Cumulative Voting and the Tension between Board and Minority Shareholders

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ABSTRACT

The separation of management and ownership has created various agency problems and long-lasting conflicts between the board and minority shareholders. Our empirical study looks into whether cumulative voting can help ease the tensions between these two groups of investors. We use shareholder proposals as an indication of the nature and amount of tensions between the board and minority shareholders. Our research shows that cumulative voting can help ease the tension between the board of directors and minority shareholders and reduce investors' monitoring costs. In some cases, however, the impact of cumulative voting can be constrained by other corporate governance mechanisms.

INTRODUCTION

In the corporate world, people try to maximize their own benefits. Under the principal–agent relationship framework, executive groups should work their best to benefit shareholders. But executives usually hold shares of the company as well and are often members of the board of directors, so it is likely that executives and directors, who are shareholders with direct control of the company, may make decisions that will benefit themselves but not necessarily other shareholders who do not have direct control of the company.

Shareholders who do not have direct control of the company are usually referred to as minority shareholders. Though directors are elected to represent the interest of shareholders, there always seems to be some discordance between minority shareholders and the board of directors. One extreme example is the "just vote no" campaign initiated by some shareholder activists in the 1990s. The idea is that because it is not very cost-benefit efficient to campaign issue-oriented shareholder proposals, these shareholder activists simply urge "just vote no", meaning to withhold votes towards a director's election to express dissatisfaction with management performance or the firm's corporate governance structure, thinking this should be more effective because directors want to avoid the public embarrassment and the associated damage to their individual reputations (Del Guercio, et al. 2008).

Facing the long lasting conflicts between the board and minority shareholders, corporations actually have an alternative choice, which is cumulative voting, to ease the tension between the board and minority shareholders. Cumulative voting allows stockholders to cast all of their available votes in director elections for a single director nominee. Therefore it will enhance the voting power of minority

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shareholders. Cumulative voting is also more cost-benefit efficient to minority shareholders compared to an issue-oriented campaign as discussed by some legal literature (Pozen, 2003).

However, even though cumulative voting was popular at the beginning of the 20th century, it has experienced a steady decline since the 1950s. In 1984, cumulative voting was mandatory in 18 states. The number reduced to six in 1992 (Maassen and Brown, 2006). According to the Investor Responsibility Research Center (IRRC), in 2003, only 9.2% of the Standard & Poor's Super 1500 have cumulative voting (Gordon, 1994).

The main reason for many states to abandon mandatory cumulative voting in the '80s was because there were numerous hostile takeovers happening during this period of time. Nowadays, U.S. corporations are operating in a much less hostile environment because of the development of investment funds in the past decades. Investment funds have become the dominant shareholders these days. The investment goals of most institutional shareholders are long term and they are not likely to takeover a corporation. However, there was little responding change in the corporate governance structures of the majority of U.S. companies. The corporate bylaws are very protective to controlling shareholders as a result of the hostile takeover wave in the '80s. So we still see many conflicts between the boards and minority shareholders. Adopting cumulative voting, repealing a classified board, and executive compensation issues, have consistently been the top three institutional shareholder proposals (Campbell et al., 1999; Gillan et al., 2007). All these shareholder proposals are associated with a costly solicitation process. Since cumulative voting will increase the chance for minority shareholders to elect some board members who can better represent their interests, with the change of minority shareholder structure, it is necessary to examine whether the corporate world needs to reconsider the adoption of cumulative voting.

Our paper tries to examine whether cumulative voting plays a role to ease the tension between board of directors and minority shareholders. Previous research on the impact of cumulative voting usually focused on the market reaction to the changes of adoption of cumulative voting. For example, Bhagat and Brickley (1984) test the stock returns around the time of the announcement of management-sponsored proposals that include amendments of cumulative voting. They find that the announcement of proposed amendments that reduce the effect of cumulative voting is associated with abnormally negative returns. In this paper we use the voting results of investor proposals to measure the conflict between board of directors and minority shareholders. First, we argue that market movements can be affected by multiple factors and it is not easy to ascertain the impact of a single factor. For example, in Bhagat and Brickley's (1984) research, they have not observed any significant market reaction when proposals that enhance cumulative voting are announced. So we consider voting results for investor proposals a better and more direct measurement to reflect the conflicts between controlling and non-controlling shareholders. Second, we consider the costs related to investor campaigns and proxy solicitation processes a reduction to investors' wealth as well and these costs should be counted when examine the value impact of cumulative voting. Previous empirical studies have not paid enough attention to these costs, so our study provides new evidence on the value impact of cumulative voting.

We look at 201 companies that have investor proposals in 2008 and find that companies with a classified board and more block holders tend to show more conflicts between controlling and non-controlling shareholders. A regression test shows a negative relationship between the presence of cumulative voting and the conflicts between the board and minority shareholders. These results indicate that cumulative voting is an efficient approach to ease the tension between the board of directors and minority shareholders and can help reduce investors' monitoring costs on a corporation.

This paper proceeds as follows. In the next section, we review the related literature on the value impact of cumulative voting. In Section III, we present the methodology applied in our study, and report the empirical evidence as well. Section IV concludes the paper.

LITERATURE REVIEW

In the corporate world, if shareholders are not satisfied with companies' performance, they have several choices. First, they can just trade their shares – a practice of voting by feet (this is known as the "Wall Street Rule"). Second, they can conduct takeovers and LBOs. Through this choice, investors could fundamentally change corporate control. Third, besides the former two extreme choices, shareholders can vote to influence managers' decisions.

Shareholders have the right to elect directors who will then make major decisions on behalf of investors' interests. Shareholders also have the right to vote on other major issues such as merger decisions, liquidations, and charter amendments. However, in the real world, power of shareholders is seldom equal. For example, Johnson et al (2000) find that tunneling, a phenomenon where controlling shareholders transfer assets or profits out of firms for the benefit of themselves, is very common in both developing and developed countries.

Theoretical discussion from the 1950s (Williams, 1955) suggests that cumulative voting is basically fair, because minority representation under cumulative voting does not break the majority rule and minority groups have the potential power to influence directors by having representation on the board.

But cumulative voting has not been a favored choice of boards and managers. It was seldom used in the greater part of U.S. corporations even several decades ago. The arguments regarding the disadvantages of cumulative voting that are frequently cited by corporate boards usually include: (1) A good director should not be captured by any special interest group; (2) The board of directors should possess mutual confidence and respect; (3) Disharmony could harm the energy of management; (4) Confidential information could be leaked; (5) Shareholders with narrow, selfish interests could abuse cumulative voting.

Bhagat and Brickley (1984) tested the stock returns around the time of the announcement of management-sponsored proposals that include amendments of cumulative voting. They analyze two kinds of amendments. One is amendments that reduce the impact of cumulative voting; the other is amendments that enhance the impact of cumulative voting. They collect samples from 1962 to 1982 and find that the announcement of proposed amendments that reduce the effect of cumulative voting is associated with abnormally negative returns. The authors find on average that proposals that enhance cumulative voting do not affect firms' values.

Dodd and Warner (1983) examine a sample of firms experiencing proxy contests for seats on their board of directors. They find that dissident shareholders usually fail to obtain a majority of board seats. However, some minority shareholders obtain some seats, via the cumulative voting mechanism, in over half of the sample contests.

The capital market has radically changed for the past several decades after the hostile takeover waves in the 1980s. One of the significant changes is that market funds have grown at an incredible pace. Institutional investors have come to own substantial common stocks of most publicly traded companies. According to a 2008 Institutional Investment Report issued by the Conference Board, in the largest 1,000 U.S. corporations, institutional investors held 76.4% of total stocks by the year end of 2007. In 1987, they only controlled 46.6%. These institutional investors include mutual funds, pension plans, banks and foundations, and insurance companies. Institutional investors controlled $27.1 trillion assets in 2007, but the number was only $2.7 trillion in 1980.

This significant growth in institutional ownership of U.S. publicly traded companies has broad implications for the corporate governance. The main purpose of these investors is to diversify risks and gain steady returns. Fund managers pay more attention to long-term consideration instead of short-term speculation. Moreover, as managers handle huge amounts of investments for each fund, it is not easy for them using the Wall Street Rule, meaning vote with their feet, to deal with their stocks. For example, fund managers usually will not sell stocks when stock price is temporarily undesirable.

As institutional investors hold an increasing share of equity of publicly traded corporations, they recognize their potential ability to influence companies. Moreover, they are becoming activists to submit their own corporate governance proposals at corporations' annual meetings. There is evidence showing that the increase of shareholders' proposals is related to the growth of institutional investors. The Investor Responsibility Research Center has tracked the shareholder proposals filed at U.S. companies since 1973. From 1973 through 2004, more than 15,000 shareholder proposals were filed at U.S. firms on a wide range of social responsibility and governance subjects during the 32 years. Remarkably, approximately 25% were filed just in the last four calendar years, 2001 through 2004.

Gillan and Starks (2007) sum up the number of corporate governance proposals submitted over two periods, one from 1987 to 1994 and the other from 2001 to 2005. They find that there are substantial changes in the sponsors of the corporate governance proposals between the two periods. Specifically, union funds had become a larger force in submitting proposals. They submitted 10% of the proposals during the 1987 to 1994 period but over 60% between 2001 and 2005. In contrast, unaffiliated individuals accounted for 70.4% in earlier period, but only 44.5% in the later period.

With the changes of minority shareholder structure, it is necessary to reconsider the appropriateness of keeping the unequal rights that exist between the board and minority shareholders.

Cumulative voting, as one of the major mechanisms that can help equalize shareholder rights, deserves more research that is based on current empirical evidence.

EMPIRICAL TESTS

We use voting results on shareholder proposals as a proxy for the conflicts between the board and minority shareholders. Data on shareholder proposal voting results are obtained from the US Annual Corporate Governance Review issued by Georgeson Inc., a Computershare company that provides strategic shareholder consulting services. The Georgeson annual review tracks the shareholder proposals voted on in the annual meetings of the Super S&P 1500 firms.

Based on Georgeson's report, 201 companies voted on shareholder proposals in their 2008 annual meeting. Non-parametric Kruskal-Wallis tests on the differences between companies that voted on shareholder proposals and other S&P1500 companies indicate that companies with bigger size, reflected in total assets and total revenue, are more likely to receive shareholder proposals. But there is no difference in performance, in terms of profit margin and yearly stock return, between companies receiving shareholder proposals and companies not receiving shareholder proposals. The average G-index of companies with shareholder proposals is higher than that of companies without shareholder proposals.

Based on the voting results on shareholder proposals tracked by Georgeson Inc. for 2008, some of the proposals received "For" votes for as low as 0.9%, whereas some receive "For" votes as high as 92%. So whether a company receives shareholder proposals is not a very reliable indicator on the conflicts between minority shareholders and the board. Companies with bigger size tend to have more shareholders, which increases the possibility of having a few unsatisfied activist investors who will bring up shareholder proposals. But not every proposal brought up in the annual meeting reflects the consensus of minority shareholders, so we consider the percentage "For" votes received for shareholder proposals a more appropriate measure on the discordance between the minority shareholders and the board. Boards of directors always recommend an "Against" vote for shareholder proposals. So if a shareholder proposal receives a high percentage of "For" votes in annual meeting, it reflects that there is some tension between the minority shareholders and the board.

We consider two major groups of factors that will influence the relationship between the minority shareholders and the board: corporate governance factors and performance factors. For corporate governance factors, besides the adoption of cumulative voting, which is the focus of our study, we also include number of board classes, number of block holders, percentage of stock held by block holders, percentage of stock held by directors and executive as a group, and G-index. For performance factors, we include total assets, total revenue, profit margin, and yearly stock return.

Among all the companies that received shareholder proposals in 2008, we first compare the differences between those companies who use cumulative voting in their director election process and those who use straight voting.

The non-parametric tests do not show statistically significant differences between the two groups of firms; especially we do not observe that companies that adopted cumulative voting tend to have less tension between the minority shareholders and the board. The correlation tests show similar results that the adoption of cumulative voting is not significantly related to any corporate governance choice or any performance feature.

Cumulative voting is just one of the corporate governance mechanisms that affect the relationship between minority shareholders and the board. A company that has adopted cumulative voting still has other options, such as classified board, to restrain the power of minority shareholder. A regression test is then used to determine the contribution of each corporate governance and performance factor. The result is reported in Table 1.

Table 1: OLS Regression testing the impacts of governance and performance factors

Variable	Parameter Estimate	Standard Error	t-Value	Pr > |t|
Intercept	0.207	0.095	2.17	0.0319
cv_code	-0.160**	0.075	-2.15	0.0334
BoardClass	0.028*	0.015	1.9	0.0589
Qblock	0.024**	0.012	1.99	0.0485
Holding_pblock	0.002	0.002	0.86	0.3923
HoldingDirExc	-0.005**	0.003	-1.98	0.0493
at	-1.53E-08	1.20E-07	-0.13	0.8992
revt	-5.60E-07	8.13E-07	-0.69	0.4919
pm	0.252**	0.126	2.01	0.0466
ret_y	-0.085	0.062	-1.37	0.1724
G	0.013	0.009	1.49	0.1384
N	153			
Adj. Rsq.	0.149			

*significant at the 10% level; ** significant at the 5% level; *** significant at the 1% level

The regression results indicate that after controlling the impacts of other factors, the adoption of cumulative voting now displays a negative relationship with the percentage of “For” votes received for shareholder proposals, meaning cumulative voting does have the influence of easing the tension between minority shareholders and the board. At the same time, there are other governance factors showing significant impacts on the shareholder proposal voting results as well. For example, there is a positive relationship between the number of board classes and the proposal voting result, indicating the more classified the board is, the more likely the company is to get more “For” votes for shareholder proposals.

Companies with more block holders tend to have more issues that can not be agreed upon between minority shareholders and the board. On the other hand, increased share holding of directors and executives has the impact of decreasing the discord between the two groups of investors.

On the performance factor side, only profit margin shows a statistically significant influence on shareholder proposal voting results. This result is different from evidence identified in the 1980 and early 1990s that underperforming companies are more likely to receive corporate governance proposals from investors (Romano, 2001).

In the next step, instead of focusing on the explanatory power of each single factor, we use an F-test to look at the explanatory power of governance and performance factors as groups.

Table 2: Explanatory power of governance and performance factors

Reduced Model	**F-test**	
	F-value	**Pr>F**
Reduced model for governance factors	4.55	0.0003
Reduced model for performance factors	1.59	0.18

When we drop the governance factors, the reduced model has an F=4.55, Pr.>F=0.0003; when we drop the governance factors, the reduced model has an F=1.59, Pr.>F=0.18, indicating the level of unsatisfactory of minority shareholders are more driven by the corporate governance structure of the company rather than its performance.

CONCLUSION

The main question we want to address through this research is whether cumulative voting can ease the tension between minority shareholders and the board of directors. Previous studies usually evaluate the impacts of the corporate agency problems by examining how firm value is influenced by various corporate governance structures. Our study, on the other hand, pays more attention to minority shareholders' monitoring costs.

Our research results show that discord between minority shareholders and the board of directors is mostly affected by corporate governance structure rather than company performance. This empirical evidence indicates that minority shareholders not only care about business performance of the corporation, they care about the fairness in benefit distribution as well. This is especially true for companies with more long-term minority shareholders, i.e. block holders.

We have also looked whether cumulative voting still plays an important role in corporate governance in today's business world. Cumulative voting attracted much attention in both business and academia in the '80s and early '90s. It became a less popular topic in the latest decade when more and more companies abandoned cumulative voting.

The recent credit crunch has demonstrated that minority shareholders may need to pay more attention to the policies adopted by the board of directors. The SEC is considering enforcing a proxy access rule, a process that could let certain dissenting shareholders nominate directors opposed to management without paying for the mailing and publicity costs from their own pocket as occurs in the current system. Our study finds that cumulative voting does have an impact in alleviating the confrontation between dissenting shareholders and the board of directors. This result indicates that cumulative voting is still an effective mechanism that can lower investors' monitoring cost on boards of directors.

Looking back to history, most of the companies chose to abandon cumulative voting where minority shareholders were mainly individuals. Now with the change of minority shareholder structure, it is time for regulators and companies with major minority shareholders to reconsider the adoption of cumulative voting. Most of the U.S. companies abandoned cumulative voting during the 1980s. There are few cases of adoption of cumulative voting after that period. Considering the unbalanced power between the boards and minority shareholders, it is hard to re-enact a mechanism that is not welcomed by the boards. As a result, there is no recent empirical evidence on the impact of adopting cumulative voting on stock prices. Bhagat and Brickley's positive evidence in 1984 can not be used as a sufficient evidence to claim that adopting cumulative voting will increase firm value under in the current and future business world. But considering the huge amount of resources used in shareholder campaigns, our research results show that it is an efficient choice if some companies could adopt cumulative voting. It will not only reduce investment costs for many shareholders, but will reduce the agency costs in the corporate world as well.

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