf.

[15] It is important to observe that it is unlikely that the modification will adversely affect the chances to achieve a quorum. The reason is that brokers will still be permitted to participate (and vote) uninstructed shares in shareholders' meeting where other "routine" matters are decided, such as, for example, the ratification of external auditors. It will therefore be sufficient, for the corporation, to include in the shareholders' meeting agenda both directors' elections and confirmation of the auditors, in order to allow brokers to participate at the meeting with the uninstructed shares, therefore raising the quorum.

A system in which existing directors have a virtually uncontestable power to select their successors on the board and are insulated from shareholders' judgment may deadly wound the fiduciary relationship between shareholders and managers. This peculiar trait of American corporate governance has been denounced by several scholars and interest groups as the cause of lack of directors' accountability to shareholders, and stronger shareholders' democracy has been advocated on both efficiency and political grounds.[16]

The North Dakota legislature was the first one to offer a comprehensive response to this call for investors' empowerment by enacting a shareholders' friendly statute that includes several provisions designed to curb the risk of managerial dictatorship, and grant a stronger voice to stockholders. In doing so, it seems to attempt to enter into the competitive arena traditionally monopolized by Delaware.

It is unlikely that the newcomer will pose a serious threat to Delaware. But the importance of the North Dakota experiment goes way beyond its effectiveness as a generator of franchise taxes for the cold border state.

2. *Experiments from the Cold: A Premise on the Regulatory Structure of the 2007 North Dakota Publicly Traded Corporations Act (NDPTCA)*

Five key provisions characterize the new North Dakota statute: shareholders' access to corporate proxy statements; majority voting in directors' elections; shareholders' advisory vote on executive compensation; limitations to supermajority rules and antitakeover provisions.[17] At least on paper, this piece of legislation appears to be quite close to a hypothetical activist shareholder's "wish list".

The first distinctive feature of the North Dakota Publicly Traded Corporations Act is that it is optional, in the sense that it applies only to corporations incorporated after July 1, 2007 that chose to be subject to the statute[18]. If, however, a corporation voluntary opts in, the provisions mentioned above are bundled together.[19] The corporation cannot cherry-pick only the rules that suit it best: adopting the North Dakota Statute is an "all-or-

[16] For a brief account of the legal and financial literature analyzing also empirically shareholders' voting *see* David Yermack, *Shareholder Voting and Corporate Governance*, forthcoming in *Annual Review of Financial Economics*. Among the contributions that need to be cited *see* P. Gompers, J. Ishii A. Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, forthcoming in Review of Financial Studies; R. Mork, A. Schleifer, Vishny R. W., *Management Ownership and Market Valuation*, 20 JOURNAL OF FINANCIAL ECONOMICS 293 (1988), according to which the greater the control over the voting process by insiders, the lower the value of the firm. In a similar vein the results of A. Shivdasani, D. Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829 (1999), arguing that the quality of the nominees is lower when the CEO has a strong role in their selection. Particularly interesting in the perspective of this work is also the study by S. Bhagat, J. A. Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J. LAW & ECON. 339 (1984), providing evidence of negative abnormal stock returns when corporations abolish cumulative voting or classify the board, decreasing the minority's role in the election of directors.

[17] Posting of Larry Ribstein, *The North Dakota Experiment*, http://www.ideoblog.org (Apr. 23, 2007)

[18] *See* http://ndcgc.org/Reference/Explain405.pdf.

[19] It should be noted that a corporation could also opt out in a later date.

nothing" choice. This legislative approach has been indicated, by some commentators, as an element of rigidity that constitutes a major disadvantage of the NDPTCA.[20] The criticism goes as follows: most of the provisions in the NDPTCA can be voluntarily adopted also by a corporation incorporated in other jurisdictions, including in particular Delaware, which offer a more permissive approach. Assuming the desirable nature of some of the provisions included in the North Dakota statute, Delaware corporations not only have the option to selectively adopt all or some of them, but also enjoy more freedom in tailoring them to their specific needs. For these reasons, there would be no incentive in to (re)incorporate in North Dakota.[21]

The argument that Delaware law is superior to North Dakota simply because it allows corporations to mimic NDPTCA provisions in their bylaws is not entirely convincing. The prescriptive and somehow rigid approach of North Dakota could, at least in theory, present an advantage. First of all, a less flexible regime carries an important signaling effect. A corporation which chose to be subject to the NDPTCA is telling its current and perspective investors that it did not simply embrace some shareholder-friendly provisions, but it has adopted *exactly* a particular "cocktail" of rules. To the extent that investors appreciate that particular concoction, this might spare them the information costs of scrutinizing and dissecting the charter and bylaws of a particular corporation to assess its governance structure. By answering the very simple question whether the issuer is subject to the NDPTCA, an investor would know without further inquiry that an allegedly shareholders' friendly package of rules applies.

Also, it can be argued that a bundled set of rules would be particularly relevant if it could be demonstrated that some of these rules achieve their intended effect in terms of investors' protection only when combined together. For example, if one could argue that proxy access and majority vote are significantly more effective and important for shareholders when they are combined, the circumstance that the NDPTCA ties the two rules together might be positively valued by the market. In other words, the lack of flexibility might be outweighed by the benefits in terms of certainty and savings of information-gathering costs.

This observation does not imply, obviously, any judgment on the presumed superiority of the NDPTCA statute to other corporate statutes. Methodologically, however, the simple fact that a corporate regime is more flexible than another one is not sufficient to conclude either that the former is able to achieve exactly the same results as the latter, let alone to argue that it is necessarily more efficient and favorable to shareholders and investors. As it will be discussed in the light of empirical data, a similar perspective assumes its conclusions; relying on the hypothesis that private ordering always allows to properly combining the preferences of the different stakeholders.[22]

3. *Directors' Election under the NDPTCA*

[20] William B. Chandler, *Thoughts on the North Dakota Publicly traded Corporations Act of 2007*, 84 N. D. L. REV. 1051 (2008).

[21] Chandler *Id.* at 1054.

[22] *See infra*.

With this premise in mind, let us consider the most important provisions of the NDPTCA relating to the nomination of directors. The key rule in this respect concerns shareholders' access to the corporation's proxy statements. Pursuant to section 10-35-08 of the Act, the corporation must include in its proxy statement the nominees advanced by qualified shareholders (together with a short statement), and make provisions for a shareholder to vote on each nominee on the proxy ballot. Shareholders qualified to access the corporate proxy statement can be a person or a group acting together that has beneficially owned more than five percent of the outstanding shares entitle to vote for at least two years.[23]

Allowing shareholders to piggy-back on the corporate proxy ballot is only one of the ways in which the North Dakota statute facilitates shareholders' involvement in the election of directors. In addition, the Act also mandates the corporation to reimburse the expenses related to a successful shareholder initiated proxy solicitation. Section 10-35-10 of the NDPTCA, in fact, provides that if shareholders' nominees are elected, the nominating shareholders are entitled to reimbursement by the corporation of the reasonable costs of the solicitation in proportion to the fraction of elected nominees over the total number of candidates nominated by the shareholder. For example, if a shareholder nominates three directors, and one is elected, she will be entitled to receive from the corporation a third of the expenses of the proxy solicitation. This rule creates an incentive to limit the number of nominees presented in a proxy fight, and concentrate the campaign effort on those nominees.

Another major feature of the NDPTCA concerns the vote required to elect directors. Subsection 2 of Section 10-35-09 of the Act mandates specific rules to apply if shareholders do not have the right to cumulate their votes. First, different candidates cannot be presented to the shareholders as one single list, but they must be voted on separately.[24] Second, the Act mandates majority voting to elect a candidate. More precisely, the "candidate must receive the affirmative vote of the majority of the votes cast for or against the candidate's election."[25] This means that a dissenting group can manage to veto a managers' candidate by casting a sufficient number of "no" votes, contrary to what would happen under a plurality voting system, in which abstentions and votes against a candidate do not count, and the nominees that receive the relatively highest number of affirmative votes are elected independently of the level of opposition. Interestingly enough, a candidate that is not elected with a majority of the shareholders' votes cannot be appointed by the board to fill a vacancy, unless he is subsequently elected as director with the affirmative vote of the shareholders. In other words, to receive a

[23] Scholarly proposals in favor of proxy access, subject to predetermined conditions, have been on the table at least since the early 1990s. *See*, for example, Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 39, 93-98 (1990); Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate: Too Little, But Not Too Late*, 43 AM. U. L. REV. 379, 452 (1994).

[24] N.D. Cent. Code §§10-35-09, par. 2, a.

[25] N.D. Cent. Code 10-35-09, par. 2, b

negative vote by shareholders "taints" the candidate: he or she cannot be let into the boardroom from the backdoor by the directors.[26]

Subsection 3 of Section 10-35-09 of the NDPTCA provides that in a contested election (*i.e.*, when the number of candidates exceeds the number of available seats on the board) in which at least one candidate has been nominated by the shareholders; the above mentioned rules contained in Subsection 2 do not apply. This means, in particular, that majority vote is not mandated, and that plurality vote is possible. The rationale of this rule, also common in corporate bylaws that spontaneously adopt majority voting, is clearly the one of avoiding deadlocks. When the number of candidates exceeds the number of positions available on the board, and with different and opposed coalitions of shareholders support different nominees, it might be impossible for any single one of them to obtain a majority of the votes.

In short, the rules enacted in North Dakota in 2007 facilitate a more proactive participation of shareholders in the election of the board. These rules, combined with other provisions of the statute aimed at enhancing investors' protection, intend to create a legal regime favorable to shareholder generally, and institutional investors in particular.[27]

4. *Delaware's Mini-Reform on Directors Election*

Delaware has probably little to fear in terms of competition from North Dakota. First, it is broadly accepted that a crucial factor of Delaware's success is its corporate-savvy, experienced and sophisticated judiciary, something that Delaware has effectively promoted and advertised in the recent past.[28] To develop this particular legal infrastructure requires time and investments. It cannot be acquired overnight and as easily as adopting a new statute. Even assuming the high desirability, from the point of view of some investors, of the NDPTCA, it is reasonable to expect reluctance to abandon Delaware and its highly specialized courts system.

Second, incorporation in Delaware has a beneficial effect in terms of "network externalities."[29] For quite obvious reasons, including for example the existence of a broad market for corporate legal services focusing on Delaware law and the very fact that the vast majority of publicly held corporations are subject to Delaware corporate law creates a strong incentive to incorporate in this state, or at least not to emigrate from it. From this point of view, North Dakota, currently hosting only three listed corporations, can hardly compete with Delaware, the state of choice for hundreds of publicly traded companies.

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[26] Therefore, North Dakota adopts a "strong" form of majority voting: a mandatory rule that does not leave to the board of directors the discretion to overcome shareholders' decisions.

[27] Carl C. Icahn, *North Dakota's Pro-Shareholder Law: A major Advancement*, 84 N. D. L. REV. 1039 (2008).

[28] Stephen M. Bainbridge, *Why the North Dakota Publically Traded Corporation Act Will Fail*, 84 N. D. L. REV. 1043, 1045 (2008).

[29] Two before NDPTCA that did not opt to reincorporate in order to be subject to the new statute, and only one, controlled by Carl Ichan, that moved from Delaware to North Dakota.

Third, it would be difficult for shareholders to force a reincorporation out of Delaware with the opposition of the directors. This issue will be further discussed below, but it should be pointed out that the reason for it is that the technical way to reincorporate in a different state is a merger. Under Delaware law, as well as in virtually any other corporate law regime, a merger can only be initiated by the board of directors. Surely enough, shareholders could appoint directors willing to do so, but the likelihood of success for such a campaign depends also on proxy regulation. What we are facing here is a typical "Catch 22" problem of the so-called market for corporate charters. If the corporation is incorporated in a state in which shareholders dissenting from the current board and management can hardly control of the board through the voting mechanism, they cannot easily obtain reincorporation in another state.

Therefore, Delaware should not fear the North Dakota move. But there are other elements that Delaware must take into account. One of them is public opinion and shareholders' sentiment. Especially in the wake of the financial crisis, the issues of directors' accountability to shareholders and shareholders' empowerment have become central issues in the corporate governance debate. In addition, and even more importantly, Delaware is preoccupied that the federal government might enter the corporate law arena pre-empting state legislation. A federal mandatory regime is particularly undesirable to Delaware because it could reduce, if not eliminate, the differences among states, infringe the state's ability to regulate domestic corporations, and ultimately erode its competitive advantage over other jurisdictions. Any federal intromission in this field is particularly threatening to Delaware not only, and probably not so much in itself, but also because it could open the door for increasingly more pervasive federal rules in the substantive regulation of the internal affairs of a corporation.

In the case of proxy regulation, those fears may come true. In 2003 and 2007, the SEC proposed the adoption of new rules affecting shareholders' access to the corporate proxy statement with respect to directors' elections.[30] These first initiatives of the Commission did not result in any meaningful regulatory change – and somehow contributed to prompt litigation focusing on shareholders' rights to nominate candidates to the board.[31] In 2009, however, the SEC, under the leadership of its newly appointed Chairman Mary Shapiro, advanced a new proposal on proxy access, showing an apparently stronger determination in approving new rules that would facilitate shareholders' participation in the election process.[32]

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[30] On the 2003 proposal and the impasse that ensued, *see* Murphy, *supra* note 6, at 140.

[31] *See* American Federation of State, County & Municipal Employees v. American International Group, 462 F.3d 121 (2d Cir. 2006), in which a large public service employees union brought suit against AIG, a Delaware corporation later involved in the 2007 financial meltdown, requiring the inclusion of a shareholder access proposal in its proxy statement. The district court denied the plaintiff's request. For an account of the 2003 and 2007 proposals *see* http://www.sec.gov/rules/proposed/34-48301.htm and http://www.sec.gov/rules/proposed/2007/34-56160.pdf.

[32] Proxy Disclosure and Solicitation Enhancement, 74 fed. Reg. 136 (proposed Jul. 17, 2009) (to be codified at 17 CFR pt. 229, 239, 240, 249, 270 and 274).

The Delaware legislature could not remain idle on this issue. In 2009, Sections 112 and 113 of the state's General Corporation Law (DGCL) have been amended. Section 112 now provides that the bylaws might grant shareholders' access to the corporate proxy statement in directors' elections, subject to specific procedures and conditions. The provision contains a list of non-exclusive conditions that shareholders might be required to meet to access the corporate proxy ballot, including a minimum threshold of ownership, a minimum duration of ownership, and the disclosure of specific information concerning the nominating stockholder and his candidates.[33]

In a similar fashion, new Section 113 of the DGCL sets forth that the bylaws may provide that the corporation reimburses the expenses incurred by a stockholder in soliciting proxies to elect directors. Somewhat similar to the NDPTCA approach, the bylaws can limit the reimbursement proportionally to the success of the proxy solicitation, measured in terms of directors elected or votes casted, or make it conditional upon other conditions.[34]

It should be noted that Sections 112 and 113 of DGCL are merely enabling on an opt-in basis, and are not bundled together. Any corporation can choose to adopt one, both or none of these rules. In addition, consistent with the overall flexible approach of Delaware law, corporations enjoy a broad degree of freedom in the ways in which they can shape proxy access and proxy reimbursement.

None of those amendments introduces a significant change to Delaware law. Especially in terms of enhancing shareholders' voice, the new rules are practically useless. Even before their enactment, the bylaws or charter could equally provide for proxy access and proxy expenses reimbursement.[35] Now the new provisions eliminate some possible doubts on the legitimacy of such bylaws provisions, but also clarify that the governing documents of a corporation can impose virtually any condition and requirement for proxy access or reimbursement of proxy solicitation expenses.[36]

In fact, both proxy access and reimbursement for proxy solicitation can be subject to procedures and requirements totally unconstrained by the statue, and for this reason Sections 112 and 113 could easily be considered meaningless in terms of shareholders' empowerment. The requirements set forth by the governing documents of the corporation can be so restrictive to make it substantially impossible, for shareholders, to actively participate in directors' elections. In addition these rules can be profoundly different from corporation to corporation, thus creating uncertainty and raising the information costs (in terms of attentive legal scrutiny of the bylaws) that investors intentioned to wage a proxy fight would have to bear.

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[33] See Del. Code Ann. Tit. 8, §112 (2009).

[34] See Del. Code Ann. Tit. 8, §113 (2009).

[35] *See* CA, Inc. v. Afscme Employees Pension Plan, 953 A.2d 227(Del. 2008).

[36] Letter from the seven law firms of Cravath, Swaine & Moore LLP, Davis Polk & Wardwell LLP, Latham & Watkins, LLP, Simpson Thatcher & Bartlett LLP, Skadden, Arps, Slate, Meagher & Flom LLP, Sullivan & Cromwell LLP and Watchell, Lipton, Rosen & Katz LLP, to Elizabeth M. Murphy, Secretary, United States Securities and Exchange Commission, (Aug. 17, 2009).

But even in the case that proxy access and/or proxy solicitation reimbursement clauses would be adopted in the bylaws, this would not necessarily improve the position of the shareholders. If directors retain the power (concurrent with shareholders) to unilaterally amend the bylaws, the new alleged protections of shareholders' voice would constantly be exposed to change. Especially when facing a difficult election, directors could simply repeal the provisions from the bylaws. In theory, shareholders might seek a judicial remedy arguing that directors disenfranchised their rights.[37] Such litigation would, however, have uncertain outcomes, be expensive and time consuming, and ultimately unattractive for institutional investors seeking to participate in the governance of the corporation.

In sum, the new provisions do not really affect or even change Delaware law. They eliminate some doubts concerning the contractual freedom of corporations, but not necessarily to the advantage of shareholders. The new rules seem mainly designed to pay lip service to investors' empowerment reminding that – in theory – Delaware law allows private ordering to introduce proxy access and reimbursement for successful proxy solicitations.

5. *The SEC's Proposed Rules on Proxy Access*

In a split vote, on May 20, 2009, the SEC approved a proposed amendment to the existing proxy rules, with the intention to facilitate shareholders' nominations of directors.[38] The two key provisions would be Rule 14a-11 and 14a-8(i)(8). Pursuant to the former, shareholders that have owned at least one, three or five percent of the voting shares (depending on the market capitalization and reporting status of the corporation) for a minimum of one year would have the right to include nominees in the corporation's proxy materials. The proposing shareholder would however be required to state his intention to hold the shares through the date of the shareholders' meeting.

One interesting aspect of the proposed rule is that shareholders can only nominate a minority of the directors: one or twenty-five percent of the board, whichever is greater. The underlying rationale is to prevent a shareholder to seek control of the board through the company's proxy solicitation. Shareholders aiming at controlling the corporation must still launch an independent proxy contest, and bear the expenses of the solicitation.[39] It might happen that, at the time of the directors' election, the maximum quota of shareholders-nominated directors has already been filled. This might be the case, for example, when a staggered board is in place. In this case proxy access is simply not available to shareholders.

An additional problem connected with the limitation to the maximum number of shareholder-nominated directors might occur when there are more shareholders' candidates than available seats. The SEC is concerned with a high number of candidates

[37] *See Blasius Indus., Inc. v. Atlas Corp*., 564 A.2d 651 (Del. Ch, 1988).

[38] Timothy M. Clark, *Shareholders to Gain Access to Company Proxy Statements for Directors Nominations*, 24 No. 4 CORP. COUNS. 1 (2009).

[39] The SEC's proposal does not include a proxy expenses reimbursement provision.

generating confusion among shareholders in the voting process. For this reason, the current version of proposed Rule 14a-11 provides that the first candidates to be proposed, within the maximum number of shareholders' candidates allowed, would be the ones added to the corporate ballot. The rationale for this "first-come, first-served" provision is very weak and has been criticized by several commentators because it would prompt a race to the proxy ballot among shareholders.[40] Some comment letters have suggested that, instead of using the "first-come, first-served" method, in these case the candidates proposed by the larger shareholders should be preferred; a solution somehow akin to the selection of the "leading plaintiff" for class action purposes.[41] In my opinion it would be preferable to allow all the candidates proposed by qualified shareholders to be listed on the ballot, and let shareholders decide which one(s) to appoint through their votes. The minimum ownership requirements should limit the problem of an excessive number of candidates anticipated by the Commission.

The nominating shareholder would have to disclose specific information by filing a new Schedule 14N form, such as the percentage of shares owned and its intent to hold them through the date of the shareholders' meeting, its relationship with the corporation, and so forth. A delicate issue in this respect is the possibility that shareholders close to the board would nominate candidates actually suggested by the board itself, attracting the votes of some minority shareholders and distorting the goal of the rule to curtail board's influence on the electoral process. The disclosure obligations are intended to ensure a certain degree of transparency on the relations between the nominating shareholder and the current directors of the corporation, allowing shareholders to fully appreciate the independence of the candidate from the existing board.

It is worth taking a closer look at the possible effects of the proxy access system envisioned by the SEC. When the total number of candidates proposed by the corporation and specific shareholders would exceed the available seats, *i.e.* in a contested election, directors would be chosen through plurality vote. As already discussed, even corporation that have opted for majority voting do not apply this voting method in case of a contested elections in order to avoid deadlocks. Pursuant to plurality vote, directors receiving the relative highest number of votes would be appointed. Proposing

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[40] *See* ,for example, Letter from James P. Hoffa, General Presdident, Int'l Brotherhood of Teamsters, to Elizabeth M. Murphy, Secretary, United States Securities and Exchange Commission, (Aug. 17, 2009); also: Email on behalf of the seven law firms of Cravath, Swaine & Moore LLP, Davis Polk & Wardwell LLP, Latham & Watkins, LLP, Simpson Thatcher & Bartlett LLP, Skadden, Arps, Slate, Meagher & Flom LLP, Sullivan & Cromwell LLP and Watchell, Lipton, Rosen & Katz LLP, to Elizabeth M. Murphy, Secretary, United States Securities and Exchange Commission, (Aug. 17, 2009).

[41] In their comment letter ten Harvard Professors suggested that a higher threshold should be used for shareholders to be entitled to proxy access, arguing that 5-10% would be more appropriate. Letter by ten Harvard Law Professors, Jay W. Lorsch, Professor, Harvard Business School, Rakesh Khurana, Professor, Harvard Business School, Raymond V. Gilmartin, Professor, Harvard Business School, Guhan Subramanian, Professor, Harvard Business and Law Schools, Robert C. Clark, Professor, Harvard Law School, John Coates, Professor, Harvard Law School, Reinier H. Kraakman, Professor, Harvard Law School, Mark J. Roe, Professor, Harvard Law School, Rajiv Lal, Professor, Harvard Business School, Joseph L. Bower, Professor, Harvard Business School to Elizabeth M. Murphy, Secretary, United States Securities and Exchange Commission, (Aug. 13, 2009). See also: Email on behalf of the seven law firms, supra note 41, at 24.

shareholders, in order to elect their candidates, should therefore be able to obtain more votes than the ones received by the nominees of the board. This goal might be very difficult to achieve, especially in situations where the current board is supported by a stable coalition of shareholders or by a qualified minority. Consider, for example, a situation where a shareholder who holds 15% and consistently votes all her shares in favor of all – and only – the candidates of the board. It might be very difficult for the candidates proposed by a shareholder holding a 3% to get even close to a similar number of votes.

It is important to point out this aspect because it underlines how the proposed SEC rule only focuses on proxy access, but does not really fosters the election of "minority directors". In the absence of a cumulative voting system or other rules designed to facilitate the election of directors proposed by dissenting shareholders such as the ones provided by in some European countries that we will examine shortly, the new proxy rules would not really tilt the scale in favor of shareholders at directors' elections.[42]

The corporation's governing documents could, however, achieve this result. In fact, another important and connected innovation proposed by the SEC is the amendment of Exchange Act Rule 14a-8(i)(8). Reversing a 2007 ruling of the Commission, the proposed new provision would allow shareholders meeting the minimum holding and tenure requirements to access the company's proxy material to propose bylaws amendments concerning the procedures to nominate directors.[43] Through this procedure, shareholders could support the adoption of cumulative voting or other similar arrangements that might facilitate the appointment of a more diverse board of directors.

6. *Reactions to the SEC's Proposal*

If adopted, the SEC proposal would have a profound impact on Wall Street and Corporate America. Not surprisingly, the new rules have received broad attention and strong reactions by both opponents and supporters of proxy access.[44] More precisely, the proposal has been attacked on two separate grounds: first, in terms of its legitimacy *vis-à-vis* the extension of the regulatory authority of the SEC; second, on its merits.

The American Chamber of Commerce, in its profound critique of proxy access, advocates that the SEC's proposal would affect the "balance of power between corporations and their shareholders", a matter that exceed the scope of action of the Commission under Section 14 of the Securities Exchange Act.[45] In support of this

[42] We will go back to the desirability of minority representation on the board in Paragraphs II3 and II.4.

[43] Under the new rule, proxy proposals that would disqualify a director standing for election, remove her before end of her term or affect in other ways the outcome of an election could still be excluded by the corporation.

[44] See for example of support: Letter by ten Harvard Professors, supra note 42.; Letter from James P. Hoffa, supra note 41. For opposing views, see for example: Letter by David T. Hirschmann, Senior Vice President, Chamber of Commerce of the United States, to Elizabeth M. Murphy, Secretary, United States Securities and Exchange Commission (Aug. 14, 2009).

[45] 15 U.S.C. 78n.

position, the Chamber of Commerce relies primarily on the famous 1990 case, *Business Roundtable v. SEC*, in which the Court of Appeals for the District of Columbia struck down an SEC rule prohibiting dual-class recapitalizations.[46]

This position is not persuasive. Even assuming that the decision in *Business Roundtable v. SEC* is correct, there is a fundamental difference between that case and the current proposal. In *Business Roundtable*, the SEC rules would have – although indirectly – limited the ability of the shareholders to choose the financial and voting structure of the corporation. The proxy access rules discussed here, on the other hand, simply regulate the information provided to shareholders in the context of a board's election, requiring that also candidates proposed by substantial shareholders are added to the corporate proxy ballot, and that shareholders are given the option to express their preference for a broader pool of possible directors.[47]

In addition, the Commission's authority over the regulation of proxies has a clear and quite broad foundation in the Securities and Exchange Act of 1934, as convincingly explained in the SEC's proposal itself. According to Federal law, in fact, the SEC has the "power to control the conditions under which proxies may be solicited".[48] The narrow reading of the extension of the powers of the SEC proposed by the Chamber of Commerce would conflict with established and uncontested rules, such as the very list of shareholders' proposals that a corporation can exclude from the proxy ballot set forth by Rule 14a-8. Rule14a-8, in fact, affects the relative powers of shareholders and directors in the voting process (in this case, however, in favor of the existing board) – a matter that could also be regulated by state law. No serious doubt, however, can be cast on the legitimacy of Rule 14a-8. It is not coherent to argue that, in regulating proxies, the SEC can allow the board to throw out shareholders' proposals, but that the Commission cannot provide that some shareholders' proposals cannot be excluded.

Some supporters of proxy access argued that the conclusion that the proposed SEC rules do not unlawfully infringe state law is even more secure if the new provisions would represent a default regime from which corporations can opt-out.[49] In any case, the issue of the Commission's authority to regulate proxy access may be settled by the Federal legislature. Section 7222 of the "Wall Street Reform and Consumer Protection Act of 2009" (H.R. 4173), approved by the House on December 11, 2009, explicitly attributes the SEC the power and responsibility to regulate this thorny issue.[50]

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[46] Letter by David T. Hirschmann, supra note 45, at 4.

[47] The Court in Business Roundtable v. SEC stated that "Congress acted on the premise that shareholder voting could work, so long as investors secured enough information and, perhaps, the benefit of other procedural protections. It did not seek to regulate the stockholders' choices. If the Commission believes that premise misguided, it must turn to Congress."

[48] Securities and Exchange Commission, Facilitating Shareholder Director Nominations; Proposed Rule, Fed. Reg. 74, 116 (June 18, 2009), at 29025.

[49] Lucian A. Bebchuk & Scott Hirst, *Private ordering and the Proxy Access Debate*, November 2009, electronic copy available at: http://ssrn.com/abstract=1513408, at 28ff.

[50] This provision stems largely from the initiative of Senator Charles Schumer (NY – Democrat). The so-called "Shareholders Bill of Rights Act of 2009" that Senator Schumer introduced in the spring of 2009, later largely incorporated in the Financial Reform Bill introduced by Senator Christopher Dodd (CT –

Proxy access is also a very divisive issue considering its merits. Both supporters and opponents of the new regulation have suggested many corrections to proposed Rules 14a-11 and 14a-8(i)(8). A part from specific technical details of the regulation, the core of the discussion centers on whether the SEC should provide a default proxy access regime (and, if so, whether it should be mandatory or weather corporation should be allowed to opt-out), or vice versa the default rule should not allow proxy access, whose adoption should be left to private ordering.

Among the most strenuous opponents of the current proxy access proposal is former SEC Commissioner and law professor Joseph Grundfest.[51] Grundfest's key argument is that the Commission's proposed rules are inherently contradictory because if shareholders must be considered sufficiently informed and capable to vote for directors, they should also be deemed to have the ability to introduce proxy access rules in the governing documents of the corporation, if they find these rules desirable. Shareholders could achieve this result either directly, or by signaling their preference to the board of directors through the voting process. On this basis, Grundfest contends that the SEC proposal violates the Administrative Procedure Act, because it imposes an arbitrary and capricious one-size-fits-all rule. The SEC, again according to him, could at most provide for an optional regime that corporations could adopt if their state of incorporation allows such an opt-in.[52]

This reasoning is not convincing. There is no contradiction between the idea that shareholders, if provided with adequate information, can intelligently select among different candidates to the board of directors; and the fact that both legal and economic obstacles might prevent – or at least seriously impair – shareholders' ability to amend the governing documents of the corporation. As the available empirical evidence seems to suggest,[53] the existing limitations to proxy access, combined with the majority requirements necessary to amend the bylaws, might actually render practically impossible for shareholders to adopt a proxy access regime, especially when directors oppose the amendment.

Democrat), included specific rules on proxy access regulation by the SEC. The proposed legislation has been repeatedly criticized by Martin Lipton on the Harvard Law School Corporate Governance Forum (*see* the posts of May 12, 2009 and November 10, 2009), arguing in particular that stronger shareholders' voice in the election of directors might enhance managers' short-termism. Serious doubt can be raised on this critique. In particular, not all shareholders have a short-time investment horizon, and in particularly certainly not some institutional investors. In addition, directors' and managers' short-termism seems much more related to their own ownership of shares and share options, than to their accountability to shareholders. Finally, even if shareholders' preferences might be for short-term results, and assuming that this is necessarily a trend that needs to be curbed, there might be other ways to achieve this result, such as longer terms for the board, or compensation and incentive packages compatible with a more long-term perspective. On H.R. 4173, *see* www.opencongress.org/bill/111-h4173/show.

[51] Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and theLaw*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1491670.

[52] Grundfest (*supra* note 51), also argues that the SEC proposal does not further shareholder wealth and optimal governance, but rather to the contrary is merely an effort to benefit large corporate constituencies with a strong lobby in Washington, even against the will of shareholder majorities.

[53] Lucian A. Bebchuk & Scott Hirst, *Private ordering and the Proxy Access Debate*, supra note 49.

In addition, as insightfully argued by Bebchuk and Hirst, even assuming that shareholders can effectively decide whether proxy access is desirable or not and regulate it in the charter or bylaws of the corporation, reliance on private ordering does not suggest, in itself, any particular default rule.[54] They suggest that while shareholders should have the freedom to adopt or reject proxy access, the default rule should be selected on the basis of a simple question: is it more efficient that shareholders opt-out of a default proxy access regime, or that they opt-in? Among these two options, Bebchuk and Hirst chose the first one. Their answer is based not only on systematic principles of accountability but also on a convincing body of empirical evidence, which appear to sustain two fundamental claims.

The first claim is that there is a negative correlation between shareholders' wealth and directors' insulation from removal. The second claim is that, in the American legal system, it is harder for shareholders to adopt a set of rules that they find desirable (especially with the opposition of the board of directors) than to opt out of a non-value-maximizing regime. As it will be discussed more extensively below, there is anecdotal evidence confirming this view. Among the different examples that Bebchuk and Hirst consider, it is worth mentioning in particular that so far only three Delaware corporations have voluntarily adopted proxy access provisions in their governing documents, and all three cases were under very specific and quite unique circumstances. It simply does not appear credible that out of all the hundreds of listed corporations incorporated in Delaware, in only three cases shareholders wanted to adopt proxy access. It seems more likely that shareholders simply cannot introduce this rule without the support of the board of directors.

III. AN EVALUATION OF THE RECENT LEGISLATIVE AND REGULATORY INITIATIVES AND AN ALTERNATIVE PROPOSAL TO EMPOWER SHAREHOLDERS

1. *Empirical Evidence on the Recent Reforms and on Shareholders' Role in Electing the Board. Why The SEC Should Provide for Proxy Access on a Default, Opt-in Basis*

The overview of the recent legislative and regulatory reforms conducted in the preceding pages shows that shareholders' empowerment in directors' elections is a crucial issue on the agenda of U.S. policy makers and represents one of the most important evolutionary trends of the American corporate governance model. To what extent this trend will result in real change?

A first issue to address is the success – or the lack thereof – of North Dakota in attracting corporations. To the best of my knowledge, two and a half years after the enactment of the NDPTCA, only one corporation, American Railcar (in 2009), has reincorporated from Delaware to North Dakota, American Railcar (in 2009). American Railcar is, however, a very particular corporation. Carl Icahn, a notorious investor and corporate activist, who was involved with and supported the enactment of the NDPTCA,

[54] *Id.*

is the controlling shareholder of the corporation, holding more than 50% of its voting shares, and is at the same time the chairperson of American Railcar's board of directors. Therefore, not even this isolated case can be singled out as an example of minority shareholders' interest in reincorporating in the North Dakota. In fact, in a somehow ironic twist, in a corporation with a strong controlling shareholder, other equity investors can hardly take advantage of the shareholders-friendly provisions of the NDPTCA, such as proxy access or reimbursement of proxy fights expenses.[55] Furthermore, it is definitely worth noting that the only two corporations that were incorporated in North Dakota before the enactment of the new statute did *not* opt-in this piece of legislation.[56]

In a limited number of corporations, some shareholders have expressed a certain interest in the possibility of reincorporating to North Dakota. In the 2009 proxy season, for example, precatory shareholders' proposals to change the state of incorporation to North Dakota were voted on in fifteen corporations nationwide. The level of support that they received at the shareholders' meeting was, however, extremely low. The following chart, based on the data of the Annual Corporate Governance Review conducted by a leading proxy services organization illustrates the voting outcomes of these proposals.[57]

[55] http://www.footnoted.org/buried-treasure/carl-icahns-move-to-north-dakota/

[56] This anecdotal piece of evidence was conveyed to the author by William Clark in a conversation following a lecture that he gave at Penn State Dickinson School of Law on Tuesday, November 24, 2009.

[57] The source of 2009 Annual Corporate Governance Review by Georgeson, available *at* http://www.georgesonshareholder.com/.

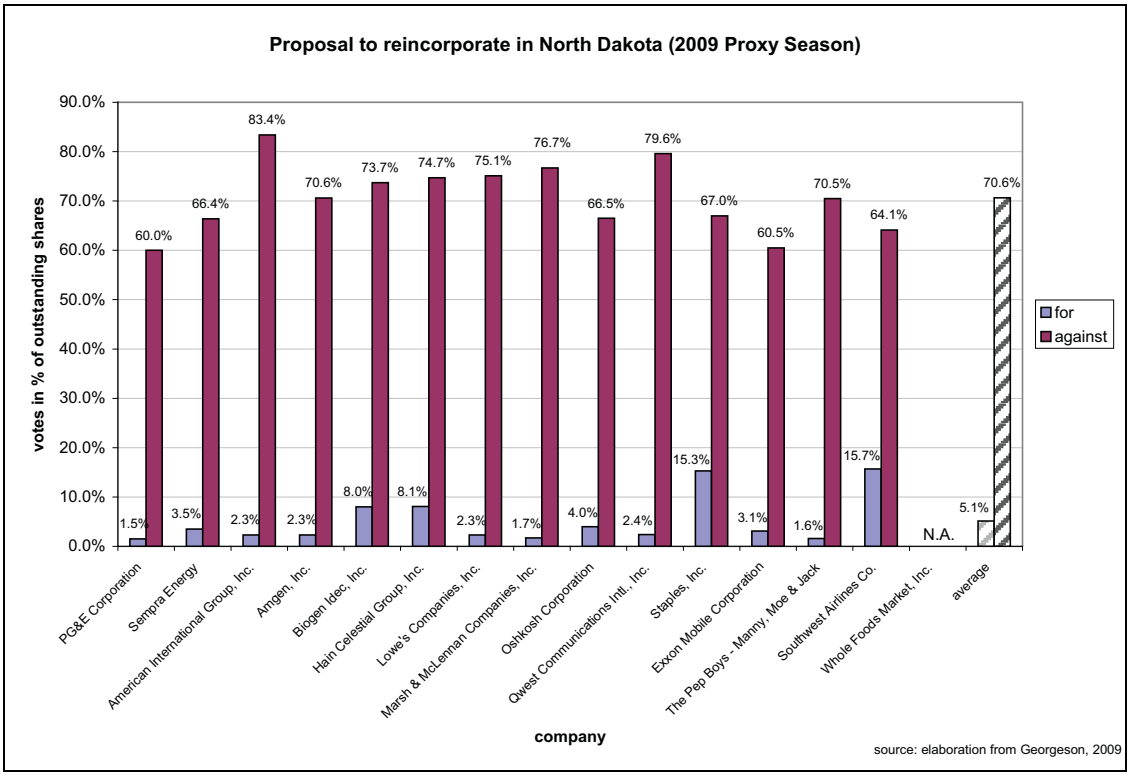


Figure 1

Interestingly enough, not all of the 15 proposals were presented by shareholders of corporations incorporated in Delaware: two corporations were incorporated in California, two in Texas, one in New Jersey, and one in Pennsylvania. It should also be pointed out that all but one of these initiatives were sponsored by individual shareholders. The only exception was a proposal advanced by Icahn Entities. Institutional investors did neither sponsor nor even seem interested in reincorporation in North Dakota.

These data supports the not-so-difficult prophecy that the North Dakota challenge to Delaware would not be successful.[58] A question more relevant to our purposes remains: should the data also be interpreted as a lack of shareholders' interest in the provisions of the NDPTCA and, in particular, its proxy access and proxy reimbursement rules?

Not necessarily. To address the general question whether the empirical evidence univocally indicates the failure of the NDPTCA to attract investors, it must first be noted that the economical way to proceed to a reincorporation is through a merger (usually with an empty-shell corporation already incorporated in the state of destination), and that a merger can only be initiated and completed with the support of the board of directors. Thus such a transaction has little, virtually zero, chance to be carried out against the will of directors. The very limited support received by these proposals, therefore, could reflect the fact that investors did not sustain a proposal that they considered destined to

[58] Bainbridge, *supra* note 28, at 1047.

fail. A partial indicia in this respect is that among the 15 cases considered, there is substantial number of situations (9) in which the percentage of shares that did not vote exceeds 10%. On the other hand, the number of shares voted against the proposals generally amounts to an overwhelming majority of both the votes cast and the outstanding shares. It should be considered, however, that in the 2009 proxy season, discretionary brokers' vote for uninstructed shares was still permissible. It would be interesting to know the percentage of "against" votes that came from brokers, which usually align with managers' preferences.

In any case, the fact that shareholders did not support reincorporation in North Dakota does not unequivocally indicates that proxy access and proxy costs reimbursement rules, and more generally facilitating shareholders' representation on the board, is not crucial to ameliorate American corporate governance. Many different reasons might explain the decision not to move to North Dakota; from lack of appreciation for the bundled package of rules offered by the NDPTCA as hypothesized by Chandler and Bainbridge,[59] to skepticism on the business expertise of the northern state's judiciary, especially when compared to Delaware's judges.

It is therefore useful to take a broader look at shareholders' proposals concerning the election of directors, independently from reincorporation in North Dakota, to establish whether it is possible to infer from the available empirical evidence an interest of shareholders to gain a greater say in the choice of directors. Taking the 2009 proxy season into account, a first observation is that very few binding proposals were advanced by shareholders while the vast majority of proposals were only precatory in nature.[60]

One indication of the importance that investors attribute to a more decisive role in directors' elections comes from shareholders' proposals to adopt or strengthen majority voting in uncontested board elections. In 2009, a total of 39 proposals to regulate majority voting were presented and voted on.[61] While the number might not seem very high when compared to the total number of listed corporations, it is noteworthy that few other issues received more attention from the shareholders. One example being is the introduction of advisory vote on executives' compensation.[62] Interestingly enough, the majority of these proposals (approximately 63%) were approved by the shareholders, as shown in Figure 2.

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[59] *Id.*

[60] With respect to governance issues, the Annual Report published by Georgeson only identifies 13 binding proposals, of which only 3 are directly related to the election of directors: one aimed at allowing shareholders to recover proxy contest expenses, and two concerning majority vote to elect directors.

[61] Of these 39, 19 concerned corporation that had already adopted some form of majority voting, usually in the "weak form" described above in page 5 paragraph . In these cases, shareholders usually required a stricter majority requirement.

[62] Georgeson, *supra* note 57.

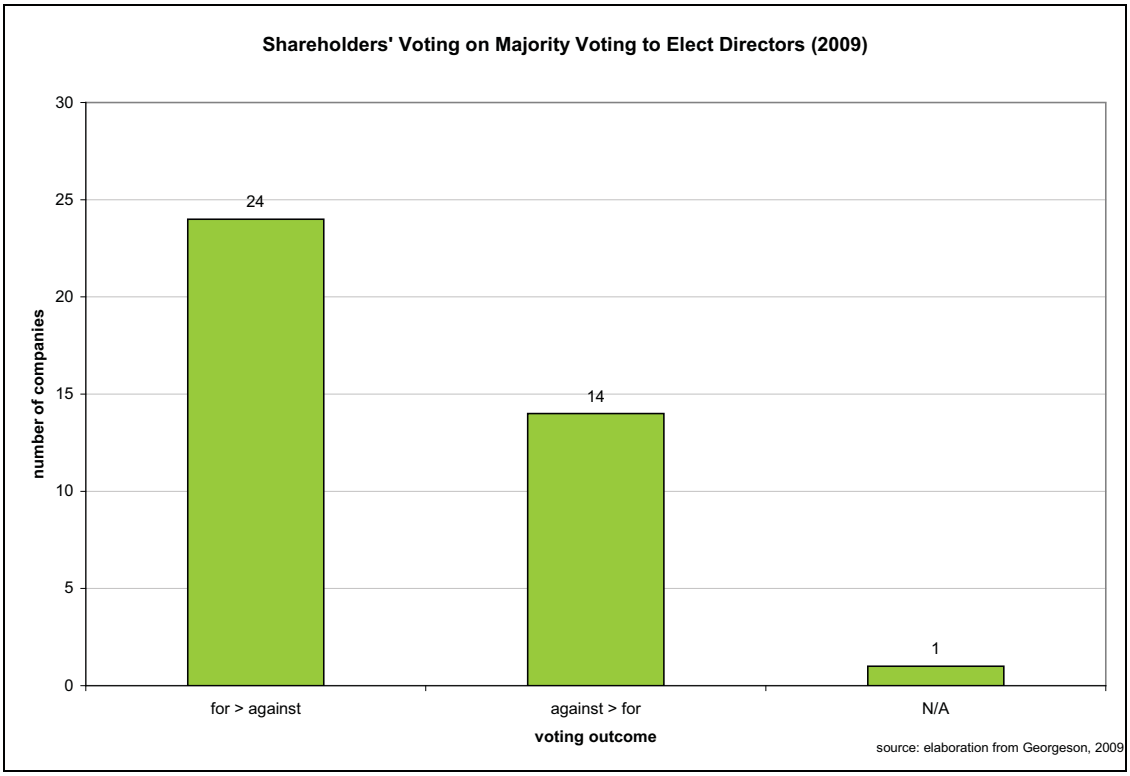


Figure 2

The level of shareholders' support for majority voting proposals was also substantial, notwithstanding the fact that they were often opposed by the management of the corporation. Figure 3 compares the average percentage of votes cast in favor and against the proposal.

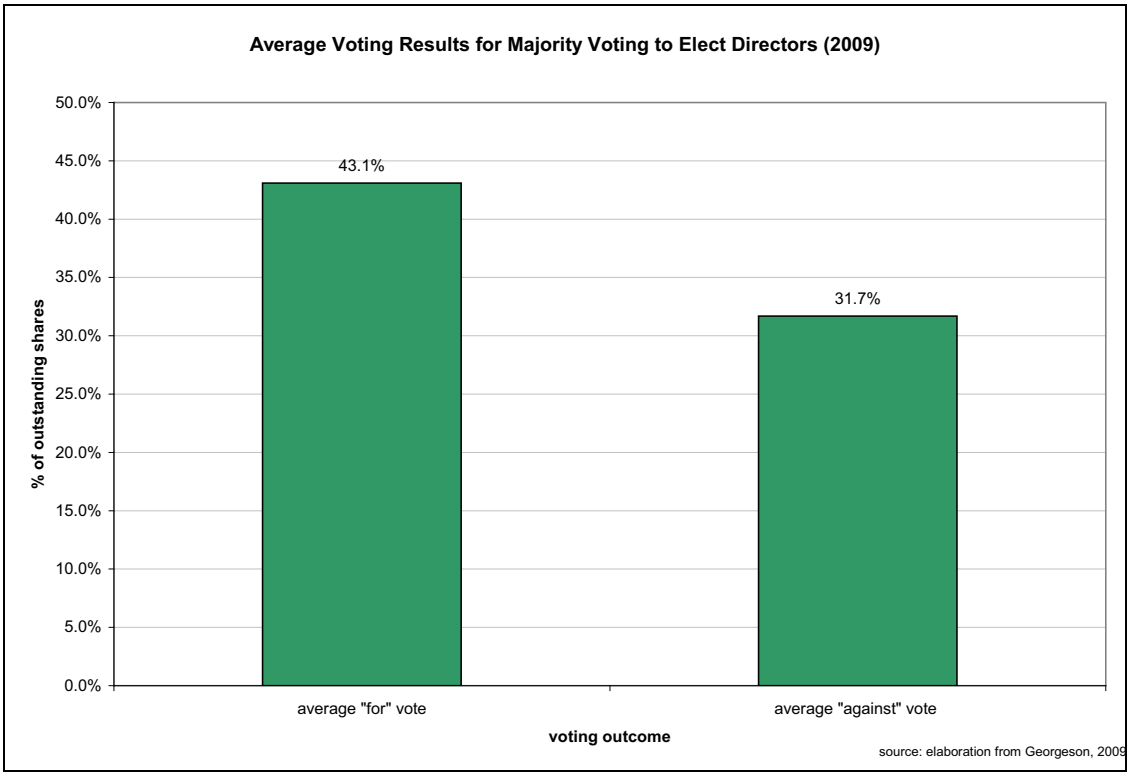


Figure 3

A second and possibly even more meaningful hint at shareholders' demand for greater control over the election of directors is represented by stockholders' proposals to introduce some form of cumulative voting for the election of directors. Since cumulative voting allows minority shareholders to be represented on the board, this data is also indicative of an interest in a more diversified team of directors. During the 2009 proxy season, 28 proposals to adopt cumulative voting for directors' elections were presented. Once again, although this number might not seem particularly relevant, it is significantly high when compared to other proposals on important governance issues. For example, in the same period of time, only 3 proposals concerning shareholders' vote on golden parachutes were presented. This seems to confirm the existence of a movement toward a stronger voice of shareholders' in determining the composition of the board.

As a matter of fact, none of the proposals to adopt cumulative voting was approved. What is interesting to point out here, however, is that notwithstanding their defeat, these proposals received a remarkable support. The average percentage of votes in favor and against cumulative voting is charted in the following Figure 4.

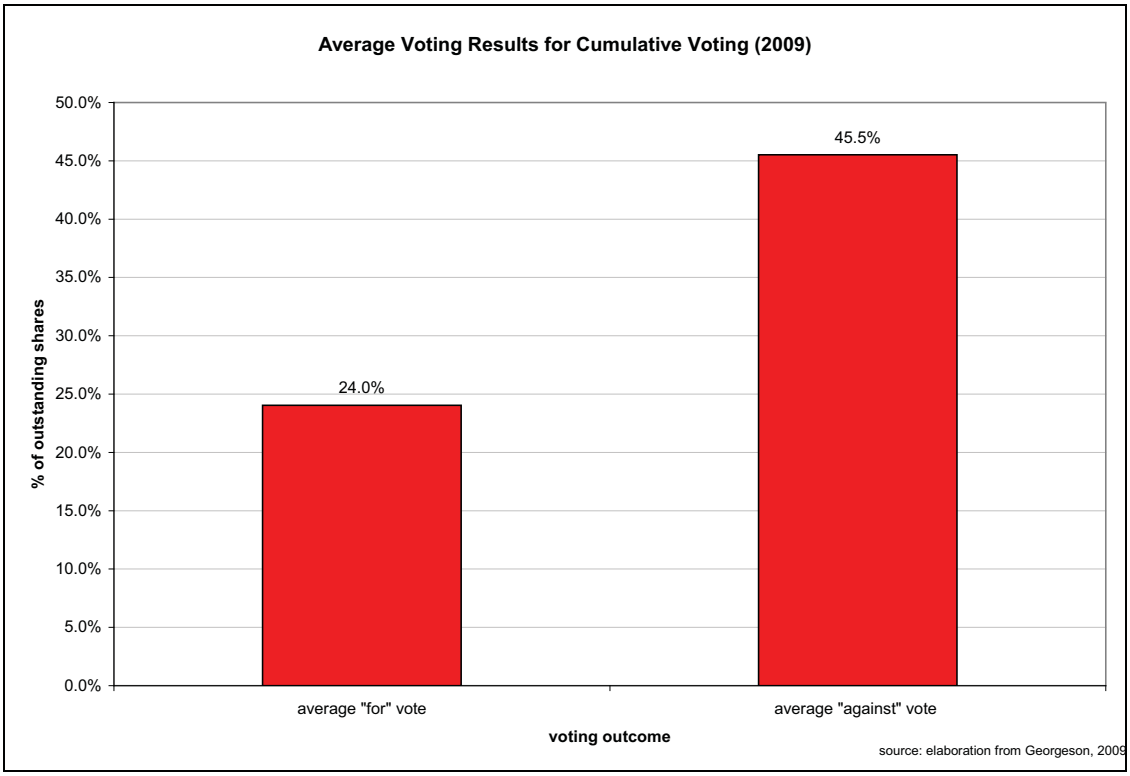


Figure 4

On average, almost a fourth of all the outstanding shareholders voted in favor of cumulative voting. Even though on average 45.5% of the shareholders opposed these proposals, it cannot be disregarded as irrelevant the fact that a very substantial minority of the equity investors, when presented with the option, would favor the possibility of opening the boardroom to minority directors.

One additional set of data relevant for the current discussion concerns proxy fights for the election of directors. Limiting the research to publicly held corporations incorporated in Delaware, in the last three years (more precisely, from January 1, 2007 to November 1, 2009) there have been 78 proxy fights in which the sponsor aimed at obtaining control or representation on the board.[63] According to the classification of the Thompson SDC Platinum database, of these 78 only 13, approximately 17%, resulted in a victory or partial victory of the dissenting shareholders that launched the proxy fight, as the following Figure 5 shows.

[63] *See* http://thomsonreuters.com/products_services/financial/financial_products/deal_making/investment_banking/sdc

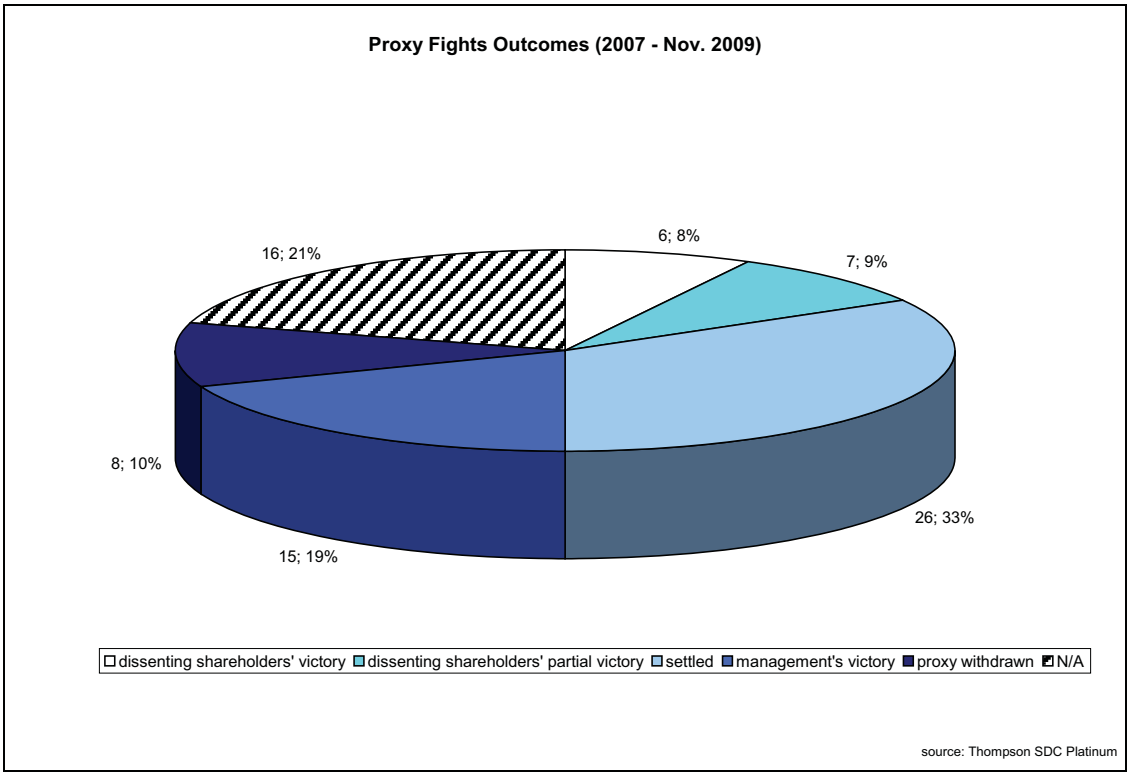


Figure 5

In addition, based on the available empirical evidence, only in a few instances shareholders actually succeeded in appointing at least one director to the board. Figure 6 shows how, on average, less than 18% of the proxy fights resulted in the appointment of at least one of the directors proposed by dissenting shareholders.

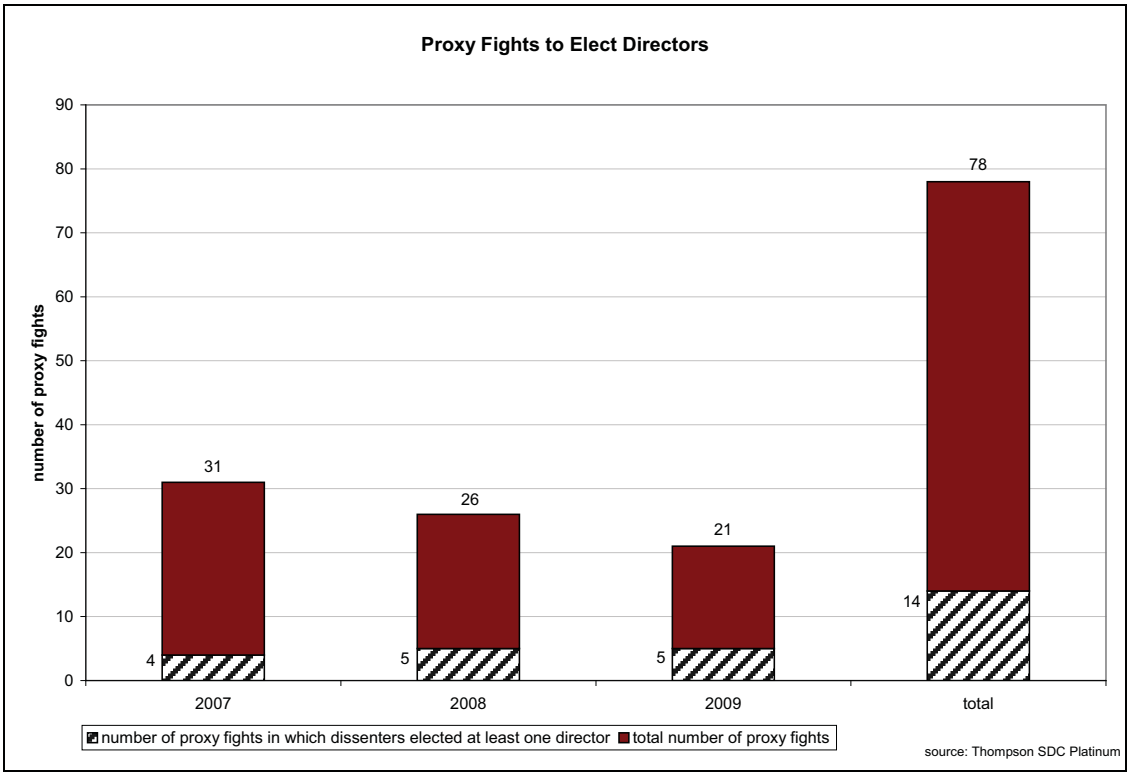


Figure 6

Figure 6 also indicates a slight growth in the rate of successful proxy fights for the nomination of directors over the last three years: from approximately 13% in 2007, to almost 24% in 2009. This effect might be related to the shareholders' dissatisfaction with the performances of the corporations after the financial crisis. However, of the 14 cases in which, in the time frame considered, at least one dissenting director was elected, the actual number of directors elected by dissenting shareholders was not substantial, as the following chart illustrates.

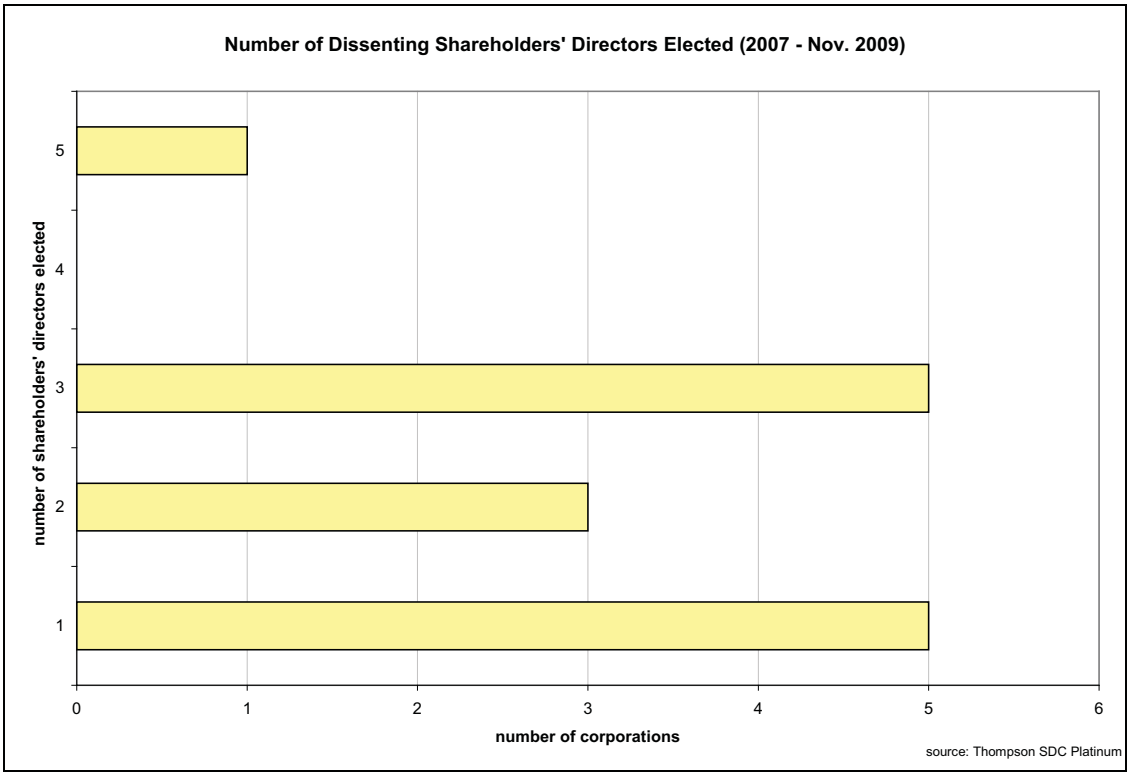


Figure 7

It is noteworthy that in almost 60% of the cases, dissenting shareholders were only able to appoint 1 or 2 member of the board of directors, a slim minority. The existing literature confirms the limited success of shareholders challenges to the existing management through proxy fights, and offers convincing theoretical explanations for this phenomenon.[64]

As it is often the case with limited empirical evidence, a note of caution is necessary before drawing conclusions from the data presented. It is, however, fair to underline a couple of take away points from the preceding analysis. The first one is that equity investors have demonstrated a meaningful interest in obtaining greater control over the election of a board of directors that is more directly accountable to shareholders (Figures 2, 3 and 4). This conclusion is suggested by both the movement favoring majority voting, and by a notable degree of support for cumulative voting. Notwithstanding this observation, very few corporations have voluntarily taken into account the desires expressed by shareholders through merely precatory proposals, once again consistently with Bebchuk's prediction that corporations tend *not* to opt-in governance regimes not favored by managers and directors.[65]

A second take away point is that the alternative route that shareholders have to actively participate in the election of directors, an independent proxy fight, is not only

[64] *See* Lucian A. Bebchuk, *The Myth of Shareholders Franchise*, 93 VA. L. REV. 675, 732 (2007) at 682.

[65] *Id.*

discouraged by its high costs, but also quite ineffective in terms of likelihood of success for the dissenting group (Figures 5 and 6).

Finally, horizontal regulatory competition among states does not seem able to curb the disproportionate power of corporate executives and existing directors in selecting the incoming board. This is clearly shown by the North Dakota experiment. The new NDPTCA had and has an important role in the theoretical debate over directors' election but it is not likely to have a meaningful concrete impact on corporate law. Very few corporations have or will reincorporate in North Dakota, as illustrated by the data presented above in Figure 1.[66] It is also unlikely that the recent amendments of the Delaware corporate statute will result in a significant increase in the number of corporations that adopt proxy access and/or proxy expense reimbursement provisions in their governing documents. The fundamental reason why reincorporation or charter or bylaws amendments that would empower shareholders in the selection of their directors are unlikely, even if desired by the investors, is that both procedures are largely controlled by directors, and can hardly be initiated or completed without directors' support. The current regulatory framework, in fact, significantly limits the ability of shareholders, even large shareholders, to unilaterally promote similar changes.

For these reason, a Federal default regime that would contribute to level the playing field between shareholders and directors, at least with respect to proxy access should be welcomed. As other scholars have observed, the uncertainties on the possible effects of the proposed rules, and the possibility that they would be used by interested groups to promote their own agendas suggest introducing the new rules as default provisions from which corporations can opt out, if such an option is favored by a majority of the shareholders.[67]

2. *The Insufficiency of the Recent Reforms to Empower Shareholders. The Case for Minority Representation on the Board through "List Voting".*

The real problem with the SEC's proposal is that it does not go far enough in limiting the self-referential composition of the board and promoting shareholders' empowerment. As mentioned above, proxy access facilitates a broader number of candidates from which shareholders can choose the members of the board, but does not in any way foster the representation of qualified minorities on the board: at best, it merely makes it possible. In this respect, the SEC's proposal is neutral, and its concrete effects might be less far-reaching than its critics fear and its supporters hope.[68]

The crucial point is that under a plurality voting system[69], there is no particular reason to expect that shareholders not affiliated with the management would have enough

[66] Bainbridge, *supra* note 28.

[67] Bebchuk and Hirst, *supra* note 49.

[68] Doubts on the concrete effects on the proxy machinery of shareholders' direct access are expressed also by Murphy, *supra* note 6, at 179.

[69] I refer to plurality voting because it is the rule that would generally apply whenever there are more nominees than available seats on the board, but the observation in the text would obviously apply also to a majority voting system.

voting power to elect even one single director, notwithstanding the fact that some stockholders might be able to add their candidates to the corporation's proxy ballot.

An example can illustrate this issue. Consider a corporation in which the management and the current board are sustained by a coalition of shareholders representing 32% of the voting shares. A likely scenario is that this group of shareholders will vote for the candidates suggested by the board. In this situation, the only way for other candidates to be elected to the board is to receive at least the same number of votes, or more. This seems, in itself, improbable because candidates nominated by shareholders through proxy access under the current SEC proposal are, by definition, a minority of the board (either one candidate or a fourth of the board, whichever is greater), and shareholders have limited room to campaign for their candidates (a 500 words limit on the corporate proxy ballot according to proposed Rule 14a-11). For this reason, proxy access will have a very limited effect on corporate governance: if there is a dissenting group that can count – or believes it can count – on more than 32% of the votes, it might make more sense for them to seek control of the board.

This is exactly what, in my opinion, constitutes an inherent contradiction of the current SEC's proposal: it requires shareholders' nominees to obtain a plurality of the votes (or at least the same number of votes received by the majority directors) to elect a minority of the members of the board.

One possible objection in favor of the importance of proxy access is that an alternative scenario might occur. The same group of shareholders who sustains the current board might decide to cast some of their votes for certain directors proposed by other shareholders. Shareholders may, in other words, endorse the list of names advanced by the existing board only in part, in order to appoint a more diverse group of directors. Alternatively, some members of the coalition that has supported the old board might become turncoats and vote for the candidates presented by other shareholders. Although these outcomes are not impossible, in most instances they do not seem very likely.

As I have argued above, the SEC's proxy access proposal is certainly better than nothing in giving shareholders the opportunity to play a more active role in the selection of the board. And there is no doubt that the amendment of NYSE Rule 452 and the abolition of brokers' discretionary voting on uninstructed shares will make it more difficult for managers to ensure a high and stable level of "passive approval" of their candidates. In addition, as it will be considered below, the Commission would probably not have the authority to enact rules affecting the voting process much more profoundly than the ones currently proposed and, in particular, providing for minority representation on the board. A similar a reform would require a legislative intervention at the federal or state level. My general point is, however, that a proxy access regime in which shareholders' candidates are, by definition, a minority of the board, without any type of mechanism intended to favor minority representation, runs the risk or being largely ineffective.

I am aware that my observations call into question, more broadly, the role of the modern board of directors and what we expect from shareholders' empowerment in the

selection of directors. In large listed corporations the role of the board is predominantly to control. The board has the duty and power to approve the overall strategy of the corporation, but clearly not to manage its day-to-day operation. The board has, on the other hand, the fundamental duty to oversee the managing of the corporation acting as the agent of the shareholders, and to ensure that the operating officers and managers pursue effectively and loyally the best interests of the investors.[70]

Accepting this largely shared view, the presence of directors who represent different shareholders – and in particular shareholders not affiliated with the majority of the directors – seems to strengthen the monitoring function of this body and to offer a constructive critical point of view on the management of the corporation. On the other hand, specifically in the light of the limited involvement of the board with the day-to-day life of the corporation and its primarily supervisory role, the concern about a divisive and conflicted board seem largely exaggerated, if not misplaced.[71] A better and more realistic, although somehow simplified, way to describe the position of minority directors is that they would act as a sort of "super-independent" members of the board, whose judgment is not impaired by a sense of deference to the directors or managers who sponsored their candidacy.

Representation of minority shareholders on the board would really, and profoundly, increase the accountability of the board to a broader constituency of shareholders, and create the internal organizational incentives for greater attention to the protection of the interests of all shareholders, including minority shareholders. With an analogy drawn from the realm of politics, a proportional correction would operate a little bit like the Senate versus the House of Representative, granting a stronger voice also to those constituencies that in terms of population (number of shares) would otherwise be condemned to be marginalized. It would significantly prompt shareholders' democracy.[72]

3. *How Does "List Voting" Work and Why Would It be Better than "Cumulative Voting"*

Then how should a minority representation on the board then be regulated? In the U.S., the first technical instrument that comes to mind is cumulative voting. Cumulative voting is, historically, the system used to give qualified minority shareholders the possibility to appoint part of the board, and it was, in fact, proposed as a voting mechanism in listed corporations by Jeffrey Gordon in an important article of 1994.[73] In the light of the path dependency of legal systems, cumulative voting has the clear and strong advantage of fitting in the American legal tradition and culture.

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[70] Jeffrey N. Gordon, *The Rise of Independent Directors in the United States,1950-2005: Of Shareholder Value and StockMarket Prices*, 59 STAN. L. REV. 1465 (2007).

[71] Jeffrey N. Gordon, *Institution as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 *at* 128.

[72] *Id. at* 142.

[73] *Id.* Reserving seats on the board of directors for directors voted by minority shareholders had also been argued by LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 209-10 (1988).

Notwithstanding this consideration, I still advocate that cumulative voting is not be the best way to allow the election of minority directors. I propose an alternative regime, partially inspired by comparative experiences, that I will call "list voting". After a sketch of the basic rules of this system, I will explain why it should be preferred over cumulative voting.

First, with list voting shareholders would be allowed to submit candidates to the board according to the current SEC proposed proxy access rule. Instead of voting on single directors, shareholders would however vote for alternative lists of directors: the ones proposed by the management, or the ones proposed by other shareholders. A predetermined number of seats on the board (depending on the size of the body) would be reserved for the first candidates of the list that receives the second largest number of votes. For example, if the list presented by the exiting board would receive 42% of the votes, and the list supported by minority shareholders would rank second receiving 11% of votes, the first nominee(s) from the latter list would also enter the board.

To discuss the technical details of this approach would be beyond the scope of this article. The goal here is to illustrate the overall rationale of the proposed system. It is however necessary to address two important issues. First, a minimum threshold of votes that needs to be reached in order to actually elect the minority director(s) to the board could be imposed either mandatorily by regulation, or on a more flexible bais in the bylaws of the corporation. This would guarantee that minority directors represent a qualified minority. Bylaws or statutory provisions could hypothetically require that the second ranked candidates receive at least one fifth of the votes obtained by the first list, or a fixed threshold, for example 5% of the votes cast.

Second, when it comes to the fine tuning of this proposal, it would need to be ensured that minority directors really represent minority shareholders. There is a risk that a shareholder affiliated with the controlling group might try to "disguise" themselves as an independent investor, with the result that the alleged "minority" director(s) would, in truth, be expressed by the controlling group "*en travesti*". To avoid this risk is not easy, but a combination of disclosure obligations imposed on the proposing shareholder and her nominees, with a requirement that minority directors are proposed by shareholders independent from the management of the other shareholders that support the managers, could achieve this goal.

We now come to the issue of why this approach is preferable to cumulative voting even if it is less familiar to the American system of corporate governance. In a nutshell, it is for three reasons: its greater simplicity, predictability and certainty.

It seems unnecessary to analytically describe here how cumulative voting works. In brief, each shareholder is entitled to cast a pool of votes corresponding to the product of his or her votes, times the number of directors up for election. The shareholder is free to distribute his or her votes among the different candidates as he or she wants. The practical result is that a qualified minority of shareholders, by "concentrating" all their

votes on one or a few candidates, might be able to have those candidates elected to the board under a plurality voting system.[74]

However, let us compare the possible effects of cumulative voting and list voting in a hypothetical election of directors in a listed corporation with a simplified ownership structure. Imagine that 9 directors are up for election, and the "managers group" is supported by a relatively stable coalition of shareholders, or even better by one single large shareholder (M), holding 50 shares corresponding to 50% of the outstanding voting shares. The managers' candidates are named from M1 to M9. Let us also imagine that two different groups of dissenting shareholders propose and vote their own candidates. Shareholders' coalition A, a group of public pension funds holding 20 shares or 20% of the outstanding voting shares, sponsors through the proxy access regime candidates A1 and A2. A second shareholders' coalition, sponsored by a trade union, B, might launch a proxy fight and manage to bring together a package of 12 votes equal to 12% of the voting capital in favor of its candidate, B1. Finally, suppose that a total of 85% (85 votes) is represented at the meeting, and that 3% of the shareholders will either abstain or not vote.

In this scenario, under cumulative voting (*see* the formulas in footnote 74), coalition A could appoint at least two directors, coalition B one director, and the remaining 6 directors would be appointed by the majority group affiliated with the management. An example of the outcome of the election could be the one represented in the following table (elected candidates are highlighted):

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[74] To illustrate with a simple example, imagine that the controlling shareholder holds 10 voting shares, and a minority shareholder holds 4 shares. If there are 3 directors to elect, the former shareholder will have 30 votes, and the former 12. If the minority shareholder casts all her 12 votes for one candidate, it is impossible for the controlling shareholder to cast more than 12 votes (of his total of 30) for each of his three favorite candidates. Under a cumulative voting system, the formula to calculate the minimum number of shares to elect a given minimum number of directors is the following:

$$min.\ number\ of\ shares = \frac{number\ of\ directors\ you\ want\ to\ appoint \cdot number\ shares\ represented}{number\ of\ vacancies\ on\ the\ board + 1} + 1$$

Consequently, if a board of 12 directors is up for election, and 1,000,000 shares are represented either in person or in proxy at the shareholders' meeting, in order to appoint at least 2 minority directors you would need 166,668 shares, corresponding to approximately 16% of the voting shares.

Conversely, the number of directors that can be elected by a fraction of shareholders holding a given number of shares is:

$$number\ of\ directors = \frac{(shares\ controlled - 1) \cdot (number\ of\ vacancies\ on\ the\ board + 1)}{number\ \ shares\ \ represented}$$

candidate	votes from M shareholders	votes from A shareholders	votes from B shareholders
M1	75	0	0
M2	75	0	0
M3	75	0	0
M4	75	0	0
M5	75	0	0
M6	75	0	0
M7	0	0	0
M8	0	0	0
M9	0	0	0
A1	0	109	0
A2	0	71	0
B1	0	0	108

This example illustrates two points. First, the outcome of the cumulative voting system – especially when compared with the system proposed in this Article – is a more divided board. One-third of the directors are elected by shareholders dissenting from the current managers and current directors, and not only by one coalition of shareholders, but by two different ones, with potentially different and maybe conflicting goals. Second, from the point of view of minority shareholders, the outcome of the election is not very predictable and the system might lead to strategic voting. Imagine that the majority shareholders and the managers succeed in convincing coalition B, represented by trade unions, to vote for their candidates, and find additional block owners holding 12% of the shares willing to vote for their candidates. At this point, shareholder group A may be unable to appoint two directors, but remain with only one ((20 - 1) · (9 + 1)/ 97 = 1.95). The numbers in the example are not completely realistic, because shareholders' meeting of a listed corporation rarely see 97% of the shares voting, but the problem exists also with more realistic figures.

This analysis leads to the conclusion that, depending on the ownership structure, cumulative voting can lead to the appointment of a more divisive board, which has more potential for conflicts, and that its outcome may be less predictable also from the point of view of minority shareholders.

On the other hand, a voting mechanism in which shareholders vote a proposed list of candidates, knowing that a predetermined number of seats on the board will be allocated to the list that receives the second largest number of votes (as long as it reaches a certain threshold) is more simple and straightforward. List voting ensures a meaningful but predetermined level of representation of minority shareholders on the board, and it encourages the creation of shareholders' coalitions that share the same interests.

For example, using the same set of facts as in the previous example, let us consider a list voting system in which two seats on the board are reserved to the list ranked second, as long as it receives at least 5% of the votes cast. In this case, the managers' list would appoint seven directors, and the two minority directors would be A1 and A2. Shareholder groups A and B would have an incentive to coordinate their voting

and select their candidates together in order to make sure that no other list is able to beat theirs. Accordingly, both the controlling group and minority shareholders might favor this voting system over cumulative voting. The former group knows in advance, and with more certainty, what the maximum number of potential minority directors will be. Also managers would need only a lower percentage of shareholder support to appoint seven directors. For example, with a 40% majority, it would be highly unlikely that any other coalition would have more votes and rank first. Minority shareholders, on the other hand, might prefer to renounce the possibility of electing more representatives on the board, in exchange for greater certainty to have at least some candidates among the directors of the company. They would thus also profit from list voting.

In other words, list voting, in comparison with cumulative voting, offers a more stable, clear and certain mechanism for a limited representation of minority shareholders on the board. The system, if introduced as a default, opt-out rule, can be flexibly tailored to the specific needs and ownership structures of different corporations. It represents a sensible compromise between the total absence of minority representation that characterizes today's boards, and the potentially more extreme and less predictable effects of cumulative voting. The increased but limited diversity on the board could improve directors' accountability to shareholders and enhance the monitoring and controlling role of the board in the interest of a broader number of shareholders. As mentioned above, the concern for the development of disruptive conflicts on the board seems quite limited, especially in the light of the non-managerial role played by the modern board of directors.

4. *A Brief Comparative Digression. Why Minority Directors Could Be Useful also in U.S. Corporations with a Widespread Ownership Structure*

As briefly mentioned above, proportional voting systems are not unknown in international corporate governance. Even a superficial comparative overview shows that various legal systems as diverse as Iceland, Italy, Russia and Spain have adopted some form of minority shareholders' representation on the board, not to mention the individual states in the U.S. that still retain mandatory cumulative voting provisions in their corporate statutes.[75]

The Italian and Spanish experiences are particularly relevant for our purposes because they offer an occasion to address a possible objection to minority representation in the United States based on the ownership structures dominant in this country. A detailed discussion of these two systems would be beyond the scope of this Article, but it is necessary to offer a brief description of the two approaches.

Under Italian law, Article 147-*ter* of the Consolidated Law on Financial Markets (Testo Unico della Finanza, or TUF) provides that shareholders holding a minimum

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[75] *See* M. Belcredi, *Amministratori Indipendenti, Amministratori di Minoranza, e Dintorni*, 50 RIV. SOC. 863 (2005); Mario Stella Richter jr., *Considerazioni Preliminari in tema di corporate governance e risparmio gestito*, 33 GIUR. COMM. 205 (2006); Marco Ventoruzzo, *La Composizione del Consiglio di Amministrazione delle Società Quotate dopo il D. Lgs. N. 303 del 2006: Prime Osservazioni*, 52 RIV. SOC. 205 (2007), *supra* 15.

thresholds of shares which is inversely proportional with the market capitalization of the corporation and varying from 0.5% to 4.5%, can present lists of candidates for the election to the board. These lists would usually compete with the list presented by the controlling shareholder. The law provides that at least one director (more if the bylaws provides that) should be appointed by the list that receives the second largest number of votes. Corporate bylaws can also require that, in order to be taken into account, the list must have received a minimum percentage of votes at the shareholders' meeting.[76] In order to prevent the controlling group to present and vote for "false minority lists", minority candidates cannot be "connected" with the list that ranks first. For example, the list from which minority directors will be selected must be presented and voted by shareholders not affiliated with the majority shareholder that sponsors the first list. This system, introduced in 2006, has so far worked quite smoothly. It has affected the composition of the boards of listed corporations and no significant problem of conflicting boards has been reported.[77]

Similarly, Article 137 of the Spanish *Ley des Sociedades Anonimas* also provides for the right of a minority of shareholders to appoint directors in proportion to their stake in the capital of the corporation. For example, if a corporation has a board of directors of 9 members, shareholders owning 10% of the shares can require the appointment of one representative to the board. This statutory right raises, in fact, several questions concerning its reconciliation with the powers of the shareholders' meeting and the majority rule, in particular when the shareholders' meeting wants to reduce the number of directors. The case law and scholarly work has not fully resolved these issues yet, but for our purposes the example of Spain is relevant to point out that minority representation on the board is in some form also embedded in the corporate statute of this important economy, which has a quite developed corporate governance system.[78]

As mentioned above, the two examples of Italy and Spain might raise a serious, but in my opinion not sustainable, objection.[79] Considering the concentrated ownership structures prevailing in those countries, one could argue that a list voting system may make more sense, and indeed becomes necessary, in systems where the crucial governance problem is the relationship between a strong controlling shareholder and minority shareholders. Under such circumstances, obviously, an effective way to make the board accountable to minority shareholders is to open the boardroom to candidates selected and voted by minority shareholders. On the contrary, the objection would go, in a system with a more widespread ownership structure, and variable majorities that can be

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[76] This percentage cannot be higher than half of the threshold required to present a list. For example, if the bylaws provide that a list can be presented only by shareholders holding at least 3% of the voting shares, the bylaws can also provide that minority directors, to be elected, must receive the second largest number of votes amounting to at least 1.5%, but cannot require a higher threshold.

[77] On list voting in Italian listed corporations *see* Mario Notari – Mario Stella Richter Jr., *Adeguamenti statutari e voto a scrutinio segreto nella legge sul risparmio*, __ SOCIETÀ 533 (2006); Marco Ventoruzzo, *supra* note 75. Under Italian law, a similar system is also mandated for the election of the members of the internal board of statutory auditors, a controlling body elected directly by shareholders, as mentioned by Murphy, *supra* note 6, at 183 ff.

[78] Guillermo J. Jiménez Sánchez, Derecho Mercantil, 372, 2006.

[79] This issue has been raised with the Author by Jeffrey Gordon, email on file with the Author.

formed at the shareholders' meeting to support or oppose the management, the major agency problem lies in the relationship between managers and directors on the one hand, and all the shareholders, on the other hand. In other words, when shareholders coalitions can change and that entrenched controlling shareholders are less common, it is less important to establish a mechanism for minority representation on the board.

Since in the U.S. listed corporations tend to have a widespread ownership structure, this is an important issue. Despite the apparent appeal of this objection, ultimately it is an optical illusion in the mind's eye, for at least a couple of reasons.

First, in theory it is true that the agency problem in the U.S. is primarily the struggle between powerful executives and a large number of relatively smaller shareholders when compared to continental European systems. It is also true that, again in theory, that the majority that supports the directors can change more easily. However, the crucial question is what happens at a specific shareholders' meeting. To the extent that a controlling group exists, whether composed of a temporary coalition of votes that supports managers or by one single large shareholder, it is always relevant to balance the interests of the minority who is not allied with the majority.

Obviously, the more stable and unchallengeable the position of the controlling coalition is and the more the board is insulated from the risk of being replaced, the more serious the problem of self-referential directors is. But the very fact that the shareholders' coalition supporting the board can vary, does not necessarily imply that the board is more accountable to shareholders. If the board, relying on collective action problems and rational apathy of shareholders, can easily find a majority that votes for its candidates at every election, and challenges from dissenting shareholders are not easy, then shareholders are not really empowered also in legal systems with a widespread ownership structure. The absolute power and lack of accountability of the CEOs can be founded either on a complacent strong controlling shareholder, or on the absence of a large shareholder and on the inability of a multitude of small investors to coordinate their voting strategies: a sort of "divide and rule" – or "*divide et impera*" – strategy.

Finally, minority representation on the board could increase the likelihood of shareholders who launch a proxy fight would obtain at least a partial victory. This might strengthen the voice and monitoring function of institutional investors and lead to increased participation and thus improve directors' accountability.

As a second response to the objection that list voting is only suited for countries with concentrated ownership structures, I argue that even if the prevailing ownership structures in the U.S. are less concentrated than in continental Europe, this feature of the American system is sometimes overestimated. Recent literature has questioned how diffused share ownership in the U.S. really is, observing that this idea might largely be "a myth".[80] For example, to cite the data from a research conducted by Clifford Holderness, 53% of U.S. public corporations has a single family as a blockholder, versus 59% of the non-U.S. firms examined. The average ownership percentage of these blockholders is 32% in the United States, versus 36% in other countries. The difference, at least

[80] Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. OF FIN. STUDIES 1377, 1406 (2009).

according to this empirical evidence, is not as profound as it is commonly believed. In addition, in the U.S., because of antitakeover devices and other legal mechanisms that can be adopted to protect the current management and the shareholders' coalition that support them, it can be very difficult for minority shareholder to challenge a bolockholder holding even a 30% stake in a listed corporation.[81]

For all these reasons, at a time when the regulation of directors' election is so central to the American debate on corporate governance, minority representation on the board of directors, and more specifically list voting, should be put on the agenda of policy makers, institutional investors and activist shareholders.

IV. CONCLUSIONS

The flurry of reform activity examined in this article blows toward shareholders empowerment in the election of the board and greater accountability of directors to the stockholders. It is unclear, however, whether this wind will suffice to dispel the specter of directors' dictatorship.

Many of the reforms that have been recently introduced or proposed might, in fact, be much less profound than some fears, and others hope. The NDPTCA is unlikely to have a meaningful concrete impact on corporate law, both because it is not clear how desirable it would be for shareholders to reincorporate in North Dakota, and because even if it were, the existing legal framework does not really allow shareholder to reincorporate without directors' consent. The 2009 reform of the Delaware corporate statute simply introduced enabling opt-in provisions on proxy access and proxy expenses reimbursements, provisions that only few corporations are likely to adopt. The SEC proposed reform of proxy access would represent an important innovation to the electoral process, but it is quite timid from the point of view of shareholders' empowerment.

Reserving some seats on the board of directors for candidates nominated and voted by minority shareholders not affiliated with the board would ensure broader representation of the different interests of investors and enhance the monitoring function of the board. One of the major concerns that this approach raises is the creation of a divisive and ineffective board. In the light of the actual role of the board of directors in the modern listed corporation, which does not focuses on the actual managing of the corporation, this concern seems to be not very well founded, if not raised instrumentally. Directors appointed to board become agents of *all* shareholders, and they owe fiduciary duties to the corporation as a whole. The idea that directors supported by institutional investors or other qualified minorities would be subversive elements of disruption discounts, among other things, the role of fiduciary duties in constraining directors' actions. A more diverse board could, on the contrary, not only better represent different

[81] This is largely demonstrated by the data presented in Figures 5 and 6 on proxy fights. A system to favor minority representation on the board might increase the likelihood of success of proxy fights, which notoriously affect positively shareholders' wealth.

shareholders, but also reduce corporate conflicts and the need to use litigation as a protection for minority shareholders.

If shareholder empowerment in the election of the board is worth an experiment, list voting should be preferred over cumulative voting. Even if list voting is less familiar to the American corporate scenery, it offers greater certainty with respect to its impact on the composition of the board, and for this reason can be, at the same time, less frightening to controlling groups and more reliable for qualified minorities.

Finally, it should be considered that, in theory, vote listing could be introduced by the Federal legislature, by State legislatures, or by single corporations in their bylaws. For the reasons examined above, it is highly unlikely that either state legislatures or specific corporations would have the incentives to move toward this direction, even if this would be highly desirable from the point of view of shareholders. The Federal legislature, on the other hand, may be more prepared and willing to take such a step, since minority representation might be seen as part of the effort towards increased investors protection in which it is already engaged.

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