MICROFILM DIVIDER

OMB/RECORDS MANAGEMENT DIVISION
SFN 2053 (2/85) 5M

ROLL NUMBER

DESCRIPTION

1340

2007 HOUSE JUDICIARY

HB 1340

2007 HOUSE STANDING COMMITTEE MINUTES

Bill/Resolution No. HB 1340

House Judiciary Committee

☐ Check here for Conference Committee

Hearing Date: 1/24/07

Recorder Job Number: 1772

Committee Clerk Signature N Penrose

Minutes:

Chairman DeKrey: We will open the hearing on HB 1340.

Rep. Larry Klemin: Introduced the bill, sponsor. This bill relates to public corporations. In this bill, ND would be embarking on a new type of corporation authorized under ND law specifically designed to attract large public corporations to ND. This is a very exciting concept. It is also complicated. The persons who will be here explaining the bill will include Bill Clark, from Pennsylvania and Al Jaeger, Secretary of State.

Chairman DeKrey: Thank you. Further testimony in support.

Al Jaeger, Secretary of State: (see attached testimony).

Chairman DeKrey: Thank you. Further testimony in support.

Rep. Rick Berg: I support this bill. This bill has tremendous potential that would encourage businesses to come to ND. The way it has been conveyed to me, it has a real opportunity to not only attract these businesses, but also tell the rest of the country and beyond the country, that ND believes in a business model that encourages shareholder involvement and support.

Chairman DeKrey: Thank you. Further testimony in support.

William Clark, Jr., President, ND Corporate Governance Council: (see attached testimony).

Rep. Dahl: Can a publicly traded company do these things anyway. Can't they put this in place within their own corporate structure to take on some of these initiatives.

William Clark: Yes, you're correct. Every one of these provisions, as a rule, could be put into a company's organic documents today. There are certain issues that would difficult depending on the particular state in which a company is incorporated. I mentioned that DE amended their corporation law just this past year in order to prevent companies to moving toward a system of majority voting. The answer is, by and large, yes on a piecemeal basis. The problem is the way the system works at the moment, shareholders have the ability to submit proposals to their companies to make certain changes, but as a shareholder you only get one chance every year. If you wanted to embark on a program of putting everything that's in 10-35 in a company's charter, you could do it, but it would take you many years. You would have to go through a very lengthy process to get to this result. One of the things we're trying to do is create a new model. What we're trying to do is say, here is the best thinking on all of these issues and you can move in this direction by one act; instead of having to do these piecemeal simply by incorporating in ND and electing to be subject to this statute, you get all of this as a package. One of the things we would like to do is actually create a brand. One of the goals of this statute, is have everyone immediately recognize when they are told that a company is a ND corporation. That will immediately brand that company as a company that elected to take advantage of the full plan.

Rep. Dahl: I guess I'm a little skeptical as to why a publicly traded corporation would elect to re-incorporate in ND, wouldn't it be the board that decides to reincorporate. Some of these provisions may be perceived as giving shareholders the ability to meddle in matters that traditionally were handled by the board.

William Clark: You actually raise two issues. First, will this be disruptive and meddlesome. The argument that's always raised against giving shareholders more rights is, in fact, that it will be disruptive to the affairs of the corporation. I don't personally think that is a very compelling argument for the following reason. If you think about what the basic interest of the shareholder is, when you invest in a company, you want to make money and you want your investment to increase in value. To me, economically illogical to use rights that we are giving shareholders here to make trouble, if it is going to be disruptive and depress the value of your investment. What we have found when we talked to large pension funds and investors in Europe, that they behaved differently in Europe because they have these additional rights. There is a much more cooperative spirit that's to be found between management and the shareholders in Europe, because the shareholders understand that they have rights, management understands that the shareholders have rights that they can use, and you don't want to have a fight, you don't want to see those rights used, so you work things out and behave more cooperatively. I'm not particularly worried about bad effects simply because if the shareholders do that, they injure themselves. Yes, it is possible, but it is hard to tell. Secondly, who would move here. I think initially you will find two groups of companies moving here. The good guys and the bad guys. What do I mean. There are some companies already today that are very committed to the notion that they believe in good corporate governance and try to portray themselves as being shareholder friendly. For a company with that kind of culture and attitude, moving to ND is a great thing because it allows them to brand themselves. They now know that simply as a ND corporation, it feeds directly into their general approach and allows them to identify themselves in a quick way as being committed. There is going to be the other group as well. One of the things that will happen if this statute is passed is that shareholders and companies who are in trouble, may actually have fights trying to push their

company into ND. They recognize that they're losing money, they're in a bad investment, they're not being listened to, will actually try to push their management here. How many of each company will there be. We'll have to see who comes to our field of dreams. I'm sure that there will be some.

Rep. Kretschmar: If this becomes law in ND, could ND corporations that are here now opt in to these provisions.

William Clark: Only with great difficulty. They are not intended to be able. There are various kinds of ND corporations. The clearest case is a ND corporation that is already publicly traded, there are three of those today. They are completely grandfathered out of the bill. The bill says that to be subject to this new chapter, it only applies to companies that are incorporated after July 1, 2007 so that the three existing companies are already in existence. Existing ND corporations that are not publicly traded, but have already been incorporated, if they go public in the future, will also not have the ability directly to elect to be subject to this chapter, because they were incorporated before July 1, 2007. However, in the future, a company that is founded in November of this year, after July 1, if it decides to go public, will be able to opt in simply by amending its articles of incorporation. It will depend on the situation of the company.

Rep. Koppelman: If a new company starts and this bill passes, it can elect to be part of this statute or not.

William Clark: It would have a choice. When it incorporates October 1, it can incorporate just under the existing Business Corporation Act, chapter 19.1, it could also choose to include in its articles the statement that it's also subject to new chapter 10-35. If it did not include that statement, it is incorporated under the normal process as it's always been. As long as that provision is in its articles, it's subject to the new chapter. If at any time, it decides that it

doesn't like it, the shareholders and directors can approve and amend the articles to take that provision out, in which case it would go back to the existing Business Corporation Act, or it could reincorporate in another state. Either action could be taken by a simple majority vote of its shareholders.

Rep. Koppelman: So if a company from another state decides to take advantage of this and comes to ND, they would have to reincorporate here.

William Clark: Yes.

Rep. Koppelman: If an existing ND corporation decided to do this, it sounds like it would be more difficult for them for another company coming in from out of state coming in.

William Clark: Yes. Companies would move in by reincorporating here. That would be much easier, it's possible for them to do that. An existing company in ND, really can't. If they really wanted to, I suppose they could move out and move back in. That's an awful trouble to do that. I don't think that is going to happen.

Rep. Koppelman: You're saying that for out of state companies to take advantage of this, it would be to come to ND and reincorporate.

William Clark: Yes.

Rep. Koppelman: But an existing ND corporation wouldn't be that easy.

William Clark: Not intended for that to be possible.

Rep. Charging: Is this a tool for economic growth.

William Clark: We have not touched at all on the principal benefit to ND, which is built into the statute. Companies today pay a lot of money to be incorporated in DE. Half of the publicly traded companies in the US are incorporated in DE; have no physical presence in DE. DE collected in 2005, $491 million dollars in these publicly traded companies that have no presence there but just want to be incorporated there. Chapter 10-35 proposes that

companies that are subject to this new chapter will pay the same type of fee that they pay to DE, we essentially copies the DE fee except that we set its rate at 1/2 of the DE statute, so a very large publicly traded company incorporated in DE, every year pays a franchise tax of $160,000/yr just for the privilege of being incorporated in DE and not having any operations or any other contact with the state. We propose that the same corporation, if it were incorporated in ND would pay $80,000/year. So you can imagine with just a little bit of success and the $80,000 is the top end of the sliding scale, so it is very difficult to make these estimates, that there is a possibility of substantial revenue from incorporations in ND at a rate that is a bargain, 50% of what you would pay in DE. I believe there is actually a fiscal note that's been prepared that has some estimates. The revenue shown in that note is a guess, it will depend on how popular this thing will be as it takes off. The other direct impact on ND, that as companies begin to incorporate here, they are going to need ND lawyers when they do financing and transactions, they will need counsel. There will be other economic development as well.

Rep. Delmore: Will this create a disadvantage to ND companies if they want to take advantage of these changes and can't.

William Clark: No, I don't think so. There are only three public traded companies that are clearly being grandfathered out. New companies that are incorporated after July 1, will have this option How many existing companies that are not publicly traded but may go public, will they. I don't think there are a large number.

Rep. Charging: Because we don't have a public franchise fee, what will that mean.

William Clark: If you look back on page 18, line 23, the fee that's imposed on public companies by this bill is purely a function of the number of shares of stock that they are authorized to issue. Simply by reading the records in the Secretary of State's office, you can

determine how many shares of stock a corporation is authorized to issue and then it's simply a mathematical formula; it's $60 for every 10,000 share that are being issued up to a maximum of $80,000. If you have a million authorized shares, you would pay less than a company with 100 million authorized shares. It would be a sliding scale, of every 10,000 shares, which is exactly the way DE does it.

Rep. Koppelman: You talked about the benefits to lawyers and litigation, etc. that might occur. I noticed that in one section of the bill it talks about, under a particular set of circumstances that the corporation would deal with the district court, specifically specifies Burleigh County. On page 23, lines 9-12, is there a reason for that, or could a corporation go elsewhere.

William Clark: This provision is part of the mechanics for making the franchise fee work. This is patterned after provisions in existing ND law which provides that if an existing ND corporation does not file its annual report timely and pay a fee that Clara Jenkins was telling them that needs to be changed that there are provisions for the Secretary of State to administratively dissolve the company and if the company then catches up and tries to correct the defects and doesn't think it's been treated properly, the existing ND law in the other statutes say that you go to Burleigh County, obviously because this is related directly to a governmental function and it located here. I'm sure that the Secretary of State's office would not like to see this procedure different than what is in the other statutes.

Rep. Koppelman: I noticed in the bill there are several references to poison pill. Can you touch on that.

William Clark: Poison pills were invented in the 1980's. At a time when there were a raft of hostile takeovers. It was the kind of thing we saw in the movie with Michael Douglas in Wall Street, trying to manipulate companies and taking over. Poison pills were invented as a way of

stopping those kinds of hostile takeovers. Effectively what happens with poison pills, a company issues securities to its shareholders which are not exercisable, shareholders have no immediate rights under the poison pill, but the poison pill provides that if there is a hostile, tender offer and the raider acquires typically more than 20-30% of the shares of the company, then all of a sudden the poison pill becomes operative and poisonous. The poison pill says that shareholders, other than the raider are entitled to acquire shares in the company at ½ of their market price, but the poison pills provides that the raider is not permitted to exercise its right to do the same thing. The point being is that if the shareholders buy additional shares in the company at ½ price and the raider can't buy those shares, then the raider gets deluded, they lose a lot of money and won't go forward. There has never been a situation since that time, in which a company lit a poison pill, where the raider allowed the poison pill to be operative. The raiders always stop short of triggering the poison pill. It's a way to effectively stop a raider from acquiring a large block in a company without the approval of the board of directors. What's happened in the past 15 years, under DE law, there have been a lot of lawsuits addressed to the question of how long can a board leave a poison pill in place and stop a raider and when do you reach a point where there's been an auction for the company, and the raider is willing to pay a price that's high enough that the shareholders ought to be allowed to sell their shares in the offer. There is actually now a whole body of law in DE that helps you decide when you get to appoint that a court will order a poison pill to be disabled. Some of the activist shareholders hate poison pills and would like to get rid of them completely. We have not done that. Chapter 10-35 actually permits poison pills because we have found that actually having a poison pill can be very valuable for a corporation because it stops a corporation from being taken over quickly on the cheap. It stops a raider from coming in, offering just a small premium, stampeding shareholders into selling their shares and it allows

the board to negotiate with a raider and stops him by buying shares. Poison pills can be good. They can also be used improperly to entrench management. So what you have to do is try to find a balance. So the provisions in the bill actually say you can have a poison pill for a year or two years, if shareholders approve it, we want to not have ND corporations subject to being taken over too easily.

Rep. Dahl: On page 13, subsection 3 talks about being reasonable, fair, and not favor or disadvantage the proponent of any action. Isn't that a little broad and ambiguous.

William Clark: The first comment to be made about section 19 is that we took this provision from the Model Business Corporation Act and it was added to the model act within the last five years or so. That's important because it relates directly to your question. What exactly do these various tests mean. We don't yet know. In fact, it will take a little bit of experience under the model act itself and some potential fights and lawsuits before we know exactly this means. But to a certain extent, this provision is intended to deal with interorum provision in the sense that it is intended to tell people that there is a line. We may not be exactly sure where the line is, but you don't want to cross it and in fact, you want to stay back from it. It is intended to tell the person who is conducting the meeting that they need to be thinking that they have to be fair and reasonable and if they aren't, they are going to be subject to challenge and the hope is that will kind of play it down the middle. If there is a fight, we will have to find out what the court tells us it needs. Since it is taken from the model act, there will be case law that builds up around the country that will help us understand.

Rep. Griffin: On page 3, section 10-35-03, it says that this chapter applies to every public corporation. Wouldn't this apply to public corporation, it must be defined somewhere else in the code, wouldn't it also apply to other chapters as well.

William Clark: I couldn't understand what you are asking.

Rep. Griffin: The current public corporations in our state, are they defined anywhere in code. It says that this chapter applies to every public corporation.

William Clark: The term public corporation, is not a defined term anywhere else in the ND Century Code. There are, in your existing business corporation act, provisions which refer to publicly traded corporations. If you look over on page 4 of the bill, the first line, you will see that this statute says "a public corporation" which is a defined animal in 10-35 also is a "publicly held corporation" as that term is used in chapter 10-19.1. So in your existing Business corporation act, there are probably less than a half of dozen provisions which talk about publicly held corporations. Public corporation is a brand new term which would only be in this statute. In other words, there isn't going to be slop over from this chapter to the other chapter. This is a term that's really here. If it were ever used in a new statute, you would get this content, but otherwise it doesn't exist at the moment.

Rep. Koppelman: You talked about the potential benefits to ND being a boon to the state treasury perhaps, which could trickle down to be a benefit to taxpayers. Secondly, the lawyers are going to be doing well, and hopefully there is an economic benefit that's going to trickle into our economy from that. Is there another economic benefit from the standpoint that you believe that companies that incorporate here, that some of them will actually locate here in ND and therefore create jobs, etc.

William Clark: I would hesitate to say that. I'm even reluctant to over promise on the fees and what's involved. Certainly it's possible that some companies will want to have some presence here, maybe even once they are subject to ND law, every two years have a lobbyist to come around. It's so speculative, I'd rather than not have you think that there are those benefits.

Rep. Koppelman: You talked about this opt-out. Is there more than one place in the bill where that's discussed.

William Clark: It is all in the provision we were just looking at, which is the definition of the term. The whole issue is, are you included in that or not.

Rep. Dahl: You testified that some of the confidence has been shaken in recent times. Are there any provisions in chapter that would really prevent a scandal. Does this address that issue.

William Clark: No, it's not really trying to do that. This bill is not trying to prevent scandals and people breaking the law. This bill is trying to focus directors and management on what their principal job is, to pay attention to the interests of shareholders. Ultimately, that's what is going on here. We're not trying to prevent scandals. We are, to a certain extent, trying to prevent abuse. We aren't trying to prevent things that are already illegal or to make new things illegal, we are trying to change the way people behave under the existing rules.

Rep. Onstad: Ten percent of shareholders can call a special meeting, is that typical.

William Clark: It is not the rule in DE. Shareholders in DE do not have the right to call a special meeting of shareholders. It is already the rule under your existing business corporation act. It is the law in certain other states. It is the law in PA, for example. The practice varies around the country.

Rep. Onstad: If a present corporation in ND is not publicly traded, it they choose to become publicly traded after July 1, they would have the option to adopt under 10-35.

William Clark: No, because they were incorporated before July 1. They'd have to reincorporate.

Rep. Koppelman: Could you tell us why there is one state that has looked at this, is this happening anywhere else.

William Clark: This law does not exist anywhere else. Various pieces of it exist in various places, but no one has assembled all of the pieces in one place. When I first started working on this project, we actually wanted to come to ND as our first choice, but I started working on the project in the fall of 2005 and at that point, your 2005 session was over and you weren't going to be around in 2006, and we were eager enough to get started on this that we actually went to our second choice, which was the state of Vermont. They had characteristics a lot like ND. Their legislation met every year. We actually drafted a bill that would have added these provisions to Vermont law, it was introduced, received a lot of support initially, particularly from the person who was the state treasurer in Vermont, who because of his position as fiduciary for all of the state pension funds, understood investment issues and was very sympathetic to issues of corporate governance. We made a big mistake in VT, however, in that we did not clearly enough grandfather the existing publicly traded companies that were incorporated in VT. We did not have a provision in VT that was as clear as what's on page 3 of the definition of public corporation. As a result, half a dozen publicly traded corporations in VT decided that they had to get very involved in the issue, decided that they didn't like the bill and didn't like the possibility that they had to be more responsive to their shareholders. The net results was that the vote did not come up vote because we didn't have time before crossover in the VT system to resolve those issues and to fix the grandfathering provision. Since we were unsuccessful in VT, the good news is that we were able to come back to our first choice, although we had to wait a year. We also learned a lesson about how to do it the right way. This does not exist anywhere else.

Rep. Koppelman: Are you still pursuing it in VT or is it a dead issue.

William Clark: That's a fascinating question. Believe it or not, last week I got a call from one of the lawyers I was working with in VT, who said to me that he's gotten calls from two

legislators in VT who've asked where's the bill. Is it coming back. Well, not in my efforts, because I'm off in a much friendlier, better place that was my first choice. I don't know what they are going to do.

Chairman DeKrey: Thank you. Further testimony in support.

William Guy: I would like to testify in support of this bill. I think this will be an excellent bill for ND. There is really no downside to it at all that I can see.

Chairman DeKrey: Thank you. Further testimony in support. Testimony neutral.

Rick Clayburgh, President and CEO of ND Bankers Association: We are taking a neutral position on the bill today. Our legislative committee meets tomorrow. We have forwarded the legislation to them and to some attorneys in the state. We have not had an opportunity to look at that and we'd ask if you could hold this hearing open for us to have our discussion. On a personal note, the Uniform Trust Code had a lot of opposition in the last session. We spent an interim looking at it, and came up with some good solutions.

Chairman DeKrey: Thank you. Further testimony neutral. Testimony in opposition. We will recess the hearing.

2007 HOUSE STANDING COMMITTEE MINUTES

Bill/Resolution No. HB 1340

House Judiciary Committee

☐ Check here for Conference Committee

Hearing Date: 1/24/07

Recorder Job Number: 1845

Committee Clerk Signature Dawn Penrose

Minutes:

Chairman DeKrey: We will take up HB 1340. There was an amendment that we didn't discuss this morning.

William Clark: It was my pleasure to testify this morning. We had passed out an amendment which all of us forgot this morning, but we wanted to bring that to committee at this point. I'm happy to answer questions about it. Obviously, after the bill was prepared, we proofread it and noticed a variety of typos. We also were finishing our work on it and there were some things that we realized that we wanted to change and there is one section that we wanted to improve on the contents and we would like to get that thrown into the process if you can, so the bill is in its complete and final form, for your consideration. I am happy to take questions. The amendment itself is behind the document that's entitled, "Explanation of Proposed Amendment". The first two pages are discussion of the amendment. The substantive changes in the amendment are discussed in the memo at the front. That memo does not describe all of the typos and minor changes that are corrected. It only talks about the substantive changes. The single most substantive change is the addition of a new section, which is being added as section 17. It is adopting a provision that's been added to the Model Business Corporation Act and applies generally to corporations incorporated under that statute

and it is also the rule for companies who are traded on the New York Stock Exchange. What it says is that when a corporation is planning to issue 20% or more of its shares, it has to get approval of its shareholders first, before it does a major issuance of stock. The Stock Exchange requires it. The Model Business Corporation Act requires it. It is not in ND law at the moment; although I am told by Bill Guy that when he heard about the issue, he thinks it probably should be added to your General Business Corporation Act, but that is for another day, but we wanted to get it included in the Public Corporation provisions now.

Chairman DeKrey: Thank you for coming back and explaining that to us. We will close for now.

2007 HOUSE STANDING COMMITTEE MINUTES

Bill/Resolution No. HB 1340

House Judiciary Committee

☐ Check here for Conference Committee

Hearing Date: 1/30/07

Recorder Job Number: 2300

Committee Clerk Signature A Penrose

Minutes:

Chairman DeKrey: We will take a look at HB 1340. What are the committee's wishes in regard to this bill. All the amendments have been rolled into one document.

Rep. Koppelman: I move the Secretary of State's amendments.

Rep. Wolf: Second.

Rep. Dahl: So every publicly traded corporation that incorporates after July 1, this chapter is going to apply. I don't see that as an option.

Chairman DeKrey: Where is that found.

William Clark: There was another amendment that addresses your question. It's on the first page of the amendment, third from the above, which is new to this amendment, page 3, line 16, we would insert a phrase so that the bill only applies to corporations meeting the definition of a publicly traded corporation, during such time as its articles state that it is governed by this chapter. That is the additional language that is being inserted to make it clear that it's only while the provision of the articles is in effect, that the corporation is subject to the chapter. I think that was the issue raised by Joel Gilbertson.

Rep. Koppelman: I think the other thing that would help, this is inserting publicly traded would be new language so it would be easily distinguished.

Chairman DeKrey: Further discussion on the amendments. We will take a voice vote. Motion carried. We now have the bill before us as amended.

Rep. Delmore: I move a Do Pass as amended.

Rep. Koppelman: Second.

Rep. Dahl: While I do think this bill is optional, I do think that we are delusional if we think companies are going to come here. I remain very skeptical about this bill. I think it puts another tool in the belt of activist shareholders, or green mailers. A green mailer is someone who comes in and stirs up chaos and then lets the board of directors that they could be bought out.

Rep. Klemin: I think this is pretty straightforward. It's another option.

Rep. Charging: They might not move here, but may come on paper.

Chairman DeKrey: The clerk will call the vote.

11 YES 3 NO 0 ABSENT DO PASS AS AMEND CARRIER: Rep. Kretschmar

2007 HOUSE STANDING COMMITTEE MINUTES

Bill/Resolution No. HB 1340

House Judiciary Committee

☐ Check here for Conference Committee

Hearing Date: 2/5/07

Recorder Job Number: 2836

Committee Clerk Signature D Penrose

Minutes:

Chairman DeKrey: We need a motion to rerefer this bill.

Rep. Kretschmar: I so move.

Rep. Kingsbury: Second.

Chairman DeKrey: It has been moved and seconded to Rerefer HB 1340 to Appropriations.

Voice vote. Motion carried.

FISCAL NOTE

Requested by Legislative Council
02/06/2007

Amendment to: HB 1340

1A. **State fiscal effect:** *Identify the state fiscal effect and the fiscal effect on agency appropriations compared to funding levels and appropriations anticipated under current law.*

	2005-2007 Biennium		2007-2009 Biennium		2009-2011 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues	$0	$0	$720,000	$80,000	$1,440,000	$160,000
Expenditures	$0	$0	$0	$60,000	$0	$120,000
Appropriations	$0	$0	$0	$80,000	$0	$160,000

1B. **County, city, and school district fiscal effect:** *Identify the fiscal effect on the appropriate political subdivision.*

2005-2007 Biennium			2007-2009 Biennium			2009-2011 Biennium		
Counties	Cities	School Districts	Counties	Cities	School Districts	Counties	Cities	School Districts
$0	$0	$0	$0	$0	$0	$0	$0	$0

2A. **Bill and fiscal impact summary:** *Provide a brief summary of the measure, including description of the provisions having fiscal impact (limited to 300 characters).*

A new chapter in the Century Code is created for publicly traded corporations wishing to have this form of corporate governance structure. The provisions with a fiscal impact pertain to the filing of an annual report having a franchise fee connected with it.

B. **Fiscal impact sections:** *Identify and provide a brief description of the sections of the measure which have fiscal impact. Include any assumptions and comments relevant to the analysis.*

Annually, according to 10-35-28 on pages 19, 20, and 21, a franchise fee is due each year that cannot be less than $60 nor exceed $80,000.

3. **State fiscal effect detail:** *For information shown under state fiscal effect in 1A, please:*
   A. **Revenues:** *Explain the revenue amounts. Provide detail, when appropriate, for each revenue type and fund affected and any amounts included in the executive budget.*

It is unknown at this time as to how many corporate charters will be issued under this chapter. Therefore, the estimated revenue is based on five corporations during the first biennium paying the maximum fee. The number of corporations was doubled for the next biennium.

B. **Expenditures:** *Explain the expenditure amounts. Provide detail, when appropriate, for each agency, line item, and fund affected and the number of FTE positions affected.*

Because it is unknown as to the number of corporate charters that might be issued under this new chapter, 10% of the franchise fee is allocated to the agency's general services operating fund to allow the agency to respond to the demand regardless how few or how many there might be. By law, any excess is deposited in the state's general fund at the end of the biennium.

C. **Appropriations:** *Explain the appropriation amounts. Provide detail, when appropriate, for each agency and fund affected. Explain the relationship between the amounts shown for expenditures and appropriations. Indicate whether the appropriation is also included in the executive budget or relates to a continuing appropriation.*

The appropriation is to establish the spending authority for the agency based on the estimated revenue. If the revenue exceeds projections, the agency will seek the approval of the Emergency Commission and the Legislative Budget Section to increase the spending authority.

Name:	Al Jaeger	**Agency:**	Secretary of State
Phone Number:	328-2900	**Date Prepared:**	02/06/2007

FISCAL NOTE

Requested by Legislative Council
01/11/2007

Bill/Resolution No.: HB 1340

1A. **State fiscal effect:** *Identify the state fiscal effect and the fiscal effect on agency appropriations compared to funding levels and appropriations anticipated under current law.*

	2005-2007 Biennium		2007-2009 Biennium		2009-2011 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues	$0	$0	$720,000	$80,000	$1,440,000	$160,000
Expenditures	$0	$0	$0	$60,000	$0	$120,000
Appropriations	$0	$0	$0	$80,000	$0	$160,000

1B. **County, city, and school district fiscal effect:** *Identify the fiscal effect on the appropriate political subdivision.*

2005-2007 Biennium			2007-2009 Biennium			2009-2011 Biennium		
Counties	Cities	School Districts	Counties	Cities	School Districts	Counties	Cities	School Districts
$0	$0	$0	$0	$0	$0	$0	$0	$0

2A. **Bill and fiscal impact summary:** *Provide a brief summary of the measure, including description of the provisions having fiscal impact (limited to 300 characters).*

A new chapter in the Century Code is created for publicly traded corporations wishing to have this form of corporate governance structure. The provisions with a fiscal impact pertain to the filing of an annual report having a franchise fee connected with it.

B. **Fiscal impact sections:** *Identify and provide a brief description of the sections of the measure which have fiscal impact. Include any assumptions and comments relevant to the analysis.*

Annually, according to 10-35-28 on pages 18 and 19, a franchise fee must be paid that cannot be less than $60 nor exceed $80,000.

3. **State fiscal effect detail:** *For information shown under state fiscal effect in 1A, please:*
   A. **Revenues:** *Explain the revenue amounts. Provide detail, when appropriate, for each revenue type and fund affected and any amounts included in the executive budget.*

It is unknown at this time as to how many corporate charters will be issued under this chapter. Therefore, the estimated revenue is based on five corporations during the first biennium paying the maximum fee. It was doubled for the next biennium.

B. **Expenditures:** *Explain the expenditure amounts. Provide detail, when appropriate, for each agency, line item, and fund affected and the number of FTE positions affected.*

Because it is unknown as to the number of corporate charters, 10% of the franchise fee is allocated to the agency's general services operating fund to allow the agency to respond to the demand either how little or how large it might be.

C. **Appropriations:** *Explain the appropriation amounts. Provide detail, when appropriate, for each agency and fund affected. Explain the relationship between the amounts shown for expenditures and appropriations. Indicate whether the appropriation is also included in the executive budget or relates to a continuing appropriation.*

The appropriation is to establish the spending authority for the agency based on the estimated revenue. If the revenue exceeds projections, the agency will seek the approval of the Emergency Commission and the Legislative Budget Section to increase the spending authority.

Name:	Al Jaeger	**Agency:**	Secretary of State
Phone Number:	328-2900	**Date Prepared:**	01/17/2007

Proposed Amendments to House Bill No. 1340

Page 3, line 3, replace "is incorporated" with "becomes governed by chapter 10-19.1"

Page 3, line 16, after "applies" insert "only"

Page 3, line 16, replace "every public" with "a"

Page 3, line 16, after "corporation" insert "meeting the definition of a "public corporation" in subsection 6 of section 10-35-02 during such time as its articles state that it is governed by this chapter"

Renumber accordingly

Date: 1/30/07
Roll Call Vote #: 1

2007 HOUSE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 1340

House JUDICIARY Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken Do Pass as Amended

Motion Made By Rep. Delmore Seconded By Rep. Koppelman

Representatives	Yes	No	Representatives	Yes	No
Ch. DeKrey	✓		Rep. Delmore	✓	
Rep. Klemin	✓		Rep. Griffin	✓	
Rep. Boehning	✓		Rep. Meyer	✓	
Rep. Charging	✓		Rep. Onstad	✓	
Rep. Dahl		✓	Rep. Wolf		✓
Rep. Heller		✓			
Rep. Kingsbury	✓				
Rep. Koppelman	✓				
Rep. Kretschmar	✓				

Total (Yes) 11 No 3

Absent 0

Floor Assignment Rep. Kretschmar

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

HB 1340: Judiciary Committee (Rep. DeKrey, Chairman) recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends **DO PASS** and **BE REREFERRED** to the **Appropriations Committee** (11 YEAS, 3 NAYS, 0 ABSENT AND NOT VOTING). HB 1340 was placed on the Sixth order on the calendar.

Page 1, line 2, replace "public" with "publicly traded"

Page 1, line 7, replace "Public" with "Publicly Traded"

Page 1, line 19, replace "public" with "publicly traded"

Page 2, line 28, replace "public" with "publicly traded"

Page 3, line 1, replace ""Public" with ""Publicly traded"

Page 3, line 3, replace "is incorporated" with "becomes governed by chapter 10-19.1"

Page 3, line 5, replace ""Public" with ""Publicly traded"

Page 3, after line 6, insert:

"8. "Qualified shareholder" means a person or group of persons acting together that satisfies the following requirements:

a. The person or group owns beneficially in the aggregate more than five percent of the outstanding shares of the publicly traded corporation that are entitled to vote generally for the election of directors; and

b. The person or each member of the group has beneficially owned the shares that are used for purposes of determining the ownership threshold in subdivision a continuously for at least two years."

Page 3, line 7, replace "8." with "9."

Page 3, line 8, after the first "the" insert "publicly traded"

Page 3, line 16, after "applies" insert "only", replace "every public" with "a publicly traded", and after "corporation" insert "meeting the definition of a "publicly traded corporation" in section 10-35-02 during such time as its articles state that it is governed by this chapter"

Page 3, line 19, replace "public" with "publicly traded"

Page 3, line 20, replace "public" with "publicly traded"

Page 3, line 21, replace "public" with "publicly traded"

Page 3, line 25, replace "public" with "publicly traded"

Page 3, line 28, replace "public" with "publicly traded"

Page 4, line 1, replace "public" with "publicly traded"

Page 4, line 6, replace "public" with "publicly traded"

Page 4, line 8, replace "public" with "publicly traded"

Page 4, line 12, replace "public" with "publicly traded"

Page 4, line 14, replace "public" with "publicly traded"

Page 4, line 16, replace "public" with "publicly traded"

Page 4, line 22, replace "public" with "publicly traded"

Page 4, line 27, replace "public" with "publicly traded"

Page 5, line 1, replace "public" with "publicly traded"

Page 5, line 10, replace "The date" with "Any deadline"

Page 5, line 17, remove ", the later of:"

Page 5, remove lines 18 through 22

Page 5, line 23, replace "(2) Ninety" with "ninety"

Page 5, line 27, replace "public" with "publicly traded"

Page 6, line 4, replace "public" with "publicly traded"

Page 6, line 11, replace "public" with "publicly traded"

Page 6, line 13, replace "shareholder" with "person" and remove the fourth "of"

Page 6, line 14, remove "shareholders"

Page 6, line 15, replace "shareholder" with "person" and remove "of shareholders"

Page 6, line 16, replace "3" with "8 of section 10-35-02 and reasonable evidence of the required ownership of shares by the person or group"

Page 6, line 17, replace "shareholder" with "person" and remove "of shareholders"

Page 6, line 30, replace ""Qualified shareholder" means a person or group of persons acting together that" with "If the qualified shareholder does not own at least five percent of the outstanding shares of the publicly traded corporation entitled to vote generally for the election of directors on the date of the meeting, the qualified shareholder is not entitled to nominate the candidates named in the notice provided under subsection 1."

Page 6, remove line 31

Page 7, remove lines 1 through 11

Page 7, line 13, replace "public" with "publicly traded"

Page 7, line 18, replace "public" with "publicly traded"

Page 8, line 21, replace "public" with "publicly traded"

Page 8, line 25, after "shareholders" insert "of a publicly traded corporation"

Page 9, line 2, replace "public" with "publicly traded"

Page 9, line 13, replace "Director supermajority" with "Supermajority"

Page 9, line 14, replace "public" with "publicly traded", remove the first "for", remove "greater", and replace the second "for" with ":

1. For"

Page 9, line 15, after the second "board" insert "that is greater"

Page 9, line 16, after "vacancies" insert "; or

2. For shareholders that is greater than a majority of the voting power of the shares entitled to vote on the item of business or, in the case of a class or series entitled to vote as a separate group, a majority of the voting power of the outstanding shares of the class or series"

Page 9, line 19, replace "public" with "publicly traded"

Page 9, line 23, replace "public" with "publicly traded"

Page 9, line 27, replace "public" with "publicly traded"

Page 10, line 1, replace "public" with "publicly traded"

Page 10, line 5, replace "public" with "publicly traded"

Page 10, line 12, replace "public" with "publicly traded"

Page 10, line 17, replace "public" with "publicly traded"

Page 10, line 22, replace "public" with "publicly traded"

Page 11, line 5, replace "The date" with "Any deadline"

Page 11, line 12, remove ", the later of:"

Page 11, remove lines 13 through 17

Page 11, line 18, replace "(2) Ninety" with "ninety"

Page 11, line 22, replace "public" with "publicly traded"

Page 11, line 28, replace "public" with "publicly traded"

Page 12, line 1, replace "public" with "publicly traded"

Page 12, line 7, after "shareholders" insert "and reasonable evidence of that ownership"

Page 12, line 9, replace "public" with "publicly traded"

Page 12, line 14, replace "Quorum at" with "Requirements for convening" and after the boldfaced underscored period insert:

"1. If the articles or bylaws of a publicly traded corporation have a provision for advance notice authorized by section 10-35-07 or 10-35-14, a regular

meeting of shareholders of the corporation may not be convened unless the corporation has announced the date of the meeting in the body of a public filing, and not solely in an exhibit or attachment to a filing, regardless of whether the exhibit or attachment has been incorporated by reference into the body of the filing, with the commission under the Exchange Act at least twenty-five days before the deadline in the articles or bylaws for a shareholder to give the advance notice."

Page 12, line 15, replace "1." with "2." and replace "public" with "publicly traded"

Page 12, line 17, remove "for"

Page 12, line 18, remove "purposes of section 10-19.1-76"

Page 12, line 19, after "meeting" insert "for purposes of determining the existence of a quorum under section 10-19.1-76"

Page 12, line 20, remove "2."

Page 12, line 22, replace "section" with "subsection"

Page 12, line 23, replace "Shareholder supermajority provisions prohibited. Neither the articles nor" with:

"Approval of certain issuances of shares.

1. An issuance by a publicly traded corporation of shares, or other securities convertible into or rights exercisable for shares, in a transaction or a series of integrated transactions, requires approval of the shareholders if the voting power of the shares that are issued or issuable as a result of the transaction or series of integrated transactions will exceed twenty percent of the voting power of the shares of the corporation which were outstanding immediately before the transaction.

2. Subsection 1 does not apply to:

   a. A public offering solely for cash, cash equivalents or a combination of cash and cash equivalents; or

   b. A bona fide private financing, solely for cash, cash equivalents or a combination of cash and cash equivalents, of:

      (1) Shares at a price equal to at least the greater of the book or market value of the corporation's common shares; or

      (2) Other securities or rights if the conversion or exercise price is equal to at least the greater of the book or market value of the corporation's common shares.

3. For purposes of this section:

   a. The voting power of shares issued and issuable as a result of a transaction or series of integrated transactions shall be the greater of:

      (1) The voting power of the shares to be issued; or

(2) The voting power of the shares that would be outstanding after giving effect to the conversion of convertible shares and other securities and the exercise of rights to be issued.

b. A series of transactions is integrated if consummation of one transaction is made contingent on consummation of one or more of the other transactions.

c. "Bona fide private financing" means a sale in which:

(1) A registered broker-dealer purchases the shares, other securities, or rights from the publicly traded corporation with a view to their private sale to one or more purchasers; or

(2) The corporation sells the shares, other securities, or rights to multiple purchasers, and no one purchaser or group of related purchasers acquires, or has the right to acquire, more than five percent of the voting power of shares issued or issuable in the transaction or series of integrated transactions."

Page 12, remove lines 24 through 27

Page 12, line 29, replace "public" with "publicly traded"

Page 13, line 1, replace "public" with "publicly traded"

Page 13, line 4, replace "meting" with "meeting"

Page 13, line 24, replace "public" with "publicly traded"

Page 13, line 28, replace "public" with "publicly traded"

Page 13, line 30, replace "public" with "publicly traded"

Page 14, line 2, replace "public" with "publicly traded"

Page 14, line 13, replace "public" with "publicly traded"

Page 14, line 21, replace "public" with "publicly traded"

Page 15, line 4, replace "public" with "publicly traded"

Page 15, line 10, replace "public" with "publicly traded"

Page 15, line 13, replace "twenty-five" with "twenty"

Page 15, line 24, replace "prohibition" with "restrictions or prohibitions" and remove "adoption of"

Page 15, line 25, replace "The" with "A provision of the" and replace "public" with "publicly traded"

Page 15, line 26, after the underscored period insert "Such a provision may provide for the effect it has on a poison pill in force at the time of the provision's adoption."

Page 15, line 28, replace "public" with "publicly traded"

Page 16, line 4, replace "public" with "publicly traded"

Page 16, line 14, replace "corporations" with "corporation"

Page 16, line 23, replace "corporations" with "corporation"

Page 17, line 24, replace "that" with ":

(1) If the shares"

Page 17, line 26, after "pill" insert "; or

(2) Which serves to protect dividend, interest, sinking fund, conversion, exchange, or other rights of the shares, or to protect against the issuance of additional securities that would be on a parity with or superior to the shares"

Page 17, line 30, replace "public" with "publicly traded"

Page 18, line 2, replace "public" with "publicly traded"

Page 18, line 4, replace "10-25-29" with "10-35-29"

Page 18, line 5, replace "public" with "publicly traded"

Page 18, line 6, replace "public" with "publicly traded"

Page 18, line 7, replace "public" with "publicly traded"

Page 18, line 8, replace "public" with "publicly traded"

Page 18, line 9, replace "public" with "publicly traded"

Page 18, line 10, replace "public" with "publicly traded"

Page 18, line 13, replace "public" with "publicly traded"

Page 18, line 18, replace "public" with "publicly traded"

Page 18, line 20, replace "public" with "publicly traded"

Page 18, line 25, replace "public" with "publicly traded"

Page 18, line 26, replace "public" with "publicly traded"

Page 18, line 27, replace the first "public" with "publicly traded" and replace the second "public" with "publicly traded"

Page 18, line 28, replace "public" with "publicly traded"

Page 18, line 30, replace "public" with "publicly traded"

Page 19, line 1, replace "public" with "publicly traded"

Page 19, line 3, replace "public" with "publicly traded"

Page 19, line 5, replace "public" with "publicly traded"

Page 19, line 6, replace "public" with "publicly traded"

Page 19, line 12, replace "public" with "publicly traded"

Page 19, line 16, replace "public" with "publicly traded"

Page 19, line 18, replace "public" with "publicly traded"

Page 19, line 19, replace "public" with "publicly traded"

Page 19, line 20, replace "public" with "publicly traded"

Page 19, line 21, replace "public" with "publicly traded"

Page 19, line 23, replace "public" with "publicly traded"

Page 19, line 26, replace "public" with "publicly traded"

Page 20, line 4, replace "public" with "publicly traded"

Page 20, line 7, replace "public" with "publicly traded"

Page 20, line 10, replace "public" with "publicly traded"

Page 20, line 18, replace "public" with "publicly traded"

Page 20, line 19, replace the first "public" with "publicly traded" and replace the second "public" with "publicly traded"

Page 20, line 21, replace "public" with "publicly traded"

Page 20, line 25, replace "public" with "publicly traded"

Page 20, line 29, replace "public" with "publicly traded"

Page 20, line 30, replace "public" with "publicly traded"

Page 21, line 3, replace "public" with "publicly traded"

Page 21, line 4, replace "public" with "publicly traded"

Page 21, line 7, replace the first "public" with "publicly traded" and replace the second "public" with "publicly traded"

Page 21, line 12, replace "public" with "publicly traded"

Page 21, line 13, replace "public" with "publicly traded"

Page 21, line 16, replace the first "public" with "publicly traded" and replace the second "public" with "publicly traded"

Page 21, line 19, replace "public" with "publicly traded"

Page 21, line 21, replace "free" with "fee"

Page 22, line 1, replace "public" with "publicly traded"

Page 22, line 3, replace "public" with "publicly traded"

Page 22, line 4, replace "public" with "publicly traded"

Page 22, line 6, replace "must" with "may"

Page 22, line 11, replace "public" with "publicly traded"

Page 22, line 12, replace "public" with "publicly traded"

Page 22, line 17, replace the first "and" with "any"

Page 22, line 19, replace "public" with "publicly traded"

Page 23, line 1, replace "public" with "publicly traded"

Page 23, line 9, replace "public" with "publicly traded"

Page 23, line 10, replace "public" with "publicly traded"

Page 23, line 13, replace "public" with "publicly traded"

Page 23, line 18, replace "public" with "publicly traded"

Page 23, line 20, replace "and" with "any"

Page 23, line 21, replace "public" with "publicly traded"

Page 23, line 23, replace "public" with "publicly traded"

Page 23, line 31, replace "public" with "publicly traded"

Renumber accordingly

2007 HOUSE APPROPRIATIONS

HB 1340

2007 HOUSE STANDING COMMITTEE MINUTES

Bill/Resolution No. **HB 1340**

House Appropriations Committee

☐ Check here for Conference Committee

Hearing Date: 2-10-2007

Recorder Job Number: 3306

Committee Clerk Signature Marilyn Kinzler

Minutes:

Chairman Svedjan: Called the meeting to order for HB 1340. He mentioned that this bill is one of the few bills that increase revenue.

Rep Klemin: Reviewed the bill. HB 1340 is a bill to create a new chapter of ND Law relating to publicly traded corporations. This bill would not have been possible previously because of the anti corporation provisions that we had in our ND Constitution. In the June 2006 election, 73% of our voters proved our amendment to article 12 of ND Constitution which brought North Dakota into the 21 Century with respect to how corporations are handled. North Dakota has always been a place where we have provided options to the people who want to do business in this state. We have numerous forms of methods of doing business, some we have proved over the last 10 to 20 years. For example we have sole proprietorships, corporations, limited liability companies, we have general partnerships, limited partnerships, limited liability partnerships, and limited liability limited partnerships. This bill provides us with another option, publicly traded corporations.

The state now only has 3 state chartered corporations. The reason for that is because of the provisions that we had on our Constitution. It is hoped that by adopting HB1340 we may be able to attract other publicly traded corporations to incorporate in North Dakota. In most of the publicly traded corporation now go to the state of Delaware. They don't go there to set up

business there but incorporate under Delaware Law. Delaware Law has long been a place where the corporate law has been favorable to corporations. When the incorporate in Delaware they are required to pay an annual franchise fee for publicly traded corporations. That franchise fee is currently $160,000 a year for those corporations. What this bill does respect to the fiscal part of it is that it provides for an annual franchise fee and you will find this in the bottom of page 19 is where the annual franchise fee starts. This is based on the amount of stock that a publicly traded corporation is authorized to issue. It would range from a minimum $60 to maximum of $80,000 a year. Those franchise fees brought over 1 million dollars over 400 million dollars into the state of Delaware.

This bill 1340 does not change any of our excising laws it is purely an optional law. Those publicly traded corporations that chose to come to North Dakota to incorporate here, it will have beneficial provisions for them. This is a completely optional statute; it is not required of any one to any thing.

What this bill does it creates certain shareholder rights that are not present in your regular corporation. As you know a corporation is owned by shareholders and shareholder elect the directors, directors select the officers and the officers run the company. This still works the same way. The difference is that under this bill there is some differences that how you elect directors. For example it allows you to vote no on the directors. Usually what happens now, is that you get a proxy statement from them or go to the corporate meeting instead, but you are presented with a slate of candidates and you have no other choice as to who those candidates are, you either vote for them or you don't vote for them.

Chairman Svedjan: This bill has a positive projected impact in terms of revenue. I do not understand there to be any negative revenue implications of this bill.

Rep Wald: Is there going to an impact to the Secretary of States Office or the Security Commissions office for addition work load? Was that discussed in your committee?

Rep Klemin: There will be more work for the Secretary of State but the amount of work that the Secretary of States office will have to do is going to be paid for by those franchise fees, so it is still a net/net gain. As far as the Securities Commissioner, these corporations are going to governed by the Federal Securities and Exchanged Commission not by our local Securities commission.

Rep Dahl: I would like to discuss why the monies in the FN will not be realized.

For starters: The proponents of the bill went out of the way in the hearing to disavow that we may even get one company. Here in the first biennium there is a projection of $720,000 and he has the right to say that and he was honest in saying that essentially for 2 reasons. There are essentially 2 ways a publicly corporation going to come to ND. The first is by choice. What we have been told is that this bill is share holder friendly and this is an economic development opportunity for North Dakota. However this is not a management friendly bill and it is the Board of Directors who makes the decisions if they are going to choose to reincorporate some where else. So it really wouldn't make sense for a corporation to reincorporate under a statue such as this.

Further companies can already do this in there articles of corporation right now and there are not. So why would they, under a whole set of guidelines that they can't choose the wording of their own.

The 2nd way they could incorporate is by forced incorporation if the shareholders gain control of the company and would force the reincorporation. No one has ever done this in our country and there is case law that strongly suggests that the Internal Affairs Doct is the Constitutional mandate so that states can't simply intervene with a contract right of all or the majority of

constituents of a corporation without violating the very foundation of the Interstate Commerce upon which our Federal system is based.

I have consulted 3 different sources for their expertise on corporate government and all three of them feel this is extremely unrealistic and very foolish for North Dakota. We had a 2 hour hearing on this bill but yet I would venture to wage that nobody actually understands what this bill is doing or what we are accomplishing.

Chairman Svedjan: We are here for only the financial part of this bill and I would have to say there is no negative impact with this bill. Would you agree with that?

Rep Dahl: That is correct and I just wanted to let appropriation committee know because you are going to be taking the $720,000 into a projected.

Chairman Svedjan: No

Rep Dahl: My intent is to inform the Appropriation Committee my opinion that that money will not be realized.

Rep Wald made a motion for a "Do Pass" and Rep Thoreson seconded it.

Roll Call vote is 19 yes, 3 no and 2 absent.

Date: 2/9/07
Roll Call Vote #: 1

2007 HOUSE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 1340

House Appropriations Full Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number —

Action Taken Do Pass as amended

Motion Made By Wald Seconded By Thoreson

Representatives	Yes	No	Representatives	Yes	No
Chairman Svedjan	✓				
Vice Chairman Kempenich	✓				
Representative Wald	✓		Representative Aarsvold	—	
Representative Monson	✓		Representative Gulleson		✓
Representative Hawken	✓				
Representative Klein	✓				
Representative Martinson	✓				
Representative Carlson	—		Representative Glassheim	✓	
Representative Carlisle	✓		Representative Kroeber	✓	
Representative Skarphol	✓		Representative Williams	✓	
Representative Thoreson	✓				
Representative Pollert	✓		Representative Ekstrom		✓
Representative Bellew	✓		Representative Kerzman		✓
Representative Kreidt	✓		Representative Metcalf	✓	
Representative Nelson	✓				
Representative Wieland	✓				

Total (Yes) 19 No 3

Absent 2

Floor Assignment Kretschmar

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

HB 1340, as engrossed: Appropriations Committee (Rep. Svedjan, Chairman) recommends **DO PASS** (19 YEAS, 3 NAYS, 2 ABSENT AND NOT VOTING). Engrossed HB 1340 was placed on the Eleventh order on the calendar.

2007 SENATE JUDICIARY

HB 1340

2007 SENATE STANDING COMMITTEE MINUTES

Bill/Resolution No. **HB 1340**

Senate **Judiciary Committee**

☐ Check here for Conference Committee

Hearing Date: March 5, 2007

Recorder Job Number: 4405

Committee Clerk Signature

Minutes: Relating to Publicly traded corporation ND Century Code and Sec. of States general service fund.

Senator David Nething, Chairman called the Judiciary committee to order. All Senators were present. The hearing opened with the following hearing:

Testimony in Favor of the Bill:

Rep. Klemin, Dist. #47 Intro the bill as the prime sponsor. This is an exciting new area that we should be getting into in respect to business associations in ND. Spoke of flexibility of organizations and this is another form to do businesses that corporations who are publicly traded may choose. He spoke to the fees the Secretary of State will receive and introduced Bill Clark who will review the bill for the committee.

Al Jaeger, ND Secretary of State – Att. #1

William Clark Jr. Att. #2a ND Corporate Governance Council, Vogal Law Firm. Reviewed the bill – Att. # 3; Sen. Nething asked who would use this? His response was that he did not know. He also submitted Corp. Accountability Report Att. #2b and a letter from Melvin A. Eisenberg, U of CA Att. #3c

Sen. Nething stated in the property access portion, as he understands it, the bill would mandate a corporation utilizing this structure to include in its listing of candidates for director those nominated by 5% of its shareholders, who have owned it for at least two years. Yes and he reviewed the proxy statement ballet process. Mr. Clark continued with section 5 (meter 22:00) He spoke to the bill being a collection of leading ideas in its area and what the intent of the bill is trying to do; spoke to corporate radars, poison pills and proxy.

Att. #4 is a short overview of the bill.

Sen. Nething spoke to the reimbursement portion of the bill (meter 26:47) and they discussed the process and gave a proxy election example. They spoke to the limitations on "poison pills" and what the chapter will permit (meter 29:00). The majority vote was discussed on page 6 (meter 30:00) and the anti-take-over provision.

Sen. Fiebiger asked could a public corporation sign on to this if it has such specific provisions? Why would they not do it the way they want to do it? (meter 33:00) Publicly traded organizations can do most of what is in this bill. **Mr. Clark** spoke to legislation passed in Delaware and other states he though would make the changes. Problem is under FCC rules can submit one proposal a year. To do the whole set, it would take a large effort. What we are hoping is this will create a "brand" under which people investing into ND they guarantee the most responsive business to invest in, this is consistent with my studies of profitability. Referred to current system and how you have to read through all of its detailed paperwork. The marketplace would like this "Brand".

Sen. Nething stated you can either take the whole law or go by current law and pick and chose what you want to do. They spoke to both processes (meter 36:50) Sen. Nething asked how would you know who was what. (meter 37:20) If they file under 10-35 it is one step. This is identified in the "Article of Corporation".

Sen. Fiebiger questioned on the bottom of page 14, in the conduct and business of the share holders meeting, No. 3 How is "resonable and fair" defined? They sound very vague. **Mr. Clark** responded that the language came from the model Business Corporation Act. This is recently adopted and we will find out what it means as states use it. We will probably get case law on this more so then any other provision.

Jim Poolman, ND Insurance Commissioner (meter 39:14) I am interested in this bill due to the regulatory aspects. As a state base insurance regulation, the hallmark is financial solvency. I think this legislation is innovated from the stand point of shareholder rights. Potential insurance companies from around the country who's shareholders are interested in the actions of companies. We a currently working on settlements from insurance companies, and he stated severe, where the shareholders have been at the verge of riots and want more say. They will look at ND to incorporate here. This is an optional piece of legislation. We are doing corporate governances' issues with some of our smaller local mutual companies. He gave the definition and spoke to them.

William Guy III, Spoke in support (meter 41:00) of the bill stating it will be good for ND with no discernable downsides, since it is optional.

Testimony Against the bill:

Dave MacIver, President of ND Chamber representing ND Chamber of Commerce (meter 42:12) – Att. #5, representing 16 other chambers across ND. Stated that this bill could do the reverse that it is intending. ND has 2 current companies that this would apply. Also submitted a letter from Mark Anderson's letter Att. # 6. Spoke of his corporate legal advisors. I am not an attorney and do not pretend to be one. I stand before you asking you to not vote for this piece of legislation, there are too many questions about this legislation that have yet to be resolved.

Sen. Nething stated that it would have been nice if Mr. Anderson was here to ask questions to. How can someone who is not involve in this, have his own business to run, and worry about someone else's opportunity? He continued, "Capital Insider" is your publication? Yes, **Mr. MacIver** replied.

Sen. Nething: On page 4, you list this on your hearing schedule and it is listed as "neutral".

Mr. MacIver: Yes we did as of last Thursday;

Sen. Nething: This article is dated March 2nd, Friday.

Mr. MacIver: I did not get to my staff in time, I apologize. **Sen. Nething** continued by asking how his organization decides if they are for or against, what is your process?

Mr. MacIver: It is to contact the people who are available along with presenting the information to our executive committee.

Sen. Nething asked that each member is contacted with the information?

Mr. McIver: Yes all those who speak **for** us are contacted; we also take a large amount of our information from the people around us. **Sen. Nething** continued to question; does your organization not have a legislative committee?

Mr. McIver: Yes, we have a legislative committee and it is near impossible to get them all together, they live across the state.

Sen. Nething: Your opinion is not from your legislative committee.

Mr. McIver: No sir, it is not.

Sen. Fiebiger asked (meter 48:37) stated the bill being optional, I do not understand your concerns. Why are you so concerned if they do not have to do it? He replied, as a non attorney, people are telling us, which even as optional people trying to corporate out of state people from other states, if they chose to move in, will take a look at this as a detriment. This would be looked as an "anti" business state to them.

Sen. Nething asked if he had stated this in the house. No. The Sen. continued with his thoughts of this as another opportunity to do business and a handful of you do not. Are there any others in opposition? No, I guess the chamber stands alone.

Testimony Neutral to the bill:

Rick Clayburgh, ND Bankers Assoc. We have reached out to a number of attorneys across the country, our concern is to how this will impact economic development, our banks are very active with that. Spoke of conversations with the former governor Ed Schafer, and his work with his "charge of elimination of accumulative voting rights". With that gone what type of impact will this have with them? His concern is if we pass it, perhaps we should put a sunset on it to reevaluate it, if it does give us a "black eye". At that time if it did not, make it law. He spoke of the putting the legislation in as a study and passing it after, the findings are satisfied. It would still not address our concern; that other people in the country may wonder what ND is up to.

Senator David Nething, Chairman closed the hearing.

2007 SENATE STANDING COMMITTEE MINUTES

Bill/Resolution No. **HB 1340**

Senate **Judiciary Committee**

☐ Check here for Conference Committee

Hearing Date: March 12, 2007

Recorder Job Number: 4877

Committee Clerk Signature Mona L Galley

Minutes: Relating to publicly traded corporation ND Century Code and Secretary of States general service fund.

Senator David Nething, Chairman called the Judiciary committee to order. All Senators were present. The hearing opened with the following committee work:

Sen. Lyson stated that Bankers in his hometown were not in approval of the bill. Sen. Nething stated that the bill has nothing to do with them.

Sen. Nelson made the motion to Do Pass HB 1340 and **Sen. Marcellais** seconded the motion. All members were in favor and the motion passes.

Carrier: **Sen. Nething**

Senator David Nething, Chairman closed the hearing.

Date: 3-12-07
Roll Call Vote # 1 of 1

2007 SENATE STANDING COMMITTEE ROLL CALL VOTES

BILL/RESOLUTION NO. 1340

Senate Judiciary Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number _____

Action Taken Do Pass

Motion Made By Sen. Nelson Seconded By Sen. Marcellais

Senators	Yes	No	Senators	Yes	No
Sen. Nething	✓		Sen. Fiebiger	✓	
Sen. Lyson	✓		Sen. Marcellais	✓	
Sen. Olafson	✓		Sen. Nelson	✓	

Total Yes 6 No 0

Absent 0

Floor Assignment Sen. Nething

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

HB 1340, as engrossed: Judiciary Committee (Sen. Nething, Chairman) recommends **DO PASS** and **BE REREFERRED** to the **Appropriations Committee** (6 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). Engrossed HB 1340 was rereferred to the **Appropriations Committee.**

2007 SENATE APPROPRIATIONS

HB 1340

2007 SENATE STANDING COMMITTEE MINUTES

Bill/Resolution No. 1340

Senate Appropriations Committee

☐ Check here for Conference Committee

Hearing Date: 03-16-07

Recorder Job Number: 5205

Committee Clerk Signature

Minutes:

Chairman Holmberg opened the hearing on HB 1340.

David Nething, District 12, Jamestown, introduced HB 1340 indicating the bill creates other methods of operating a business with specific benefits to publicly held corporations. There are three publicly held corporations in ND but they will not be able to participate in this structure. The main difference between this and other types of ownership is that the current law favors management and this ownership would favor the shareholder. It gives the shareholder the opportunity to review management and if the shareholders choose they can elect officers. The dollars come from the fees that are paid. We don't know how many will elect this.

Senator Bowman questions the poison pill. The response was when talking about corporations and hostile takeovers that is the poissoin pill. This is designed for protection of the corporation from certain things.

Al Jaeger, Secretary of State, discussed HB 1340 indicated the bill has been in development for six months. This is an opportunity for public traded corporations. Ilt must be specifically stated in the articles of corporation. This type of legislation is a choice. We have no idea how many companies will do this. Out of every fee, the Secretary of State keeps 10 percent to put in the operating fund and if it goes over big and there are many players, we will go to the emergency commission. The general services operating fund has a top amount of $75,000 so

everything over that at the end of the biennium will go to the general fund. In doing it this way, the Secretary of State Office will have funds to cover expenses.

Senator Krebsback asked if she was right that this bill would give shareholders more rights. The response was yes.

Senator Tallackson asked how the fees are set. The response was the formula is based on the number of stocks. If we have a very large company we could easily hit $80,000 .

Senator Lindaas questioned if there is a downside and did anyone testify against the bill. The response was that in the House no one testified against the bill. In the Senate, there was one person testifying against the bill, but the testimony didn't make sense as it was not based on accuracy. We don't know of any downside.

Senator Mathern questioned there being only two corporations that are publicly traded in ND. The response was those companies were incorporated under the laws in place at the time. People will not leave ND in groves as we only have two publicly traded companies.

Senator Lindaas asked if other states have this. The response was other states have different forms of this but ND will have the only stand alone chapter that is very specific.

Cal Rolfson, representing non-profit corporations, testified in support of HB 1340. He believed the front page of the Wall Street Journal will feature ND and this legislation. It is the purest of the win win situation for ND. There is no risk to the corporations, only options and opportunities.

Chairman Holmberg closed the hearing on HB 1340.

Senator Mathern moved a do pass, Senator Christmann seconded. A roll call vote was taken resulting in 13 yes, 0 no, 1 absent. The motion passed and Senator Nething will carry the bill.

2007 SENATE STANDING COMMITTEE MINUTES

Bill/Resolution No. **HB 1340**

Senate Appropriations Committee

☐ Check here for Conference Committee

Hearing Date: **March 19, 2007**

Recorder Job Number: **5232**

Committee Clerk Signature	Janet Pinks

Minutes:

Al Jaeger, Secretary of State

This type of legislation is permissive, it's a choice, and by passing this law you're building a ball field, we don't know as I've stated in the fiscal note, we have no idea where they're going to come from. The way we have it structured is that rather than making any changes to the budget to accommodate this, what we have suggested is that out of every fee that comes in my office gets 10% to put in the operating fund. Those of you who have seen the operating fund, my retail account. If we get one, we can cover the expense, if we get inundated by 100, or 20 or 50, we will have the revenue to cover expenses. If we really go way overboard and get many, many players, then what we'll do is that we will come through the process of emergency commission and the budget section and ask you to raise our spending authority if we needed to cove rour expenses. The general services operating fund that I have in my budget has a ceiling, at the end of the biennium, any profit that I have in that account gets turned over into the general fund. If we get 5 or whatever the number might be, at the end of the biennium if I'd been able to cover all expenses in current appropriations, great, whatever we've generated into the fund, everything over $75,000 gets turned into the general fund anyway. The thing we were concerned about is that there's no way before I could have stood before this committee

and asked for a general fund appropriation when we have no clue whether we'll have the funds. By doing it this way, whatever the traffic will bear, we will be able to cover the expenses associated with administering the law. At the end of the biennium, you'll get it anyway. We thought that would work the best. The bulk of it goes to the general fund, we have no way of knowing. We know we're going to have some, we know that there will be interest out there, but we have to wait and see, that's why I structured the bill the way it was. I'm excited about it because it is an option and if we get some players, all I can say, it is more than we had before. If we get none, we didn't lose any, either.

S Krebsbach: My recollection on all of this is that it has to voting rights, and is it correct in that fact that it gives the share holders MORE rights?

Al J: Yes, that's what it's all about. The testimony in the Judiciary was very detailed and extensive. Of all the copies of all the different testimony, it's a different structure. I can share with you numerous news stories where publicly traded corporations and their shareholders are up in arms right now and don't like the structure going on right now. I foresee there will be corporations that are going to look at this as an opportunity because you wonder if it is worth $80,000, in a sense, we're selling a brand. Rather than being XYZ, that will indicate to investors that this is a company that is shareholder friendly. I would suspect some astute company is going to say, "you know, that is worth something to me if I can go out with all the controversy going on out there, publicly traded companies, I can go to investors and say, we're shareholder friendly." That's an option. If we know there are people that are against us and I'm puzzled by it because no one is forced to use it. As S Nething said, this body in the last 14 years has created options for the people in ND. Limited liabilities companies were created in 1993. We have almost 9,000 companies that choose one of these, they were options and this is just another option.

S Tallackson: How do you effect the fee? You said you have a range.

Al J: There is a formula based on stock and different things, there is a calculation made. If we land some really large accounts as in any stock exchange, they're going to hit the $80,000 very easily. There is a ceiling, not more than $80,000, there is a formula in there.

S Lindaas: What's the down side? Did anyone testify against it? What was their view?

Al J: Both the House and Senate. In the House, no one testified against it and in the Senate, when a person testified against it and the testimony attached to it was puzzling. There were comments that corporations would leave ND in droves. I thought, OK, we have 2, so they're going to leave in droves? I didn't understand that. The other comment was that there would be NO attorney in their right mind that would recommend this type of business. First of all, I would not be involved in it if I didn't think it was OK. You know my office has worked with a committee of the bar association. The person we've worked with is William Guy III, Attorney from Fargo. He has been involved with us from the beginning. He testified in favor of this bill in Senate Judiciary. This has gone through a lot of scrutiny. I do not understand the opposition. What I have read is not based, at all, with any type of accuracy. I don't know of any down side. The worst that could happen is that nobody will show up.

S Mathern: The corporations that are publicly trading, how did they come to be publicly trading in ND if they didn't have a vehicle as we are providing?

Al J: Essentially, what we did the incorporated under the previous laws that we had, which was possible. The constitution has previously dictated how the corporation could operate with shareholders. They consciously could operate with shareholders. If they consciously made a decision to go up to go ahead, but the fact that we only have 2 after 117 years, indicates our regular corporations, we're at an all time high. Our numbers are there, there's not going to be anybody that's going to be leaving in droves. They have to opt in, and it's very specific. Very

specific guidelines were set. It had to be a separate, stand-alone chapter and the articles specifically have to reference that chapter, the articles SPECIFICALLY have to reference that chapter. So there's NO misunderstanding as to what they're doing and that's free choice. If people are willing to pay $80,000 a year and play in our ball field...why not?

S Lindaas: Are there other ball fields around the country in other states? Do they have the same set up, or the percentage?

Al J: This is the beauty of it right now. Different states have varying laws but would allow different forms of it. The fact is because they have the laws in place and they're scattered and what have you, the beauty of it is that we will have the ONLY stand-alone chapter that is very specific. There isn't any other state that has it as securely set out as this one has. Quite frankly, our founding fathers did us a favor, they put a restriction in the constitution that for 117 years we weren't very attracted to the business community. That's another thing that was said, that it's going to make ND look anti-business, I said, "ok, compared to what?" For 117 years we weren't very attractive to a publicly traded corporation. We're kind of a virgin in this area, we can come in and create this chapter that's not mixed with any other laws. Again, it's a choice if people want to come in and use it, let's give them that option.

S Holmberg: We would have used "ingénue" instead of virgin.

Cal Wilson, Non-Profit Corporation sponsoring the bill, Supports the bill & concept

I support what SOS has told you. I'm assuming he's answered all your questions. The value of this bill is that when this bill passes, the next day, the Wall Street Journal will make ND one of the premier business communities in the U.S., it's about time. There are unknown values that this can provide. There are unknown risks that the state faces by having this. It is the purest of the "win-win" situations for the state of ND, and can only say that I am proud to be a small part of this bill. The option part is wonderful, it is the opposite of what Delaware provides and since

we have a publicly-traded corporation area, since we are probably with the smallest number of publicly-traded operations in the U.S., I'm sure, we've had "2," seems to me it's a wonderful opportunity in the state. The existing ones are grandfathered-in. There is no risk to any existing appropriations, there are only options and opportunities.

S Holmberg: No more testimony, we will close the hearing.

CLOSED

Motion for a DO PASS by S Mathern

Second by S Christmann

Roll Call for DO PASS ON HB 1340. Unanimous DO PASS

Bill goes back to Judiciary

Date:
Roll Call Vote #:

2007 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 1340

Senate Appropriations Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number

Action Taken DP

Motion Made By Nath Seconded By ChrisTmann

Senators	Yes	No	Senators	Yes	No
Senator Ray Holmberg, Chrm	✓		Senator Aaron Krauter	✓	
Senator Bill Bowman, V Chrm	✓		Senator Elroy N. Lindaas	✓	
Senator Tony Grindberg, V Chrm			Senator Tim Mathern	✓	
Senator Randel Christmann	✓		Senator Larry J. Robinson	✓	
Senator Tom Fischer	✓		Senator Tom Seymour	✓	
Senator Ralph L. Kilzer	✓		Senator Harvey Tallackson	✓	
Senator Karen K. Krebsbach	✓				
Senator Rich Wardner	✓				

Total (Yes) 13 No 0

Absent 1

Floor Assignment Nathang ~~HB~~ Jud

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

HB 1340, as engrossed: Appropriations Committee (Sen. Holmberg, Chairman) recommends **DO PASS** (13 YEAS, 0 NAYS, 1 ABSENT AND NOT VOTING). Engrossed HB 1340 was placed on the Fourteenth order on the calendar.

2007 TESTIMONY

HB 1340

NORTH DAKOTA CORPORATE GOVERNANCE COUNCIL

200 North 3rd Street ▪ Suite 201 ▪ Bismarck ▪ North Dakota ▪ 58502

January 23, 2007

Overview of New Chapter 10-35, N.D.C.C.

Purpose of Chapter 10-35

- The ultimate goal in enacting Chapter 10-35 is to improve the performance of publicly traded companies. Academic studies are increasingly demonstrating a clear link between improved corporate governance and improved performance. Thus, enactment of Chapter 10-35 is fundamentally a pro-business initiative.
- Virtually everyone is a shareholder today – either directly or indirectly (through 401K's and similar plans, state or union pension funds, life insurance products, etc.). So we all have a stake in improved corporate performance.
- Continued attention to issues of corporate governance is needed – and inevitable – because the "Wall Street Walk" is no longer an option for many institutional investors.
    - Before the rise of large mutual funds, pension plans, and index funds, investors who were dissatisfied with a stock's performance sold out their position and invested in another company.
    - Today, investors with a large position are essentially locked into their investment and have no choice but to focus on improving governance. Index funds and funds with very specific investment strategies or narrow industry focuses also have very limited options other than using their governance rights to seek change and improved performance.
- Sadly, the Enron, WorldCom, Tyco, Adelphia, etc. scandals of a few years ago that produced the federal Sarbanes-Oxley law have not ended. The latest scandals and signs of continuing abuse include option backdating and the severance package for the recently departed CEO of Home Depot. The need for an alternative model of good corporate governance like Chapter 10-35 remains as important as ever.
- By providing a new model of corporate governance at the state level, Chapter 10-35 is a much less radical approach to corporate governance reform than if changes are imposed at the federal level on all publicly traded corporations.
    - Chapter 10-35 will hopefully avoid some of the problems caused by Sarbanes-Oxley which imposed its changes on all publicly-traded corporations.
    - By applying on a limited and voluntary basis, Chapter 10-35 will allow for "experimentation" to see what works and will permit future adjustment based on experience.

Chapter 10-35 is Optional

- Chapter 10-35 does not apply to existing corporations. It will apply only to

corporations that elect to incorporate under it after July 1, 2007.

- After a corporation becomes subject to chapter 10-35, it remains optional because the shareholders may elect to exempt their corporation from chapter 10-35 or to reincorporate under a different state law. Either of those actions will be able to be taken by a simple majority vote.

Benefits to North Dakota

- The franchise fee imposed by Chapter 10-35 should eventually produce substantial revenue.
    - According to the 2005 annual report of the Delaware Division of Corporations, which is available on its website, the Division collected $491.1 million in corporation franchise taxes during fiscal year 2005.
- Chapter 10-35 will encourage infrastructure growth.
    - ND public corporations will need ND lawyers.
    - Having any substantial number of public corporations incorporated in ND will produce an increase in commercial litigation involving those corporations. (Which will be a good thing from the point of view of economic development in ND. Local counsel in ND will be needed; out-of-state lawyers coming for trials will need hotels, etc.)
- Enactment of Chapter 10-35 will give ND national visibility.
    - ND will be at the center of the national debate on corporate governance. No other state has a corporation law that is as focused on the concerns of shareholders. Other state laws reflect to a substantial degree the perspective of management (reflecting the fact that management has been much more active in the political process).
    - Enactment of Chapter 10-35 will be an opportunity for ND to portray itself as committed to the future of capitalism and to strengthening the economy for the benefit of everyone.

Significant Provisions (in decreasing order of importance)

- Majority voting in election of directors.
    - This is currently the biggest issue for activist shareholders and is already being proposed on a company-by-company basis.
    - Majority voting has been the rule in Europe for years.
    - Delaware and the Model Business Corporation Act have added provisions that provide for a partial form of majority voting, but Chapter 10-35 will be the first state law to require true majority voting.
- Advisory shareholder votes on compensation reports.
    - Controlling run-away CEO compensation is currently a major corporate governance issue, with even major CEOs such as Jeffrey Immelt of GE saying that CEO compensation should be more in-line with the compensation of a company's other senior management.
    - Advisory shareholder votes have been used successfully in Europe.
- Proxy access (right of large, long-term shareholders to include nominees in the corporation's proxy statement).
    - This was proposed by the SEC in 2003, but has been on hold.

- Reimbursement for successful proxy contests.
    - This has been proposed by academics, but has not been implemented to date.
    - The purpose is to provide a more level playing field for shareholders since management has the resources of the corporation to pay for its proxy solicitation.
- Separation of roles of Chair and CEO.
    - Many companies have already voluntarily adopted this restriction.
- Limitations on poison pills.
    - It is important to note that Chapter 10-35 does not prohibit all poison pills. Some activist shareholders would look to prohibit poison pills entirely, but experience has shown that poison pills can be valuable in keeping a company from being sold at less than full value. Chapter 10-35 strikes a balance that protects a corporation from being taken over "on the cheap" while not allowing a poison pill to be used improperly to entrench management.
- Limitations on supermajority provisions.
    - Supermajority provisions are becoming less common and many companies are already eliminating them from their governance documents when that is proposed by shareholders.
- Limitation on antitakeover provisions.
    - As with supermajority provisions, these provisions are becoming less common and are also the subject of shareholder proposals to eliminate them.

NORTH DAKOTA CORPORATE GOVERNANCE COUNCIL

200 North 3rd Street ▪ Suite 201 ▪ Bismarck ▪ North Dakota ▪ 58502

January 23, 2007

Explanation of House Bill No. 1340 (the North Dakota Public Corporations Act)[1]

Proposed Chapter 10-35 of the North Dakota Century Code with respect to publicly-traded corporations provides a system of corporate governance that is designed to strengthen corporate democracy and improve the performance of publicly-traded corporations.

An increasing number of studies have demonstrated a clear link between improved corporate governance and improved performance by publicly-traded corporations.[2] Notwithstanding the growing evidence of the direct correlation between greater rights for shareholders and improved performance, state corporation laws have not yet moved in the direction of providing those greater rights. Instead, it has been left to shareholders to seek greater rights on a company-by-company basis.

Chapter 10-35 will be the first state corporation law to focus on providing a new model of shareholder rights that builds upon the best thinking of large institutional investors. No other state corporation law provides the full set of shareholder rights provided by Chapter 10-35. Being incorporated in North Dakota will represent a new seal of approval for publicly-traded corporations committed to corporate democracy and improved performance.

Chapter 10-35 has two basic parts:

- Sections 10-35-01 through 10-35-27 establish the new system of corporate governance for publicly-traded corporations. The new rules on corporate governance will apply only to those corporations that elect to be incorporated under North Dakota law and to be subject to Chapter 10-35.
- Sections 10-35-28 through 10-35-33 impose a franchise fee on the corporations subject to Chapter 10-35, similar to the Delaware franchise tax, but at 50% of the rate imposed by Delaware.

---

[1] The discussion in this explanation assumes that amendments that will be proposed to HB 1340 at the hearing before the House Judiciary Committee on January 24, 2007 have already been made.

[2] See the article behind tab 1 describing the results of some of that research which concludes that "the quality of a particular company's governance practices and procedures positively correlates with both good corporate financial performance and stockholder value." Eisenhofer and Levin, "Does Corporate Governance Matter to Investment Returns?" Corporate Accountability Report, Vol. 3, No. 57 (September 23, 2005).

Corporate Governance Provisions

The corporate governance provisions applicable to publicly-traded corporations incorporated in North Dakota that elect to be subject to Chapter 10-35 are as follows:

Citation (§ 10-35-01) The short title "North Dakota Public Corporations Act" provides a convenient way of referring to Chapter 10-35.

Definitions (§ 10-35-02) The definitions in this section are used throughout Chapter 10-35.

"Beneficial owner" and "executive officer" have the same meanings in Chapter 10-35 as they do in the rules of the SEC. By using the SEC definitions of those terms, the provisions of Chapter 10-35 will stay consistent with federal law.

"Commission" and "Exchange Act" are standard ways of referring to the U.S. Securities and Exchange Commission and the principal Federal securities law applicable to publicly-traded corporations.

"Poison pill" was originally coined as a pejorative term for the most effective antitakeover device developed during the 1980's which is sometimes referred to by the more formal name of a "shareholder rights plan." This definition is used in sections 10-35-22 through 10-35-25 and is intended to be construed broadly to accomplish the purposes of those sections. The definition of "poison pill" is patterned in part after 15 Pa.C.S. § 2513.

The definition of "public corporation" sets forth the characteristics of a corporation that is subject to Chapter 10-35:

- it is a domestic corporation incorporated under the North Dakota Business Corporation Act, Chapter 10-19.1 (the "BCA") after July 1, 2007; and
- its articles of incorporation state that it is subject to Chapter 10-35.

The final requirement that a corporation include a provision in its articles electing to be subject to Chapter 10-35 is what makes Chapter 10-35 an optional choice that must be affirmatively elected by a corporation.

"Qualified shareholder" is used in section 10-35-08 with respect to access to a corporation's proxy statement.

"Required vote" is used in section 10-35-26 with respect to adoption of antitakeover provisions.

Application and Effect of Chapter 10-35 (§ 10-35-03)

Chapter 10-35 provides a new paradigm for corporate governance of public corporations. As described above, the definition of "public corporation" in section 10-

35-02 requires a corporation affirmatively to elect to be subject to Chapter 10-35. Section 10-35-03(1) confirms that Chapter 10-35 only applies to those corporations.

Section 10-35-03(2) makes clear that Chapter 10-35 does not affect any statute or law applicable to a corporation that is not a domestic public corporation. Thus the rules in Chapter 10-35 should not have any effect on North Dakota corporations that are not "public corporations."

Section 10-35-03(3) makes clear that the articles of incorporation or bylaws of a public corporation may not be inconsistent with Chapter 10-35. This same rule is found in sections 10-19.1-10(6) and 10-19.1-31(1) which provide that the articles and bylaws may not be inconsistent with the BCA. If a public corporation could change the way Chapter 10-35 applies to it, that would defeat one of the purposes of Chapter 10-35 which is to permit corporations committed to good corporate governance to be identified simply by the fact of their incorporation in North Dakota. Stated differently, section 10-35-03(3) prevents dilution of the brand "North Dakota public corporation."

Section 10-35(4) provides clarity on how share ownership percentages are to be computed for purposes of Chapter 10-35.

Application of Chapter 10-19.1 (§ 10-35-04)

Several of the provisions of Chapter 10-35 vary the otherwise applicable rules in the BCA. Thus, section 10-35-04(1) provides generally that the provisions of Chapter 10-35 control over any inconsistent provision of the BCA.

Section 10-35-04(2) and (3) make the definitions in Chapter 10-19.1 applicable to Chapter 10-35 as well.

Amendment of the Bylaws (§ 10-35-05)

The BCA limits the right of shareholders to propose amendments of the bylaws to shareholders who own 5% or more of the outstanding shares. Section 10-35-05(1) adopts the more usual rule that any shareholder may propose a bylaw amendment. A similar change is made by section 10-35-12(3) with respect to the right of a shareholder to demand the holding of a delinquent regular meeting.

Section 10-35-05(2) reverses the otherwise applicable rule under BCA section 10-19.1-31(3)(a) that the articles or bylaws may impose additional requirements on proposals by shareholders to amend the bylaws.

Board of Directors (§ 10-35-06)

BCA section 10-19.1-35(1) permits the articles or bylaws to provide a fixed term for directors of up to five years. Section 10-35-06(1), in contrast, requires that the term of directors of a public corporation not exceed one year.

Section 10-35-06(2) prohibits a public corporation from staggering its directors into different classes, with the result that all directors will be elected each year. This varies the rule in BCA section 10-19.1-35(2) which permits the articles or bylaws to provide for staggered terms for directors.

Section 10-35-06(3) prohibits a public corporation from changing the size of its board of directors at a time when the board of directors knows or has reason to know that there will be a contested election of directors. This will keep the corporation from improperly interfering in the election contest and is consistent with the case law in Delaware. *See, e.g., MM Companies, Inc. v. Liquid Audio, Inc.*, No. 606 (Del. Supreme 2003); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

Section 10-35-06(4) requires the board of directors to elect a chair and prohibits the chair from serving as an executive officer of the corporation.

Nomination of Directors (§ 10-35-07) Section 10-35-07 permits a public corporation to adopt a requirement that a shareholder notify the corporation in advance if the shareholder plans to nominate a candidate for election as a director. The adoption of this type of provision by public corporations is very common. But Section 10-35-07 adds a time limit, the same as in § 10-35-14 with regard to advance notice of shareholder proposals, on how far in advance the notice may be required to be given. See also the requirement in section 10-35-16(1) that a corporation make a public announcement of the date of a meeting which will give the shareholders notice of the deadline for complying with the advance notice provision. Section 10-35-07(2) restricts the corporation from imposing burdensome requirements on the shareholder to provide information about the nominations.

Access to Corporation's Proxy Statement by Major Shareholders (§ 10-35-08) Section 10-35-08 gives a shareholder or group of shareholders who have held at least 5% of the outstanding shares of a public corporation for at least two years the right to have candidates nominated by them included in the corporation's proxy statement. This provision is similar to a proposal made by the SEC in 2003 which has been put on hold by the SEC. The language of section 10-35-08 is patterned after portions of the SEC's proposal. The most significant differences between section 10-35-08 and the SEC proposal are that the SEC proposal would give the shareholder the right to include only a limited number of nominees and would only apply after certain triggering events had occurred.

Election of Directors (§ 10-35-09)

Section 10-35-09(1) prohibits a public corporation from adjourning a meeting at which directors are to be elected until the election has been completed. The purpose of this provision is to keep the incumbent directors from adjourning to solicit additional votes if they know their candidates are losing.

Currently under the BCA, shareholders do not have the right to vote against nominees for election as directors; they can only vote in favor of candidates or withhold their votes. Those candidates receiving the highest number of votes, up to the number of positions to be filled, are elected. Changing that system of electing directors is currently one of the hottest topics in corporate governance. Shareholder activists have been seeking to change the current system for two reasons: it does not give them an effective way to express their displeasure with a nominee (as they feel being able to vote "no" would do), and it can result in a candidate being elected with a very small number of votes (theoretically as few as one vote).

In contrast to the plurality voting system, section 10-35-09(2) provides for a true majority voting system under which shareholders in an uncontested election[3] may vote "yes" or "no" on each candidate, and only those candidates receiving a majority of "yes" votes are elected.

Section 10-35-09(5) recognizes that directors may be elected by consent without a meeting and provides a rule on when an election of directors by consent will substitute for the holding of a regular meeting. Section 10-35-09(5) is patterned after Section 211(b) of the DGCL.

Reimbursement of Proxy Expenses (§ 10-35-10) Section 10-35-10 requires that a shareholder be reimbursed for the expenses of conducting a proxy contest to the extent the shareholder is successful. Thus, for example, if a shareholder nominates four candidates and three are elected, the shareholder will be reimbursed for 75% of the shareholder's expenses.

Supermajority provisions prohibited (§ 10-35-11) Section 10-35-11(1) establishes a majority of the full board of directors as the maximum quorum and vote requirement that may be imposed by the articles or bylaws. Section 10-35-11(2) similarly establishes a majority as the maximum quorum and vote for shareholders.

Regular Meeting of Shareholders (§ 10-35-12)

Section 10-35-12 requires a public corporation to fix in its articles or bylaws the latest date by which the corporation's regular meeting must be held each year. This will keep a corporation from delaying its annual meeting to avoid being accountable to its shareholders.

Section 10-35-12(5) adopts the European practice of having the shareholders vote on an advisory basis on a report of the compensation committee of the board of directors.

Call of Special Meeting of Shareholders (§ 10-35-13)

BCA section 10-19.1-72 permits the holders of at least 10% of the votes entitled

[3] The definition of what constitutes an uncontested election in section 10-35-09(3) is derived from Model Business Corporation Act § 10.22(b).

to be cast on an issue to call a special meeting of shareholders to vote on the issue, except that a meeting called to consider a business combination may only be called by shareholders owning 25% or more of the outstanding shares. Section 10-35-13 eliminates the special rule for calling a meeting to consider a business combination, with the result that 10% of the shares will be able to call a meeting for any purpose.

Section 10-35-13(2) prevents the corporation from restricting the right to call a special meeting or the business that may be conducted at a special meeting.

Shareholder Proposals of Business (§ 10-35-14) Section 10-35-14 permits a public corporation to adopt a requirement that a shareholder notify the corporation in advance if the shareholder plans to propose any business at a regular meeting. The adoption of this type of requirement by public corporations is very common. But section 10-35-14 adds a time limit on how far in advance the required notice must be given. See the discussion of section 10-35-07, above. Section 10-35-14(2) restricts the corporation from imposing burdensome requirements on the shareholder to provide information about the proposal.

Shareholder Proposals of Amendment of the Articles (§ 10-35-15) BCA section 10-19.1-19 gives shareholders owning 5% or more of the outstanding voting power the right to propose an amendment of the articles. Section 10-35-15(1) restricts the corporation from imposing burdensome requirements on shareholders exercising that right to provide information about the proposed amendment.

Requirements for Convening Shareholder Meetings (§ 10-35-16)

Section 10-35-16(1) requires a public corporation to make a public announcement of the date of a regular meeting far enough in advance of the meeting so that its shareholders can comply with an advance notice requirement adopted under section 10-35-07 or 10-35-14.

Brokers who hold shares in "street name" have the ability to vote those shares on routine matters without receiving instructions from the beneficial owner, but in instances where the broker is not permitted to vote on non-routine matters the broker may return a proxy card with a "broker non-vote." Section 10-35-16(2) makes clear how broker non-votes affect the existence of a quorum at a meeting of shareholders.

Approval of Certain Issuances of Shares (§ 10-35-17) Both the Model Business Corporation Act and the New York Stock Exchange require shareholder approval before a corporation may issue shares having more than 20% of the outstanding voting power. Section 10-35-17 adopts the same approach for all public corporations since not all public corporations are subject to the NYSE requirement.

Preemptive Rights (§ 10-35-18) Section 10-35-18 makes clear that shareholders in a public corporation do not have preemptive rights.

Conduct and Business of Shareholder Meetings (§ 10-35-19) Subsections 1 through 4 of section 10-35-19 are patterned after Section 7.08 of the Model Business Corporation Act and provide rules on how shareholder meetings are to be conducted.

Action by Shareholders Without a Meeting (§ 10-35-20) BCA section 10-19.1-75 permits shareholders to act by majority consent without a meeting if the articles authorize them to do so. Section 10-35-20 eliminates the requirement that action by majority consent be authorized in the articles, thus making action by majority consent available in all public corporations.

Financial Statements (§ 10-35-21) Since public corporations are subject to the periodic reporting requirements of the Exchange Act, section 10-35-21 makes inapplicable to them the requirement in BCA section 10-19.1-85 that a corporation furnish a financial statement on request by a shareholder.

Restrictions on Poison Pills (§§ 10-35-22, 10-35-23, 10-35-24, and 10-35-25) Chapter 10-35 does not prohibit the adoption of all poison pills because experience has shown that poison pills may be used to benefit shareholders by preventing a corporation from being sold at an inadequate price. But Chapter 10-35 does place limitations on the use of poison pills to keep them from being used improperly to entrench incumbent management. The provisions dealing with poison pills are as follows:

- **Duration of Poison Pills (§ 10-35-22)** Section 10-35-22 prohibits a poison pill that was not approved by the shareholders from being in effect for longer than the shorter of one year or 90 days after a majority of the shareholders have indicated that they wish to accept an offer for the sale of their company. The 90 day period is based on the practice of the Ontario Securities Commission which requires the withdrawal of a poison pill under those circumstances. A poison pill approved by the shareholders is subject to a longer time limit of two years.

- **Prohibition of "Dead Hand" Poison Pills (§ 10-35-23)** Section 10-35-23 prohibits the use of "dead hand" and similar provisions in poison pills. Under that type of provision, only directors in office before an offer is made for the corporation (or successors that those directors approve) may redeem or otherwise disable the poison pill. "Dead hand" provisions have been invalidated by the Delaware courts. Since North Dakota does not have similar case law, section 10-35-23 confirms that the Delaware case law is also the rule in North Dakota. *See Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998); *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180 (Del. Ch. 1998)

- **Restriction on Poison Pill Triggering Level (§ 10-35-24)** Section 10-35-24 prohibits a corporation from adopting a poison pill that has a triggering level of less than 20%. The triggering level is the amount of shares that a party may acquire in a corporation without interference from a poison pill. When poison pills were first being adopted, they usually had triggering levels of between 20% and 30%, but recent poison pills have had triggering levels as low as 10% to 15%.

- **Optional Prohibition of Poison Pills (§ 10-35-25)** Section 10-35-25 makes clear that, if they choose to do so, the shareholders may prohibit the adoption of a poison pill by their corporation.

Adoption of Antitakeover Provisions (§ 10-35-26) Section 10-35-26 requires that any antitakeover provision included in the articles or bylaws of a public corporation must be approved by at least a two-thirds vote of the shareholders.

Liberal Construction (§ 10-35-27) Section 10-35-27 has been included to provide the courts with guidance as to the purpose of new Chapter 10-35, as well as with regard to the general approach that should be taken when interpreting the BCA as it applies to public corporations.

Franchise Fee

Sections 10-35-28 through 10-35-33 impose a franchise fee on public corporations. The fee will be paid only by those publicly-traded corporations subject to Chapter 10-35 (*i.e.*, only those corporations that elect to be subject to Chapter 10-35).

The fee is imposed based on the number of shares a corporation is authorized to issue, with a minimum fee of $60 and a maximum fee of $80,000 each year. The rate at which the fee is imposed is one-half the rate of the similar Delaware franchise tax. Compare DGCL § 503.

ALVIN A. JAEGER
SECRETARY OF STATE

IE PAGE www.nd.gov/sos

PHONE (701) 328-2900
FAX (701) 328-2992

E-MAIL sos@nd.gov

SECRETARY OF STATE

STATE OF NORTH DAKOTA
600 EAST BOULEVARD AVENUE DEPT 108
BISMARCK ND 58505-0500

January 24, 2007

TO: Rep DeKrey, Chairman, and Members of the House Judiciary Committee

FR: Al Jaeger, Secretary of State

RE: HB 1340 – North Dakota Public Corporations Act

There are times in life when someone begins a journey not always knowing where the road will lead. I know I started a few of those journeys on several occasions. However, I also discovered, if one begins the journey for the right reasons, the road could lead to many unanticipated and very satisfying results.

Such a journey, for the right reasons, started in October 2001 and it traveled through two legislative sessions and two statewide elections. It ended when 73% of the voters in the June 2006 election approved an amendment to Article XII of the North Dakota Constitution.

Those of us working to accomplish this goal were not sure what would happen after the constitution was amended, but we knew this. Something needed to be done. We knew there were North Dakota companies incorporating in other states because of provisions in the state's constitution unfavorable to public corporations. As it is, North Dakota has only three state chartered public corporations. All other North Dakota based public corporations are chartered in other states.

Today, North Dakota is in the right place and the right time in history. The bill before you is here because the state's constitution was amended.

As I testified earlier for HB 1241, during the past eight legislative sessions, the Legislative Assembly adopted legislation drafted by the State Bar Association of North Dakota and my office, which resulted in the creation of limited liability companies, limited liability partnerships, and limited liability limited partnerships. In other words, these new business entities provided the state business entrepreneurs with options. Today, those options have been chosen by approximately 9,000 businesses.

North Dakota has provided options for its citizens. Now, it has an opportunity to provide an option to the nation with the adoption of HB 1340.

This bill does not change any of the state's existing laws. Corporations can still operate and still incorporate under the provisions of the state's business corporation act in Chapter 10-19.1. Foreign corporations, regardless of the state of charter, can still do business in North Dakota by filing the appropriate certificate of authority. What this bill does do is create, in law, a form of corporate governance focused on the concerns of shareholders and chosen by those corporations that wish to be chartered under those provisions. No corporation is forced to incorporate under this new chapter.

Since this bill was introduced, several individuals have asked me if the passage of this bill would make North Dakota appear to be an anti-business state. I have to ask, compared to what? For 117 years, the most anti-business corporation clause in the nation was in North Dakota's constitution. Now, North Dakota has an opportunity to provide business corporations with an option. To me, that is the correct image for being viewed as a business friendly state. We provide options.

I am not the expert on the governance structure in this bill. Others will provide that testimony. I also don't know how many corporations will take advantage of this law. I do know this. It is an option. No one is forced to use it. But, if they do, whether it is 5, 10 or 15, I have the best staff in the country and these corporations will experience the North Dakota way of doing things, i.e., efficient, friendly, and timely.

Explanation of Proposed
Amendments to House Bill No. 1340

The attached amendment to House Bill No. 1340 makes both substantive and editorial changes to the bill. The substantive changes are as follows:

Sections 10-35-07, 10-35-14, and 10-35-16: Sections 10-35-07 and 10-35-14 permit a public corporation to require a shareholder to give the corporation advance notice if the shareholder plans to nominate directors or propose business at a regular meeting. When a regular meeting is held at the same time as the previous year's regular meeting, application of an advance notice requirement is fairly easy. But when the date of a regular meeting is moved from its usual time, compliance with an advance notice requirement becomes more difficult. To protect shareholders from a situation in which the date of a regular meeting is moved in a way that makes it difficult to comply with an advance notice requirement, House Bill No. 1340 requires the corporation to announce the date of the meeting. The attached amendment takes the provisions on announcement of a moved meeting date out of sections 10-35-07 and 10-35-14 and replaces them with a single provision in section 10-35-16.

Section 10-35-08: This section gives certain 5% owners the right to have director nominees included in the corporation's proxy statement. It follows the approach of a proposal made by the SEC several years ago which has not yet been adopted. Several changes to the section are made by the amendment:

- The definition of "qualified shareholder" is moved to the definitions section of chapter 10-35.
- The language of subsection 2 is conformed to the definition of "qualified shareholder" in subsection 8 of section 10-35-02.
- The length of time shares must be owned is changed from one year to two years. This change conforms the section to the SEC proposal in this regard and will reduce the number of situations in which the section applies.
- A requirement is added that evidence be provided of ownership of the required 5% of shares.
- The requirement that the shares be owned on the date of the meeting is clarified.

Section 10-35-15: This section relates to the right of shareholders under chapter 10-19.1 to propose amendments to the articles of incorporation. The amendment adds a requirement that a shareholder proposing an amendment provide the corporation with evidence of the shareholder's ownership of the required shares. This change is similar to one of the changes made to section 10-35-08 and tracks similar requirements in sections 10-35-07 and 10-35-14.

Sections 10-35-11 and 10-35-17: A new provision requiring shareholder approval before a public corporation issues 20% or more of its shares is added by the amendment. The Model Business Corporation Act imposes this requirement on all corporations. The

New York Stock Exchange also imposes this requirement, but publicly traded corporations that are not listed on the NYSE may not be subject to it. The current text of section 10-35-17 is moved to section 10-35-11 to make room for the new requirement without the need to add a new section that would require renumbering existing sections 10-35-18 and following.

Section 10-35-24: House Bill No. 1340 permits a public corporation to adopt a poison pill but imposes certain limitations on what the terms of the poison pill may be. The amendment lowers the permitted triggering threshold for poison pills from 25% to 20%. This will permit a corporation to adopt a poison pill that will be more effective because it will stop potential acquirors at a lower ownership level.

Sec of State

PROPOSED AMENDMENTS TO HOUSE BILL NO. 1340

Page 1, line 2, replace "public" with "publicly traded"

Page 1, line 7, replace "Public" with "Publicly Traded"

Page 1, line 14, replace "securities and exchange commission" with "Securities and Exchange Commission"

Page 1, line 19, replace "public" with "publicly traded"

Page 2, line 28, replace "public" with "publicly traded"

Page 3, line 1, replace "Public" with "Publicly traded"

Page 3, line 3, replace "is incorporated" with "becomes governed by chapter 10-19.1"

Page 3, line 5, replace "Public" with "Publicly traded"

Page 3, after line 6, insert

"8. "Qualified shareholder" means a person or group of persons acting together that satisfies the following requirements:

a. The person or group owns beneficially in the aggregate more than five percent of the outstanding shares of the publicly traded corporation that are entitled to vote generally for the election of directors; and

b. The person or each member of the group has beneficially owned the shares that are used for purposes of determining the ownership threshold in subdivision a continuously for at least two years."

Page 3, line 7, replace "8." with "9."

Page 3, line 8, after the first "the" insert "publicly traded"

Page 3, line 16, after "applies" insert "only"

Page 3, line 16, replace "every" with "a"

Page 3, line 16, replace "public" with "publicly traded"

Page 3, line 16, after "corporation" insert "meeting the definition of a "publicly traded corporation" in subsection 6 of section 10-35-02 during such time as its articles state that it is governed by this chapter"

Page 3, line 19, replace "public" with "publicly traded"

Page 3, line 20, replace "public" with "publicly traded"

Page 3, line 21, replace "public" with "publicly traded"

Page 3, line 25, replace "public" with "publicly traded"

Page 3, line 28, replace "public" with "publicly traded"

Page 4, line 1, replace "public" with "publicly traded"

Page 4, line 6, replace "public" with "publicly traded"

Page 4, line 8, replace "public" with "publicly traded"

Page 4, line 12, replace "public" with "publicly traded"

Page 4, line 14, replace "public" with "publicly traded"

Page 4, line 16, replace "public" with "publicly traded"

Page 4, line 22, replace "public" with "publicly traded"

Page 4, line 27, replace "public" with "publicly traded"

Page 5, line 1, replace "public" with "publicly traded"

Page 5, line 10, replace "The date" with "Any deadline"

Page 5, line 17, remove "the later of:"

Page 5, remove lines 18 through 22

Page 5, line 23, replace "(2) Ninety" with "ninety"

Page 5, line 27, replace "public" with "publicly traded"

Page 6, line 4, replace "public" with "publicly traded"

Page 6, line 11, replace "public" with "publicly traded"

Page 6, line 13, replace "shareholder" with "person"

Page 6, line 13, remove the fourth "of" appearing at the end of the line

Page 6, line 14, remove "shareholders"

Page 6, line 15, replace "shareholder" with "person"

Page 6, line 15, remove "of shareholders"

Page 6, line 16, replace "3" with "8 of section 10-35-02 and reasonable evidence of the required ownership of shares by the person or group"

Page 6, line 17, replace "shareholder" with "person"

Page 6, line 17, remove "of shareholders"

Page 6, line 30, remove ""Qualified shareholder" means a person or group of persons acting together that"

Page 6, remove line 31

Page 7, remove lines 1 through 11

Page 7, after line 11, insert:

" If the qualified shareholder does not own at least five percent of the outstanding shares of the public traded corporation entitled to vote generally for the election of directors on the date of the meeting, the qualified shareholder is not entitled to nominate the candidates named in the notice provided under subsection 1."

Page 7, line 13, replace "public" with "publicly traded"

Page 7, line 18, replace "public" with "publicly traded"

Page 8, line 21, replace "public" with "publicly traded"

Page 8, line 25, after "shareholders" insert "of a publicly traded corporation"

Page 9, line 2, replace "public" with "publicly traded"

Page 9, line 13, replace "**Director supermajority**" with "**Supermajority**"

Page 9, line 14, replace "public" with "publicly traded"

Page 9, line 14, remove the first "for"

Page 9, line 14, remove "greater"

Page 9, line 14, remove the second "for" and immediately thereafter insert ":

1. For"

Page 9, line 15, after second "board" insert "that is greater"

Page 9, line 16, after "vacancies" insert "; or

2. For shareholders that is greater than a majority of the voting power of the shares entitled to vote on the item of business or, in the case of a class or series entitled to vote as a separate group, a majority of the voting power of the outstanding shares of the class or series"

Page 9, line 19, replace "public" with "publicly traded"

Page 9, line 23, replace "public" with "publicly traded"

Page 9, line 27, replace "public" with "publicly traded"

Page 10, line 1, replace "public" with "publicly traded"

Page 10, line 5, replace "public" with "publicly traded"

Page 10, line 12, replace "public" with "publicly traded"

Page 10, line 17, replace "public" with "publicly traded"

Page 10, line 22, replace "public" with "publicly traded"

Page 11, line 5, replace "The date" with "Any deadline"

Page 11, line 12, remove "the later of:"

Page 11, remove lines 13 through 17

Page 11, line 18, replace "(2) Ninety" with "ninety"

Page 11, line 22, replace "public" with "publicly traded"

Page 11, line 28, replace "public" with "publicly traded"

Page 12, line 1, replace "public" with "publicly traded"

Page 12, line 7, after "shareholders" insert "and reasonable evidence of that ownership"

Page 12, line 9, replace "public" with "publicly traded"

Page 12, line 14, replace "**Quorum at**" with "**Requirements for convening**"

Page 12, line 15, after "1." insert "If the articles or bylaws of a publicly traded corporation have a provision for advance notice authorized by section 10-35-07 or 10-35-14, a regular meeting of shareholders of the corporation may not be convened unless the corporation has announced the date of the meeting in the body of a public filing, and not solely in an exhibit or attachment to a

filing, regardless of whether the exhibit or attachment has been incorporated by reference into the body of the filing, with the commission under the Exchange Act at least twenty-five days before the deadline in the articles or bylaws for a shareholder to give the advance notice.

2."

Page 12, line 15, replace "public" with "publicly traded"

Page 12, line 17, remove "for"

Page 12, line 18, remove "purposes of section 10-19.1-76"

Page 12, line 19, after "meeting" insert "for purposes of determining the existence of a quorum under section 10-19.1-76"

Page 12, line 20, remove "2."

Page 12, line 22, replace "section" with "subsection"

Page 12, line 23, remove "**Shareholder supermajority provisions prohibited.** Neither the articles nor "

Page 12, remove lines 24 through 27

Page 12, after line 27, insert:

"**Approval of certain issuances of shares.**

1. An issuance by a publicly traded corporation of shares, or other securities convertible into or rights exercisable for shares, in a transaction or a series of integrated transactions, requires approval of the shareholders if the voting power of the shares that are issued or issuable as a result of the transaction or series of integrated transactions will exceed twenty percent of the voting power of the shares of the corporation that were outstanding immediately before the transaction.
2. Subsection 1 does not apply to:
   a. A public offering solely for cash, cash equivalents or a combination of cash and cash equivalents; or
   b. A bona fide private financing, solely for cash, cash equivalents or a combination of cash and cash equivalents, of:
      (1) Shares at a price equal to at least the greater of the book or market value of the corporation's common shares; or
      (2) Other securities or rights if the conversion or exercise price is equal to at least the greater of the book or market value of the corporation's common shares.
3. For purposes of this section:

a. The voting power of shares issued and issuable as a result of a transaction or series of integrated transactions shall be the greater of:
(1) The voting power of the shares to be issued; or
(2) The voting power of the shares that would be outstanding after giving effect to the conversion of convertible shares and other securities and the exercise of rights to be issued.
b. A series of transactions is integrated if consummation of one transaction is made contingent on consummation of one or more of the other transactions.
c. "Bona fide private financing" means a sale in which:
(1) A registered broker-dealer purchases the shares, other securities, or rights from the publicly traded corporation with a view to their private sale to one or more purchasers; or
(2) The corporation sells the shares, other securities, or rights to multiple purchasers, and no one purchaser or group of related purchasers acquires, or has the right to acquire, more than five percent of the voting power of shares issued or issuable in the transaction or series of integrated transactions."

Page 12, line 29, replace "public" with "publicly traded"

Page 13, line 1, replace "public" with "publicly traded"

Page 13, line 4, replace "meting" with "meeting"

Page 13, line 24, replace "public" with "publicly traded"

Page 13, line 28, replace "public" with "publicly traded"

Page 13, line 30, replace "public" with "publicly traded"

Page 14, line 2, replace "public" with "publicly traded"

Page 14, line 13, replace "public" with "publicly traded"

Page 14, line 21, replace "public" with "publicly traded"

Page 15, line 4, replace "public" with "publicly traded"

Page 15, line 10, replace "public" with "publicly traded"

Page 15, line 13, replace "twenty-five" with "twenty"

Page 15, line 24, replace "**prohibition**" with "**restrictions or prohibitions**"

Page 15, line 24, remove "**adoption of**"

Page 15, line 25, replace the first "The" with "A provision of the"

Page 15, line 25, replace "public" with "publicly traded"

Page 15, line 26, after "." insert "Such a provision may provide for the effect it has on a poison pill in force at the time of the provision's adoption."

Page 15, line 28, replace "public" with "publicly traded"

Page 16, line 4, replace "public" with "publicly traded"

Page 16, line 14, replace "corporations" with "corporation"

Page 16, line 23, replace "corporations" with "corporation"

Page 17, line 24, remove "that" and immediately thereafter insert ":
(1) If the shares"

Page 17, line 26, after "pill" insert "; or"

Page 17, after line 26, insert:
"(2) That serves to protect dividend, interest, sinking fund, conversion, exchange, or other rights of the shares, or to protect against the issuance of additional securities that would be on a parity with or superior to the shares."

Page 17, line 30, replace "public" with "publicly traded"

Page 18, line 2, replace "public" with "publicly traded"

Page 18, line 4, replace "10-25-29" with "10-35-29"

Page 18, line 5, replace "public" with "publicly traded"

Page 18, line 6, replace "public" with "publicly traded"

Page 18, line 7, replace "public" with "publicly traded"

Page 18, line 8, replace "public" with "publicly traded"

Page 18, line 9, replace "public" with "publicly traded"

Page 18, line 10, replace "public" with "publicly traded"

Page 18, line 13, replace "public" with "publicly traded"

Page 18, line 18, replace "public" with "publicly traded"

Page 18, line 20, replace "public" with "publicly traded"

Page 18, line 25, replace "public" with "publicly traded"

Page 18, line 26, replace "public" with "publicly traded"

Page 18, line 27, replace the first "public" with "publicly traded"

Page 18, line 27, replace the second "public" with "publicly traded"

Page 18, line 28, replace "public" with "publicly traded"

Page 18, line 30, replace "public" with "publicly traded"

Page 19, line 1, replace "public" with "publicly traded"

Page 19, line 3, replace "public" with "publicly traded"

Page 19, line 5, replace "public" with "publicly traded"

Page 19, line 6, replace "public" with "publicly traded"

Page 19, line 12, replace "public" with "publicly traded"

Page 19, line 16, replace "public" with "publicly traded"

Page 19, line 18, replace "public" with "publicly traded"

Page 19, line 19, replace "public" with "publicly traded"

Page 19, line 20, replace "public" with "publicly traded"

Page 19, line 21, replace "public" with "publicly traded"

Page 19, line 23, replace "public" with "publicly traded"

Page 19, line 26, replace "public" with "publicly traded"

Page 20, line 4, replace "public" with "publicly traded"

Page 20, line 7, replace "public" with "publicly traded"

Page 20, line 10, replace "public" with "publicly traded"

Page 20, line 18, replace "**public**" with "**publicly traded**"

Page 20, line 19, replace the first "public" with "publicly traded"

Page 20, line 19, replace the second "public" with "publicly traded"

Page 20, line 21, replace "public" with "publicly traded"

Page 20, line 25, replace "public" with "publicly traded"

Page 20, line 29, replace "public" with "publicly traded"

Page 20, line 30, replace "public" with "publicly traded"

Page 21, line 3, replace "public" with "publicly traded"

Page 21, line 4, replace "public" with "publicly traded"

Page 21, line 7, replace the first "public" with "publicly traded"

Page 21, line 7, replace the second "public" with "publicly traded"

Page 21, line 12, replace "public" with "publicly traded"

Page 21, line 13, replace "public" with "publicly traded"

Page 21, line 16, replace the first "public" with "publicly traded"

Page 21, line 16, replace the second "public" with "publicly traded"

Page 21, line 19, replace "public" with "publicly traded"

Page 21, line 21, replace "free" with "fee"

Page 22, line 1, replace "public" with "publicly traded"

Page 22, line 3, replace "public" with "publicly traded"

Page 22, line 4, replace "public" with "publicly traded"

Page 22, line 6, replace "must" with "may"

Page 22, line 11, replace "public" with "publicly traded"

Page 22, line 12, replace "public" with "publicly traded"

Page 22, line 17, replace the first "and" with "any"

Page 22, line 19, replace "public" with "publicly traded"

Page 23, line 1, replace "public" with "publicly traded"

Page 23, line 9, replace "public" with "publicly traded"

Page 23, line 10, replace "public" with "publicly traded"

Page 23, line 13, replace "public" with "publicly traded"

Page 23, line 18, replace "public" with "publicly traded"

Page 23, line 20, replace "and' with "any"

Page 23, line 21, replace "public" with "publicly traded"

Page 23, line 23, replace "public" with "publicly traded"

Page 23, line 31, replace "public" with "publicly traded"

Renumber accordingly.

NORTH DAKOTA CORPORATE GOVERNANCE COUNCIL

200 North 3rd Street • Suite 201 • Bismarck • North Dakota • 58502

Testimony of
William H. Clark, Jr.
before
The Judiciary Committee
of the
North Dakota House of Representatives
Regarding
House Bill No. 1340
(The North Dakota Public Corporations Act)

January 24, 2007

Good morning. My name is William H. Clark, Jr. I am a partner in the law firm of Drinker Biddle & Reath LLP and practice corporate law in the Philadelphia office of the firm.[1] I am appearing before you today in my capacity as the President of the North Dakota Corporate Governance Council[2] and the person principally responsible for drafting House Bill No. 1340.

Purpose of HB 1340

Enactment of proposed Chapter 10-35 is fundamentally a pro-business initiative. The ultimate goal of Chapter 10-35 is to improve the performance of publicly traded companies by providing a new model of corporate governance.

An increasing number of studies have demonstrated a clear link between

---

[1] My experience drafting state business entity laws, which may be of interest to the Committee, includes:

- Secretary and Draftsman for the Title 15 Task Force of the Pennsylvania Bar Association, which drafts all of the Pennsylvania business entity laws.
- Member of the Committee on Corporate Laws of the American Bar Association Section on Business Law ("BLS"), which drafts the Model Business Corporation Act.
- Reporter for the special task force of the BLS Committee on Nonprofit Corporations revising the Model Nonprofit Corporation Act.
- Reporter for the Model Entity Transactions Act prepared jointly by the BLS and the National Conference of Commissioners on Uniform State Laws ("NCCUSL").
- Reporter for the Model Registered Agents Act prepared by NCCUSL, which has been introduced in North Dakota as Senate Bill No. 2153.
- BLS Advisor to the NCCUSL drafting committee that prepared the Uniform Limited Liability Company Act.
- BLS Advisor to the NCCUSL drafting committee preparing the proposed Uniform Statutory Trust Entity Act.

[2] The North Dakota Corporate Governance Council was recently incorporated and is currently in the process of being organized. The board of directors currently consists of myself, Steve Herman, and Bill Sorensen.

improved corporate governance and improved performance by publicly-traded corporations.[3] Notwithstanding the growing evidence of the direct correlation between greater rights for shareholders and improved performance, state corporation laws have not yet moved in the direction of providing those greater rights. Instead, it has been left to shareholders to seek greater rights on a company-by-company basis.

Virtually everyone is a shareholder today – either directly or indirectly (through 401K's and similar plans, state or union pension funds, life insurance products, etc.). So we all have a stake in improved corporate performance.

Why is Corporate Governance Still an Issue?

A continuing focus on corporate governance is needed – and inevitable – because what has been called the "Wall Street Walk" is no longer an option for many institutional investors. Before the rise of large mutual funds, pension plans, and index funds, investors who were dissatisfied with a stock's performance sold out their position and invested in another corporation.

But today an investor with a large position in a corporation may be essentially locked into its investment and have no choice but to focus on improving the governance of the corporation. In addition, index funds and funds with very specific investment strategies or narrow industry focuses have very limited options other than using their governance rights to seek change and improved performance.

Sadly, the Enron, WorldCom, Tyco, and Adelphia scandals of a few years ago that produced the federal Sarbanes-Oxley law have not ended. The latest scandals and signs of continuing abuse include option backdating and the severance package for the recently departed CEO of Home Depot. The need for an alternative model of good corporate governance like Chapter 10-35 remains as important as ever.

Chapter 10-35 is Optional

Chapter 10-35 is purely optional. It will not apply to any existing North Dakota corporation, and instead will apply only to corporations that elect to incorporate under it after July 1, 2007.

After a corporation becomes subject to Chapter 10-35, it will also remain optional because the shareholders may elect to exempt their corporation from Chapter 10-35 or to reincorporate under a different state law. Either of those actions will be able to be taken by a simple majority vote.

---

[3] Attached to this testimony is an article describing the results of some of that research which concludes that "the quality of a particular company's governance practices and procedures positively correlates with both good corporate financial performance and stockholder value." Eisenhofer and Levin, "Does Corporate Governance Matter to Investment Returns?" Corporate Accountability Report, Vol. 3, No. 57 (September 23, 2005).

Significant Provisions of Chapter 10-35

In my view, the most significant provisions of Chapter 10-35, in decreasing order of importance, are the following:

Majority voting in election of directors (§ 10-35-09). The issue of the system used to elect directors is currently the biggest concern of activist shareholders. Change from the current system of plurality voting to a system of majority voting is being proposed by shareholders at a significant number of companies this year.

Currently under the North Dakota Business Corporation Act, shareholders do not have the right to vote against nominees for election as directors; they can only vote in favor of candidates or withhold their votes. Those candidates receiving the highest number of votes, up to the number of positions to be filled, are elected. That system – known as "plurality voting" – is also currently used in every other state corporation law. Shareholders are seeking to change the plurality vote system for two reasons:

- First, plurality voting does not give shareholders an effective way to express their displeasure with a director nominee. In contrast, the feeling is that being able actually to vote "no" will send a much clearer message.
- Second, plurality voting can result in a candidate being elected with a very small number of votes. Theoretically, in fact, as few as one vote.

In contrast to the plurality voting system, section 10-35-09(2) provides for a true majority voting system under which shareholders in an uncontested election[4] may vote "yes" or "no" on each candidate, and only those candidates receiving a majority of "yes" votes are elected.

Delaware and the Model Business Corporation Act have added provisions in the last year that provide for a partial form of majority voting, but Chapter 10-35 will be the first state corporation law to require true majority voting. Majority voting has been the rule in Europe for years.

Advisory shareholder votes on compensation reports (§ 10-35-12(5)). Controlling run-away CEO compensation is currently a major corporate governance issue, with even major CEOs such as Jeffrey Immelt of GE saying that CEO compensation should be more in-line with the compensation of a company's other senior management. Section 10-35-12(5) requires the compensation committee of the board of directors to report to the shareholders at each regular meeting of shareholders and further requires that the shareholders be able to vote on an advisory basis on whether they accept the report of the committee. This type of advisory shareholder vote is required in Europe, and the rejection of a compensation report frequently results in changes to a corporation's compensation practices.

[4] The definition of what constitutes an uncontested election in section 10-35-09(3) is derived from Model Business Corporation Act § 10.22(b).

Proxy access (§ 10-35-08). In 2003, the SEC proposed that shareholders who have held 5% or more of a corporation's shares for at least two years should have the right under certain circumstances to have nominees proposed by them included in the corporation's proxy statement. That proposal met with significant resistance from business groups and the SEC put the proposal on hold. Section 10-35-08 is derived from the SEC proposal and requires a public corporation to include in its proxy statement nominees proposed by 5% shareholders who have held their shares for at least two years.

Just last week four European pension fund managers who have collectively invested more than $100 billion in the United States wrote a letter to the SEC urging it to adopt the proxy access proposal. The chief executive of Hermes, a UK pension fund manager, said "The US prides itself on its great democracy but democratic rights do not exist in corporate America. Shareholders do not have the right to fire directors. It seems reasonable to me for shareholders to be able to nominate people they think should run the company." A director of Norway's Norges Bank Investment Management, said insufficient shareholder rights were reducing the attractiveness of US capital markets.

Reimbursement for successful proxy contests (§ 10-35-10). The cost of soliciting proxies in support of management's slate of nominees for election as directors each year is paid by the corporation. Shareholders who wish to run a competing slate of nominees, on the other hand, have to pay the cost of soliciting proxies. Having the corporation pay the cost of management's solicitation obviously gives management a significant advantage. The issue of proxy access discussed above is an important way to level the playing field. Section 10-35-10 addresses the issue even more directly by requiring the corporation to reimburse shareholders who conduct a proxy contest to the extent they are successful. The shareholders will still be at a disadvantage because they will initially have to pay the costs of the proxy contest until it is known whether they have been successful and they will not be reimbursed to the extent they are unsuccessful. But section 10-35-10 will be a substantial move toward a more level playing field.

Separation of roles of Chair and CEO (§ 10-35-06(4)). Section 10-35-06 requires that the board of directors have a chair who is not an executive officer of the corporation. Separating the roles of Chair and CEO is considered a "best practice" and many companies have already voluntarily adopted this restriction. The purpose of having an independent chair of the board is to reduce the domination of the board by the CEO and permit the board to be more effective in providing independent oversight of the corporation's affairs.

Limitations on poison pills (§§ 10-35-22 through 10-35-25). Poison pills, more formally known as "shareholder rights plans," were invented in the 1980s as a way to stop hostile takeovers. Some activist shareholders would like to prohibit poison pills entirely, but experience has shown that poison pills can be valuable in keeping a company from being sold at less than full value. Chapter 10-35 strikes a balance that protects a corporation from being taken over "on the cheap" while not allowing a poison pill to be used improperly to entrench management.

Limitations on supermajority provisions (§ 10-35-11). Provisions that require more than a majority vote by directors or shareholders are becoming less common and many companies are already eliminating them from their governance documents when that is proposed by shareholders. Section 10-35-11 provides that a public corporation may not have a quorum or vote requirement for directors or shareholders that is higher than a majority.

Limitation on antitakeover provisions (§ 10-35-26). As with supermajority provisions, antitakeover provisions in a corporation's articles or bylaws are becoming less common and are often the subject of shareholder proposals to eliminate them. Section 10-35-26 does not completely prohibit antitakeover provisions, but requires a two-thirds vote for the valid adoption of such a provision.

AH #2a
3-5-07

NORTH DAKOTA CORPORATE GOVERNANCE COUNCIL

200 North 3rd Street • Suite 201 • Bismarck • North Dakota • 58502

Testimony of
William H. Clark, Jr.
before
The Judiciary Committee
of the
North Dakota Senate
Regarding
House Bill No. 1340
(The North Dakota Publicly Traded Corporations Act)

March 5, 2007

Good morning. My name is William H. Clark, Jr. I am a partner in the law firm of Drinker Biddle & Reath LLP and practice corporate law in the Philadelphia office of the firm.[1] I am appearing before you today in my capacity as the President of the North Dakota Corporate Governance Council[2] and the person principally responsible for drafting House Bill No. 1340.

Purpose of HB 1340

Enactment of proposed Chapter 10-35 is fundamentally a pro-business initiative. The ultimate goal of Chapter 10-35 is to improve the performance of publicly traded companies by providing a new model of corporate governance.

An increasing number of studies have demonstrated a clear link between

[1] My experience drafting state business entity laws, which may be of interest to the Committee, includes:

- Secretary and Draftsman for the Title 15 Task Force of the Pennsylvania Bar Association, which drafts all of the Pennsylvania business entity laws.
- Member of the Committee on Corporate Laws of the American Bar Association Section on Business Law ("BLS"), which drafts the Model Business Corporation Act.
- Reporter for the special task force of the BLS Committee on Nonprofit Corporations revising the Model Nonprofit Corporation Act.
- Reporter for the Model Entity Transactions Act prepared jointly by the BLS and the National Conference of Commissioners on Uniform State Laws ("NCCUSL").
- Reporter for the Model Registered Agents Act prepared by NCCUSL, which has been introduced in North Dakota as Senate Bill No. 2153.
- BLS Advisor to the NCCUSL drafting committee that prepared the Uniform Limited Liability Company Act.
- BLS Advisor to the NCCUSL drafting committee preparing the proposed Uniform Statutory Trust Entity Act.

[2] The North Dakota Corporate Governance Council was recently incorporated and is currently in the process of being organized. The board of directors currently consists of myself, Steve Herman, and Bill Sorensen.

improved corporate governance and improved performance by publicly-traded corporations.[3] Notwithstanding the growing evidence of the direct correlation between greater rights for shareholders and improved performance, state corporation laws have not yet moved in the direction of providing those greater rights. Instead, it has been left to shareholders to seek greater rights on a company-by-company basis.

Virtually everyone is a shareholder today – either directly or indirectly (through 401K's and similar plans, state or union pension funds, life insurance products, etc.). So we all have a stake in improved corporate performance.

Why is Corporate Governance Still an Issue?

A continuing focus on corporate governance is needed – and inevitable – because what has been called the "Wall Street Walk" is no longer an option for many institutional investors. Before the rise of large mutual funds, pension plans, and index funds, investors who were dissatisfied with a stock's performance sold out their position and invested in another corporation.

But today an investor with a large position in a corporation may be essentially locked into its investment and have no choice but to focus on improving the governance of the corporation. In addition, index funds and funds with very specific investment strategies or narrow industry focuses have very limited options other than using their governance rights to seek change and improved performance.

Sadly, the Enron, WorldCom, Tyco, and Adelphia scandals of a few years ago that produced the federal Sarbanes-Oxley law have not ended. The latest scandals and signs of continuing abuse include option backdating and the severance package for the recently departed CEO of Home Depot. The need for an alternative model of good corporate governance like Chapter 10-35 is as important as ever.

Chapter 10-35 is Optional

Chapter 10-35 is purely optional. It will not apply to any existing North Dakota corporation, and instead will apply only to corporations that elect to incorporate under it after July 1, 2007.

After a corporation becomes subject to Chapter 10-35, it will also remain optional because the shareholders may elect to exempt their corporation from Chapter 10-35 or to reincorporate under a different state law. Either of those actions will be able to be taken by a simple majority vote.

---

[3] Attached to this testimony is an article describing the results of some of that research which concludes that "the quality of a particular company's governance practices and procedures positively correlates with both good corporate financial performance and stockholder value." Eisenhofer and Levin, "Does Corporate Governance Matter to Investment Returns?" Corporate Accountability Report, Vol. 3, No. 57 (September 23, 2005).

Because Chapter 10-35 is clearly optional, North Dakota will not be saying "We in North Dakota think the approach of Chapter 10-35 is right for everyone and American business has been wrong to date." Rather, the message in the enactment of Chapter 10-35 will be "We in North Dakota are offering a new model of corporate governance for those corporations that wish to adopt it because we think corporate governance is an important issue and no other state has offered this type of innovative option that provides a real alternative system of corporate governance."

General Approach of Chapter 10-35

Chapter 10-35 represents the best thinking today in the academic and institutional investor communities on issues of corporate governance. It has been consciously designed to address corporate governance issues in a responsible way and not to be a wish list for corporate raiders. For example, Chapter 10-35 does not abolish poison pills and thus a North Dakota publicly traded corporation will still be able to protect itself from a corporate raider by adopting a poison pill.

The North Dakota Corporate Governance Council has retained as a consultant the foremost expert on corporate governance in the country, Professor Melvin Eisenberg, who teaches at both Berkeley and Columbia law schools. Among other things, Professor Eisenberg was the Reporter for the American Law Institute's Principles of Corporate Governance. Attached to this testimony is a letter from Professor Eisenberg analyzing Chapter 10-35 in which he concludes that Chapter 10-35 "would constitute a major advance in American corporate law."

Who Will Use Chapter 10-35?

Every publicly traded corporation makes choices about its governance structure. Many businesses are properly cautious and do not make changes in their governance structure quickly. But there are also corporations that have consciously placed themselves in the forefront of corporate governance issues. For example, Pfizer was the first corporation to move away from the plurality system of electing directors to a different system in which shareholders have a more meaningful vote, and Aflac has become the first corporation to give its shareholders a vote on its compensation policies (so-called "say on pay"). Other corporations have begun to follow the lead of those corporations as they realize the potential investor relations benefits and they also realize that changing their governance structure does not bring the disruption they feared. No one can predict which corporations will choose to incorporate in North Dakota under Chapter 10-35, but we know for certain that there are some companies that have chosen to be known as innovative in the area of corporate governance.

In effect, Chapter 10-35 is designed to create a new "brand." A corporation that wishes to be known as in the forefront of governance changes and responsive to its owners will now have the option of becoming a "North Dakota publicly traded corporation" which will immediately identify it as having state of the art provisions on all of the major issues of corporate governance.

Significant Provisions of Chapter 10-35

In my view, the most significant provisions of Chapter 10-35, in decreasing order of importance, are the following:

Majority voting in election of directors (§ 10-35-09). The issue of the system used to elect directors is currently the biggest concern of activist shareholders. Change from the current system of plurality voting to a system of majority voting is being proposed by shareholders at a significant number of companies this year.

Currently under the North Dakota Business Corporation Act, shareholders do not have the right to vote against nominees for election as directors; they can only vote in favor of candidates or withhold their votes. Those candidates receiving the highest number of votes, up to the number of positions to be filled, are elected. That system – known as "plurality voting" – is also currently used in every other state corporation law. Shareholders are seeking to change the plurality vote system for two reasons:

- First, plurality voting does not give shareholders an effective way to express their displeasure with a director nominee. In contrast, the feeling is that being able actually to vote "no" will send a much clearer message.
- Second, plurality voting can result in a candidate being elected with a very small number of votes. Theoretically, in fact, as few as one vote.

In contrast to the plurality voting system, section 10-35-09(2) provides for a true majority voting system under which shareholders in an uncontested election[4] may vote "yes" or "no" on each candidate, and only those candidates receiving a majority of "yes" votes are elected.

Delaware and the Model Business Corporation Act have added provisions in the last year that provide for a partial form of majority voting, but Chapter 10-35 will be the first state corporation law to require true majority voting. Majority voting has been the rule in Europe for years.

Advisory shareholder votes on compensation reports (§ 10-35-12(5)). Controlling run-away CEO compensation is currently a major corporate governance issue, with even major CEOs such as Jeffrey Immelt of GE saying that CEO compensation should be more in-line with the compensation of a company's other senior management. Section 10-35-12(5) requires the compensation committee of the board of directors to report to the shareholders at each regular meeting of shareholders and further requires that the shareholders be able to vote on an advisory basis on whether they accept the report of the committee. This type of advisory shareholder vote is required in Europe, and the rejection of a compensation report frequently results in changes to a corporation's compensation practices.

[4] The definition of what constitutes an uncontested election in section 10-35-09(3) is derived from Model Business Corporation Act § 10.22(b).

Proxy access (§ 10-35-08). In 2003, the SEC proposed that shareholders who have held 5% or more of a corporation's shares for at least two years should have the right under certain circumstances to have nominees proposed by them included in the corporation's proxy statement. That proposal met with significant resistance from business groups and the SEC put the proposal on hold. Section 10-35-08 is derived from the SEC proposal and requires a public corporation to include in its proxy statement nominees proposed by 5% shareholders who have held their shares for at least two years.

Just last month four European pension fund managers who have collectively invested more than $100 billion in the United States wrote a letter to the SEC urging it to adopt the proxy access proposal. The chief executive of Hermes, a UK pension fund manager, said "The US prides itself on its great democracy but democratic rights do not exist in corporate America. Shareholders do not have the right to fire directors. It seems reasonable to me for shareholders to be able to nominate people they think should run the company." A director of Norway's Norges Bank Investment Management, said insufficient shareholder rights were reducing the attractiveness of US capital markets.

Reimbursement for successful proxy contests (§ 10-35-10). The cost of soliciting proxies in support of management's slate of nominees for election as directors each year is paid by the corporation. Shareholders who wish to run a competing slate of nominees, on the other hand, have to pay the cost of soliciting proxies. Having the corporation pay the cost of management's solicitation obviously gives management a significant advantage. The issue of proxy access discussed above is an important way to level the playing field. Section 10-35-10 addresses the issue even more directly by requiring the corporation to reimburse shareholders who conduct a proxy contest to the extent they are successful. The shareholders will still be at a disadvantage because they will initially have to pay the costs of the proxy contest until it is known whether they have been successful and they will not be reimbursed to the extent they are unsuccessful. But section 10-35-10 will be a substantial move toward a more level playing field.

Separation of roles of Chair and CEO (§ 10-35-06(4)). Section 10-35-06 requires that the board of directors have a chair who is not an executive officer of the corporation. Separating the roles of Chair and CEO is considered a "best practice" and many companies have already voluntarily adopted this restriction. The purpose of having an independent chair of the board is to reduce the domination of the board by the CEO and permit the board to be more effective in providing independent oversight of the corporation's affairs.

Limitations on poison pills (§§ 10-35-22 through 10-35-25). Poison pills, more formally known as "shareholder rights plans," were invented in the 1980s as a way to stop hostile takeovers. Some activist shareholders would like to prohibit poison pills entirely, but experience has shown that poison pills can be valuable in keeping a company from being sold at less than full value. Chapter 10-35 strikes a balance that protects a corporation from being taken over "on the cheap" while not allowing a poison pill to be used improperly to entrench management.

HH #3 3-5-07

NORTH DAKOTA CORPORATE GOVERNANCE COUNCIL

200 North 3rd Street ▪ Suite 201 ▪ Bismarck ▪ North Dakota ▪ 58502

January 31, 2007

Explanation of House Bill No. 1340
(the North Dakota Publicly Traded Corporations Act)

Proposed Chapter 10-35 of the North Dakota Century Code with respect to publicly traded corporations provides a system of corporate governance that is designed to strengthen corporate democracy and improve the performance of publicly traded corporations.

An increasing number of studies have demonstrated a clear link between improved corporate governance and improved performance by publicly traded corporations.[1] Notwithstanding the growing evidence of the direct correlation between greater rights for shareholders and improved performance, state corporation laws have not yet moved in the direction of providing those greater rights. Instead, it has been left to shareholders to seek greater rights on a company-by-company basis.

Chapter 10-35 will be the first state corporation law to focus on providing a new model of shareholder rights that builds upon the best thinking of large institutional investors. No other state corporation law provides the full set of shareholder rights provided by Chapter 10-35. Being incorporated in North Dakota will represent a new seal of approval for publicly traded corporations committed to corporate democracy and improved performance.

Chapter 10-35 has two basic parts:

- Sections 10-35-01 through 10-35-27 establish the new system of corporate governance for publicly traded corporations. The new rules on corporate governance will apply only to those corporations that elect to be incorporated under North Dakota law and to be subject to Chapter 10-35.
- Sections 10-35-28 through 10-35-33 impose a franchise fee on the corporations subject to Chapter 10-35, similar to the Delaware franchise tax, but at 50% of the rate imposed by Delaware.

[1] See the article behind tab 1 describing the results of some of that research which concludes that "the quality of a particular company's governance practices and procedures positively correlates with both good corporate financial performance and stockholder value." Eisenhofer and Levin, "Does Corporate Governance Matter to Investment Returns?" Corporate Accountability Report, Vol. 3, No. 57 (September 23, 2005).

Corporate Governance Provisions

The corporate governance provisions applicable to publicly traded corporations incorporated in North Dakota that elect to be subject to Chapter 10-35 are as follows:

Citation (§ 10-35-01) The short title "North Dakota Publicly Traded Corporations Act" provides a convenient way of referring to Chapter 10-35.

Definitions (§ 10-35-02) The definitions in this section are used throughout Chapter 10-35.

"Beneficial owner" and "executive officer" have the same meanings in Chapter 10-35 as they do in the rules of the SEC. By using the SEC definitions of those terms, the provisions of Chapter 10-35 will stay consistent with federal law.

"Commission" and "Exchange Act" are standard ways of referring to the U.S. Securities and Exchange Commission and the principal Federal securities law applicable to publicly traded corporations.

"Poison pill" was originally coined as a pejorative term for the most effective antitakeover device developed during the 1980's which is sometimes referred to by the more formal name of a "shareholder rights plan." This definition is used in sections 10-35-22 through 10-35-25 and is intended to be construed broadly to accomplish the purposes of those sections. The definition of "poison pill" is patterned in part after 15 Pa.C.S. § 2513.

The definition of "publicly traded corporation" sets forth the characteristics of a corporation that is subject to Chapter 10-35:

- it is a domestic corporation that becomes governed by the North Dakota Business Corporation Act, Chapter 10-19.1 (the "BCA") after July 1, 2007; and
- its articles of incorporation state that it is subject to Chapter 10-35.

The final requirement that a corporation include a provision in its articles electing to be subject to Chapter 10-35 is what makes Chapter 10-35 an optional choice that must be affirmatively elected by a corporation.

"Qualified shareholder" is used in section 10-35-08 with respect to access to a corporation's proxy statement.

"Required vote" is used in section 10-35-26 with respect to adoption of antitakeover provisions.

Application and Effect of Chapter 10-35 (§ 10-35-03)

Chapter 10-35 provides a new paradigm for corporate governance of publicly traded corporations. As described above, the definition of "publicly traded corporation"

in section 10-35-02 requires a corporation affirmatively to elect to be subject to Chapter 10-35. Section 10-35-03(1) confirms that Chapter 10-35 only applies to those corporations while the corporation's election to be subject to Chapter 10-35 is in effect.

Section 10-35-03(2) makes clear that Chapter 10-35 does not affect any statute or law applicable to a corporation that is not a domestic publicly traded corporation. Thus the rules in Chapter 10-35 should not have any effect on North Dakota corporations that are not "publicly traded corporations."

Section 10-35-03(3) makes clear that the articles of incorporation or bylaws of a publicly traded corporation may not be inconsistent with Chapter 10-35. This same rule is found in sections 10-19.1-10(6) and 10-19.1-31(1) which provide that the articles and bylaws may not be inconsistent with the BCA. If a publicly traded corporation could change the way Chapter 10-35 applies to it, that would defeat one of the purposes of Chapter 10-35 which is to permit corporations committed to good corporate governance to be identified simply by the fact of their incorporation in North Dakota. Stated differently, section 10-35-03(3) prevents dilution of the brand "North Dakota publicly traded corporation."

Section 10-35(4) provides clarity on how share ownership percentages are to be computed for purposes of Chapter 10-35.

Application of Chapter 10-19.1 (§ 10-35-04)

Several of the provisions of Chapter 10-35 vary the otherwise applicable rules in the BCA. Thus, section 10-35-04(1) provides generally that the provisions of Chapter 10-35 control over any inconsistent provision of the BCA.

Section 10-35-04(2) and (3) make the definitions in Chapter 10-19.1 applicable to Chapter 10-35 as well.

Amendment of the Bylaws (§ 10-35-05)

The BCA limits the right of shareholders to propose amendments of the bylaws to shareholders who own 5% or more of the outstanding shares. Section 10-35-05(1) adopts the more usual rule that any shareholder may propose a bylaw amendment. A similar change is made by section 10-35-12(3) with respect to the right of a shareholder to demand the holding of a delinquent regular meeting.

Section 10-35-05(2) reverses the otherwise applicable rule under BCA section 10-19.1-31(3)(a) that the articles or bylaws may impose additional requirements on proposals by shareholders to amend the bylaws.

Board of Directors (§ 10-35-06)

BCA section 10-19.1-35(1) permits the articles or bylaws to provide a fixed term

for directors of up to five years. Section 10-35-06(1), in contrast, requires that the term of directors of a publicly traded corporation not exceed one year.

Section 10-35-06(2) prohibits a publicly traded corporation from staggering its directors into different classes, with the result that all directors will be elected each year. This varies the rule in BCA section 10-19.1-35(2) which permits the articles or bylaws to provide for staggered terms for directors.

Section 10-35-06(3) prohibits a publicly traded corporation from changing the size of its board of directors at a time when the board of directors knows or has reason to know that there will be a contested election of directors. This will keep the corporation from improperly interfering in the election contest and is consistent with the case law in Delaware. *See, e.g., MM Companies, Inc. v. Liquid Audio, Inc.*, No. 606 (Del. Supreme 2003); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

Section 10-35-06(4) requires the board of directors to elect a chair and prohibits the chair from serving as an executive officer of the corporation.

Nomination of Directors (§ 10-35-07) Section 10-35-07 permits a publicly traded corporation to adopt a requirement that a shareholder notify the corporation in advance if the shareholder plans to nominate a candidate for election as a director. The adoption of this type of provision by publicly traded corporations is very common. But Section 10-35-07 adds a time limit, the same as in § 10-35-14 with regard to advance notice of shareholder proposals, on how far in advance the notice may be required to be given. See also the requirement in section 10-35-16(1) that a corporation make a public announcement of the date of a meeting which will give the shareholders notice of the deadline for complying with the advance notice provision. Section 10-35-07(2) restricts the corporation from imposing burdensome requirements on the shareholder to provide information about the nominations.

Access to Corporation's Proxy Statement by Major Shareholders (§ 10-35-08) Section 10-35-08 gives a shareholder or group of shareholders who have held at least 5% of the outstanding shares of a publicly traded corporation for at least two years the right to have candidates nominated by them included in the corporation's proxy statement. This provision is similar to a proposal made by the SEC in 2003 which has been put on hold by the SEC. The language of section 10-35-08 is patterned after portions of the SEC's proposal. The most significant differences between section 10-35-08 and the SEC proposal are that the SEC proposal would give the shareholder the right to include only a limited number of nominees and would only apply after certain triggering events had occurred.

Election of Directors (§ 10-35-09)

Section 10-35-09(1) prohibits a publicly traded corporation from adjourning a meeting at which directors are to be elected until the election has been completed. The purpose of this provision is to keep the incumbent directors from adjourning to solicit

additional votes if they know their candidates are losing.

Currently under the BCA, shareholders do not have the right to vote against nominees for election as directors; they can only vote in favor of candidates or withhold their votes. Those candidates receiving the highest number of votes, up to the number of positions to be filled, are elected. Changing that system of electing directors is currently one of the hottest topics in corporate governance. Shareholder activists have been seeking to change the current system for two reasons: it does not give them an effective way to express their displeasure with a nominee (as they feel being able to vote "no" would do), and it can result in a candidate being elected with a very small number of votes (theoretically as few as one vote).

In contrast to the plurality voting system, section 10-35-09(2) provides for a true majority voting system under which shareholders in an uncontested election[2] may vote "yes" or "no" on each candidate, and only those candidates receiving a majority of "yes" votes are elected.

Section 10-35-09(5) recognizes that directors may be elected by consent without a meeting and provides a rule on when an election of directors by consent will substitute for the holding of a regular meeting. Section 10-35-09(5) is patterned after Section 211(b) of the DGCL.

Reimbursement of Proxy Expenses (§ 10-35-10) Section 10-35-10 requires that a shareholder be reimbursed for the expenses of conducting a proxy contest to the extent the shareholder is successful. Thus, for example, if a shareholder nominates four candidates and three are elected, the shareholder will be reimbursed for 75% of the shareholder's expenses.

Supermajority provisions prohibited (§ 10-35-11) Section 10-35-11(1) establishes a majority of the full board of directors as the maximum quorum and vote requirement that may be imposed by the articles or bylaws. Section 10-35-11(2) similarly establishes a majority as the maximum quorum and vote for shareholders.

Regular Meeting of Shareholders (§ 10-35-12)

Section 10-35-12 requires a publicly traded corporation to fix in its articles or bylaws the latest date by which the corporation's regular meeting must be held each year. This will keep a corporation from delaying its annual meeting to avoid being accountable to its shareholders.

Section 10-35-12(5) adopts the practice in England of having the shareholders vote on an advisory basis on a report of the compensation committee of the board of directors.

---

[2] The definition of what constitutes an uncontested election in section 10-35-09(3) is derived from Model Business Corporation Act § 10.22(b).

Call of Special Meeting of Shareholders (§ 10-35-13)

BCA section 10-19.1-72 permits the holders of at least 10% of the votes entitled to be cast on an issue to call a special meeting of shareholders to vote on the issue, except that a meeting called to consider a business combination may only be called by shareholders owning 25% or more of the outstanding shares. Section 10-35-13 eliminates the special rule for calling a meeting to consider a business combination, with the result that 10% of the shares will be able to call a meeting for any purpose.

Section 10-35-13(2) prevents the corporation from restricting the right to call a special meeting or the business that may be conducted at a special meeting.

Shareholder Proposals of Business (§ 10-35-14) Section 10-35-14 permits a publicly traded corporation to adopt a requirement that a shareholder notify the corporation in advance if the shareholder plans to propose any business at a regular meeting. The adoption of this type of requirement by publicly traded corporations is very common. But section 10-35-14 adds a time limit on how far in advance the required notice must be given. See the discussion of section 10-35-07, above. Section 10-35-14(2) restricts the corporation from imposing burdensome requirements on the shareholder to provide information about the proposal.

Shareholder Proposals of Amendment of the Articles (§ 10-35-15) BCA section 10-19.1-19 gives shareholders owning 5% or more of the outstanding voting power the right to propose an amendment of the articles. Section 10-35-15(1) restricts the corporation from imposing burdensome requirements on shareholders exercising that right to provide information about the proposed amendment.

Requirements for Convening Shareholder Meetings (§ 10-35-16)

Section 10-35-16(1) requires a publicly traded corporation to make a public announcement of the date of a regular meeting far enough in advance of the meeting so that its shareholders can comply with an advance notice requirement adopted under section 10-35-07 or 10-35-14.

Brokers who hold shares in "street name" have the ability to vote those shares on routine matters without receiving instructions from the beneficial owner, but in instances where the broker is not permitted to vote on non-routine matters the broker may return a proxy card with a "broker non-vote." Section 10-35-16(2) makes clear how broker non-votes affect the existence of a quorum at a meeting of shareholders.

Approval of Certain Issuances of Shares (§ 10-35-17) Both the Model Business Corporation Act and the New York Stock Exchange require shareholder approval before a corporation may issue shares having more than 20% of the outstanding voting power. Section 10-35-17 adopts the same approach for all publicly traded corporations since not all publicly traded corporations are subject to the NYSE requirement.

Preemptive Rights (§ 10-35-18) Section 10-35-18 makes clear that shareholders in a publicly traded corporation do not have preemptive rights.

Conduct and Business of Shareholder Meetings (§ 10-35-19) Subsections 1 through 4 of section 10-35-19 are patterned after Section 7.08 of the Model Business Corporation Act and provide rules on how shareholder meetings are to be conducted.

Action by Shareholders Without a Meeting (§ 10-35-20) BCA section 10-19.1-75 permits shareholders to act by majority consent without a meeting if the articles authorize them to do so. Section 10-35-20 eliminates the requirement that action by majority consent be authorized in the articles, thus making action by majority consent available in all publicly traded corporations.

Financial Statements (§ 10-35-21) Since publicly traded corporations are subject to the periodic reporting requirements of the Exchange Act, section 10-35-21 makes inapplicable to them the requirement in BCA section 10-19.1-85 that a corporation furnish a financial statement on request by a shareholder.

Restrictions on Poison Pills (§§ 10-35-22, 10-35-23, 10-35-24, and 10-35-25) Chapter 10-35 does not prohibit the adoption of all poison pills because experience has shown that poison pills may be used to benefit shareholders by preventing a corporation from being sold at an inadequate price. But Chapter 10-35 does place limitations on the use of poison pills to keep them from being used improperly to entrench incumbent management. The provisions dealing with poison pills are as follows:

- **Duration of Poison Pills (§ 10-35-22)** Section 10-35-22 prohibits a poison pill that was not approved by the shareholders from being in effect for longer than the shorter of one year or 90 days after a majority of the shareholders have indicated that they wish to accept an offer for the sale of their company. The 90 day period is based on the practice of the Ontario Securities Commission which requires the withdrawal of a poison pill under those circumstances. A poison pill approved by the shareholders is subject to a longer time limit of two years.

- **Prohibition of "Dead Hand" Poison Pills (§ 10-35-23)** Section 10-35-23 prohibits the use of "dead hand" and similar provisions in poison pills. Under that type of provision, only directors in office before an offer is made for the corporation (or successors that those directors approve) may redeem or otherwise disable the poison pill. "Dead hand" provisions have been invalidated by the Delaware courts. Since North Dakota does not have similar case law, section 10-35-23 confirms that the Delaware case law is also the rule in North Dakota. *See Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998); *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180 (Del. Ch. 1998)

- **Restriction on Poison Pill Triggering Level (§ 10-35-24)** Section 10-35-24 prohibits a corporation from adopting a poison pill that has a triggering level of

less than 20%. The triggering level is the amount of shares that a party may acquire in a corporation without interference from a poison pill. When poison pills were first being adopted, they usually had triggering levels of between 20% and 30%, but recent poison pills have had triggering levels as low as 10% to 15%.

- **Optional Prohibition of Poison Pills (§ 10-35-25)** Section 10-35-25 makes clear that, if they choose to do so, the shareholders may prohibit the adoption of a poison pill by their corporation.

Adoption of Antitakeover Provisions (§ 10-35-26) Section 10-35-26 requires that any antitakeover provision included in the articles or bylaws of a publicly traded corporation must be approved by at least a two-thirds vote of the shareholders.

Liberal Construction (§ 10-35-27) Section 10-35-27 has been included to provide the courts with guidance as to the purpose of new Chapter 10-35, as well as with regard to the general approach that should be taken when interpreting the BCA as it applies to publicly traded corporations.

Franchise Fee

Sections 10-35-28 through 10-35-33 impose a franchise fee on publicly traded corporations. The fee will be paid only by those publicly traded corporations subject to Chapter 10-35 (*i.e.*, only those corporations that elect to be subject to Chapter 10-35).

The fee is imposed based on the number of shares a corporation is authorized to issue, with a minimum fee of $60 and a maximum fee of $80,000 each year. The rate at which the fee is imposed is one-half the rate of the similar Delaware franchise tax. Compare DGCL § 503.

BNA INC.

CORPORATE ACCOUNTABILITY

BNA Employee-Owned Since 1947

REPORT

Investment Returns

Does Corporate Governance Matter to Investment Returns?

BY JAY W. EISENHOFER AND GREGG S. LEVIN

Introduction

Although Conrad Black will tell you that corporate governance is a form of terrorism, an increasing body of evidence suggests that enhanced governance equals enhanced performance. Does this mean there is a perfect correlation between the two? Of course not. However, empirical evidence suggests what common sense tells us is correct—those corporate boards that are more concerned about shareholder rights are also better guardians of shareholder money. Indeed, as one commentator noted in early 2004, "the good news is the discovery of an increasing amount of new evidence suggesting that these links [between returns and governance] do exist."[1]

[1] Nick Bradley, "Corporate Governance Scoring and the Link Between Corporate Governance and Performance Indicators: In Search of the Holy Grail," *Corporate Governance: An International Review*, Vol. 12 at 8 (January 2004).

Mr. Eisenhofer is a Partner in the law firm of Grant & Eisenhofer P.A., a leading litigation boutique located in Wilmington, Delaware, representing shareholders in securities litigation and corporate governance matters nationally. Mr. Levin is an associate at Grant & Eisenhofer P.A.

As summarized below, the empirical studies conducted to date have generally come in one of two forms. In the first group of studies, researchers have focused on corporate governance practices generally, that is, they examine simultaneously a multitude of variables that relate to "sound" corporate governance. These studies have concluded that the quality of a particular company's governance practices and procedures positively correlates with both good corporate financial performance and stockholder value. A second group of studies has been more narrowly tailored, concentrating upon some specific aspect of "sound" corporate governance (such as the adoption of anti-takeover provisions or limiting excessive executive compensation). While these studies have employed varying methodologies, they all have tended to reach the same conclusion: those companies that have adopted specific procedures and practices designed to (a) ensure managers' accountability to owners and (b) align managers' interests as closely as possible with those of the stockholders perform more strongly than do their counterparts.

This article also addresses the phenomenon known as "socially responsible investing" (or SRI), which involves "the process of integrating values, societal concerns and/or institutional mission into investment

 ISSN 1542-9563

decision-making."[2] As noted below, several recent studies have found that SRI translates into higher returns for investors.

I. The Empirical Link Between Corporate Governance Generally and Firm Performance

One of the primary aims of shareholder activism in recent decades has been the promotion of "sound" corporate governance practices as a means to improve corporate performance and shareholder returns. A pivotal question is whether the hypothesis underlying the movement is valid: *i.e.*, does good corporate governance actually translate into good corporate performance? In recent years, there have been a number of empirical studies, mostly academic journal articles, on the relationship between good corporate governance generally and firm performance. As discussed below, a substantial number of these studies have found that corporations practicing good corporate governance outperform those companies whose processes and procedures are "unsound."

A. Institutional Shareholder Services Study. In a research study commissioned by Institutional Shareholder Services, Inc. (ISS) and published in 2004, Lawrence D. Brown and Marcus L. Caylor of Georgia State University examined whether firms with "weaker" corporate governance perform "more poorly" than firms with "stronger" corporate governance.[3] The criteria Brown and Caylor used to separate "weak" from "strong" corporate governance were derived from ISS's "CGQ"—the Corporate Governance Quotient utilized in ISS's proprietary rating system to help institutions evaluate the quality of corporate boards and the impact of their governance practices. Brown and Caylor's methodology used industry-adjusted CGQ scores to relate to 15 industry-adjusted variables, or performance measures, suggested by ISS and to 20 others that the authors considered of interest. The variables included total returns (one-, three-, five- and 10-year), profitability (ROA, ROE and ROI returns on average equity/average investment), stock price volatility risk (beta), profit margins, market cap, P/E ratios, solvency ratios, interest coverage, ratio of operating cash-flow to total liabilities, dividend payouts, and dividend yields.

Generally, the study found that industry-adjusted CGQ scores reflecting stronger corporate governance were directly correlated to positive performance in four areas—shareholder returns, profitability, risk (measured by stock price volatility), and dividend payouts and yields—while scores reflecting worse corporate governance correlated to worse performance results in those areas. In a second-stage examination, Brown and Caylor related the 35 variables (performance measures) to four "core" factors of the CGQ—board composition, compensation, takeover defenses, and audit—in an effort to determine which were the driving factors behind the results. Brown and Caylor identified board composition as the most important factor and takeover defenses as the least.

While the study found a direct correlation between corporate governance and three-year, five-year, and 10-year shareholder returns, results for one-year total returns were inconclusive. The study interpreted that result to mean that one-year total return was more of a risk measure (as a proxy for share price momentum) than a true return measure.

B. Lipper/GMI Research on Corporate Governance in Mutual Fund Performance. In a research study conducted jointly by Lipper, Inc., a Reuters company which performs global research on mutual funds, and GovernanceMetrics International (GMI), a corporate governance ratings agency, the two firms paired the stock holdings of 725 large-cap domestic equity mutual funds in Lipper's database with the governance ratings calculated by GMI for more than 1,000 publicly traded firms, including all of the companies covered in the S&P 500 Index and the S&P Midcap 400, plus other widely held stocks. GMI's ratings are on a scale from 1 to 10, with 10 reserved for companies with truly independent boards, audit and compensation committees and other good-governance characteristics. The ratings decline in the event of board structures and company policies that limit the board's effective oversight of management and actions indicating the board has not been effective.

The study results, released in January 2004,[4] found that managers of large-cap mutual funds tend to overweigh their portfolios with companies that have above-average corporate governance profiles. Funds that are heavily overweighted in well-governed companies were found to outperform the average fund in both three- and five-year holding periods and, over the same periods, tended to perform better than funds with a large number of poorly governed companies in their portfolios. The outperformance did not, however, hold true for over just a one-year holding period, perhaps for the same reason observed earlier in relation to the ISS-commissioned study.

In September 2004, GMI announced new ratings on 2,588 global companies, of which only 26 (20 American, five Canadian, and one Australian) received GMI's highest rating of 10.0. GMI reported that as of August 31, 2004, as a group, these 26 companies outperformed the S&P 500 Index as measured by total returns for each of the last one-, three- and five-year periods by 4.9 percent, 8.3 percent, and 10 percent, respectively.[5]

C. The Governance Index of Gompers, Ishii, and Metrick. In a 2003 article published in the *Quarterly Journal of Economics*,[6] Paul A. Gompers (Harvard Business School and National Bureau of Economic Research (NBER)), Joy L. Ishii (Department of Economics, Harvard), and Andrew Metrick (Department of Finance, The Wharton School, and NBER) asked the empirical question: Is there a relationship between shareholder rights and corporate performance? Their answer, put simply, was yes.

---

[2] Steven J. Schueth, "SRI in the U.S.," *available at* http://www.firstaffirmative.com/news/sriArticle.html (emphasis in original deleted) ("Schueth").

[3] Lawrence D. Brown and Marcus L. Caylor, *The Correlation Between Corporate Governance and Company Performance* (2004) (*available at* http://www.bermanesq.com/pdf/ISSGovernanceStudy04.pdf).

[4] *Corporate Governance as a Factor in Mutual Funds Holdings* (2004), available upon request through the GMI Website, at http://www.gmiratings.com.

[5] *See* "Improvements Seen Following Enactment of SOX, But Risks Remain," GMI Press Release, September 7, 2004.

[6] Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q. Journ. of Economics 107 (2003).

  CARE ISSN 1542-9563

In the context of this study, "shareholder rights" referred to a set of unique "provisions," many of them at the firm level, and some embodied in state law, which affect the balance of power between shareholders and corporate management.[7] These provisions were those that have been tracked since 1990 in the database of the Investor Responsibility Research Center (IRRC), covering a universe of firms representing 93 percent of the total capitalization of the NYSE, AMEX and NASDAQ markets. The study divided the provisions into five groups: *Delay* (tactics for delaying hostile bidders); *Voting* (voting rights); *Protection* (director/officer protection); *Other* (other takeover defenses); and *State* (state laws).

The authors then devised their Governance Index ("*G*") which considered only the impact of each provision on the balance of power in the corporation. When the thrust of a "provision" was to increase the power of managers within a firm, a point was scored toward a "Dictatorship" model of the corporation, while the absence of that provision (or the presence of a provision that cut the other way, in favor of shareholders) tilted the balance of power toward shareholders (in the direction of a "Democracy" model). *G* was the sum of one point for the existence (or absence) of each provision. Thus, the higher a firm's score on the index, the stronger its management control (and the weaker its "shareholder rights").

In the remainder of the paper, special attention was paid to two extreme portfolios: the "Dictatorship Portfolio" of the firms with the weakest shareholder rights (*G* 14) and the "Democracy Portfolio" of the firms with the strongest shareholder rights (*G* 5). The portfolios were updated at the same frequency as *G* (which changes over time, along with changes or deletions of firms in the sample), so as to create a proxy for the level of shareholder rights at about 1,500 large firms—those tracked by IRRC—during the 1990s. The authors compared those firms and their scores to share price data maintained by the Center for Research in Security Prices (CRSP) and, where necessary, to Standard & Poor's Compustat database. They concluded from the data that an investment strategy that *bought* firms in the *lowest* decile of the index (*strongest* shareholder rights) and *sold* firms in the *highest* decile (*weakest* shareholder rights) of the index would have earned abnormal returns of 8.5 percent per year during the sample period. Other findings also emerged, among them that firms with stronger shareholder rights had higher firm value, higher profits and higher sales growth.

D. The Entrenchment Index of Bebchuck, Cohen, and Ferrell. Researchers have utilized *G*, or a variation of this index, in a number of studies published since 2003.[8] In one such study, Harvard Law School professors Lucian A. Bebchuk, Alma Cohen and Allen Ferrell, posited that of the 24 IRRC provisions that comprised the *G*, certain provisions influenced shareholder value more than others. Specifically, Bebchuck, Cohen and Ferrell hypothesized that during two time periods: (1) 1990-1999 and (2) 1990-2003, the corporate governance provisions relating to entrenchment (six of the 24 IRRC provisions studied by Gompers, Ishii and Metrick) impacted firm value and stock returns more than the other 18 IRRC provisions combined.[9]

Accordingly, instead of using the *G*, which was a composite index that gave equal weight to all 24 IRRC provisions, the authors divided the IRRC provisions into two indices: an "entrenchment" index and an "other provisions" index. The entrenchment index was comprised of six provisions the authors claimed would best measure entrenchment based on personal experience and knowledge, interviews with six "prominent" corporate attorneys and "[e]vidence about the provisions attracting the most widespread opposition from institutional investors voting on precatory shareholder resolutions."[10] The IRRC provisions in the entrenchment index were staggered boards, limits to shareholder bylaw amendments, supermajority requirements for (a) mergers and (b) charter amendments, poison pills and golden parachutes.[11] The "other provisions" index was comprised of the remaining 18 IRRC provisions.[12] In this study, each firm received a score based on the same Dictatorship/Democracy guidelines described above in connection with the Gompers, Ishii and Metrick study. The indices represented the sum of one point for the existence (or absence) of each provision.

Upon analyzing the scores of approximately 90 percent of all U.S. public companies during the two time periods, the authors found that the higher the firm's entrenchment score, the lower the firm's value.[13] In addition, the authors found "no evidence" between the 18 other IRRC governance provisions (either individually or in the aggregate) and firm valuation.[14] As to the issue of stock value, the authors concluded that firms with higher entrenchment scores had lower stock returns.[15] Bebchuk, *et al* further found that the six entrenchment provisions were the driving force behind a correlation identified by Gompers, Ishii, and Metrick

---

[7] The term "corporate management" refers to both directors and officers.

[8] *See, e.g.*, Belen Villalonga and Raphael H. Amit, *How Do Family Ownership, Control, and Management Affect Firm Value?* (June 7, 2004), AFA 2005 Philadelphia Meetings, EFA 2004 Maastricht Meetings Paper No. 3620, *available at* http://ssrn.com/abstract=556032; Hollis S. Ashbaugh, Daniel W. Collins and Ryan LaFond, *The Effects of Corporate Governance on Firms' Credit Ratings* (June 2004), *available at* http://ssrn.com/abstract=511902; Lawrence D. Brown and Marcus L. Caylor, *Corporate Governance and Firm Performance* (December 7, 2004) (creating a new index, called Gov-Score, and finding evidence that good corporate governance practices lead to better firm performance) (*available at* http://www.issproxy.com/pdf/Corporate%20Governance%20Study%201.04.pdf). The *Corporate Governance and Firm Performance* study is discussed later in this article.

[9] Lucien Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?* (September 2004), Harvard Law School John M. Olin Center Discussion Paper No. 491, *available at* http://ssrn.com/abstract=593423 ("Bebchuk, *et al.*").

[10] *Id.* at 7.

[11] *Id.* at 7-11.

[12] The remaining 18 IRRC factors are generally set forth as: Blank Check, Limits to Special Meetings, Limits to Written Consent, Compensation Plans, Director Indemnification Contracts, Director Indemnification, No Secret Ballot, Unequal Vote, Anti-Greenmail, Director Duties, Fair Price, Pension Parachutes, No Cumulative Vote, Director Liability, Business Combination Law, Silver Parachutes, Cash-Out Law, and Severance Agreements. *Id.* at 39.

[13] *Id.* at 3, 39.

[14] *Id.* at 3.

[15] *Id.* at 40.

between the 24 IRRC provisions on the one hand and reduced firm value and lower share returns during the 1990s on the other.[16]

E. Corporate Governance and Firm Performance. In December 2004, Lawrence Brown and Marcus Caylor published another study in which they again opined that good corporate governance correlates positively with firm value.[17] After creating "a broad measure of corporate governance, Gov-Score, based on a new dataset" supplied by ISS, the authors "relate[d] Gov-Score to operating performance, valuation, and shareholder payout for 2,237 firms."[18] As noted by the authors, "Gov-Score" was intended to be "a broad measure of corporate governance comprised of both external and internal governance mechanisms"[19] which encompassed "51 factors that span eight categories."[20] Those eight categories were "audit, board of directors, charter/bylaws, director education, executive and director compensation, ownership, progressive practices, and state of incorporation."[21] The authors suggested that their 51-factor metric was "more highly associated with expected firm performance than is the oft-used 24-factor G-Index derived by Gompers, Ishii and Metrick"[22] (which is discussed earlier in this article).

Brown and Caylor concluded that "better-governed firms are relatively more profitable, more valuable, and pay out more cash to their shareholders,"[23] stating that "[w]ith the exception of sales growth, all of our firm performance measures have their expected positive relation with Gov-Score and are significant in our correlation analysis . . . decile analysis . . . , or both, suggesting that firms with relatively poor governance are relatively less profitable (lower return on equity and profit margin), less valuable (smaller Tobin's Q), and pay out less cash to their shareholders (lower dividend yield and smaller stock repurchases)."[24]

The authors noted further that "the 13 factors associated most often with good performance are [that] all directors attended at least 75% of board meetings or had a valid excuse for non-attendance, board is controlled by more than 50% independent outside directors, nominating committee is independent, governance committee meets once a year, board guidelines are in each proxy statement, option re-pricing did not occur in the last three years, option burn rate is not excessive, option re-pricing is prohibited, executives are subject to stock ownership guidelines, directors are subject to stock ownership guidelines, mandatory retirement age for directors exists, performance of the board is reviewed regularly, and board has outside advisors."[25] Brown and Caylor also suggested that government officials consider supplementing existing regulations by mandating "the presence of a separate corporate governance committee that meets at least once a year and a provision limiting a firm's option burn rate, two governance factors [the authors found] to be highly related to good performance."[26]

While the authors stated that generally speaking, the corporate governance reforms required by Sarbanes-Oxley Act of 2002 ("SOX") and the listing exchanges "facilitate good performance," they also posited that one such reform ("auditors not providing most non-audit services to clients") in fact may be detrimental to corporate performance.[27]

II. Studies Focusing Upon Specific Aspects of Sound Corporate Governance

While the construct of "sound" corporate governance practices cannot be reduced to a dogmatic "one-size-fits-all" approach, a convergence has developed in recent years as to what core structures constitute "best" corporate governance practices. These "best" practices include, for example: (a) the elimination of takeover defenses such as the poison pill or the staggered board (viewed by many as entrenchment devices which permanently impair long-tem shareholder value); (b) linking executive compensation to a corporation's underlying financial performance (so-called "pay for performance") and (c) curbing excessive grants of stock options to senior management. It is objectives such as these that form the frontiers of modern shareholder activism and serve as the basis for a second group of empirical studies. As summarized below, those studies that have focused upon a specific "best" governance practice have concluded that there is a direct empirical link between (a) particular processes or procedures which promote managerial accountability and align the interests of management and stockholders and (b) higher firm values.

A. The Correlation Between Staggered Boards and Investment Returns. In 2002, Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian published a working paper on staggered boards. The paper's central thesis maintained that this model of board structure represented a truly massive deterrence to unwanted corporate takeovers—perhaps the mightiest of all takeover defenses.[28] *Staggered Boards* recognizes a subspecies of the classified board—the effective staggered board (or ESB)—which, coupled with a poison pill, can prevent circumvention by a hostile bidder, essentially forcing such a party to wage concurrently a proxy contest for board control. Due to the prototypical ESB, which is comprised of three classes each of approximately the same number of director seats, board control cannot be achieved in a single annual meeting election. The ESB will severely try both the staying power and the finances of a dissident group to wage a contest extending over two annual meeting cycles. An ESB clearly increases an incumbent management's protection

[16] *Id.*
[17] Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Performance*, December 7, 2004 (*available at* http://www.issproxy.com/pdf/Corporate%20Governance%20Study%201.04.pdf).
[18] *Id.* (quotes located in Abstract).
[19] *Id.* at 24.
[20] *Id.* at 3.
[21] *Id.* at 28.
[22] *Id.* at 3-4.
[23] *Id.* (quote located in abstract).
[24] *Id.* at 29.
[25] *Id.*
[26] *Id.* at 31.
[27] *Id.*
[28] Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, National Bureau of Economic Research, NBER Working Paper 8974 (June 2002), *available at* http://www.nber.org/papers/w8974 (hereinafter "*Staggered Boards*").

  CARE ISSN 1542-9563

against takeovers, and, most of the time, the ESB succeeds in maintaining the company's independence. However, as to the effect of the ESB on investment returns, the empirical evidence supported the proposition that the stockholders are worse off with the corporation remaining independent than they would be if the hostile bid were accepted.[29]

Staggered Boards also cites Robert Daines' finding[30] that Delaware corporations have higher values than non-Delaware firms, which translates to the conclusion that Delaware incorporation correlates to higher shareholder returns. While DGCL § 141(d) permits classified boards in accordance with formal requirements, including stockholder approval via the corporation's certificate or its initial by-laws, Delaware does not *require* board classification and maintains only one real antitakeover provision, DGCL § 302, which nevertheless allows for corporate opt-outs. Bebchuk, Daines and others believe that Delaware law therefore maintains the mildest antitakeover regime in the nation.

B. The Relationship Between CEO Compensation and Credit Risk. In July 2005, Moody's Investor Service ("Moody's"), which provides ratings on over 85,000 corporate and government securities, published a study which investigated "the empirical relationship between executive compensation and credit risk."[31] Studying "non-financial corporations in the United States with senior unsecured bond ratings of B3 or higher, from 1993 through 2003,"[32] Moody's found a link between the compensation paid to Chief Executive Officers on the one hand and "overall credit risk" on the other.[33] Specifically, Moody's found that firms in the top 10 percent with respect to "high unexplained bonuses" and "high unexplained option grants" experienced "dramatically higher default rates and dramatically higher downgrade rates than did the middle 70% of the distribution."[34] For example, in the case of "high unexplained bonuses," the default rate for the top 10 percent of companies was 1.8 percent, compared to only 0.1 percent for corporations which fell in the middle 20 percent.[35]

The term "unexplained bonuses" (or "unexplained option grants"), as used in this study, refers to bonuses (or option grants) that "deviate[] substantially" from what might be expected "based on firm size, past performance, and other variables."[36] Stated more specifically, "[t]o determine unexplained compensation," Moody's developed "a model that predict[ed] expected salary, expected bonus, and expected option grants based on firm size, past operating performance, CEO tenure, and industry—variables selected from the academic literature on CEO compensation."[37]

In its study, Moody's offered "three possible explanations" for this empirical link that "could be inferred from the [academic] literature."[38] As an initial matter, Moody's noted that "excessive compensation may be indicative of weak management oversight."[39] In addition, Moody's posited that "large pay packages that are highly sensitive to stock price and/or operating performance may induce greater risk taking by managers, perhaps consistent with stockholders' objectives, but not necessarily bondholders' objectives."[40] Finally, Moody's stated that "large incentive-pay packages may lead managers to focus on accounting results, which may, at best, divert management attention from the underlying business or, at worst, create an environment that ultimately leads to fraud."[41]

C. Takeover Defenses and Credit Risk. In a prior study, published in December 2004, Moody's found a "albeit weak" between takeover defenses and corporate credit risk.[42] Specifically, Moody's concluded that:

> Credit risk is found to have been positively related to the number of takeover defenses. Having more takeover defenses led to more defaults and more large downgrades for both investment-grade and speculative-grade firms. Further, more defenses led to fewer large upgrades. These effects are present, even after controlling for credit ratings.[43]

This study analyzed data for 1,058 companies from 1990 to 2003,[44] and focused on the number of takeover defenses a firm had in place (such as poison pills, staggered boards, and golden parachute payments to executives upon a change in control), as well as on information regarding credit upgrades and downgrades and incidents of credit default. Moody's analysis of the data led it to conclude that:

- "[t]he association of takeover defenses with downgrade rates appears fairly strong;"[45]
- "[t]he probability of a downgrade increases as the number of takeover defenses increases for all categories" of issuers;[46]

---

[29] *See also* Lucien Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 853 (January 2005) ("There is evidence that having a staggered board greatly increases the likelihood that targets of hostile bids remain independent, and that it considerably reduces the returns to the target's shareholders both in the short-run and in the long-run. There is also evidence that staggered boards are correlated with lower firm value.") ("*Increasing Shareholder Power*"); Lucian Bebchuk and Alma Cohen, *The Costs of Entrenched Boards*, June 2004; rev. Sept. 2004 ("We find that staggered boards are associated with a lower firm value (as measured by Tobin's Q). We also find some suggestive evidence consistent with the possibility that staggered boards bring about, and not merely reflect, an economically significant reduction in firm value. Finally, the correlation with reduced firm value is stronger for staggered boards that are established in the corporate charter (which shareholders cannot amend) than for staggered boards established in the company's bylaws (which can be amended by shareholders.") (quote found in Abstract) (*available through* http://www.law.harvard.edu/programs/olin_center/).

[30] *See* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. Fin. Econ. 525 (2001).

[31] "Special Comment—CEO Compensation and Credit Risk," *Moody's Investor Service*, July 2005 at 1 (copy on file with the authors).

[32] *Id.* at 3.

[33] *Id.* at 1, 8.

[34] *Id.* at 6.

[35] *Id.* at 5.

[36] *Id.* at 1.

[37] *Id.* at 3.

[38] *Id.* at 8.

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] "Special Comment—Takeover Defenses and Credit Risk," *Moody's Investor Service*, December 2004 at 1 (copy on file with the authors).

[43] *Id.* at 8.

[44] *Id.* at 5.

[45] *Id.* at 6.

[46] *Id.*

- the adoption of "[m]ore takeover defenses" correlated to lower credit "upgrade rates" (although theses results were "not as statistically significant" as those pertaining to credit downgrades);[47] and
- the risk of credit default seemed to be "higher for firms with greater numbers of takeover defense" (although Moody's stated that the relationship was "much weaker than that observed for downgrades").[48]

Moody's also found that so-called "democrats" (defined as corporations with five or fewer take over defenses) "earned 8.9% greater annual stock returns" than those companies defined as "dictators" (those corporations that had 14 or more takeover defenses in place) during the period beginning in 1990 and ending in 1999.[49] Moody's noted that the foregoing finding was "consistent" with prior literature on the subject.[50] Interestingly, however, Moody's also discovered that "firms with the fewest defenses earned 14.7% lower annual returns for the period 2000 to 2003."[51]

Although this study concluded that a positive correlation existed between credit risk and the number of takeover defenses enacted by a corporation, Moody's cautioned that the magnitude of the link was "modest."[52] Moody's further noted that since corporations' use of takeover defenses "continues to change," the results seen for the period studied "might not hold in the future."[53] In addition, Moody's posited that "the effect and meaning of takeover defenses depends highly on the specific circumstances of each firm as well as the firm's overall corporate governance structure" and that, as such, the effect of such defenses are "highly contingent on specific context."[54] In Moody's view, this indicated that "a case-by-case approach" might be more valuable than making "broad assumptions" regarding the influence of such defenses "on credit quality."[55]

D. Related Party Transactions: Harmful or Efficient? In the wake of the corporate scandals of recent years, which focused attention on related party transactions between companies and members of their senior management team, Rutgers Business School Professors Elizabeth Gordon, Elaine Henry and Darius Palia conducted a study to test whether a relationship existed between such transactions and firm value.[56] The authors presented two hypotheses as to how related party transactions might affect the performance of a company. The first hypothesis, which can be traced to Berle and Means' famous treatise on the "modern corporation," was that related party transactions "represent a conflict of interest" between managers and shareholders that harm firm value.[57] In their seminal work first published in the 1930s, Berle and Means posited that the separation of ownership from control "posed a fundamental threat to the public shareholder" since "[m]anagement groups might pursue their personal interest in higher salaries, favorable stock options, or other conflicts of interest at the expense of the majority of public shareholders."[58]

The second hypothesis proposed that "related party transactions are efficient transactions" that benefit the corporation.[59] Under this second hypothesis, these transactions are viewed as a means for corporations to retain skilled executives which, in turn, improves firm value.

The authors concluded that, as an overall matter, related party transactions were not beneficial and negatively affected firm value:

> the evidence indicates that shareholders do not benefit from, and in fact are harmed by some related party transactions. Our investigation of the corporate mechanisms associated with related party transactions and their impact on firm value supports the hypothesis that they are conflicts of interest between managers/board members and their shareholders. We find that this effect is especially strong for loans and the number of transactions (other than loans) with non-executive directors. . . . Therefore, it appears that concerns among regulators and stock market participants about related party transactions are warranted.[60]

The issue of related-party transactions ("RP transactions") was also at the heart of a September 2004 study published by University of Wisconsin Professors Mark J. Kohlbeck and Brian W. Mayhew.[61] There, the authors examined the RP transactions of 1,261 of the S&P 1500 companies. Kohlbeck and Mayhew found that one of the most common forms of RP transaction were loans to related parties.[62] They further concluded, *inter alia*, that "board of director independence (stronger corporate governance) is associated with a lower probability of RP transactions, and when there were RP transactions, the transactions [were] more likely to be disclosed . . . ."[63] The authors also opined that the evidence suggested that "board monitoring plays a role in mitigating the occurrence of RP transactions and helps to discipline disclosure of the transactions when they do occur."[64]

E. The Relationship Between Earnings Manipulation and Stock Option Timing. Several studies have focused on the troubling relationship between the timing of the release of a corporation's earnings results and an award of stock options to senior executives. In a 2000 study titled

---

[47] *Id.*
[48] *Id*
[49] *Id.* at 3, 4.
[50] *Id.* at 4.
[51] *Id.* (emphasis in original deleted).
[52] *Id.* at 8.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] Elizabeth A. Gordon, Elaine Henry and Darius Palia, *Related Party Transactions: Associations with Corporate Governance and Firm Value* (August 2004), EFA 2004 Maastricht Meetings Paper No. 4377, *available at* http://ssrn.com/abstract=558983 ("Gordon, *et al.*").
[57] *Id.* at 8.
[58] Joel Seligman, "A Modest Revolution in Corporate Governance," 80 Notre Dame L. Rev. 1159, 1162 and n.16 (March 2005) (discussing Berle and Means).
[59] Gordon, *et al.*, *supra* at note 56, at 8.
[60] *Id.* at 37-38.
[61] Mark J. Kohlbeck and Brian W. Mayhew, *Related Party Transactions* (September 15, 2004), AAA 2005 FARS Meeting Paper, *available at* http://ssrn.com/abstract=591285 ("Kohlbeck").
[62] *Id.* at 4, 11-12. Of course, SOX now prohibits a public corporation from making "personal loans to a director or executive officer, except for home improvement loans, manufactured home loans or loans made or maintained by an insured depository institution if the loan is subject to the insider lending restrictions of the Federal Reserve Act." William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* § 1245; *see also* 15 U.S.C. § 78m(k).
[63] Kohlbeck, *supra* at note 61, at 23.
[64] *Id.*

CARE ISSN 1542-9563

CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures, two business professors, David Aboody of UCLA and Ron Kasznik of Stanford University, found that chief executives engage in a kind of self-interested behavior "around [option] award dates by delaying good news and rushing forward bad news."[65] Specifically, Aboody and Kasznick discovered that "CEOs who receive their options before the earnings announcement are significantly more likely to issue bad news forecasts, and less likely to issue good news forecasts, than are CEOs who receive their awards after the earnings announcement."[66] In their study, the authors also cited to an earlier study by New York University Professor David Yermack, who had concluded that "CEO option awards are preceded, on average, by insignificantly negative abnormal returns, and are followed by significantly positive abnormal returns."[67]

While the authors did not mean to "necessarily imply that this activity adversely affects shareholder wealth,"[68] the results of the study do suggest that chief executives are engaging in opportunistic behavior which could be mitigated through better governance practices. Indeed, as Aboody and Kaznick specifically stated, their "findings suggest[ed] that CEOs' incentives to manage investors' expectations around scheduled awards could be mitigated by setting award dates immediately after earnings announcements."[69]

That corporate management engages in self-interested behavior vis-à-vis option grants also was the subject of a January 2005 study published by Professors M.P. Narayanan and H. Nejat Seyhun of the University of Michigan Business School.[70] In that study, the authors examined "a database of 605,106 option grant filings by insiders between 1992 and 2002" and discovered "significant abnormal stock return reversals around the grant date."[71] More specifically, the authors found that the:

> overall evidence is consistent with substantial managerial influence on their compensation. Stock price [sic] fall significantly prior to option grant dates and rise significantly following option grant dates, thereby producing sharp reversals of abnormal returns. The market-adjusted return for the 90 days preceding the grant date is about -3.6% and the return for the 90 days following the grant date is about 9.4%. In small firms, the 90-day post-grant date average abnormal rise in stock price is about 17%. *These patterns are significantly larger than any that has been documented in previous literature.*[72]

The authors also concluded that these "abnormal stock return reversals are more pronounced on average when the grants involve top executives such as CEOs, Chairmen of the Board, Presidents, and CFOs, who possess more company specific information, have the ability to manage information disclosure, and wield greater influence with the board."[73]

The Narayanan/Seyhun analysis appears to go one step further than prior studies. According to the authors, while senior management does control the public disclosure of good and bad information, the evidence also suggests that "some firms are setting the [option] grant date on a back-date basis, i.e., picking a date in the past with a lower stock price compared to that on the decision date."[74] In this regard, the authors stated that:

> while the stock return reversals are consistent with both opportunistic timing of information releases by firms and opportunistic timing of grant dates, these two methods of influencing do not completely explain the observed stock return reversals. In particular ... the correlation between post-grant and pre-grant abnormal returns cannot be easily explained by these two methods of influencing alone. We propose that some firms may be setting the grant date on a back-date basis, i.e., choosing a grant date in the recent past with a lower stock price than the price on the day of the grant decision is made. If back-date method is employed by some firms, the stock return reversals should be positively related to the reporting lag (the time interval between the grant date and the date on which the SEC receives the grant disclosure forms from the executive). *We find this is indeed the case.*
>
> The magnitude of the gains for large grants from backdating can be significant. Our results show that if grant date is back-dated by 20 days, executives receiving large grants (500,000 shares or greater) increase the value their option compensation by about 10%. By conservative estimates, this is equivalent to a windfall of $0.7 million per grant.[75]

As one recent press report noted, the Narayanan/Seyhun study "suggests one easy litmus test of a company's corporate governance: Check the company's filings for the timing of recent option grants. If they occur with an eerie regularity at prices close to the company's trailing 52-week lows, then you should become suspicious of its internal corporate culture."[76]

F. The Correlation Between Executive Compensation and Accounting Fraud. In a study published in February 2004, Merle Erickson (Graduate School of Business, University of Chicago), Michelle Hanlon (University of Michigan Business School), and Edward Maydew (Kenan-Flagler Business School, University of North Carolina) set out to determine if a relationship existed between the structure of executive compensation and accounting fraud. The authors used a sample of 50 firms that had been accused of such fraud by the SEC from January 1996 to November 2003.[77] Ericksen, *et al.* tested two opposing views on the impact of stock-based compensation on executive incentive.[78] One view is that option-based compensation aligns manager and shareholder interests and is consistent with the maximization of firm value.[79] The opposing view is that option-based

---

[65] David Aboody and Ron Kasznick, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. Acct. & Econ. 73 (2000).

[66] *Id.* at 75.

[67] *Id.* at 76.

[68] *Id.* at 98.

[69] *Id.*

[70] M.P. Narayanan and H. Nejat Seyhun, "Do Managers Influence their Pay? Evidence from stock price reversals around executive option grants," January 2005 (*available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649804).

[71] *Id.* (quotes found in Abstract).

[72] *Id.* at 30 (emphasis added).

[73] *Id.*

[74] *Id.* (quote found in Abstract).

[75] *Id.* at 31 (emphasis added).

[76] Mark Hulbert, "Does corporate governance matter?" *Marketwatch*, February 18, 2005.

[77] Merle Erickson, Michelle Hanlon and Edward L. Maydew, *Is There a Link Between Executive Compensation and Accounting Fraud?* (February 24, 2004), *available at* http://ssrn.com/abstract=509505 ("Erickson, *et al.*").

[78] *Id.* at 2-4.

[79] *Id.* at 2.

compensation poorly aligns the long-term interests of shareholders and managers, provides ineffective incentive for managers, and leads to misleading corporate reporting on executive compensation.[80] The authors concluded that a positive correlation existed between accounting fraud and equity-based executive compensation, noting that "[t]he results are consistent with the likelihood of accounting fraud increasing in the percent of total executive compensation that is stock based."[81]

A 2003 study published by Louisiana State University Professors Shane A. Johnson, Harley E. Ryan and Yisong S. Tian reached a similar conclusion.[82] After studying 43 firms accused of accounting fraud by the SEC from 1992 to 2001, the authors found that "executives who commit fraud face greater financial incentive to do so" and that these incentives "stem from significantly larger stock and option holdings."[83] The authors further noted that the "level of equity-based compensation [has] trended upward is recent years" and that, as a result, anti-fraud measures (including such measures at the investor level) "should increase commensurately."[84]

In a recent study presented to the Academy of Management in Honolulu, Jared Harris and Professor Philip Bromiley of the Carlson School of Management at the University of Minnesota, concluded that when a chief executive receives a large stock option package, there is a much greater likelihood that the company in question will "misrepresent their financial position."[85] The Harris/Bromiley study analyzed companies that had restated their financial results over a five and one-half year period (January 1, 1997 to June 30, 2002) because of "accounting 'irregularities' "[86] and found that within those companies, stock options comprised one-half of a chief executive's total compensation (this stood in stark contrast to CEO compensation at comparable companies that did not experience such a restatement—where options comprised only 39 percent of remuneration).[87] The authors also concluded that probability of financial misrepresentation increased "rapidly" when stock options constituted "more than 76% of compensation."[88] Moreover, "while [t]he analyzed sample reveal[ed] that a publicly traded company has approximately an 8.77% probability of having a financial misrepresentation discovered during a given five-year time period,"[89] the authors noted that among those companies that paid their chief executives over 92 percent of compensation as stock options, the probability of misrepresentation was 21 percent[90]

III. Other Studies on the Relationship Between Sound Corporate Governance and Firm Performance

There are, of course, numerous other recent studies not specifically cited above which also have concluded that sound corporate governance is directly correlated with firm performance. By way of example, on its website, ISS states that "[t]aken as a whole, the empirical evidence shows that governance matters—in terms of firm value for large firms, reducing earnings management, reducing the risk of fraud, and restoring trust if fraud is discovered."[91] Among the studies cited by ISS in this regard were *Restoring Trust After Fraud: Does Corporate Governance Matter?* authored in January 2004 by David B. Farber of the Eli Broad Graduate School of Management at Michigan State University.[92] Farber's study "focused on firms that had been cited by the SEC for financial fraud" and concluded that "fraud detection consistently led to improvements in the quality of the board of directors and increases in audit committee activity."[93] Significantly, the study also found a "positive and economically significant relation between increases in board independence and long-run buy-and-hold abnormal returns over the three-year period following fraud detection."[94]

In late 2004, a study by Richard Bernstein, chief U.S. strategist at Merrill Lynch, received a great deal of attention in the media.[95] As noted in those media accounts, Mr. Bernstein concluded that companies which have "split" the roles of Chairman and CEO perform better than those companies which have the same individual in both positions.[96] In this regard, ISS reported that "[i]n the past decade, companies with different people serving as chairman and CEO have outperformed those that combine the roles, according to Richard Bernstein, chief U.S. strategist at Merrill Lynch & Co. Of the 100 largest companies in the S&P 500 Index, corporations that split the roles have posted a 22 percent annual return since 1994, outpacing the 18 percent return earned by firms that did not . . . ."[97]

---

[80] *Id.* at 3-4, citing, *inter alia*, to various studies.

[81] *Id.* at 32. *See also id.* at 33 ("We consistently find that a higher stock-based mix of pay is positively associated with a likelihood of fraud.").

[82] Shane A. Johnson, Harley E. Ryan, and Yisong S. Tian, *Executive Compensation and Corporate Fraud* (July 2003), *available at* http://www.nd.edu/~finance/020601/news/Johnson_paper.pdf and version *available at* http://ssrn.com/abstract=395960.

[83] *Id.* at 30.

[84] *Id.* at 31.

[85] Jared Harris & Philip Bromiley, "Incentives to Cheat: The Influence of Executive Compensation and Firm Performance on Financial Misrepresentation," March 2005 at 1 (copy on file with the authors).

[86] *Id.* at 8.

[87] *Id.* at 43 (table 1).

[88] *Id.* at 31.

[89] *Id.* at 35.

[90] *Id.* at 31.

[91] ISS Governance Center, Governance Weekly – Studies Show Governance Refroms Matter (*available at* http://www.issproxy.com/governance/publications/2004archived/105.jsp) ("Governance Weekly").

[92] Study *available at* http://ssrn.com/abstract=485403.

[93] Governance Weekly, *supra*, at note 91.

[94] *Id.*

[95] *See, e.g.*, "Study Says Two Chiefs Not Too Many, Firms Which Divvy Up The Power Outperform Those With One Leader," *Columbia State (SC)*, November 8, 2004 (*available at* 2004 WLNR 6690167); "The division of corporate powers pays," *New Jersey Record*, October 20, 2004 (*available at* 2004 WLNR 3246145).

[96] *See, e.g.*, "Companies with split officials best for stockholders," *Belleville News Democrat (IL)*, October 24, 2004 (*available at* 2004 WLNR 4285085) ("It turns out that those companies with different people at the helm tend to see their stock outperform those that don't, at least according to new research tracking returns over the last decade.").

[97] Ted Allen, "Independent Board Chairs Remain a 'Priority,' " *ISS Governance Weekly*, November 12, 2004 (*available*

CARE . ISSN 1542-9563

In March 2005, ameinfo.com posted an article titled "Corporate responsibility and corporate governance," which discussed "two major new studies" on the relationship between "corporate responsibility" on the one hand and "financial performance" on the other.[98] The first such study, authored by Marc Orlitzky (University of Sydney) and by Frank Schmidt and Sara Rynes (University of Iowa), concluded that there was "a statistically significant association between corporate social performance and financial performance . . . varying 'from highly positive to modestly positive.' "[99] The second such study, titled "Corporate Environmental Governance," was "commissioned by the UK Environment Agency" and reviewed "60 research studies over the last six years."[100] The author found that 85 percent of those research studies "showed a positive correlation between environmental management and financial performance," leading to a conclusion that "companies with sound environmental policies and practices are highly likely to see improved financial performance."[101]

IV. The Benefits of Socially Responsible Investing

"Socially Responsible Investing . . . is a general term used to describe investments that reflect good values, morals, and ethics."[102] As a general matter, SRI involves the process of assessing "the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis."[103]

SRI has increased dramatically in recent years. Indeed, a recent press report noted that "approximately $2.16 trillion was invested using a socially responsible strategy as of December 2003."[104] Along these same lines, a growing number of *companies* also now make "social responsibility" an important part of their corporate culture.[105] As noted in a recent article in *Business Week*, "managers from all parts of American business are increasingly seeing social responsibility as a strategic imperative."[106] In the view of Home Depot's CEO, Robert L. Nardelli, this thought-process reflects:

> a growing embrace of so-called stakeholder theory, which posits that companies are beholden not just to stockholders — but also to suppliers, customers, employees, community members, even social activists. That's quite a departure from the long-dominant notion that corporations' only duty is to increase profits for shareholders. 'Things have become a lot more interdependent,' says Nardelli. 'There are a broader range of constituents.'[107]

Of course, the recognition that corporations should embrace public service and philanthropic causes also may be viewed as a "gussied-up bid for good favor."[108] In that regard, *Business Week* noted that:

> [t]arred by a raft of corporate scandals from Enron to WorldCom, social outreach can be a way to regain the high ground. That's probably one reason corporate giving hit $3.6 billion last year, an all-time high, up from $3.5 billion in 2003, according to philanthropy research group the Foundation Center.[109]

Some academics have deduced that "socially responsible investing results in a less profitable portfolio."[110] However, as noted below, several recent studies have cast doubt on that conclusion.

A. The Study Conducted by Derwall, Günster, Bauer, and Koedijk. In a 2004 study authored by Erasmos University professors, Jeroen Derwall, Nadja Günster, and Kees Koedijk, in conjunction with Rob Bauer of ABP Investments and Maastricht University,[111] the authors hypothesized that eco-efficiency ("the ratio of the value a company adds (e.g. by producing products) and the waste a company generates from the creation of that value")[112] related to better portfolio performance. Five criteria were used to analyze the eco-efficiency of a number of U.S. companies, "historical liabilities" (*i.e.*, "risks resulting from preceding actions"); "operating risk" (*i.e.*, "risk exposure from recent events"); "sustainability and eco-efficiency risk" (*i.e.*, "future risks initiated by the weakening of the company's material sources of long-term profitability and competitiveness"); "managerial risk efficiency" (*i.e.*, management's "ability to handle environmental risk successfully"); and "environmentally-related strategic profit opportunities" (*i.e.*, available business opportunities that result in a competitive advantage over other "industry peers").[113] The authors then constructed "two mutually exclusive stock portfolios," each of which had "distinctive eco-efficiency characteristics."[114] Upon conducting various analyses on the performance of each portfolio, the authors concluded that SRI adds value to an investor's portfolio:

> In spite of the widespread skeptical attitude towards SRI, we present evidence that a stock portfolio consisting of companies labeled 'most ecoefficient' sizably outperformed its 'less eco-efficient' counterpart over the period 1995-2003. Using several enhanced performance attribution models to overcome methodological concerns, we show that the observed performance difference cannot be explained by differences in market sensitivity, investment style, or extreme industry tilts. Even in the presence of transaction costs, a simple best in-class stock selection strategy historically earned a higher risk-adjusted return of 6% compared to a worst-in-class portfolio. Overall, our find-

---

at http://www.issproxy.com/governance/publications/2004archived/150.jsp).

[98] *See* AME Info – Middle East Finance and Economy, "Corporate responsibility and corporate governance," March 16, 2005 (*available at* http://ameinfo.com/55905.html).

[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] "Socially Responsible Investing," *available at* http://www.investorhome.com/sri.htm.

[103] Schueth, *supra*, at note 2.

[104] Eddie Roodveldt, "Smart Investing," *Contra Costa Times*, July 15, 2005 (*available at* 2005 WLNR 11103597).

[105] *See* Brian Grow, *et al.*, "The Debate Over Doing Good," *Business Week*, August 15, 2005.

[106] *Id.*

[107] *Id.*

[108] *Id.*

[109] *Id.*

[110] Anupam Chander, "Diaspora Bonds," 76 N.Y.U. L. Rev. 1005, 1071 (October 2001).

[111] Jeroen Derwall, Nadja Günster, Rob Bauer, and Kees Koedijk, "The Eco-Efficiency Premium Puzzle," May 17, 2004 (*available at* https://ep.eur.nl/bitstream/1765/1296/1/ERS+2004+043+F%26A.pdf) ("Derwall, *et al.*").

[112] *Id.* at 7.

[113] *Id.* at 8.

[114] *Id.* at 16.

ings suggest that the benefits of considering environmental criteria in the investment process can be substantial.[115]

B. Other Studies on the Benefits of SRI. The study authored by Derwall, *et al.* is not alone in its conclusion that SRI obtains superior investment returns. As noted in the January 2003 issue of the *Journal of Accountancy*, two other studies also have opined that SRI enhances shareholder returns.[116] First, during the period 1990 to 1998, "the Domini 400 Social Index—a benchmark that measures the impact of social screening on financial performance—returned 18.54% vs. 16.95% for the S&P 500."[117] Second, a Spring 2000 article in the *Financial Analysts Journal*, "took a comprehensive look at the risk-and-return characteristics of socially responsible mutual funds" and concluded that "[n]ot only did the screened funds do better, they did so at a modest risk premium—14.19% standard deviation vs. 13.23% for the S&P 500."[118]

C. The Impact of ERISA on Socially Responsible Investing. Institutional investors who are subject to the fiduciary requirements imposed by the Employee Retirement Income Security Act ("ERISA"),[119] should be mindful of two pronouncements from the Department of Labor ("DOL") pertaining to socially responsible investing. In an interpretative bulletin issued in June 1994 (so-called Interpretative Bulletin 94-1), the DOL addressed plan investments in so-called "economically targeted investments" (or "ETIs") which it termed, "investments selected for the economic benefits they create apart from their investment return to the employee."[120] The DOL opined that the that "[t]he fiduciary standards applicable to ETIs . . . are no different than the standards applicable to plan investments generally" and that plan fiduciaries must—in making any investment decision—"give[] appropriate consideration to those facts and circumstances that . . . the fiduciary knows or should know are relevant" including "diversification, liquidity and risk/return characteristics."[121] The DOL further noted that that since "every investment necessarily causes a plan [or a participant] to forgo other investment opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return."[122]

In an advisory opinion written in May 1998, the DOL reiterated the foregoing principles in connection with an inquiry regarding the application of ERISA's fiduciary's responsibilities to a plan's selection "of a 'socially-responsible fund' as a plan investment or a designated investment alternative."[123] While the DOL stated that ERISA does not "preclude consideration of collateral benefits, such as those offered by a 'socially-responsible' fund, in a fiduciary's evaluation of a particular investment opportunity," those collateral benefits can be determinative "only if the fiduciary determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks."[124] In the DOL's view, a fiduciary's obligation to act in the best interests of plan participants and beneficiaries cannot be subordinated to other social objectives. Accordingly, "in deciding whether and to what extent to invest in a particular investment, or to make a particular fund available as a designated investment alternative, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment, or to designate an investment alternative, may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments."[125] As noted by one commentator, "the DOL is of the opinion that, once it is determined that an investment alternative is prudent for participant direction–based on an analysis of only the investment considerations–the fiduciaries can then, and only then, consider the collateral issues, like the socially responsible screen."[126]

Conclusion

In a *Harvard Law Review* article published in January 2005, Lucian Arye Bebchuk noted that "[t]o students of corporate law, the proposition that corporate governance matters requires little explanation. As the evidence indicates that the quality of governance arrangements affects firm performance and shareholder value."[127] Similarly, a April 2004 piece published by Deutsche Bank concluded that "investments in companies with the highest quality of governance structures and behavior have significantly outperformed those with the weakest governance."[128] Indeed, Deutsche further found that "companies that have taken action to improve their governance standards have outperformed those that have taken negative actions over the past two years."[129]

As discussed throughout this article, a substantial number of studies support the notions that investing in companies with sound corporate governance programs

---

[115] *Id.* at 18; *see also id.* at 15 ("companies performing relatively well along environmental dimensions collectively provided superior returns.").

[116] Cynthia Harrington, "Socially Responsible Investing," *Journal of Accountancy*, January 2003 (*available at* http://www.aicpa.org/pubs/jofa/jan2003/spec_har.htm).

[117] *Id.*

[118] *Id.*

[119] 29 U.S.C. §§ 1001, *et. seq.*

[120] 29 C.F.R. § 2509.94-1.

[121] *Id.*

[122] *Id.*

[123] *See* "Calvert Letter," U.S. Dep't. of Labor PWBA Advisory Opinion 98-04A (May 28, 1998) (*available at http://www.dol.gov/ebsa/programs/ori/advisory98/98-04a.htm*).

[124] *Id.*

[125] *Id.*

[126] Fred Reish, "Doing Well While Doing Good: Doing the Right Thing with Socially Responsible Funds," May 2003 (*available at http://www.reish.com/publications/article_detail.cfm?ARTICLEID=381*).

[127] *Increasing Shareholder Power*, *supra* at note 29, 118 Harv. L. Rev. at 850.

[128] Deutsche Bank "Beyond the Numbers, Corporate Governance: Implications for Investors," April 2004 (concluding that (*available at* http://www.unepfi.org/fileadmin/documents/materiality1/cg_deutsche_bank_2004.pdf).

[129] *Id.*

  CARE ISSN 1542-9563

and practices makes good economic sense and that good corporate governance fosters long-term profitability. Simply put, good corporate governance does, in fact, pay.

Boost shareholders' rights, warn pension funds

By Steve Johnson in London
Published: January 22 2007 02:00 | Last updated: January 22 2007 02:00

Europe's most powerful pension fund managers have warned US regulators that shareholders' rights need to be strengthened to maintain confidence in the US equity market.

Norway's Norges Bank Investment Management, Hermes of the UK and Dutch duo ABP and PGGM, which collectively manage assets of $765bn- more than $100bnof which is invested in the US - have told the Securities and Exchange Commission (SEC) that a lack of shareholders' rights on Wall Street is a factor in the growing popularity of non-US markets.

The quartet is pressing for the SEC to allow shareholders more access to company proxies to nominate and elect boards of directors.

The pension funds said in a letter to the SEC last week: "We consider the ability of shareholders of US issuers to nominate individuals for election to the board in a cost-effective way as an issue of major importance in the development of the integrity of American capital markets.

"Proxy access . . . is fundamental to a well-functioning market and to shareholders' meaningful participation. In most other advanced countries there have been strong moves towards opening proxy access. This is certainly one reason for the growing popularity of foreign stock markets."

The SEC is believed to be deadlocked on the issue. Its rules allow companies to refuse votes on proposals that "relate to an election". Shareholders have to produce their own slate tonominate directors and remove existing board members, typically at a cost of several million dollars.

A US appeals court ruled in September that the SEC was wrong to block an attempt by the American Federation of State, County and Municipal Employees to put a shareholder proposal on the ballot of AIG, the insurer, which would have permitted shareholders to nominate directors and forced the company to co-operate in the process. The SEC is expected to issue revised proposals on the issue in the coming weeks.

Mark Anson, chief executive of Hermes, said: "The US prides itself on its great democracy but democratic rights do not exist in corporate America.

"Shareholders do not have the right to fire directors. It seems reasonable to me for shareholders to be able to nominate people they think should run the company."

Opponents of any move to widen proxy access, such as the US Chamber of Commerce, have argued that it would allow elections to be hijacked by special interests.

But the funds say that the right to nominate directors is used sparingly in Europe, with the existence of such powers being enough to influence directors' be-haviour.

Knut Kjaer, a director of Norges Bank Investment Management, said insufficient shareholder rights were reducing the attractiveness of US capital markets.

Executive pay returns to the crosshairs

Drumbeat for shareholder approval louder, but new legislation faces hurdle

By Robert Schroeder, MarketWatch
Last Update: 1:38 PM ET Jan 16, 2007

WASHINGTON (MarketWatch) -- Bolstered by new federal disclosure rules and a slate of news about outsized pay packages, lawmakers and fed-up investors are coming out swinging ahead of this year's corporate proxy season and promising to press companies harder than ever about spiraling levels of CEO pay.

Packages like the $210 million given to former Home Depot Inc. CEO Bob Nardelli have helped to reignite outrage in Washington and among investors' advocates over huge executive pay, and the combination of likely legislative proposals in Congress and shareholder initiatives at upcoming annual meetings may force companies to rethink the way they pay top executives.

New House Financial Services Committee Chairman Barney Frank, a Massachusetts Democrat, is planning hearings on CEO pay this year, and wants to give shareholders more of a say in approving compensation. Last year, he introduced a bill that would've given shareholders a vote about pay and "golden parachute" packages for CEOs.

It's unclear if Frank will reintroduce the bill or write a new one–Frank's spokesman, Steven Adamske, says the congressman hasn't decided what course to take this year. But one way or another, analysts say, sentiment is moving toward an even tighter process for approving corporate chiefs' salaries and benefits.

One such way to raise the bar is by requiring shareholder approval of pay packages, a right already enjoyed in the United Kingdom.

"I think that there's large shareholder momentum behind the concept," says Richard Ferlauto, the director of pension and benefit policy for the American Federation of State, County and Municipal Employees. "Given the continued revelations about egregious pay packages...it'll be difficult to vote against something like this," Ferlauto predicts. His group has called for non-binding votes by shareholders on pay packages.

Investors have seen a growing number of CEOs step down with big compensation deals. Nardelli walked away with $210 million after battling with Home Depot Inc. (HD) shareholders. Ex-Pfizer Inc. (PFE) chief Henry McKinnell got a $200 million retirement package in spite of presiding over a 49% slide in the value of the pharmaceutical giant's stock between 2000 and 2005. ExxonMobil (XOM) leader Lee Raymond left with $357 million.

With proxy season approaching, more revelations are expected, thanks to new Securities and Exchange Commission rules about pay disclosure.

"It's going to be one of the, if not the, hottest issues this proxy season," said Amy Borrus, deputy director of the Council of Institutional Investors, a pension group that focuses on shareholder rights. Most companies hold annual meetings in March, April and May.

Observers say there are several avenues to reining in pay and benefits packages, including congressional legislation, new federal rules and shareholder proxy initiatives.

Congressional hurdle

But congressional legislation will almost certainly be complicated by the narrowly divided House and Senate. Democrats enjoy only a 31-seat majority in the House, and the Senate is evenly split, though its two independents vote with Democrats. Still, it's likely that any Democratic initiative about executive pay will need Republican support.

Michael Townsend, a vice president with Charles Schwab & Co., Inc. (SCHW) , isn't predicting a big push toward legislation. Rather, he says, Frank and other Democrats will use their majority to convince regulators more needs to be done about the issue.

"My sense is that that is more about maintaining pressure" on the Securities and Exchange Commission, Townsend said in an interview. "When Frank talks, [SEC Chairman Christopher] Cox hears it."

SEC rules approved last summer direct companies to publish a table showing executives' total compensation, a move designed to bring better disclosure to shareholders. Companies must also detail stock-option grants. But instead of showing options' value in the year granted, a controversial revision just before Christmas allows companies to spread the value of options over several years. However, the full value of the option in the year given and the expensed value will be included in a separate table.

Neither the SEC nor Frank has aimed to cap executive pay.

Shareholder activism

But shareholders may not have to wait for Congress or regulators to act. The AFSCME Employee Pension Plan, for one, is planning to file resolutions this year that would give shareholders a vote about approving CEO pay. Last year, the plan filed such resolutions at companies including US Bancorp (USB) , Merrill Lynch (MER) , Sara Lee (SLE) and Home Depot. Ferlauto says more are coming this year.

Meanwhile, outplacement firm Challenger, Gray & Christmas, Inc. is predicting more shareholder discontent about spiraling levels of pay.

"With new regulations about full disclosure of CEO compensation we will undoubtedly see more instances of shareholder outcry on this issue," said John Challenger, the consultancy's CEO, in a statement. "Chief executives will have to prove day in and day out that they are worthy of such rewards," Challenger said Monday.

In a survey released Monday, Challenger's firm said CEO departures were up 12% last year, particularly in the health care, financial and computer industries.

"There is more transparency, more scrutiny and more pressure than ever," Challenger said. "It is coming from all sides--board members, shareholders, industry analysts, government agencies and the media. The CEO's ivory tower has been razed."

Borrus of the Council of Institutional Investors agreed. In real estate, she said, it's location, location, location. In the corporate world this year, "it's CEO pay, CEO pay, CEO pay."

Robert Schroeder is a reporter for MarketWatch in Washington.

Source: Financial Times (Main)
Edition:
Country: UK
Date: Thursday 18, January 2007
Page: 12
Area: 339 sq. cm
Circulation: ABC 437720 Daily
BRAD info: page rate £46,700.00, scc rate £91.00
Phone: 020 7873 3000
Keyword: ICAEW

Oceans apart on the rights and wrongs of control

The ICAEW roundtable on Anglo-American corporate governance in London last week revealed how stark differences are, says Robert Bruce

THE ACCOUNTANCY COLUMN

A roundtable meeting held in London last week by the Institute of Chartered Accountants in England & Wales on emerging issues in Anglo-American corporate governance revealed yet again how far apart the two countries are. Distinguished contributors from both sides of the Atlantic, sometimes unwittingly, showed how wide the gulf still is.

The roundtable was part of an initiative launched by the ICAEW last year, dubbed "Beyond the myth of Anglo-American corporate governance" and marked the publication of a paper on "emerging issues".

This paper provides a useful compilation of where the differences lie. But it was down to Tim Bush, director at Hermes UK Focus Fund, at a dinner on the eve of the roundtable, to mark out the territory. His original research on the different financial reporting models, which sparked much of the debate, was published by the ICAEW last year.

He spoke of how Enron provided good examples of the issues. "It used 'mark-to-market accounting', which, in plain English, is counting chickens before they are hatched. Second, it used 'off-balance sheet' financing, which, in plain English, is not showing your shareholders how much debt you've got behind your income, and third, it privately pledged unissued Enron stock as collateral for these hidden loans, instead of taking a visible charge on Enron's assets."

As he pointed out: "None of these things, separately or together, were permissible under UK company law. Yet Enron's accounting had passed the tests of US Generally Accepted Accounting Principles on these things."

This was the starting point. So how did the US business culture foster this difference? Lady Barbara Judge suggested some answers. She is deputy chairman of the Financial Reporting Council, the UK's accounting regulator, and was, in her time, the youngest ever commissioner of the US Securities and Exchange Commission. She had no doubts: "Directors are used to having their own unfettered way in the US, whereas in the UK there is greater pressure from shareholders."

Then there are the lawyers: "Corporate governance in the UK has surpassed the US because it doesn't have class action lawyers sitting around waiting to bring an action," she added.

This fostered a different system in the UK. "CEOs are less imperial," said Mr Bush, "and boards are more collegiate. There is also collegiate representation in all of the market-regulating bodies, making the regulatory system work. Nationality is not a bar, nor is being a securities lawyer the key requirement for being a regulator. The accountancy profession is altogether more confident."

Another Anglo-American speaker backed up this thesis. Mark Anson was chief investment officer for Calpers, California's state retirement system, and is now chief executive of Hermes Pension Management in London. "Somewhere along the line the US forgot to extend its democratic principles to the capital markets," he said.

He described a comment by an amazed US CEO on learning how corporate governance works in the UK: "What a concept – shareholders could elect their own directors."

But it fell to Ethiopis Tafara, director of the office of international affairs at the SEC, to make plain the real differences when it comes to regulation of the capital markets. His comments reminded participants how far US regulation is dictated by its local markets whereas London had a much more outward-looking focus. Mr Tafara emphasised that "the UK market attracts sophisticated capital" whereas "the US market attracts retail investors".

He made an analogy to motoring regulations. In the US they were dealing with "public roadways" whereas the UK was dealing with "Formula One". "Our system has to go with the 50mph speed limit," he said. "We cannot move to a driver-led 'comply or explain' approach." He emphasised the SEC's constraints. "It would be very difficult for us to drive faster within the 50 mph speed limit. It provides the optimal protection."

Mr Tafara conceded that, when it came to the competitiveness of the US markets, "the landscape has changed dramatically". He suggested they were not less competitive but simply faced greater competition. "There is greater liquidity and choice for global investors," he said. For example, he thought Chinese companies could prefer a Hong Kong listing as they might get better analyst coverage there.

Sir Christopher Hogg, chairman of the FRC, concluded the discussions with the thought that: "UK shareholders have enviable rights compared with the US. The long-term benefits of this are clear."

ATLANTIC DIVIDE

- Enron failings acceptable under US rules; illegal in UK
- Lack of shareholder pressure in the US
- US CEOs more "imperial"
- American regulation shaped by domestic market
- Difficult to move to "comply or explain" model

Att #4
3-5-07

HB 1340 Short Overview

- This bill is totally optional.
- It is limited in scope.
- It affects only publicly-traded corporations who choose to be affected. Freedom of a business to choose is good public policy. Limited options and mandates are not good public policy.
- We presently have two publicly held corporations domiciled in the state. This will affect none of them.
- For future publicly held corporations that become domiciled in the state, this will affect them only if they chose this shareholder friendly option. They can utilize the present laws if they wish to do so and incorporate under the present corporate structure.
- The Secretary of State, who strongly supports this bill, believes that this will generate income in the future for the state of North Dakota.

AH #5
3-5-07

TESTIMONY OF DAVE MACIVER
North Dakota Chamber of Commerce
HB 1340
March 5, 2007

Mr. Chairman and members of the committee, my name is Dave MacIver and I represent the ND Chamber of Commerce, in addition to 16 chambers of commerce representing 7,236 members. The North Dakota Chamber of Commerce would like to oppose HB 1340.

Several North Dakota Chamber members have contacted me expressing their concern about HB 1340 and the affects it could have if passed by our legislature. After discussing it with a number of attorneys and accountants, it was their opinion that instead of bringing new corporations to North Dakota this would be a deterrent.

As you are aware, there are only two publicly traded companies in North Dakota – Integrity Mutual Funds and Dakota Growers Pasta. I did call Mark Anderson, CEO of Integrity Mutual Funds in Minot, and his initial reaction was one of disbelief.

When his attorney informed him that it would not apply to them, he was very pleased, however was still concerned for new business that may be looking at North Dakota for incorporation and would hope that legislators would give a do not pass to HB 1340.

I have included with my testimony copies of e-mails sent to Mr. Anderson from his legal advisors for you to review as you consider this bill.

2000 Schafer Street PO Box 2639 Bismarck, ND 58502 Toll-free: 800-382-1405 Local: 701-222-0929 Fax: 701-222-1611
Web site: www.ndchamber.com E-mail: ndchamber@ndchamber.com

The North Dakota Chamber would ask that the Judiciary Committee give HB 1340 a do not pass.

Thank you Mr. Chairman and members of the Committee, and I will stand for any questions.

Att #6
3-5-07

FROM: Gordon Dihle, Esquire
6041 S. Syracuse Way, Suite 305
Greenwood Village, CO 80111

March 2, 2007

RE: Engrossed House Bill No. 1340 - Proposed "North Dakota Publicly Traded Corporations Act" NDCC 10-35

TO: Ladies and Gentlemen of the North Dakota Legislature:

As a person who grew up and was educated in western North Dakota and still feel a strong bond to the state of North Dakota, I feel compelled to comment on Engrossed House Bill NO. 1340, Proposed "North Dakota Publicly Traded Corporations Act" NDCC 10-35. My background is that I am a securities attorney and investment banking professional working out of Denver, Colorado. I work with a large number of public companies, securities brokerage firms and shareholders of public companies on daily basis. As a former North Dakotan, I regular promote and extol the virtues and work ethic of the people of North Dakota and its resources whenever I can.

I read the proposed provisions of Engrossed House Bill NO. 1340, Proposed as the "North Dakota Publicly Traded Corporations Act" NDCC 10-35 with horror. The provisions of this bill are such that no competent attorney would ever allow a public company to incorporate in North Dakota. The board of director provisions, the "poison pill" restrictions and the outlandish franchise fees are simply senseless. With the current federal regulatory system in place with respect to public corporations, small public companies are already struggling to comply with federal regulations. Huge sums which could be shareholder dividends and corporate growth are already being spent on excessive legal and accounting costs mandated by existing federal law. Every public corporation I am involved with or know of has more than 13,333,333 authorized shares and would therefore be subject to the maximum $80,000 franchise fee. Compared to similar fees of approximately $500 a year in most other states, this alone would deter any company from incorporating in North Dakota. The other provisions are cumbersome and restrict logical and efficient corporate governance which are necessary to operate a profitable entity. The proposed provisions also invite predatory litigation.

The only result I can see from this bill is the harassment and ultimate destruction of the few public corporations which are incorporated in North Dakota by predatory attorneys and professional plaintiffs from outside of the state of North Dakota. This certainly does nothing but harm the citizens of North Dakota, particularly those employed by the public companies or doing business with those public companies. The only result I can envision from this patently anti-business bill is Corporate America fleeing from the state of North Dakota together with what few non-agricultural or mining jobs remain there.

Thank you for your consideration of my views.

Sincerely,
Gordon Dihle
Gordon Dihle

Att #6
3-5-07

-----Original Message-----
From: Walt Draney [mailto:draney@chapman.com]
Sent: Friday, March 02, 2007 5:18 PM
To: Mark Anderson
Cc: Mark J Kneedy; Jonathan A Koff
Subject: ND Publicly Traded Corporations Act

We have had an opportunity to conduct a preliminary review of the proposed "North Dakota Publicly Traded Corporation Act" and would like to pass along the following observations:

1. Although an interpretation of the statute is not entirely clear, it appears that, pursuant to Sections 10-35-02 and 10-35-03, the Act would not apply to a North Dakota Corporation unless it becomes subject to the Act after July 1, 2007 AND its articles of incorporation specifically state that it is governed by the Act. As such, the Company would not be subject to the Act, even after it was passed into law, unless its board of directors and shareholders elected to amend its articles of incorporation to "opt into" the statute.

2. Notwithstanding the question of the Act's applicability to the Company, it is worth noting that the Act attempts to eliminate many of the corporate governance measures available to a public company to protect itself from unsolicited and unwarranted attempts to change the management and/or ownership of the Company as well as impose certain corporate governance measures typically viewed as within the purview of the board of directors. These provisions are numerous, and include:

- the inability to institute a "staggered board"
- the inability to change the size of the board during a contested election
- the prohibition of appointing a Chairman of the Board that is an executive officer of the Company
- the elimination of advance notice provisions for shareholder director nominees
- a requirement that the Company include a shareholder's director nominee and statement (up to 500 words) in the Company's proxy statement (the cost of which must be reimbursed to the shareholder)
- the inability of the Company to adjourn the shareholder meeting and seek more Company slate votes prior to opening the polls for the meeting
- the requirement that a director candidate must receive an affirmative vote of at least a majority of the votes cast for a candidate to be elected (rather than a plurality)
- the elimination of "super-majority" voting requirements for change of control transactions;
- the ability for shareholders to vote on an "advisory" basis on whether they accept the compensation committee's report on executive compensation
- limits on the use of poison pills
- the ability to make direct proposals to amend the Company's articles of incorporation without Board approval.

As you are aware, many of the above corporate governance changes are being instituted by companies on an issue by issue basis, under the direction of institutional shareholders. We believe that having the

statutory framework with these provision in place, although not necessarily applicable to the Company at this time, could create even more pressure for the Company to incorporate many of its provisions into its charter documents in the future. In addition, if enacted in its current form, the legislation would likely serve as a substantial deterrent for companies faced with the decision of incorporating in North Dakota.

Should you have any questions on any of the specific provisions of the proposed statute, please do not hesitate to give us a call.

Regards,

Walt Draney
Chapman and Cutler LLP
111 W. Monroe Street
Chicago, IL 60603-4080
Tel: 312-845-3273
Fax: 312-701-2361
draney@chapman.com

Att #6
3-5-07

From: Mark Anderson [mailto:MAnderson@integrityfunds.com]
Sent: Monday, March 05, 2007 8:48 AM
To: Dave MacIver
Subject: HB 1340

Dave,
As you know from the emails I forwarded last week, this bill does not apply to Integrity Mutual Funds, as we were organized under a different statute and before July 2007. That being said, there are some areas of great concern for the State of North Dakota that should be brought to the attention of the Senate Judiciary Committee.

1. This bill does not protect Mom and Pop on Main Street. Rather, it is a political tool which would allow corporate raiders to more easily take over North Dakota publicly-traded companies. This bill will not be utilized by the general public.

2. The definition of "poison pill" include everything, including the kitchen sink. It strips away all forms of protection that a company currently (and legally) has to protect itself from unscrupulous raiders. One year terms, no staggering, independent director, stock issuance...it is all in there and, cumulatively, it is all bad.

3. If anyone in state government is waiting for the franchise fees to start rolling in, they should think again. Two of our corporate attorneys have said that we should immediately begin the process of reincorporating in another state, should this law pass. Not only will they never see another firm organized under this statute, any that might be on the books right now will be gone. Looking at our annual filing fee go from $25 per year to $80,000 per year speaks for itself. No firm would willingly agree to that.

4. This bill will effectively kill capital formation in the State of North Dakota. There are already too few publicly-traded companies being organized here. This will be the death knell for capital formation in the future.

Yours truly,

Mark R. Anderson
Integrity Mutual Funds, Inc.
1 Main St. N
Minot, ND 58703-3189
(701) 852-5292
(701) 838-4902 Fax
www.integrityfunds.com

HB 1340
3-5-07

ALVIN A. JAEGER
SECRETARY OF STATE

ME PAGE www.nd.gov/sos

PHONE (701) 328-2900
FAX (701) 328-2992

E-MAIL sos@nd.gov

SECRETARY OF STATE

STATE OF NORTH DAKOTA
600 EAST BOULEVARD AVENUE DEPT 108
BISMARCK ND 58505-0500

March 5, 2007

TO: Senator Nething, Chairman, and Members of the Senate Judiciary Committee

FR: Al Jaeger, Secretary of State

RE: HB 1340 – North Dakota Public Corporations Act

Over the past several months, my office has been working with an ad-hoc committee to draft this legislation. I like it because it offers one more choice for businesses.

Offering choices is consistent with legislative action taken beginning with the 1993 legislative session. You may recall, in my testimony for HB 1241, I stated almost 9,000 businesses have chosen business structures that did not exist prior to that session. This is just another choice.

For 117 years, the state's constitution contained provisions mandating how a corporation could govern itself. Because of these mandates, there are only two publicly traded domestic chartered corporations in North Dakota.

After a five-year effort beginning in October 2001, two legislative sessions and two statewide elections, 73% of the voters approved an amendment to Article XII of the North Dakota Constitution removing the mandated form of corporate governance.

This bill does not change any of the state's existing laws. Corporations can still operate and still incorporate under the provisions of the state's business corporation act in Chapter 10-19.1 (without the previous constitutional restrictions). Foreign corporations, regardless of the state of charter, can still do business in North Dakota by filing the appropriate certificate of authority.

This bill creates a new chapter (Chapter 10-35) in the Century Code offering a form of corporate governance more focused on shareholder rights and chosen by those corporations that wish to be chartered under those provisions. No corporation is forced to incorporate under this new chapter. So that there is no misunderstanding, under the provisions of the bill, a corporation must specifically declare in its articles of incorporation it will be subject to the provisions of Chapter 10-35.

Since this bill was introduced, several individuals have asked me if the passage of this bill would make North Dakota appear to be an anti-business state. I have to ask, compared to what? Since its statehood, the most anti-business publicly traded corporation clause in the nation was in North Dakota's constitution. Now, North Dakota has an opportunity to provide business corporations with one of two options. To me, that is the correct image for a business friendly state. That is, a choice.

I am not the expert on the governance structure in this bill. Others will provide that testimony. I also do not know how many corporations will take advantage of this new law. However, if they do, whether it is 5, 10 or 15 corporations, I have the best staff in the country. These corporations will experience the North Dakota way of doing things, i.e., efficient, friendly, cost-effective, and timely.