Pandora's Ballot Box, Or A Proxy With Moxie? The Majority Voting Amendments to Delaware Corporate Law

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"The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims …and…which can generally be sold without permission of the other contracting individuals."

Michael Jensen and William Meckling
Theory of the Firm

"You own the company. That's right -- you, the stockholder. And you are all being royally screwed over by these, these bureaucrats, with their luncheons, their hunting and fishing trips, their corporate jets and golden parachutes."

Gordon Gekko (Played by Michael Douglas)
Annual Stockholders Meeting of Teldar Paper
The Movie *Wall Street*

The Delaware General Assembly has recently adopted an amendment to the Delaware General Corporation Law which provides that where shareholders have adopted a majority voting bylaw for corporate elections over the traditional plurality scheme, a corporation may not subsequently amend its bylaws to return to plurality voting without shareholder approval. I will compare this provision to other approaches and try to explain the reasons underlying its adoption. I will also briefly summarize the evolving shareholder empowerment debate and analyze the majority voting provision in the context of that discussion. I will describe some unique and unanticipated interactions between majority voting bylaws and various other working parts of corporation and securities law affecting the shareholder franchise, a carefully protected right

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I take full responsibility for all metaphors and errors.

in Delaware jurisprudence.[1] *The most prevalent corporate strategies responding to this movement will be explored and the difficulties of implementing majority voting will be described. Finally, I will analyze voting schemes from the political sphere in an attempt to find analogous lessons for the corporate arena. I will then end with some predictions about future developments which will hinge on the outcome of SEC rules proposals, further DGCL revisions, and the responses of Delaware incorporated entities.*

This piece blends three distinct groups of thought: i) Theoretical corporate law scholarship and financial regulatory theory, ii) Interpretation of Delaware Chancery Court cases, and iii) Practical analysis on the future of the majority voting movement and the strategic choices facing board of directors in the aftermath of the Delaware amendments and corollary SEC and NYSE regulatory initiatives.

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[1] *See Harrah's Entertainment, Inc. v. JCC Holding Co*., 802 A.2d 294, 311 (Del. Ch. 2002).

VII. An Analysis of Voting Outcomes Using an Analogy to Political Science
VIII. Conclusion and Predictions

I. A Summary of the Statutory Changes

An analysis of Delaware corporate law must necessarily begin with Delaware General Corporation Law ("DGCL") 141, "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors".[2] The DGCL further provides that, in the absence of a bylaw to the contrary, directors shall be elected by a plurality of the votes cast.[3] Plurality voting means that the candidates receiving the greatest number of affirmative votes cast, limited by the number of seats up for election, is victorious in that election. Thus it would be possible for an uncontested candidate to receive one vote in favor, and millions of no or "withhold" votes, and still emerge victorious in the election. Since corporate elections are not subject to a runoff process, and shareholders are able to nominate rival candidates for corporate elections, the plurality default was adopted in response to the potential situation in which no nominee was able to obtain a majority of the votes cast, thus resulting in a failed election.[4]

Under the DGCL, the bylaws of a corporation may contain any provision not in conflict with the DGCL, and may be adopted by the shareholders, or, if given the power to do so in the corporate charter, the board of directors.[5] A recent addition to section 216 and the subject of this article, adopted in August of 2006, specifies that "A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors."[6] This effectively means that a shareholder approved change to the default plurality voting standard

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[2] 8 Del.C. § 141.

[3] 8 Del.C. § 216 states "In the absence of such specification in the certificate of incorporation or bylaws of the corporation: . . . (3) Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors."

[4] *See* American Bar Association, *Committee on Corporate Laws Discussion Paper* 1506 PLI/Corp 473, *506 (2005). *Citing* S. 93 134th Gen. Assembly, 66 Del. Laws ch. 136, § 11 (1987), reprinted in 2 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, § 216.

[5] 8 Del.C. § 109(b).

[6] 8 Del.C. § 216.

cannot be unilaterally altered by the board without shareholder ratification.

DGCL 141 also provides that "Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors", but then subjects that provision to the following exception: "(1) Unless the certificate of incorporation otherwise provides, in the case of a corporation whose board is classified as provided in subsection (d) of this section, shareholders may effect such removal only for cause."[7] The obvious result is that nearly all corporate charters will allow removal (between elections) by a majority of shareholders only for cause, thus requiring some alternative means for removal of a director. Furthermore, in any event, a removed director continues to serve until a replacement can be nominated and elected under the "holdover" rule.[8]

Another recent addition to the DGCL, relevant to this exploration, is the advance resignation provision providing that "A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable."[9] The statutorily protected permanence of such a board policy may fall in line with an emerging trend toward holding boards firmly to their representations to their shareholders in Delaware courts.[10]

II. The Genesis of the Majority Voting Amendment and a Comparison to Other Regulatory Approaches

A. Development of Withhold Vote Campaigns by Institutional Investors and the Grey Line between Symbolic and Pyrrhic Victories

Former SEC Commissioner Joseph Grundfest initially proposed the use of withhold vote campaigns in a law review article in 1993.[11] At the time, the active takeover market of the 80s was killed by a cocktail of poison pills, antitakeover legislation, and diminished access to capital; takeovers could no longer be used to control management excess and

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[7] 8 Del. C. § 141 (k).

[8] 8 Del. C. § 141(b).

[9] 8 Del. C. § 141(b).

[10] *See*, *e.g., Unisuper Ltd. v. News Corp*., 2005 WL 3529317, at *5(Del. Ch. Dec. 20, 2005). Compare *Omnicare, Inc. v. NCS Healthcare, Inc.* 818 A.2d 914 (Del. 2003); *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

[11] *See* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993).

urge boards to respond to shareholder discontent.[12] Proxy fights were also of marginal utility because the institutional investors who could lead the charge suffered from a collective action problem.[13] Grundfest's proposal was to use withhold votes as a mechanism whereby investors could communicate dissatisfaction with a board at low cost.[14] Compared to the enormous expense of running an independent proxy fight, investors, both institutional and otherwise, would find that a withhold vote campaign would be more capable of sustaining momentum.[15]

SEC proxy rules require that a proxy allow for withhold votes, or an instruction to not vote for a management slate even if they are running unopposed.[16] In compliance, the proxy may include (i) a "withhold" box next to the name of each nominee, or (ii) an instruction in bold face type that a voter may strike through a name to vote against the nominee, or (iii) designated blank spaces in which the voter is permitted to enter names of nominees for which they intend to withhold a vote, or (iv) any other similar means, provided that clear instructions are furnished indicating how the security holder may withhold authority to vote for any nominee.[17]

Many have since challenged the usefulness of withhold vote campaigns.[18] However, Grundfest urged that they would provide institutional investors with the facility to negotiate with boards concerned about the prospect of becoming a target.[19] Grundfest reasoned that board members taking the job out of a desire for prestige would want to avoid the negative publicity[20] surrounding a withhold

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[12] *Id.* at 934.

[13] Grundfest cites three iterations of the institutional investor collective action problem:, rational apathy where each discounts the marginal effectiveness of individually joining the group, a game-theory type dilemma whereby each individual has an incentive to free ride, and the difficulty of finding a homogenous result that they can all agree on with the attendant costs of communicating among shareholders in the group. *Id.* at 909. Also explored in more detail in Section III B *infra.*

[14] *Id.* at 866.

[15] *Id.* at 909.

[16] SEC Rule 14-a4(b)(2); 17 C.F.R. § 240.14.

[17] SEC Rule 14-a4(b)(2); 17 C.F.R. § 240.14

[18] Diane Del Guercio, Laura Wallis & Tracey Woidtke, *Do Board Members Pay Attention When Institutional Investors 'Just Say No'?*, (June 2005) (unpublished manuscript, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=575242).

[19] Grundfest, *supra,* at 865.

[20] That negative publicity would be facilitated by the SEC's directive that the results of corporate elections, including a tally of withhold votes, be publicly disclosed. 17 C.F.R. 240.14a-1 to 240.14a-7, 240.14a-10.

vote campaign.[21] A looming withhold vote would also give directors more of an incentive and justification to challenge a domineering CEO.[22] Or, in the aftermath of a withhold vote, takeover artists may smell weakness and be more willing to run the gauntlet of a tender offer (with its attendant proxy fight and risk of expensive litigation). He also raises the possibility of the Chancery Court enhancing its review of a board's decision not to withdraw a poison pill in response to a tender on the heels of a successful withhold vote campaign.[23] Grundfest notes that, as a signal without the necessity of legally binding effect, withhold votes would not even need to obtain a majority vote to be useful.[24]

Majority voting is the true progeny of the withhold vote movement. This is because majority voting turns a symbolic withhold vote into an effective vote of "no" (which otherwise does not appear on the corporate proxy). Seeing the effectiveness of withhold vote campaigns when they were merely a symbolic gesture, institutional investors have lately moved to make withhold votes into a more effective negotiating tool by supporting majority voting in certain circumstances.[25]

B. Case in Point: The Disney Withhold Vote Campaign; It's is a small world after all, Mr. Eisner

Michael Eisner, former Chairman and CEO of the Walt Disney Co., faced a number of challenges in his final years at the helm.[26] Due to these ongoing problems, ISS recommended shareholders withhold their votes for his unopposed election as director of Disney. A number of large institutional investors followed suit, resulting in a 43% withhold

[21] Grundfest, *supra,* at 927-930.

[22] *Id.* at 930.

[23] *Id.* at 935. *See, e.g., Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 956 (Del. 1985), *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989). *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 286-92 (Del. Ch. 1989).

[24] Grundfest, *supra,* at 913. This prediction ultimately proved to be quite prescient. See, e.g., withhold vote campaigns at Safeway, Inc., Disney, Inc., and Home Depot. Mentioned in Stephen Deane, *Majority Voting, From the Symbolic to the Democratic*, Institutional Shareholder Services Center for Corporate Governance (2005) [hereinafter ISS Report].

[25] Former Chancellor William Allen observed that just voting no is "like chicken soup; it couldn't hurt, and what if it helps?" See Grundfest*, supra,* at 868, *citing* a "Private Communication with Chancellor William T. Allen (Mar. 6, 1992)." at fn 40. Perhaps, as we shall see, majority voting is the spice to liven the soup up a bit. However, with corollary SEC and NYSE action, perhaps too many cooks will also spoil the broth.

[26] Phyllis Furman, Joy in the Mouse House: Disney Shareholders Give Eisner Thumbs Up, N.Y. Daily News, Feb. 12, 2005. For instance, Eisner was engaged in momentous litigation over the hiring of Michael Ovitz and had just lost Pixar Studios over what was arguable a personality conflict.

vote against Eisner.[27] The Board responded by forcing Eisner to step down as Chairman, and he eventually left Disney when his contract expired. Here, no majority voting bylaw was in effect (although Disney has since adopted a majority voting regime for uncontested elections), Eisner managed to receive a majority of the votes cast, and the holdover rule would have still maintained his office until a replacement could be elected even if the vote had legal effect. Further, he remained as CEO for the remainder of his contract. Nevertheless, the board responded to the outcome by replacing him as Chairman. If institutional investors were able to convince owners of 43% of the shares cast to withhold their votes when the result had no legal significance, then it is then conceivable that they could have come closer to breaking the 50% threshold when legal consequence are present.[28] And if the Board of Directors responds to a vote result with no legal significance, then it is conceivable they would respond more strongly to one that does. This proves that, even if later shown to be ill advised, the majority voting amendment to the DGCL is at least not irrelevant.

C. Political Analysis of the Majority Voting Amendment; A Tour Inside the Corporate Law Factory.

When viewed through the lens of the various academics that have sought to explain the process of how Delaware makes corporate law,[29] we can begin to understand the factors shaping the present amendment.

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[27] *See* http://www.usatoday.com/money/media/2004-03-03-disney-shareholder-meeting_x.htm.

[28] Absent broker street voting, the vote would have been a majority withhold vote. See Section V B *infra.*

[29] See Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law,* 106 COLUM. L. REV. 1749, *1750 fn. 2, *citing* ("E.g., Lucian Arye Bebchuk & Assaf Hamdani, Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters, 112 Yale L.J. 553 (2002); William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 Yale L.J. 663 (1974); Jill E. Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. Cin. L. Rev. 1061 (2000); Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U. L. Rev. 913 (1982); Renee M. Jones, Rethinking Corporate Federalism in the Era of Corporate Reform, 29 J. Corp. L. 625 (2004); Marcel Kahan & Edward Rock, Symbiotic Federalism and the Structure of Corporate Law, 58 Vand. L. Rev. 1573 (2005); Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908 (1998); Jonathan R. Macey & Geoffrey P. Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987); Brett H. McDonnell, Two Cheers for Corporate Law Federalism, 30 J. Corp. L. 99 (2004); Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588 (2003) [hereinafter Roe, Delaware's Competition]; Mark J. Roe, Delaware's Politics, 118 Harv. L. Rev. 2491 (2005) [hereinafter Roe, Delaware's Politics]; Roberta Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709 (1987) [hereinafter Romano, Competition Debate]; Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977).").

One can hardly call the Delaware response anything but conservative. The amendment merely says that, where shareholders adopt a majority voting bylaw, the board will not be able to unilaterally amend the bylaw. Its corollary says that advance resignation letters conditioned on failure to get a majority vote are binding. Shareholders' ability to nominate directors was not enhanced, the plurality default was not altered. This is consistent with Hamermesh's three-fold observation that Delaware i) will not act in the absence of clear policy implication, ii)favors private parties ordering their own relations, and iii)always makes slow, conservative changes to corporate law when it is moved to make a change at all.[30] The Delaware response allows shareholders and board to decide the election system they favor and merely makes such a decision concrete if shareholder approved. It was based on extensive discussion that began at the federal level and only lately provoked a muted response at the Delaware Committee on Corporate Laws.[31]

Mark Roe has also explored in some depth the process by which Delaware Corporate Law evolves and the interest groups and goals shaping that evolution.[32] In effect, he posits that in order to attract and maintain corporate franchise fees, Delaware will respond jointly to the interests of shareholders and management to the exclusion of other affected groups, as the ratification of both groups is required for re-incorporation into or out of Delaware.[33] Thus, when the two groups can agree, they get a quick change, and when they disagree the state will offer a moderated proposal that balances their interest. Roe also argues that Delaware will be spurred to act where the threat of federal action is imminent, because once both groups have achieved a result in Delaware they will be unmotivated to move beyond the status quo to push for changes on the federal level, which might bring in other parties (e.g., Unions) who may advocate for a result that neither of them favor.[34] Thus Delaware is a place to pre-empt unwieldy and unpredictable federal reform.[35] Delaware might also act to pre-empt in cases where national scandal make federal response likely.[36] Furthermore, to make Delaware pre-emption of federal action more likely, Delaware will moderate its action to minimize the chances of federal ire.[37] Consistent

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[30] Hamermesh indeed uses the majority voting amendment as an example of his theory in action. *See* Id. at 1773.

[31] Id.

[32] *See generally* Mark Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (June 5, 2005); Mark Roe, Delaware's Competition, 117 HARV. L. REV. 588 (December 2003).

[33] Mark Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, at 2495 (June 5, 2005).

[34] *Id.* at 2513

[35] *Id*. at 2516

[36] *Id.* at 2516.

with that thesis, Former Chief Justice Veasy of the Delaware Supreme Court commented at an SEC roundtable discussion considering shareholder nominations that the Delaware Corporate Law's Committee should consider adopting majority voting to pre-empt federal legislation.[38]

In order to fully understand the Roe hypothesis in the context of the majority voting amendment, we must also understand the interest groups involved. For that, we need only look to the comment letters submitted to the committee whose task it was to study the proposal. The Council of Institutional Investors, a trade group representing large pension funds, wrote to the committee charged with examining the majority voting amendment to express its whole hearted support of majority voting as a new default standard for shareholder elections.[39] Institutional Shareholder Services ("ISS'), a proxy advisory firm that represents the interests of a broader group of institutional investors, also has exhibited support for majority voting.[40] The U.S. Chamber of Commerce, representing the interest of corporate management of Delaware Corporations, felt that there was no need for a present revision, but the businesses it represents were happy to institute board approved (and thus board revocable) bylaws or director resignation policies. We can then view Delaware result as a mediation between the extremes. The default rule of plurality voting wasn't altered, despite the insistence of the CII and ISS, but bylaws that pass with shareholder approval are protected from board meddling. Further, the director advance resignations that companies were already throwing corporate governance activists to keep the wolves at bay become permanent once

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[37] *Id.* at 2513.

[38] Available at http://sec.gov/spotlight/dir-nominations/transcript03102004.txt ("And perhaps the Commission would want to consider if you want to adopt the provision you have on the table to create an exception for any state law that allows…majority…voting, for example, or any organic document of a corporation like the certificate of incorporation or bylaws be effective, to allow that, then this provision wouldn't apply to any such situation as that. I think it would be an interesting proposal for the Delaware legislative branch to consider through the good offices of the counsel of the Delaware State Bar Association Corporate Law's Committee, and there are others.").

[39] Available at http://www.cii.org/library/correspondence/061705_mcbride.htm ("I am writing to you in your capacity as Chairman of the Corporation Law Section (the "Section") of the Delaware State Bar Association to request that the Section consider recommending to the Delaware legislature an amendment to Section 216 of the Delaware General Corporation Law ("DGCL"), 8 Del. C. § 216, to make majority voting for director elections the presumptive choice for Delaware corporations.").

[40] In 2007, ISS plans to include the presence and strength of a company's majority voting bylaw as an additional factor in the scoring systems it uses to rate the effectiveness of the company's corporate governance effectiveness. *See* http://www.issproxy.com/pdf/2007%20US%20Policy%20Update.pdf.

received. Institutional investors and management each get a little something, reform is measured and narrowly tailored, and let the wheels of commerce continue to spin.

In this case, the specter of corporate ballot reform is also looming on the federal level consistent with the Roe hypothesis. After a failed effort at granting shareholders proxy access to the corporate ballot, the SEC is again considering a hotly contested proposal to allow shareholders access.[41] A move to make majority voting bylaws resolute, once passed, could be a measure to minimize institutional shareholder interest in such a proposal.[42] The present amendment doesn't give unions the opportunity to place divisive directors onto the ballot, something they might achieve under a ballot access rule. But it does allow institutional investors to send a message by voiding directors when they are dissatisfied with their performance.[43] Additionally, one can see this as following in the scandal, seen among institutional investor advocacy groups, of the Eisner saga. Excessive executive compensation and the last vestiges of post-Enron outrage have given advocates of investor democracy just enough fuel to bring this to the attention of federal regulators. In that case, perhaps Delaware is hoping it can moderate the eventual federal response.[44] Thus Hamermesh and Roe have shown us the *raison de-etre* for these amendments to the DGCL. What remains to be seen is if they will, in their interaction with other regulatory powers, have the effect that was originally intended.

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[41] TAKEOVER LAW AND PRACTICE 2006 1571 PLI/Corp 259, *380 ("See, e.g., Proxy Access: To Be or Not to Be? Thirteen Months after SEC Proposes Rule, Resolution is No Closer, 17 M&A Rep. 45 (Nov. 22, 2004) (noting that proxy access proposal received 16,000 comment letters, a record-breaking number); Judith Burns and Siobhan Hughes, SEC Chairman Sees "Consensus" on US Market Reforms, Dow Jones Newswires (Feb. 10, 2005) (quoting SEC Chairman William Donaldson as acknowledging that the SEC's original proxy access proposal "doesn't fly," is "too complicated," and that he would like to start over with "wholly new thoughts" on how to tackle the subject).").

[42] Indeed, former Commissioner Grundfest wrote to the SEC to urge that majority voting is a proper alternative to corporate proxy access. See ISS Report, *supra,* at 9.

[43] ISS lists three reasons for targeting individual directors for withhold vote campaigns: i)interlocking directorates involving key board committees ii)poor director attendance and iii)serving on too many boards. They also cite 4 factors they use in targeting boards overall: i)ignoring majority votes on shareholder precatory proposals ii)payment of excessive non-audit fees iii)overlooking obvious boardroom conflicts and iv)adoption of dead-hand poison pills. *See* ISS Report, *supra,* at iii.

[44] Roe, *supra,* at 2529. This analysis does run the risk of a reverse-causation paradox. Does the SEC act because of a lack of attention in the DGCL? Then does Delaware act to pre-empt the SEC? And then does the Delaware action alter the SEC's response? And here, we have a Delaware amendment related to an SEC proposal that previously failed to pass, but is subsequently being reconsidered due to a federal court ruling. In the end, the portion of the Roe hypothesis regarding Delaware action in advance of federal pre-emption is helpful for analyzing this policy, but shouldn't be taken to excess limits.

D. Alternative Regulatory Schemes

1) The MBCA Recommendation

The American Bar Association promulgates the Model Business Corporation Act ("MBCA"), which serves as a model corporate code utilized by most states (except, of course, Delaware).[45] Though some groups advocated for an alteration to the plurality voting default found in the code, the Committee opted against recommending a change from the plurality default for three reasons: it virtually assures a successful election of directors in every election, voting results are delivered in a simple and transparent way, and it is a standard that fits well with the many varying shareholder rights schemes (e.g., cumulative votes, multiple share classes).[46]

However, it recommended a change to the MBCA[47] that substantially mirrors the Delaware majority voting amendments (including facilitating a director resignation policy) with the following caveat: operation of the holdover rule default[48] could be stayed to require a director failing to receive a majority vote in favor of their election, in a company that adopted majority voting in its bylaws, to step down within 90 days of the election.[49] The Committee reasoned that, absent an alteration to the holdover rule, the consequences of a majority voting bylaw would remain largely symbolic.[50] So its recommendation would amend the MBCA to expressly permit a bylaw to opt out of the holdover default in the sole circumstance of a director

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[45] McBride, PLI report at 298.

[46] Preliminary report at 20.

[47] As there is some overlap between the membership of the ABA Committee and the Delaware Council on Corporate law, and both are composed in part by practicing members of the Delaware Bar, the deliberations by each group are appropriately cross-referenced. See American Bar Association, *"Preliminary Report of the Committee on Corporate Laws on Voting by Shareholders for the Election of Directors"* at 7 (Jan. 17, 2006), available at www.abanet.org/buslaw/committees/CL270000pub/directorvoting/20060117000001.pd .7[hereinafter "Preliminary Report"] ("Delaware is not a Model Act State, but Delaware lawmakers carefully study the work of Committee and Model Act Developments").

[48] The holdover rule, allowing for a director failing to win an election to stay on until a replacement is elected and qualified, serves the purpose of ensuring that "the power of the Board of Directors to act continues uninterrupted even though an annual shareholder's meeting is not held or the shareholders are deadlocked and unable to elect directors at the meeting." *See* MOD. BUS. CORP. ACT ANN., §8.05 at 8-47 (Official Comment).

[49] See Preliminary Report, *supra,* at 4

[50] See *Id.* at 16.

elected by plurality vote but failing to achieve a majority of votes cast. The recommendations specifically exempt private, non-traded corporations and corporations that allow cumulative voting, since the justification of empowering shareholders is not as availing in those cases.[51]

2) California's approach

California, in considering amendments concerning majority voting, had to also take into account the effect of majority voting on cumulative voting, as California mandates cumulative voting for firms incorporated in California (but then provides an exemption to all firms listed on a national exchange).[52] The effect of majority voting on cumulative voting is subject to some debate. In California, no director may be removed by a majority of shareholders whose votes would be sufficient to win under cumulative voting.[53] Otherwise, a majority vote may eliminate a director who would otherwise be victorious under a cumulative voting regime. So, if one must choose between the two methods, the choice would depend on whether the relevant value judgment presented is empowering all shareholders vs. the board or empowering large shareholders vs. small shareholders. Adopting cumulative voting for contested elections, but allowing a majority withhold vote provision for uncontested elections may resolve the disparity.[54]

A bill seeking to amend the California Corporation Code currently awaiting the Governor's signature, much like the MBCA, exempts corporations with cumulative voting (and also, by implication, corporations not listed on a national exchange).[55] It only permits shareholders to opt out of plurality voting for uncontested elections, reaching the same result as the MBCA but by different means.[56] It originally disallowed board discretion in carrying out a director resignation policy, but has since been amended to grant the board of directors of corporations the authority to reappoint a rejected director if special circumstances, as determined by the board, warrant the retention of the director.[57] In addition, the bill provides that the vote to

[51] See *Id.* at 13.

[52] 1 Cal. Corp. Code § 301.5(a).

[53] 1 Cal. Corp. Code § 303.

[54] See an exchange between Broc Romanek and a Calpers representative, posted on www.thecorporatecounsel.net/blog/archive/2006_08.html.

[55] See California Senate Bill 1207, available at http://www.leginfo.ca.gov/.

[56] *Id.*

[57] *Id.*

change the corporate bylaws to majority vote requirements for director elections must be by vote of all outstanding shares rather than by a majority of votes cast, a more onerous requirement than the MBCA or Delaware's default rule.[58]

3) The Grundfest proposal

Professor Grundfest has proposed tailoring SEC regulations and listing standards to take into account a successful majority withhold vote against a director.[59] This would have the benefit of not requiring abolition of the holdover rule to give effect to a successful campaign against a recalcitrant board. Among many alternative strategies for his proposal, Grundfest notes that SRO listing standards could be amended to exclude from the definition of independent director one from whom a majority of votes have been withheld[60], or they could have their vote unrecognized for purposes of any listing standard voting requirement.[61] Furthermore, the SEC could enhance their disclosure liability, commit to challenging indemnification of such directors, or enhance regulatory scrutiny of filings by companies with a majority withheld director.[62] For that matter, the Chancery Court could also alter its review of decisions by directors in which a majority withhold vote has been successful.[63]

Grundfest would temper his approach with a 90 day delay of the effective date and a cure mechanism using shareholder consents to allow the board an opportunity to respond to a successful withhold campaign without penalty.[64] This approach would enhance the negotiating leverage for financial intermediaries that are able to institute

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[58] *Id*.

[59] Grundfest, Joseph A., *Advice and Consent: An alternative Mechanism for Shareholder Participation in the Nomination and Election of Corporate Directors.* In Lucian Bebchuk, ed., Shareholder Access to the Corporate Ballot (Harvard University Press, 2004).

[60] *Id.* at 10.

[61] *Id.*

[62] *Id.*

[63] *Id.* at 12. For instance, decisions of special litigation committees are afforded discretion under business judgment review. Upon proper pleading, they can be examined under "entire fairness review". *See Aronson v. Lewis,* 473 A.2d 805 (1984).

[64] *Id*. Grundfest also notes that allowing cures by shareholder consent could allow the regulatory body to designate replacements as tainted by the withhold vote as well, thus keeping the board from using its power to replace to minimize the effect of Grundfest's proposal.

successful campaigns, without entirely halting a board's ability to function.[65]

4) An International Perspective

For European Companies, majority voting is the default method for electing directors in both contested and uncontested elections, with some rare exceptions.[66] Japan uses a supermajority voting requirement to oust directors.[67] Proponents of majority voting use examples from corporate elections in Europe and Japan to counter arguments that the collateral damages of majority voting makes it inherently too risky (failed elections, etc.).[68] Critics might counter that the numerous other governance differences between the United States and Europe/Japan strain a meaningful comparison.[69]

III. The Shareholder Power Debate, A Foucault Pendulum

A. The General Debate

Berle and Means were the first noble souls to develop the story of corporate development in the 19th century.[70] They argued that the development of capital intensive operations of the industrial revolution

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[65] ISS Report, *supra,* at 10.

[66] Around the World in Sixty Minutes, An overview of international Corporate Governance Trends, Institutional Investor Services, October 21, 2005, page 5. Available at http://www.issproxy.com/pdf/GlobalCorporateGovernancePerspectivesSD.pdf.

[67] Id. at 16.

[68] ISS Report, *supra,* at 13.

[69] For more information on those differences, *See generally* Klaus J. Hopt, Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe, 14 INT'L L REV. L.& ECON. 203 (1994).

[70] *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) AT 6. The Berle Means theory of corporate history is far from universally accepted. For instance, Werner argues that the ownership/control dichotomy preceded the industrial revolution. Walter Werner, *Corporation Law in Search of its Future*, 81 COLUM L. REV. 1611, 1612 (1981). Mark Roe also presents a more nuanced explanation of how market segmentation resulted from interested groups exercising political influence in favor of financial disintermediation. See Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance 44 (1994). However, we will stick with Berle and Means for the time being as a useful model. In much the way that Einsteinian relativity and quantum physics did not replace Newtonian mechanics so much as show circumstances in which it was unable to describe the world, leaving Newtonian mechanics to still describe most conventional physical phenemona, the Berle Means theory of corporate history is still a useful explanation despite the various alternate versions of economic history that it inspired.

required larger capital inflows than any individual could provide. That, combined with an interest in diversification, resulted in a fragmentation of share ownership and a resulting divergence between ownership and control in the modern corporate organism.

Fama & Jensen's model of agency conflict informs a discussion of the relationship between a board of directors and its shareholders in describing how the separation of ownership from control can complicate matters in the modern Berle-Means corporation.[71] Jensen described that relationship as one in which principals engage agents to perform a service which entails delegation of authority. If both parties to the relationship are utility-maximizers, many situations may arise in which the agents interest will diverge from that of the principal. Principals would then expend to create incentives for agents to limit aberrant activities, and agents would frequently expend bonding costs to ensure principal interest and maintain a profitable relationship. But if agents can take advantage of information asymmetries to engage in profitable aberration at the principals' expense and without the principals' knowledge, it may be rational for them to do so.[72]

In steps corporate law fiduciary duties to relieve the conflict, but corporate law is fairly deferential to board decisions. The shareholder franchise serves as the justification for this deference of authority given to the board of directors in the form of the business judgment rule and the demand requirement for derivative litigation.[73] In essence, the argument goes, "you elected them, now let them do their jobs, and if you don't like it, replace them."[74] The threat of being able to replace directors should mean that shareholders will be in a better position to negotiate for change, and directors will have added incentive to avoid

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[71] Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

[72] Berle and Means, *supra,* at 6.

[73] A key element of the corporate structure is the shareholder franchise-- shareholders' power to elect and replace directors. Corporate statutes provide shareholders with this power, which courts view as a fundamental element of the corporate structure. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 851 (January 2005), *citing Blasius Indus. v. Atlas Corp*., 564 A.2d 651, 659 (Del. Ch. 1988) (noting the "central importance of the franchise to the scheme of corporate governance"); See also *Unocal Corp. v. Mesa Petroleum Co*., 493 A3d 946 (Del. 1985).

[74] Some argue that shareholder supremacy fails to take into account stakeholders, such as employees or creditors, who deserve a say in corporate decision-making. The U.S. model provides for shareholder supremacy, as shareholders are the only group with a fixed and permanent interest in the underlying assets of the corporation. Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 66-72 (1991). I will leave the shareholder v. stakeholder debate to other fora for now and focus on the shareholder v. manager conflict, with the debatable assumption that the U.S. shareholder supremacy model is superior.

results that will induce shareholders to initiate a campaign to replace them.[75]

The field of corporate law is awash in battles over whether or not shareholder control is largely a myth perpetrated by those who stand to benefit by board entrenchment.[76] Recent evidence compiled by Professor Bebchuk indicates that the balance of power in corporate elections has, over the last 10 years, run markedly in favor of boards.[77] But corporate law traditionalists argue that the case for increasing shareholder power is inherently flawed.[78] They urge that the internal inconsistency of shareholder's commitment to a company and the inconsistent goals of different shareholders make it extremely difficult for corporate law to make shareholders absolutely prime, even if that is the outcome favored.[79] The question arises: which type of shareholder matters more?[80] The day trader, or the pensioner; the institutional investor, or the small investor?[81] The time horizon and the character of the investor determine the ability of corporate lawmakers and chancellors to encourage the shareholder primacy model.[82] The different interests of shareholders makes it difficult for corporate policymakers to engineer legal regimes in such a way as to determine which type of shareholder the board member should serve. This describes the difficulty in determining whether shareholder primacy goals are attainable without even going into the non-financial goals that

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[75] Also observed in Stephen Bainbridge, The *Case for Limited Shareholder Voting Rights* 53 UCLA L. REV. 601, at 614 (February 2006).

[76] Robert C. Clark, Corporate Law 95 (1986) (noting cynic's view that "the whole institution of shareholder voting is a fraud"); *See also* Stout, Lynn *The Mythical benefits of Shareholder Contro*l working paper; See also Stephen Bainbridge, *Director Primacy and Shareholder Disempowerment* 119 HARV. L. REV. 1735, *1736 (2006); Lucian Arye Bebchuk, *Letting Shareholders Set the Rules,* 119 HARV. L. REV. 1784 (April 2006).

[77] Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (January 2005).

[78] "Far from the single owner of a building, the shareholders are a diverse and ever-shifting group of people and institutions, with differing interests and, in the case of institutional investors, differing obligations to their own diverse constituencies." Martin Lipton and Steven Rosenblum, *Election Contests on the Corporate proxy, An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, *68, (November 2003). A logical observation; but also a consistent one, coming from the inventor of the poison pill.

[79] "Shareholders with private interests, however, might prefer the firm to pursue those interests at the expense of the interests they have in common with other shareholders.", Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, *575 (February 2006).

[80] Id..

[81] Also observed by Bainbridge, *The Case for Limited Voting Rights*, *supra,* at 634.

[82] Lipton, *supra,*at 74

shareholders may have. Corporate Pensions investing in the companies that employ their membership are one example. Those shareholders potentially have an interest in full employment that could conflict with the wealth maximization goals of other shareholders.[83] Socially responsible investors who seek policy changes like divestment present another interesting problem.[84]

The corporate law traditionalists[85] urge that a corporation is merely a "nexus of contracts"[86], and shareholders deserve no more than the benefit of the contracts they are able to negotiate.[87] If one should leave it up to shareholders to express dissatisfaction with their share performance by taking the "Wall Street Walk,"[88] access to capital markets may be sufficient to discipline managerial shirking or self-dealing. If one assumes semi-strong market efficiency, shareholders should be looking out for their own interests already without the need for corporate law by simply determining who they invest in.[89] Reputation costs in the capital market should be the controlling force that keeps management focused on the interests of shareholders. Another interesting dimension to the shareholder democracy debate is whether one share, one vote is the even the right allocation of voting rights.[90] For instance, warrant and option holders, who have an

[83] Bainbridge, *supra*, at 609, *citing* Morris M. Kleiner & Marvin L. Bouillon*, Providing Business Information to Production Workers: Correlates of Compensation and Profitability*, 41 INDUS. & LAB. REL. REV. 605, 614-15 (1988)

[84] Continuing that line of analysis, one might ask what about shareholders that have moderate risk preferences, versus high risk preferences? Also, conflicts may directly arise between shareholders that implicate anti-competitive practices. Would a large hedge fund that owns an interest in each of two competing companies make voting decisions that would work to erode value for other shareholders?

[85] For an effective summary of the traditionalist view, see Leo Strine, *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate Americ*a, 119 HARV. L. REV. 1759, *1762 (April 2006).

[86] Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

[87] Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); But compare Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985)

[88] Selling your shares, also known as the "Wall Street Rule", explored in further detail in Bainbridge, *supra,* at 619.

[89] There is a substantial literature regarding bounded rationality, beyond the scope of this article, which calls into question the rational choices of economic actors. *See* generally John Conlisk *Why Bounded Rationality?* 34 JOURNAL OF ECONOMIC LITERATURE 669 (June 1996).

[90] *See generally* Shaun Martin and Frank Partnoy, *Encumbered Shares*, U. ILL. L. REV., (2005).

expected interest somewhat similar to plain vanilla shareholders, get no voting rights.[91]

The pro-management side of the argument continues that corporate law will not be nearly as effective at setting up a shareholder primacy regime, in that it's efficiency would lag behind that of an information market such as the securities market.[92] Some argue that what it can provide is a regime that mandates accurate disclosure to make this market more efficient, as the securities laws do, but it cannot be an effective instrument to force companies to put shareholders first.[93] Traditionalists also cite what is essentially an "if it ain't broke, don't fix it" argument that the U.S. financial markets perform well in comparison to other countries, so corporate governance and board primacy cannot be all that bad.[94] It's a simple and effective system, according to its adherents. But not everyone agrees that the Wall Street Rule is a congent justification for a lack of real shareholder democracy. For one, large investor's need to diversify means they can't sell off their whole portfolio. Further, too much buying and selling leads to tax and fee consequences that will diminish returns for investors. What is more, institutions selling out to express dissatisfaction will itself diminish the share value for other investors, leading to a sort of downward spiral effect.[95] And while they can diversify against individual corporate operational risk, finding a way to minimize operational risk (from shirking and self-dealing) systematically might well be worth the cost of changing the balance of power, according to advocates of the shareholder democracy movement. Shareholder rights advocates urge that it's worth giving it a shot, as we have never have given institutions a chance to oversee management. How do we know if a refined shareholder franchise doesn't earn a premium through encouraging more effective governance if we never try?

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[91] *Id.* This analysis can get quite complicated. For instance, a shareholder who also sells shares short is betting against the enterprise but still gets to vote in elections controlling its future.

[92] Bainbridge, *supra,* at 627.

[93] They effectively argue that all we can do is require disclosure of financial data and other information, leave ultimate power and discretion in the hands of managers, and allow the capital markets to reward managers if shareholders like what the managers are doing.

[94] Stephen Bainbridge, *Director Primacy and Shareholder Disempowerment,* 119 HARV. L. REV. 1735, *1739 (April 2006)("Despite the alleged flaws in its governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries."). This argument, however, is the least convincing proposed by traditionalist apologists. The question remains: Under an optimal governance regime, how much better would our markets perform?

[95] Furthermore, index investors, an increasingly popular asset class, are stuck as they do not sell shares based on idiosyncratic characteristics of the stock.

Bebchuk offers evidence that management typically ignores precatory proposals to eliminate staggered boards.[96] Bebchuk, Coates, and Subramanian aptly note that staggered boards serve as an effective sandbar against any wave of shareholder reform.[97] Critics would use this as evidence that changing election defaults is a useless endeavor. It is nevertheless uncertain whether this is an indictment of the argument of board accountability, or merely a reflection of a lack of board accountability.[98] At present, about half of companies have staggered boards, so perhaps reform activity can be effective at those companies notwithstanding. Bebchuk argues that shareholders should be able to decide the balance of power they favor.[99] In effect, he would let the shareholder decide, through adopting bylaws that control the balance of power, where their preference sits in the shareholder power debate. It's an effective resolution, as most of the arguments in favor of management discretion rest on assumptions about preferences for capital owners, efficiencies that work to the benefit of capital owners, and freedom of contract. Perhaps the power to adopt bylaws that change Bebchuk's rules of the game[100] is a way of minimizing the adhesive contract that purchasing a share is currently and would, effectively, make the contract bargaining process more balanced.[101]

Now we've come around full circle to see that the majority voting amendment comports with Bebchuk's challenge to resolve the debate by allowing shareholders to initiate rules of the game changes into the corporate bylaws. The majority voting provision initiated by Delaware will not end the tug of war between management and

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[96] "The evidence put forward below shows that management often elects not to initiate rules-of-the-game decisions for which shareholders register strong support in precatory resolutions." Bebchuk, *supra,* at 852.

[97] See generally Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 925-39 (2002). Indeed, companies failing to accommodate the precatory proposals, as members of staggered boards, would be difficult to replace in response to their refusal to eliminate the staggered board under the precatory proposal.

[98] In other words, do shareholders fail to hold directors to the carpet because they are disinterested due to cost inefficiencies, or because they are unable due to staggered directorships?

[99] See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (January 2005).

[100] *Id.* at 844

[101] It might be that some firms would see shareholder adoption of pro-management bylaws, others wouldn't. Policy makers would also be able to then regress the performance of the different allocations of authority, something we haven't previously been able to study. Perhaps the difference in whether such a bylaw passes would depend in part on earning performance preceding the election, and would only target perennial under-performers.

shareholders that has picked up speed over the last 30 years. This debate is bound to continue well into the 21st century. But the effect of this majority voting accommodation will interact with other elements of corporate governance policy in as yet unforeseen ways, and will likely have a more powerful effect on the balance of power between boards and shareholders than is presently understood. On the other hand, the effectiveness of majority voting will depend, as we shall see, on the ability of firms to outflank majority voting amendments with various evasive tactics still available. But before exploring that further, we should get a firmer grasp of the present economic incentives facing the shareholders who would make use of the power of majority voting.

B. Institutional Investors and the Collective Action Problem; Why no one volunteers for Kitchen Patrol in Mutual Fund Families.

Institutional Investors own a significant percentage of equity outstanding in U.S. markets.[102] However, their ability to influence corporate decision making is minimized by the effect of securities laws,[103] conflicts of interest,[104] and economic cost phenemona.[105] Activism was also classically constrained by the free rider problem.[106] Historically, institutional investors used their power in two ways: "jawboning" management in negotiations and presenting a shareholder governance proposal at an annual meeting.[107] Institutions would typically target a small number of underperforming firms to make

[102] See, e.g., Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 BUS. LAW 95, 95 n.2 (2003) (institutional investors held 55.8% of publicly traded equities in the United States in 2001).

[103] See Bainbridge *Limited Voting*, *supra,* at 618.

[104] ("Those institutions most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest. By contrast, those institutional investors one might think are best situated to make wise voting decisions--the money managers who operate mutual funds, particularly index funds--have little desire to spend money on stockholder activism or offend corporate management.") *See* Strine, *supra,* at *1765; See also Brickley, J.A., Lease, R.C. and Smith, C.W., 1988, *Ownership structure and voting on antitakeover amendments*,

Journal of Financial Economics 20: 267-292.

[105] Coffee, J.C., Jr., *Liquidity versus control: The institutional investor as corporate monitor*. *Columbia Law Review* 91: 1277-1368; See also footnote from Grundfest, Just Vote No, *supra*.

[106] Even the most activist institutions spend less than less than half a basis point of assets under management (.005%) per year on their governance efforts (Del Guercio and Hawkins 1997). Black, *infra,* at 5.

[107] Black, Bernard. *Shareholder Activism and Corporate Governance in the United States*; published in Peter Newman, ed., *The New Palgrave Dictionary of Economics and the Law* (1998), page 2.

examples of them.[108] Merely voting no is certainly less costly than submitting an alternate slate of directors. Withold vote campaigns were more of a remote-control sort of activism.

Numerous academics (notably: Grundfest, Rock, and Black, among others) have modeled investor rationality using Equation (A) to describe where it becomes economically rational for an investor to undertake action[109] using variants of the following equation:

(A) $c_i < p_i * x_i * B_i$

where,

c_i = shareholder i's expected cost of participation;

p_i = shareholder i's estimate of the probability that her decision to participate will result in successful collective action with benefits B_i ;

x_i = the percentage of the corporation's shares owned by shareholder i; and

B_i = shareholder i's estimate of the aggregate net benefits to all shareholders that will result from successful collective action.

This equation states that a profit-maximizing shareholder will agree to bear the private costs of participation, c_i, only when those costs are less than the anticipated benefits to that individual shareholder, x_iB_i, weighted by the estimated probability, p_i, that the shareholder's participation in the initiative will contribute to generating those benefits.[110]

This simple equation described why mutual funds and other institutional investors weren't more active in calling for change. Institutional activism is picking up speed, however, in both majority voting and calls for a shareholder nomination capability. Granted, withhold votes are still an inexpensive means to call for change as

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108 Black, Bernard *supra* "For example, CalPERS, the largest state pension plan and the Council iof Institutional Investors annually identify a handful of poorly performing firms as targets for governance initiatives. This lets a proposal serves double duty: as a way to improve governance procedures and as a signal of investor displeasure with management."

109 This equation and its explanation in the paragraph that follows it is drawn from Grundfest, Joseph, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates* 45 STAN. L. REV. 857, *910 (1993); citing Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, at 575-91 (1989); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453-63 (1991).

110 *Id*, Grundfest further explains: "This last variable, p_i, incorporates (1) each shareholder's ex ante estimate that the process as a whole will overcome the collective action problems described above, as well as (2) the shareholder's subjective assessment of the extent to which her participation in the process contributes to reaching the final outcome."

before, it's just that the law is changing to give this inexpensive form of activism legal consequence. But, assuming the rationality model is still valid, there may be more that we can add to the rationality equation. At present, I would posit that a handful of phenomena uniquely alter the calculus of investor rationality and explain part of the reason for this change from the status quo.

First, the expected rapid decrease in the cost of proxy solicitation[111] due to the SEC's move for online proxy availability makes the variable c_i significantly lower than before. The elimination of broker voting[112] will also make shareholder initiatives more likely to succeed by decreasing the number of votes necessary to achieve success, thus increasing the variable p_i. Additionally, the development of information intermediaries, such as ISS and Glass Lewis, Inc., that specialize in compiling data and quantifying and rating the corporate governance function of companies, and then use that information to advise institutions how to vote their proxy, dramatically decrease the cost of collaboration in a proxy campaign and also work to increase the odds of its success.[113]

Additionally, we must add activist hedge funds into the calculus.[114] Hedge funds run over 1.5 trillion dollars, and investors in hedge funds count on their managers for active management to increase alpha (returns). Hedge funds earn a percentage of their fund returns and a management fee based on the size of funds under management. One strategy that hedge funds use to achieve returns is instituting shareholder activist activity. After taking a significant position in an underperforming company, it may agitate for corporate policy changes through threatening to lead a proxy fight or threatening litigation by using rights afforded shareholders.[115] Recognizing legal consequence for withhold vote campaigns adds another tool to their arsenal. Whether this works to the benefit of other shareholders is legitimately debated.[116]

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[111] See Section infra on online proxy solicitation.

[112] See Section infra on the NYSE's amendment to Rule 452.

[113] See Strine, *supra,* at 1765 "For that reason, many rely heavily on the advice of yet another level of agency, firms like Institutional Investor Services (ISS) that provide advice on how to vote on corporate ballot issues, to satisfy their legal obligation to vote in an informed manner on behalf of their investors."

[114] Bainbridge also observes that hedge funds are a new exception to the rarity of institutionally funded proxy fights. See Bainbridge, *supra,* at 630.

[115] E.g., 220 actions, shareholder derivative suits, appraisal rights, seek injunctions of corporate merger activity, etc. The potential for such annoyance could make it economically rational for the board to pay the fund to go away by, say, buying back the fund's shares at a premium.

[116] For an exploration of some of the disturbing implications of empty voting, where hedge funds purchasing the right to vote other owners shares may result in an incentive

Some say they are reminiscent of the greenmailers of the 80s, while others argue that they can effectively overcome the shareholder collective action problem and inure benefits for their fellow shareholders.[117]

A rational activist fund would include the expected returns of future inflows of investment that might result from a successful campaign to alter management policies through a withhold vote or proxy fight. Proxy fights are always heavily covered in the business press, and raising funds from even sophisticated investors is inherently a sales game. So a sensible fund would include the value of that good P.R. in its calculus. We might model it this way:

(B) $c_i < p_i * x_i * B_i + p_{ii} * R_{ii}$

Where

p_{ii} = The expected probability of the proxy campaign's overall success.

R_{ii} = The expected present value of future benefits to activist hedge fund ii in the form of management fees and performance fees earned in the future on an influx of future capital due to the favorable signals to hedge fund investors that the fund initiating the campaign has a distinct advantage in increasing returns through activism.

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to vote in a way that actually harms the firm, see Henry T.C. Hu and Bernard Black, *Empty Voting and Hidden (Morphable) ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011, (May 2006). Hedge fund participation in withhold vote campaigns using borrowed shares could mean that this shareholder democracy movement could be hijacked by market players with perverse incentives, as in the case of a fund with a leveraged short position in a firm that bought voting rights in that firm. Whether hedge fund participation in the shareholder democracy movement will collaborative or parasitic remains to be seen. This concern was also recently relayed by SEC Commissioner Paul Atkins in a speech before the 2007 Corporate Directors' Forum. Available at http://www.sec.gov/news/speech/2007/spch012207psa.htm#10.

117 See the share buyback programs initiated at Imclone and AOL Time Warner as a result of Carl Icahn's activism at those firms. In a share buyback, a company will buy shares and convert them to treasury holdings, which has the effect of increasing the per share price of all shares outstanding as the total market value is divided over a lower number of shares. This method may be preferred over a simple dividend due to income tax efficiency. Whether this works to the benefit of other shareholders would depend on whether the time horizon of the fund, typically very short, meches well with the other shareholders. For instance, some shareholders may prefer that more money be invested in research and development for future appreciation in share value because the firm has a distinct advantage in some area over the long term. Other shareholders may want appreciation immediately.

R_i might look something like the standard equation for discounting future cash flows:

$$R_i = \Sigma_{t=0}\ FV_t / (1+d)_t$$

Or, put more simply, the sum of future cash flows over the applicable period. Those cash flows would come as a percentage of the influx of future capital in the form of a management fee and would include a percentage of the performance fee on the amount by which the fund presumed it could make the capital influx grow.

Activist hedge funds would use Equation (B) in ascertaining whether or not a proxy fight was worth their while. Additionally, though it would be difficult to quantify, we might analogize that union and private pension fund investors may also obtain some private benefit, either for political advantage for the appointed board or future membership drives in a union, that would make activism more profitable for them than it would be for, say, a mutual fund whose investors are more passive.[118] Making hedge fund especially relevant to this discussion is the fact that the institutions that traditionally served as active intermediaries, such as Calpers, are increasingly investing in activist hedge funds.[119]

IV. The Shareholder Power Debate as Applied to Majority Voting

A. General Arguments

In the context of withhold votes, some argue this will decrease incentives for eligible directors to want to serve, would turn usually collegial board activity divisive, or would distract board members from more productive activity.[120] Of course, every change in corporate governance that works against the discretion and the financial security of management is hailed as yet another factor diminishing the pool of talent willing to serve on boards of directors. The response would be that either you're dealing with prestige seekers, who we're not worried about anyway because how could that conflict with the interest of the company; Or, we're dealing with people who want money, in which

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[118] Romano explores institutional shareholder conflicts of interest in more detail. See Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE. J. ON REG. 174, 177 (2001).

[119] *E.g.,* One of activist hedge fund Shamrock Holdings' largest investors is Calpers.

[120] See Strine, *supra,* at 1768 "Due to her knowledge of how corporate boards work, the traditionalist has little interest in initiatives that single out specific board members for defeat or embarrassment. She knows boards almost always work by consensus and it is therefore silly to hold a solitary director responsible for a company's poor performance or lack of responsiveness to shareholder interests".

case just increase board compensation. This is not nearly as convincing an argument in this context as it is in discussing increases in director liability. The embarrassment of a withhold vote pales in comparison to the obligations directors face in the wake of *Disney*[121] and Sarbanes-Oxley. The marginal disincentive against serving on boards presented by the prospect of a withhold vote campaign would be minimal.

The argument has also been raised that giving the power to eliminate directors through a withhold vote campaign would make directors prey to the self interested desires of groups, like labor unions and public pensions, whose interests may run counter to the larger group of shareholders.[122] Directors would be risk-adverse, the argument runs, and would fold in negotiations with these groups in the event a withhold vote was threatened.[123] However, this presumes that the threat was credible. Would a Board give credence to the threat of a union shareholder to institute a withhold vote campaign if the Board didn't enhance its retention policies? Fidelity and Calpers would prove more difficult to convince in such a campaign than the buildup to shareholder dissatisfaction with Michael Eisner. Thus when shareholders have reasons that don't comport with benefits to share value, the other sophisticated shareholder would presumably side with management in the campaign. The only exception may be that unions and public pensions might use their clout for private benefit in companies where a withhold vote would be salient for other reasons.[124]

Yet another argument against giving legal effect to withhold votes is that it would actually have the unintended effect of making them less likely. The same group that originally argued against withhold votes as damaging director reputations now asserts that symbolic withhold votes are a positive force in governance, but only when they remain symbolic. Institutions may be less likely to institute them if it has powerful and concrete effects on the firm in which they are invested. This is clearly a complicated quantitative question, one we will probably not know that answer to until more time has passed. Interestingly, ISS doesn't see this as an issue.[125]

B. A First Strike Capability for financial intermediaries

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[121] *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27 (Del. Sup. 2006).

122 *See* Saunders, Robert. "Why Majority Voting in Director Elections is a Bad Idea," 1 *Virginia Law & Business Review* 107 (2006).

[123] *Id.* at 122.

[124] For example, if an employee's union had agreed not the go along with the withhold vote against Eisner, in exchange for concessions on employee bargaining, but such collusion would be possible without the specter of a voting challenge.

[125] ISS Report, *supra,* at 16.

Critics assert that, should a withhold vote be successful against a number of directors, then the ability of the board to function could be constrained.[126] Institutional shareholder claim that, far from killing the golden goose, they only want an opportunity to single out individual directors and hope to negotiate in advance of the specter of a withhold vote campaign.[127] But, even if the holdover rule were abolished and withhold vote wars could create such chaos, would the ability to threaten such an outcome be without precedent? And if such brinkmanship is a legitimate tool of corporate power negotiations, why not give some such power to institutional investors? If a withhold vote could eliminate the independent members of a board, thus making the board non-compliant with independence rules and unable to create independent committees, then institutional investors would be vested with the same form of scorched-earth tactic that case law has blessed in the poison pill.[128] Though there would be no fiduciary check on such a power, we might expect some form of détente in this nuclear arms race.

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[126]For instance, it may be unable to achieve a quorum to conduct business; it could constitute a breach of an executive candidate's employment agreement resulting in a trigger of severance payments; it could result in a "change of control" under corporate credit agreements resulting in accelerating debt or canceling a line of credit, or triggering changes in licenses, franchise agreements or other important corporate arrangements, or if a fixed number of directors is to be elected by holders of one class of securities, a failure to elect one or more directors could alter the relationship among shareholders of different classes, or the company's ability to comply with stock exchange listing standards or other requirements for maintaining independent directors or directors with particular qualifications may be inhibited, or the failure to elect one or more candidates may alter the consequences of having a staggered or classified board, and finally a dissident group with minority representation on the board of directors could enlarge its percentage of directors if new nominees to the board are not elected -- thereby avoiding the need for a direct proxy contest challenge and altering the existing dynamics of control contests. COMMITTEE ON CORPORATE LAWS DISCUSSION PAPER 1506 PLI/Corp 473, *481

[127] The President of the United Airlines Pilots Union claimed "We don't want to kill the golden goose, just choke it by the neck until it give us every last egg" Roger Lowenstein, "Into Thin Air", New York Times, Feb. 17, 2002, § 6 at 40.

[128] *Moran v. Household International, Inc.*, 500 A.2d 1346, 1353 (Del. 1985) ("Having concluded that sufficient authority for the Rights Plan exists in 8 Del.C. § 157, we note the inherent powers of the Board conferred by 8 Del.C. § 141(a), n11 concerning the management of the corporation's "business and affairs" also provides the Board additional authority upon which to enact the Rights Plan."); *Unocal v. Mesa Petroleum Corp.,* 493 A.2d 946, 953-954 (Del. 1985)("The board has a large reservoir of authority upon which to draw. Its duties and responsibilities proceed from the inherent powers conferred by 8 Del.C. § 141(a), respecting management of the corporation's "business and affairs". n6 Additionally, the powers here being exercised derive from 8 Del.C. § 160(a), conferring broad authority upon a corporation to deal in its own stock. From this it is now well established that in the acquisition of its shares a Delaware corporation may deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office.") ; *Maldonado v. Flynn,* 413 A.2d 1251, 1255 (Del. Ch. 1980) *rev'd on other grounds*.

After all, the threat would only be salient in the event that it appeared likely a majority of shareholders voting in the election would go along, and turnout would seemingly be higher if the prospect of such consequences were present. The traditionalist's ready response would be that the scorched earth tactic embodied in the poison pill is permitted only for a discrete case, the change of control transaction, which is especially subject to a risk of erosion of shareholder value. Thus, it hardly justifies expansion of that form of power into the hands of institutional and activist investors for general use. This diversion is entirely academic at this point, as the holdover rule would function (as a sort of missile defense) to ultimately protect against nearly all of the enumerated fallout. However, in the event that alterations to the holdover rule enter the agenda this analysis should be revisited.

Critics of institutional investor activism generally also cite concerns over the growth of influence wielded by ISS and other proxy solicitation firms.[129] Corporate law traditionalists also posit that institutions and proxy advisory services are not constrained by the strictures of fiduciary duty jurisprudence and are more short term oriented than corporate managers, thus they can't be trusted to wield corporate power as responsibly.[130] One response might be that alternative directors put forth by the institutions in proxy fights would also be held to the same responsibilities, or that such analysis flips fiduciary duty on its side…shareholders were never meant to bear fiduciary burdens, and can be trusted to make decisions about bylaws and elections outside of the change-of-control context that serve the interests of all shareholders. We need not resolve the debate here, however. My objective is merely to set the stage for withhold votes to enter the fray. But first, we should examine some initiatives that other regulatory agencies have been exploring in 2006 that will have a profound effect on majority voting.

V. Brewing a Perfect Storm---SEC proxy reform, NYSE Exchange Rule 452, and Internet Proxy Solicitation.

A. A Modest Proposal

In 2003, The Securities Exchange Commission considered a rule to allow shareholders to include nominees on the corporate ballot upon

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[129] See Strine, *supra*, at 1765.

[130] Strine, *supra*, at "Unlike corporate managers, neither institutional investors as stockholders nor ISS as a voting advisor owe fiduciary duties to the corporations whose policies they seek to influence. And unlike the individual investors whose capital they use to wield influence, institutional investors and their advisors bear far less of the residual risk of poor voting decisions, as their compensation turns more on short-term factors than on long-run growth."

the occurrence of certain triggering events.[131] This is extremely important, as companies typically vote on behalf of shareholders who are unable to attend the annual meeting, and solicit the proxies of those shareholders in order to do so. A proxy statement must be delivered to shareholders in connection with that solicitation which will describe the issues and proposals up for vote.[132] As a company uses its resources to pay the cost of these proxy solicitations, which can be prohibitive, getting one's proposal onto the corporate proxy is vital.[133] However, a company may exclude a shareholder proposal if it relates to an election or falls under other criterion enumerated by the SEC.[134] Recently, the SEC has initiated a process to revisit its interpretation of the election exclusion in response to *AFSCME v. AIG,* in which the Second Circuit held that a shareholder bylaw proposing a method for including shareholder nominees on the corporate ballot in future elections did not relate to "an election", as the SEC held in a letter ruling, but related to the election process in general, and thus could not be properly excluded from the corporate proxy.[135]

Additionally, the SEC instituted a proposal to explicitly allow shareholder nominations to the corporate ballot under a new Rule 14a-11 in 2003, which has since stalled in the review process.[136] The proposed rule would have required companies to include between one and three nominees of holders of at least 5% of all outstanding shares (for 2 years) if one of two triggers applied : i)at least 35% of shareholders previously withheld support for a board nominee or ii)a majority of shareholders voted to be governed by14a-11.[137]

Shareholder bylaws regarding nominations would still need to be legal under state corporation law. The Delaware legislature seems to

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[131] SEC Release Nos. 34-48626 (Oct. 14, 2003).

[132] Exchange Act Rule 14a-3(a), 17 C.F.R. § 240.14a-3 (2004).

[133] McDonnell, Brett, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, *211 (December 2005).

[134] This includes proposals that relate to an election, are improper under state law, have been substantially implemented by the company, or conflict with the company's own proposal on the current ballot, among other exclusions. *See* Exchange Act Rule 14a-8, 17 C.F.R. § 240.14a-8 (2004)

[135]*American Federation of State, County & Municipal Employees v. American Intern. Group, Inc*., 462 F.3d 121, *128 (2d Cir. 2006). ("Thus, we cannot agree with the second half of the SEC's interpretation of the 1976 Statement: that a proposal may be excluded under Rule 14a8(i)(8) if it would simply establish a process for shareholders to wage a future election contest.").

[136] See Proposed Rule 14a-11. *See also* Security Holder Director Nominations, 68 Fed. Reg. at 60,784-85; *See also* Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, July 15, 2003, p. 1.

[137] See proposed Rule 14a-11(a)(2)(i); 14a-11(a)(2)(ii); 14a-11(b); 14a-11(d).

have presumptively blessed the legality of shareholder bylaws requiring removal upon a majority withhold vote, so clearly a shareholder bylaw will not be held illegal simply for relating to the election process for Delaware Corporations. However, this does not guarantee that all iterations of shareholder nomination bylaws that are included on the corporate ballot will be enforceable under Delaware law.[138]

However, presuming that shareholders will manage to achieve the holy grail of corporate ballot access through one of these two SEC venues, either through SEC action under 14a-11 that will restrict corporate discretion to exclude shareholder nominees, or under a shareholder approved bylaw that survives the scrutiny of the Delaware courts, the withhold vote bylaw will interact with nominations to potentially flip the empowerment debate on its side. In the event that a company's board became host to an insurgent nominee, that managed to win by a mere plurality, the company could use a withhold vote campaign to remove that director from its board in a successive election. Management would effectively be able to institute a withhold vote campaign against insurgent directors elected by a plurality vote in a contested election, but whose motives seem suspect to a majority of shareholders voting in a subsequent election.

Conversely, an institutional investor could potentially overcome the holdover rule by a combination withhold vote/insurgent nominee campaign over two successive annual meetings. The withhold vote campaign is muted by the phenemona were a director may lose a majority, but maintain his seat until a new director can be elected. Since, absent a shareholder access rule or bylaw, the replacement nominee will usually be hand picked by the board, the director would always be replaced with a board nominee. However, if institutional investors are able to win a withhold vote, and then place a nominee on the corporate ballot at the next election, the power of the withhold vote bylaw would then be enhanced.

C. Rule 452

In addition to SEC regulation of the proxy solicitation process, the NYSE regulates proxy voting through rules defining when a broker who holds a share on behalf of his client (in "street name") may vote that client's shares.[139] Brokers are permitted to vote in the absence of directions from the client in the event that the matter is considered

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[138] Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 CARDOZO L. REV. 511, 546 (1997).

[139] See NYSE Rule 452.

routine.[140] The most compelling justification for allowing brokers to vote on behalf of clients is that attaining a quorum would be exceedingly difficult if broker held shares went uncounted.[141] Historically, Rule 452 classified uncontested elections of directors as routine.[142] However, in response to a growing use of withhold vote campaigns and shareholder activism, the NYSE commissioned a working group to study the issue which recommended that uncontested elections be classified as non-routine, meaning brokers could not vote those shares on behalf of their client in an uncontested election.[143] That recommendation is on the verge of being instituted.

The ability of brokers to vote shares held in street name has dramatic implications for the dynamics of withhold vote campaigns, a factor the NYSE considered in their exploration of the rule change.[144] By some estimates, 70-80% of all publicly traded shares are held in street name.[145] Brokers typically vote in favor of management re-election and in favor of management proposals.[146] For instance, if broker votes had not been counted in the Eisner withhold vote campaign, Eisner would have only received 45% in favor of his re-election and a majority of

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[140] Rule 452 states, "Voting procedure without instructions: A member organization which has transmitted proxy soliciting material to the beneficial owner of stock or to an investment adviser, registered either under the Investment Advisers Act of 1940 or under the laws of a state, who exercises investment discretion pursuant to an advisory contract for the beneficial owner and has been designated in writing by the beneficial owner of such stock (hereinafter "designated investment adviser") to receive soliciting material in lieu of the beneficial owner and solicited voting instructions in accordance with the provisions of Rule 451, and which has not received instructions from the beneficial owner or from the beneficial owner's designated investment adviser by the date specified in the statement accompanying such material, may give or authorize the giving of a proxy to vote such stock, provided the person in the member organization giving or authorizing the giving of the proxy has no knowledge of any contest as to the action to be taken at the meeting and provided such action is adequately disclosed to stockholders and does not include authorization for a merger, consolidation or any other matter which may affect substantially the rights or privileges of such stock."

[141] *See* NYSE Report at 12.

[142] Rule 452.11(2) defines a ''contest'' as a matter that ''is the subject of a counter-solicitation, or is part of aproposal made by a stockholder which is being opposed by management."

[143] Report and Recommendations of the Proxy Working Group to the New York Stock Exchange. June 5, 2006. available at http://www.nyse.com/pdfs/PWG_REPORT.pdf. [hereinafter "NYSE Report"].

[144] NYSE Report at 13.

[145] "The majority of publicly traded shares are not registered in companies' records in the names of the beneficial owners. Instead, an estimated 70 to 80 percent of all public companies' shares are held in "street name," meaning that they are held of record by brokers, banks or their depositories." NYSE Report at 10.

[146] *See* NYSE Report at 14.

votes withheld.[147] The NYSE working group estimated that, in 2004 alone, elimination of street voting would have meant 32 directors of publicly held companies would have failed to obtain a majority vote in favor of their re-election.[148] The NYSE Working Group remained cognizant of the effect the rule change would have on the costs of corporate elections, from increasing influence of special interest groups to increasing the cost of campaigns due to a renewed need to increase shareholder participation.[149] However, it recommended this move as vital to enhancing corporate accountability and the transparency of the election process.[150]

C. Online Solicitation

Yet another element of securities law affecting majority voting is the SEC's policy shift to allow online proxy solicitation.[151] The SEC approved a proposal on December 13, 2006 to allow electronic delivery of proxy materials by anyone soliciting proxies through a model utilizing notice and access.[152] A proxy solicitor's obligation to furnish proxy materials would, under that rule, be satisfied by posting them to a website and sending a notice of their availability, details of the meeting and proposal, and contact information for shareholders to request a hard copy.[153] Currently, the SEC only allows online furnishing of proxy materials if the shareholder has previously consented in writing. [154] This proposal would significantly reduce the costs of communicating with shareholders for anyone interested in soliciting proxies of shareholders, including management, insurgent nominees, or institutions running withhold vote campaigns. Since corporate reimbursement of proxy costs has traditionally worked to benefit management, the rules proposal would alter the balance of power against management in proxy fights or withhold vote campaigns.

D. Case in Point: The Heinz Proxy War: Would You Please Pass the Proxy?

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[147] *See* NYSE Report at 9.

[148] *See* NYSE Report at 13.

[149] *See* NYSE Report at 21.

[150] *See* NYSE Report at 21.

[151] *See* Internet Availability of Proxy Materials, SEC Rel. No. 34-52926 (Dec. 8, 2005) 70 Fed. Reg. 74598.

[152] SEC Press Release 2006-209 available at http://www.sec.gov/news/press/2006/2006-209.htm.

[153] SEC Press Release.

[154] *See* SEC Rel. No. 33-7233 (Oct. 6, 1995); Rel. No. 33-7288 (May 9, 1996); Rel. No. 33-7856 (Apr. 28, 2000).

Leading up to its annual meeting in August of 2006, H.J. Heinz Co.[155] was engaged in the most bitter proxy war in its history.[156] Leading the charge was billionaire investor Nelson Peltz and his activist hedge fund, Trian Investment Partners.[157] Trian purchased 5.5% of Heinz's outstanding shares and immediately started to rattle the saber.[158] It submitted SEC filings outlining a plan to save the company $575 million; within months Heinz management announced an alternative plan.[159]

The annual election became a referendum on the insurgent's plan. Five seats were up for election on the twelve member board. Peltz offered five candidates, including himself, 3 allies and, for good measure, former pro-golfer Greg Norman. The institutional investors were divided: Calpers and PNC Financial announced that they would vote for re-election of all of Heinz's current board.[160] ISS, however, urged its institutional investor clients to accept three from Peltz's slate (including Norman).[161] Pelz's speech at the annual meeting was compared to the famous Gordon Gekko diatribe in the movie Wall Street.[162] Capital Research and Associates (a large mutual fund family), owning 13% of Heinz stock, was the likely swing vote that would carry the day.[163]

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[155] Though H.J. Heinz is not a Delaware corporation, the pertinent operation of majority vs. plurality voting, and the process of a proxy fight, would remain the same if it were incorporated in Delaware.

[156] Lisa Gewirtz, "Heinz, Anticipation Still Buzzword" The Daily Deal, August 17, 2006, also available as 2006 WLNR 14215438.

[157] *Id.* Pelz is one of the more prolific activist hedge fund in the space, with a previous victory against Wendy's and a looming war against Tribune Co, see Los Angeles Times, 8/17/06, 2006 WLNR 14218025.

[158] *Id*.

[159] See Gerwitz, *supra*.

[160] Gerwitz, *supra.*

[161] Id.

[162] "When a reporter asked him if he considered his speech during the meeting "his Gordon Gekko moment"--a reference to Michael Douglas' classic "Greed is good" speech in the 1980s-era movie "Wall Street"--Peltz was not amused. "That doesn't warrant a response," he said frostily. Instead, Peltz sought to emphasize that he and his partners are interested in helping fix companies and participating in their growth--not tearing them down or flipping them for a quick profit. O'Neal, Michael. "Pelz group preaches its Gospel of Truth," Chicago Tribune, August 17, 2006, also available as 2006 WLNR 14251264. See also opening quotation, supra.

[163] Lisa Gerwitz, "Heinz Vote May Hinge On One Firm" The Daily Deal, August 18, 2006.

The result: the insurgents were 2 for 5, Peltz and associate Michael Weinstein were elected over two of the board's candidates, and the management slate was 3 for 5.[164] At the time of the proxy fight, Heinz had a full plurality voting regime, but in November of 2006 they adopted majority voting for uncontested elections.[165] This means that, provided the new board members turn out to be inimical to a majority of the institutional investors, a distinct possibility given the divisive nature of the proxy fight, the board could institute a majority withhold vote campaign against them. If Calpers is amenable, a board initiated withhold vote may prove successful in ousting the Trian directors. Of course, the holdover rule would allow the directors to remain if they have not submitted previous resignation policies. But it is certainly interesting that majority voting would give management an entrenchment tool in situations such as these.

VI. Implementation of Majority Voting and Its Many Iterations

Corporations have been in a rush to implement some form of majority voting even before the adoption of the Delaware amendments.[166] More than 120 companies had some form of majority voting related provision, predominately in the form of director resignation policies, as of March 2006.[167] But the question is, if plurality voting is more likely to allow management to control the election, then what would explain the lack of resistance? Three possibilities come to mind: i) firms want to adopt a lighter version of the majority voting standard, and then keep shareholder versions of a similar bylaw off of the corporate ballot under SEC Rule 14(a)(8) or simply steal the thunder from an alternate campaign, ii) firms anticipate that majority voting may have the converse result of helping them to fend off divisive directors proposed under a shareholder nomination rule, if the SEC's ongoing exploration of this issue eventually yields results, or iii) firms

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[164] See Heinz Press Release, September 8, 2006, "Heinz Announces Preliminary Proxy Voting Results; Looks Forward with Confidence to Executing Its Plans to Increase Shareholder Value" available at http://www.heinz.com/News_f.aspx.

[165] Heinz Board Approves Majority Voting, Morningstar News Service, November 8, 2006, available at http://news.morningstar.com/news/ViewNews.asp?article=/BW/20061108006002_univ.xml&pgid=qtqnPress5.

[166] TAKEOVER LAW AND PRACTICE 2006 1571 PLI/Corp 259, *278 ("In June 2005, Pfizer Inc. became the first company to amend its corporate governance guidelines to require that any director who receives a majority of withheld votes submit his or her resignation to the board, leaving the outcome in the hands of the board. Since then, Walt Disney, Office Depot, Circuit City, Lucent Technologies, and over 30 other companies have adopted similar guidelines.").

[167] See Dennis Berman, Boardroom Defensetration—As Proxy Season Heats Up, Companies Consider Rules to Boot Unwanted Directors," Wall Street Journal, Mar. 16, 2006, at B1.

are actually interested in improving their corporate governance apparatus in order to satisfy institutional investors.[168]

The question of using a policy to keep shareholder bylaws off the ballot under Rule 14(a)(8) has been answered by the SEC in the negative.[169] However, SEC letter rulings on Rule 14, as we have seen in *AFSCME v. AIG*, are not necessarily dispositive and challenges to it in federal court could be seen in future contests. Further, an open question also remains as to whether a majority voting bylaw adopted by the Board, that provides wider board discretion in responding to a successful withhold vote, would keep an alternative bylaw proposal off the ballot.[170] However, the primary advantage to having a policy already in place is that it makes a contest to institute an alternative new bylaw more difficult to win. During the 2006 Proxy season, 86% of majority voting proposals, put forward where no majority voting governance policy was currently in place, were successful.[171] Alternatively, only 18% of proposals passed where a company had previously adopted a Pfizer Governance Policy.[172]

A. Mechanical Issues in Tallying the Voting Outcome

The DGCL provides that "In the absence of such specification in the certificate of incorporation or bylaws of the corporation…Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors."[173] This seemingly straightforward definition of how a vote

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[168] ISS has indicated that it may decline to endorse a campaign for a majority voting bylaw in instances where a proposal has already been adopted that substantially implemented majority voting.

[169] Capital One Financial Corporation, SEC Letter Opinion, 2006 WL 129325, *1 (January 16, 2006).

[170] See Exchange Act Release No. 34-20091 (Aug. 16, 1983). See also Texaco, Inc., SEC No-Action Letter (March 28, 1991) ("a determination that the Company has substantially implemented the proposal depends on whether its particular policies, practices and procedures compare favorably with the guidelines of the proposal."). In the context of majority voting proposals, *See* Bristol-Myers Squibb Company, SEC No-Action Letter, (February 14, 2005) where a stockholder proposal for a "simple majority vote" was properly excluded as "substantially implemented" under Rule 14a-8(i)(10) where the registrant was engaged in the process of removing supermajority voting provisions from its governing documents. Compare KeySpan Corporation, SEC No-Action Letter, 2006 WL 626123 (March 7, 2006).

[171] See Wachtell, Lipton, Rosen, & Katz Client memo (white paper), Majority Voting - A look back at the 2006 proxy season. June 12, 2006. page 1.

[172] *See* Section infra.

[173] 8 Del. C. § 216.

should be tallied, placing in the denominator the number of shares present in person or represented by proxy and entitled to vote in the election of directors, is subject to a surprisingly tangled web of case law defining its application. [174] For instance, any shares present that are entitled to vote, but do not vote in the election for some reason, would end up increasing the number of affirmative votes necessary to elect a director in a majority voting regime (by increasing the denominator) and would also count as no votes (by being placed in the numerator).[175]

This issue becomes particularly interesting in the context of broker street voting. *Berlin v. Emerald*[176] outlines the various situations in which shares are counted in the denominator and which are not in determining voting outcomes.[177] To the extent that shareholders give their brokers directions on how to vote, even if that instruction is precisely not to vote or to abstain, those shares are counted in the denominator under Delaware law.[178] Where voting in uncontested elections was previously deemed discretionary by the NYSE, broker street votes were counted in the denominator of shares entitled to vote, even if the beneficial shareholders gave no instruction to their broker.

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[174] By way of contrast, New York law uses as its metric a much simpler "votes cast" denominator. *See Bank of New York Co. v. Irving Bank Corp.,* 531 N.Y.S.2d 730 (N.Y.Sup.Ct.1988), *aff'd,* 533 N.Y.S.2d 411 (N.Y.App.1988).

[175] *Licht v. Storage Technology Corp*., 2005 WL 1252355, at *1 (Del.Ch. May 6, 2005) *citing* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, § 7.25, at 7-51 (2004) ("[I]n determining whether a [shareholder] proposal has passed in a circumstance where the vote is required "a majority of the shares present and entitled to vote on the subject matter," abstentions ··· are to be treated as shares present and "entitled to vote on the subject matter." Applying that standard, an abstention would be counted as a "no" vote····").

[176] *Berlin v. Emerald Partners,* 552 A.2d 482, *494 (Del.,1988) ("Delaware law expressly recognizes the right of the corporation to rely upon record ownership, not beneficial ownership, in determining who is entitled to notice of and to vote at the meetings of stockholders. Therefore, from the perspective of the Delaware corporation, a broker who is the stockholder of record, has the legal authority to vote in person or by proxy on all matters. Nevertheless, the relationship between a broker, who is the "record owner", and the beneficial owner is governed by the rules of the various stock exchanges…The shares represented by a limited proxy cannot be considered as part of the voting power present on a nondiscretionary proposal from which power has been withheld by crossing it out or otherwise.") (Citations omitted).

[177] The Chancery Court has applied the test outlined in Berlin to interpret the "entitled to vote" language in Section 216. *See Hammersmith v. Elmhurst-Chicago Stone Co.,* 1989 WL 99129, at *3 (Del Ch. Aug. 17, 1989).

[178] *North Fork Bancorpation., Inc. v. Toal,* 825 A.2d 860 (Del. Ch.2000), *aff'd, Dime Bancorporation, Inc. v. North Fork Bancorporation, Inc.,* 781 A.2d 693 (Del.2001) (TABLE).

So, effectively, the alteration to Rule 452[179] to make voting in uncontested elections non-discretionary will mean that not only will there be fewer brokers voting in the affirmative for management candidates in the numerator, but there will also be fewer votes tallied in the total denominator. This will result in fewer withhold votes required to achieve a majority withhold vote for withhold vote campaigns against directors of Delaware corporations. The specter of this double whammy effect was not mentioned in the NYSE report, and it is uncertain whether that phenomenon was brought to their attention.[180]

Moderating this analysis is the fact that Delaware law merely provides a default provision for determining voting outcomes.[181] Adopting a bylaw that simplifies the process of counting votes, and addresses the complications inherent in a majority voting situation, would greatly simplify the question. Perhaps, in the aftermath of Rule 452 and the Delaware Amendment, boards will have a reason to explore alternative arrangements.[182]

B. The Various Bylaw Strategies

1) The Pfizer Governance Policy[183]

Pfizer included within its governance principles (and not the charter or bylaws) a provision that, in any uncontested election in which a nominee receives a greater number of withhold votes than for votes that nominee must immediately offer their resignation to the board. Then, the Corporate Governance Committee, without participation of the director against whom the withhold vote campaign was instituted, will make a recommendation to the Board as to whether action is required. The Board is then required to act within 90 days of receipt of the recommendation. Most companies implementing the Pfizer approach have defined a successful withhold vote as a majority of shares voting, rather than outstanding.[184] A few, however, have used

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[179] See Section V B supra.

[180] *See* NYSE Report. The Report mentions that elimination of affirmative broker votes would have had a profound effect on the outcomes of majority withhold vote campaigns. However, it stands to reason that the calculation, if it omitted the double whammy effect of Berlin v. Emerald, significantly underestimated the consequences of the alteration to Exchange Rule 452.

[181] *Licht* at 3.

[182] And Institutional Investors and other activists will also have an incentive to monitor those arrangements, or propose their own alternatives.

[183] Also known as the Intel strategy, as Intel was the first to adopt it.

[184] See, e.g., Intel Corporation Bylaw Article III Section 1 available at http://www.intel.com/intel/finance/docs/bylaws.pdf.

the more onerous "majority of shares outstanding" approach. Over 100 companies have adopted the Pfizer Governance Policy approach.

This approach has been uniquely unpopular with institutional investors, and would be unlikely to convince many of them against supporting an alternative majority voting bylaw.[185] However, it seems that instituting such a policy is helpful in preventing the efficacy of a campaign to install alternative bylaws. One relevant question would be how Delaware case law would treat a decision to reject a director's nomination under a modified plurality Pfizer Plan. Most business decisions receive business judgment review, but where a board acts for the sole or primary purpose of perpetuating its own control, this improper motive overrides the ordinary protection of the business judgment rule.[186] If the board's rejection is perceived to be for such an entrenchment purpose, and no other reason, it may be subject to enhanced scrutiny.

2) The GE Bylaw

GE requires that any director nominee that receives more withhold votes than affirmative votes in an uncontested election immediately tender their resignation.[187] A process is established for the board to then consider that resignation, in similar fashion to the Pfizer Policy. The difference is that the language of the bylaw clearly outlines that "Absent a compelling reason for the director to remain on the Board, the Board shall accept the resignation".[188]

3) The Bebchuk Bylaw

Professor Bebchuk's proposal, contained in General Dynamics 2006 proxy statement, is a bylaw providing that a director candidate be ineligible to stand for election if he or she received more withheld votes than for votes in an immediately preceding uncontested election.[189] Though it failed to pass, it received a 37.9% favorable vote.[190]

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[185] Indeed, ISS has openly stated that it will push for recommend voting for an alternative bylaw in the event that a company has adopted the Pfizer Policy approach.

[186] *See Unocal Corp. v. Mesa Petroleum Co.,* Del.Supr., 493 A.2d 946 (1985); *Aronson v. Lewis,* Del.Supr., 473 A.2d 805 (1984).

[187] Article II C. Bylaws of the General Electric Company, available at http://www.ge.com/en/citizenship/governance/bylaws/index.htm.

[188] Id.

[189] Company proxy Statement of General Dynamics. Page 38. Available on EDGAR at http://www.sec.gov/Archives/edgar/data/40533/000119312506069331/ddef14a.htm#tx18358_15

[190] Wachtell Lipton white paper majority voting at A-2.

Interestingly, General Dynamics inserted an announcement of its just adopted Pfizer Policy just below the section of its Proxy Statement recommending a no vote on the Bebchuk bylaw.[191]

C. The sobering effect of the holdover rule, the staggered board, and board replacement or resignation rejection.

The holdover rule dams the tide of horrible outcomes put forward by the traditionalist apologists. Delaware Corporate law provides that "Each director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal."[192] The significance of this provision depends on the type of majority provision in place. If the board or the shareholders have adopted a bylaw requiring the removal of a director that has failed to obtain a majority vote, then the effect of the holdover rule would be that a director who fails to obtain such a vote in an uncontested election may stay on as a director until a new director can be found by the board. If, as in the GE bylaw, automatic resignation is required, then the holdover rule is inapplicable. In the case of a Pfizer policy, the holdover rule will be unnecessary as the Board can conceivably decide not to remove the director. The Bebchuk Bylaw realistically takes into account the effect of the holdover rule by only requiring a director targeted by a successful withhold vote to stand down from running in the next successive election.

Should Delaware at least allow the shareholders to amend the bylaws to immediately require removal of holdover directors, in order for 15 to apply? Some provisions in the DGCL are merely defaults that bylaws can alter at will, some are mandatory.[193] The distinction between them is subject to a multi-factor test.[194] The equal dignities rule may, nonetheless, allow a bylaw to conflict with other provisions.[195]

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[191] See General Dynamics Proxy Statement, *supra,* at 39.

[192] 8 Del C 141(b).

[193] *Frantz Mfg. Co. v. EAC Industries*, 501 A.2d 401, *407 (Del.,1985) ("The bylaws of a corporation are presumed to be valid, and the courts will construe the bylaws in a manner consistent with the law rather than strike down the bylaws... A bylaw that is inconsistent with any statute or rule of common law, however, is void; *see Kerbs v. California Eastern Airways, Inc.,* Del.Supr., 90 A.2d 652, 659 (1952), and bylaws must be reasonable in their application. *Schnell v. Chris-Craft Industries, Inc.,* Del.Supr., 285 A.2d 437 (1971); *State v. Jessup & Moore Paper Co.,* Del.Supr., 77 A. 16 (1910).")(some citations omitted).

[194] *Jones Apparel Group, Inc. v. Maxwell Shoe Co*., 883 A.2d 837 (Del. Ch. 2004).

[195] Under the so called equal dignities doctrine, "the general theory of the Delaware General Corporation Law is that action taken under one section of that law is not legally dependent, and its validity is not dependent upon, nor to be tested by the requirements of other unrelated sections under which the same result might be obtained by different means." *Orzek v. Englehart* 195 A.2d 375 (Del. 1963). This has been

Furthermore, a bylaw which interferes with what is understood to be the traditional province of the Board will be struck down.[196] The next question is whether to make a bylaw altering the holdover rule, once approved by the shareholders, unalterable by the Board without shareholder approval.[197] Presently it is unclear whether bylaw provisions which purport to prohibit the board from altering or amending them are effective.[198] A board may be constrained in its ability to unilaterally remove bylaws adopted by shareholders by

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applied to bylaw amendments in *Chesapeake Corp. v. Shore* 2000 Del. Ch. LEXIS 20 (Del. Ch. Feb. 7, 2000).

[196] Coffee explores four dimensions that seem to indicate whether a bylaw restricting the power of the board might be upheld. *Se*e John Coffee, *The Bylaw Battlefield: Can Institutions Change the outcome of Corporate Control Contests?*. *Coffee*, 51 U. MIAMI L. REV. 605 (1997). Those are i)Ordinary vs. Fundamental-courts are more likely to allow bylaws that affect fundamental changes to the corporation, but not day to day business decisions ii)Orders vs. Constraints-courts prefer shareholder restrain boards from certain actions by requiring shareholder approval than mandating that they take specified actions. iii)Procedure vs. Substance. Bylaws necessarily codify and express the corporation's "housekeeping" and procedural rules, but rarely address specific substantive decisions iv)Corporate Governance vs. Business Decisions- bylaws are most viable where they generally re-allocate authority between shareholders and boards than when they affect specific instances of that authority.

[197] Thought unclear, directors may have the authority to unilaterally eliminate bylaws not otherwise protected by the DGCL. *See General DataComm Industries, Inc. v. State of Wisconsin Investment Board,* 731 A.2d 818 (Del. Ch. 1999) (noting, in the context of a motion for expedited proceedings, that "the question of whether a stockholder-approved bylaw can be repealed by a board of directors with such authority has not clearly been answered by a Delaware Court. However, the Supreme Court's decision in *Centaur Partners* and the views of a learned commentator (Hamermesh) suggest that the affirmative answer may be the correct one."). *See American Int'l Rent a Car, Inc. v. Cross*, 1984 Del. Ch. LEXIS 413 (Del. Ch. 1984) (Berger, V.C.) ("If a majority of American International's stockholders in fact disapproved of the Board's amendment of the bylaw, several recourses were, and continue to be, available to them. They could vote the incumbent directors out of office. *Alternatively, they could cause a special meeting of the stockholders to be held for the purpose of amending the bylaws and, as part of the amendment, they could remove from the Board the power to further amend the provision in question.*") (emphasis added).

[198] Coates and Faris consider the issue in some depth. John Coates and Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post Quickturn Alternatives* 56 BUS. LAW. 1323, at n. 200 (2001). In their view, the "best response is that Section 109(a) of DGCL reserves to the shareholders the residual authority to adopt, amend, and repeal bylaws. If the shareholders' residual authority under Section 109(a) is to mean anything, the argument would go, it must mean that the shareholders may adopt a bylaw that is beyond board repeal." However, they also argue that courts would likely find a non-repeal provision illegal, despite this argument. Nonetheless, they believe that a similar restriction on repeal, such as a unanimous vote provision, would be evaluated in the same way as any other limiting provision, and thus could be upheld. They s also note possible ways to uphold a no-repeal provision, either by arguing that the repeal of the bylaw is a violation of fiduciary duty, or that it is a *Blasius* like disenfranchisement of the shareholders. *Cf.* Larry Hamermesh, *Corporate Democracy and Stockholder-Adopted By-laws: Taking Back the Street?* 73 TUL. L. REV. 409 (1998).

fiduciary duty obligations,[199] but fortifying holdover alterations into the DGCL, like the concrete provision for majority voting, would ensure that boards would not meddle with it. An alternative approach would be to require a replacement be found within a certain time frame, as the MBCA offers.

Or, if you like sneaky lawyer tricks, how about simply trying the following: if the shareholders were to adopt, in the same bylaw that specifies the number of votes required for election, a provision that "In the event that a director standing for an uncontested election fails to obtain a majority of the votes cast in their favor, a written consent from shareholders constituting 20% of the total shares voting in that election shall be sufficient to require that director's immediate removal" or something similar. The iterations are limitless; the point though, is that arguably the holdover rule repeal would be contained in a bylaw already entrenched by the new majority voting amendment requiring that "A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors."[200] It doesn't say that the bylaw amendment cannot include provisions beyond the votes necessary provision, and it would literally read that the entire bylaw would be unalterable.

By way of complicating this question even further, if a director receives a majority withhold vote, and remains protected by the holdover rule, there is no way to replace that director in the interim between the next election if he/she is unwilling to go. The other directors have no authority to remove a director.[201] Another relevant question will be: Who gets to replace a removed director? The default is that a director may be replaced by a vote of a majority of the other directors, but the firms' charter will control the question.[202] If the Board has the authority to do so, then it may mute the effect of a successful withhold vote. For instance, a removed Chairman could simply have the Board appoint a director amenable to their aims if the target Board were truly dysfunctional.

Some would argue that the presence of a staggered board would also make majority voting less effective. As of 2005, 53% of the top 5,000

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[199] *Hollinger Int'l Inc. v. Black*, 844 A.2d 1022, 1078 (Del. Ch. 2004), aff'd, 872 A.2d 559 (2005).

[200] 8 Del.C. § 216

[201] Rodman Ward, Edward P. Welch & Andrew S. Turezyn, Folk on the Delaware General Corporation Law, § 141.5.4 at GCL-4-161; See *also Bruch v. National Guarantee Credit Corp.*, 116 A. 738 (Del Ch. 1922).

[202] 8 Del. C. § 223(d)

U.S. Corporations by size had classified boards, meaning that the directors are divided into groups of three and run in staggered years.[203] The practical effect of this practice is that it would take two successive elections to replace a majority of the board, thus serving as a means to entrench the present management. The presence of a staggered board also minimizes the effectiveness of a withhold vote campaign, as it will mean that at most a third of the board could be removed at a time under either a majority voting bylaw or a resignation policy. Indeed, ISS is concerned that a negative drawback to the majority voting movement will be a diminished willingness on the part of firms to declassify their boards.[204] If the aim of majority voting is to replace the whole board, then staggering is an issue. However, the flip is that the presence of staggered boards may lessen board resistance to majority voting bylaws.

E. *The Strategy of the Stalking Horse Candidate*[205]

An idea heretofore unexplored in the literature, that would presumably be effective to halt completely the operation of a bylaw requiring majority voting in uncontested elections, would be to artificially create a contested election in advance of a threatened vote. Management could enlist a dummy candidate to add to the corporate ballot to make the number of nominees for the election exceed the number of seats up for election. The existence of such a strategy would mean that shareholder advocates would need to ensure an advance resignation policy were in place in order to outflank a stalking horse maneuver.

VII. An Analysis of Voting Outcomes Using an Analogy to Political Science

The debate between plurality and majority voting schemes was originally sired in the context of political representation. Analysis in that sphere typically revolves around four distinct criterion.[206] The first factor is decisiveness, or the existence of a clear outcome at the final

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[203] ISS Report, *supra,* at 15.

[204] *Id*.

[205] The term stalking horse originally derived from hunting wildfowl. Sportsmen observed that birds flee on the approach of humans, but tolerate the presence of other animals, such as horses. Hunters would approach their quarry by walking alongside their horses, keeping their upper bodies out of sight until the flock was within range. Animals trained for this purpose are called stalking horses.

[206] Miller, Nicholas R. Voting. From Eatwell, John, Murray Milgate, and Peter Newman, eds., The New Plagrave: a Dictionary of Economics, Vol. 4, London, Macmillan, 1988: Pages 826-830. Citing May, K. (1952) A set of independent necessary and sufficient conditions for simple majority rule, *Econometrica*, January.

round of voting.[207] The second is anonymity of voters, meaning that we do not need to know who cast which votes to determine the outcome.[208] Neutrality is a third criterion, the voting result should be such that if everyone voted in the opposite fashion, then the other alternative would win (a criterion which becomes particularly cogent in the event that multiple alternatives are put forward, and the number of alternatives presented is greater by two or more than the number of selections permitted).[209] The fourth is positive responsiveness; if alternative A is at least tied with B, and someone then changes their vote to make it more favorable to A(by either voting for A instead of abstaining, or by abstaining instead of voting for B) then A wins.[210]

In analyzing these four criterion in the corporate context, it would seem the anonymity criterion is least important.[211] Shareholder votes are a matter of corporate record, and the large institutional shareholders that will have the most say in withhold vote campaigns typically are very vocal about their interest.[212] Decisiveness would be especially important to the board of directors, an inability to elect directors would stifle the board's ability to act. Shareholders would share that interest, unless one accepts the use of brinksmanship in reform negotiations (see analysis concerning a "first strike capability" for institutional shareholders above). I would also add cost as a fifth criterion to analyze voting schemes for corporate elections; with fixed corporate resources and the voters sharing the cost of incumbent management's proxy solicitations (though not the cost of the challenger, unless they are victorious), shareholder voters would benefit from a cost efficient voting method.

Majority voting is the optimal method for a choice between two outcomes.[213] However, when the alternatives extend beyond a single binary choice, the analysis becomes increasingly complex. Some form of plurality voting must be utilized in order to achieve the decisiveness criterion, but the ordering of alternatives, the ordering of rounds of voting, and the inclusion of non-viable alternatives can all be used to game the outcome in favor of an alternative which may not be

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[207] *Id* at 827.

[208] *Id.*

[209] *Id.*

[210] *Id.*

[211] Indeed, some would argue that hidden voting is dangerous. See note 116, *supra*, *citing* Hu and Black.

[212] *See, e.g.*, the Disney withhold vote campaign.

[213] See Miller, *supra,* at 827.

preferred, and in fact might otherwise be rejected, by a majority of the voters.[214] This outcome violates the positive responsiveness criterion.

Majority voting for uncontested elections of directors, as the bylaws adopted in response the majority voting movement provide, would enhance the ability of corporate plurality elections to achieve the four criterion *ex post* (and perhaps years later) by giving voters an opportunity to eliminate directors for which a majority of the electorate would express a clear preference against. In effect, the ability of a majority of shareholders to express a "withhold" or no vote against an incumbent director would allow the voters to mop up the results that spring from a weakness in the plurality voting scheme by eliminating directors elected only because of a lack of alternatives or because of a gamed process in the subsequent round of voting.

The solution that political systems in the United States have discovered for the purposes of state wide elections is a compromise between plurality and majority voting: the runoff election, with a plurality election followed by a majority election for the top two vote recipients.[215] In that system, decisiveness is achieved, as you eliminate the instance of a single candidate failing to win a majority in a race between three or more. You also minimize gamesmanship and the attendant risk to the neutrality criterion, as the winner of the runoff must be ultimately selected by a majority of the electorate.

Runoff elections may be a useful addition to tools of the shareholder democracy movement. The most significant roadblock to any reform of the corporate election process is the additional cost of the replacement system.[216] However, the SEC's current rule change to allow proxy solicitation via mere postcard notice, combined with internet access to the full proxy, should reduce the cost of contested elections for both corporations and challengers.[217] Furthermore, putting a runoff bylaw to a shareholder vote would allow shareholders to decide if the added cost

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[214] For the seminal work on why voting systems are incapable of meeting all necessary criterion at once, *See* Arrow, Kenneth. "A Difficulty in the Concept of Social Welfare", The Journal of Political Economy, Volume 58, Issue 4 (August, 1950), pp. 328–346.

[215] Also of interest are the various systems of tournament elimination used in sports playoffs, not analyzed in this context in light of the excessive cost they would require for corporate elections.

[216]Opponents of any change in corporate elections would doubtless add a sixth criterion involving fiduciary duty; that the voting scheme cannot result in election of a director that would put his own interest before that of the corporation and its fellow shareholders. I do not include such a criterion for two reasons: such risk is not intimately related to the form of election, and is also more properly addressed in the fiduciary duty strictures of shareholder derivative suits.

[217] http://www.sec.gov/news/press/2006/2006-209.htm

of a runoff election for directors is worth their while. Besides, it is supposedly a rare occurrence anyway. I do not mean to suggest that runoffs are appropriate for every company, or that this analysis is exhaustive. However, runoffs in the context of contested corporate elections is a concept that has thus far been wrongfully left off the table of alternatives discussed in the shareholder democracy debate.

Some would argue that a comparison to democratic regimes is inappropriate, as voting in the corporate context, governed as it is by freedom of contract and transferability of rights, is simply too different for rational comparison to other systems.[218] However, I would note that companies have used comparison to the plurality standard to justify plurality voting.[219]

VIII. Conclusion and Predictions

Supporters of the majority voting amendment include a unique cast; including SEC Chairman Cox, Ira Milstein,[220] a number of Unions, CalPERs, Professors Grundfest and Bebchuk, and former Delaware Chief Justice Norm Veasey.[221] However, the purple haze surrounding the multi-layered reforms, recently initiated at the federal level and the exchanges, that have affected or will affect the efficacy of withhold vote campaigns, combined with the proximity of this change to the still recent wave of reform flowing form Sarbanes Oxley and its regulatory cousins, calls for a cooling off period before we stretch the analogy of corporate democracy too far. The working parts of corporate and securities law will interact in ways that are as yet incompletely understood in the context of withhold votes, so perhaps we should merely keep a keen eye on the golden goose for awhile and give the regulatory engines a rest. In that vein, rather than advocate for a particular alternative proposal related to the shareholder democracy movement, or for a rollback of the reforms already instituted, or even attempt to justify the reform movement, the conclusion of this examination will be simply a few predictions about developments that can be reasonably expected in the near term.

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[218] *See* Editorial, "The Corporate Democracy Oxymoron" Wall Street Journal, Professor Henry Manne, January 2, 2007.

[219] See General Dynamics Proxy Statement, *supra,* at 39 "This proposal would require that director nominees receive the support of a majority of votes cast to be elected. For a number of compelling reasons, plurality voting is the prevailing standard for the election of federal, state and local officials as well as for directors in U.S. public companies. Our Company elects its directors by a plurality standard for the same reasons that democracies use plurality standards."

[220] See ISS Report, *supra.*

[221] *Id.*

1) *It is likely that the next move is for institutional investors to rally for an amendment to the DGCL to permit shareholders to adopt a bylaw altering the holdover rule, and making such a rule, once adopted, similarly unalterable by the board absent shareholder ratification.*

2) *Expect hedge funds to take an active role in withhold vote campaigns for firms that have adopted such a policy, but not to take an active role in fighting to get a strong majority voting amendment into the bylaws as that would make board seats won in proxy contest victories more difficult to keep.*

3) *Expect litigation in federal courts over whether firms can exclude from the corporate ballot under 14a8 shareholder proposals for majority voting where a quasi-majority voting rule has already been adopted.*

4) *Expect attempts to institute holdover rule bylaws that result in challenges in federal courts, or seek declaratory judgments from Delaware Chancery Court.*[222]

5) *Expect a withhold vote campaign, in the event that one occurs in the future in which the vote is close, to erupt into litigation over whether shares are properly counted at "able to vote" for purposes of establishing a majority.*[223]

6) *Expect litigation over a board's response to any successful withhold vote campaigns, especially if its policy or ratified bylaw doesn't provide with specificity a board's response to a withhold vote campaign.*[224]

7) *In the event that the shareholder access rule is revisited and is a strong as before, look for management to institute or threaten withhold vote campaigns against insurgency directors.*[225]

8) *Expect that these victories by the shareholder democracy movement will add fuel to management decisions to sell out to private equity buyers that do not present the difficulties of accountability to disparate financial intermediaries*.[226]

9) *Expect that, as institutional investors gain negotiating leverage through victories in the shareholder democracy movement, activist hedge funds will*

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[222] *See Bebchuk v. CA*, Inc., 2006 WL 1805545 (Del. Ch. June 22, 2006). Though Bebchuk's move for a declaratory judgment declaring his bylaw proposal legal in Delaware Chancery Court was dismissed for lack of ripeness, this doesn't mean that such challenges will not be likely once such bylaws are approved.

[223] *See* Section VI A, *supra*, Mechanical Issues in Tallying the Voting Outcome.

[224] Made more difficult by the rule in 14a-8 that a shareholder proposal to the corporate proxy cannot exceed 500 words.

[225] See SectionV , *supra.*

[226] Article, Front page of the New York Times, January 8, 2007.

make use of that leverage as well and their activity in that space will increase as they are able to acquire access to more capital.

10) *Expect that, as financial intermediaries power is linked to flow of capital into their coffers, future recessions and major shifts in Federal Reserve policy will have an effect on activist investor activity.*[227]

[227] In other words, rattling the saber loses its effectiveness when your opponent knows you can't afford to pay for the war.