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John F. Coyle

ALTERING RULES, CUMULATIVE VOTING, AND VENTURE CAPITAL

John F. Coyle*

I. INTRODUCTION

Legal scholars have long debated the proper balance between mandatory and default rules in corporate law. One group—the contractarians—maintain that corporate law should function as an off-the-rack set of default rules that approximate, as much as possible, the rules that the transacting parties would have agreed to if bargaining were costless.[1] The contractarians are generally skeptical of mandatory rules because they interfere with the ability of the parties to decide for themselves how to organize their economic relationships. Another group of scholars—the anti-contractarians—have argued that corporate law should seek to achieve certain regulatory objectives separate and apart from the goal of private wealth maximization.[2] In order to achieve these objectives, such as the protection of uninformed investors, these scholars argue that it is necessary that corporate law contain some mandatory rules that cannot be altered by the transacting parties.[3]

In the debates between the contractarians and the anti-contractarians, the distinction between mandatory and default rules is often portrayed as binary. A rule is said to be *either* mandatory *or* default.[4] This portrayal is, however, an

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 Associate Professor of Law, University of North Carolina at Chapel Hill. I would like to thank Elisabeth de Fontenay, Tom Hazen, Rebecca Morrow, Jeff Schwartz, and Andrew Verstein for their comments on an earlier draft of this Article. I would also like to thank John Wolf and Nate Pencook for their excellent research assistance.

[1] *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 34 (1991).

[2] *See, e.g.*, Kent Greenfield & D. Gordon Smith, *Debate: Saving the World with Corporate Law?*, 57 EMORY L.J. 947, 962–63 (2008); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1762 (2006); *see also* Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703, 704 (1999) (discussing the role of mandatory rules in arbitration); W. Mark C. Weidemaier, *Toward a Theory of Precedent in Arbitration*, 51 WM. & MARY L. REV. 1895, 1933–34 (2010) (discussing the use of default rules in arbitration).

[3] There are four different types of mandatory rules in corporate law: (1) procedural, (2) power allocating, (3) economic transformative, and (4) fiduciary standards setting. Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1591–93 (1989). California's cumulative voting regime would be classified as a "power allocating" type of mandatory rule because it affects the balance of power between the shareholders vis-à-vis one another and the balance of power between the shareholders and the directors. *See id.* at 1592.

[4] *See* Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3, 6 (2006); Brett H. McDonnell, *Sticky Defaults and Altering Rules in Corporate Law*, 60 SMU L. REV. 383, 386 (2007).

oversimplification.[5] Sticky defaults—rules that may be altered only with some extra effort by the parties—constitute a middle ground between these two extremes.[6] In recent years, scholars such as Ian Ayres and Brett McDonnell have explored how legislatures can make substantive rules more or less sticky through the use of *altering rules*.[7] An altering rule is a rule that states the "necessary and sufficient conditions for displacing a default legal treatment with some particular other legal treatment."[8] A legislature may adopt an altering rule that makes it relatively easy for the parties to contract around a substantive rule. Alternatively, the legislature may adopt an altering rule that makes this task quite difficult. Through the use of more or less stringent altering rules, therefore, a legislature can move substantive rules back and forth along the continuum between pure mandatory rules and pure defaults.

On rare occasions, a single substantive rule may be subjected to multiple altering rules, as the legislature seeks to strike just the right level of stickiness. An example of such a carefully calibrated regime—and the subject of this Article—is a California rule that grants shareholders in private companies the right to elect directors via cumulative voting. This substantive rule is often described as mandatory and hence unalterable.[9] If the rule were truly mandatory, however, then technology start-ups based in Silicon Valley would routinely elect their directors via cumulative voting. They do not.[10] In fact, California's cumulative voting rule is a sticky default that *seems* mandatory to the uninitiated because it is surrounded by a bewildering array of altering rules. These altering rules severely limit the ability of the parties to contract around the cumulative voting rule. They do not, however, establish a regime of mandatory cumulative voting.

The goal of this Article is to offer a comprehensive overview of the role that altering rules play in the California cumulative voting regime and, in so doing, to

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[5] *See* Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032, 2045 (2012).

[6] *Id.* at 2087–88 ("Relative to traditional mandatory rules, sticky defaults with their impeding altering rules offer private parties greater freedom of contract. But relative to traditional defaults, sticky defaults restrict private-ordering freedom."); *see also* John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 138 (2014) (noting the utility of sticky default rules but observing that they can discourage contractual innovation).

[7] Ayres, *supra* note 5, at 2036; McDonnell, *supra* note 4, at 385.

[8] Ayres, *supra* note 5, at 2036.

[9] *See, e.g.*, Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CALIF. L. REV. 29, 41 (1987) (stating that California has adopted a regime of "mandatory cumulative voting").

[10] E-mail from Former Partner, AmLaw 100 Law Firm, to author (Oct. 1, 2015, 12:09 PM) (on file with author) (stating that the issue of cumulative voting had never come up over the course of a fourteen-year career representing start-up companies); e-mail from Partner, AmLaw 100 Law Firm, to author (Sept. 30, 2015, 3:41 PM) (on file with author) (stating that he had never seen a private company cumulative voting issue over the course of a twenty-year career representing start-up companies); *see generally* John F. Coyle & Gregg D. Polsky, *Acqui-hiring*, 63 DUKE L.J. 281, 324–26 (2013) (discussing the role that Silicon Valley attorneys play in advising entrepreneurs).

gain insights into altering rules and cumulative voting more generally. The Article proceeds in six parts. Part II provides an overview of cumulative voting. Part III offers a brief history of cumulative voting in the United States and chronicles its decline over the past few decades. Part IV surveys the current law in California as it relates to cumulative voting and describes the negative altering rules that the legislature has enacted to protect the cumulative voting rights of California-based shareholders. Part V describes the positive altering rules that enable private companies in Silicon Valley to opt out of the cumulative voting rule. Part VI offers a few observations about altering rules and the limits of cumulative voting as a means of protecting minority shareholders.

II. CUMULATIVE VOTING

There are two systems by which shareholders in the United States may elect directors. Under a system of straight voting, every shareholder is entitled to cast a number of votes equal to the number of shares that he owns for each director position.[11] To illustrate, imagine a company in which there are one hundred shares outstanding and three seats on the board. Abe owns fifty-one shares. Barrett owns forty-nine shares. Under a straight voting system, Abe may cast fifty-one votes for each of his three preferred candidates and Barrett may cast forty-nine shares for each of her three preferred candidates. When the votes are tallied, all of the candidates supported by Abe are elected to the board because each of them received more votes (fifty-one) than the candidates supported by Barrett (forty-nine). In corporations that employ a system of straight voting, a shareholder who owns a bare majority of the shares will have the power to elect all of the members of the board of directors.[12] Minority shareholders will not be able to elect anyone to the board to represent their interests if the majority opposes their election.[13]

Under a system of cumulative voting, every shareholder is entitled to cast votes equal to the number of shares that he or she owns multiplied by the number of open director positions.[14] Each shareholder is, moreover, permitted to allocate these votes among the various director candidates as he or she sees fit. Under a cumulative voting system in the hypothetical outlined above, Abe would be entitled to cast a total of 153 votes (fifty-one times three) and Barrett would be entitled to cast a total of 147 votes (forty-nine times three). If Barrett casts all of her 147 votes for a single candidate, she is guaranteed at least one seat on the board; there is no state of the word in which Abe can give each of the three separate candidates more votes than

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[11] Amihai Glazer et al., *Cumulative Voting in Corporate Elections: Introducing Strategy into the Equation*, 35 S.C. L. REV. 295, 296 (1984).

[12] *See* Sanjai Bhagat & James A. Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339, 339 (1984) ("If a group controls 51 percent of the vote, it can elect the entire board of directors by casting all of its votes for the candidate that it favors for each position.").

[13] *Id.*

[14] W. Edward Sell, *Cumulative Voting, a Seemingly Endless Debate Topic*, 2 CORP. PRAC. COMMENTATOR 23, 25, 27 (1960).

Barrett's preferred candidate. In corporations that elect directors via a system of cumulative voting, therefore, minority shareholders holding a sufficient number of shares may be able to elect one or more representatives to the board of directors even if the majority opposes their election.

The rationale for electing directors via a system of cumulative voting is that it will sometimes—though not always—enable minority shareholders to obtain board representation.[15] If cumulative voting were a mere default rule, however, then the majority could strip the minority of its right to board representation by amending the articles of incorporation to provide for straight voting. In order to ensure that the minority's cumulative voting rights are protected, proponents of cumulative voting maintain that the majority must also be forbidden from adopting a straight voting system.[16] Such a prohibition is sometimes described—not altogether accurately—as

[15] REINER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 54 (2004) ("Board seats are valuable even if a minority shareholder acting alone cannot determine corporate policy. They provide access to information, a forum for addressing minority interests, an opportunity to pressure controlling shareholders, and perhaps a real chance to shape policy by forming coalitions with independent directors on the company's board."). The fact that the minority has a seat on the board, of course, does not always mean that it will be able to shape corporate policy. *See* Hans A. Mattes, *The Burden of the Corporate Director Elected Noncumulatively*, 63 CALIF. L. REV. 463, 465 (1975) ("Board presence, the 'listening post' demanded by the protagonists of cumulative voting, does not protect minority shareholders against adverse action of a controlling faction . . . .").

[16] This Article is agnostic as to the question of whether electing corporate directors via a system of cumulative voting is good policy. The question of whether cumulative voting enhances firm value is a contested empirical question. *Compare* Bhagat & Brickley, *supra* note 12, at 350 (finding that firms that eliminated cumulative voting saw the value of their stock decrease), *and* James M. Mahoney et al., *The Differential Impact on Stockholder Wealth of Various Antitakeover Provisions*, 17 MANAGERIAL & DECISION ECON. 531, 534 (1996) (finding that firms that reduced cumulative voting rights suffered negative average abnormal returns), *with* Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 299–302 (2000) (finding that firms in which shareholder proposals to adopt cumulative voting were defeated saw an increase in their cumulative abnormal returns), *and* James Nelson, *Corporate Governance Practices, CEO Characteristics and Firm Performance*, 11 J. CORP. FIN. 197, 220 (2005) (finding that the mean abnormal return for firms that adopted cumulative voting was negative over a five-year period, whereas the mean abnormal return for firms that eliminated cumulative voting was positive). It is also possible that the market does not really care about cumulative voting one way or the other. *See* Elliott J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CALIF. L. REV. 551, 601–602 (1987) (questioning whether "event study methodology provides an appropriate technique for evaluating corporate governance decisions").

"mandatory" cumulative voting.[17] Several decades ago, this voting system was commonplace in the United States.[18] Today, it is quite rare, as discussed below.

III. A BRIEF HISTORY OF CUMULATIVE VOTING IN THE UNITED STATES

In 1870, Illinois adopted a new constitution requiring that cumulative voting be used to elect directors to the boards of Illinois corporations.[19] Over the next eighty years, a number of states followed suit and adopted laws granting shareholders the right to elect their directors cumulatively. As one scholar has written:

> The high water mark of mandatory cumulative voting as a force in American corporate law was probably the late 1940s. At that point, twenty-two states had mandatory provisions. The Banking Act of 1933 required cumulative voting for national banks. The Securities and Exchange Commission favored cumulative voting in the reorganization cases of the 1930s and 1940s. The first Model Business Corporation Act proposed by the American Bar Association, officially published in 1950 but drafted in the late 1940s, called for mandatory cumulative voting.[20]

Over the past seventy years, the tide in the United States has turned decisively against cumulative voting.[21] Whereas the first version of the Model Business

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[17] *See, e.g.*, Bhagat & Brickley, *supra* note 12, at 340, 340 n.2.

[18] *See* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 143–46 (1994) (describing the rise and fall of cumulative voting in the United States).

[19] Whitney Campbell, *The Origin and Growth of Cumulative Voting for Directors*, 10 BUS. LAW. 3, 4 (1955). *See generally* ROBERT E. WRIGHT, CORPORATION NATION 135 (U. of Penn. Press ed. 2013) (discussing voting systems used in shareholder elections during the nineteenth century); Colleen A. Dunlay, *From Citizens to Plutocrats: Nineteenth-century Shareholder Voting Rights and Theories of the Corporation*, *in* CONSTRUCTING CORPORATE AMERICA: HISTORY, POLITICS, CULTURE 72–86 (Kenneth Lipartito & David B. Sicilia eds., 2004) (further discussing voting systems used in shareholder elections during the nineteenth century).

[20] Gordon, *supra* note 18, at 145 (citations omitted).

[21] This is not true in other nations, where cumulative voting is undergoing a resurgence in popularity. In 2002, China announced that all listed firms in which a shareholder—or group of shareholders—controlled over 30% of the stock must utilize cumulative voting to ensure that the minority was represented on the board of directors. Chao Xi & Yugang Chen, *Does Cumulative Voting Matter? The Case of China: An Empirical Assessment*, 15 EUR. BUS. ORG. L. REV. 585, 588 (2014). This provision was formally codified in 2005. *Id.* In 2004, Russia adopted a rule mandating that cumulative voting be used to elect directors in all corporations, regardless of size. Gregory F. Maassen & Rilka Dragneva, *Cumulative Voting and the Protection of Minority Shareholders in the CIS*, *in* INVESTOR PROTECTION IN THE CIS: LEGAL REFORM AND VOLUNTARY HARMONIZATION 85, 87 (Rilka Dragneva ed., 2007). Cumulative voting has also gained a foothold in other countries that border Russia. Kazakhstan mandates the use of cumulative voting for all firms. *Id.* Armenia mandates its

Corporation Act mandated the use of cumulative voting, the modern incarnation of that Act makes straight voting the default rule.[22] In 2006, Congress repealed the provision in the Banking Act of 1933 that had required that directors of national banks be elected via cumulative voting.[23] Surveys have found that the number of United States corporations utilizing cumulative voting has plummeted over the past thirty years.[24]

What explains this sharp turn away from cumulative voting? Professor Jeffrey Gordon attributes this shift to opposition by incumbent managers in public companies.[25] Because cumulative voting lowers the vote threshold for obtaining a seat on a corporation's board, its use increases the chance that a group of insurgent shareholders will launch a proxy contest.[26] Even if this group fails to garner enough shares to gain control of the board outright, the acquisition of some number of board seats made possible by cumulative voting will make it easier to launch subsequent proxy fights and, in so doing, to gain control of the corporation.[27] After corporate raiders initiated a series of high-profile proxy contests against corporations with cumulative voting in the 1950s, corporate America—and the corporate bar—began

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use in corporations that have more than 500 shareholders. *Id.* Moldova does the same for corporations with more than fifty shareholders. *Id.* Kyrgyzstan makes cumulative voting the default rule for director elections. *Id.* In Brazil, the law provides that shareholders holding at least 10% of the shares can demand that directors be elected cumulatively. Érica Gorga, *Culture and Corporate Law Reform: A Case Study of Brazil,* 27 U. PA. J. INT'L ECON. L. 803, 835 (2006). Still other nations—including South Korea—make cumulative voting the default rule but allow corporations to opt out of this rule if they so choose. Hye-Sung Kim, *Corporate Elections and Shareholder Proposal Rights: From Case Studies in South Korea*, 7 U. PA. E. ASIA L. REV. 257, 282–83 (2012).

[22] *Compare* Model Business Corporation Act § 31 (1950) (requiring the use of cumulative voting), *with* Model Business Corporation Act § 7.28(b) (2010) (adopting straight voting as the default rule).

[23] Michael E. Murphy, *Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension*, 36 DEL. J. CORP. L. 121, 150–51 (2011).

[24] In 1982, a survey found that 24% of the firms listed on the New York Stock Exchange had cumulative voting. Bhagat & Brickley, *supra* note 12, at 343. In 1992, another survey found that 14% of Fortune 500 companies for which information was available used cumulative voting. Gordon, *supra* note 18, at 160. In 2013, a study conducted by the author found that less than 5% of Fortune 500 companies, for which information was available, used cumulative voting. John F. Coyle, Survey of Cumulative Voting at Fortune 500 Companies (2013) (unpublished spreadsheet) (on file with author).

[25] Gordon, *supra* note 18, at 148–60.

[26] *See id.* at 150. A proxy contest is a contest for control of the corporation in which insurgent shareholders solicit proxies in an attempt to obtain enough voting power to elect a slate of directors opposed by incumbent management. *See* THOMAS LEE HAZEN, JERRY W. MARKHAM & JOHN F. COYLE, CORPORATIONS AND OTHER BUSINESS ENTERPRISES: CASES AND MATERIALS 225–26 (4th ed. 2016); Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CALIF. L. REV. 1073, 1074 (1990).

[27] Gordon, *supra* note 18, at 148–60.

to rethink the virtues of cumulative voting.[28] So long as proxy fights and hostile takeover attempts were rare, there was no immediate need to take action. When the early 1980s saw a dramatic increase in hostile takeover activity, however, these managers began lobbying state legislatures to relax cumulative voting rules to protect local corporations from unwanted suitors.[29] These lobbying campaigns were successful. In 1980, there were nineteen states that granted shareholders the right to elect their directors cumulatively.[30] By 2016, this number had shrunk to six.[31] One of these six remaining states is California.

IV. CUMULATIVE VOTING AND NEGATIVE ALTERING RULES

State policy in California has long been strongly supportive of cumulative voting. Under California law, state agencies that own shares in private companies are required to vote as shareholders in favor of proposals to permit or authorize cumulative voting.[32] California also requires that shareholders in private companies

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[28] *See, e.g.*, Herbert F. Sturdy, *Mandatory Cumulative Voting: An Anachronism*, 16 BUS. LAW. 550, 550–51 (1961) (noting the existence of widespread opposition to cumulative voting among investment professionals).

[29] Gordon, *supra* note 18, at 154–60.

[30] These nineteen states were Arizona, Arkansas, California, Hawaii, Idaho, Illinois, Kansas, Kentucky, Mississippi, Missouri, Montana, Nebraska, North Carolina, North Dakota, Ohio, South Carolina, South Dakota, West Virginia, and Wyoming. *See* Gordon, *supra* note 18, at 181–88.

[31] These six states are Arizona, California, Hawaii, Nebraska, South Dakota, and West Virginia. ARIZ. REV. STAT. ANN. § 10-728(b) (2013); CAL. CORP. CODE § 708(a) (West 2014); HAW. REV. STAT. ANN. § 414-149 (LexisNexis 2008); NEB. REV. STAT. ANN. § 21-270 (LexisNexis 2015); S.D. CODIFIED LAWS § 47-1A-728 (Supp. 2013); W. VA. CODE ANN. § 31D-7-728 (LexisNexis 2015). California and Hawaii permit public companies to opt out of this requirement. CAL. CORP. CODE § 301.5(a); HAW. REV. STAT. ANN. § 414-149. The state constitutions in Arizona, Nebraska, South Dakota, and West Virginia require that all companies—private and public—elect their directors via cumulative voting. *See* Gordon, *supra* note 18, at 181–88. In South Dakota, a proposal to amend the state constitution to abolish mandatory cumulative voting has twice been approved by the state legislature—in 2008 and again in 2012—but the state's voters declined to approve the change. *An Amendment to the South Dakota Constitution Regarding Certain Provisions Relating to Corporations: Constitutional Amendment M*, VOTE SMART (Nov. 6, 2012), https://votesmart.org/elections/ballot-measure/1699/an-amendment-to-the-south-dakota-constitution-regarding-certain-provisions-relating-to-corporations#.VyO4F_krKM8 [https://perma.cc/7PBX-DT44]; *Repeal Certain Provisions of the State Constitution Relating to Corporations: Constitutional Amendment H*, VOTE SMART (Nov. 4, 2008), https://votesmart.org/elections/ballot-measure/82/repeal-certain-provisions-of-the-state-constitution-relating-to-corporations#.VyO46PkrKM8 [https://perma.cc/3FZ8-VTGM]. The State Bar of South Dakota is planning to put the issue on the ballot again in 2016. Telephone Interview with Law Firm Partner in Rapid City, South Dakota (May 14, 2015).

[32] *See* CAL. GOV'T CODE § 6900 (West 2008) ("Whenever any governmental body is a shareholder of any corporation, and a resolution is before the shareholders which will permit or authorize cumulative voting for directors, such governmental body shall vote its shares to

be permitted to elect their directors cumulatively. Section 708 of the California Corporations Code provides that:

> [E]very shareholder . . . entitled to vote at any election of directors may cumulate such shareholder's votes and give one candidate a number of votes equal to the number of directors to be elected multiplied by the number of votes to which the shareholder's shares are normally entitled, or distribute the shareholder's votes on the same principle among as many candidates as the shareholder thinks fit.[33]

While the statute permits public companies to opt out by amending their articles of incorporation to provide for straight voting, it denies this ability to private companies.[34]

This legislative commitment to a system of mandatory cumulative voting is reinforced by a number of altering rules. At the outset of this analysis, it should be noted that there are two different types of altering rules. Positive altering rules tell the parties *how* to change the default. Section 2-316 of the Uniform Commercial Code, for example, provides that a sales contract must mention merchantability and be conspicuous in order to exclude the implied warranty of merchantability.[35] It is a positive altering rule. Negative altering rules tell the parties that they are *prohibited* from altering the default in certain ways.[36] The majority of altering rules that affect the cumulative voting rules in California are negative altering rules that forbid the parties from taking certain actions that might have the effect of eliminating or watering down the shareholders' right to elect directors cumulatively. These negative altering rules are discussed below.

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permit or authorize cumulative voting."). The California Public Employees' Retirement System ("CalPERS"), the largest public pension fund in the United States with some $300 billion in assets under management, is therefore required under California law to vote in favor of resolutions in support of cumulative voting in companies in which it is a shareholder. CALPERS, CALPERS AT A GLANCE (2016), https://www.calpers.ca.gov/docs/forms-publications/calpers-at-a-glance.pdf [https://perma.cc/4Y85-LBR3].

[33] CAL. CORP. CODE § 708(a). Any shareholder who wishes to vote cumulatively must give notice of his or her intent to do so at the meeting prior to the voting. *Id.* § 708(b). In practice, such notice is rarely given. Most board elections are uncontested. In these cases, it doesn't matter which voting system is used because there is only a single slate of directors. The fact that cumulative voting rights are rarely formally invoked does not, however, mean that they are inconsequential. Parties bargain in the shadow of the law. It may be that minority requests for board seats are more likely to be granted in companies where cumulative voting is used. The mere possibility that a shareholder will exercise his or her cumulative voting rights, in other words, may be enough to obtain the majority's consent to the desired board representation.

[34] *Id.* § 301.5 ("A listed corporation may, by amendment of its articles or bylaws, adopt provisions to . . . eliminate cumulative voting . . . .").

[35] U.C.C. § 2-316(2) (AM. LAW INST. & UNIF. LAW COMM'N 2012).

[36] *See infra* notes 39, 47, 50, 53 and accompanying text (discussing negative altering rules in the context of cumulative voting in California).

A. Section 2115: Pseudo-Foreign Corporations

One possible means of evading a corporate law rule is to incorporate in another state. The internal affairs rule has long held that a corporation's state of incorporation shall govern all matters affecting the internal affairs of the corporation.[37] If one wanted to start a business in California and elect directors via a system of straight voting, therefore, this goal could ordinarily be achieved by incorporating in one of the many U.S. jurisdictions that do not require that cumulative voting be used to elect directors.[38]

The California legislature long ago foresaw this possibility and took steps to block it. The legislature enacted a statute—Section 2115—that provides that California corporate law shall apply to govern the internal affairs of out-of-state corporations so long as the corporation in question has sufficiently close ties to California.[39] This means that cumulative voting rights are available to California resident shareholders even if the private company in which they own shares is incorporated under the laws of another state.[40] The effect of this statutory provision is to limit the ability of a majority shareholder to evade the state's cumulative voting rules by incorporating elsewhere.[41] The fact that most start-up companies in Silicon

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[37] RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 302–10 (1971).

[38] *See* Ralph E. Axley, *The Case Against Cumulative Voting*, 1950 WIS. L. REV. 278, 285 (discussing possibility of incorporating in another state to evade a rule of mandatory cumulative voting).

[39] Under Section 2115, the corporate law of California shall be applied to a company organized under the law of another state where "(1) the corporation transacts more than half of its business (as measured by various objective criteria) in California, and (2) a majority of the voting securities are held by California residents." Greb v. Diamond Int'l Corp., 295 P.3d 353, 357–58 (Cal. 2013) (citing CAL. CORP. CODE § 2115 (West 2014)).

[40] *See* Wilson v. Louisiana-Pacific Res., Inc., 187 Cal. Rptr. 852, 854 (Ct. App. 1982) ("California may constitutionally impose its law requiring cumulative voting by shareholders upon a corporation which is domiciled elsewhere but whose contacts with California . . . are greater than those with any other jurisdiction.").

[41] In recent years, courts in other states have suggested that Section 2115 is unconstitutional because it violates the dormant foreign commerce clause. *See* VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1113–14 (Del. 2005). Although some lower courts in California have expressed some sympathy for this position, *see, e.g.*, Lidow v. Superior Court, 141 Cal. Rptr. 3d 729, 737 (Ct. App. 2012), the California Supreme Court has continued to enforce Section 2115. *See Greb*, 295 P.3d at 357–58. Companies incorporated in other states continue, moreover, to caution their shareholders that they may be subjected to a cumulative voting requirement pursuant to Section 2115 if they are headquartered in California. *See* Cryoport, Inc., Registration Statement (Form S-1) (July 23, 2015) ("Even though we are not incorporated in California, we may become subject to a number of provisions of the California General Corporation Law . . . . If we become subject to Section 2115(b), we may be required to permit cumulative voting if any stockholder properly requests to cumulate his or her votes.").

Valley are incorporated in Delaware, therefore, cannot by itself explain why cumulative voting is virtually unknown in Silicon Valley.

To be clear, this particular altering rule does not apply exclusively in the cumulative voting context. It applies to any attempt by a California-based corporation to contract around any rule of California corporate law by incorporating elsewhere.[42] In practice, however, courts and commentators have recognized that one of the most important consequences of this rule is its impact on cumulative voting rights.[43] In this respect, Section 2115 functions as an important negative altering rule with respect to cumulative voting.

B. Section 301: Staggering the Board

Another way to render a cumulative voting regime less effective is to stagger a corporation's board.[44] If all nine directors on a corporate board stand for election annually, then a minority shareholder must own or control only 11% of the shares to be assured of electing at least one director. If the terms of these nine directors are staggered, so that only three directors come up for election in any given year, then a minority shareholder must own or control at least 26% of the shares to be assured of electing at least one director.[45] A majority shareholder may, therefore, substantially dilute the impact of a cumulative voting requirement by instituting a staggered board in which not all the directors stand for election in any one year.[46]

California has addressed this loophole—and buttressed the quasi-mandatory nature of its cumulative voting regime—by forbidding private companies from staggering their boards. Under Section 301 of the California Corporations Code, all corporate directors in private companies in California must stand for election

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[42] *See supra* note 39 and accompanying text.

[43] *See, e.g.*, W. Air Lines, Inc. v. Sobieski, 12 Cal. Rptr. 719, 729 (Ct. App. 1961); John W. Edwards II, *Busy Bees and Busybodies: The Extraterritorial Reach of California Corporate Law*, 11 U.C. DAVIS BUS. L.J. 1, 25–30 (2010).

[44] For cases discussing attempts to evade cumulative voting rules by staggering the board, see McDonough v. Copeland Refrigeration Corp., 277 F. Supp. 6, 6–9 (E.D. Mich. 1967); Stockholders Comm. for Better Mgmt. of Erie Tech. Prods., Inc. v. Erie Tech. Prods., Inc., 248 F. Supp. 380, 384–89 (W.D. Pa. 1965); Bohannan v. Corp. Comm'n, 313 P.2d 379, 380 (Ariz. 1957); Humphrys v. Winous Co., 133 N.E.2d 780, 783–89 (Ohio 1956); *see also* Wolfson v. Avery, 126 N.E.2d 701, 704–12 (Ill. 1955) (holding that statute allowing for election of staggered board violated constitutional guarantee of cumulative voting); Edmund A. Stephan, *Cumulative Voting and Classified Boards: Some Reflections on* Wolfson v. Avery, 31 NOTRE DAME LAW. 351, 356–59 (1956).

[45] The mathematics of cumulative voting can be quite complicated. *See* Glazer et al., *supra* note 11, at 305 (using D'Hondt Remainders Table to formulate optimal cumulative voting strategy); Lewis R. Mills, *The Mathematics of Cumulative Voting*, 1968 DUKE L.J. 28, 30 (correcting math errors in the most widely used formula for solving mathematical problems of cumulative voting).

[46] *See* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 38 (Del. Ch. 2010).

annually.[47] The effect of this negative altering rule is, again, to limit the ability of a majority shareholder to contract around the general rule that California shareholders be permitted to elect their directors cumulatively.

C. Section 212: Reducing the Number of Directors

Still another way to limit the impact of cumulative voting rights is to reduce the number of directors who serve on the corporation's board.[48] As the number of directors decreases, the size of the minority stake necessary to elect at least one director goes up.[49] If the majority shareholder were to amend the articles or the bylaws to dramatically reduce the size of the board, this would make it more difficult for the minority to elect a director via cumulative voting. In recognition of this fact, the California state legislature long ago enacted a law requiring that any proposal to reduce the size of the board to fewer than five directors must be approved by at least 83.3% of the shareholders.[50] The effect of this negative altering rule is, like the two discussed above, to limit the ability of a majority shareholder to contract around the cumulative voting requirement adopted by the California state legislature.

D. Section 303: Removing Directors

As a last resort, a majority shareholder may seek to limit the minority's ability to elect a director via cumulative voting by acting to remove any director elected by

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[47] CAL. CORP. CODE § 301 (West 2014). In 1989, California amended its Corporations Code to allow California corporations that are listed on a national securities exchange to stagger their boards. *See id.* §§ 301.5(a), 708.5(b).

[48] *See* Note, *Cumulative Voting and Classification of Directors—The* Wolfson *and* Winous *Cases*, 30 ST. JOHN'S L. REV. 83, 85 (1955) (discussing connection between the board-shrinking rule and cumulative voting); Comment, *Cumulative Voting—Removal, Reduction and Classification of Corporate Boards*, 22 U. CHI. L. REV. 751, 753–54 (1955) (same).

[49] *See* Stone v. Auslander, 212 N.Y.S.2d 777, 778, 781 (N.Y. 1961) (upholding the reduction in board size from 14 to 7 against a challenge that it diluted cumulative voting rights).

[50] CAL. CORP. CODE § 212(a). Significantly, this particular rule applies only to attempts to *shrink* the board. Under California law, a private corporation may have fewer than five directors so long as the lower number is set at the time the corporation is created. *See id.* In Hawaii and West Virginia, two other states that mandate the use of cumulative voting in some contexts, the board is permitted to decrease the number of directors last approved by the shareholders only by a maximum of 30%. *See* HAW. REV. STAT. ANN. § 414-193 (LexisNexis 2008); W. VA. CODE ANN. § 31D-8-803 (LexisNexis 2015). A Hawaiian or West Virginian company with a nine-member board, for example, could reduce the number of directors serving on that board to seven (a 22% reduction) but not to six (a 33% reduction). These rules—like the California rule—are intended to protect the cumulative voting rights of the minority.

the minority from the board.[51] If a director may be removed by a simple majority vote, then this gambit is likely to be successful.[52] However, California has enacted a law—section 303 of the California Corporations Code—that specifically provides that no director may be removed if the number of votes cast against removal would be sufficient to elect the director in an election in which cumulative voting was used.[53] In this way, the legislature sought once again to use a negative altering rule to ensure that the cumulative voting rule could not be undermined through the use of the removal power.

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Each of the four rules outlined above—the mandate that California corporate law be applied to out-of-state corporations with a close connection to California, the requirement that directors stand for election annually, the limitations on reducing the size of the board, and the constraints on director removal—is a negative altering rule that makes it difficult to contract around the California cumulative voting rule. The California Corporations Code also contains several positive altering rules that tell corporate actors how to opt out of this rule. These positive altering rules—which are regularly used by Silicon Valley attorneys to evade the cumulative voting rule—are discussed in the next Part.

V. CUMULATIVE VOTING AND POSITIVE ALTERING RULES

Lawmakers in the United States have long recognized the right of shareholders to enter into agreements relating to their rights and interests as shareholders.[54] Section 706 of the California Corporations Code specifically provides that, "*[n]otwithstanding any other provision of this [Code]*, an agreement between two or more shareholders of a corporation, if in writing and signed by the parties thereto, may provide that in exercising any voting rights the shares held by them shall be voted as provided by the agreement . . . ."[55] This statute is a positive altering rule that permits shareholders to contract around virtually any provision in the California

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[51] CAL. CORP. CODE § 303. California has long been recognized as a jurisdiction that is exceptionally committed to preserving the cumulative voting rights of minority shareholders. CHARLES M. WILLIAMS, CUMULATIVE VOTING FOR DIRECTORS 61 (1951) ("[I]t appears that only California with its requirement of annual elections, and with its curbs on the removal of directors and a partial restriction on the reduction of directors, has established a cumulative provision with 'real teeth.'").

[52] Campbell v. Loew's, Inc., 134 A.2d 852, 858 (Del. Ch. 1957) (stating that shareholders have an inherent right to remove a director elected via cumulative voting for cause).

[53] CAL. CORP. CODE § 303(a)(1).

[54] *See, e.g.*, Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 53 A.2d 441, 448 (Del. 1947) (enforcing a shareholder agreement in a corporation that elected directors using cumulative voting).

[55] CAL. CORP. CODE § 706(a) (emphasis added).

Corporations Code by entering into a separate shareholder agreement. It is therefore possible for a minority shareholder to bargain away her right to elect directors cumulatively by entering into a shareholder agreement with another shareholder.

The existence of this rule goes a long way toward explaining why cumulative voting is all but unknown in Silicon Valley. When a venture capital fund invests in a start-up, it will typically demand that all—or virtually all—of the company's shareholders enter into a voting agreement. In this agreement, the signatories agree on how they will vote their shares in board elections.[56] A particular agreement may, for example, require the shareholder signatories to vote their shares in support of (1) the company's CEO, (2) a person designated by a particular investor, and (3) a shareholder with a significant interest in the company. The effect of these voting agreements is to determine the composition of the board of directors purely as a matter of contract law and, in so doing, to nullify cumulative voting rights.[57] Any contracting shareholder who attempted to invoke his right to elect directors cumulatively would find himself blocked by the voting agreement.

Why has the California legislature given its blessing to this particular positive altering rule? It is most likely because shareholder agreements typically serve to further the goal of providing for minority representation on the board. Indeed, a venture capitalist investing in an early-stage technology company is itself typically a minority shareholder whose representation on the board is assured by means of a shareholder agreement. If the goal of achieving minority representation is achieved, and if this is done with the consent of the minority shareholders whose interests are affected, then the legislature is indifferent as to whether this goal is achieved via cumulative voting or a shareholder agreement.

While the use of a shareholder agreement is the most straightforward means of contracting around the cumulative voting rule, there are two other devices by which private actors may achieve this same end. First, there is no California law mandating that LLCs use cumulative voting.[58] One can, therefore, contract around California's cumulative voting rules by organizing a new business as an LLC rather than a corporation.[59] Second, the effect of the cumulative voting rule may be diluted by creating a dual-class board in which each class of shares is entitled to elect a specified number of directors to the board.[60] The creation of dual-class board can dilute a shareholder's cumulative voting rights in much the same manner as a

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[56] *See* AMENDED AND RESTATED VOTING AGREEMENT § 1.2 (NAT'L VENTURE CAPITAL ASS'N 2014) (model voting right agreement). These agreements also subject the shareholder signatories to "drag-along rights" that require all of the signatories to sell their shares if a majority of the stockholders vote in favor of a sale to a third party. *See id.* § 3.2.

[57] *See* E.K. Buck Retail Stores v. Harkert, 62 N.W.2d 288, 295, 308 (Neb. 1954) (upholding a shareholder voting agreement against a challenge that it contravened the cumulative voting rights of other shareholders).

[58] *See* CAL. CORP. CODE § 17704.07(r).

[59] *See id.* § 1151.

[60] *Id.* § 301(a) ("The articles may provide for the election of one or more directors by the holders of the shares of any class or series voting as a class or series.").

staggered board.[61] Although California corporate law specifically forbids private companies from staggering their boards, it does not forbid these same companies from creating dual-class boards.[62] When a venture capital fund invests in a technology start-up, therefore, it will typically insist that the company's articles of incorporation be amended to create a dual-class board and to give the holders of the preferred stock—the venture capital fund—the power to elect a certain number of directors to that body.[63] The result is a dilution of the common shareholders' cumulative voting rights that is nowhere expressly forbidden under California law.

VI. THE LIMITS OF CUMULATIVE VOTING (AND ALTERING RULES)

In California, the legislature went to great lengths to craft a cumulative voting regime that was very sticky but not quite mandatory. It surrounded its cumulative voting rule with an array of negative altering rules that foreclosed several means of contracting around it. At the same time, it enacted a positive altering rule that specifically permitted the parties to opt out of this rule by entering into a shareholder agreement.[64] In the annals of altering rules and sticky defaults, this particular scheme represents an impressive legislative effort to calibrate the precise stickiness of a particular rule.[65] This balanced regime notwithstanding, cumulative voting does not appear to play a meaningful role in contemporary corporate practice in Silicon Valley or, indeed, the rest of California.[66] This irrelevance is not attributable to any altering rules. It is instead attributable to the creation of new causes of action that arguably protect the rights and interests of minority shareholders in private companies more effectively than does cumulative voting.[67]

Cumulative voting, it will be recalled, seeks to protect the rights and interests of minority shareholders by making it easier for them to gain board representation.[68] There are, however, at least two other devices by which the rights and interests of

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[61] *See* Diamond v. Parkersburg-Aetna Corp., 122 S.E.2d 436, 444 (W. Va. 1961).

[62] It is not altogether clear whether dual-class boards are compatible with cumulative voting in California. That fact that the relevant portion of the dual-class board statute lacks the "[n]otwithstanding any other provision of [this Code]" language that is contained in section 706 suggests that they are not. The fact that courts in other jurisdictions have held that the creation of dual-class boards does not offend cumulative voting rules suggests that they are. *See id.* at 446–47. The issue does appear to have ever been litigated in California.

[63] *See* AMENDED AND RESTATED CERTIFICATE OF INCORPORATION § 3.2 (NAT'L VENTURE CAPITAL ASS'N 2013) (model certificate of incorporation). There are, to be sure, many reasons to create a dual-class board. In many cases, these reasons will have little to do with cumulative voting rules.

[64] CAL. CORP. CODE § 706(a).

[65] McDonnell, *supra* note 4, at 435 ("In many, though not all, cases, an intermediate degree of stickiness will lead to a better outcome than would either of the extremes.").

[66] The virtual absence of case law in the California Appellate Reports relating to cumulative voting over the past thirty years suggests that shareholders in California rarely invoke their right to elect directors cumulatively.

[67] KRAAKMAN ET AL., *supra* note 15, at 54–57.

[68] *Id.*

the minority may be protected.[69] First, the courts in many states, including California, have held that majority shareholders owe fiduciary duties to minority shareholders as a matter of common law.[70] Second, the legislatures in many states, including California, have enacted so-called "oppression" statutes that give minority shareholders a right of action against majority shareholders who engage in persistent unfairness toward the minority.[71] Each of these legal rules protects the rights and interests of the minority at least as well, if not better, than the protections enshrined in a cumulative voting regime. While cumulative voting may give the minority the ability to elect a director, it will not give the minority the ability to dictate corporate policy; the minority director is almost certain to be outvoted by the other directors when a disagreement arises. By comparison, a cause of action for oppression or breach of shareholder fiduciary duties gives the minority the ability to force the majority to buy out the minority's equity stake.[72] In the vast majority of shareholder disagreements, the right to be bought out is likely to be perceived as more useful than the right to board representation.

If a substantive legal rule is not viewed as particularly useful as compared to the available alternatives, then it is of little moment whether that rule is optimally situated on the continuum between pure mandatory rules and pure defaults. In this respect, the cumulative voting regime in California is something of a fossil preserved in amber. The legislature used altering rules to protect a substantive rule that was believed to be critically important in protecting minority shareholders in private companies. When this substantive rule was subsequently discovered to be of somewhat limited utility as compared to the alternatives, the complex web of altering rules intended to protect was transformed into a relic of a bygone age. What remains is a legal regime that highlights the myriad ways in which altering rules may be used

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[69] Debra R. Cohen, *West Virginia Corporate Law: Is it "Broke"?*, 100 W. VA. L. REV. 5, 44 (1997) ("Eliminating mandatory cumulative voting does not necessarily mean eliminating shareholder protection. Many other mechanisms can protect minority shareholders.").

[70] *See* Stephenson v. Drever, 947 P.2d 1301, 1307 (Cal. 1997) (noting that the California courts long ago rejected the rule that "majority shareholders owed no fiduciary duty to minority shareholders absent reliance on inside information" and that "[m]ajority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority") (quoting Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969)).

[71] *See* CAL. CORP. CODE § 1800(b)(4); Sturdy, *supra* note 28, at 558. Over the past several decades, all of the states that continue to mandate the use of cumulative voting in one form or another have enacted "oppression" statutes. *See* ARIZ. REV. STAT. ANN. § 10-1430(B)(2) (2013); HAW. REV. STAT. ANN. § 414-411(2)(B) (2008); NEB. REV. STAT. ANN. § 21-2,197(a)(2)(B) (LexisNexis 2015); S.D. CODIFIED LAWS § 47-1A-1430(2)(b) (2007); W. VA. CODE ANN. § 31D-14-1430(2)(B) (LexisNexis 2015). California has granted LLC members a cause of action for oppression that is broadly similar to the cause of action that it confers on corporate shareholders. *See* CAL. CORP. CODE § 17707.03(b)–(c).

[72] *See* CAL. CORP. CODE § 2000. While these protections may be waived ex post, neither may be bartered away ex ante. *See* Neubauer v. Goldfarb, 133 Cal. Rptr. 2d 218, 223–27 (Ct. App. 2003).

to calibrate the precise stickiness of a rule while simultaneously demonstrating that this act of calibration makes little difference if the underlying substantive rule has fallen into disuse.