Transforming the Myth of Democratic Shareholder Power into a Reality

A new paper by Harvard Professor Lucian Bebchuk debunks the myth of shareholder power to replace directors, and recommends reforms that could jumpstart the stalled SEC proxy access rule.

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This month, on the two-year anniversary of the yet-to-be-enacted US Securities and Exchange (SEC) rule proposal to allow shareholders access to the corporate proxy ballot to nominate board of director candidates, Harvard Professor Lucian Bebchuk has issued a paper on this very issue. Entitled *The Myth of the Shareholder Franchise*, the paper counters the notion that shareholders have the power to replace the board, "a central element in the accepted theory of the modern public corporation with dispersed ownership." Prof. Bebchuk provides empirical evidence debunking this myth, and advances recommendations for how to transform the myth of democratic shareholder power into a reality.

"Lucian Bebchuk, with his now-to-be-expected impeccable standards of exhaustive research and lucid writing, tells us a surprising truth: American shareholders are virtually without rights--except to the extent they can be plaintiffs in litigation," corporate governance maven Bob Monks told SocialFunds.com. "Why is this surprising?--because so much discussion proceeds in ignorance of this ugly reality."

Prof. Bebchuk's research seeks to dispel such ignorance, which underpins not only the myth of shareholder enfranchisement but also Business Roundtable and New York Bar Association opinions that shareholders have effective power to run election contests and do so "regularly." Unlike most democratic elections, corporate board elections bar voters (namely shareholders) from nominating candidates, and require not a plurality nor even a majority but rather a single vote to secure an election. And while company coffers are open to the board to campaign for incumbent candidates, shareholders are barred access to these funds (which they have rightful claim over) and must instead finance rival candidacy campaigns from their own funds.

Examining data from 1996 through 2004, Prof. Bebchuk finds 279 such contests, but notes that less than half (108, or an average of 12 per year) involved "a rival team seeking to run the company differently." Only a third of the challengers actually won such contests.

"The absolute numbers make the picture especially stark," Prof. Bebchuk writes.

"[R]ivals seeking to oust incumbents succeeded in gaining control in only two companies with a market capitalization exceeding $200 million."

"One possible interpretation is that shareholders are uniformly happy with incumbent directors," he continues, injecting some dry humor amidst the numbers. "A[nother] plausible interpretation of the evidence is that, even when shareholder dissatisfaction with board actions and decisions is substantial, challengers face considerable impediments to replacing boards."

Prof. Bebchuk enumerates the impediments, including costs, the asymmetric structural advantages of incumbents compared to challengers, and staggered boards that would require challengers to mount a campaign over two election cycles. He then lists his recommendations, which essentially reframe the current SEC rule proposal with achievable reforms.

"In particular, I argue that, at least every two years, elections should be held with shareholder access to the corporate ballot, shareholder power to replace all directors, reimbursement of expenses to shareholders nominating candidates that receive a sufficiently significant number of votes (for example, one third of the votes cast), and confidential voting," states Prof. Bebchuk. "Legal rules should set these arrangements as a default, with opting out allowed provided it takes place through shareholder-approved bylaws."

To sew his argument up tight, he counters objections to his proposal. For example, in response to the notion that such changes might result in "bad choices," Prof. Bebchuk retorts, "When circumstances convince shareholders to overcome their tendency to defer to management, there is little basis for a paternalistic view of their choices as misguided."

"Release of the paper couldn't be more timely, with a federal appeals court set to hear AFSCME's arguments on December 12th for access to the proxy at American International Group," said James McRitchie, editor of corporate governance watchdog website CorpGov.net.

In the absence of implementation of the SEC rule proposal, the American Federation of State, County, and Municipal Employees (AFSCME) filed suit in February 2005 to require AIG to place a binding shareholder resolution seeking access to the proxy to nominate directors. While the suit proceeds in court, AFSCME is pursuing a related tack by filing resolutions at a half-dozen companies next proxy season. The resolutions, which will be filed by other institutional investors as well, are binding and call for director elections by majority vote.

Ironically, it was the threat of a lawsuit by the US Chamber of Commerce against the SEC if the rule was enacted that contributed to the scuttling of the rule proposal.

"Since 2002, when I petitioned the SEC for access to corporate proxies for the purpose of nominating and electing shareholders, I have been convinced that this reform represents what will be the equivalent to a Magna Carta for shareholders," Mr. McRitchie told SocialFunds.com. "I am thoroughly convinced that if the current SEC fails to adopt its now-dormant proposal, an SEC with new members appointed by a Democratic administration will enact rules like those advocated by Prof. Bebchuk to provide shareholders real power."

"Opponents of change, such as the Business Roundtable and the US Chamber of Commerce, would do well to support the SEC's token proposal or they will face much more strident regulations in the near future," he added.