

March 31, 2004

Mr. Jonathan G. Katz, Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

Dear Mr. Katz:

Please find attached a working paper from the Institute for Law and Finance, Frankfurt am Main, Germany, comparing the proposed, Security Holder Director Nominations Rule with existing shareholder nomination procedures under German law, as well as evaluating the arguments for and against the proposed rule. The main comments made in the attached paper are:

- Proposed Rule 14a-11 assists exercise of a state law right, and thus should and can be adopted by the SEC under the Exchange Act.
- The use of "withhold votes" as a trigger is questionable, given that it both distorts the intended, state law value of voting rights by attaching a secondary, federal meaning and assumes that shareholders are unable simply to opt-in to the proposed Rule. A straightforward opt-in would be preferable.
- It is unlikely that the eligibility holding requirement violates the equal treatment of shares, given that a similar, albeit higher, threshold is found in § 7.02 of the Revised Model Business Corporation Act.
- Proponents of Rule 14a-11 make a convincing argument that because the shareholders of U.S. corporations are currently unable to enforce management accountability, the proposed Rule is necessary.
- Certain arguments against the Rule – that accountability is misplaced because shareholders do not own the corporation and management needs no monitoring – are without merit.
- Germany has a very liberal system of shareholder proposals and nominations, yet this has led neither to an expensive overuse of corporate assets nor to balkanized boards.
- A controlled, electronic environment for shareholder communications, as recently established in Germany, would appear to have value for the effective use of proposed Rule 14a-11, at least as long as shareholder identities are known only to clearing agencies and their participants.

We hope very much that you find the comments in the attached working paper to be useful for the rulemaking process.

Yours Sincerely,  
David C. Donald

Research Associate  
Institute for Law and Finance  
Johann Wolfgang Goethe-Universitat  
Senckenberganlage 31, Postfach 1119  
60054 Frankfurt am Main  
tel. 069 798 28 949  
fax 069 798 28 946



INSTITUTE FOR LAW AND FINANCE  
JOHANN WOLFGANG GOETHE-UNIVERSITÄT FRANKFURT

David C. Donald\*

## THE NOMINATION OF DIRECTORS UNDER U.S. AND GERMAN LAW

### Contents

I. Introduction.....	3
II. The Nomination and Election of Directors in U.S. Companies .....	8
A. Position of Shareholders under Delaware Law and U.S. Federal Law .....	8
B. The SEC Shareholder Nominations Proposal.....	13
III. The Arguments for and against Shareholder Nominations .....	19
A. Addressing Agency Problems through Procedurally Ensured Accountability to Shareholders.....	19
B. Protecting the Company through Management's Fiduciary Duties .....	22
IV. The Nomination and Election of Directors in German Stock Corporations .....	30
A. The Composition of the Board under German Law .....	30
B. The Nomination of Directors under German Law.....	32
1. Nomination by the Supervisory Board.....	32
2. Nomination by Shareholders .....	33
3. Voting through Bank Proxies .....	36
V. Conclusions .....	39

### Working Paper Series No. 21

---

\* Research Associate, Institute for Law and Finance, Johann Wolfgang Goethe-Universität, Frankfurt am Main, J.D. Georgetown, Ph.D., SUNY at Buffalo, member, New York State Bar, doctoral candidate, Johann Wolfgang Goethe-Universität.

## I. INTRODUCTION

For decades the U.S. Securities and Exchange Commission ("SEC") has periodically considered issuing rules to give shareholders an official channel of communication to propose candidates for election to the boards of publicly held companies.<sup>1</sup> In October of 2003, the SEC once again turned its attention to the possibility of allowing shareholders, under certain limited circumstances, the right to place nominees on their company's proxy card. Two historical developments have led the SEC to this juncture. First, as Prof. Melvin Eisenberg pointed out as early as 1969,<sup>2</sup> and as the business and academic communities have increasingly stressed and analyzed ever since,<sup>3</sup> sophisticated institutions are increasingly becoming the primary shareholders in American public companies.<sup>4</sup> The picture of dispersed, isolated and inexperienced shareholders so graphically drawn by Adolf Berle and Gardiner Means in 1932<sup>5</sup> is for the most part no longer accurate in today's market, although their famous observations on the separation of control and ownership of public corporations remain true. A second development, the serious deterioration and ultimate failure of corporate gate keeping and monitoring systems during the bull market of the 1990's, gave urgency to the situation. A slowly leaking tech bubble finally burst with the bankruptcy of Enron Corp. in 2001,<sup>6</sup> and helped to erase about seven trillion dollars in market

---

<sup>1</sup> Proposed Rule: Security Holder Director Nominations, SEC Release No. 34-48626, 68 *Federal Register* 60784, 60785 (October 14, 2003) ("Shareholder Nominations Proposal"). The SEC would issue such a rule under its authority to regulate the solicitation of proxies, consents or authorizations pursuant to § 14 of the Securities Exchange Act of 1934. The solicitation of proxies to exercise the voting rights of a company's securities is subject to § 14 if such securities must be registered under § 12 of the Exchange Act. Securities must be so registered either (i) if they are listed on a national securities exchange (§ 12(a) Exchange Act), (ii) if the company has more than 500 shareholders and total assets exceeding \$ 10 million (§ 12(g) Exchange Act in connection with Exchange Act Rule 12g-1), or (iii) during the fiscal year in which the company had to register a securities offering under the Securities Act of 1933 (§ 15(d) Exchange Act).

<sup>2</sup> M. Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, at 46 *et seq.* (1969).

<sup>3</sup> See e.g., R. Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, in CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY, A. McCahery, *et al.* eds., 507 (2002); B. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992), J. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUMBIA L. REV. 1277 (1991).

<sup>4</sup> In 1969, Prof. Melvin Eisenberg pointed out that large shareholders were relatively well represented in listed companies (see Eisenberg, *supra* note 2), and as of 2001, institutional investors held 55.8% of the publicly traded equities in the United States. See R. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 BUS. LAW. 95 (2003).

<sup>5</sup> A. Berle/G. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (revised ed., 1968).

<sup>6</sup> See J. Coffee, *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L.R. 269 (2004); -- *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS LAW 1403 (2002); L. Strine, *Derivative Impact? Some Early Reflections on the Corporation Law Implications of*

capitalization,<sup>7</sup> which prompted lawmakers,<sup>8</sup> regulators<sup>9</sup> and stock exchanges<sup>10</sup> to shore up the ailing system where necessary. One result has been the SEC's attempt to give shareholders better information about how their shares are voted,<sup>11</sup> and how the nominating committees of corporations choose candidates for the board,<sup>12</sup> as well as to propose that shareholders receive some say in the selection of such candidates.

The resulting debate has sought to define the appropriate role of shareholders in the governance of public corporations.<sup>13</sup> The debate offers an interesting opportunity for the model-shopping function of comparative law.<sup>14</sup> The strengthening of shareholder influence

---

*the Enron Debacle*, 57 BUS. LAW. 1371 (2002); J. Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. UNIV. L.Q. 449 (2002).

<sup>7</sup> This was the approximate amount of market capitalization that the roughly 6,000 companies included in the Wilshire 5000 lost between March 24, 2000, when the index stood at 14,751.64 points and July 23, 2002, when it fell about 48 % to 7,601.84 points in the wake of scandals at numerous listed companies. This data is available at [wilshire.com/indexes/Broad/Wilshire5000/](http://wilshire.com/indexes/Broad/Wilshire5000/).

<sup>8</sup> See Public Law 107-204, July 30, 2002 (H.R. 3763) Sarbanes-Oxley Act of 2002, "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes," which primarily amended the Exchange Act.

<sup>9</sup> Since 2002, the SEC has issued numerous rules to correct abuses and to implement the Sarbanes-Oxley Act, primarily focusing on the quality of disclosure (timeliness, inclusiveness and accuracy), accounting (the introduction of a new supervisory entity), and board monitoring (independent audit committee, ethics rules, financial expertise). The Shareholder Nominations Proposal would be the latest of these measures. The proposed and final rules of the SEC for about the last 10 years are available on its website, [www.sec.gov/](http://www.sec.gov/).

<sup>10</sup> The New York Stock Exchange Inc. and the Nasdaq Stock Market, Inc., a subsidiary of the National Association of Securities Dealers (NASD), have both substantially revised their corporate governance rules in response to this governance breakdown. See Self-Regulatory Organizations, Approval of Proposed Rule Changes, SEC Release No. 34-48745, 68 *Federal Register* 64154 (November 12, 2003).

<sup>11</sup> Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, SEC Release Nos. 33-8188, 34-47304, 68 *Federal Register* 6564 (February 7, 2003) ("As of September 2002, mutual funds held \$2.0 trillion in publicly traded U.S. corporate equity, representing approximately 18% of all publicly traded U.S. corporate equity. This represents a dramatic increase from only 7.4% at the end of 1992. Millions of individual American investors, in turn, hold shares of equity mutual funds, relying on these funds—and the value of the corporate securities in which they invest—to fund their retirements, their childrens' educations, and their other basic financial needs. Yet, despite the enormous influence of mutual funds in the capital markets and their huge impact on the financial fortunes of American investors, funds have been reluctant to disclose how they exercise their proxy voting power with respect to portfolio securities. We believe that the time has come to increase the transparency of proxy voting by mutual funds." *Id.* at 6564-65). Also see Final Rule: Proxy Voting by Investment Advisers, SEC Release No. IA-2106, 68 *Federal Register* 6585 (February 7, 2003).

<sup>12</sup> See Final Rule: Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, SEC Release Nos. 33-8340; 34-48825, 68 *Federal Register* 69204 (December 11, 2003).

<sup>13</sup> See Part III, *infra*.

<sup>14</sup> "Comparative law is an 'école de vérité' which enriches the 'supply of solutions' (Zitelmann) and offers the scholar of critical capacity the opportunity of finding the 'better solution' for his time and place." K. Zweigert/H. Kötz, AN INTRODUCTION TO COMPARATIVE LAW, trans. T. Wier (1998), at 15.

in the annual meeting as a possible consequence of the U.S. economy's shift toward large, institutional shareholders presents certain characteristics that German corporate law has displayed since the late 19<sup>th</sup> century, given that banks acting as block shareholders and proxy agents have been important, if not dominant, players in the German economy.<sup>15</sup> Indeed, at the convention held to amend the stock corporation rules during the Weimar Republic, the German Ministry of Justice strongly promoted the interests of banks, and sought to leave banks completely unregulated in their exercise of the votes from stock held in their customers' custody accounts, arguing that the "lethargic" shareholders would probably not vote unless the banks did it for them.<sup>16</sup> It is reasonable to assume that this strong presence of the bank lobby also sought strengthened creditor protection in German corporate law, such as in the legal capital regime that pre-dated the requirements of the Second EC Company Law Directive<sup>17</sup> by about 100 years,<sup>18</sup> and the creditor-oriented German accounting

---

<sup>15</sup> Banks exercise influence over German corporations in three ways. First, German "universal" banks are permitted to hold equity stakes in industrial companies, and have done so, although this trend has been decreasing in recent decades. Based on data from the late 1990's, Barca and Becht show that banks and bank-related investment firms hold 82 voting blocks with a median size just under 15 % of 372 public industrial companies in Germany. F. Barca/M. Becht, *THE CONTROL OF CORPORATE EUROPE* 143 (2001). Second, given that most German stock takes the form of bearer shares, beneficial owners have traditionally held their stock in bank custody accounts, allowing the bank to exercise the stock's voting power. Beginning in the 1870's large German banks exercised the voting power of stock in their custody, even without formal proxy from the owners. *See* R. Tuerks, *DEPOTSTIMMRECHTSPRAXIS VERSUS U.S.-PROXY-SYSTEM* 5 (2000). In the 1992 annual meetings of the 20 DAX companies that issued voting bearer shares, banks held more votes than all other blockholders in 19 companies. Barca/Becht, *supra* at 129 *et seq.* Third, German companies have in the past relied heavily on bank credit, thus giving banks an incentive to monitor their debtors' behaviour. Prof. John Coffee points out how the generous lending of the German Central Bank in the late 19<sup>th</sup> century served to make industrial companies dependent on bank credit, thus stunting the growth of the securities markets. J. Coffee, *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 *YALE L.J.* 1, 55 *et seq.* (2001). It should be noted, however, that in recent decades only small and medium sized German companies rely heavily on commercial credit, and thus – at least as far as the power of banks as lenders goes – "[t]he description of the German corporate governance system as bank oriented is misleading." T. Baums, *The German Banking System and its Impact on Corporate Finance and Governance*, in M. Aoki/H. Patrick, eds., *THE JAPANESE MAIN BANK SYSTEM* 409, 445 (1995).

<sup>16</sup> P. Hommelhoff, *Machtbalancen im Aktienrecht*, in W. Schubert/P. Hommelhoff, *DIE AKTIENRECHTSREFORM AM ENDE DER WEIMAR REPUBLIK* 71, 91 *et seq.* (1987). The use of bank proxies was in fact regulated in the law that eventually entered into force in 1937, *Id.* at 92. Deliberately moving in the direction of the U.S. proxy rules, German law has sought increasingly to provide the beneficial owners of stock with more information through their custodian banks and to bind such banks more tightly on the will of the beneficial owners. For a discussion of the reform measures adopted in 1998, *see* S. Knauer, *NEUREGELUNGEN DES DEPOTSTIMMRECHTS NACH DEM KONTRAG, PRAKTISCHE BEWÄHRUNG UND WEITERE REFORMBEDÜRFTIGKEIT* 37 *et seq.* (2003).

<sup>17</sup> Second Council Directive of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (77/91/EEC).

principles.<sup>19</sup> However, the power of banks as shareholders and proxy agents has tended to outweigh their influence as lenders, and banks thus probably sought protections on both sides of the traditional dichotomy of shareholder and creditor interests.<sup>20</sup> Because German banks have exercised their primary influence as institutional investors and proxy agents rather than lenders,<sup>21</sup> they probably supported the other large, blockholders in seeking shareholder rights.<sup>22</sup> The result has been a body of corporate law that disfavors the type of protections to which *small and individual* shareholders can take recourse, such as derivative or direct actions against management for breach of fiduciary duties,<sup>23</sup> but favors shareholder empowerment in the annual meeting,<sup>24</sup> including significant powers to shape the agenda and the slate of nominees that will be considered at the meeting.

---

<sup>18</sup> On the creditor protection aim of the various rules in German law regulating the creation and maintenance of legal capital, see A. Cahn, *KAPITALERHALTUNG IM KONZERN 12 et seq.* (1998). For a general discussion in English of the German legal capital rules, see F. Kübler, *The Rules of Capital under Pressure of the Securities Markets*, in K. Hopt/E. Wymeersch, *CAPITAL MARKETS AND COMPANY LAW 95* (2003).

<sup>19</sup> "Die offizielle Reformdiskussion wandte sich, wohl nicht unbeeinflusst von den leitenden Kreisen der Industrie und Banken, den Fragen der Kapitalbildung zu." H. Wiedemann, *GESELLSCHAFTSRECHT* Bd. I, 29 (1980). An example of the creditor-oriented nature of German accounting principles is found in § 252(1) no. (4) of the Commercial Code (*Handelsgesetzbuch* – HGB), according to which foreseeable losses are to be booked before they occur, yet profit to be booked only when it is received. See W. Ballwieser, Comment on § 252 HGB, in *MÜNCHENER KOMMENTAR: HANDELSGESETZBUCH* (2001) for a thorough discussion and bibliography.

<sup>20</sup> A classic discussion of these competing interests is found in B. Manning/J. Hanks, *A CONCISE TEXTBOOK ON LEGAL CAPITAL 5 et seq.* (3<sup>rd</sup> ed. 1990).

<sup>21</sup> "The typical large German firm with dispersed shareholders finds its shares in voting blocks which are voted by a few banks . . . . This voting power, which helps place representatives of the banks on the supervisory board, comes from different sources: from directly owned stock, from investment companies controlled by banks, or from voting the shares held by banks as custodians for their clients." T. Baums, *Takeovers versus Institutions in Corporate Governance in Germany*, in D. Prentice/P. Holland eds. *CONTEMPORARY ISSUES IN CORPORATE GOVERNANCE 151, 158* (1993), also see T. Baums, *Vollmachtstimmrecht der Banken – Ja oder Nein?*, 1 *DIE AKTIENGESELLSCHAFT 11* (1996).

<sup>22</sup> As Barca and Becht point out, individuals and industrial firms hold a total of 385 voting blocks (out of 648 blocks) ranging from between 5 and 62 percent in 372 public industrial companies in Germany. F. Barca/M. Becht, *supra* note 15, at 143, Table 5.5.

<sup>23</sup> See T. Baums, *Haftung wegen Falschinformation des Sekundärmarktes*, 167 *ZHR 139* (2003), T. Baums/K. Scott, "Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany," Johann Wolfgang Goethe-Universität, Institute for Banking Law, Working Paper No. 119 (2003), available at <http://www.jura.uni-frankfurt.de/baums/>; and P. Ulmer, *Aktienrecht im Wandel, -- Entwicklungslinien und Diskussionsschwerpunkte*, 202 *AcP 143, 163 et seq.* (2002).

<sup>24</sup> For example, while the directors of a Delaware corporation have sole authority to issue or withhold dividends pursuant to § 170 of the Delaware General Corporation Law, the shareholders of a German Stock Corporation (*Aktiengesellschaft*, or "AG" make their own decision whether they will receive dividends out of the distributable profits under § 174(1) of the German Stock Corporation Act (*Aktiengesetz* or "AktG"). This right is checked only by the fact that distributable profits are derived on the basis on the balance sheet after the management makes appropriations to reserves pursuant to § 58 AktG (See G. Henn, *DIE RECHTE DES AKTIONÄRS: RECHTE UND PFLICHTEN IN UND AUßERHALB DER HAUPTVERSAMMLUNG 48-49* (1984)). Shareholders also appoint the AG's auditors (§318 Commercial

This is not to say that German law is *influencing* U.S. law, in a way that a dual listing might convey a direct influence from one system to another,<sup>25</sup> or that the United States is somehow evolving towards Germany's past, but rather to note that similar configurations of interested parties tend to seek similar legal rules to address similar tasks. This development certainly exhibits a form of convergence, although in this paper I do not attempt to discuss either international influence or causes for divergence in development,<sup>26</sup> but rather compare one model to another to study their structural properties and developmental tendencies. A review of the remedies offered in U.S. and German law appears to show the United States weakening the striking capabilities of small shareholders through securities actions<sup>27</sup> and (potentially) strengthening the voice of larger shareholders or groups of shareholders within the corporation,<sup>28</sup> while Germany is moving in a complementary direction by working to strengthen shareholder suits<sup>29</sup> and decrease the control that some block holders exercise over the shares that they hold in custody for others.<sup>30</sup>

---

Code – *Handelsgesetzbuch*, or "HGB") and may appoint a special auditor to investigate the board's handling of contributions to capital or management (§ 142 AktG). The capital of an AG may only be increased or decreased with shareholder approval (§§182, 192, 202 207, 222, 229, 237 AktG), including by way of an issue of convertible debt securities (§ 221 AktG). Given that the shareholders of an AG have statutory pre-emptive rights, they must vote to waive such rights before any new shares may be issued to third parties free of rights (§ 186 AktG). The shareholders of an AG also have somewhat more authority over structural changes than is provided under Delaware law. As in Delaware, German shareholders have a veto over business combinations (§§ 319, 320 AktG; §§ 65, 73 Reorganization Act – *Umwandlungsgesetz* or "UmwG") and sales of all or substantially all of the corporate assets (§ 179a AktG). However, shareholders also have a voice in spin-offs or divisions (§§ 65, 125 UmwG) and in corporate alliance contracts that create relationships of control or diversions of profits (§ 293, 295 AktG).

<sup>25</sup> "[B]ecause cross-listing on a U.S. exchange commits an issuer to at least some marginal change in its governance and disclosure practices, a deeper regulatory competition over governance and disclosure philosophies thus underlies the surface cross-border competition among market centers for listings and trading volume. Competition need not, however, drive corporate governance in a single direction." J. Coffee, *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUMBIA L. REV. 1757, 1761 (2002) and – J. Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NORTHWESTERN UNIVERSITY L. R. 641, 663 (1999).

<sup>26</sup> The most significant recent U.S. paper on this subject is probably, L. Bebchuk/M. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 134 et seq. (1999).

<sup>27</sup> In 1994, U.S. the Supreme Court, in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 128 L.Ed 2d 119 (1994), read the language of § 10 Exchange Act as restricting actions for securities fraud to primary actors who themselves commit fraud, thereby eliminating actions for aiding and abetting. The Private Securities Litigation Reform Act of 1995 (Pub. L. No. 104-67) was promulgated to reduce the number of abusive law suits filed against heavily capitalized persons to seek compensation for losses from bad investments and raised the hurdles for plaintiffs in a securities fraud action. None of these initiatives were reversed by the Sarbanes-Oxley Act of 2002.

<sup>28</sup> Evidence of this would be the SEC's Shareholder Nominations Proposal discussed in this paper.

<sup>29</sup> See Baums/Scott, *supra* note 23.

<sup>30</sup> See Knauer, *supra* note 16, at 81, and Tuerks, *supra* note 15, at 35 et seq.

This paper will study one point of possible convergence: the ability of shareholders to nominate candidates for election to their corporation's board. Part II will briefly discuss the position of the shareholder under U.S. law and the Shareholder Nominations Proposal, which would give larger shareholders or shareholder groups somewhat more voice in the corporation. Part III will then take a look at the arguments that have been raised for and against more shareholder participation in U.S. corporations in the context of the Shareholder Nominations Proposal. Part IV will outline the powers that shareholders have within German corporations to call meetings, shape the agenda, nominate candidates and vote for them.

## **II. THE NOMINATION AND ELECTION OF DIRECTORS IN U.S. COMPANIES**

### **A. Position of Shareholders under Delaware Law and U.S. Federal Law**

Corporate Law in the United States is state law, and most listed companies are incorporated under the General Corporation Law of the State of Delaware.<sup>31</sup> However, companies become subject to a significant regime of federal securities law if they are required to register with the SEC.<sup>32</sup> As a result, corporations in the United States are governed by a mixture of state and federal law. Generally speaking, state law governs what might be called the "substantive" rights of a shareholder in connection with the assets and governance of the corporation, while federal law requires corporations to make certain disclosures and follow specified procedures designed to protect investors and the market as a whole.<sup>33</sup>

One type of required disclosure specifies the information that any person must give to a shareholder when soliciting a proxy to vote the shares of a company that are registered under § 12 of the Securities Exchange Act of 1934 (the "Exchange Act").<sup>34</sup> This disclosure,

---

<sup>31</sup> According to the Department of State, Division of Corporations, of the State of Delaware, as consulted in February 2004, "more than half a million business entities have their legal home in Delaware including more than 50% of all U.S. publicly-traded companies and 58% of the Fortune 500." This information is available at <http://www.state.de.us/corp/default.shtml/>.

<sup>32</sup> See *supra* note 1, and §§ 12(a) and (g), and 15(d) Exchange Act.

<sup>33</sup> This line between state and federal law was crossed in § 301 of the Sarbanes-Oxley Act of 2002, which requires all listed companies to have an audit committee consisting entirely of independent directors, thereby mandating a specific type of governance organ to be established in each such listed corporation. This section was incorporated into the Exchange Act as § 10A(m).

<sup>34</sup> The information that must be provided is set forth in Schedule 14A to the SEC proxy rules. See 17 CFR § 240.14a-101.

referred to as a "proxy statement,"<sup>35</sup> is sent out by management to shareholders in advance of each annual meeting, and the company pays for preparing, printing and distributing the statement and related materials. Among other things, the proxy materials will contain a list of candidates that the management proposes for election or re-election to the board of directors.<sup>36</sup> Current Rule 14a-8 issued under the Exchange Act allows shareholders who meet specified holding requirements to include a proposal and brief supporting statement in the company's proxy materials.<sup>37</sup> Because Rule 14a-8 was designed to broadly skirt potential conflict with substantive issues of state corporate law, it contains a number of such grounds why management may exclude a proposal from the proxy materials. Proposals may be excluded, for example, if they are improper under state law, relate to the election of directors, deal with the company's ordinary business operations, conflict with a proposal made by the company, or repeat proposals that received insufficient support in the past.<sup>38</sup> A technique recommended by the SEC to avoid encroaching on the board's powers is to formulate proposals as "recommendations" that do not bind the company's board of directors to take the action proposed.<sup>39</sup> The failure of the SEC's proxy disclosure guarantees to successfully connect with substantive powers of shareholders under state law weakens the potential governance uses of Rule 14a-8. One avenue, however, where the formal channel of a Rule 14a-8 proposal does intersect with a state law right is the power of shareholders to amend the company's by-laws.<sup>40</sup> The SEC reports that it did not allow management to exclude a Rule 14a-8 proposal to amend the by-laws of General Motors Corp. to require "a transition to independent directors for each seat on the audit, compensation and nominating

---

<sup>35</sup> See Schedule 14A, Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934. 17 CFR § 240.14a.101. If no proxies are solicited, the company must send out an "information statement" as provided for in 17 CFR § 240.14c-2.

<sup>36</sup> See Item 7 of Schedule 14A. 17 CFR § 240.14a.101.

<sup>37</sup> In order to qualify to submit a proposal, a shareholder must "have continuously held at least \$2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year by the date" it submits the proposal, and continue to hold such securities through the date of the meeting. 17 CFR 240.14a-8(b)(1).

<sup>38</sup> 17 CFR 240.14a-8(i).

<sup>39</sup> In a note to the provision allowing exclusion for impropriety under state law, the SEC explains: "Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise." 17 CFR 240.14a-8(i)(1).

<sup>40</sup> This power is expressly given to shareholders in both § 109(a) Del. Gen. Corp. Law and § 10.20(a) Revised Model Business Corporation Act. The Delaware provision is used in two additional states and the Model Act provision is used in 23 additional states. Jonathan R. Macey, MACEY ON CORPORATIONS, 2002, § 3.06[B].

committees as openings occur."<sup>41</sup> In this way, shareholders were able to take measures against insider entrenchment in the key committees of GM's board of directors. Shareholder use of by-law amendments to exercise voice in corporate governance are limited by the legal nature of the by-laws themselves, which may not be inconsistent with law or the certificate of incorporation.<sup>42</sup> Delaware courts regard by-laws generally "as the proper place for self-imposed rules and regulations deemed expedient for [the corporation's] convenient functioning" as opposed to the certificate of incorporation, which "is an instrument in which the broad and general aspects of the corporate entity's existence and nature are defined."<sup>43</sup>

As mentioned above, Rule 14a-8 expressly prohibits proposals relating to an "election for membership on the company's board of directors or analogous governing body."<sup>44</sup> If shareholders desire to nominate a candidate for election to the board in advance of the shareholders' meeting, they must either seek "informal" contact with the board and rely on its voluntary cooperation or launch a "proxy contest" in which they pay both for the printing and distribution of their own proxy materials and bear a portion of the impact of their opponents' spending on efforts against them (which will be funded by the corporation whose shares they hold).<sup>45</sup> Such contests are rarely conducted to replace management outside of the takeover context.<sup>46</sup> The only remaining alternative would be to nominate one or more candidates on the floor of the meeting,<sup>47</sup> but this would have little actual effect because the vast majority of shareholder votes will have been cast by proxy on the basis of the materials distributed before the meeting. The SEC Shareholder Nominations Proposal attempts to

---

<sup>41</sup> SEC Division of Corporation Finance, Staff Legal Bulletin No. 14, "Shareholder Proposals", July 13, 2001, at 7. The Bulletin is available at <http://www.sec.gov/interp/legal.shtml>.

<sup>42</sup> See § 109(b) Del. Gen. Corp. Law and § 2.06(b) Revised Model Business Corporation Act.

<sup>43</sup> E. Welch/A. Turezyn, FOLK ON THE DELAWARE GENERAL CORPORATION LAW 2002, at § 190.1, citing *Gow v. Consolidated Coppermines Corp.* 165 A. 136, 140 (Del. Ch. 1933).

<sup>44</sup> 17 CFR 240.14a-8(i)(8).

<sup>45</sup> See L. Loss/J. Seligman, FUNDAMENTALS OF SECURITIES REGULATION, 5<sup>th</sup> ed. 2004, at 529 *et seq.* and E. Aranow/H. Einhorn, PROXY CONTESTS FOR CORPORATE CONTROL, 2<sup>nd</sup> ed. 1968, at 547 *et seq.*

<sup>46</sup> Prof. Lucien Bebchuck has explained that he studied proxy contests conducted by all listed companies between 1996 and 2002, and found that for the thousands of companies studied over a period of seven years, only 80 companies experienced proxy contests to replace management outside of the takeover context. See L. Bebchuck, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45-46 (2003).

<sup>47</sup> Delaware law does not prevent a shareholder from nominating a candidate to the board during the annual meeting even if such candidate was not listed in the proxy materials, provided that the nominee agrees to his or her candidacy and the nominee meets any eligibility requirements that might be set forth in the company by-laws. R.F. Balotti/J. Finkelstein, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, 1996 Supp., at § 7.58. Also see Aranow/Einhorn, *supra* note 45, at 363 *et seq.*

level this playing field somewhat by requiring disclosure of the shareholder nomination in the distributed materials.<sup>48</sup> The comments the SEC has received on this proposal appear to be divided between investors (such as investment funds, pension funds, and private persons) in favor and management against.<sup>49</sup>

As mentioned above, state corporate law governs the "substantive" matters on which shareholders may vote. U.S. corporate law tends to leave parties significant freedom for the contracting parties *ex ante*, while providing injured persons with relatively effective remedies in court *ex post*.<sup>50</sup> To be more specific, the Delaware General Corporation Law ("Del. Gen. Corp. Law") provides the relevant parties with almost unlimited freedom to structure a corporation as they see fit, and – unless the parties have used this freedom to introduce special limitations in the certificate of incorporation – gives management substantially unlimited power over the corporation. Pursuant to § 141(a) Del. Gen. Corp. Law, a corporation is managed "by or under the direction of the board of directors," which means that the board has exclusive authority to initiate almost all corporate actions. For example, although the shareholders have a right to vote on major structural changes, such as mergers or consolidations (§ 251(c) Del. Gen. Corp. Law) or sales, leases or exchanges of all or substantially all of the corporation's property and assets (§ 271(a) Del. Gen. Corp. Law), the board has sole authority to put any such decision to shareholder vote and, in the case of a sale, lease or exchange of assets, the board need not consummate the transaction even after the shareholders have voted to approve it (§ 271(b) Del. Gen. Corp. Law). The board of directors also has exclusive authority to decide whether the company will pay dividends (§ 170 Del. Gen. Corp. Law). Much of the board's authority may be redistributed in the certificate of incorporation, and such amendment takes place by shareholder vote (§ 242(b) Del. Gen. Corp. Law), but the board has sole authority to initiate the procedure amending the certificate (§ 242(b)(1) Del. Gen. Corp. Law). This leaves the shareholders with two avenues – aside from consents<sup>51</sup> – through which they may exercise direct influence on their

---

<sup>48</sup> The proposal seeks to provide shareholders with "meaningful participation in the proxy process in connection with the nomination and election of directors." Shareholder Nominations Proposal, *supra* note 1, at 60786.

<sup>49</sup> Most comments are available at <http://www.sec.gov/rules/proposed/s71903.shtml>.

<sup>50</sup> See D. Donald, *Some Observations on the Use of Structural and Remedial Measures in American and German Law After Sarbanes-Oxley*, which can be found in 4 German Law Journal No. 2, available at <http://www.germanlawjournal.com/article.php?id=231>.

<sup>51</sup> Under § 228 Del. Gen. Corp. Law, "Unless otherwise provided in the certificate of incorporation, any action required . . . to be taken at any annual or special meeting of stockholders . . . may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing, setting

own initiative: they may authorize the dissolution of the corporation without board approval (§ 275(c) Del. Gen. Corp. Law)<sup>52</sup> and they may influence the board through the company by-laws (§ 109 Del. Gen. Corp. Law). The fact that shareholders have been driven to use such by-law amendments as a tool to achieve a meaningful influence in the corporation seems to evidence a malfunction in the corporate mechanism.

Since a corporation organized under Delaware law rests squarely in the control of its board of directors, the shareholders' main avenue of influence would be to choose who sits on that board. Indeed, directors appointed for full terms receive their seats on the board by shareholder vote (§ 211(b) Del. Gen. Corp. Law), which should mean that shareholders have significant influence on the composition of the board. However, this is not the case. The board controls the list of candidates that is put up for election and Delaware law provides no means of voting against such candidates. Although Delaware law does not prohibit shareholders from nominating candidates to the board, federal law prohibits it (to avoid possible conflict with state law). The result, as the Vice Chancellor of the Delaware Court of Chancery, Leo Strine, has noted in a law review article, is that the "proxy mechanism is tilted heavily in favour of the management slate, and contested elections rarely occur outside the takeover context,"<sup>53</sup> which of course raises questions about "a corporate election process that is so heavily biased towards incumbents and their self-chosen successors."<sup>54</sup> This does not reflect a fault in Delaware law, but evidences how the position of the shareholder is adversely affected by the manner in which state and federal law work together on this point.

---

forth the action so taken, shall be signed by the holders of outstanding stock having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting. . . ." Combined with the fact that § 220 Del. Gen. Corp. Law allows a stockholder to obtain a list of a corporation's stockholders for the purpose of communicating with them (*see The Conservative Caucus Research Analysis & Education Foundation, Inc. v. Chevron Corp.*, 525 A.2d 569 (Del. Ch. 1987), and the increasing efficiency of communications technology, the use of consents would seem to offer a powerful tool for shareholders. However, the way information is channelled in the current indirect system for holding securities destroys the value of stockholder lists by reducing them to one or two nominees or street names. *See* Loss/Seligman, *supra* note 45, at 593 *et seq.* and Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities, Section of the Business Law of the American Bar Association, "Report on Proposed Changes in Proxy Rules and Regulations Regarding Procedures for the Election of Corporate Directors," 59 *Bus. Law* 109, 117-17 (2003).

<sup>52</sup> Perhaps this recognizes the shareholders' position as the residual claimants for the corporation's assets after payment of all debts. *See* F. Easterbrook/D. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW*, 1991, p. 10 *et seq.*, but it also shows the "love it or leave it" prejudice expressed by the Wall Street Rule and the de-emphasizing of shareholder voice in U.S. corporations. *See Id.* at 17.

<sup>53</sup> Strine, *supra* note 6, at 1377.

<sup>54</sup> Strine, *supra* note 6, at 1397.

The inability of shareholders to nominate candidates for seats on the board of directors in an effective manner is rendered even more problematic by the fact that, once a candidate is nominated by the management, the shareholders in most cases have no realistic opportunity to avoid his or her election. Unless a certificate of incorporation provides otherwise, directors are elected by a "plurality of the votes of the shares present in person or represented by proxy and entitled to vote on the election of directors" (§ 216 Del. Gen. Corp. Law).<sup>55</sup> Election by a "plurality" has little meaning in the absence of alternative candidates. As Prof. Joseph Grundfest recently noted, under a plurality rule, if "a million shares count as a quorum, and if 999,999 ballots strike your name out and say no, you, as the director, owning only one share, and you vote for yourself, congratulations, you win. You have the plurality."<sup>56</sup> As a result, shareholders have no opportunity to contest the election of a management candidate unless they pay for the distribution of proxy materials for an alternative list of candidates.

The SEC Shareholder Nominations rule was proposed against this background.

### **B. The SEC Shareholder Nominations Proposal**

The SEC notes in its proposing release that it considered offering more support to shareholder' nomination of candidates in 1942 and in 1977, but decided not to make a formal proposal.<sup>57</sup> The SEC decided against a proposal in 1977 because the use of nominating committees – which were hoped to be a possible cure for the self-perpetuation of insiders on corporate boards – was just emerging, so the SEC staff advised to monitor developments and not adopt an additional rule at that time.<sup>58</sup> In its October 14, 2003 proposing release, the SEC noted that "the presence of nominating committees has not eliminated the concerns among some security holders with regard to the barriers to meaningful participation in the proxy process in connection with the nomination and election of directors."<sup>59</sup> As a result,

---

<sup>55</sup> The same rule is set forth in § 7.28(a) of the Revised Model Business Corporation Act and § 614(a) of the New York Business Corporation Law.

<sup>56</sup> Remarks of Prof. Joseph Grundfest in "Symposium on Corporate Elections", A. Bebchuck, ed. (November 2003), at 95, available from The Social Science Research Network Electronic Paper Collection: <http://ssrn.com/abstract=471640>.

<sup>57</sup> Shareholder Nominations Proposal *supra* note 1, at 60785.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* at 60786.

the SEC has proposed reinforcing its updated transparency rules for nominating committees<sup>60</sup> with a process for limited shareholder access to the corporate ballot.

The core of the proposal is simple. If the state law governing the affairs of the relevant corporation would allow shareholders to propose a candidate for the board *at the shareholders' meeting*, a new Rule 14a-11 would allow such candidates to be included in the company's proxy materials that are distributed *before the shareholders' meeting*.<sup>61</sup> Proposed Rule 14a-11 would thus merely facilitate disclosure of a question to be raised at the shareholder's meeting. As such, Rule 14a-11 would fall clearly within the SEC's scope of authority under § 14 of the Exchange Act, as interpreted by the Court of Appeals for the District of Columbia in its 1990 decision, *The Business Roundtable v. Securities and Exchange Commission*, which explains the "purpose of the proxy protections as ensuring that stockholders have 'adequate knowledge' about the 'the major questions of policy, which are decided at stockholders' meetings.'"<sup>62</sup> However, by actually giving shareholders an opportunity seriously to consider a shareholder-proposed candidate, the SEC disclosure procedure would in fact lend substance to a largely symbolic state law right and could have "sweeping consequences to governance of publicly held companies in the United States."<sup>63</sup> Such potential "sweeping consequences" have led to substantial resistance to the proposal from corporate management,<sup>64</sup> and have led the SEC to qualify application of the proposed rule by introducing a complex series of triggering events and eligibility requirements that must be met before a shareholder include its intended nominee in the proxy materials.

---

<sup>60</sup> See Final Rule: Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, SEC Release Nos. 33-8340; 34-48825, 68 *Federal Register* 69204 (December 11, 2003) ("Nominating Committee Disclosure Release").

<sup>61</sup> See Shareholder Nominations Proposal *supra* note 1, at 60788 and proposed Exchange Act Rule 14a-11, printed in *Id.* 60819 *et seq.*

<sup>62</sup> *The Business Roundtable v. Securities and Exchange Commission*, 905 F.2d 406, 410 (DC Cir. 1990), citing the Senate Report prepared at the time the Exchange Act was adopted, Senate Report No. 792, 73d Cong., 2d Sess. 12 (1934).

<sup>63</sup> Comments of Debevoise & Plimpton, December 17, 2003, available at <http://www.sec.gov/rules/proposed/s71903.shtml/>.

<sup>64</sup> See, for example, the comments of Michael C. Wyatt, Chair, Corporate & Securities Law Committee, Association of Corporate Counsel, January 12, 2004 (having shareholder nominees on the board would create a "confrontational" atmosphere), comments of Henry A. McKinnell, Ph.D., Chairman of the Board and CEO, Pfizer Inc.; Chairman, The Business Roundtable, December 22, 2003 (the rule would place special interests in the board), and comments of 8 officers of Caterpillar Inc. beginning December 12, 2003 and after (the rule could undercut the role of the board and its nominating committee), available at <http://www.sec.gov/rules/proposed/s71903.shtml/>.

The proposed rule would only apply to companies subject to registration with the SEC because they are listed on a national securities exchange (§ 12(a) Exchange Act), have over 500 shareholders and total assets exceeding \$ US 10 million (§ 12(g) Exchange Act), or have made a public offering of securities during the same fiscal year (§ 15(d) Exchange Act). Pursuant to Exchange Act Rule 3a12-3(b), "foreign private issuers" are exempted from § 14(a) of the Exchange Act and thus from the rules issued under it.<sup>65</sup> The German companies listed on the New York Stock Exchange are almost certainly "foreign private issuers"<sup>66</sup> and therefore exempted. The SEC is also considering narrowing the circle of application to include only the larger, more seasoned (domestic) listed companies falling under the category of "accelerated filers."<sup>67</sup>

There are two proposed triggering events, which are designed to ensure that the rule would be used only when it is needed.<sup>68</sup> One is an opt-in, requiring shareholders to choose application of the rule by a qualifying shareholder<sup>69</sup> submitting a proposal pursuant to Rule 14a-8, and such proposal receiving more than 50% of the votes cast on it at the shareholders' meeting.<sup>70</sup> This straightforward choice presents no potential conflict with state law. The other trigger, however, does. Pursuant to this trigger, Rule 14a-11 would become applicable if:

At least one of the registrant's nominees for the board of directors for whom the registrant solicited proxies received "withhold" votes from more than 35% of

---

<sup>65</sup> 17 CFR § 240.3a12-3(b) ("Securities registered by a foreign private issuer, as defined in Rule 3b-4 shall be exempt from sections 14(a), 14(b), 14(c), 14(f) and 16 of the Act.").

<sup>66</sup> Pursuant to Exchange Act Rule 3b-4, a "foreign private issuer" is any "corporation or other organization incorporated or organized under the laws of any foreign country" unless "(1) More than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and (2) Any of the following: (i) The majority of the executive officers or directors are United States citizens or residents; (ii) More than 50 percent of the assets of the issuer are located in the United States; or (iii) The business of the issuer is administered principally in the United States." 17 CFR § 240.3b-4.

<sup>67</sup> An issuer becomes an "accelerated filer" after it meets the following conditions as of the end of its fiscal year: (i) the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is \$75 million or more; (ii) the issuer has been subject to the requirements of Section 13(a) or 15(d) of the Act (15 U.S.C. 78m or 78o(d)) for a period of at least twelve calendar months; (iii) the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Act; and (iv) the issuer is not eligible to use Forms 10-KSB and 10-QSB (§ 249.310b and § 249.308b) for its annual and quarterly reports. Forms 10-KSB and 10-QSB may be used by "small business" issuers.

<sup>68</sup> § 240.14-11(a), printed in Shareholder Nominations Proposal *supra* note 1, at 60819.

<sup>69</sup> Such a shareholder would have to hold "more than 1% of the securities entitled to vote on that proposal for at least one year as of the date the proposal was submitted and provide evidence of such holding" to the company. § 240.14-11(a)(2)(ii), printed in Shareholder Nominations Proposal *supra* note 1, at 60819.

<sup>70</sup> § 240.14-11(a)(2)(ii), printed in Shareholder Nominations Proposal *supra* note 1, at 60819.

the votes cast at an annual meeting of security holders (or, in lieu of an annual meeting, a special meeting) held after January 1, 2004, at which directors were elected (provided, that this event will be deemed not to occur with regard to any contested election to which § 240.14a-12(c) applies or an election to which this section applies).<sup>71</sup>

This triggering event would ascribe a secondary meaning to votes in favor of or withheld from the election of a particular director. As Prof. John Coffee has remarked, this secondary meaning would "skew" (distort) the vote on the principal issue of the resolution.<sup>72</sup> A shareholder might decide to cast or withhold a vote for the sole purpose of triggering or preventing the trigger of Rule 14a-11, which would make election results confusing. In this way, a secondary, federal meaning would be tacked on to a vote exercised under state law for an essentially unrelated issue. The process encumbers shareholder votes with a secondary value that is unexpressed (i.e., the vote would still be expressly cast or withheld for the election of a director, not for application of the rule), contingent (i.e., the unexpressed meaning of the vote would not arise unless the withholds exceed 35% of the votes cast), and ancillary (i.e., reaching the 35% threshold would have no impact on whether the director in question is in fact elected). Such a redefinition of the value of the voting rights attaching to a corporation's shares not only causes "votes [to be] affected by ulterior considerations,"<sup>73</sup> but also may exceed the SEC's present statutory authority under § 14 of the Exchange Act. As such, the express opt-in trigger is superior unless we are to understand shareholders as a constituency that is unable to grasp the meaning of Rule 14a-11 and take deliberate action themselves to ensure its application.<sup>74</sup>

The eligibility requirements set forth in section (b) of the proposed Rule are designed to prevent the ballot access rule from becoming a tool of corporate raiders and "gadfly" shareholders,<sup>75</sup> and the requirements restricting relationships between nominees and

---

<sup>71</sup> § 240.14-11(a)(2)(i), printed in Shareholder Nominations Proposal *supra* note 1, at 60819.

<sup>72</sup> See Remarks of Prof. John Coffee in Symposium on Corporate Elections, *supra* note 56, at 98 *et seq.*

<sup>73</sup> See *Id.* at 99.

<sup>74</sup> By supplementing an express opt-in with a trigger that hinges on the circumstances Rule 14a-11 is designed to prevent, i.e., powerless shareholders who futilely withhold votes during an election, it appears that the SEC is also adopting the patronising stance resembling what has been referred to as management's erroneous attribution to investors of "a child-like simplicity." *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The very assumption that the proposed rule is designed to dispel is that shareholders are unable to understand issues, make decisions and take action. It would therefore seem advisable – especially given the potential skewing of elections and conflicts with state law – that the SEC trust shareholders to propose and vote on an opt-in proposal rather than advocating a blind trigger.

<sup>75</sup> "Gadfly" is a term used to refer to "activist shareholders" who make proposals that are not invited by management. For a discussion of such activities, see R. Monks/N. Minow, CORPORATE GOVERNANCE

shareholders is designed to prevent the development of "special interest" directors.<sup>76</sup> To discourage "gadflies", a nominating shareholder or shareholder group must have held "more than 5% of the registrant's securities that are eligible to vote for the election of directors"<sup>77</sup> "continuously for at least two years and intend to continue to hold those securities through the date of the subject election of directors."<sup>78</sup> As the SEC explains, these requirements attempt to "balance security holders' interest in being able to access company proxy materials for the purpose of nominating directors against companies' concerns about the potential disruption that some contend may result from frequent use of the process by security holders who do not represent a significant ownership stake in the subject company."<sup>79</sup> An American Bar Association task force has expressed concern that eligibility requirements giving nomination rights to large shareholders could conflict with the general rule under Delaware law, deriving from § 212(a) Del. Gen. Corp. Law, that holder of the same class of shares be treated equally.<sup>80</sup> In this regard, it may be useful to remember that the ABA's Revised Model Business Corporation Act also includes a general, equal treatment provision (§ 6.01(a) RMBCA), but allows shareholders or groups of shareholders holding 10% of the votes entitled to be cast at a given type of meeting to demand the convening of such meeting (§ 7.02(a)(2) RMBCA).

Because proposed Rule 14a-11 intends to give large, longer-term shareholders more potential to influence the board, it also tends to run up against the SEC's "creeping tender offer" rules,<sup>81</sup> which are designed precisely to prevent such shareholders from increasing their power over the company without declaring a tender offer, thereby avoiding the procedural safeguards and required disclosure that such an offer entails. Therefore, the proposed rule also requires that the nominating shareholder or group be "passive" in the

---

162 (3<sup>rd</sup> ed, 2004). The argument recognized by the SEC is that "the composition of the board of directors is critical to a corporation's functions and, accordingly, security holders should have to evidence a significant financial interest." Shareholder Nominations Proposal *supra* note 1, at 60794.

<sup>76</sup> See Shareholder Nominations Proposal *supra* note 1, at 60795.

<sup>77</sup> § 240.14-11(b)(1), printed in Shareholder Nominations Proposal *supra* note 1, at 60820.

<sup>78</sup> § 240.14-11(b)(2), printed in Shareholder Nominations Proposal *supra* note 1, at 60820.

<sup>79</sup> Shareholder Nominations Proposal *supra* note 1, at 60794.

<sup>80</sup> See ABA Task Force on Shareholder Proposals, *supra* note 51, at 133 *et seq.* Also see the comments of The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association dated December 22, 2003, available at <http://www.sec.gov/rules/proposed/s71903/>.

<sup>81</sup> See 17 CFR § 240.13d-1 *et seq.*, discussed in, *inter alia*, Loss and Seligman, *supra* note 45, at 619 *et seq.*

sense that they have no intention to change or influence the control of the issuer.<sup>82</sup> This is done by requiring the nominating shareholder to fall within an existing category that distinguishes financial institutions holding shares as portfolio investments from investors seeking control.<sup>83</sup> To avoid too close a contact between nominating shareholders and board members they nominate, which could also result in "special interest" directors who could disrupt the board by promoting the interests of their nominating shareholder above the good of the company, proposed Rule 14a-11 also requires nominees to be independent of the nominating shareholder.<sup>84</sup> The nominating shareholder or nominating group must disclose compliance with eligibility and independence requirements during the nomination process,<sup>85</sup> and must hold the company harmless from any false or misleading information published in such disclosure.<sup>86</sup>

The proposed rule would restrict the number of permitted shareholder nominees, which would be set in relation to the size of the company's board.<sup>87</sup> Only one nominee would be permitted in a board of up to eight members, two nominees in a board of between nine and 19 members, and three nominees in a board of 20 or more members.<sup>88</sup> To avoid the potential costs and disruptive effect of a number of shareholders simultaneously nominating candidates, the rule allows only one nominating shareholder, which would be that shareholder or group with "the largest two-year beneficial ownership at the time" the notice of nomination is delivered.<sup>89</sup> This, again, would raise the same question of distinctions

---

<sup>82</sup> See § 240.14-11(b)(3), (4), printed in Shareholder Nominations Proposal *supra* note 1, at 60820.

<sup>83</sup> The distinction is set forth in 17 CFR § 240.13.d-1, which differentiates between persons that may use Schedule 13D, which is designed for active investors (17 CFR § 240.13d-101) and those eligible for Schedule 13G, which is designed for passive or institutional investors (17 CFR § 240.13d-102).

<sup>84</sup> See § 240.14-11(c)(2)-(4), printed in Shareholder Nominations Proposal *supra* note 1, at 60820-21. The independence requirement resembles existing, similar requirements for all independent board members, but is focused on guarding against ties specifically between the nominee and the nominating shareholder or group of shareholders. It prohibits the nominee from being first, the nominating shareholder or a member of the nominating group (§ 240.14-11(c)(3)(i)), second, an employee of the nominating shareholder or any group member (§ 240.14-11(c)(3)(ii)), third, a recipient of fees from the nominating shareholder or group member (§ 240.14-11(c)(3)(iii)), fourth, an executive officer or director of the nominating shareholder or any group member (§ 240.14-11(c)(3)(iv)(A)), fifth, neither controlling nor controlled by the nominating shareholder or any group member (§ 240.14-11(c)(3)(iv)(B)), and sixth, in compliance with the applicable independence requirements for directors under the relevant stock exchange rules (§ 240.14-11(c)(4)).

<sup>85</sup> See § 240.14-11(c), printed in Shareholder Nominations Proposal *supra* note 1, at 60820 *et seq.*

<sup>86</sup> See § 240.14-11(e), printed in Shareholder Nominations Proposal *supra* note 1, at 60822.

<sup>87</sup> See § 240.14-11(d)(1), printed in Shareholder Nominations Proposal *supra* note 1, at 60822.

<sup>88</sup> *Id.*

<sup>89</sup> See § 240.14-11(d)(3), printed in Shareholder Nominations Proposal *supra* note 1, at 60822.

among, and thus unequal treatment of shareholders, but would probably not be found impermissible. To ease the cost and difficulty of assembling support to propose a nominee, the rule would exempt the shareholders' solicitation of support for the nomination from most of the extensive proxy solicitation rules, provided that (i) no more than 30 persons are solicited or the solicitation states no more than the intent to form a nominating group, the holding percentage of each member, and how the soliciting party can be contracted, and (ii) a copy of the solicitation materials are filed with the SEC on or before the date they are sent out.<sup>90</sup> Such communication between shareholders could perhaps be facilitated through an electronic message board, as discussed in Part IV.B.2, *infra*, and will in any case be significantly impeded by the indirect holding system, in which exact information on the identity of the shareholders is known only to the clearing agency and its participants, but is almost never revealed to either the company or the shareholders themselves.<sup>91</sup>

### III. THE ARGUMENTS FOR AND AGAINST SHAREHOLDER NOMINATIONS

#### A. Addressing Agency Problems through Procedurally Ensured Accountability to Shareholders

The most prominent advocate of the SEC's Shareholder Nominations Proposal is probably Prof. Lucian Arye Bebchuck. In his recent article, *The Case for Shareholder Access to the Ballot*,<sup>92</sup> he argues for the adoption of a measure at least as strong as the SEC proposal, and in his working paper, "The Case for Empowering Shareholders,"<sup>93</sup> Prof. Bebchuck sets forth the policy and corporate law arguments that would support a stronger shareholder voice in certain kinds of corporate decisions.

Both papers approach the relationship between shareholders and directors as one characterized by agency problems,<sup>94</sup> i.e., potentially damaging differences between the

---

<sup>90</sup> See § 240.14-11(f), printed in Shareholder Nominations Proposal *supra* note 1, at 60822-23.

<sup>91</sup> As the ABA Task Force on Shareholder Proposals notes, "[I]f it is to become a goal of federal securities regulation to ensure that in some or all circumstances beneficial owners of shares have a direct franchise without intermediation by their fiduciaries, the issue [of "street name" holdings] should be addressed in general, not only in the context of shareholder participation in the director election process." Task Force on Shareholder Proposals, *supra* note 51, at 117.

<sup>92</sup> L. Bebchuck, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003). Prof. Bebchuck has been concerned with the predicament of shareholders for some time. See L. Bebchuck/M. Kahn, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073 (1990).

<sup>93</sup> L. Bebchuck, "The Case for Empowering Shareholders," March 2003, available from the Social Sciences Research Network at <http://ssrn.com/>.

<sup>94</sup> See Bebchuck, *Shareholder Access*, *supra* note 92, at 57 ("Accountability [of directors to shareholders] is important because the interests of an agent and principal do not always fully overlap"), and Bebchuck, *Empowering Shareholders*, *supra* note 93, at 15 ("[T]he case against shareholder

decisions directors make and "those decisions that would maximize the welfare of the" shareholders.<sup>95</sup> The difficulty in addressing such problems is that shareholders have almost no power to influence the behavior of management. Bebchuck points out that shareholder impotence is not caused only by their dispersed state and the resulting "collective action problems"<sup>96</sup> experienced by the isolated individuals, but by corporate laws that leave shareholders without effective rights.<sup>97</sup> The board has sole power over the management of the company<sup>98</sup> and the distribution of dividends,<sup>99</sup> as well as the sole power to initiate any action regarding an amendment of the certificate of incorporation or a change in the state of incorporation,<sup>100</sup> merger, sale of assets, consolidation or dissolution of the company.<sup>101</sup>

This leaves shareholders with one "weapon of last resort," the power to replace directors.<sup>102</sup> Yet such right "is largely a myth. Attempts to replace directors are extremely rare, even in firms that systematically under perform over a long period of time. By and large, directors nominated by the company run unopposed and their election is thus guaranteed. The key for a director's re-election is remaining on the firm's slate."<sup>103</sup> Access

---

intervention should not be based on ignoring agency problems. Rather, it should be made by showing that such problems are best addressed by a regime without shareholder intervention."). Addressing agency problems does not mean that the law of agency is applied literally to the relationship between shareholders and management. As Bebchuck notes in *Empowering Shareholders* at 16, footnote 31, "[T]he relationship between shareholders and directors is not well described as being between principals and agents" (quoting Robert Charles Clark, *CORPORATE LAW* 22 (1986)), given that shareholders have no power to direct the activities of management. Although directors are not the agents of shareholders in the legal sense of the word, they are "however, agents in the economic sense, because they are under both a moral and a legal obligation to manage the corporation in the interest of the shareholders." Melvin Aron Eisenberg, *Contractual Freedom in Corporate Law: Articles & Comments; The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, at 1471, footnote 46 (1989).

<sup>95</sup> M. Jensen/W. Meckling, *Theory of the Firm: Management Behavior, Agency Costs, and Ownership Structure*, printed in M. Jensen, *A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS* 86 (2000).

<sup>96</sup> See Clark, *supra* note 94, at 390 *et seq.*

<sup>97</sup> Bebchuck, *Empowering Shareholders*, *supra* note 93, at 7. It would appear that any legal inadequacies in the statutory power of shareholders cannot be excused with assertions that shareholders are by nature "lethargic" or "rationally apathetic". Empirical difficulties should serve as a basis for designing legal solutions, not as an excuse for neglecting their pursuit.

<sup>98</sup> Bebchuck, *Empowering Shareholders*, *supra* note 93, at 9.

<sup>99</sup> Bebchuck, *Empowering Shareholders*, *supra* note 93, at 12.

<sup>100</sup> Bebchuck, *Empowering Shareholders*, *supra* note 93, at 10 *et seq.*

<sup>101</sup> Bebchuck, *Empowering Shareholders*, *supra* note 93, at 11 *et seq.*, regarding dissolution *see* footnote 15.

<sup>102</sup> Bebchuck, *Empowering Shareholders*, *supra* note 93, at 16.

<sup>103</sup> Bebchuck, *Shareholder Access*, *supra* note 92, at 45 *et seq.*, citing a study performed on proxy contests held by listed companies between 1996 and 2002, which showed that on an average only two contests were run each year for companies with market capitalization exceeding \$ 200 million.

to the firm's slate of director candidates is, moreover, controlled by the board, and the presence of independent directors on a board nominating committee fails to provide comfort exactly in those cases when it is most needed: when shareholders mistrust the board and wish to appoint new members.<sup>104</sup> Because proxy contests are financed by a single shareholder or group of shareholders, yet benefit all shareholders, they present a "public good" problem, in that the active shareholder is forced to become the benefactor of all other shareholders.<sup>105</sup> Providing access to the company's proxy machinery would reduce these costs for the active shareholder.<sup>106</sup>

Bebchuck then addresses a number of arguments raised against shareholder nomination. The fear of "special interest" directors is unfounded because, "[u]nlike cumulative voting, shareholder access would not enable any candidate to be elected without majority support among shareholders."<sup>107</sup> The prediction that contested elections would occur often, disrupting the corporation and wasting its assets, is unfounded given the passive character of most institutional investors – which would make the possibility of nomination more of a threat and deterrent than an often used tool.<sup>108</sup> Bebhuck counters the fear that the possibility of removal would deter good directors from serving with the prediction that, "[p]roviding directors with complete job security as a means of attracting directors would be counterproductive."<sup>109</sup>

Bebchuck offers no real counterargument against the criticism that, because the directors comprising the nominating committee are subject to a fiduciary duty to the company<sup>110</sup> and are well informed of the board's current needs in terms of skills and

---

<sup>104</sup> Bebhuck, *Shareholder Access*, *supra* note 92, at 49. The domination of the nomination process by incumbent management is well known and documented. See Clark, *supra* note 94, at 109 ("It is a notorious fact that in the over-whelming majority of elections for directorships in public corporations the public shareholders simply vote for whomever is proposed by the corporation's nominating committee. At least in the past . . . . Nominees tended to be agreeable, chummy persons, usually of the same social class as the incumbents. . . . This characterization frequently had to be qualified, however, when the corporation had a large shareholder whose director-representatives were really looking out for that shareholder's interest."); Task Force on Shareholder Proposals, *supra* note 51, at 118; Monks/Minow, *supra* note 75, at 212 *et seq.*, and Strine, *supra* note 6, at 1377.

<sup>105</sup> Bebhuck, *Shareholder Access*, *supra* note 92, at 45; also see Pozen, *supra* note 4, at 99.

<sup>106</sup> Bebhuck, *Shareholder Access*, *supra* note 92, at 47.

<sup>107</sup> Bebhuck, *Shareholder Access*, *supra* note 92, at 55.

<sup>108</sup> Bebhuck, *Shareholder Access*, *supra* note 92, at 52 *et seq.*

<sup>109</sup> Bebhuck, *Shareholder Access*, *supra* note 92, at 54.

<sup>110</sup> M. Lipton/S. Rosenblum, *Election Contest in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 93 (2003).

backgrounds for a board slot,<sup>111</sup> such committee would be able to make superior choices for nomination. Instead, he counters the "stupid shareholder" aspect of the argument by pointing out that institutional investors possess the sophistication necessary to choose nominees.<sup>112</sup> He addresses the common argument that shareholder-nominated directors on the board would produce a "balkanized, politicized and dysfunctional board" with the reminder that a shareholder-nominated director would be elected by a majority of the shareholders and thus committed to enhancing shareholder value; as a result, "[o]ther directors should not be expected to have legitimate reasons either to be on guard against such shareholder-nominated directors or to treat them with suspicion."<sup>113</sup> With regard to another variation of the fiduciary duty argument, i.e., that directors are subject to such a duty, but shareholders are not,<sup>114</sup> making their nominees a potential threat to creditors or employees, Bebchuck points out that "[b]y making directors accountable to no one and protecting them from removal even in the event of dismal performance, such limits would be costly to *both* shareholders and stakeholders."<sup>115</sup> In the final part of his argument, Bebchuck points out empirical evidence showing the shares of companies with boards insulated from removal have lower market value.<sup>116</sup> He also somewhat discounts the effectiveness of the currently favored governance tool – independent directors, by stating that no solid evidence demonstrates "a systematic correlation between having a majority of independent directors and corporate value and performance."<sup>117</sup>

### **B. Protecting the Company through Management's Fiduciary Duties**

Two members of the prominent U.S. law firm, Wachtell, Lipton, Rosen & Katz – Messrs. Martin Lipton and Steven Rosenblum – offer arguments against the shareholder nomination of director candidates in their article, *Election Contest in the Company's Proxy: An Idea Whose Time Has Not Come*.<sup>118</sup> The paper approaches the relationship between

---

<sup>111</sup> Task Force on Shareholder Proposals, *supra* note 51, at 122.

<sup>112</sup> Bebchuck, *Shareholder Access*, *supra* note 92, at 56 et seq.

<sup>113</sup> Bebchuck, *Shareholder Access*, *supra* note 92, at 58.

<sup>114</sup> Lipton/Rosenblum, *supra* note 110, at 79.

<sup>115</sup> Bebchuck, *Shareholder Access*, *supra* note 92, at 59 (emphasis in original). Here it might have been useful to point out that shareholders *are* under certain circumstances subject to fiduciary duties. See note 122, and accompanying text.

<sup>116</sup> Bebchuck, *Shareholder Access*, *supra* note 92, at 61 et seq.

<sup>117</sup> Bebchuck, *Shareholder Access*, *supra* note 92, at 63.

<sup>118</sup> Lipton/Rosenblum, *supra* note 110.

shareholders and directors from a "managerialist viewpoint",<sup>119</sup> i.e., shareholders should not interfere with the activities of management because the "directors and officers of the corporation are the only constituency that has legal obligations to act in the best interest of the corporation. . . . to balance all the competing interests of the corporation and try to ensure the long-term health and success of the enterprise as a whole."<sup>120</sup> The predictability lent by a body of directors' fiduciary duties that have been carefully parsed in decades of litigation is a strong argument for this viewpoint.<sup>121</sup> On the other hand, it is also true that controlling shareholders do owe fiduciary duties to the corporation and to minority shareholders,<sup>122</sup> and that numerous types of actions may be initiated under both state and federal law against any person soliciting proxies in a contest for corporate control.<sup>123</sup> Outside of proxy contexts, however, we should expect to find no cases that shed light on duties applicable to a *shareholder's* selection of a candidate for the board because such right does not exist in any practical sense of the word.<sup>124</sup> Moreover, aside from violations of clear requirements applicable to candidates, such as independence requirements set forth in the rules of a stock exchange, or the selection of a grossly unqualified candidate, it is difficult to image the *board's* choice of a candidate being condemned by a court under principles of fiduciary duty.<sup>125</sup>

---

<sup>119</sup> As Prof. Melvin Eisenberg points out, "the managerialists . . . would achieve ends of social policy by increasing management power, on the theory that while shareholders are interested only in profits, and client-groups only in their own welfare, management is in a position to balance the claims of all groups dependent on the corporation, including not only client-groups and shareholders, but the general public; in a position, that is, to run the corporation in the public interest." M. Eisenberg, *THE STRUCTURE OF THE CORPORATION* 25 (1976).

<sup>120</sup> Lipton/Rosenblum, *supra* note 110, at 79.

<sup>121</sup> "The most general formulation of corporate law's attempted solution to the problem of managerial accountability is *the fiduciary duty of loyalty*: the corporation's directors, officers, and, in some respects and situations, its controlling shareholders owe a duty of undivided loyalty to their corporation . . . . *The overwhelming majority of particular rules, doctrines, and cases in corporate law are simply an explication of this duty or of the procedural rules and institutional arrangements involved in implementing it.*" Clark, *supra* note 94, at 34 (italics in original).

<sup>122</sup> See *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110 (1994), *Sinclair Oil Corporation v. Levien*, 280 A.2d 717 (1971), and *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464 (1969)

<sup>123</sup> See Aranow/Einhorn, *supra* note 45, at 496 *et seq.*

<sup>124</sup> See Part II.A.

<sup>125</sup> A different matter would be the board's interference with the shareholders' rights to propose and elect candidates, as the Delaware Court of Chancery has observed, "[t]he corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates. In the interests of corporate democracy, those in charge of the election machinery of a corporation must be held to the highest standards in providing for and conducting corporate elections." *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1206-07 (Del. Ch. 1987).

Aside from stressing the effectiveness of directors' fiduciary duties in safeguarding other constituencies, Messrs. Lipton and Rosenblum also attempt to refute the theoretical underpinnings of what they call the "managerial discipline model of corporate governance."<sup>126</sup> They see this model as supported by the twin assertions that shareholders are the "owners" of the company and that the relationship between shareholders and directors is characterized by agency problems.<sup>127</sup> Their approach to the rather complex property interests certificated in a share of stock regrettably lacks depth. The argument achieves its end primarily by equating non-ownership of the *company's assets*, a black-letter principle of corporate law,<sup>128</sup> with non-ownership of the *company itself*:

A share of stock does not confer ownership of the *underlying assets owned by the corporation*. . . . Shareholders have no more claim to intrinsic ownership and control of the *corporation's assets* than do other stakeholders. . . . The rights we choose to confer on shareholders . . . cannot be justified on the basis of their intrinsic right as the "owners" to control the corporation (emphasis added).<sup>129</sup>

When Messrs. Lipton and Rosenblum do on occasion refer to ownership of the company itself, they give us the somewhat simplified example that is often found in legal literature because the status of shareholders as owners is not disputed:<sup>130</sup> "the ownership of a share of stock in a public company is simply not analogous to the ownership of a car or a building . . . . A share of stock is a financial instrument, more akin to a bond than to a car or

---

<sup>126</sup> Lipton/Rosenblum, *supra* note 110, at 79. Also see Martin Lipton and Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

<sup>127</sup> "Having demonstrated that the ownership analogy and the principal-agent analogy are flawed and insufficient bases for granting control power to shareholders as a matter of intrinsic right, . . ." Lipton/Rosenblum, *supra* note 110, at 76.

<sup>128</sup> "Corporate property is owned by the corporation as a distinct legal person; its shareholders have only an indirect interest in the assets and business." James D. Cox and Thomas Lee Hazen, CORPORATIONS § 7.2 (2002); "When a corporation acquires property the title vests in it as a legal person distinct from its shareholders." Henry Winthrop Ballantine, BALLANTINE ON CORPORATIONS § 119 (1946).

<sup>129</sup> Lipton/Rosenblum, *supra* note 110, at 72 *et seq.*

<sup>130</sup> It also should be noted that shareholders' ownership is usually discussed at a political economic level, where one rarely finds attempts to specify exactly what kind of property rights a share of stock conveys. This runs throughout prominent literature from Berle and Means, *supra* note 5, at 247 ("Conceived originally as a quasi-partner, manager and entrepreneur, with definite rights in and to property used in the enterprise and to the profits of that enterprise as they accrued, he has now reached an entirely different status. . . . He becomes simply a supplier of capital on terms less definite than those customarily given or demanded by bondholders; and the thinking about his position must be qualified by the realization that he is, in a highly modified sense, not dissimilar in kind from the bondholder or lender of money."), and occasionally becomes rather specific, such as in Monks and Minow, *supra* note 75, at 99 ("Stockholders, for example, are deemed to 'own' the company in which they invest. But a share of stock does not translate into a specific segment of the company's assets, at least not until the company dissolves and there is something left over after the creditors get what they are owed."). See also Mark J. Roe, STRONG MANAGERS WEAK OWNERS (1994).

a building."<sup>131</sup> This leads the authors to the economic argument that has been well known since Berle and Means, i.e., the owner does not have direct control over the corporation the way he or she would over an automobile or building: "The owner of the building . . . is an individual . . . in a position to have full knowledge . . . generally views the property or business as a complete entity . . . . In contrast, the shareholder of the large public corporation is one of a far-flung, diverse, and ever-changing group."<sup>132</sup> The authors then jump back to the fiduciary duties argument without really saying anything more about ownership: shareholders have an "interest is in a financial return . . . the legal system allows them to act purely in their self-interest. They are not fiduciaries and they do not owe duties to the corporation."<sup>133</sup> Their conclusion is that increasing shareholder voice would "change the nature of the ownership of shares of a public corporation in fundamental and unhealthy ways."<sup>134</sup>

The fact that shareholders do not own a corporation's assets has little to say about whether shareholders own the corporation itself. As the Delaware Court of Chancery has explained, "[a] certificate of stock is evidence of ownership, in the nature of a chose in action."<sup>135</sup> A "chose in action" is "a proprietary right *in personam*."<sup>136</sup> As the Restatement (First) of Property explains, "[t]he word 'property' is used in this Restatement to denote legal relations between persons with respect to a thing. The thing may be an object having physical existence or it may be any kind of an intangible such as a patent right or a chose in action."<sup>137</sup> A shareholder has non-possessory interests in the corporation, which, drawing analogically from to rights in real property,<sup>138</sup> consist of at least "profits"<sup>139</sup> and a pro rata

---

<sup>131</sup> Lipton/Rosenblum, *supra* note 110, at 72.

<sup>132</sup> Lipton/Rosenblum, *supra* note 110, at 73.

<sup>133</sup> Lipton/Rosenblum, *supra* note 110, at 73.

<sup>134</sup> Lipton/Rosenblum, *supra* note 110, at 74.

<sup>135</sup> *Equitable Trust Co. v. Gallagher*, 67 A.2d 50, 54 (Del.Ch. 1949) *See also* *Hook v. Hoffman*, 16 Ariz. 540, 546 (Arizona S.Ct. 1915); *Barksdale & als. v. Finney & als.*, 55 Va. 338 (Virginia S.Ct. 1858).

<sup>136</sup> B. Garner, ed., BLACK'S LAW DICTIONARY 234, (7<sup>th</sup> ed. 1999).

<sup>137</sup> Restatement (First) of Property, Division I. Introduction, Chapter 1. Definition of Certain General Terms, Introductory Note (Current through June 2003). This would also apply to a stock option, as the California Court of Appeals has recently explained: "An employee stock option grant is thus "not an expectancy but a chose in action, a form of property . . . ' susceptible of division in spite of being contingent or not having vested.'" *In re Marriage of Margaret and Grant Palin*, 2002 Cal. App. Unpub. LEXIS 4318, January 31, 2002.

<sup>138</sup> One of the reasons why the "more exotic interests" in personal – as opposed to real – property are rarely discussed is because "virtually anyone who wants to create complicated future interests in personal property . . . does so through a trust." T. Merrill/H. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 Yale L.J. 3, 18 (2000).

"remainder" in the corporate assets.<sup>140</sup> Referring to Farwell J.'s classic definition of a share of stock in *Borland's Trustee v. Steel*,<sup>141</sup> Prof. Paul Davies observes:

The company itself is treated not merely as a person, the subject of rights and duties, but also as a *res*, the object of rights and duties. It is the fact that the shareholder has rights in the company as well as against it, which, in legal theory, distinguishes the member from the debenture-holder whose rights are also defined by contract . . . but are rights against the company and, if the debenture is secured, in its property, but never in the company itself.<sup>142</sup>

This does not mean that the share of stock conveys "an individual right in specific property," for it does not.<sup>143</sup> However, the property right *certificated by* a share of stock is no less a property right because it does not vest in specific assets, just as the property right *in* a share of stock does not disappear merely because the shareholder has only a pro rata property interest in all shares of the same type that are held in fungible bulk by his or her broker.<sup>144</sup> When a corporation is dissolved, shareholders have a right to assets remaining after claims are settled pursuant to law (§ 281 Del. Gen. Corp. Law), and these rights "run with the assets,"<sup>145</sup> allowing an action for recovery of the property if such assets are unjustly transferred to another class of shareholders.<sup>146</sup> The generally accepted truism that shareholders "own" corporations is not a myth.

---

<sup>139</sup> Ballantine, *supra* note 128, at 375; H. Henn/J. Alexander, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 396 (1983); Clark, *supra* note 94, at 13.

<sup>140</sup> Ballantine, *supra* note 128, at 375; Henn/Alexander, *supra* note 139, at 396; Clark, *supra* note 94, at 13.

<sup>141</sup> [1901] 1 Ch. 279 at 288.

<sup>142</sup> P. Davies, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 616-17 (7<sup>th</sup> ed. 2003).

<sup>143</sup> Ballantine, *supra* note 128, at 289.

<sup>144</sup> See § 8-503(b) Uniform Commercial Code: "An entitlement holder's property interest with respect to a particular financial asset . . . is a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset."

<sup>145</sup> "For our purposes, the attribute that distinguishes a property right from a contract right is that a property right is enforceable, not just against the original grantor of the right, but also against other persons to whom possession of the asset, or other rights in the asset, are subsequently transferred. In the parlance of property law, the burden of a property right "runs with the asset.'" H. Hansmann/R. Kraakman, "Property, Contract and Verification: The Numerus Clauses Problem and the Divisibility of Rights," Harvard Law School Public Law Research Paper No. 037, at 5. This paper can be downloaded without charge from the Social Science Research Network Electronic Paper Collection at: [http://ssrn.com/abstract\\_id=323301](http://ssrn.com/abstract_id=323301).

<sup>146</sup> *Mohawk Carpet Mills, Inc. v. Delaware Rayon Co.*, 110 A.2d 305 (Del. Ch. 1954). Another interesting case involving the property rights attaching to shares is the right of a shareholder to separate dividend rights from a share when it is sold in close proximity to the annual meeting at which dividends will be declared, thereby causing the profit rights accruing to a share of stock purchased *ex dividend* spring back only after such immediately succeeding declaration, and certainly giving the original shareholder an actionable right against any subsequent purchaser who happens to erroneously receive the dividends from such meeting.

Messrs. Lipton and Rosenblum next set out to refute the approach of corporate governance that seeks to address "agency problems": "Just as the analogy of the shareholder as property owner is flawed, so too is the principal-agent analogy."<sup>147</sup> As discussed above, the strict application of agency principals to corporate governance, given that shareholders have no right to issue instructions to managers, has already been refuted by Dean Robert Clark and this point has been well taken by Bebchuck.<sup>148</sup> The argument offered by Messrs. Lipton and Rosenblum, however, is not legal or normative – it is economic and practical:

In the principal-agent model, the principal is typically a sole owner, with direct knowledge of and interest in a property, who selects and monitors an agent to manage the property. . . . the shareholder in the public corporation is part of a wide and ever-changing body . . . . managers will have been involved with the corporation far longer than the vast majority of the shareholders . . . . shareholders buy and sell shared financial interests in an on-going business enterprise.<sup>149</sup>

This analysis does not address the legal position of either shareholders or managers, but looks very much like an optimistic re-evaluation of the state of affairs that Berle and Means found so discouraging.<sup>150</sup> By stressing market liquidity and shareholder exit, the argument also begs the question why more shareholders do not choose to stay with a corporation and change it when it under-performs, rather than following the Wall Street Rule. As Prof. Albert Hirschman has pointed out, the frequency of a member's exit from an organization tends to increase in direct proportion to the cost and ineffectiveness of voice.<sup>151</sup> Messrs. Lipton and Rosenblum do not go into this issue, but rather turn to why shareholder voice is both unnecessary and disruptive, given the fiduciary duties and general psychological make-up of management.

In what might be called a "behavioral" argument, Messrs. Lipton and Rosenblum explain, no doubt based on their vast experience as counsel to many of the world's leading

---

<sup>147</sup> Lipton/Rosenblum, *supra* note 110, at 75.

<sup>148</sup> See *supra* note 94 and accompanying text.

<sup>149</sup> Lipton/Rosenblum, *supra* note 110, at 75.

<sup>150</sup> "Outwardly the change is simple enough. Men are less likely to own the physical instruments of production. They are more likely to own pieces of paper, loosely known as stocks, bonds, and other securities, which have become mobile through the machinery of the public markets. Beneath this, however, lies a more fundamental shift. Physical control over the instruments of production has been surrendered in ever growing degree to centralized groups who manage property in bulk, supposedly, but by no means necessarily, for the benefit of the security holders." Berle/Means, *supra* note 5, at 8.

<sup>151</sup> "[T]he decision whether to exit will often be taken *in the light of the prospects for the effective use of voice*" (emphasis in original) A. Hirschman, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 37 (1970).

corporations, the character and required working conditions of directors: "The best candidates for director typically do not need the job. . . . Rather, they serve for the challenge . . . . the best candidates do not need to be constrained or disciplined."<sup>152</sup> Indeed, "[r]eplacing a chief executive officer or other senior executive . . . . can be disruptive to the corporation . . . . In order for a board to perform its adversary role effectively, there must be a level of mutual respect and trust . . . . When the executives view directors as being 'on the same side' . . . the executives are likely to volunteer more and better information."<sup>153</sup> As a result, if shareholder nominated directors were to seek to monitor the activities of management rather than helping out with nurturing trust, they would be "viewed as adversaries rather than partners, [and] the relationship between the board and the management can also break down."<sup>154</sup> The productive tranquility and ambiance of trust would also be damaged if directors were forced to compete with shareholder candidates for their seats. Such elections would "reintroduce the kind of adversarial relationships spawned by the hostile takeover era."<sup>155</sup> This is because "[s]eeking to replace one or more directors on a company's board is an intrinsically adversarial act, and companies and boards that find themselves subject to election contests react to it as such."<sup>156</sup> This argument seems both to underestimate "how strongly the dark force of fraud can pull on the heart of man,"<sup>157</sup> and to ignore the fact that even free negotiations to reach cooperative equilibriums take place "in the shadow of the law."<sup>158</sup> That is, if the law were to increase shareholder voice, management would eventually stop posing with suspicious resentment and settle down to work on the basis of the new balance of power.

The authors also raise the arguments that institutional investors are not suited for performing monitoring activity,<sup>159</sup> which is a point one finds often raised by persons who

---

<sup>152</sup> Lipton/Rosenblum, *supra* note 110, at 86. Also, "directors and managers of public corporations . . . measure their success in terms of the success of the corporations they direct and manage. . . . Regardless of the compensation package, no director or manager wants to see the corporation he or she runs fail to succeed and thrive. Managers do not need to be 'disciplined'." *Id.* at 76.

<sup>153</sup> Lipton/Rosenblum, *supra* note 110, at 80.

<sup>154</sup> Lipton/Rosenblum, *supra* note 110, at 82.

<sup>155</sup> Lipton/Rosenblum, *supra* note 110, at 85.

<sup>156</sup> Lipton/Rosenblum, *supra* note 110, at 85.

<sup>157</sup> Clark, *supra* note 94, at 113.

<sup>158</sup> See Remarks of Prof. John Coffee in Symposium on Corporate Elections, *supra* note 56, at 98.

<sup>159</sup> Lipton/Rosenblum, *supra* note 110, at 77.

speak from the perspective of such investors.<sup>160</sup> Like many other commentators, Messrs. Lipton and Rosenblum also argue that the reforms surrounding the Sarbanes Oxley Act of 2002 should be allowed to work their effects before additional measures are introduced.<sup>161</sup> The interesting thing about this argument is that it depicts the Shareholder Nominations Proposal as a measure that is *separate* from other measures adopted in reaction to the scandals that prompted the Sarbanes Oxley Act, although the SEC has issued a relatively steady flow of new protective measures since 2002 and makes express reference to such scandals in its proposing release.<sup>162</sup> This argument has been raised by a number of commentators,<sup>163</sup> but is not supported by any discernable end to the reforms that began in 2002. Indeed, corporate governance problems and scandals still fill the headlines of our daily newspapers in 2004.<sup>164</sup>

---

<sup>160</sup> See Pozen, *supra* note 4, at 96 *et seq.*

<sup>161</sup> Lipton/Rosenblum, *supra* note 110, at 90 *et seq.*

<sup>162</sup> "Reflecting concern over corporate scandals and the accountability of corporate directors, many commenters urged the Commission to adopt rules that would provide security holders with greater access to the nomination process and the ability to exercise their rights and responsibilities as owners of their companies." Shareholder Nominations Proposal *supra* note 1, at 60784.

<sup>163</sup> A few of the commentators who used this argument are: Task Force on Shareholder Proposals, *supra* note 51, at 119; Comments of Congressman Gerald W. Hocker, Delaware State Representative, 38th District, U.S. House of Representatives, December 19, 2003; Comments of Stephen F. Gates, Senior Vice President and General Counsel, ConocoPhillips, December 19, 2003; Comments of Henry A. McKinnell, Ph.D., Chairman of the Board and CEO, Pfizer Inc.; Chairman, The Business Roundtable, December 22, 2003. The above comments are available at <http://www.sec.gov/rules/proposed/s71903.shtml>.

<sup>164</sup> See, e.g., A. Galloni *et al.*, "Big U.S. Firms Face Parmalat Charges," *Wall Street Journal Europe*, p. 1, March 19, 2004; C. Cummins, "Shell's Top Executives Kept Board in Dark on Reserves," *Wall Street Journal Europe* p. 1, March 10, 2004; B. Orwall *et al.*, "Eisner Gives up a Disney Post," *Wall Street Journal Europe*, p. A5, March 5, 2004; M. Walker, "Germany Awaits Mannesmann Trial", *Wall Street Journal Europe*, p. 1, January 19, 2004; S. Ascarelli/J. Lubin, "Adecco Delays '03 Results, Prompting Fear of Scandal," *Wall Street Journal Europe*, p. 1, January 13 2004; A. Galloni *et al.*, "Parmalat Fraud May Top € 7 Billion, Prosecutors Say," *Wall Street Journal Europe*, p. 1, December 24, 2003.

#### IV. THE NOMINATION AND ELECTION OF DIRECTORS IN GERMAN STOCK CORPORATIONS

##### A. The Composition of the Board under German Law

Although Germany, like the United States, has a federal system, all relevant corporate and securities laws are federal.<sup>165</sup> This means that the German corporate governance system does not suffer from the types of potential overlaps, conflicts and gaps between state and federal law discussed above with regard to U.S. Exchange Act Rule 14a-8 and proposed Rule 14a-11.<sup>166</sup> Although German federal corporate and securities law has been substantially shaped by European Community Directives, such Directives are implemented through national legislation and thus corporations usually are not forced to comply with two sets of laws.<sup>167</sup> It is also very important to note that, unlike under the Delaware General Corporation Law, which gives incorporators substantial leeway in configuring a corporation,<sup>168</sup> the German Stock Corporation Act (*Aktiengesetz* or "AktG") is composed primarily of mandatory provisions, which means that a corporate charter may not change such provisions unless expressly permitted by law.<sup>169</sup>

Under the *Aktiengesetz*, a stock corporation (*Aktiengesellschaft* or "AG") has a two-tier board.<sup>170</sup> This system is not completely dissimilar from the governance structure found in

---

<sup>165</sup> The primary corporate law statutes in Germany are the Stock Corporation Act (*Aktiengesetz*), which provides a relatively inflexible system of rules for larger companies with transferable shares, and the Limited Liability Company Act (*Gesetz betreffend die Gesellschaft mit beschränkter Haftung*), which provides a flexible system of rules for closely held corporations. The primary securities laws are the Securities Trading Act (*Wertpapierhandelsgesetz*), the Exchange Act (*Börsengesetz*), the Securities Prospectus Act (*Verkaufsprospektgesetz*), and the Securities Acquisitions and Takeovers Act (*Wertpapiererwerbs- und Übernahmegesetz*).

<sup>166</sup> See Part II.A.

<sup>167</sup> With the exception of the Limited Liability Company Act, all of the federal laws listed in note [•], *supra*, have been significantly shaped by EC Directives. Exceptions to the rule that EC law takes effect only via implementation through national law are EC "Regulations". Unlike Directives, Regulations have direct effect in EC Member States, and need not be implemented through national legislation. See Article 249 (previously 189), Consolidated Version of the Treaty Establishing the European Community ("A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States."). Two significant Regulations for the corporate law area are Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE) and Council Regulation (EEC) No 2137/85 of 25 July 1985 on the European Economic Interest Grouping (EEIG).

<sup>168</sup> See, for example, § 141(a) Del. Gen. Corp. Law, which allows all of the powers and duties of the board to be "exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation."

<sup>169</sup> "The charter may deviate from the provisions of this Act only if expressly allowed." (§ 23(5) AktG).

<sup>170</sup> See T. Baums, "Company Law Reform in Germany," Johann Wolfgang Goethe-Universität, Institute for Banking Law, Working Paper No. 100 (2002), available at <http://www.jura.uni-frankfurt.de/baums/>, and K. Hopt, *The German Two-Tier Board (Aufsichtsrat): A German View on Corporate Governance*, in K. Hopt/E. Wymeersch, eds., *Comparative Corporate Governance* 3 (1997). It should be noted that

U.S. listed companies, in which auditing, nominating, and compensation committees composed of independent directors perform special tasks with a focus on monitoring.<sup>171</sup> A significant difference, however, lies in the way the board members are appointed. In an AG, shareholders elect the monitoring directors, who are seated on the supervisory board (*Aufsichtsrat*) (§ 101(1) AktG), and the supervisory board in turn appoints the "managing" directors (§ 84(1) AktG), who make up the management board (*Vorstand*), and have direct responsibility for managing the company (§ 76(1) AktG). In an AG with more than 2,000 employees, half of the seats on the supervisory board are filled by employee representatives,<sup>172</sup> but to avoid deadlock in these evenly divided boards, the chairman – who can always be elected by the shareholders – holds a tie-breaking vote.<sup>173</sup> This allows

---

after the EC SE Regulation enters into effect in October of 2004, it will be possible for an SE based in Germany to use a single-tier board. See Art. 38(b), EC SE Regulation, *supra* note 167.

<sup>171</sup> See New York Stock Exchange, LISTED COMPANY MANUAL, § 303.01 (Audit Committee), § 303A.04 (Nominating/Corporate Governance Committee), and § 303A.05 (Compensation Committee), available at [www.nyse.com/](http://www.nyse.com/).

<sup>172</sup> The Works Constitution Act of 1952 (*Betriebsverfassungsgesetz*) requires that a company have a supervisory board and that one-third of the board members be appointed by employees if the corporation employs more than 500 persons. The Co-Determination Act of 1976 (*Mitbestimmungsgesetz*), applies to limited liability companies and AGs with more than 2,000 employees, requiring that one-half of the board be appointed by the employees and their unions. The Co-Determination Act also specifies the size of the supervisory board, which varies from 12, 16 or 20, depending on the number of employees (§ 7(1), Co-Determination Act 1976). See T. Baums/B. Frick, *The Market Value of the Codetermined Firm*, in M. Blair/M. Roe, eds., EMPLOYEES AND CORPORATE GOVERNANCE 206 (1999).

<sup>173</sup> The supervisory board of a corporation to which the Co-Determination Act 1976 applies must have a chairman who is elected by the vote of  $\frac{2}{3}$  of the entire supervisory board. If the required  $\frac{2}{3}$  majority is not attained, the board members representing the shareholders can elect the chairman by a simple majority of votes cast on a second ballot. Section 31 Co-Determination Act 1976 gives the supervisory board chairman a tie-breaking vote. Under § 31(2) Co-Determination Act 1976, the election of the managing directors requires a  $\frac{2}{3}$  majority on the first ballot. If this is not attained, § 27 III Co-Determination Act 1976 requires that a committee composed of the chairman, deputy chairman and two further board members (one representing the shareholders, the other the employees) submit a nomination slate to the entire supervisory board within one month after the first ballot. The entire supervisory board then votes on this slate and, on this second ballot, management board members are appointed by the simple majority of the votes of the members of the supervisory board. If the employee and the shareholder representatives split on their vote, thereby choosing different candidates for managing directors, the result will be a tie. The tie will trigger a third ballot pursuant to § 31(4) Co-Determination Act 1976 in which the chair of the supervisory board will have a tie-breaking vote. Because the chair of the supervisory board will almost certainly be a shareholder appointee, he or she will vote for the shareholders' candidates for the management board, thereby ensuring their election. This slight predominance of shareholder influence on the appointment of the corporation's managing directors has kept the Constitutional Court from striking down the Co-Determination Act 1976 as an unjust taking of private property in violation of the protections set forth in Article 14 of the German Federal Constitution (the court's decision may be found in volume 50 of the Constitutional Court Reporter, BVerfGE 50, at page 290). The foregoing is paraphrased from A. Cahn, "Note on Co-Determination of Employees in Germany," manuscript on file with the Institute for Law and Finance.

shareholder representatives to control the appointments to the supervisory board, for which only a simple majority of the supervisory board is required.<sup>174</sup>

The election of supervisory board members usually takes place at the annual meeting (§ 101(1), 124(2) AktG). The terms of supervisory board members can be as long as five years (measured as four years from the first annual meeting that reviews the member for approval, § 102(1) AktG),<sup>175</sup> but either the charter or the shareholder resolution electing a given member may specify a shorter period.<sup>176</sup> As a result, staggered boards are possible.<sup>177</sup> Each year, shareholders have an opportunity at the annual meeting to approve or disapprove of the actions that both the supervisory and management boards have taken during the past fiscal year (§ 120 AktG). A disapproval of a director's actions during the year amounts to a vote of no confidence against such director, and although it does not automatically remove the director from office or create liability, it does focus significant media attention on the relevant director and often raises a number of issues that later serve as the basis for a lawsuit.<sup>178</sup> Shareholders may also remove the shareholder-appointed supervisory board members with or without cause (§ 103 AktG),<sup>179</sup> although the high, required majority of  $\frac{3}{4}$  of the votes cast results in such board members being removed rarely,<sup>180</sup> perhaps as rarely as under § 141(k) Del. Gen. Corp. Law.

## **B. The Nomination of Directors under German Law**

### *1. Nomination by the Supervisory Board*

As said, the members of the supervisory board are elected by the shareholders; shareholders' meetings, including the annual meeting, are called by the management board (§ 121(2) AktG). The supervisory board is required to draft a slate of candidates and the management board must distribute it with the call to meeting (§ 124 AktG). The

---

<sup>174</sup> W. Hefermehl/G. Spindler, Comment to § 84 AktG, marginal note 15, in MÜNCHENER KOMMENTAR: AKTIENGESETZ (2004).

<sup>175</sup> Either the charter or the shareholder resolution electing a member may specify a shorter period. See J. Semler, Comment to § 102 AktG, marginal note 19 in MÜNCHENER KOMMENTAR: AKTIENGESETZ (2004).

<sup>176</sup> See J. Semler, *supra* note 175, Comment to § 102 AktG, marginal note 19.

<sup>177</sup> See *Id.* at marginal note 17.

<sup>178</sup> See D. Kubis, Comment on § 120, marginal notes 2, 24, 33-36, in MÜNCHENER KOMMENTAR: AKTIENGESETZ (2004).

<sup>179</sup> This requires  $\frac{3}{4}$  of the votes cast pursuant to § 103(1) AktG. The supervisory board may remove management board members for good cause (§ 84 AktG).

<sup>180</sup> See Baums, *Takeovers v. Institutions in Germany*, *supra* note 21, at 155-56.

management board must call a meeting at least one month in advance (§ 123(1) AktG) by publishing the call to meeting and the agenda – which includes the slate of candidates – in business newspapers (§ 124(1) AktG). Since the beginning of 2003, this duty is satisfied by placing the notice in a web-accessible, notice board segment of the German "federal register" (*elektronischer Bundesanzeiger*) (§ 25 AktG).<sup>181</sup> Within 12 days after giving this notice, the management board must dispatch copies of the call to meeting to the banks and shareholder organizations that exercised proxies in the last general meeting (§ 125(1) AktG), as well as to registered shareholders and to shareholders that have deposited bearer shares with the company or requested the materials (§ 125(3) AktG).<sup>182</sup>

If supervisory board members are to be elected at the annual meeting, the notice of the call to meeting and agenda must contain a slate of nominees formulated by the supervisory board and relevant information about such nominees (§ 124(3) AktG).<sup>183</sup> The proposed slate of nominees may be drafted by the entire supervisory board or a committee thereof, but the employee representative members of the supervisory board should not take part in these deliberations.<sup>184</sup> Just as in the United States,<sup>185</sup> candidates may be nominated on the floor of the meeting,<sup>186</sup> but because a great number of votes are cast by proxy, the proposed slate will largely dominate the outcome of the election.<sup>187</sup>

## *2. Nomination by Shareholders*

Under German law, shareholders have a number of avenues for proposing matters to the annual meeting. They can themselves call a meeting (§ 122(1) AktG), add items to the meeting agenda (§ 122(2) AktG), make proposals that supplement or oppose those of the management (§ 126 AktG), or propose nominees for election to the supervisory board (§ 127 AktG). Although it has been remarked that shareholder proposals often involve social issues

---

<sup>181</sup> This notice board is found at <https://www.ebundesanzeiger.de/research/banzservlet>.

<sup>182</sup> The record date after which newly registered shareholders will not receive the call to meeting or the agenda is "two weeks" before the date of the meeting (§ 125(2) no. 3 AktG).

<sup>183</sup> Section 124 contains certain requirements for supervisory boards affected by the Law on Co-Determination for Enterprises Engaged in the Mining, Iron and Steel Industries of May 21, 1951 (*Montan-Mitbestimmungsgesetz*) and the August 7, 1965 law that supplements this Act (*Mitbestimmungsergänzungsgesetz*). Because almost no German companies are still governed by this law, I do not go into the details of its impact in this paper.

<sup>184</sup> Kubis, *supra* note 178, Comment to § 124 AktG, at marginal note 48.

<sup>185</sup> See *supra* note 46 and accompanying text.

<sup>186</sup> J. Semler, *supra* note 175, Comment to § 101, at marginal note 16.

<sup>187</sup> Kubis, *supra* note 178, Comment to § 124 AktG, at marginal note 42.

not directly related to the business of the company,<sup>188</sup> the German corporate law literature does not complain that shareholder nominees exercise special interests or balkanize the supervisory board.

Shareholders representing 5 % of an AG's capital may demand that the management board call a meeting (§ 122(1) AktG), and such demand will be enforced by a court (§ 122(4) AktG). Unlike proposed Rule 14a-11, there is no duration requirement on the 5 % holding; it must merely exist at the time the demand is made,<sup>189</sup> and need not be made personally by the shareholder, but may be exercised by anyone holding a power to represent the shareholder.<sup>190</sup> Either together with a demand for a shareholders' meeting or in the context of an existing call to meeting, shareholders may demand that one or more items be placed on the meeting agenda if they either represent 5 % of the AG's corporate capital or have a holding with a par value of at least € 500,000 (§ 122(2) AktG), which sum would represent significantly less than a 5 % holding in a large, publicly listed company.<sup>191</sup> Shareholders may make proposals with regard to the agenda items they demand.<sup>192</sup> Again, there is no minimum holding period to be eligible for the demand right.<sup>193</sup> All costs for the meeting and the preparation and distribution of the call to meeting, agenda and proposals are paid by the company (§ 122(4) AktG).<sup>194</sup> Prof. Hans-Joachim Mertens noted in 1997 that shareholder use of § 122 to add items to the meeting agenda was on the increase.<sup>195</sup> It may be useful with regard to the challenges that have been made to proposed Rule 14a-11,<sup>196</sup> to note that the question of unequal treatment of shareholders, which is also generally forbidden in German corporate law,<sup>197</sup> is not even raised in connection with the above rights,

---

<sup>188</sup> See H-J. Mertens, *Das Minderheitsrecht nach § 122 Abs. 2 AktG und seine Grenzen*, 42 DIE AKTIENGESELLSCHAFT 481 (1997).

<sup>189</sup> Kubis, *supra* note 178, Comment to § 122 AktG, at marginal note 7.

<sup>190</sup> Kubis, *supra* note 178, Comment to § 122 AktG, at marginal note 5.

<sup>191</sup> Kubis, *supra* note 178, Comment to § 122 AktG, at marginal note 28.

<sup>192</sup> W. Werner, Comment to § 122, at marginal note 70, in *GROßKOMMENTAR AKTG* (1993).

<sup>193</sup> Kubis, *supra* note 178, Comment to § 122 AktG, at marginal note 29.

<sup>194</sup> See Kubis, *supra* note 178, Comment to § 122 AktG, at marginal note 65, Werner, *supra* note 192, Comment to § 122, at marginal note 77 *et seq.*

<sup>195</sup> See Mertens, *supra* note 188, at 481.

<sup>196</sup> See *supra* note 80 and accompanying text.

<sup>197</sup> Section 53a of the *Aktengesetz* provides: "Shareholders shall be treated equally under equal circumstances."

perhaps because such demand rights by minority shareholders are older than the *Aktiengesetz* itself.<sup>198</sup>

In addition to this right of certain, larger shareholders or groups of shareholders to call general meetings and set the meeting agenda, all shareholders, regardless of the size or duration of their holding, have a right to propose candidates for election to the supervisory board (§ 127 AktG). The shareholder may nominate either a full or a short slate of candidates.<sup>199</sup> The management board, however, need not publish or dispatch such proposal with the call to meeting, but only "make it available," which is satisfied by placing the proposed nomination and any supporting statement of up to 5,000 words on the company's website.<sup>200</sup> Shareholder nominations take place through analogical application of a shareholder proposal rule, § 126 AktG,<sup>201</sup> that resembles U.S. Exchange Act Rule 14a-8, and which like the U.S. rule contains a number of grounds on which the management board may refuse to make a proposal available. Section 126 allows all shareholders to make proposals that either *oppose*<sup>202</sup> or supplement management proposals, and allows management to exclude them if:

- they do not oppose, but merely repeat a proposal made by management (§ 126(2), no. 4 AktG);
- the management board could be subject to prosecution for making the proposal know (§ 126(2), no. 1 AktG)
- violate the law or the charter (§ 126(2), no. 2 AktG);
- are materially false or misleading (§ 126(2), no. 3 AktG);
- have been repeatedly rejected in the past (§ 126(2), no. 5 AktG);
- the shareholder plans not to be present or represented at the meeting (§ 126(2), no. 6 AktG); or
- the shareholder has failed to support one of his or her proposals at the last, two meetings (§ 126(2), no. 7 AktG).

---

<sup>198</sup> This right has been part of German corporate law since the latter half of the 19<sup>th</sup> century, when corporate law was still part of the Commercial Code. See W. Werner, *supra* note 192, Comment to § 122 AktG.

<sup>199</sup> Kubis, *supra* note 178, Comment to § 127 AktG, at marginal note 4.

<sup>200</sup> *Id.*, at marginal note 1, and Comment to § 126, marginal note 21. This resembles the use of "increased communications capabilities" that the ABA Task Force on Shareholder Proposals recommends as Alternative II in its Report. See Task Force on Shareholder Proposals, *supra* note 51, at 122 *et seq.*

<sup>201</sup> See generally, U. Noack, *Das neue Recht der Gegenanträge nach § 126 AktG*, 1393 Betriebs-Berater (2003).

<sup>202</sup> This offers an interesting opportunity for comparison to Rule 14a-8, which allows a proposal to be excluded if it *does conflict with* a management proposal. See 17 CFR 240.14a-8(i)(9).

The ground for exclusion that would be likely to apply most often to a shareholder nomination is that expressed in § 126(2), no. 2 AktG, given that the law provides specific requirements for eligibility of a supervisory board member.<sup>203</sup> Existing figures on such shareholder nominations show a relatively low rate of success.<sup>204</sup> However, despite the fact that no shareholder eligibility requirements serve to screen out either opposing proposals or shareholder nominations, no significant disruption or balkanization of German corporate governance has been widely reported as a consequence of such shareholder rights.

In January 2004, the German government introduced a draft bill for "Business Integrity and Modernization of Shareholder Actions" (*Gesetzes zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts* or "UMAG").<sup>205</sup> Article 6 UMAG would allow shareholders freely to canvas each other seeking support for a given action or proposal in the notice board of the German "federal register" discussed above. This option resembles what the SEC has proposed for the Shareholder Nominations Proposal combined with the ABA Task Force on Shareholder Proposals' recommendations regarding expanded use of new information technology.<sup>206</sup> The creation of such an electronic area for SEC registered companies – perhaps in the context of the EDGAR system,<sup>207</sup> using mandatory templates for the information posted, so as to standardize the content and format of notices and responses – could increase shareholder communication and coordination by reducing costs while eliminating some of the risks of free-wheeling internet correspondence.

### *3. Voting through Bank Proxies*

The supervisory board members who represent shareholders are elected with a simple majority of the votes cast unless the charter provides for a higher majority (§ 133(1) AktG). Most votes in large companies are cast by proxy.<sup>208</sup> As explained above, at the beginning of

---

<sup>203</sup> Kubis, *supra* note 178, Comment to § 127, marginal note 8. A member of the supervisory board may not simultaneously sit on the management board (§ 105(1) AktG), and must fulfill other requirements listed in § 101 AktG.

<sup>204</sup> See T. Baums/C. Fraune, *Institutionelle Anleger und Publikumsgesellschaft*, DIE AKTIENGESELLSCHAFT 97 (1995), at 110, Table 18.

<sup>205</sup> *Entwurf eines Gesetzes zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts*, currently available from the German Ministry of Justice on its website at <http://www.bmj.de/> under "Gesetzentwürfe" / "Corporate Governance".

<sup>206</sup> See *supra* note 90 and accompanying text, as well as ABA Task Force on Shareholder Proposals, *supra* note 51, at 122 *et seq.*

<sup>207</sup> For those not familiar with EDGAR, it is the Electronic Data Gathering Analysis and Retrieval System developed by the SEC in the 1990's, and used for the filing of disclosures required by law. See <http://www.sec.gov/edgar/searchedgar/webusers.htm>.

<sup>208</sup> See Barca/Becht, *supra* note 15, at 130, Table 5.1.

the 20<sup>th</sup> century, German banks were accustomed to dipping into the voting power of their customers' shares to supplement their own block holdings.<sup>209</sup> Even after written proxies were required under the *Aktiengesetz of 1937*,<sup>210</sup> banks still exercised *de facto* a significant amount of power over their customer's shares,<sup>211</sup> even though they were under no legal obligation to exercise such votes.<sup>212</sup> Like institutional investors in the United States, banks are generally believed to vote for management proposals, in particular for management nominees.<sup>213</sup> Following a reform initiative to replace bank voting with independent, competing proxy agents,<sup>214</sup> the German legislature in 1997 took steps to reduce the influence that banks could exercise over the shares of beneficial owners held in their custody accounts,<sup>215</sup> and in 2001, the German legislation reinforced the use of registered shares in Germany and sought to facilitate the exercise of votes attached to such shares.<sup>216</sup> As a result, current law requires that banks disclose additional information regarding conflicts of interest in their exercise of voting rights, take steps to check any effects of such conflicts, and inform shareholders of other proxy agents that can legally exercise such rights.<sup>217</sup> A bank must include in its financial statements a list of companies in which it either has a holding exceeding 5 % or to which it has elected a supervisory board member (§ 340a(4) HGB) and must notify its customers holding stock custody accounts if:

- any of its managing directors or employees are members of the supervisory board of the company whose shares are to be voted, or if any employee or managing director

---

<sup>209</sup> See Tuerks, *supra* note 15, at 5 *et seq.*

<sup>210</sup> See Hommelhoff, *supra* note 16, at 92, and H. Schröer, Comment to § 135, marginal note 8, in MÜNCHENER KOMMENTAR: AKTIENGESETZ (2004). The requirement of written form has since been deleted from the law. *Id.* at marginal note 13.

<sup>211</sup> See Baums, *supra* note 21.

<sup>212</sup> For a discussion of why banks exercise the votes of their custody account holders, see Baums, *Takeovers v. Institutions in Germany*, *supra* note 21, at 158 *et seq.* and Baums, *Vollmachtstimmrecht*, *supra* note 21, at 12 *et seq.*

<sup>213</sup> See Baums/Fraune, *supra* note 204, at 109—111.

<sup>214</sup> See T. Baums/P. von Randow, *Shareholder Voting and Corporate Governance: The German Experience and a New Approach*, in M. Aoki/H. Kim, eds., CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES: INSIDER CONTROL AND THE ROLE OF BANKS 435 (1995) and *Id.*, *Der Markt für Stimmrechtsvertreter*, in DIE AKTIENGESELLSCHAFT 145 (1995).

<sup>215</sup> See *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* (Law for Monitoring and Transparency in Business Undertakings), November 6, 1997, German Federal Law Reporter (BGBl), No. 24, 786 *et seq.*

<sup>216</sup> See *Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung* (Law Concerning Registered Shares and to Facilitate the Exercise of Voting Rights), January 18, 2001, German Federal Law Reporter (BGBl), No.1, 125

<sup>217</sup> The following discussion of the reforms brought about in 1997 relies on Knauer, *supra* note 16, at 81 *et seq.*

of such company holds a seat in its own supervisory board (§ 128(2), sentence 6 AktG);

- it has a holding in the company that must be notified under the "creeping tender offer" rules of § 21 Securities Trading Act (§ 128(2) , sentence 7 AktG);<sup>218</sup> and
- it has been a member of an underwriting syndicate for a securities issue of such company during the last, five years (§ 128(2), sentence 7 AktG).

The bank is bound by a fiduciary duty that it exercise the voting rights in the best interests of the shareholder (§ 128(2), sentence 3 AktG), and since 1997, banks have been required to take "organizational steps to ensure that interests arising in other business areas" of the bank do not influence voting, as well as to name the manager responsible for fulfilling such duty (§ 128(2), sentence 3 AktG). Banks must facilitate voting by providing proxy forms in paper or electronically (§ 128(2), sentence 5 AktG). They must also make proposals to shareholders and inform them that, in the absence of a returned proxy card, the bank will vote according to its proposals (§ 128(2), sentence 4 AktG). To open up the field for competition from other agents, management must now, together with the call to meeting, inform the shareholders of their right to appoint a proxy agent – particularly a shareholder interest group – to vote their shares (§ 125(1) AktG). In a reversal of earlier policy, the 2001 reform introduced the possibility for the company itself to name a proxy agent that the shareholders may appoint (§ 134(3) AktG). Banks may now hold an enduring proxy for their customers, but must inform them on an annual basis that they can revoke the proxy at any time (§ 135(2) AktG). By contrast to U.S. law, even if a bank is the registered shareholder for shares it holds for a customer, it must have a proxy in order to exercise the voting rights of such shares (§ 135(7) AktG). In the debate leading up to the adoption of the Registered Share Act, the German Ministry of Justice advocated very strongly that – given that today's technology allows replication and communication of shareholder data – the

---

<sup>218</sup> Section 21 of the Securities Trading Act provides as follows: "(1) Any person who through acquisition, disposal, or in another manner reaches, exceeds or falls below one of the thresholds of 5 per cent, 10 per cent, 25 per cent, 50 per cent or 75 per cent of the voting rights of a listed company (person required to report), shall in conformance with § 22(1) and (3) promptly, and at the latest within seven calendar days, provide written notice of such reaching, exceeding, or falling below the specified thresholds to the company and to the Federal Agency, together with the amount of its proportion of voting rights, its address, and the date of the reaching, exceeding, or falling below. The period for giving notice shall start from the time when the person required to report learns, or in view of the circumstances should have learnt that his or her share of voting rights reached, exceeded or fell below the specified thresholds."

indirect holding system must not be permitted to destroy the value of registered shares by reducing the shareholder register to a couple of nominees and "street names".<sup>219</sup>

## **V. CONCLUSIONS**

The SEC's Shareholder Nominations Proposal lends effectiveness to an existing state law right, and is therefore a welcomed supplement to the existing disclosure framework. The SEC appears to have authority to issue the proposed Rule 14a-11 under § 14 of the Exchange Act. The use of "withhold votes" as a trigger is questionable, however, given that it both distorts the intended, state law value of voting rights by attaching a secondary, federal meaning and assumes that shareholders are unable simply to opt-in to the proposed Rule. The straightforward opt-in would better express the philosophy behind the proposed Rule (i.e., shareholders can make decisions), and does not skew votes cast for other purposes. It is unlikely that the eligibility holding requirement violates the equal treatment of shares, given that a similar requirement is found in § 7.02 of the Revised Model Business Corporation Act.

Proponents of Rule 14a-11 make a convincing argument that the shareholders of U.S. corporations are currently unable to enforce management accountability. Certain arguments against the Rule – that accountability is misplaced because shareholders do not own the corporation and management does not need monitoring – are without merit. The existence of a deep body of case law articulating directors' fiduciary duties strongly supports continued board control of nominations. Nevertheless, shareholders do have fiduciary duties, and if they were given a realistic opportunity to nominate candidates, the courts would eventually articulate doctrine outlining the fiduciary duties applicable to such nominations.

A brief comparison of U.S. and German law illustrates the development of legal rules in one system where the presence of sophisticated investors is now being taken into account and another where such shareholders have long been at home. To the extent that experience is transferable from one legal system to another, German experience casts doubt on the predictions that the proposed Rule will cause disruptions and waste. Germany has a very liberal system of shareholder proposals and nominations, yet this has led neither to an expensive overuse of corporate assets nor to balkanized boards. A controlled, electronic environment for shareholder communications, as recently established in Germany, would

---

<sup>219</sup> See remarks of Ulrich Seibert, *Der Entwurf eines Gesetzes zur Namensaktie*, in R. von Rosen/W. Seibert, *DIE NAMENSAKTIE* 11, 31 (2000).

appear to have value for the effective use of proposed Rule 14a-11, at least as long as shareholder identities are known only to clearing agencies and their participants.