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COOPERATIVES AND CONDOMINIUMS

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Cumulative Voting Revisited

With the annual meeting season now under way for many co-ops and condominium associations, cumulative voting remains a concern for those using this system. Over 12 years ago, we wrote on this topic.[1]

This column reexamines the issue and provides guidance and recommendations for boards seeking to eliminate cumulative voting, diminish its impact or hold an election of directors governed by cumulative voting.

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What Is Cumulative Voting?

It is a system permitting minority shareholders to concentrate their votes to secure representation on a board. Each shareholder is entitled to multiply the number of shares owned by the number of directors to be elected and cast the product for one or more candidates.[2]

Cumulative voting in co-ops is only effective if provided for in the certificate of incorporation.[3] As the Court of Appeals has held: "the voting rights of stockholders fixed by the corporate charter are immune from change except by amendment of the certificate of incorporation."[4] For condominiums, the provision must be in the bylaws.

The policy underlying cumulative voting—empowering minority shareholders to elect directors protective of their interests—presents special problems for co-ops and condominiums. Their boards are generally comprised of building residents who serve without compensation. Unlike a public corporation, with diverse shareholder interests,[5] co-op and condominium boards expect a unity of interest and collegiality that fosters efficient management—goals at odds with board dissension and the resulting strife between neighbors. Therefore, boards generally seek to minimize the impact of cumulative voting.

Eliminating Cumulative Voting

Under Business Corporation Law (BCL) §803, board approval and a majority vote of shares is required to amend the certificate of incorporation to eliminate cumulative voting.[6] This may be difficult to attain. Shareholders may be reluctant to give up potential minority representation and boards may be apprehensive about alienating shareholders with a threat of diminished rights.[7] Further, appraisal rights of dissenting shareholders pose a serious obstacle to eliminating cumulative voting.

Elimination of a substantial shareholder right permits a dissenting shareholder to exercise appraisal rights under BCL §§623 and 806.[8] Under BCL §806, a dissenting shareholder is entitled to a judicial appraisal of the fair value of the shares and can compel the corporation to purchase them at their appraised value if the amendment to the certificate of incorporation adversely affects the shareholder's interest.

• *Application of New York Hanseatic Corp.*[9] remains the leading New York case on eliminating cumulative voting and triggering appraisal rights. It holds:

> the right to cumulative voting is a valuable one for minority shareholders….The taking away of this right…constitutes the elimination of a substantial right which…entitles the affected common stockholder to an appraisal of their stock under the provisions of the Stock Corporation Law.[10]

No New York court has considered this issue since 1951 and the *Hanseatic* decision is cited as the authority by courts and treatises.[11]

However, there are fundamental differences between business corporations and co-ops that makes appraisal rights more complex in the co-op context. Co-op residents own shares in a corporation, while the corporation holds title to the real property. Proprietary leases permit shareholders to occupy apartments in the co-op's building. New York case law holds

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that co-op leaseholds and share interests are inseparable.[12]

When shareholders turn in their shares to the co-op after an appraisal, they must also relinquish occupancy of their apartment. Is the co-op then obligated to pay the fair market value of the apartment, i.e., the shares plus the leasehold? No New York court has decided whether elimination of cumulative voting in a co-op triggers appraisal rights. However, the possibility that appraisal rights may be invoked is a strong deterrent to co-op boards seeking to eliminate cumulative voting.

A board may consider seeking a declaratory judgment determining whether elimination of cumulative voting triggers appraisal rights. In *Standard Brewing Co. v. Peachey*,[13] the court held that such a judgment was "practical and useful [and] would permit the plaintiff corporation to chart its future course with a knowledge of its rights and liabilities."[14] However, a board should consider the potentially high cost of such a proceeding and whether eliminating of cumulative voting is an appropriate use of corporate funds.

In condominiums, unit owners do not own shares in the condominium association. Therefore, no appraisal rights are triggered if cumulative voting is eliminated. However, doing so requires a two-thirds vote of unit owners to amend the bylaws[15] which may be difficult to attain. Short of eliminating cumulative voting, boards can implement strategies that reduce its impact.

The Staggered Board

"Classification" or "staggering" of directors is one method of minimizing the impact of cumulative voting. BCL §704 permits the certificate of incorporation or a bylaw adopted by shareholders to provide that directors may be divided into two, three or four classes, as equal in number as possible.[16] The term of the first class initially classified expires at the next annual meeting; the second class at the second annual meeting; and so on. After the initial classification, each director serves for the same number of years as there are classes. This means that each year, only one-half, one-third or one-quarter of the board is up for election. By reducing the number of directors elected at one time, the likelihood that minority shareholders can elect a director by cumulating votes is mathematically reduced.

Last-minute floor nominations from minority shareholders can defeat a board's strategy to elect the maximize number of directors. This is best dealt with by a bylaw requiring nomination of all candidates at a specified time prior to the election —for example, seven days before the meeting—by written notice to the co-op's secretary. The board then knows who is running and can determine for whom to cast its votes.

The majority may also be able to maintain control by taking a "second look" after all votes have been cast, but before the polls are declared closed. New York law gives shareholders and proxies the right to change their votes until the polls are declared closed. Theoretically, after the votes have been cast, but before the polls are closed, management may take a "second look" at the voting results and adjust its votes accordingly.

While there is no legal authority to support or condemn this approach, it appears unfair to shareholders who do not control closing the polls and who anticipate that votes will be counted as originally cast. Board members considering this approach must be cognizant of possible undesirable consequences—a court challenge by dissident shareholders, legal expenses and ill-will and contention among shareholders.

Proxies

Before the election, management should prepare a strategy that accounts for the uncertainties and procedural hurdles of an election under cumulative voting. New York law does not require shareholders to notify management that they intend to vote cumulatively. Therefore, a board should craft the wording of its proxy solicitation to give it maximum flexibility during the election.[17]

Proxies should not require the holder to vote only one way. In *Heffner v. Union National Bank and Trust Co.*,[18] the proxy committee for the management slate of directors determined to give fewer votes to certain candidates to maximize the number of slate members elected. The U.S. Court of Appeals for the Third Circuit held that proxies stating that votes would be cast for the 15 listed candidates did not confer authority to vote for only 13 of those 15. Imprecise language in management's proxy defeated its strategy. A broad grant of power will also avoid questions of irregularity if proxy holders change strategy during the election. The slightest appearance of irregularity may invite a challenge to an election.[19]

To avoid such problems, the proxy statement and the proxy itself should clearly state that proxy holders may apportion their votes in any manner they see fit, using language similar to the following:

> If no contrary instruction is indicated, proxies in the enclosed form will be voted at the meeting for any or all of the nominees above. Should the number of votes given to the proxy holders selected by the Board permit the election of less than all of these individuals, the proxy holders will vote the shares for those whom the proxy holders, in their discretion, believe can best serve the Corporation, unless instructions to the contrary are provided by the shareholder on the proxy. (This means that the proxy holders may cast all votes for a single director or may distribute them among any two or more of them as the proxy holders see fit, up to the maximum number to be elected.)

Voting Formulas

Under cumulative voting, shareholders

may cast all of their votes for one candidate or distribute their votes among the directors to be elected. The formula to determine the number of shares necessary to elect a majority of directors

Table 1

$$X = \frac{Y \times N^1}{N + 1} + 1$$

X — # of shares needed to elect a given # of directors
Y — total # of shares at meeting
N^1 — # of directors desired to elect
N — total # of directors to be elected

is shown in Table 1.

The formula to determine how many directors can be elected by a group controlling a certain number of shares

Table 2

$$X = \frac{X \times (D+1)}{S}$$

N — # of directors that can be elected
X — # of shares controlled
D — total # of directors to be elected
S — total # of shares that will be voted at meeting

is shown in Table 2.

For example, assume there are 33,396 outstanding shares and nine directors to be elected. If all shares are voted, 3,341 votes would be needed to elect one director, 6,680 votes to elect two directors, and so on. If a group of shareholders controls 17,000 votes, they would be able to elect five directors.

However, with a staggered board, the number of votes required to elect a single director is markedly higher. Assume a nine-member board divided into four classes, with three classes of two members and one class of three members. Assuming that 33,396 shares are voted, 11,132 votes would be needed to elect a director in a class of two and 8,349 votes to elect a director in a class of three. Thus, electing one director in a class of two members would require almost 34 percent of total votes and 25 percent of total votes in a class of three members, a difficult undertaking for minority shareholders.

Before the election, it is advisable for boards to make calculations based upon several different permutations to ensure mistake-free voting. However, before any calculations can reliably be made, it is essential to know the number of shares that will be voted. It is, therefore, critical to obtain a final count of shares present and voting at the election portion of the co-op or condominium voting, because shareholder or unit owners may come and go as the meeting progresses. The best way to do so is to require a role call of those present and meeting, in person or by proxy, immediately preceding the election portion of the meeting.

Co-ops and condominium associations will have great difficulty in eliminating a cumulative voting system. However, following recommended strategies can limit its impact. First, bylaws should be amended to provide for staggered boards, thereby substantially increasing the number of votes required to elect a director. Bylaws should also be amended to require advance notice of nominations. This will identify all candidates and allow boards to reliably determine how best to cast their votes. Lastly, proxies should be crafted to give boards maximum flexibility to achieve the goals of the shareholders they represent.

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1. See, Siegler, "Cumulative Voting," NYLJ, Jan. 8, 1992 at 3, col. 1. There have been few new legal developments in this area. However, a meaningful number of co-ops are governed by cumulative voting and the need for guidance by their boards and managing agents warrants revisiting the issue.

2. 3 White, New York Corporations, §618.02-03.

3. N.Y. Bus. Corp. Law §704(a) (McKinney 2003). See also, e.g., *Christal v. Petry,* 275 A.D. 550 (2d Dept. 1949), aff'd, 301 N.Y. 562 (1950); *Matter of American Fibre Chair Seat Corp.,* 265 N.Y. 416 (1934). An exception to the general rule is *Thistlewaite v. Thistlewaite,* 101 N.Y.S.2d 679 (Sup. Ct. Monroe Co. 1950), where cumulative voting was provided for only in the bylaws. There, the court required the directors to amend the certificate to allow for such voting because the bylaws stated: "the shareholders hereby agree with each other to execute any papers or to do any act necessary to give legal effect to the above provision as to cumulative voting." 101 N.Y.S.2d at 681. Without similar language, a bylaw providing for cumulative voting will be invalid.

4. *Matter of American Fibre Chair Seat Corp.,* 265 N.Y. 416, at 422.

5. Although it originated in the public corporation, cumulative voting is almost unheard of in the modern corporate setting, notwithstanding periodic calls for its reinstatement. See, e.g., Jeffrey N. Gordon, "Institutions as Relational Investors: A New Look at Cumulative Voting," 94 Colum. L. Rev. 124 (1994).

6. N.Y. Bus. Corp. Law §803(a) (McKinney 2003 & Supp. 2005).

7. See, Siegler, "Modern, Flexible By-Laws," NYLJ, May 2, 1990 at 3, col. 1.

8. N.Y. Bus. Corp. Law §623 (McKinney 2003), sets forth detailed procedural requirements in connection with the enforcement of appraisal rights. Note that the failure of a dissenting shareholder to strictly comply with each of these procedural requirements is grounds for immediate dismissal of the claim, unless the New York Supreme Court, for good cause shown, directs otherwise.

9. 200 Misc. 530 (Sup.Ct. King's Co. 1951).

10. Id. at 536. *Hanseatic* was decided under the Stock Corporation Law, the predecessor to the BCL. However the legislative history to BCL §806 indicates an intention to continue the existing case law. See BCL §806, Historical and Statutory Notes (McKinney 2003), citing to a note appended to L.1966, c.869, which provides: "This bill (amending this section) restores the law to what is was under §38(11) of the (former) Stock Corporations Law. It neither expands nor diminishes the right of appraisal as established in such section and as construed by the applicable case law."

11. See e.g., *Brill et. al. v. Certificate Associates, Inc. et. al.,* 281 A.D. 532 (1st Dept. 1953); Sears Roebuck & Company, SEC No-Action Letter, 1993 WL 8574; 14A N.Y. Jur. 2d Business Relationships §858; Lorenzo's N.Y. Condo & Coop. Law §3:15; 7A Fletcher Cyc. Corp. §3697 (Perm. Ed.).

12. *New York State Tax Commission v. Shor,* 43 N.Y.2d 151 (1977).

13. 202 Misc. 279 (Sup. Ct. Monroe Co. 1951).

14. Id. at 283.

15. N.Y. Real Prop. Law §339 v1(a)(j) (McKinney 1989).

16. N.Y. Bus. Corp. Law §704(a) (McKinney 2003).

17. Unless the bylaws establish specific requirements, proxies do not require any particular wording; all that is required is that they be in writing, and that they show the intention to give the proxy holder the power to vote on behalf of the shareholders. *Prince v. Albin,* 23 Misc. 2d 194 (Sup. Ct. N.Y. Co. 1960). If the bylaws provide for voting by proxy, the board may not impose additional requirements without amending the bylaws. *Brodsky v. Board of Mgrs. of Dag Hammarskjold,* 1 Misc. 3d 591 (Sup. Ct. N.Y. Co. 2003) (board may not require proxies to be acknowledged where bylaws provide that proxies need only be in writing, signed and dated). As agent of the shareholder, the proxy holder must vote according to the shareholder's instructions.

18. 639 F.2d 1011 (3d Cir. 1981).

19. Dissident shareholders wishing to challenge an election of directors must follow the procedures of BCL §619. There is a statutory limit of four months, under N.Y. CPLR §217, in which the shareholder can make this challenge. See, e.g., *Springut v. Don & Bob Restaurants of America Inc.,* 57 A.D.2d 302, 304-305 (4th Dept. 1977). If the alleged improprieties on the part of the incumbent board are established and were significant, and the election results would have been different had the alleged improprieties not occurred, the court can direct a new election. *Vallone v. First Women's Bank,* 92 A.D.2d 799 (1st Dept. 1983), citing *Carter v. Muscat,* 21 A.D.2d 543 (1st Dept. 1964). Generally, courts have held that small irregularities in the vote will not be enough to set an election aside if the results would have been the same had the voting procedures been scrupulously adhered to. *Schmidt v. Magnetic Head Corp.,* 97 A.D.2d 244 (2d Dept. 1983).