Institute for Law and Finance

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The Nomination of Directors under U.S. and German Law

Institute for Law and Finance
Johann Wolfgang Goethe-Universität Frankfurt

Working paper series No. 21

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Revised Draft: January 2005

David C. Donald*

Contents

I. INTRODUCTION

The picture of dispersed, isolated and uninterested shareholders so graphically drawn by Adolf Berle and Gardiner Means in 1932[1] 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. As Prof. Melvin Eisenberg pointed out as early as 1969,[2] and as the business and academic communities widely discussed during the 1990s,[3] financial

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1 ADOLF A. BERLE, GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (revised ed., 1968).

2 Melvin A. Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, 46 *et seq.* (1969).

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

institutions are increasingly becoming the primary shareholders in American public companies.[4] This steadily growing concentration of voting power in the hands of sophisticated, professional investors has been somewhat haltingly accompanied by measures to facilitate the exercise of shareholder rights, as well as to ensure that such rights are exercised properly. Throughout the 1980s, the U.S. Securities and Exchange Commission (hereinafter, the "SEC") and the U.S. Congress took some action to facilitate communication with shareholders who held shares indirectly through brokers or banks.[5] In 1992, the SEC amended its proxy rules to, *inter alia*, allow shareholders to discuss their voting intentions among themselves without triggering a duty to file a proxy statement pursuant to § 14 of the Securities Exchange Act of 1934 (hereinafter, the "Exchange Act").[6] In 1994, the U.S. Department of Labor codified the duty of trustees and investment managers under the Employee Retirement Income Security Act of 1974 to exercise the voting rights attaching to pension plan shares pursuant to fiduciary duties.[7] Although regulatory reform slowed during the bull market of the late 1990s, when in 2001, the slowly leaking tech bubble finally burst with the bankruptcy of Enron Corp.,[8] erasing about seven trillion dollars in market

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

5 The relevant measures are found in current Rule 14a-13, 17 CFR § 240.14a-13 (duty of issuer to inquire whether registered broker or bank holds for customer shareholders), Rule 14b-1, § 240.14b–1 (duty of broker or dealer to forward proxy materials to customer shareholders), and Rule 14b-2, § 240.14b–2 (duty of banks to forward materials). *See* the historical description provided in Randall S. Thomas & Catherine T. Dixon, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL § 8.02[B] (1998) and Shaun M. Klein, *Rule 14b-2: Does it Actually Lead to the Prompt Forwarding of Communications to Beneficial Owners of Securities?*, J. Corp. L. 155 (1997).

6 Perhaps the most important of the amendments was the adjustment of the definition of a "solicitation" to exclude certain consultative communications from triggering a duty to file a proxy statement. *See* Regulation 14A, Solicitation of Proxies, 17 CFR § 240.14a-1 *et. seq.* These shareholder communication rules are discussed in Steven A. Rosenblum, *The Shareholder Communications Proxy Rules and Their Practical Effect on Shareholder Activism and Proxy Contests*, in A PRACTICAL GUIDE TO SEC PROXY AND COMPENSATION RULES 11-4 *et. seq.* (Amy L. Goodman & John F. Olson, eds., 2004).

7 DOL Interpretive bulletin relating to written statements of investment policy, including proxy voting policy or guidelines, 29 CFR § 2509.94–2 (2004).

8 *See* John C. 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); Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371 (2002); Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. UNIV. L.Q. 449 (2002).

capitalization,[9] public opinion once again swung towards supporting improvements in corporate governance. Lawmakers,[10] regulators[11] and stock exchanges[12] all took action to shore up the regulatory and governance framework where necessary. In 2003, the SEC further strengthened shareholder monitoring through institutional investors by requiring investment companies to publish their voting policies and their voting records,[13] and requiring investment advisers to adopt written policies and procedures designed to ensure that client securities are voted in the best interest of clients, provide clients with information on such policies and procedures, and upon request inform them of how votes were actually cast.[14] Also in 2003, the SEC published a proposed rule that would allow shareholders, under certain circumstances, to include a limited number of nominees for board positions in the company's proxy materials.[15]

The debate on measures to empower shareholders inevitably seeks to define the appropriate role of shareholders in the governance of public corporations.[16] Such efforts present an interesting opportunity for the model-shopping function of comparative law.[17] The

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9 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/.

10 *See* Pub. L. No. 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.

11 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 security holder nominations proposal discussed herein 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/.

12 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).

13 Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, SEC Release Nr. 33–8188, 34–47304, 68 *Federal Register* 6564 (Feb. 7, 2003).

14 Final Rule: Proxy Voting by Investment Advisers, SEC Release Nr. IA–2106, 68 *Federal Register* 6585 (Feb. 7, 2003).

15 Proposed Rule: Security Holder Director Nominations, SEC Release No. 34–48626, 68 *Federal Register* 60784 (October 14, 2003) ("Security Holder Nominations Proposal").

16 *See* Part III, *infra.*

17 "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."

strengthening of shareholder influence in the annual meeting as a possible consequence of the U.S. economy's shift toward large, institutional shareholders presents a configuration of interests and influences that has traditionally been found in Germany, given that banks acting as block shareholders and proxy agents have been important, if not dominant, players in the German economy.[18] 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.[19] 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[20] by about 100 years,[21] and the creditor-oriented

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Konrad Zweigert & Hein Kötz, AN INTRODUCTION TO COMPARATIVE LAW 15 (Tony Wier, trans., 3rd ed., 1998), at 15.

18 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. Farizio Barca & Marco 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* Robin Tuerks, DEPOTSTIMMRECHTSPRAXIS VERSUS U.S.-PROXY-SYSTEM 5 (2000). In the 1992 annual meetings of the 20 blue chip companies on the DAX index that issued voting bearer shares, banks held more votes than all other blockholders in 19 companies. Barca, *Id.* 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 19th century served to make industrial companies dependent on bank credit, thus stunting the growth of the securities markets. John C. 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." Theodor Baums, *The German Banking System and its Impact on Corporate Finance and Governance*, in THE JAPANESE MAIN BANK SYSTEM 409, 445 (Masahiko Aoki & Hugh Patrick, eds., 1995).

19 Peter Hommelhoff, *Machtbalancen im Aktienrecht*, in DIE AKTIENRECHTSREFORM AM ENDE DER WEIMAR REPUBLIK 71, 91 *et seq.* (Wolfgang Schubert & Peter Hommelhoff, eds., 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* Sabine Knauer, NEUREGELUNGEN DES DEPOTSTIMMRECHTS NACH DEM KONTRAG, PRAKTISCHE BEWÄHRUNG UND WEITERE REFORMBEDÜRFTIGKEIT 37 *et seq.* (2003).

20 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

German accounting principles.[22] 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.[23] Because German banks have exercised their influence primarily as institutional investors and proxy agents rather than lenders,[24] it is likely that they supported the other large, blockholders in seeking shareholder rights.[25] The result has been a body of corporate law that disfavors the type of protections to which ***dispersed*** and ***individual*** shareholders can take recourse, such as derivative or direct actions against management for breach of fiduciary duties,[26] but favors

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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).

21 On the creditor protection aim of the various rules in German law regulating the creation and maintenance of legal capital, *see* ANDREAS CAHN, KAPITALERHALTUNG IM KONZERN 12 *et seq.* (1998). For a general discussion in English of the German legal capital rules, *see* Friedrick Kübler, *The Rules of Capital under Pressure of the Securities Markets*, in CAPITAL MARKETS AND COMPANY LAW 95 (Klaus Hopt & Eddy Wymeersch, 2003).

22 *See* HERBERT WIEDEMANN, GESELLSCHAFTSRECHT Vol. I, 29 (1980) ("*Die offizielle Reformdiskussion wandte sich, wohl nicht unbeeinflusst von den leitenden Kreisen der Industrie und Banken, den Fragen der Kapitalbildung zu*."). 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* Wolfgang Ballwieser, *Comment on § 252 HGB*, in MÜNCHENER KOMMENTAR: ZUM HANDELSGESETZBUCH Vol. 4 (2001) for a thorough discussion and bibliography.

23 A classic discussion of these competing interests is found in BAYLESS MANNING & JAMES J. HANKS, A CONCISE TEXTBOOK ON LEGAL CAPITAL 5 *et seq.* (3rd ed. 1990).

24 "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." Theodor Baums, *Takeovers versus Institutions in Corporate Governance in Germany*, in CONTEMPORARY ISSUES IN CORPORATE GOVERNANCE 151, 158 (D. D. Prentice & P. R. J. Holland, eds., 1993), also *see* Theodor Baums, *Vollmachtstimmrecht der Banken – Ja oder Nein?*, 1 DIE AKTIENGESELLSCHAFT 11 (1996).

25 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. Barca/Becht, *supra* note 18, at 143, Table 5.5.

26 *See* Theodor Baums, *Haftung wegen Falschinformation des Sekundärmarktes*", 167 ZHR 139 (2003); Theodor Baums & Kenneth 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 Peter Ulmer, *Aktienrecht im Wandel, -- Entwicklungslinien und Diskussionsschwerpunkte*, 202 AcP 143, 163 *et seq.* (2002).

shareholder empowerment in the annual meeting,[27] including significant powers to shape the agenda and the slate of nominees that will be considered at the meeting.

This is by no means 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,[28] but rather to note that similar configurations of interested parties tend to seek similar legal rules to address similar tasks. This development exhibits a form of convergence, although speculation on the teleological development of a system is likely to be less helpful than accurate descriptions of the systems under discussion and, perhaps, a "functional" analysis and comparison of relevant system elements.[29] A review of developments affecting the remedies offered in U.S. and German law during recent decades appears to show the United States weakening the striking capabilities of individual shareholders through litigation[30] or takeovers,[31] and strengthening

[27] 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* Günther Henn, DIE RECHTE DES AKTIONÄRS: RECHTE UND PFLICHTEN IN UND AUßERHALB DER HAUPTVERSAMMLUNG 48-49 (1984). Shareholders also appoint the AG's auditors (§318 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).

[28] "[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 of cross-border competition among market centers for listings and trading volume. Competition need not, however, drive corporate governance in a single direction." John C. 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 – *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NORTHWESTERN UNIVERSITY L. R. 641, 663 (1999).

[29] *See* REINER R. KRAAKMAN, *ET AL.*, THE ANATOMY OF CORPORATE LAW 3 *et. seq.* (2004).

[30] 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. Neither of these initiatives was reversed by the Sarbanes-Oxley Act of 2002.

the ability of larger shareholders or groups of shareholders to act within corporate "political" mechanisms,[32] while Germany is moving in a complementary direction by working to strengthen shareholder suits[33] and decrease the control that some block holders exercise over the shares that they hold in custody for others.[34]

This paper will study the ability of shareholders to nominate candidates for election to their corporation's board in the United States and in Germany. Part II will briefly discuss the position of the shareholder under U.S. state and federal law. 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 SEC's Security Holder 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. Part V offers concluding remarks.

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 of course state law, and most listed companies are incorporated under the General Corporation Law of the State of Delaware.[35] However, U.S. companies must also comply with a significant regime of federal securities law. Any public offerings of securities must be registered pursuant to the Securities Act of 1933 (hereinafter, the "Securities Act"), fraudulent practices in connection with securities can be

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31 Prof. Coffee summarizes the decline in takeover activity succinctly: "The rate of takeovers and other acquisitions has declined significantly and continues to decline. During the first quarter of 1991, merger and acquisition activity declined 18% over the corresponding quarter in the preceding year and hit an eleven year low. *See* Mergers at an 11-year Low, N.Y. TIMES, Apr. 18, 1991, at D10. The reasons for this decline are various: The drying up of the junk bond market; restrictive state antitakeover legislation, see infra note 5 and accompanying text; and judicial decisions that have accepted preemptive defensive tactics by target management. See, e.g., *Paramount Communications Inc. v. Time Inc*., 571 A.2d 1140 (Del. 1989). This decline in takeover activity, particularly as a result of restrictive state legislation, has supplied the impetus, in my judgment, for scholars to consider the thesis that politics, more than economics, shaped the modern American corporation." Coffee, *supra* note 3, at 1277, n. 1.

32 For a discussion of shareholder voting and the use of proxy contests as a "political" model opposed to the "transaction" model of the market for corporate control, *see* John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003 (1993).

33 *See* Baums & Scott, *supra* note 26.

34 *See* Knauer, *supra* note 19, at 81,and Tuerks, *supra* note 18, at 35 *et seq.*

35 According to the Department of State, Division of Corporations, of the State of Delaware, as consulted in November 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/.

prosecuted under the Exchange Act, and if an issuer is required to register with the SEC,[36] it must comply with the reporting requirements of § 13 Exchange Act and the proxy rules issued under § 14 of the Exchange Act.[37] As a result, corporations are governed in the United States by both state and federal law.[38] Generally speaking, state corporate 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 may only encroach on this territory where specifically provided by Congress,[39] and has done so to require corporations to make certain disclosures and follow specified procedures designed to protect investors and the market as a whole.[40] The line drawn by this substantive/disclosure distinction has been somewhat blurred by the independent audit committee requirements and the prohibition of loans to directors introduced by the Sarbanes-Oxley Act of 2002,[41] which go to the substantive composition of a company's board of directors and its activities. When disclosure is required under federal rules, it is almost always designed to facilitate an informed exercise of the substantive rights provided under state law.

Thus, state corporate law generally governs the "substantive" matters on which shareholders may vote. The corporate laws of the U.S. states tend to leave significant

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36 Securities must be registered under § 12 of the Exchange Act if either (i) if they are listed on a national securities exchange (§ 12(a) Exchange Act), (ii) if the issuer of the securities 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) the issuer has made an offering of securities under the Securities Act of 1933, but only during the fiscal year in which the issuer makes such offering (§ 15(d) Exchange Act).

37 For an excellent presentation of the reporting requirements under § 13 Exchange Act and the proxy requirements under § 14 Exchange Act, *see* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION, 509-518 and 534-593 (5th ed. 2004).

38 This is of course without referring to the various laws that might regulate a particular type of business activity, with regard to its environmental impact, antitrust considerations or other effects on the society.

39 *Santa Fe Industries v. Green*, 430 U.S. 462, 479 (1977) ("corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.").

40 *See* Donald C. Langevoort, *Seeking Sunlight in* Santa Fe's *Shadow: the SEC's Strategic Pursuit of Managerial Accountability*, 79 WASH. U. L. Q. 449 (2001).

41 Pub. L. No. 107-204, July 30, 2002,116 Stat. 745. Section 301 of the Sarbanes-Oxley Act of 2002 requires the boards of directors of 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). To implement § 301, the SEC issued the rules codified as 17 CFR § 240.10A–3. *See* Final Rule: Standards Relating to Listed Company Audit Committees, SEC Release Nos. 33–8220; 34–47654, 68 *Federal Register* 18788 (April 16, 2003). Section 402 of the Act prohibited loans to executives in most cases. This section was incorporated into the Exchange Act as § 13(k).

freedom for the contracting parties *ex ante*, while providing injured persons with relatively effective remedies in court *ex post.*[42] For example, 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).[43] 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[44] – through which they may exercise direct influence on their own

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42 *See* David C. Donald, *Some Observations on the Use of Structural and Remedial Measures in American and German Law After Sarbanes-Oxley*, 4 GERMAN LAW JOURNAL No. 2 (2003), available at http://www.germanlawjournal.com/article.php?id=231. This dichotomy is elaborated much more extensively, but without the specific focus on U.S. and German remedies, in Kraakman *et al.*, *supra* note 29, at 27 *et. seq.*

43 *See* the valuable perspective illustrated by Lucian Ayre Bebchuk, in "The Case for Empowering Shareholders" (2003), available from the Social Sciences Research Network at http://ssrn.com/.

44 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 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 37, at 593 *et seq.* and Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities, Section of the Business

initiative: they may, without board approval, authorize the dissolution of the corporation (§ 275(c) Del. Gen. Corp. Law) and they may attempt to influence the board through the company by-laws (§ 109 Del. Gen. Corp. Law). A dissolution is clearly an extreme measure that would be appropriate only in exception cases. The power of shareholders to exercise control over their company through a by-laws provision is also limited, given that it would have to be a forward looking, general provision that set up procedural requirements not in conflict with the law or the certificate of incorporation.[45] These are truly blunt instruments with which shareholders can attempt to influence management.

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, the law tells us that directors appointed for full terms receive their seats on the board by shareholder vote (§ 211(b) Del. Gen. Corp. Law) at the annual meeting, which should mean that shareholders have significant influence on the composition of the board. This, however, is not the case. The manner in which candidates are nominated and the type of vote with which they are elected effectively eliminates shareholder influence.

Unless the company's 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).[46] A plurality of the votes means the largest portion of votes cast.[47] Thus, election by a "plurality" has no meaning in the absence of alternative candidates who could receive a larger portion of the votes cast. If no alternative candidate is nominated, any vote would constitute a plurality. As Prof. Joseph Grundfest has graphically 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

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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). This makes the avenue of direct contact with other shareholders via consents impracticable under current conditions.

45 *See* John C. Coffee, *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 614 (1997).

46 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.

47 "Plurality. A large number or quantity that does not constitute a majority; a number greater than another, regardless of the margin . . . ." BLACK'S LAW DICTIONARY 1176 (7th ed, 1999).

plurality."[48] The weakness of plurality voting underscores the need of providing for a fair system of shareholder nominations. As the system currently stands, shareholders have no opportunity to contest the election of a management candidate unless they become a "dissident", and pay for the distribution of proxy materials for an alternative list of candidates.[49]

The fault in the nomination system does not lie in state law. Pursuant to Delaware law, the directors must call the annual meeting within a certain time frame (§ 211, Del. Gen. Corp. Law), and provide adequate notice of the meeting to the shareholders (§ 222(a), Del. Gen. Corp. Law).[50] Under Delaware law, shareholders may nominate candidates for election to the board either on the floor of the meeting itself,[51] or through a nomination notice that is given to the board and distributed by the board to the other shareholders.[52] However, once a Delaware corporation becomes subject to the registration requirements of § 12 Exchange Act, management must notify the shareholders of the annual meeting pursuant to the rules issued under § 14 Exchange Act. Pursuant to Rule 14a-3(a), a proxy statement must be provided to any person from whom votes are solicited, the proxy statement must provide – together with an extensive list of other information – the names of the directors up for re-election, and also provide information regarding any nominating committee the company has

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48 Remarks of Prof. Joseph Grundfest in "Symposium on Corporate Elections", 95 (Lucian Ayre Bebchuk, ed., November 2003), available at: http://ssrn.com/abstract=471640.

49 The argument is sometimes raised that the "withholding" of votes is by itself a "very potent weapon" against management. Remarks of Martin Lipton in Symposium on Corporate Elections, *supra* note 48, at 22. However, the strength of such message depends not on any binding nature of withholding the vote, but only on how management might interpret its effect on their reputations, which in turn depends on the current understanding of shareholder rights. The case of Walt Disney Co. presents a good example. At its 2004 shareholders' meeting, votes withheld from the much criticized Michael Eisner exceeded 42 % of votes cast, yet the only reaction was to replace him as chairman with one of his closest allies, and to announce that he would step down from his CEO position two years later, at the normal expiration of his contract in 2006. *See* Institutional Shareholder Services, 2004 Postseason Report 5, available at http://www.issproxy.com/governance/issreports/index.jsp. It appears that any reaction at all to a withhold campaign must be interpreted as a victory, but it certainly is not a "very potent weapon."

50 Notice to an annual meeting need not specify the meeting's purpose if proxies are not solicited (*Stroud v. Grace*, 606 A.2d 75 (Del Supr., 1992)), but such specification is necessary where the meeting is called for a specific transaction. (§ 222(a), Del. Gen. Corp. Law). Notice must be given at least 10 days before the meeting (§ 222(b), Del. Gen. Corp. Law), but the date of the meeting cannot be used to disenfranchise shareholders. *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. Supr., 1971).

51 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 7.57 (1996 Supp.).

52 This procedure is discussed in *Stroud v. Grace*, 606 A.2d 75, 96 (Del Supr., 1992). *See* also *Millenco L.P. v. meVC Draper Fisher Jurvetson Fund I, Inc*. 824 A.2d 11, 19 (Del.Ch., 2002) ("the 'right of

and whether it considers nominations proposed by shareholders.[53] No provision is made for such shareholder nominations to be included, even if the shareholders have a right to make such nominations under state law. The form of proxy, or proxy card, for which specifications are made in Rule 14a-4, requires that provision must be made for approving or "withholding" a vote from the individual candidates or slate of candidates proposed.[54] Rule 14a-4 does not specify who nominates the candidates listed on the proxy card.

How, then, can shareholders exercise their rights to nominate candidates pursuant to Delaware law when the corporation is subject to the federal proxy regime? Current Rule 14a-8 would seem to be a logical avenue, as it allows shareholders who meet specified holding requirements to include a proposal and brief supporting statement in the company's proxy materials.[55] However, a shareholder proposal may be excluded on a number of grounds, including if "the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization."[56] This provision has been included to retain the balance between state corporate law and federal securities law discussed above, and would not present an obstacle to a Delaware shareholder seeking inclusion of a candidate for the board. However, Rule 14a-8 goes farther, and also allows exclusion of all proposals relating to "election for membership on the company's board of directors or analogous governing body."[57] In this way, the state law right to nominate a candidate for the board is frustrated by a federal law requirement that excludes such a nomination from the primary document through which it could be realistically made. The failure of the SEC's proxy

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shareholders to participate in the voting process includes the right to nominate an opposing slate'") and *Hubbard v. Hollywood Park Realty Enterprises, Inc*., Del. Ch., C.A. No. 11779, at 12-13.

53 Item 7 of Schedule 14A, 17 CFR § 240.14a–101. The disclosure requirements regarding nominating committees were recently added in an attempt to shore up a corporate governance mechanism for which the SEC had high hopes in the 1970s, hopes that were not fulfilled. *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").

54 17 CFR § 240.14a–4(b)(2).

55 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).

56 17 CFR 240.14a-8(i)(1).

57 17 CFR 240.14a-8(i)(8).

disclosure guarantees to successfully connect with substantive powers of shareholders under state law weakens the potential governance uses of Rule 14a-8.[58]

This leaves shareholders who desire to nominate a candidate for election to the board with few options prior to the meeting: they can 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).[59] Such contests are rarely conducted to replace management outside of the takeover context.[60] The only remaining alternative would be to nominate one or more candidates on the floor of the meeting, but this would have little actual effect because the vast majority of shareholders will have cast their votes by proxy on the basis of the materials distributed before the meeting. 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 titled heavily in favour of the management slate, and contested elections rarely occur outside the

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58 One technique that is attempted to sidestep this prohibition is a proposal to amend the company's by-laws. 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]. 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 committees as openings occur." SEC Division of Corporation Finance, Staff Legal Bulletin No. 14, "Shareholder Proposals" 7 (July 13, 2001), available at http://www.sec.gov/interps/legal.shtml. In this way, shareholders were able to take measures against insider entrenchment in the key committees of GM's board of directors. However, shareholder use of by-law amendments to exercise voice in corporate governance are limited both by a somewhat uncertain exclusionary practice of the SEC (*see* Linda C. Quinn and Ottilie L. Jarmel, *The Shareholder Proposal Process*, in Goodman & Olson, *supra* note 6, at 15-15 *et. seq.*) and by the legal nature of the by-laws themselves, which may not be inconsistent with law or the certificate of incorporation. *See* § 109(b) Del. Gen. Corp. Law and § 2.06(b) Revised Model Business Corporation Act. 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." Edward P. Welch & Andrew J. 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). On the use of by-laws for corporate governance purposes under Delaware law, *see* Coffee, *supra* note 45, at 613-615.

59 *See* Loss & Seligman, *supra* note 37, at 529 *et seq.* and *Steinberg v. Adams*, 90 F. Supp. 604 (S.D. NY, 1950).

60 Prof. Lucian Ayre Bebchuk 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* Lucian Ayre Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45-46 (2003).

takeover context,"[61] which of course raises questions about "a corporate election process that is so heavily biased towards incumbents and their self-chosen successors."[62] This frustration of the shareholder franchise is particularly disturbing when one considers that such franchise "is the ideological underpinning upon which the legitimacy of directorial power rests."[63]

The SEC Shareholder Nominations rule was proposed against this background, and attempts to somewhat level the playing field by requiring disclosure of the shareholder nominations – under very limited circumstances – in the materials distributed pursuant to § 14 Exchange Act.[64] The comments the SEC received on this proposal were divided between investors (such as investment funds, pension funds, and private persons) in favor and management against.[65]

B. The SEC Security Holder Nominations Proposal

For decades the 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.[66] The proposing release to the Security Holder Nominations Proposal notes that shareholder nomination of candidates was seriously considered in 1942 and in 1977, but no formal proposal was made.[67] 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.[68] However, as the October 14, 2003 proposing release explained: "the presence of nominating committees has not eliminated the concerns among some securityholders with regard to the barriers to meaningful participation in the proxy process in connection with the nomination and election of directors."[69]

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[61] Strine, *supra* note 8, at 1377.

[62] *Id.*, at 1397.

[63] *Blasius Industries, Inc. v. Atlas Corporation*, 564 A.2d 651, 659 (Del. Ch., 1988).

[64] The proposal seeks to provide shareholders with "meaningful participation in the proxy process in connection with the nomination and election of directors." Security Holder Nominations Proposal, *supra* note 15, at 60786.

[65] Most comments are available at http://www.sec.gov/rules/proposed/s71903.shtml.

[66] Security Holder Nominations Proposal, *supra* note 15, at 60785.

[67] *Id.*

[68] *Id.*

[69] *Id.* at 60786.

The core of the proposal is simple. If the state law governing the affairs of the relevant corporation allows shareholders to propose a candidate for the board, a new Rule 14a-11 would allow such candidates to be included in the company's proxy materials that are distributed pursuant to federal rules.[70] Proposed Rule 14a-11 would thus facilitate disclosure of a matter to be raised at the shareholder's meeting. As such, Rule 14a-11 would fall 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.'"[71] Unless a major corporate action, like a merger, is to be addressed at a shareholders' meeting, the replacement of seated directors is likely to be connected to "major questions of policy" in the future operation of the corporation.[72] Because federal rules have for years frustrated the exercise of this state law right, the change would likely have "sweeping consequences to governance of publicly held companies in the United States,"[73] as shareholders would again have a meaningful opportunity to use an almost forgotten right. Such potential "sweeping consequences" would upset the understanding of shareholders as apathetic, uninvolved and impotent, which Bearle and Means presented in 1932.[74] Corporate management therefore marshaled strong resistance to the proposal,[75] which led the SEC to qualify application of the proposed rule by introducing a

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70 *See* Security Holder Nominations Proposal *supra* note 15, at 60788 and proposed Exchange Act Rule 14a-11, printed in *Id.* 60819 *et seq.*

71 *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).

72 *See Steinberg v. Adams*, 90 F. Supp. 604, 608 (S.D. NY, 1950) finding that the replacement of management is inseparable from policy questions. Also *see Hall v. Trans-Lux Daylight Picture Screen Corp.* 171 A. 226, 229 (Del.Ch. 1934) ("It is impossible in many cases of intracorporate contests over directors, to sever questions of policy from those of persons.")

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

74 *See supra* note 1, an accompanying text.

75 *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/ru les/proposed/s71903.shtml/.

complex series of triggering events and eligibility requirements that must be met before a shareholder can include its intended nominee in the proxy materials.

Pursuant to the October 2003 proposal, there would be two triggering events, which are designed to ensure that the rule would be used only when it is needed.[76] One is an opt-in, requiring shareholders to choose application of the rule by a qualifying shareholder[77] 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.[78] This straightforward choice presents no potential conflict with state law. The other, which is a "blind" 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 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).[79]

This triggering event would ascribe a secondary meaning to votes that shareholders *intend* to cast in favor of or withhold from the election of a particular director, ascribing a symbolic value to a totally different action, and treating shareholders as a group that cannot think and act for itself. This blind trigger would also interfere with the exercise of a state law right. As Prof. John Coffee has remarked, this secondary meaning would "skew" (distort) the vote on the principal issue of the resolution.[80] 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

[76] § 240.14-11(a), printed in Security Holder Nominations Proposal *supra* note 15, at 60819.

[77] 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 Security Holder Nominations Proposal *supra* note 15, at 60819.

[78] § 240.14-11(a)(2)(ii), printed in Security Holder Nominations Proposal *supra* note 15, at 60819.

[79] § 240.14-11(a)(2)(i), printed in Security Holder Nominations Proposal *supra* note 15, at 60819.

[80] *See* Remarks of Prof. John Coffee in Symposium on Corporate Elections, *supra* note 56, at 98 *et seq.*

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,"[81] 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 condescendingly as a constituency that is unable to grasp the meaning of Rule 14a-11 and take deliberate action themselves to ensure its application.[82]

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,[83] and the requirements restricting relationships between nominees and shareholders is designed to prevent the development of "special interest" directors.[84] 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"[85] "continuously for at least two years and intend to continue to hold those securities through the date of the subject election of directors."[86] 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."[87] An American

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81 *See Id.* at 99.

82 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.

83 "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* Robert A.G. Monks & Nell Minow, CORPORATE GOVERNANCE 162 (3rd 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." Security Holder Nominations Proposal *supra* note 15, at 60794.

84 *See* Security Holder Nominations Proposal *supra* note 15, at 60795.

85 § 240.14-11(b)(1), printed in Security Holder Nominations Proposal *supra* note 15, at 60820.

86 § 240.14-11(b)(2), printed in Security Holder Nominations Proposal *supra* note 15, at 60820.

87 Security Holder Nominations Proposal *supra* note 15, at 60794.

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.[88] 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,[89] 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 sense that they have no intention to change or influence the control of the issuer.[90] 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.[91] This, of course, creates the peculiar situation in which a shareholder hopes to have his or her candidate placed on the board, but avows no intention to influence the management of the corporation. 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.[92] The nominating shareholder or

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88 *See* ABA Task Force on Shareholder Proposals, *supra* note 44, 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/.

89 *See* 17 CFR § 240.13d–1 *et seq.*, discussed in, *inter alia*, Loss & Seligman, *supra* note 37, at 619 *et seq.*

90 *See* § 240.14-11(b)(3), (4), printed in Security Holder Nominations Proposal *supra* note 15, at 60820.

91 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).

92 *See* § 240.14-11(c)(2)-(4), printed in Security Holder Nominations Proposal *supra* note 15, at 60820-21. The independence requirement resembles existing, similar requirements for all independent board

nominating group must disclose compliance with eligibility and independence requirements during the nomination process,[93] and must hold the company harmless from any false or misleading information published in such disclosure.[94]

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.[95] 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.[96] 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.[97] This, again, would raise the same question of distinctions among, and thus unequal treatment of shareholders, but would likely be permissible for the reasons discussed above. 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.[98] 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

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)).

93 *See* § 240.14-11(c), printed in Security Holder Nominations Proposal *supra* note 15, at 60820 *et seq.*

94 *See* § 240.14-11(e), printed in Security Holder Nominations Proposal *supra* note 15, at 60822.

95 *See* § 240.14-11(d)(1), printed in Security Holder Nominations Proposal *supra* note 15, at 60822.

96 *Id.*

97 *See* § 240.14-11(d)(3), printed in Security Holder Nominations Proposal *supra* note 15, at 60822.

98 *See* § 240.14-11(f), printed in Security Holder Nominations Proposal *supra* note 15, at 60822-23.

revealed to either the company or the shareholders themselves.[99] It should also be noted in the context of this comparative study that the proposed Rule would not apply to "foreign private issuers" listed on a U.S. securities exchange.[100]

III. THE ARGUMENTS FOR AND AGAINST SHAREHOLDER NOMINATIONS

A. Addressing Agency Problems through Procedurally Ensured Accountability to Shareholders

Perhaps the most prominent current advocate of shareholder rights and of the SEC's Security Holder Nominations Proposal is Prof. Lucian Arye Bebchuk. In his recent article, *The Case for Shareholder Access to the Ballot*,[101] 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

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99 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 44, at 117.

100 As discussed above, the 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. *See* 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."). Non-U.S. companies listed on a U.S. stock exchange would normally be "foreign private issuers" under Exchange Act Rule 3b-4, which defines a "foreign private issuer" as 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. They would therefore not be subject to the shareholder nominations rules. 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." 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.

101 Bebchuk, *Shareholder Access*, *supra* note 60. Prof. Bebchuk has been concerned with the predicament of shareholders for some time. *See* Lucian Ayre Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073 (1990).

Shareholders,"[102] Prof. Bebchuk 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,[103] i.e., potentially damaging differences between the decisions directors make and "those decisions that would maximize the welfare of the" shareholders.[104] The difficulty shareholders have in attempting to correct such problems is that they have almost no power to influence the behavior of management. Bebchuk points out that shareholder impotence is not caused solely by their dispersed state and the resulting "collective action problems"[105] experienced by the isolated individuals, but by corporate laws that leave shareholders without effective rights.[106] The board has sole power over the management of the company[107] and the distribution of dividends,[108] 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,[109] merger, sale of assets, consolidation or dissolution of the company.[110]

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102 Bebchuk, *Empowering Shareholders, supra* note 43.

103 *See* Bebchuk, *Shareholder Access, supra* note 60, at 57 ("Accountability [of directors to shareholders] is important because the interests of an agent and principal do not always fully over lap"), and Bebchuk, *Empowering Shareholders*, *supra* note 43, at 15 ("[T]he case against shareholder 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 Bebchuk 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 ar e 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).

104 Michael C. Jensen & William H. Meckling, *Theory of the Firm: Management Behavior, Agency Costs, and Ownership Structure*, in A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS 86 (Michael C. Jensen, ed., 2000).

105 *See* Clark, *supra* note 103, at 390 *et seq.*

106 Bebchuk, *Empowering Shareholders*, *supra* note 43, 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.

107 *Id.*, at 9.

108 *Id.*, at 12.

109 *Id.*, at 10 *et seq.*

110 *Id.*, at 11 *et seq.*, regarding dissolution *see* footnote 15.

This leaves shareholders with one "weapon of last resort," the power to replace directors.[111] 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."[112] Access 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.[113] 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.[114] Providing access to the company's proxy machinery would reduce these costs for the active shareholder.[115]

Bebchuk then addresses a number of arguments raised against shareholder nomination. The fear that directors nominated by shareholders would serve "special interests" is unfounded because, "[u]nlike cumulative voting, shareholder access would not enable any candidate to be elected without majority support among shareholders."[116] 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.[117] Bebchuk

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111 *Id.,* at 16.

112 Bebchuk, *Shareholder Access, supra* note 60, 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.

113 *Id.,* at 49. The domination of the nomination process by incumbent management is well known and documented. *See* Clark, *supra* note 103, 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 44, at 118; Monks/Minow, *supra* note 75, at 212 *et seq.*, and Strine, *supra* note 8, at 1377.

114 Bebchuk, *Shareholder Access, supra* note 60, at 45; also *see* Pozen, *supra* note 4, at 99.

115 Bebchuk, *Shareholder Access, supra* note 60, at 47.

116 *Id.,* at 55.

117 *Id.,* at 52 et seq.

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."[118]

Bebchuk offers no real counterargument against the criticism that, because the directors comprising the nominating committee are subject to a fiduciary duty to the company[119] and are well informed of the board's current needs in terms of skills and backgrounds for a board slot,[120] 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.[121] 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."[122] With regard to another variation of the fiduciary duty argument, i.e., that directors are subject to such a duty, but shareholders are not,[123] making their nominees a potential threat to creditors or employees, Bebchuk 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."[124] In the final part of his argument, Bebchuk points out empirical evidence showing the shares of companies with boards insulated from removal have lower market value.[125] He also somewhat discounts the effectiveness of the currently favored governance tool – independent

118 *Id.*, at 54.

119 Martin Lipton & Steven A. Rosenblum, *Election Contest in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 93 (2003).

120 Task Force on Shareholder Proposals, *supra* note 44, at 122.

121 Bebchuk, *Shareholder Access*, supra note 60, at 56 et seq.

122 *Id.*, at 58.

123 Lipton & Rosenblum, *supra* note 119, at 79.

124 Bebchuk, *Shareholder Access*, supra note 60, 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.

125 *Id.*, at 61 *et seq.*

directors, by stating that no solid evidence demonstrates "a systematic correlation between having a majority of independent directors and corporate value and performance."[126]

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.*[127] The paper approaches the relationship between shareholders and directors from a "managerialist viewpoint",[128] 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."[129] 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.[130] On the other hand, it is also true that controlling shareholders do owe fiduciary duties to the corporation and to minority shareholders,[131] and that numerous types of state and federal law actions may be brought against any person employing fraud in the solicitation of proxies.[132] The fiduciary duties of directors have been

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126 *Id.,* at 63. Also *see* Sanjai Bhagat & Lucian Ayre Bebchuk, *The Uncertain Relation between Board Composition and Firm Performance,* 54 BUS. LAW. 921 (1999).

127 Lipton & Rosenblum, *supra* note 119.

128 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).

129 Lipton & Rosenblum, *supra* note 119, at 79.

130 "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 103, at 34 (italics in original).

131 *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). Also *see* Ronald J. Gilson & Jeffrey N. Gordon, "Controlling Controlling Shareholders," Columbia Law School, The Center for Law and Economic Studies, Working Paper no. 228 (2003), available at http://ssrn.com/abstract=417181.

132 With regard to federal law, *see* 17 CFR § 240.14a-9(a) ("No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication,

crafted by the decisions of courts in cases challenging the actions of such directors; if federal rules have largely prevented shareholders from nominating candidates for their company's board, how could cases have arisen to craft the relevant fiduciary duties for shareholders? 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.[133]

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."[134] 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.[135] Their approach to the rather complex property interests certificated in a share of stock regretfully lacks depth. The argument achieves its end primarily by equating

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written or oral, containing any statement which . . . is false or misleading . . . ."), and with regard to state law ***see Stroud v. Grace***, 606 A.2d 75, 86-87 (Del. Supr., 1992) ("Delaware also imposes a duty of full disclosure in assessing the adequacy of proxy materials under state law. ***See Bershad***, 535 A.2d at 846; ***Rosenblatt***, 493 A.2d at 945; ***Van Gorkom***, 488 A.2d at 890; ***Weinberger***, 457 A.2d at 708; ***Michelson***, 407 A.2d at 222; ***Lynch***, 383 A.2d at 280 (tender offer circular); ***Gerlach***, 139 A.2d at 591. Two factors explain our emphasis on the adequacy of disclosures in proxy statements. First, as mentioned, is the fact that large public corporations must solicit proxies when seeking a shareholder vote. Second, and more importantly, Delaware, like Congress, has recognized that proxy voters generally do not attend shareholder meetings. We require proxy voters to have all material information reasonably available before casting their votes. Thus, proxy materials insure that directors do not use their "special knowledge" to their own advantage "and to the detriment of the stockholders." ***Weinberger***, 457 A.2d at 711; ***Lynch***, 383 A.2d at 281; ***Lank v. Steiner***, Del.Supr., 224 A.2d 242, 244 (1966); ***see*** also, ***Van Gorkom***, 488 A.2d at 864.'").

133 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).

134 Lipton & Rosenblum, ***supra*** note 119, at 79. Also ***see*** Martin Lipton and Steven A. Rosenblum, *A New System of Corporate Governance: The Quinqennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

135 "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 119, at 76.

non-ownership of the ***company's assets***, a black-letter principle of corporate law,[136] 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).[137]

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:[138] "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 a building."[139] 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."[140] The authors then jump back to the fiduciary duties argument without really saying anything more about ownership: what the shareholders have is an "interest . . . in a financial return . . . the legal system allows them to act purely in

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136 "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).

137 Lipton & Rosenblum, *supra* note 119, at 72 *et seq.*

138 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 & 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 & 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.").

139 Lipton & Rosenblum, *supra* note 119, at 72.

140 *Id.*, at 73.

their self-interest. They are not fiduciaries and they do not owe duties to the corporation."[141] 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."[142]

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."[143] A "chose in action" is "a proprietary right ***in personam***."[144] A shareholder has non-possessory interests in the corporation, which, drawing analogically from to rights in real property,[145] consist of at least "profits"[146] and a pro rata "remainder" in the corporate assets.[147] Referring to Farwell J.'s classic definition of a share of stock in ***Borland's Trustee v. Steel***,[148] 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.[149]

This does not mean that the share of stock conveys "an individual right in specific property," for it does not.[150] However, the property right ***certificated by*** a share of stock is no less a

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141 *Id.*, at 73.

142 *Id.*, at 74.

143 *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). 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.

144 B. Garner, ed., BLACK'S LAW DICTIONARY 234, (7th ed. 1999).

145 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." Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 Yale L.J. 3, 18 (2000).

146 Ballantine, *supra* note 136, at 375; H. Henn/J. Alexander, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 396 (1983); Clark, *supra* note 103, at 13.

147 Ballantine, *supra* note 136, at 375; Henn/Alexander, *supra* note 139, at 396; Clark, *supra* note 103, at 13.

148 *Borland's Trustee v. Steel* [1901] 1 Ch. 279 at 288.

149 PAUL DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 616-17 (7th ed. 2003).

150 Ballantine, *supra* note 136, at 289.

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.[151] 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,"[152] allowing an action for recovery of the property if such assets are unjustly transferred to another class of shareholders.[153] The generally accepted truism that shareholders "own" corporations is not a myth.

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."[154] As discussed above, the legal concept of agency cannot be strictly applied to corporate governance, as shareholders have no right to issue instructions to managers.[155] However, the near universal employment of the term "agency" in corporate governance literature does not refer to a legal, but rather to an economic concept.[156] In any case, the argument offered by Messrs. Lipton

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151 *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."

152 "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 Divisibilty of Rights," Harvard Law School Public Law Research Paper No. 037 (2002), at 5, available at http://ssrn.com/abstract_id=323301.

153 *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 declared at such meeting.

154 Lipton & Rosenblum, *supra* note 119, at 75.

155 *See supra* note 94 and accompanying text.

156 *See* Jensen & Meckling, *supra* note 104, at 87 ("The problem of inducing an 'agent' to behave as if he were maximizing the 'principal's' welfare is quite general. It exists in all organizations and in all cooperative efforts – at every level of management in firms, in universities, in mutual companies, in cooperatives, in governmental authorities and bureaus, in unions, and in relationships actually called 'agency relationships,' such as those common in the performing arts and the market for real estate.").

and Rosenblum does not go to either the legal or the economic meaning of the term "agency", but rather presents a kind of anecdotal, practical observation:

> 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.[157]

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.[158] 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.[159] 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.[160] Messrs. Lipton and Rosenblum do not go into this issue, but rather turn to why shareholder voice is both

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[157] Lipton & Rosenblum, *supra* note 119, at 75.

[158] "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 1, at 8. A similar re-evaluation of these observations can be found in another managerialist, Dean Bayless Manning. *See* Bayless Manning, *Review of The American Stockholder*, 67 Yale L.R. 1477, 1489 (1958) ("Thanks to the pioneering work of Berle . . . we have long known that in our modern industrial system . . . . today's large corporations may for many purposes be best viewed as an intricate, centralized, economic-administrative structure run by professional managers who hire capital from the investor.").

[159] The "Wall Street Rule" was defined in the SEC's 1971 "Institutional Investor Study Report": "[I]nstitutions tend to vote with management on questions put to a shareholder vote and . . . if they lose confidence in management they tend to sell their holdings in a company rather then to attempt to control or influence management decisions. This conclusion appears attributable to two factors. First, institutions are inclined to believe that their responsibility is to mak e investment decisions rather than to attempt to influence management decisions. Second, while there are no statutory restrictions upon the right of institutions to attempt to influence management decisions, institutions tend to believe that an effort to do so would be inappropriate and would subject them to criticism. . . . In general, it can be concluded that even where institutions have the potential power to influence management decisions they tend to be reluctant to exercise this power, particularly in an open and public way." Cited in JAMES E. HEARD & HOWARD D. SHERMAN, CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM 41 (1987).

[160] "[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).

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 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."[161] 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."[162] 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."[163] 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."[164] 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."[165] This argument seems both to underestimate "how strongly the dark force of fraud can pull on the heart of man,"[166] and to ignore the fact that even free negations to reach cooperative equilibriums take place "in the shadow of the law."[167] That is, if the law were to increase

[161] Lipton & Rosenblum, *supra* note 119, 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.

[162] *Id.*, at 80.

[163] *Id.*, at 82.

[164] *Id.*, at 85.

[165] *Id.*, at 85.

[166] Clark, *supra* note 103, at 113.

[167] *See* Remarks of Prof. John Coffee in Symposium on Corporate Elections, *supra* note 56, at 98.

shareholder voice, management would eventually stop posing with suspicious resentment and settle down to work on the basis of the new balance of power.[168]

The authors also raise the arguments that institutional investors are not suited for performing monitoring activity,[169] which is a point one finds often raised by persons who speak from the perspective of such investors.[170] However, exactly because institutional investors are not in the business of sitting on corporate boards, they would likely choose their candidates out of the pool of independent directors that has developing since the 1970s. This would combine the strengths of independent directors with the flexibility of shareholder appointment and removal, and thus each of the two governance mechanisms would work to support and facilitate the effectiveness of the other.

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.[171] The interesting thing about this argument is that attempts to characterize the Security Holder Nominations Proposal as a measure that is *separate* from other measures adopted in reaction to the scandals that prompted the Sarbanes Oxley Act, although it harks back to an idea that the SEC seriously discussed in 1942 and 1977, and was issued in proposal form roughly simultaneous to a number of other measures in 2003; moreover the SEC makes express reference to the recent scandals in its proposing release.[172] This argument has been raised by a number of commentators,[173] but is not supported by any discernable end to the reforms that began in 2002. Strategically, the

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[168] The mere fact that the Security Holder Nominations Proposal was pending during the 2004 proxy season appears to have made management considerably more open to hearing and addressing shareholders' attempts at pre-annual meeting negotiations. *See* Institutional Shareholder Services, *supra* note [•], at 7 *et seq.*

[169] Lipton & Rosenblum, *supra* note 119, at 77.

[170] *See* Pozen, *supra* note 4, at 96 *et seq.*

[171] Lipton & Rosenblum, *supra* note 119, at 90 *et seq.*

[172] "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." Security Holder Nominations Proposal *supra* note 15, at 60784.

[173] A few of the commentators who used this argument are: Task Force on Shareholder Proposals, *supra* note 44, 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.

argument plays to short public memory, and to the fact that public support for regulatory measures is strongest immediately after investments have been lost, but then quickly wanes.[174] The argument is premature. Indeed, corporate governance problems and scandals still filled the headlines of daily newspapers in 2004.[175]

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.[176] This means that the German corporate governance system has not to date suffered 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.[177] In addition, 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 different sets of law at the national and European levels.[178] This will soon change if the European Stock Corporation (*Societas Europaea*) form, which entered into existence on October 8, 2004,[179] is much used. The *Societas Europaea* is governed by the general

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174 Stuart Banner, *What Causes New Securities Regulation?: 300 Years of Evidence*, 75 Wash. U. L.Q. 849, 850 (1997).

175 *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.

176 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, the Reorganization Act (*Umwandlungsgesetz*), which regulates mergers and changes in corporate form, and the Limited Liability Company Act (*Gesetz betreffend die Gellschaft 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*).

177 *See* Part II.A.

178 With the exception of the Limited Liability Company Act, all of the federal laws listed in note 176, *supra*, have been significantly shaped by EC Directives.

179 *See* Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE). 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

framework of directly applicable supranational law (a European Regulation), which leaves gaps in areas in sensitive or difficult to harmonize areas (such as directors' fiduciary duties), for national law to fill in.[180] This will introduce problems of "federalism" in Germany as well.

It is also very important to note that, unlike under the Delaware General Corporation Law, which gives incorporators substantial leeway to configure their corporation,[181] the German Stock Corporation Act (*Aktiengesetz* or "AktG") is composed primarily of mandatory provisions, which means that a corporate charter may not deviate from such provisions unless expressly permitted by law.[182] This mandatory nature of German corporate law creates a significant body of control and protection mechanisms that make German corporations somewhat inflexible, but lend their governance systems significant uniformity.

Under the *Aktiengesetz*, a stock corporation (*Aktiengesellschaft* or "AG") has a two-tier board.[183] The two levels are the supervisory board (*Aufsichtsrat*) (§§ 95—116 AktG) and the management board (*Vorstand*) (§§ 76—94 AktG). This system resembles to some extent the governance structure found in U.S. listed companies, in which audit, nomination, and compensation committees composed of independent directors perform special tasks with a focus on monitoring.[184] A significant difference, however, lies in the way the board members are appointed. In an AG, shareholders elect all or some of the monitoring directors, who are seated on the supervisory board (§ 101(1) AktG), and the supervisory board in turn appoints the "managing" directors (§ 84(1) AktG), who make up the management board, and

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shall be binding in its entirety and directly applicable in all Member States."). It is still unclear to what extent the European Stock Corporation will be used. Another supranational entity, a kind of transnational partnership called the European Economic Interest Grouping, has only been sparsely employed. *See* Council Regulation (EEC) No 2137/85 of 25 July 1985 on the European Economic Interest Grouping (EEIG).

180 *See* SE Regulation, *supra* note 179, Art. 9.

181 *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."

182 "The charter may deviate from the provisions of this Act only if expressly allowed."(§ 23(5) AktG).

183 *See* Theodore 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 Klaus Hopt, ***The German Two-Tier Board (*****Aufsichtsrat*****): A German View on Corporate Governance***, in COMPARATIVE CORPORATE GOVERNANCE 3 (Klaus Hopt & Eddy Wymeersch, eds., 1997). It should be noted that under the SE Regulation, it is possible for an SE based in Germany to use a single-tier board. *See* SE Regulation, *supra* note 179, Art. 38(b).

184 *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/. This similarity is also discussed in Kraakman, *supra* note 29, at 40.

have direct responsibility for managing the company (§ 76(1) AktG). Another complication enters through the representation of the company's employees and their labor unions on the supervisory board, referred to as "co-determination". In an AG with more than 2,000 employees, half of the seats on the supervisory board are filled by labor representatives,[185] part of which are directly elected by the employees and part of which are appointed by the labor unions that are active in the company.[186] The purpose of co-determination is to give a particular group of stakeholders – the company's employees – a significant influence over the company's policy and management;[187] the causes for co-determination are complex,[188] and its effectiveness is much debated, especially at the current time in Germany.[189]

For the purposes of this paper, it is important to understand the effects of co-determination on the shareholders' ability to influence the appointment of management. As said, the supervisory board of a stock corporation appoints the members of the management board, and if the corporation has more than 2,000 employees, one half of the supervisory board will be composed of labor representatives. Section 31(2) of the Co-Determination Act provides that the supervisory board appoints the management board members following a

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185 The Co-Determination Act of 1976 (*Mitbestimmungsgesetz,* or "MitbestG") applies to limited liability companies and AGs with more than 2,000 employees (*see* § 1 MitbestG), and requires that one-half of the supervisory board comprise representatives of the employees and their unions (*see* § 7 MitbestG). *See* Bernt Gach, *Gesetz über die Mitbestimmung der Arbeiter*, in MÜNCHENER KOMMENTAR AKTIENGESETZ Vol 3, 1301 (Bruno Kropff & Johannes Semler, ed., 2004); Theodor Baums & Bernd Frick, *The Market Value of the Codetermined Firm*, in EMPLOYEES AND CORPORATE GOVERNANCE 206 (Margaret M. Blair & Mark J. Roe, eds., 1999). 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.

186 The Co-Determination Act specifies the size of the supervisory board, which varies from 12 members for companies with no more than 10,000 employees, 16 members for companies with no more than 20,000 employees, up to 20 members for companies with more than 20,000 employees (§ 7(1), MitbestG). Companies with a supervisory board of 12 members, would have six shareholder representatives, four employee representatives, and two union representatives; companies with a supervisory board of 16 members, would have eight shareholder representatives, six employee representatives, and two union representatives; companies with a supervisory board of 20 members, would have 10 shareholder representatives, seven employee representatives, and three union representatives (§ 7(2), MitbestG).

187 It is often discussed, and some authors have called it "the most remarkable experiment in corporate governance of the post-War period." Kraakman, *supra* note 29, at 62.

188 *See* MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE 29 (2003) and Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in Blair & Roe, *supra* note 185.

189 *See Neue Vorschläge zur Mitbestimmung* ("New Recommendations on Co-Determination"), DAS HANDELSBLATT, Nov. 12, 2004 and *EU greift deutsche Mitbestimmung an* ("The EU Attacks German Co-Determination"), DAS HANDELSBLATT, Nov. 12, 2004. The newspaper DAS HANDELSBLATT is available at http://www.handelsblatt.com.

specific procedure that begins with a two-thirds majority requirement for appointment on a first ballot, but has a waterfall structure that provides, in § 31(3), that if the two-thirds majority is not achieved, a new vote must be taken and approved by a simple majority, and § 31(4) provides that if *that* majority is not reached, then the chairman of the supervisory board has a tie-breaking vote in reaching a simple majority.[190] The chairman is elected according to a similar waterfall of decreasing majorities that allow the shareholder representatives to fill this slot.[191] As a result, the labor representatives can filibuster against election of shareholder representative candidates,[192] but they can only slow down and not stop the shareholder representatives from electing the entire management board.[193]

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),[194] but either the charter or the shareholder resolution electing a given member may specify a shorter period.[195] As a result, staggered boards are possible.[196]

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190 *See* Gach, *supra* note 185, at 1423-1429, and Hans-Joachim Mertens, *Mitbestimmung im Aufsichtsrat*, in KÖLNER KOMMENTAR ZUM AKTIENGESETZ 786-789 (Wolfgang Zöllner, ed., 1996).

191 Pursuant to § 27(1) of the Co-Determination Act, the supervisory board of a corporation to which the Act applies must have a chairman who is elected by the vote of ⅔ of the entire supervisory board. If the required ⅔ majority is not attained, § 27(2) provides that the board members representing the shareholders elect the chairman by a simple majority of votes cast and the labor representatives elect the vice chairman by a simple majority of votes cast. *See* Gach, *supra* note 185, at 1410-1415, and Mertens, *supra* note 190, at 774-779.

192 *See* Hopt, *supra* note 183, at 4-5. Following the first ballot, a "mediation committee" (*Vermittlungsausschuss*) has one month to propose new candidates. Other candidates for the second ballot may also be proposed, but the full period of one month must expire before the second ballot may take place. *See* Mertens, *supra* note 190, at 787 and Gach, *supra* note 185, at 1426-1427.

193 It was this ability of the shareholders to ultimately control the appointment of the corporation's managing directors that kept the German Constitutional Court (*Verfassungsgericht*) 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). *See also* Mertens, *supra* note 190, at 679. It appears that Prof. Kraakman and his fellow authors have stretched the ability of labor representatives to *delay* an appointment into an absolute right to *veto*. *See* Kraakman, *supra* note 29, at 63 ("Nevertheless, employee representatives are by no means powerless since they retain a veto over the appointment (and reappointment) of the management board.") This is, as discussed above, incorrect. It regretfully tends to skew the book's analysis of shareholder rights in Germany, because it assumes that employee representatives can block shareholder appointment of management through their representatives in the management board.

194 Either the charter or the shareholder resolution electing a member may specify a shorter period. *See* Johannes Semler, *Comment to § 102 AktG*, in MÜNCHENER KOMMENTAR, *supra* note 185, at marginal note 19.

195 *See Id.*, at marginal note 19.

196 *See Id.* at marginal note 17.

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.[197] Shareholders may also remove the shareholder-appointed supervisory board members with or without cause (§ 103 AktG),[198] although the high, required majority of ¾ of the votes cast results in such board members being removed rarely,[199] 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 as a rule 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 procedure used to call the meeting and inform the shareholders is provided for in detail in the Stock Corporation Act. The 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).[200] 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).[201]

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197 *See* Dietmar Kubis, *Comment on § 120 AktG*, in MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ Vol. 4, marginal notes 2, 24, 33-36.

198 This requires ¾ of the votes cast pursuant to § 103(1) AktG. The supervisory board may remove management board members for good cause (§ 84 AktG).

199 See Baums, *Takeovers v. Institutions in Germany, supra* note 24, at 155-56.

200 This notice board is found at https://www.ebundesanzeiger.de/research/banzservlet.

201 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).

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 itself and relevant information about such nominees (§ 124(3) AktG).[202] The proposed slate of nominees may be drafted by the entire supervisory board or a committee thereof, but it is not considered appropriate for the employee representative members of the supervisory board to take part in these deliberations.[203] Just as in the United States,[204] candidates may be nominated on the floor of the meeting,[205] but because a great number of votes are cast by proxy, the proposed slate will largely dominate the outcome of the election.[206]

2. Nomination by Shareholders

Under German law, shareholders have a number of avenues for proposing matters to the annual meeting. They may themselves demand that a meeting be called (§ 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 not directly related to the business of the company,[207] 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,[208] and need not be made personally by the shareholder, but may be exercised by anyone holding a power to represent the shareholder.[209]

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202 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.

203 Kubis, *supra* note 197, Comment to § 124 AktG, at marginal note 48.

204 *See supra* note 46 and accompanying text.

205 J. Semler, *supra* note 185, Comment to § 101, at marginal note 16.

206 Kubis, *supra* note 197, Comment to § 124 AktG, at marginal note 42.

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

208 Kubis, *supra* note 197, Comment to § 122 AktG, at marginal note 7.

209 *Id.*, at marginal note 5.

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 traded company.[210] Shareholders may make proposals with regard to the agenda items they demand.[211] Again, there is no minimum holding period to be eligible for the demand right.[212] 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).[213] Prof. Hans-Joachim Mertens noted in 1997 that shareholder use of § 122 to add items to the meeting agenda was on the increase.[214] My research has yielded no more recent empirical evidence of this. It may be useful with regard to the challenges that have been made to proposed Rule 14a-11,[215] to note that the question of unequal treatment of shareholders, which is also generally forbidden in German corporate law,[216] is not even raised in connection with the above rights, perhaps because such demand rights by minority shareholders are older than the *Aktiengesetz* itself.[217]

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.[218] Although the management board is not required to publish or dispatch such proposal with the call to meeting, it must "make it available" to the shareholders, which is satisfied by placing the proposed nomination and any supporting statement of up to 5,000

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210 *Id.*, at marginal note 28.

211 Winfried Werner, *Comment to § 122* in GROßKOMMENTAR AKTG marginal note 70 (Klaus Hopt & Herbert Wiedemann, eds., 4th ed., 1993).

212 Kubis, *supra* note 197, Comment to § 122 AktG, at marginal note 29.

213 *See* Kubis, *supra* note 197, Comment to § 122 AktG, at marginal note 65, Werner, *supra* note 192, Comment to § 122, at marginal note 77 *et seq.*

214 *See* Mertens, *supra* note 207, at 481.

215 *See supra* note 88 and accompanying text.

216 Section 53a of the *Aktiengesetz* provides: "Shareholders shall be treated equally under equal circumstances."

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

218 Kubis, *supra* note 197, Comment to § 127 AktG, at marginal note 4.

words on the company's website.[219] Shareholder nominations take place through analogical application of a shareholder proposal rule, § 126 AktG,[220] 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***[221] or supplement management proposals, and allows management to exclude a proposal if it:

- does not oppose, but merely repeats a proposal made by management (§ 126(2), no. 4 AktG);
- could subject the management board to prosecution for making it known (§ 126(2), no. 1 AktG);
- violates the law or the charter (§ 126(2), no. 2 AktG);
- is materially false or misleading (§ 126(2), no. 3 AktG);
- has been repeatedly rejected in the past (§ 126(2), no. 5 AktG);
- the shareholder does not plan to be present or represented at the meeting where it will be considered (§ 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).

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.[222] Existing figures on such shareholder nominations show a relatively low rate of success.[223] 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 noticeably reported as a consequence of such shareholder rights.

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219 *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 44, at 122 *et seq.*

220 *See* generally, U. Noack, *Das neue Recht der Gegenanträge nach § 126 AktG*, 1393 Betriebs-Berater (2003).

221 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).

222 Kubis, *supra* note 197, 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 requirement listed in § 101 AktG.

223 *See* Theodor Baums & Christian Fraune, *Institutionelle Anleger und Publikumsgesellschaft*, DIE AKTIENGESELLSCHAFT 97 (1995), at 110, Table 18.

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").[224] 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 Security Holder Nominations Proposal combined with the ABA Task Force on Shareholder Proposals' recommendations regarding expanded use of new information technology.[225] The creation of such an electronic area for SEC registered companies – perhaps in the context of the EDGAR system,[226] 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.[227] As explained above, at the beginning of the 20th century, German banks were accustomed to dipping into the voting power of their customers' shares to supplement their own block holdings.[228] Even after written proxies were

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224 *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". As its name suggests ("*Anfechtung*" means "legal challenge"), this legislation has also been designed to bring shareholder actions up to date by strengthening them. *See* Art. 1, no. 14 UMAG. Germany is also moving in the direction of U.S. law by making efforts to strengthen securities fraud actions. In October 2004, the German government released a "discussion draft" of a Law to Strengthen Liability for False Capital Market Information (*Gesetzes zur Verbesserung der Haftung für falsche Kapitalmarktinformationen* – "KapInHaG"), which would have made directors personally liable for releasing false information to the capital market intentionally or because of gross negligence. *See* Art. 1, no. 3 KapInHaG. Like the Security Holder Nomination Proposal, however, the efforts of the German government met significant resistance from industry trade groups, and the Government almost immediately withdrew the draft. *See* SÜDDEUTSCHEN ZEITUNG, Nov. 10, 2004, at 21.

225 *See supra* note 99 and accompanying text, as well as ABA Task Force on Shareholder Proposals, *supra* note 44, at 122 *et seq.*

226 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.

227 *See* Barca & Becht, *supra* note 15, at 130, Table 5.1.

228 *See* Tuerks, *supra* note 15, at 5 *et seq.*

required under the *Aktiengesetz of* 1937,[229] banks still exercised *de facto* a significant amount of power over their customer's shares,[230] even though they were under no legal obligation to exercise such votes.[231] Like institutional investors in the United States, banks are generally believed to vote for management proposals, in particular for management nominees.[232] Following a reform initiative to replace bank voting with independent, competing proxy agents,[233] 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,[234] 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.[235] 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.[236] 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 of such company holds a seat in its own supervisory board (§ 128(2), sentence 6 AktG);

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229 *See* Hommelhoff, *supra* note 16, at 92, and Henning Schröer, *Comment to § 135* in MÜNCHENER KOMMENTAR, *supra* note 197, at marginal note 8. The requirement of written form has since been deleted from the law. *Id.* at marginal note 13.

230 *See* Baums, *supra* note 21.

231 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.*

232 *See* Baums/Fraune, *supra* note 204, at 109—111.

233 *See* Theodore Baums & Philip von Randow, *Shareholder Voting and Corporate Governance: The German Experience and a New Approach*, in Aoki & Kim, *supra* note 18 at 435; and Theodore Baums & Philip von Randow, *Der Markt für Stimmrechtsvertreter*, in DIE AKTIENGESELLSCHAFT 145 (1995).

234 *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.*

235 *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

236 The following discussion of the reforms brought about in 1997 relies on Knauer, *supra* note 19, at 81 *et seq.*

- 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);[237] 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 a long-term 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 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".[238]

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237 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."

238 *See* remarks of Ulrich Seibert, *Der Entwurf eines Gesetzes zur Namensaktie*, in DIE NAMENSAKTIE 11, 31 (Rüdiger von Rosen & Werner G. Seifert, eds., 2000).

V. CONCLUSIONS

Legislative and regulatory initiatives regarding shareholder rights in the United States and Germany display complimentary movements. The United States has grudgingly granted an increasing number of governance tools to shareholders, although the insights of Berle and Means circa 1932 still seem to dominate much of our discussion on shareholder rights. Germany, on the other hand, has made significant efforts to reign in the power of financial institutions, particularly their exercise of other people's shares, and promote enforcement through individual shareholder actions. The two legal systems seem to be moving toward a similar constellation of shareholder rights, which could, at least in part, be caused by the uniform global business structures of institutional investors. However, the complications of federalism seem to have significantly hampered U.S. efforts and the introduction of directly applicable European corporate law through the *Societas Europaea* could change the path of Germany's development.

The SEC's Security Holder Nominations Proposal is the most recent U.S. attempt to empower shareholders, and would eliminate a federal block to an existing state law right. 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 with a secondary, federal meaning and demeans the capability of shareholders to simply opt-in. It is unlikely that the eligibility holding requirement violates the equal treatment of shares, given that similar thresholds have been used for many purposes in both state and federal law.

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 exposition of the German experience casts doubt on the predictions that the proposed Rule would 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 appear to have value for the effective use of proposed Rule 14a-11, at least as long as shareholder identities in the United States remain the sole knowledge of clearing agencies and their participants.

Given the steady growth of sophisticated, institutional investors on the U.S. market, it would seem highly improbable that the rights of shareholders in U.S. corporations will remain at their currently symbolic level. Even if the 2003 proposal for shareholder nomination of directors is defeated, it would be difficult to image the gradual increase in shareholder rights that has been evident for over 20 years to die out. It would be a rare thing if a constituency as articulate and energetic as the financial services industry remained dormant in an area where their ownership well exceeds 50 %, especially because the private households whose rights they would be indirectly asserting hold a significant number of votes.

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