Why Shareholders Must Have More Power

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The Securities and Exchange Commission formally proposed a rule this month that would provide shareholders with some access to the corporate ballot - the proxy card distributed to all voting shareholders. The rule would require some companies in certain circumstances to include the names of candidates nominated by shareholders who satisfy some minimum ownership requirements on the corporate ballot.

Management groups, including the Business Roundtable, object to this proposal, which has been defeated several times in the past. But the proposed change is a worthwhile and moderate step and should be supplemented with additional measures for making boards accountable to shareholders.

Shareholder power to replace directors plays an important role in the theory of the company. "If the shareholders are displeased with the action of their elected representatives," says a seminal corporate law case, "the powers of corporate democracy are at their disposal to turn the board out." Shareholder power to replace directors is supposed to supply a critical safety valve, preventing directors from straying from shareholder interests.

But this safety valve is missing. In a recent study, I found that electoral challenges to incumbent directors are rare. Aside from attempts to have the company taken over or sold, contests over directors occurred in fewer than 80 companies - among the thousands that are publicly traded - during the seven-year period 1996-2002. Furthermore, these businesses were usually small, with fewer than 15 having a market capitalisation exceeding Dollars 200m. Even directors whose company performed poorly over a long period of time were highly unlikely to face an electoral challenge.

How could one oppose an attempt to make the threat of replacement in the event of dismal performance more meaningful? Opponents argue that shareholder access would make distracting contests the norm. But with nomination privileges permitted only to shareholders with a significant stake, such nominations will be concentrated in companies with significant shareholder dissatisfaction. By discouraging directors from paying

insufficient attention to shareholder interests, making challenges possible could produce significant benefits in a large number of cases, without costly challenges being made.

There is also little basis for concerns that shareholder access would produce "special interest" directors. Shareholder-nominated candidates would not be elected without support from a majority of the voted stock, most of which is held by institutional shareholders. If anything, institutional shareholders are reluctant to vote against managements. Should they wish to do so, their hands should not be tied.

The insulation of boards from shareholders, some opponents argue, is necessary for boards to be able to protect the interests of stakeholders such as employees. But even though board insulation reduces directors' accountability to shareholders, it does not make directors accountable to stakeholders. Rather, it makes directors accountable to no one, protecting them in the event of poor performance that hurts both shareholders and stakeholders.

Opponents of shareholder access also claim that it will be made unnecessary by pending reforms that would require nominating committees to be composed of independent directors. To ensure that directors act in shareholders' interest, however, it is not enough that directors be independent of the company's executives. Directors must also be at least partly dependent on the shareholders. And even if most nominating committees will select well, shareholders should have a safety valve.

Besides providing shareholders with access to the corporate ballot as the SEC proposed, additional measures to invigorate corporate elections should be adopted. Under existing corporate law, incumbents' "campaign" costs are fully covered by the company, which provides a great advantage over outside candidates, who must pay their own way. To enable challengers to make their case to the shareholders, companies should be required to reimburse reasonable costs incurred by such nominees, at least when they draw sufficient support in the ultimate vote.

Incumbent directors are now protected from removal not only by impediments to running outside candidates but also by staggered boards, on which only a third of the members come up for election each year. Most public companies now have such an arrangement. As a result, no matter how dissatisfied shareholders are they must prevail in two annual elections to replace a majority of the incumbents. Requiring or encouraging companies to

have all directors stand for election together could contribute significantly to shareholder wealth.

"The shareholder franchise," says a famous corporate law case, "is the ideological underpinning upon which the legitimacy of directorial power rests." The power to remove directors, now largely a myth, is essential for a corporate system in which directors cannot stray from shareholder interests. Investors should press for all the changes necessary to making this power a real one.

The writer is Professor of Law, Economics and Finance at Harvard Law School. His study on shareholder access to the ballot was recently published by the school's Program on Corporate Governance.