Cumulative versus Straight Voting

The key unique feature of common stock is that it offers common stockholders the voting right on major corporate decisions such as election of directors to the Board, approval of merger and acquisition decisions, etc. Voting rights are the most important control device of common stockholders as the Board of directors play the crucial role of corporate governance by setting corporate policies and selecting the senior management team.

Directors are elected each year at an annual meeting by a vote of common stockholders who are present in person or via proxy (i.e., proxy voting). The exact mechanism varies across companies according to their bylaws. The important difference is whether the election or decision is to be voted cumulatively or straight.

The effect of cumulative voting is to permit participation of minority shareholders in corporate governance via the director representating their interests being elected to the Board.

- Under cumulative voting, the directors are all elected at once. Usually, total votes that each shareholder may cast equal the number of shares they own times the number of directors to be elected. **Each shareholder can distribute their votes over one or more candidates.** In general, if N directors are to be elected, it takes [1 / (N+1) percent of total shares + 1 share] to assure a deciding vote for one directorship.

Straight (majority) voting works like a U.S. political election.

- Under straight voting, the directors are elected one at a time, and every share gets one vote. Hence, **the maximum number of votes a shareholder can cast for any one candidate is the number of shares owned.** Straight voting with a majority rule has the unintended side effect of freezing out minority shareholders.

Example 1

Imagine a firm with two shareholders: A and B

1. A owns 60% of the firm (= 600 shares) and B owns 40% (= 400 shares).

2. There are three seats up for election on the board.
    - Under straight voting, A may cast 600 votes for each candidate and as a result, he gets to pick all three seats.
    - Under cumulative voting, B has 1,200 votes (= 400 shares × 3 seats) and A has 1,800 votes.
    - If B gives all her votes to one board member candidate, she can elect at least one board member.

Example 2

Mike owns 750 shares of Company ABC. Currently, the shareholders of ABC are in the process of electing three new directors to the company's board. Mike would like to be elected as one of the new directors.

1. How many votes can Mike cast for himself if the firm uses straight voting? If the firm uses cumulative voting?
    - Straight voting: 750
    - Cumulative voting: 750*3=2,250
2. Can Mike get himself elected in either situation if there are 2,200 shares of stock outstanding?

Straight Voting:	
Total votes per position	2,200
Less: Mike's votes for him	750
Votes available from other shareholders	2,200-750=1,450
Cumulative Voting:	
Total votes for all position	2,200*3=6,600
Less: Mike's votes for himself	2,250
Votes available from other shareholders	4,350

So Mike cannot guarantee himself a seat under straight voting because for each director position, Mike's 750 votes are outnumbered by other shareholders' 1,450 votes.

However, Mike can be assured of being elected under cumulative voting because when Mike casts all of his 2,250 votes for himself, other shareholders

do not have enough votes to outnumber Mike in all three director positions. In this case that Mike owns more votes than the number of shares outstanding, Mike can lock in for one position on the Board as he chooses to be.

Practice Question

Shareholders of the Unicorn Company need to elect seven new directors. There are 2 million shares outstanding. How many shares do you need to own to be certain that you can elect at least one director under: (a) straight voting? (b) cumulative voting?

Answer:

1. Straight voting: You need more than half of the outstanding shares to guarantee a seat.
2. Cumulative voting: Under cumulative voting, each shareholder has 7 votes (one for each director) for each share of common stock they own. There are a total of 14 million votes (7 × 2 million) when 7 directors are up for election.

With N shares, you can cast (N shares × 7) = 7*N votes. This leaves (14,000,000 – 7*N) votes to the remaining shareholders. To ensure the election of a single director, you need at least one share more than 1/7th of these remaining votes:

$$7*N > (14,000,000 - 7*N) / 7 \Longrightarrow N > 250,000 \text{ shares}$$

Therefore, you need at least (250,000+1 =) 250,001 shares to guarantee a seat.

This solution may not be intuitive to some students. So, to clarify, suppose there are only two shareholders. You own 250,001 shares, and your opponent owns the remaining 1,749,999 shares. With 7 directors to be elected, you have 1,750,007 (7*250,001)votes, and the other shareholder has 12,249,993 votes. Since you can cast 1,750,007 votes for yourself, to preclude you from winning, your opponent must cast 1,750,008 votes. If your opponent cast 1,750,008 votes for each of the first six candidates, he would have used up 10,500,048 (6*1,750,008)votes, with only 1,749,945 votes left (12,249,993 – 10,500,048) for the last (seventh) seat. Since you have more votes than your opponent for the last director spot, i.e., your 1,750,007 votes versus his 1,749,945 votes, you are certain that you can elect at least one director to the Board!

In summary, the cumulative voting approach suggests that an investor needs [1/(N+1) percent of total shares + one share] to guarantee a seat.