Too Busy to Think, Spread Too Thin to Matter:
Making a Rational Stockholder Voting System an Agenda Item for Management/Investor Dialogue

Lawrence A. Hamermesh
Ruby R. Vale Professor of Corporate and Business Law
Widener University School of Law, Wilmington, Delaware

Keynote Speech to the PLI Ninth Annual Directors' Institute on Corporate Governance
September 7, 2011
New York, New York

When Alan Beller invited me to speak here, I could only imagine that he must have been hoping that I would deliver a compelling narrative about the cultural shock of joining the SEC staff after 33 years of life as a member of the Delaware corporate bar. If that's so, I'm sorry to report, Alan, that the narrative would be pretty boring. Far from encountering federal bureaucrats rabid with desire to regulate, and bent on laying waste to the fields of state corporate law, I found that my fellow staff members in Corp Fin were as sensible and practical as any of my Delaware colleagues, and were sensitive to and downright respectful of the role of state law. If there was any motivating value that characterized the work of the staff, it was the goal of achieving workability.

I was not unaffected, however, by my own experience on the staff. Especially in reading comments on various rule proposals and on the proxy mechanics concept release from last year, I came to see how people on all sides of the corporate governance discussion – including me – sometimes get captured by their own rhetoric, and thus fail to persuade. No single commentator was invariably persuasive; no single commentator was invariably vapid and idiotic; every commentator had at least some piece of the truth.

Nevertheless, after reading all those comments, and after having some wonderfully rich informal discussions with my colleagues on the staff, I've arrived at some views about corporate governance, and about stockholder voting in particular. And those views articulate certain recommendations that are so radically unachievable that even a law professor should be reluctant to espouse them.

That impracticability is unfortunate, especially in a program billed as "an in-depth and practical examination of today's corporate governance challenges." But there is, I believe, no better time than now to express these views, however impractical and unconventional they may be. Because as I see it, this is a time of extraordinary ferment in the field of corporate governance, more so than any time I've seen in the last three decades. As exemplified by today's program, people involved the field are asking bigger, bolder, and better questions about corporate governance than ever before. And that's a good thing. Huge enterprises with many stakeholders play a vital role in our economy and our government, and it's increasingly important to ask who should contribute to the process by which their actions are determined – that is, who should participate in corporate governance, and how?

There are those who say the board of directors is an ineffectual anachronism, and that governance can be, and, practically speaking, is, conducted by officers and investors.[1] But if the board of directors legally remains the corporation's central governing authority, what human beings should populate it? What do we realistically expect them to do? What qualifications, attributes or incentives will best assure that they do what we expect them to do? Do we want to encourage even more independence and an even more aggressively adversarial monitoring function for the board? Or is independence from management an overrated virtue?

There has been similar fundamental reexamination of the role of those who supply equity capital, i.e. stockholders. When we talk about stockholders, to whom are we really referring? Are they the human beings whose retirement funds and insurance premiums are the source of capital, or are they the human beings responsible for managing the investment of such capital? Do they include persons whose equity investments are partly or fully hedged? Do they include

[1] Kelli A. Alces, Beyond the Board of Directors, _ Wake For. L. Rev. _ (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1893207 (July 23, 2011).

persons whose equity securities have been loaned (which really means sold, with a right to call)? On what matters should stockholders, whoever they are, vote? If votes are not prescriptive as a formal legal matter, in what ways should such votes inform managers (that is, how are stockholder advisory votes supposed to "advise")? What is it about stockholders that makes them appropriate parties to vote on or otherwise influence matters of corporate governance? Whatever that is, is voting, rather than some other forms of engagement, the best way to extract the value of stockholders' perspectives?

Into this muddle of musing about basic precepts of corporate governance, I would like to put forward for your consideration a proposition about the role of stockholder voting. To introduce that proposition, I would like to examine, or reexamine, a statement by former Chancellor William T. Allen, a jurist whose intellect I have always held in the highest regard. This is a statement with which most or all of you are quite familiar, from the Chancellor's 1988 opinion in Blasius Corp. v. Atlas Industries, Inc.[2] In that opinion, he invalidated action by a board of directors that had the effect of heading off an imminent prospect that control of the board would shift to a dissident stockholder who was proposing a leveraged recapitalization of the company. Even agreeing that this business proposal was probably a bad idea, Chancellor Allen held that the directors, even when acting in good faith, could not preempt the stockholders from electing a board majority that seemed bent on pursuing that recapitalization proposal.

In a justly famous characterization of the importance of the stockholder franchise, Chancellor Allen stated:

> The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. … [W]hether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.

[2] 564 A.2d 651 (Del. Ch. 1988).

With the benefit of 23 years of hindsight, and even so, with considerable hesitation, I suggest that the Chancellor's characterization, rhetorically stirring as it was, may have led many to oversimplify and overstate the importance of the stockholder vote. And I would go so far as to suggest that it is in the mutual interest of both managers and investors that we avoid being seduced by such powerful rhetoric – that we abandon slavish and reflexive adherence to conventional understandings of stockholder democracy, and that we collectively and more realistically consider how and when stockholder views – including but by no means limited to stockholder votes – can be used to advance shared goals of wealth creation and good corporate citizenship.

This is not a task that can be taken on in a spirit of mutual distrust. If investor representatives take the view that managers are in general a selfish, rent-seeking lot that need stern and pervasive supervision by the investor representatives themselves, we will never make any useful progress. And if managers take the view that investor representatives are also self-aggrandizers with no useful skills or knowledge to contribute to good corporate governance, we will never get anywhere.

I claim, however, that managers and investors have a joint interest in promoting the adoption of ways in which their respective comparative advantages can best be harnessed. In particular, I think that the ways and means by which stockholder voting occurs today can be improved, by rethinking stockholder meetings altogether.

Let me first return to Chancellor Allen's characterization. He posited that the stockholder vote is critical to the legitimacy of managerial power over corporate affairs. I suggest, however, that the legitimacy of managerial power is in a sorry state if it depends on a meaningfully active stockholder franchise. Even in his own statement, the Chancellor acknowledges that stockholder voting may be little more than an empty formalism. At the very least, stockholder voting is anything but an important tool of managerial discipline.

How could it be so, when voting occurs so often on so many things? For example, according to a comment letter from one public pension fund, in 2009 alone it was called upon to vote on 8,154 proposals at 2,738 stockholder meetings.[3] Another public official reports responsibility for voting on over 16,000 ballot items at over 2,000 stockholder meetings, again in just one year.[4] Even in national politics, in which the vote probably has a lot more salience to citizens than a routine vote at one of dozens of portfolio companies has to an investor, elections of the President occur only once every four years, and the members of the Senate – the oldest staggered board in America – serve six-year terms. Do institutional investors, acting as responsible stewards for the wealth of their beneficiaries, really relish voting on so much, so often?

How could the stockholder vote be an important tool of managerial discipline, when elections of directors are almost invariably uncontested? I do know of one recent article suggesting that even the latent potential for a proxy contest serves as a disciplinary tool,[5] and that the remarkably low incidence of proxy contests is not inconsistent with their serving a disciplinary function. But if latency works, can't we dispense with the burdens of holding thousands of uncontested elections every year, as long as a meaningfully latent possibility of a contest can be preserved?

How could the stockholder vote be an important tool of managerial discipline, when retail investors, who are under no legal compulsion to vote, overwhelmingly choose not to vote? I'm all in favor of making voting as easy and cheap as possible, but it's hard to ignore the verdict rendered by the unregulated behavior of retail investors. The key word in the concept of rational apathy is "rational."

How could the stockholder vote be an important tool of managerial discipline, when the costs of running a contest to elect new directors are enormous, and one side has access to the corporate treasury and the other does not? I'm not necessarily complaining about that disadvantage, especially when

---

[3] October 20, 2010 letter from Colorado Public Employees Retirement Association, *available at* http://www.sec.gov/comments/s7-14-10/s71410-192.pdf.

[4] October 19, 2010 letter from Denise Nappier, State Treasurer, State of Connecticut, *available at* http://www.sec.gov/comments/s7-14-10/s71410-124.pdf.

[5] Vyacheslav Fos, The Disciplinary Effects of Proxy Contests (June 2011), *available at* http://www.columbia.edu/~vf2158/index_files/The_Disciplinary_Effects_of_Proxy_Contests.pdf.

elections occur annually, but I suggest that it's important not to overstate the utility of stockholder voting as a viable disciplinary tool, when it's so terribly expensive and the rewards are so uncertain.

Quite simply, it is my view that stockholder meetings and votes occur unnecessarily often and crowd out more useful stockholder input. That input ought to be about much more than formal voting. So I cast about to find the culprit behind this unfortunate state of affairs. I originally thought that proxy advisory firms were the villain – that they were promoting their own profits by promoting overly frequent voting. To some extent, that may be true – witness the proxy advisors' unfailing (and undeniably self-serving) support for an annual say on pay vote, rather than a less frequent exercise. But on further reflection, I concluded that proxy advisory firms, which are hardly wildly profitable, are simply serving the need of institutional investors for help with a task of often overwhelming proportions. If proxy advisors didn't exist, it would be necessary to invent them.

So the next villain I turned to was the set of legal pronouncements that essentially force institutional investors to vote, on everything. Starting with the Department of Labor's Avon letter and continuing through the Commission's own pronouncements about the voting responsibilities of investment companies and their advisors, we see a set of voting mandates that make it difficult or impossible for law-abiding institutional investors to be selective and economically rational in determining what matters to vote on. But at the same time, I don't expect that the pertinent federal agencies will, or even should, relax those mandates.

So I finally turned to another villain, and discovered, in a Walt Kelly moment, that we had met the enemy and it is us. Specifically, it dawned on me that if anything is ultimately responsible for bringing about overly frequent stockholder voting, it's the basic state corporate statutes that inexorably compel the holding of annual meetings to elect directors.

So I thought – and put forward for your consideration, or maybe just amusement – the possibility that, somehow, the world of the annual stockholder vote to elect directors could give way to some other system in which stockholder input and control can be more usefully deployed. In other words, could we live without an annual meeting?

Why not? The ability to have stockholder meetings less than annually is already a legislative reality in at least a couple states. The corporate statutes in both Minnesota and North Dakota[6] permit corporations to dispense with stockholder meetings altogether, or to hold them less than annually, subject to the right of a minimum percentage of stockholders to require that a meeting be convened. On the other hand, an annual meeting of stockholders remains one of the few mandatory features of Delaware corporate law, and annual meetings for public companies also appear to be mandated under a variety of federal laws and stock exchange rules.

But on a clean slate, should that be the case? Is voting better the more frequently it occurs and the more matters are voted on? That is certainly not the lesson from California and other states in which referenda and ballot initiatives have become in many instances largely dysfunctional exercises.

Don't get me wrong: I do believe in accountability of corporate directors through the voting mechanism. As Delaware law has developed, and with the acceptance of the shareholder rights plan or "poison pill," the stockholders' right to elect and remove directors is the tool of last and maybe even first resort for any serious takeover bidder.

So I am not an advocate for a self-perpetuating public company board of directors that is accountable only to the share markets and the Wall Street Rule – although those market forces deserve a great deal of respect in any responsible study of corporate governance. But those who manage other people's money through institutional investment vehicles should ask themselves – and we should listen to and probe their answers – whether it is importantly useful to their own beneficiaries to vote every year in every company on uncontested elections of directors. Is it importantly beneficial to the pension plan participants who provide capital to have their representatives vote every year in every company on every

[6] Minn. Stat. Ann. §302A.431 (West); N.D. Cent. Code §10-19.1-71 (although public companies may opt into a separate legislative scheme in which annual stockholder meetings are required, N.D. Cen. Code §10-35-12).

precatory shareholder proposal presented under Rule 14a-8? Is it importantly beneficial for portfolio companies and their stockholders to incur the costs of convening meetings and soliciting proxies every year? Is it importantly beneficial for investment managers to pay for the services of one or more proxy advisory firms year in and year out, so that votes on these matters can, maybe, be better informed, or at least legally protected?

So here is my real question: why shouldn't all stockholder meetings be special? Is there a way for laws and regulations and listing standards to promote and facilitate stockholder voting when it matters, and when stockholders actually care about it for good, economic reasons, yet dispense with it when it's an empty but costly exercise?

I am hardly the first person to ask this question. Eight years ago my fellow Delawareans Chancellor William Chandler and now Chancellor Leo Strine posed the question with typical incisiveness:

> [O]ne can rightly ask why the current incumbent-biased corporate election process should be perpetuated. As of now, incumbent slates are able to spend their companies' money in an almost unlimited way in order to get themselves re-elected. As a practical matter, this renders the corporate election process an irrelevancy, unless a takeover proposal is on the table and a bidder is willing to fund an insurgent slate. The aberrational cases in which shareholder activists have actually mounted proxy contests tend to prove the incumbent bias of the system, rather than cast doubt on it.

They suggested that:

> A balance of the efficient deployment of corporate resources (*i.e.*, costs) against the utility of a genuinely open election process that generates increased accountability might be reflected in a biennial or triennial system of elections that require equal access to the proxy machinery between incumbents and insurgents with significant (*e.g.*, five or ten percent) nominating support.

Nothing much ever came of this balanced suggestion, as far as I know.

Likewise, and twelve years before Chancellors Chandler and Strine put forward their proposal about stockholder voting, Marty Lipton and Steve Rosenblum advanced a similar idea, proposing that director elections be held only every fifth year, but with more balanced access to the electoral machinery.

Not much has been done to advance this sort of approach, although the Minnesota and North Dakota statutes mentioned earlier try to achieve a balance by permitting the company to dispense with annual meetings, while giving 3% and 5% of the stockholders, respectively, the right to call a regular meeting of stockholders. Another possible framework is to require a stockholder vote on the election of directors once every three years, unless owners of more than, say, 3% of the voting power demand a meeting in the meantime. If shareholder representatives are correct in claiming that this sort of check and balance is too hard to invoke and is therefore ineffectual, many of them are wasting a lot of time promoting the adoption of bylaws that permit 10% of the stockholders to compel the convening of a special meeting.

There are multiple other ways, too, of reaching a more sensible balance. In a private ordering approach, the law could support any framework established by private agreement, at least one approved by both directors and stockholders. Indeed, such a framework could provide a mechanism to resolve the long-festering controversy over the role and form of proxy access. As an alternative, one could argue for some mandatory approach that would dispense with annual meetings but would substitute some enhanced stockholder right to ballot access and to convene stockholder meetings. Such a mandatory approach would, of course, necessarily be somewhat arbitrary – although with our current mandatory annual meeting framework and Rule 14a-8, we are already living in a world of arbitrary rules about stockholder voting.

Having put forward the idea of a mandatory alternative system, though, I recognize that a more sparing, sensible use of stockholder voting will not likely be imposed by law. I can predict with considerable confidence that the Delaware annual meeting statute – one of the few areas of Delaware corporate law in which private ordering appears to be off limits – will not be fundamentally changed without widespread support from both issuers and investor representatives. Nor do I expect that SEC rules and stock exchange listing standards that require or are built around the annual convening of stockholder meetings will change without such support. So as I said earlier, the kind of reshaping of the stockholder franchise, if it is to happen at all, has to emerge from constructive, mutually respectful engagement between managers and institutional investors.

This engagement will happen – a lot, given the SEC's action yesterday to let last year's amendments to Rule 14a-8 on proxy access proposals go into effect. But don't let wrangling over proxy access and majority voting obscure the big picture. The broader question of when and how stockholder input into corporate governance should proceed deserves a place in constructive dialogue between managers and investor representatives. I sense that somewhere out of that dialogue, there can emerge an approach that is a win-win outcome for mangers and investors, an approach in which investor input will be more concentrated and thoughtful, and therefore more valued and effective.