

# COMPETING FOR VOTES

KOBI KASTIEL<sup>†</sup> AND YARON NILI<sup>\*</sup>

*Shareholder voting matters. It can directly shape a corporation's governance, operational and social policies. But voting by shareholders serves another important function—it produces a marketplace for votes where management and dissidents compete for the votes of the shareholder base. The competition over shareholder votes generates ex ante incentives for management to perform better, to disclose information to shareholders in advance, and to engage with large institutional investors.*

*Traditional corporate law has looked to a variety of “market forces” as a means of curbing the agency costs of public corporations. Yet, for various reasons, these market forces are, at best, an incomplete answer to the agency costs associated with public corporations. This Article is the first to develop a theory of a new force that may have a better chance at curbing managerial entrenchment—the competition for votes. In a world where shareholder voting is becoming increasingly powerful, and where highly incentivized and sophisticated players, such as hedge funds, aggressively court the support of fellow shareholders, the importance of active competition for votes cannot be understated.*

*The Article empirically depicts the emergence of a vibrant competition for votes, outlines its major building blocks, and explains how to further facilitate its operation. The policy implications of our analysis are wide-ranging, casting new light on several hotly contested governance debates such as the legitimacy of dual-class shares, shareholder activism, the role of passive investors, and the role of proxy advisors.*

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<sup>†</sup>Assistant Professor of Law, Tel Aviv University, Fellow and Lecturer on Law, Harvard Law School Program on Corporate Governance.

<sup>\*</sup> Assistant Professor of Law, University of Wisconsin Law School. The Authors would like to thank Albert Choi, Cathy Hwang, Ed Rock, Eric Talley, and the participants of the Rethinking the Shareholder Franchise conference at the University of Wisconsin Law School. Will Conley, Rebecca Hart, Katie Gresham, Gabrielle Kiefer, Maya Ashkenazi, and Avner Shemla provided valuable research assistance. The Office of the Vice Chancellor for Research and Graduate Education at the University of Wisconsin–Madison provided support for this research with funding from the Wisconsin Alumni Research Foundation.

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## INTRODUCTION

One hundred forty-nine years after its incorporation, Campbell Soup Company came under attack in 2018. The battle, waged through websites, social media, videos, and direct mailings, was fought for shareholder votes. Earlier in 2018, activist investor Dan Loeb's hedge fund, Third Point LLC, demanded that Campbell Soup Company be sold to a strategic investor.<sup>1</sup> When the board refused a corporate sale, Third Point launched a proxy war to replace Campbell's entire board.<sup>2</sup> Third Point's stance was aggressive, even in hedge fund terms, including a website that outlined its "Case for Change," featuring the hashtag "#refreshtherecipe."<sup>3</sup>

<sup>1</sup> See Danielle Wiener-Bronner, *Feud over Campbell Soup's Future Could Break up the 149-year Old Soup Company*, CNN BUSINESS (Oct. 28, 2018), <https://www.cnn.com/2018/10/27/business/proxy-fight/index.html>.

<sup>2</sup> See *id.* Although the company initially offered to appoint two of Third Point's nominees to the board, the offer was rejected. See ActivistInsight, *Campbell's Soup Co. and Third Point Locked in for a Messy Proxy Contest*, VALUEWALK (Oct. 5, 2018), <https://www.valuewalk.com/2018/10/campbell-soup-co-third-point-proxy-contest/>; Scott Deveau, *Loeb, Campbell Take Steps to Cool Simmering Proxy Battle*, BLOOMBERG (Nov. 9, 2018), <https://www.bloomberg.com/news/articles/2018-11-09/third-point-scales-back-campbell-slate-to-five-directors>.

<sup>3</sup> Campbell Soup Co., Proxy Statement Pursuant to Section 14(a) of the Sec. Exch. Act (Form DFAN14A) (Nov. 7, 2018).

Importantly, however, Third Point controlled only 9.8% of shares, and management and directors controlled 37.1% of shares. Therefore, the ultimate determination depended upon the remaining 53.1% of the proxy votes held by outstanding shareholders, who, unsurprisingly, were being heavily courted by both sides. The incumbents needed to win only 9% of the remaining shareholders to keep control.<sup>4</sup>

This war for shareholder votes featured an intense information campaign by both sides.<sup>5</sup> Third Point's strategy included near-constant mailings to shareholders<sup>6</sup> and a website featuring videos, press releases, voting directions, and compilations of supportive industry comments.<sup>7</sup> In addition, the hedge fund filed a lawsuit claiming that Campbell's was misleading shareholders.<sup>8</sup> The hedge fund utilized a narrative characterizing the battle as one between "billionaire heirs and heiresses . . . attempting to intimidate smaller shareholders by flaunting their inherited voting bloc as an impenetrable moat."<sup>9</sup> In a major victory for the Third Point slate of nominees, the hedge fund secured the backing of leading proxy advisory firms ISS and Glass Lewis.<sup>10</sup> The battle, however, was resolved at the eleventh hour, with a settlement agreement to increase the board from twelve to fourteen members.<sup>11</sup>

Campbell's proxy war is just one recent example of the fierce competition that currently exists for shareholders' votes.<sup>12</sup> And Third Point and other

<sup>4</sup> If some shareholders did not vote, incumbents would need less than 9% of the votes. *Id.*

<sup>5</sup> See Stephen P. Percoco, *Thoughts & Observations on Campbell Soup's Upcoming Proxy Fight*, LARK RESEARCH (Oct. 12, 2018), <https://larkresearch.com/campbell-soups-upcoming-proxy-fight/>. Third Point's case for change includes the stock's poor relative performance over the last twenty years (and 45% decline since its peak of \$67.89 in July 2016). Third Point also stressed management's own confessions of the company having lost focus and a lack of CEO succession planning, excessive CEO compensation, decline in profitability, and "sell" ratings from Wall Street analysts. *See id.*

<sup>6</sup> Campbell Soup Co., *supra* note 3.

<sup>7</sup> *See id.*

<sup>8</sup> See Svea Herbst-Bayliss & Tom Hals, *Third Point Sues Campbell Soup, Accuses it of Misleading Investors*, REUTERS (Oct. 25, 2018), <https://www.reuters.com/article/campbell-soup-lawsuit-third-point/third-point-sues-campbell-soup-accuses-it-of-misleading-investors-idUSL2N1X51JJ> (detailing the lawsuit filed by Third Point).

<sup>9</sup> Scott Deveau, *Loeb Rebuffed by Family With 41% Stake in Campbell Soup*, BLOOMBERG LAW (Oct. 17, 2018), <https://news.bloomberglaw.com/corporate-law/loeb-rebuffed-by-family-with-41-stake-in-campbell-soup-1>. The family company has previously withheld from selling the company and has relied on "supportive, long-term shareholders," until the recent surge by activist investors following the company's strategic plan. *See Svea Herbst-Bayliss, Proxy Fight Looms as New Investors Ramp up Pressure on Campbell Soup*, REUTERS (Aug. 18, 2018), <https://www.reuters.com/article/us-campbell-soup-shareholders-focus/proxy-fight-looms-as-new-investors-ramp-up-pressure-on-campbell-soup-idUSKCN1LE0BW>.

<sup>10</sup> See Elissa Doyle, *Third Point Announces That ISS and Glass Lewis Strongly Recommend That Shareholders Vote for Independent Short Slate Nominees to Refresh the Recipe at Campbell*, THIRD POINT (Nov. 15, 2018), <https://www.businesswire.com/news/home/20181115005543/en/Point-Announces-ISS-Glass-Lewis-Strongly-Recommend>.

<sup>11</sup> See Danielle Wiener-Bronner, *The Battle is Over: Campbell Soup and Activist Investor Reach Agreement*, CNN BUSINESS (Nov. 26, 2018), <https://www.cnn.com/2018/11/26/business/campbell-soup-third-point-settlement/index.html>.

<sup>12</sup> *See, e.g.,* Scott Deveau & Phil Serafino, *Procter & Gamble Faces Board Seat Fight from Peltz's Trian*, INDUSTRYWEEK (Jul. 17, 2017), <https://www.industryweek.com/companies->

prominent hedge funds wage these types of battles with regularity.<sup>13</sup> To achieve their goals, activist investors must compete for votes in order to accomplish major change in industry behemoths, sometimes doing so with only a minor financial stake in the company. These anecdotes are indicative of a broader and more significant development: the creation of a vibrant competition for votes.

In addition to hedge funds like Third Point, an increasingly large number of capital market players—including activist investors, social actors, institutional investors, and individual shareholders—utilize the shareholder vote as a way to actuate change. Because these players are competing against company insiders for shareholders' votes as either a means to elect a desired slate of directors or to change corporate policies, harnessing shareholder support has become increasingly important.

In the past, shareholder voting was largely inconsequential,<sup>14</sup> and was even once maligned as “a vestige or ritual of little practical importance.”<sup>15</sup> This was because shareholders—if they even voted at all—typically paid little attention to corporate governance and often sided with management.<sup>16</sup> This is no longer the case. Various developments over the past two decades—such as the rise in activist investing, the shift from active to passive investment vehicles,<sup>17</sup> the increasing concentration of power of certain index funds,<sup>18</sup> and the use of e-proxies<sup>19</sup>—created a new, unwieldy dynamic to

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executives/procter-gamble-faces-board-seat-fight-peltzs-trian (detailing similar investments in Nestle, PepsiCo, Wendy's, and GE).

<sup>13</sup> See *infra* notes 70–81.

<sup>14</sup> Excluding very specific situations of conflicted transactions. See, e.g., Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 *BUS. LAW.* 43, 50 (2003) [hereinafter *Bebchuk, Case for Shareholder Access*]; Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 *VA. L. REV.* 675, 688–89 (2007) [hereinafter *Bebchuk, Myth of the Shareholder Franchise*]; Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 *BUS. LAW.* 329, 334 (2010); Melvin Eisenberg, *Access to the Corporate Proxy Machinery*, 83 *HARV. L. REV.* 1489, 1490 (1970); Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 *BERKELEY BUS. L.J.* 205, 208 (2005); William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 *CONN. L. REV.* 459, 493 (2007).

<sup>15</sup> *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

<sup>16</sup> See Paul H. Edelman et al., *Shareholder Voting in an Age of Intermediary Capitalism*, 87 *S. CAL. L. REV.* 1359, 1402 (2014) (citing *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988)) (outlining a history of shareholder voting, policy revisions, and market and regulatory responses to trends in shareholder voting, including recent increases). See also Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 *YALE L. J.* 223, 261 (1962) (“It is commonplace to observe that the modern shareholder . . . does not think of himself or act like an ‘owner.’ He hires his capital out to the [corporate] managers and they run it for him; how they do it is their business, not his, and he always votes ‘yes’ on the proxy.”).

<sup>17</sup> See Giovanni Stampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 *SAN DIEGO L. REV.* 804, 809–13 (2018); Timothy Strauts, *5 Charts on U.S. Fund Flows that Show the Shift to Passive Investing*, *MORNINGSTAR* (Mar. 12, 2018), <https://www.morningstar.com/2018/03/12/fund-flows-charts.html>.

<sup>18</sup> See John C. Coates, IV, *The Future of Corporate Governance Part I: The Problem of Twelve* 6–13 (Harvard Public Law, Working Paper No. 19-07, 2018); Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Frame-*

tame. Indeed, even Delaware courts recognized the renaissance of shareholder voting and recently expanded their reliance on voting, allowing shareholder votes to negate the need for enhanced judicial oversight.<sup>20</sup>

The Article offers a fresh take on the importance of institutional and retail investors' votes, beyond the sheer voting outcomes, and the impact of the emerging competition for votes on important contemporary governance debates. After first identifying the building blocks necessary to create a competition for votes, we then outline and develop the essential ingredients needed to ensure a vibrant marketplace for votes.

We support our theory with an empirical analysis of recent shareholder voting patterns. Using the SharkRepellent dataset for the years 2005 to 2017, we collect and analyze detailed data on shareholder voting outcomes, finding that shareholder votes often fluctuate and can sway unpredictably between advocates for such votes.<sup>21</sup> A comprehensive review of additional empirical studies further corroborates our results, demonstrating a significant variance among institutional investors' votes.<sup>22</sup> Even the most management-deferential investors occasionally vote against management.

The competition for votes yields fundamental advantages: it avoids costly and imperfect regulatory intervention,<sup>23</sup> it creates incentives to improve the overall information levels in the market, and it improves the ex ante incentives of both management and those shareholders who compete with management for votes. Simply put, a competition for votes provides management and counterparties with incentives to take preemptive actions that will bring about greater net benefits for the company and investors.

Our framework has important policy implications for a wide array of heated corporate governance debates. Consider, for example, the recent high-profile debate over the shift from active to passive management.<sup>24</sup> So far, a series of prominent scholars have mostly focused on whether or not the "Big Three" investment managers—BlackRock, Vanguard, and State Street Global Advisors<sup>25</sup>—have sufficient incentives to monitor company insiders,

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*work for Passive Investors* 20 (ECGI Law, Working Paper No. 414, 2018) ("Although the extent to which index funds will continue to grow remains unclear, some estimates predict that by 2024, they will hold over 50% of the market.").

<sup>19</sup> See Coates, *supra* note 18.

<sup>20</sup> See *infra* Part II.D.

<sup>21</sup> See *infra* Part III.A.

<sup>22</sup> See *infra* Part III.B.

<sup>23</sup> For well-known scholars' studies that advocate for a market-based approach and criticize regulatory intervention in corporate governance, see, for example, Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 123–25 (1987); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361 (1998).

<sup>24</sup> See *infra* Part IV.B.

<sup>25</sup> Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298 (2017) (finding that as of April 2017, the "Big Three" constituted the largest shareholder in 88% of the S&P 500 firms).

and whether they should even be allowed to vote.<sup>26</sup> However, questioning whether passive investors are willing (or not) to invest effort and resources in stewardship activities has limited importance from a competition for votes perspective. What truly matters is that institutional investors do not always side with management. The existence of robust competition over investors' pivotal votes provides managers with strong ex ante incentives to take actions that benefit public investors, in order to convince such investors to support them.<sup>27</sup>

The Article also examines other corporate governance reforms and initiatives, including recent objections to any limitation on the use of dual-class structures at the IPO stage,<sup>28</sup> reforms that aim to increase the barriers for submitting shareholder proposals,<sup>29</sup> recent proposals to regulate the activity of proxy advisors,<sup>30</sup> reforms aimed at increasing the participation of retail investors,<sup>31</sup> and the long-standing debate over vote buying.<sup>32</sup> In all of these cases, we analyze the proposed reforms and initiatives, as well as their potential implications, through the competition for votes framework, showing how such a framework enriches and modifies these corporate governance debates. Going forward, we argue, when investors or policymakers form their view on a given governance reform, they should consider whether the adopted governance arrangement would foster or stifle the competition for votes.

The rest of this Article is organized as follows. Part I sets the background to our discussion, presenting the traditional market forces aimed at curbing managerial opportunism and their shortcomings. It also highlights recent trends that led to the increased importance of shareholders' votes. Part II depicts the rise of a new force: the competition for votes. It also analyzes the normative allure of the competition for votes, its potential impact, and key factors that facilitate its activity. Part III presents the empirical evidence

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<sup>26</sup> See Fisch, Hamdani & Davidoff Solomon, *supra* note 18 at 39–40 (arguing that passive asset managers have direct financial incentives to vote intelligently); Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders 2* (NYU Law and Economics Research Paper Series, Working Paper No. 18-30, 2019) (arguing that index funds should be allowed to vote). Other scholars, led by Lucian Bebchuk and Scott Hirst, claim that index funds have poor incentives to engage in stewardship activities that could improve firm value. See Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy* 2043 (ECGI Law, Working Paper No. 433, 2018). Dorothy Shapiro Lund took this latter view to the extreme, proposing to prevent passive investors from voting altogether. See Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 101, 105 (2018).

<sup>27</sup> See *infra* Part IV.A. For a recent discussion of passive investors' pivotal role as well as management incentives to take ex ante measures that such shareholders favor, see Kahan & Rock, *supra* note 26, at 3–4; Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 983–992 (2019).

<sup>28</sup> See *infra* Part IV.A.

<sup>29</sup> See *infra* Part IV.E.

<sup>30</sup> See *infra* Part IV.F.

<sup>31</sup> See *infra* Part IV.C.

<sup>32</sup> See *infra* Part IV.D.

on the prevalence and importance of the competition for votes by analyzing trends in shareholder votes and recommendations of proxy advisors. Finally, Part IV presents key policy implications that our analysis has on a wide array of contemporary corporate governance debates and discusses a potential avenue for further fostering the competition for votes.

## I. THE SHAREHOLDER FRANCHISE AND CORPORATE GOVERNANCE

A majority of public corporations are widely held with no controlling shareholder.<sup>33</sup> Indeed, it is the ability to tap the public equity markets that allows companies to grow and prosper, yet the dispersed ownership structure of most U.S. publicly held corporations does not come without costs.<sup>34</sup> A core problem—if not *the* core problem—of the corporate form is the agency problem: that is, shareholders own the corporation, but they delegate day-to-day running of their corporation to hired managers.<sup>35</sup> Managers, due to their limited ownership stake in the corporation, do not fully realize the gains in equity as a result of their success; conversely, they also do not directly suffer the losses as a result of their mistakes to the extent that the remaining shareholders do.<sup>36</sup>

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<sup>33</sup> Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. OF FIN. 471, 471 (1999).

<sup>34</sup> ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (1932).

<sup>35</sup> See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983) (defining agency cost as the “costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests”); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. ASS’N 323, 323 (1986); Yaron Nili, *Missing the Forest for the Trees: A New Approach to Shareholder Activism*, 4 HARV. BUS. L. REV. 157, 162–165 (2014) [hereinafter Nili, *Missing the Forest for the Trees*]; Jeffrey Zwiebl, *Dynamic Capital Structure under Managerial Entrenchment*, 86 AM. ECON. REV. 1197, 1197 (1996); see also BERLE & MEANS, *supra* note 34, at 66, 78, 82.

<sup>36</sup> E.g., Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283 (1998).

State law,<sup>37</sup> shareholder activism,<sup>38</sup> and an enormous body of scholarly literature in law and many related fields have all risen in response to this problem.<sup>39</sup>

Corporate governance scholars and legal actors have raised key policies, which can be divided into two prominent approaches, in response to this inherent tension. One school of thought has suggested that existing market mechanisms may be sufficient to curb these agency concerns,<sup>40</sup> while a second school of thought has focused on the obstacles shareholders face,<sup>41</sup> advocating for reducing the barriers to shareholder involvement.<sup>42</sup>

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<sup>37</sup> State law fiduciary duties can reduce the agency problems. Managers of corporations are, by statute, required to disclose conflicts of interest, to eschew corporate opportunities, and to approach business decisions with due care. Stanley A. Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883, 887–888 (1975) (describing the primary duties of corporate managers in managing the affairs of a corporation). But corporations also pushed the boundaries on how much they could excuse their directors and officers from fiduciary duties. In particular, Delaware corporate law authorizes companies to waive director liability for breaches of duty of care. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2019). Delaware law also allows corporations to buy their directors and officers insurance against fiduciary duty suits. See DEL. CODE ANN. tit. 8, § 145(g) (2019).

<sup>38</sup> See, e.g., Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, in NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES 101 (Yasuyuki Fuchita & Robert E. Litan eds., 2007) (observing that activist hedge funds “have shaken up boardrooms and forced radical changes at many publicly-traded firms”). For a survey of the empirical literature on the disciplinary effect of shareholder activism, see Matthew Denes, Jonathan M. Karpoff & Victoria McWilliams, *Thirty Years of Shareholder Activism: A Survey of Empirical Research*, 44 J. CORP. FIN. 405–24 (2017).

<sup>39</sup> See Ronald L. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 231 (2008). Gilson and Whitehead refer to the seminal paper by Jensen and Meckling as the starting point of this ongoing academic debate. See Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure*, 3 J. FIN. ECON. 305 (1976).

<sup>40</sup> See *infra* notes 83–84 for a discussion on the Chicago School of Thought. For an opposing view regarding shareholder empowerment see, for example, LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC*, 63–73 (2012); Stephen M. Bainbridge, *Response, Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1744–51 (2006) [hereinafter Bainbridge, *Shareholder Disempowerment*]; William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 653–54, 657–59 (2010) (discussing problems created by increase in shareholder power and rise of short-term investors).

<sup>41</sup> Examples include: the proxy rules and reimbursement policies, the lack of binding power of shareholders resolutions, and costs related to nominating board candidates. See Bebchuk, *Myth of Shareholder Franchise*, *supra* note 14, at 688.

<sup>42</sup> See generally Bebchuk, *Myth of the Shareholder Franchise*, *supra* note 14 (discussing the uneven playing field in director elections and the power of management in controlling it); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) [hereinafter Bebchuk, *Case for Increasing*] (advocating for more shareholder access to the election system of directors); Lucian A. Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557 (2005); Bebchuk, *Case for Shareholder Access*, *supra* note 14, at 563; Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005) (discussing how boards insulate themselves from shareholders and the associated costs).

This Part introduces the current market approach to corporate law, its limitations, and the increased impact that shareholders have had on corporate governance in the last decade.

A. *The Market-Based Approach to Agency Costs*

The agency cost in widely held public corporations described in the beginning of this Part is, theoretically, mitigated by various market forces. Corporate legal scholarship sheds light on these market forces and their importance in constraining this managerial agency cost for shareholders. Among these forces are the market for corporate control,<sup>43</sup> the market for new capital<sup>44</sup> and trading shares,<sup>45</sup> the product market,<sup>46</sup> and the managerial labor market.<sup>47</sup>

The first of these mechanisms, the market for corporate control, refers to the threat of a firm takeover as an incentive for management to pursue actions that best serve the shareholders. The theory follows that a poorly managed corporation will lead to poor returns for investors, facilitating an attractive takeover opportunity, which inevitably will result in a change in control and subsequently in the replacement of management.<sup>48</sup> While the market for corporate control might have played an important role until the mid-1980s, its impact has weakened substantially since Delaware courts began allowing the combined use of poison pills and staggered boards and the ability of the board to “just say no” (that is, to reject offers of hostile bid-

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<sup>43</sup> See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965). It seems that increasing shareholders' involvement in corporate life becomes even more of a crucial issue than it used to be, due to the ineffectiveness of the hostile takeover market under the new antitakeover mechanisms. See Bebchuk & Cohen, *supra* note 42, at 35; Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 889 (2002) [hereinafter Bebchuk et al., *The Powerful Antitakeover Force*].

<sup>44</sup> See Bebchuk, *Myth of Shareholder Franchise*, *supra* note 14, at 715. For a general review of the efficient capital market hypothesis, see RONALD J. GILSON ET AL., *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 135–81 (2d ed. 1995). For an analysis of the efficient capital market hypothesis for debt instruments, see Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323, 325–27 (1986). Jensen took a further step, asserting that the leveraged buyouts of the 1980s are the starting point of the eclipse of the public, widely held corporation altogether. See Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. (1989).

<sup>45</sup> Greenfield, *supra* note 36, at 296–297.

<sup>46</sup> See Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1262 (1982) (noting that inability to compete in the product market will lead corporations to be pushed out of their business altogether).

<sup>47</sup> See Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992); Nili, *Missing the Forest for the Trees*, *supra* note 35, at 173.

<sup>48</sup> Greenfield, *supra* note 36, at 297; Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965).

ders).<sup>49</sup> This led scholars to argue that shareholder involvement is even more crucial due to the ineffectiveness of the hostile takeover market.<sup>50</sup>

The second mechanism, a capital market for new and trading shares, relies on assumptions that are not necessarily applicable in all circumstances. The market for trading shares emphasizes the ability of shareholders to “vote with their feet” by selling their company shares in response to poor management performance, which results in decreased company value. This assumes, however, that shareholders will be willing to suffer a loss on their investment through the sale of their shares at a lower price<sup>51</sup> and that they are even able to sell at all. Index funds, for example, must mimic the specific index, such as the S&P 500, and lack the ability to sell particular shares in an individual company.<sup>52</sup> Similarly, the market for new capital assumes that dissatisfied shareholders would inhibit management’s ability to go out and raise additional capital.<sup>53</sup> Yet, as the IPO of Snap tells us, investors are willing to invest in some “hot” companies, even when the shares grant no voting rights.<sup>54</sup>

A third mechanism, the managerial labor market, theoretically incentivizes managers to perform adequately and maximize value for shareholders through the use of greater compensation and upward mobility that may come with the success of a company.<sup>55</sup> Finally, underlying the product market mechanism is the idea that poorly run firms will produce unsuccessful and uncompetitive products and lead to firm failure, causing management to lose their positions, incentivizing management to perform.<sup>56</sup> Yet both of these markets may fail to effectively constrain management, as both the labor and product markets may suffer from their own inefficiencies.<sup>57</sup>

<sup>49</sup> See Neil C. Rifkin, *Should Uninformed Shareholders Be A Threat Justifying Defensive Action by Target Directors in Delaware?: “Just Say No” After Moore v. Wallace*, 78 B.U. L. REV. 105 (1998) (highlighting the Delaware Court’s perceived favor of boards’ utilization of defensive tactics amounting to just saying no, but warning against this policy); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Airgas, Inc. v. Air Prods. & Chems., Inc.*, 8 A.3d 1182 (Del. 2010) (applying the *Unocal* test to reaffirm the legality of combined staggered boards and poison pills to defend against hostile takeovers).

<sup>50</sup> See Bebchuk & Cohen, *supra* note 42, at 35; Bebchuk et al., *The Powerful Antitakeover Force*, *supra* note 43, at 900.

<sup>51</sup> Bebchuk, *Myth of Shareholder Franchise*, *supra* note 14, at 108.

<sup>52</sup> Scott Hirst & Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 B.U. L. REV. 107, 111–112 (2019) (“Once a company with a disfavored governance structure is included in an index, all index fund managers that track that index are essentially required to invest in the company, despite their opposition to its governance structures.”).

<sup>53</sup> See Bebchuk, *Myth of Shareholder Franchise*, *supra* note 14.

<sup>54</sup> Snap Inc., Prospectus (Form 424B4) 4–6 (Mar. 3, 2017) (“Holders of our Class A common stock—the only class of stock being sold in this offering—are entitled to no vote on matters submitted to our stockholders.”).

<sup>55</sup> See Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 330 (1998).

<sup>56</sup> See, e.g., Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1466–67 (1992) [hereinafter *Bebchuk, Federalism and the Corporation*].

<sup>57</sup> See Chad D. Cotti & Scott Drewianka, *Labor Market Inefficiency and Economic Restructuring: Evidence from Cross-Sectoral Data*, 74 S. ECON. J. 214 (2007); Bebchuk, *Feder-*

Legal scholarship in the United States has largely questioned the efficacy of these markets, positing that these market mechanisms, while perhaps offsetting some shareholder concerns, do not adequately reduce the agency costs faced by investors.<sup>58</sup>

### B. *The Rise of Shareholder Voting and the Shareholder Franchise*

Contemporary corporate law has moved toward a focus on shareholder interests and a greater reliance on stock markets to reflect accurate information.<sup>59</sup> As part of the transition to a shareholder-centric model, corporate governance discourse has increasingly contemplated means of empowering shareholders vis-à-vis management.<sup>60</sup> Shareholders have increasingly challenged the ultimate discretion held by the board of directors by actively using their rights to create some form of checks and balances that limit the agency costs between management and shareholders—often termed as the shareholder franchise movement.<sup>61</sup>

The shareholder franchise movement has received support from governmental bodies. In particular, Congress has passed an extensive bill that increases the impact shareholders can have on the governance of the corporation.<sup>62</sup> Shareholder voting has consequently become more prominent in board elections, as proxy access and majority voting have made shareholder votes on director elections more significant.<sup>63</sup> Another trend that has facilitated shareholder participation is mandatory non-binding votes on executive compensation.<sup>64</sup> At the same time, the engagement of activist and insti-

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*alism and the Corporation*, *supra* note 56, at 1466–67 (“Although product market competition does provide managers with some valuable incentives, it cannot discourage managers from seeking value-decreasing rules that are significantly redistributive in their favor.”).

<sup>58</sup> See Bebchuk, *Myth of Shareholder Franchise*, *supra* note 14, at 688–89.

<sup>59</sup> Bebchuk, *Myth of Shareholder Franchise*, *supra* note 14, at 688–694; see also Bebchuk, *Case for Shareholder Access*, *supra* note 14; Melvin A. Eisenberg, *Access to the Corporate Proxy Machine*, 83 HARV. L. REV. 1489 (1970); Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations and Poison Pills*, 3 BERKELEY BUS. L.J. 205 (2005); Sjostrom & Kim, *supra* note 14.

<sup>60</sup> Bebchuk, *Case for Increasing*, *supra* note 42; Geeyoung Min, *Shareholder Voice in Corporate Charter Amendments*, 43 IOWA J. CORP. L. 289 (2018) (analyzing shareholder power to vote on charter amendments as a method of curbing management authority).

<sup>61</sup> See Bebchuk, *Myth of Shareholder Franchise*, *supra* note 14.

<sup>62</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). For a review of the main provisions of the act, see *Brief Summary of The Dodd-Frank Wall Street Reform and Consumer Protection Act*, [http://banking.senate.gov/public/\\_files/\\_Dodd\\_Frank\\_Wall\\_Street\\_Reform\\_\\_s\\_Finalpdf](http://banking.senate.gov/public/_files/_Dodd_Frank_Wall_Street_Reform__s_Finalpdf); DAVID A. SKEEL JR., *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* (2010). For a critical review of the act, see Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011).

<sup>63</sup> Stephen Choi, Jill Fisch, Marcel Kahan & Edward Rock, *Does Majority Voting Improve Board Accountability*, 83 U. CHI. L. REV. 1119 (2016) (describing shift from plurality to majority voting).

<sup>64</sup> See *infra* note 138 and accompanying text.

tutional investors is on the rise,<sup>65</sup> and the concentrated voting power of institutional investors is making a difference.<sup>66</sup> The notion of shareholder passivity in the market is being undermined.<sup>67</sup> And as some prominent scholars have observed, “[n]ever has voting been more important in corporate law.”<sup>68</sup> Taken together, those trends led to the emergence of a vibrant competition for votes.

## II. THE RISE OF A NEW DISCIPLINARY FORCE: COMPETITION FOR VOTES

The fierce competition for investors’ votes has become increasingly visible in recent high-profile proxy battles like the Campbell Soup Company’s proxy war.<sup>69</sup> Dan Loeb, the same activist investor that launched the Campbell’s battle through his hedge fund, Third Point, also mounted a 2017 high-profile campaign against Dow Chemical Co. (“Dow”) to push his own agenda in a post-merger plan with American conglomerate DuPont. Prior to launching his campaign, Loeb had invested more than \$1 billion in Dow at the start of 2014, ultimately mounting a campaign to obtain board seats in the shadow of a full-blown proxy campaign.<sup>70</sup> As with Campbell’s, Loeb’s Dow strategy to reach investors included mailings, websites, and attack videos.<sup>71</sup>

Despite Loeb’s vocal campaign, Third Point maintained only a 2% stake.<sup>72</sup> That meant it had to lean heavily on the support of other shareholders, courting them aggressively. On the heels of the campaign, Dow agreed to add four new independent directors (an agreement that precipitated a

<sup>65</sup> See, e.g., ISS Analytics, *The Long View: US Proxy Voting Trends on E&S Issues from 2000 to 2018*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Jan. 31, 2019), <https://corp.gov.law.harvard.edu//31/the-long-view-us-proxy-voting-trends-on-es-issues-from-2000-to-2018/>. See also Choi, Fisch, Kahan & Rock, *supra* note 63 (providing data on shareholder engagement in the voting process and its increasing impact).

<sup>66</sup> See Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds* (Feb. 14, 2018) (analyzing voting by mutual funds by breaking it down into three major groups: the managerial, shareholder intervention, and shareholder veto; the characterization of which depends on whether they vote with or against management); see also *infra* notes 99–108 and accompanying text.

<sup>67</sup> See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 608 (1990) (explaining that shareholder passivity is not inevitable but is a construct of legal rules and barriers that could be amended to increase shareholder participation).

<sup>68</sup> Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1227 (2008).

<sup>69</sup> See *supra* notes 1–12; *infra* notes 70–81.

<sup>70</sup> Nathan Vardi, *Billionaire Dan Loeb Wins Board Seats at Dow, His Second Victory This Week*, FORBES (Nov. 21, 2014), <https://www.forbes.com/sites/nathanvardi/2014/11/21/billionaire-dan-loeb-wins-board-seats-at-dow-his-second-victory-this-week/#63b95d761eb3>.

<sup>71</sup> *Id.*; Julia La Roche, *Dan Loeb Releases a Mini-Documentary Slamming Dow Chemical’s Board for ‘Broken Promises’*, BUS. INSIDER (Nov. 13, 2014), <https://www.com/dan-loeb-video-on-dow-chemical-2014-11>.

<sup>72</sup> Sayantani Ghosh & Kanika Sikka, *Dow Chemical, Dan Loeb settle board debate*, REUTERS (Nov. 21, 2014), <https://www.reuters.com/article/us-dowchemical-thirdpoint-board-idUSKCN0JSX201>.

4.5% rise in share value).<sup>73</sup> In a nod to the efficacy of Loeb's strategy (and its impact on other investors), the agreement between Dow and Third Point included a provision that Third Point not publicly criticize the company for one year.<sup>74</sup>

In another headline-stirring fight, Trian Partners launched a campaign to elect its founding partner, Nelson Peltz, to Procter & Gamble's ("P&G") board of directors.<sup>75</sup> At \$22.8 billion, P&G was the largest company ever to be the target of such a campaign, and Trian held \$3.3 billion worth of shares.<sup>76</sup> Retail investors held close to 40% of the outstanding stock, and therefore, their votes mattered significantly.<sup>77</sup> Both Trian and P&G attempted to reach these voters through press interviews, social media, Facebook messages, phone calls, YouTube videos, websites, paper mail, and email.<sup>78</sup> Overall, Trian spent at least \$25 million on its fight with P&G.<sup>79</sup> Its willingness to incur these costs in an effort to secure the needed votes in this high-stake battle provides a visible manifestation of the competition for votes.<sup>80</sup> Eventually, despite losing the election for a board seat, Peltz secured almost half of the shareholder votes and was placed on the board anyway.<sup>81</sup>

We argue that these anecdotes are indicative of a larger market development: the creation of a vibrant and robust competition for votes. In other words, an increasingly large number of market players utilize the shareholder vote as a way to effectuate change. As a result, investors are courted for their votes more than ever before.

While this courtship may be most noticeable in high-profile proxy fights, it has been ongoing in many other voting contexts, from shareholder precatory proposals, to Say on Pay votes and proxy access. Below, this Part highlights the normative appeal of a vibrant competition for votes as well as

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<sup>73</sup> Jack Kaskey, *Dow Chemical Pact with Three Point Avoids Proxy Fight*, BLOOMBERG (Nov. 11, 2014), <https://www./news/articles/2014-11-21/dow-to-add-directors-after-pressure-from-third-point>; Ghosh & Sikka, *supra* note 72.

<sup>74</sup> Ghosh & Sikka, *supra* note 72.

<sup>75</sup> Tae Kim, *Billionaire Hedge Fund Manager Nelson Peltz Calls P&G a 'Suffocating Bureaucracy'*, CNBC (July 17, 2017), <https://www.cnbc.com/2017/07/17/billionaire-hedge-fund-manager-nelson-peltz-on-pg-biggest-company-ever-to-face-an-activist.html>.

<sup>76</sup> *Id.*

<sup>77</sup> Michael Flaherty, *P&G, Peltz Vie for Small Investor Votes in Biggest-Ever Proxy Fight*, REUTERS (Sept. 25, 2017), <https://www.reuters.com/article/us-procter-gamble-trian-investors/pg-peltz-vie-for-small-investor-votes-in-biggest-ever-proxy-fight-idUSKCN1C01CW>.

<sup>78</sup> *Id.*

<sup>79</sup> Chris Isidore & David Goldman, *Procter & Gamble Declares Victory in Expensive Proxy Fight*, CNN BUSINESS (Oct. 10, 2017), <https://money.cnn.com/2017/10/10/news/companies/procter-gamble-proxy-fight/index.html>.

<sup>80</sup> In another proxy fight with DuPont, Peltz spent \$8 million, and DuPont answered with \$15 million for a combined \$23 million fight. See Jeff Mordock, *DuPont Spent \$15M to Keep Activist Investor off Board*, USA TODAY (May 19, 2015), <https://www.usatoday.com/story//business//05//dupont-spent-15m-proxy-fight/27575179/>. Also, H.J. Heinz Co. spent \$14 million to defend against Trian, which resulted in two Peltz nominations to the Heinz board. *Id.*

<sup>81</sup> Dan Monk, *Procter & Gamble Co. Shareholder: Why is Nelson Peltz on the board?*, WCPO (Oct. 9, 2018), <http://www.wcpo.com/news/insider/procter-gamble-co-shareholder-why-is-nelson-peltz-on-the-bo>.

the key conditions necessary for its prosperity. Part III will then empirically demonstrate the existence of this market.

A. *The Normative Allure of the Competition for Votes*

Much like other market forces mentioned in the corporate governance literature,<sup>82</sup> a competition for votes enjoys two fundamental allures. First, it is driven by a true market and not by a regulatory arrangement. The idea that the free market, rather than government intervention, produces optimal outcomes is often known as the Chicago School of Thought.<sup>83</sup> The Chicago School of Thought argues that markets are most efficient when left alone because “rewards and punishments arise automatically in any market system,” given that investors who do not understand the market will quickly be out of business through a natural selection process.<sup>84</sup> Similarly, if a shareholder vote on a matter is sufficiently important, then the incentives of market participants to pursue voters increases, resulting in market-based allocation of the value of the costs associated with lobbying for votes.

The competition for votes also creates several positive “spill-over” effects on other areas of corporate governance. Specifically, the competition for votes likely: first, improves the overall information levels in the market; second, improves the ex ante incentives of management and challengers to be more attentive to the concerns of voting shareholders; and third, increases the impact of reputation on the various actors’ behavior.<sup>85</sup> Simply put, a competition for votes provides management and challengers with incentives to take actions that in themselves could benefit the company and shareholders’ interests.<sup>86</sup> We now turn to discuss each of these effects.

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<sup>82</sup> See *supra* Part I.A.

<sup>83</sup> William H. Page, *The Chicago School and the Evolution of Antitrust: Characterization, Antitrust Injury, and Evidentiary Sufficiency*, 75 VA. L. REV. 1221, 1229; Thomas A. Piraino, Jr., *Reconciling the Harvard and Chicago Schools: A New Antitrust Approach for the 21st Century*, 82 IND. L.J. 345, 346 (2007); Richard A. Posner, *The Chicago School of Antitrust Analysis*, 127 U. PA. L. REV. 925 (1979).

<sup>84</sup> Frank H. Easterbrook, *The Supreme Court, 1983 Term: Foreword: The Court and the Economic System*, 98 HARV. L. REV. 4, 8 (1984); see also Robert H. Bork, *Legislative Intent and the Policy of the Sherman Act*, 9 J. L. & ECON 7 (1966) (arguing that Congress’s intent through the Sherman Act was to promote consumer welfare and thus requires judicious application of the act only when the activities decrease efficiency through restriction of output); Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 3 (1984); Richard A. Posner, *The Effects of Deregulation on Competition: The Experience of the United States*, 23 FORDHAM INT’L L.J. 7, 11 (2000) (noting that in the height of the antitrust movement, average prices “may have been as high as they would have been without regulation, even in industries such as electrical power distribution where there are substantial natural monopoly elements”).

<sup>85</sup> See Roy Shapira, *A Reputational Theory of Corporate Law*, 26 STAN. L. & POL’Y REV. 1 (2015) (discussing how reputation and reputational sanctions affect corporate law).

<sup>86</sup> To some extent, this process is equivalent to a political election in which two parties are competing for the swing voters.

## 1. Information

A competition for votes is likely to provide management and activists with incentives to produce and disseminate more information to shareholders in a simplified and clear way. That way, voting shareholders will be able to digest this information quickly and subsequently exercise a vote in favor of the party that produces such information.

Indeed, when activist hedge funds engage in contested situations with targets, they try hard to persuade both proxy advisors and large institutional investors of the merits of their plans for the targeted firms. With their resources and financial expertise, hedge funds are also able to bring private information to a corporate decision.<sup>87</sup> They prepare detailed presentations and informative white papers to support their views. Companies respond by preparing their own counterarguments and presentations.<sup>88</sup> As a result, transparency is improved and new information flows to shareholders.

Most importantly, evidence shows that shareholders enjoy greater transparency even outside the context of hedge fund engagements. For example, a study examining shareholder proposals related to proxy access shows that management is more likely to present a longer rebuttal and to disseminate additional materials to shareholders when the vote is close.<sup>89</sup>

Another line of studies examined the impact of Say on Pay votes on company disclosure after the introduction of the legislation mandating them. One of these studies finds that disclosure of executive pay underwent significant changes as more companies improved proxy disclosures making them not only compliant, but also more informative and persuasive.<sup>90</sup> Many companies also added additional disclosures explaining pay practices that had come onto shareholders' radar screens, offering summaries on their pay-performance relationship, often with graphical representations and "layered" disclosure, making this information more transparent to shareholders. Some companies went even further by filing supplemental proxy disclosures, including slideshow presentations, letters to proxy advisory firms taking issue with information or analysis in their reports, and letters to shareholders defending their pay-for-performance orientation.<sup>91</sup> These efforts bore fruit.

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<sup>87</sup> Edelman et al., *supra* note 16, at 1419–21.

<sup>88</sup> *Id.*; see also Kahan & Rock, *supra* note 26, at 41–43 (explaining that in the high-profile proxy contests or merger votes that shareholders must decide each year, both management and activists both produce detailed presentations).

<sup>89</sup> Tara Bhandari, Peter Iliev & Jonathan Kalodimos, *Governance Changes through Shareholder Initiatives: The Case of Proxy Access* 1, 22–24 (Feb. 18, 2019) (unpublished working paper), available at <https://ssrn.com/abstract=2635695>.

<sup>90</sup> See Randall S. Thomas, Alan R. Palmiter & James F. Cotter, *Dodd-Frank's Say on Pay: Will it Lead to a Greater Role for Shareholders in Corporate Governance*, 97 CORNELL L. REV. 1213, 1257–58 (2012).

<sup>91</sup> *Id.* at 1258–59.

Companies that added disclosure and presented it in a simplified way received more Say on Pay support.<sup>92</sup>

Indeed, this dynamic suggests that when there is a need to ensure that shareholder support exceeds a certain threshold, as in the Say on Pay context, management provides more information to shareholders, well beyond what is required by regulation. And, as evidence from activist engagements and votes on shareholder proposals clearly demonstrates, the incentives to provide more information increase when the vote is close.

## 2. Incentives to Engage and Avoid Misbehavior

Information dissemination is only one side of the equation. Stronger competition for votes may also improve the ex ante behavior of management and shareholders who challenge management. When there is a competition for votes, both management and challengers have an increased incentive to conduct additional engagements and discussions with leading institutional investors and proxy advisors in hopes of winning shareholder support.<sup>93</sup>

If management is more concerned about the likelihood of activist campaigns and the chances of a proponent winning, management will try ex ante to avoid such a campaign altogether by proactively taking steps to increase shareholder value, such as increasing leverage or decreasing capital expenditures.<sup>94</sup> Companies with a healthy respect for, and facilitation of, shareholder communication with the board will signal success.<sup>95</sup> At the other extreme, failure to engage with shareholders can be detrimental to management in firms who later face an activist challenge.

Studies that examine the impact of the mandatory Say on Pay votes provide additional evidence regarding the impact of the competition for votes on management's incentives to engage with shareholders. These studies show that the Say on Pay legislation led companies to open lines of communication and have a broader dialogue with shareholders (and proxy advisory firms) regarding executive compensation, and to more generally re-

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<sup>92</sup> *Id.* at 1249.

<sup>93</sup> Edelman et al., *supra* note 16, at 1416 (“hedge funds first talk with institutional investors about the target company, then contact that company once they know they have the support of institutions and their large shareholders”); *see also* Kahan & Rock, *supra* note 26, at 42–43 (explaining that in the high-profile proxy contests, “there is very substantial lobbying by each side, with management and activists both meeting as frequently as possible with each of the large holders”).

<sup>94</sup> For a comprehensive analysis of management incentives to communicate with their shareholders and to take ex ante measures that such shareholders favor, *see* Hamdani & Hanes, *supra* note 27, at 983–992.

<sup>95</sup> *See, e.g.*, Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. ILL. L. REV. 821 (2013) (arguing that corporations must enhance their levels of communication between shareholders and the board, as the benefits of engagement are significant, and in the last several years, shareholders have both gained and exercised authority in corporate governance such that there is demand for increased communication with the board).

evaluate their corporate governance practices.<sup>96</sup> Moreover, management at companies whose pay programs received negative Say on Pay recommendations by proxy advisory firms connected with shareholders and provided them additional explanations in order to receive a favorable vote in the following year.<sup>97</sup>

Finally, since management and challengers are often repeat players, the ongoing competition for investors' votes could cause them to avoid, in the first place, actions that will trigger severe investor retaliation through the company ballot box. For instance, if an activist investor successfully advances a change that other shareholders disfavor, that activist investor will encounter greater difficulties competing for votes in the future. As such, bad faith actions of repeat players are less likely to occur.

### B. *The Impact of the Competition for Votes*

The proxy battles discussed in the beginning of this Part are perhaps marquee examples of a vivid competition for votes. In recent years, these types of high-profile contests have been on the rise, but proxy fights are not alone in marking the impact of the competition for votes.<sup>98</sup> Shareholder voting, more broadly, serves as an important vehicle for shareholders to communicate their preferences to the board. While companies do not always take immediate action in response to a shareholder vote, a large body of empirical research suggests that corporate directors pay attention to voting outcomes and, in many cases, incorporate the results of the vote in future decisions.

This is particularly true when shareholders register a strong "protest vote"—a material vote in opposition to a proposed action.<sup>99</sup> For instance, a

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<sup>96</sup> See Randall S. Thomas et al., *supra* note 90, at 1264. See Luis A. Aguilar, Comm'r, Sec. & Exch. Comm'n, Speech by SEC Commissioner: An Inflection Point: The SEC and the Current Financial Reform Landscape at the Social Investment Forum 2011 Conference (June 10, 2011), available at <http://www.sec.gov/news/speech/2011/spch061011laa.htm>.

<sup>97</sup> Edelman et al., *supra* note 16, at 1432–33. Minor Myers argued that shareholder engagement, particularly Say on Pay votes, could actually reduce the pure accountability of directors for individual decisions. According to Myers, the more involved shareholders are in a firm's managerial decisions, the more difficult it is for directors to be held accountable for the outcome of those decisions. See Minor Myers, *The Perils of Shareholder Voting on Executive Compensation*, 36 DEL. J. CORP. L. 417 (2011). This argument, however, is not supported by empirical evidence and it ignores the existence of the business judgement rule which practically insulates managers from liability for any non-conflicted business decision. Therefore, in the absence of shareholder engagement and the competition for votes, we doubt that management will have stronger ex ante incentives to act in the interests of shareholders.

<sup>98</sup> For a survey of the empirical literature on the impact of shareholder activism, see Matthew Denes et al., *Thirty Years of Shareholder Activism: A Survey of Empirical Research*, 44 J. CORP. FIN. 405 (2017).

<sup>99</sup> See Paul E. Fischer et al., *Investor Perceptions of Board Performance: Evidence from Uncontested Director Elections*, 48 J. ACCOUNTING & ECON. 173 (2009). See also Diane Del Guercio et al., *Do Boards Pay Attention When Institutional Investor Activities 'Just Vote No'?*, 90 J. FIN. ECON. 84, 102 (2008) (finding that "just vote no" campaigns may be particularly effective for larger companies because "the power of the media and public opinion is most effective where directors have the most to lose").

few studies find that protest votes in uncontested director elections have a substantial negative impact on directors' careers, increasing the likelihood that a director will leave the board and decreasing that director's future opportunities in the director labor market.<sup>100</sup> Such protest votes are also associated with higher management turnover and increased corporate activity (such as major asset sale or acquisition) in the year following the vote.<sup>101</sup> Similarly, another study demonstrates that directors are subject to higher rates of protest votes and increased termination rates across all of their directorships following the board's adoption of a "poison pill," an anti-takeover tool that institutional investors generally disfavor.<sup>102</sup> Companies targeted by shareholder proposals experience similar outcomes.<sup>103</sup>

Conversely, when directors implement a proposal that receives majority support, board turnover decreases, and the directors are less likely to lose other directorships.<sup>104</sup> Similarly, Thomas and Cotter find that when shareholder proposals receive majority shareholder support, this support translates into directors implementing more of the actions called for by shareholders. In particular, they found that "boards are increasingly willing to remove important anti-takeover defenses, such as the classified board and poison pill, in response to shareholders' requests, something rarely seen in the past."<sup>105</sup> Renneboog and Szilagyi, who provide empirical evidence on implemented proposals, conclude that "shareholder proposals are a useful device of external control."<sup>106</sup>

Compelling evidence as to the impact of the shareholder protest vote also exists in the context of executive compensation. For example, Martin and Thomas find that when shareholders protest against executive-only stock

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<sup>100</sup> Reena Aggarwal, Sandeep Dahiya & Nagpurnanand R. Prabhala, *The Power of Shareholder Votes: Evidence from Uncontested Director Elections*, 133 J. FIN. ECON. 134 (2019).

<sup>101</sup> *Id.*

<sup>102</sup> William C. Johnson, Jonathan M. Karpoff & Michael D. Wittry, *The Consequences to Directors of Deploying Poison Pills* (Fisher C. of Bus., Working Paper No. 2019-03-023, 2019), <https://ssrn.com/abstract=3460201>.

<sup>103</sup> See, e.g., Bonnie G. Buchanan et al., *Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom*, 49 AM. BUS. L.J. 739, 790, 974-96 (2012) (reporting that firms targeted by shareholder proposals are more likely to replace their CEOs and separate the CEO and Chairman positions, and that shareholder proposals submitted from 2000 to 2006 were followed by positive stock returns).

<sup>104</sup> See, e.g., Yonca Ertimur, Fabrizio Ferri & Stephen R. Stubben, *Board of Directors Responsiveness to Shareholders: Evidence from Shareholder Proposals*, 16 J. CORP. FIN. 53, 54 (2010) (showing that the implementation of a proposal that receives majority support is associated with approximately a one-fifth reduction in both the probability of director turnover and the probability of losing other directorships).

<sup>105</sup> Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 389 (2007).

<sup>106</sup> Luc Rennebooga & Peter G. Szilagyi, *The Role of Shareholder Proposals in Corporate Governance*, 17 J. CORP. FIN. 167 (2011).

option plans, directors respond by reducing executive salaries.<sup>107</sup> Ferri and Maber find that companies receiving low levels of shareholder support on their Say on Pay votes are more likely to amend their executive compensation plans to make them more shareholder-friendly.<sup>108</sup>

More broadly, evidence also shows that increased shareholder involvement results in stronger firm performance. In a study examining firm performance, “democracies earned significantly higher returns, were valued more highly, and had better operating performance.”<sup>109</sup> The study finds that firm performance increased when shareholders were given meaningful decision-making opportunities, while firms that granted weak shareholder rights lagged behind.<sup>110</sup>

Piecing the empirical evidence together, the picture becomes clearer: shareholder voting is no longer inconsequential. Instead, its outcomes can have lasting and significant impacts on managerial decision-making.

### C. *Facilitating the Competition for Votes*

In the previous sections, we highlighted the importance of the competition for votes. We now turn to outline some of the key factors that are important for facilitating a vibrant competition for votes.

#### 1. “Liquidity”

Just as financial markets are dependent on asset liquidity,<sup>111</sup> the competition for votes requires sufficient “liquidity” to operate effectively. In the competition for votes context, the liquidity at stake is not the ability to sell a share but rather the number of undecided votes that are in play. Consequently, this liquidity depends on two factors. The first factor is the number of votes that are potentially “up for grabs;” in other words, what is the “float” of votes.<sup>112</sup> A larger, rather than limited, float would benefit the mar-

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<sup>107</sup> Kenneth J. Martin & Randall S. Thomas, *When is Enough, Enough? Market Reaction to Highly Dilutive Stock Option Plans and the Subsequent Impact on CEO Compensation*, 11 J. CORP. FIN. 62 (2005).

<sup>108</sup> Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, 17 REV. FIN. 529 (2013). See also David F. Larcker, Brian Tayan & James R. Copland, *The Big Thumb on the Scale: An Overview of the Proxy Access Advisory Industry*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (June 14, 2018), <https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-the-proxy-advisory-industry/>.

<sup>109</sup> Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 108–09 (2003). See also Trevor M. Gomberg, *After the Storm: Unmasking Publicly-Traded Private Equity Firms to Create Value Through Shareholder Democracy*, 73 ALB. L. REV. 575, 588–89 (2010).

<sup>110</sup> Gompers et al., *supra* note 109.

<sup>111</sup> Radhakrishnan Gopalan et al., *Asset Liquidity and Stock Liquidity*, 47 J. FIN. & QUANTITATIVE ANALYSIS 334 (2012).

<sup>112</sup> Float votes are unrestricted votes controlled by public investors who are not affiliated with the management of the company. See Magnus Dahlquist et al., *Corporate Governance and the Home Bias*, 38 J. FIN. & QUANTITATIVE ANALYSIS 100 (2003).

ket, as it produces a large pool of votes to compete for. Therefore, companies with no controlling shareholder or other large shareholders could exhibit a stronger competition for votes.<sup>113</sup> Similarly, companies that have a higher percentage of voting shareholders would have a higher float.

The second factor that determines liquidity involves the likelihood of a vote being cast in a proponent's favor. If a company has a large float, but all "floating" votes are always cast in support of management, market liquidity in the context of vote competition would be zero. Therefore, more fluctuation in the voting patterns of shareholders would lead to greater effective potential for votes that are up for grabs. In other words, if shareholders tend to switch sides over time, and with respect to various issues, the market for the votes' liquidity would improve.

## 2. Cost

A second factor that facilitates the competition for votes bears on the question of cost. If voting is costly to shareholders, their likelihood of exercising their votes, even if convinced by a proponent's argument, is diminished. Conversely, if the costs of exercising a vote are low, then more shareholders may be willing to show up to vote, even on matters with lower direct or expected impact on their interests.

The voting patterns, or lack thereof, of retail investors demonstrate the costs of voting. As we discuss in Part IV.C., retail investors' participation in voting currently remains low precisely because of the costs associated with voting.<sup>114</sup> How and when firms are able to influence shareholder voting is crucial to the market, and firms may have a motive to increase or decrease the efficiency of shareholder voting based on their expected success. Recent developments in online proxy voting, including regulatory support,<sup>115</sup> have facilitated an easier and less costly process for participation in voting by utilizing online mechanisms (although e-proxies may lead to both a slight decrease in voter participation and an inverse correlation to management support).<sup>116</sup> However, the retardation of shareholder voting efficiency is then also a strategy and point of influence for the competition for votes. In comparison to retail investors, institutional investors can vote their shares inex-

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<sup>113</sup> However, even companies with limited float could occasionally be subject to a competitive voting process, as reflected in the example of Campbell Soup Company referenced in the Introduction of this Article. See *supra* notes 1–9.

<sup>114</sup> See *infra* Part IV.C.

<sup>115</sup> See Rachel Geoffroy, *Electronic Proxy Statement Dissemination and Shareholder Monitoring* 7–8 (Nov. 30, 2018), <https://ssrn.com/abstract=3264846>.

<sup>116</sup> *Id.* at 4.

pensively.<sup>117</sup> Retail investors have a cumbersome, individualized process that is unattached from their brokerage account.<sup>118</sup>

Yet, the costs of the competition for votes are not only associated with the supply of votes. The costs that a party lobbying for a vote must incur are also an important factor affecting the facilitation of the competition for votes. If a proponent (a hedge fund, for example) must invest a lot of time, effort, and money in the process of soliciting and courting for votes, then the number of instances where such competition for votes occurs will decrease. This is because a proponent must balance the costs of this engagement against the likelihood of success and the potential benefit.

### 3. Value of Votes

Finally, the competition for votes is further facilitated by the value of votes. We refer to the value of votes as the potential impact or benefit a proponent could expect if they were to receive the sufficient votes needed to achieve their suggested change.<sup>119</sup>

First, the more matters that go to a shareholder vote, the more important the competition for votes becomes. Moreover, alongside the number of matters that go to a vote, a second important factor is what these votes determine. Voting stakes for auditor ratification would certainly be lower compared to those for director election in a high-profile proxy contest or merger approval. As Kahan and Rock observed, in these high-profile situations, votes are likely to have a significant impact on the market price of target companies, and therefore generate material incentives for large institutional investors, who often play a pivotal role, to cast informed votes.<sup>120</sup>

Recent years have seen an increase in the number of issues that go to shareholder vote as well as an increase in the importance of these votes in shaping corporate policy.<sup>121</sup> The recent calls for more sunset terms in corporate governance may only strengthen this trend, as such terms create more opportunities for shareholders to vote.<sup>122</sup>

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<sup>117</sup> Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 MINN. L. REV. 11, 13 (2017) (citing John Endean, *The Untapped Power of Individual Investors*, WALL ST. J. (Oct. 5, 2014), <https://www.wsj.com/articles/john-endean-the-untapped-power-of-individual-investors-14125433>).

<sup>118</sup> *Id.*

<sup>119</sup> Our proposition is distinct from the question of vote buying, that is, whether it is allowed, or beneficial, to buy the power to vote from a shareholder.

<sup>120</sup> Kahan & Rock, *supra* note 26, at 3–4.

<sup>121</sup> Edelman et al., *supra* note 16, at 1359–60; Paul Mason et al., *Does Shareholder Voting Matter? Evidence From the Takeover Market*, 53 WAKE FOREST L. REV. 157, 160 (2018) (“Over time, federal law in the form of securities regulation and SEC-approved rules imposed by self-regulatory organizations (‘SROs’)—notably NASDAQ and the New York Stock Exchange (‘NYSE’)—have increased the scope of the shareholder franchise”).

<sup>122</sup> *See infra* note 173.

#### 4. The Doctrinal Shift from Adjudication to the Ballot Box

The significance of shareholder voting has further increased in recent years due to recent landmark decisions by the Delaware Court that were intended to reduce litigation by reallocating power from courts to investors.<sup>123</sup> This line of recent cases follows a doctrinal framework which subjects matters that are brought to the approval of well-informed shareholders to the most lenient standard of review: the business judgment rule. The cases recognize that investors' judgment is usually sound and that the costs of intensive litigation regarding transactions approved by uninterested shareholders generally outweigh the benefits.<sup>124</sup>

An important building block of this novel doctrinal approach is the Delaware Supreme Court's now-seminal 2014 decision in *Kahn v. M&F Worldwide Corp.* (“*MFW*”). In that case, the court provided business judgment rule protection for controlling stockholder transactions that were conditioned from the outset on certain procedural protections being utilized, including approval by, first, a fully-empowered independent special committee and, second, a fully-informed, uncoerced vote of a majority of the target shareholders unaffiliated with the controller.<sup>125</sup> Since then, Delaware courts have extended the scope of *MFW* to other types of conflicted transactions involving a controlling shareholder.<sup>126</sup> The court also ruled that small, alleged “foot faults” will not cause the business judgment rule protection afforded by *MFW* to be lost.<sup>127</sup>

Next, in its 2015 decision *Corwin v. KKR Financial Holdings LLC*, the Delaware Supreme Court held that, when a third-party merger is approved by a fully informed and uncoerced majority vote of disinterested stockholders, the business judgment rule standard of review applies, and the typical result is dismissal of the complaint.<sup>128</sup> Then-Chief Justice Strine emphasized

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<sup>123</sup> For empirical evidence documenting the shift in litigation market, see Matthew D. Cain et al., *The Shifting Tides of Merger Litigation*, 71 VAND. L. REV. 603 (2018).

<sup>124</sup> See, e.g., Wachtell, Lipton, Rosen & Katz, *Post-Closing Merger Litigation—The Road Ahead*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Jan. 16, 2019), <https://corpgov.law.harvard.edu/2019/01/16/post-closing-merger-litigation-the-road-ahead/>.

<sup>125</sup> *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014). The business judgment rule specifies that the court will not review the business decisions of directors who performed their duties in good faith; with the care that an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the directors reasonably believe to be in the best interests of the corporation. *Aranson v. Lewis*, 473 A.2d 805, 812 (1984); *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971).

<sup>126</sup> See, e.g., in re Ezc Corp. Inc. Consulting Agreement Derivative Litig., C.A. No. 9962-VCL, 2016 WL 301245 (Del. Ch. Jan. 25, 2016) (extending *MFW* framework to controlling shareholder going concern self-dealing transactions); in re Martha Stewart Living Omnimedia, Inc. Stockholder Litig., 2017 Del. Ch. LEXIS 151 (extending *MFW* to third-party merger that provides that controller with a unique benefit); *IRA Trust FBO Bobbie Ahmed v. Crane*, C.A. No. 12742-CB (Del. Ch. Dec. 11, 2017) (extending *MFW* to the creation and distribution of new classes of low-vote stock in order to preserve the voting power of a controller).

<sup>127</sup> In re Synutra Int'l, Inc. S'holder Litig., C.A. No. 2017-0032-VCL (Del. Ch. Feb. 2, 2018) (granting motion to dismiss).

<sup>128</sup> *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015).

that “the long-standing policy of our law has been to avoid the uncertainties and costs of judicial second-guessing when the disinterested shareholders have had the free and informed chance to decide on the economic merits of a transaction for themselves.”<sup>129</sup> Since 2015, Delaware courts have applied the new standard set forth in *Corwin* to dismiss several shareholder suits.<sup>130</sup>

The common thread in these rulings is the view that, “[w]hen disinterested equity owners . . . can easily protect themselves at the ballot box . . . the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits.”<sup>131</sup> As prominent corporate lawyers noted: “The evolving doctrine affirms the view that, with sophisticated institutional investors now dominating equity markets, the courts can (and as a matter of efficiency should) avoid extensive litigation-driven second-guessing in the great run of transactional situations.”<sup>132</sup>

This shift, which also affected other jurisdictions, has important implications on our competition for votes analysis.<sup>133</sup> First, *Corwin* and *MFW* generated strong incentives for company insiders to bring *more* matters to shareholder vote. Under this new paradigm, control over major corporate decisions relocated from courts to the market,<sup>134</sup> thereby increasing the overall importance of the competition for votes. Second, in order to fulfill its new role as a substitute for enhanced judicial protection, the competition for votes has to operate seamlessly and without frictions. This, in turn, requires a broader understanding of the legal mechanisms that facilitate the operation of the competition for votes, an understanding that this Article aims to promote.

### III. THE EMPIRICAL EVIDENCE

This Part explores, based on empirical analysis and other existing studies, the factors affecting shareholder voting, including proxy advisor support, management support, majority shareholder support, and types of proposals. It demonstrates that shareholder votes fluctuate and change based

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<sup>129</sup> *Id.* at 312–13.

<sup>130</sup> See, e.g., Cadwalader, Wickersham and Taft LLP, *2016 Year in Review: Corporate Governance Litigation and Regulation*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Jan. 31, 2017), <https://corpgov.harvard.edu/2019/01/16/post-closing-merger-litigation-the-road-ahead/>; Wachtell, Lipton, Rosen & Katz, *supra* note 124.

<sup>131</sup> *Corwin*, 125 A.3d, at 313.

<sup>132</sup> Wachtell, Lipton, Rosen & Katz, *supra* note 124. See also Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263 (2019) (describing how the rise of institutional ownership led to the decline in the importance of Delaware courts).

<sup>133</sup> For example, in May 2016, the New York Court of Appeals adopted the standard of review outlined in *MFW*. See *Matter of Kenneth Cole Prods., Inc., S’holder Litig.*, 27 N.Y.3d 268 (2016).

<sup>134</sup> Goshen & Hannes, *supra* note 132, at 265.

on a variety of factors, and therefore gives credence to the potential for a competition for votes.

### A. *Shareholder Voting is Not a Constant*

To examine the various patterns in shareholder voting, we created a dataset of all matters that were brought to a shareholder vote from 2005 to 2017 at all publicly traded companies in the United States. Using the Shark-Repellent dataset, we collected detailed data on three major types of shareholder votes: (i) proxy fights; (ii) shareholders' proposals; and (iii) Say on Pay proposals.

For proxy fights, we collected and analyzed information on the vote outcome (for example, whether management or dissident won the proxy fight) and on the interaction between the support of ISS or Glass Lewis and the vote outcome. For shareholder proposals, we collected and analyzed data on the number of submitted proposals during the examined period and on the level of shareholder support for proposals in which management has recommended "no." We also conducted several specified analyses by subject matter. For Say on Pay proposals, we collected data on average support rates during the examined period and on the percentage of passed proposals.

The upshot of this data analysis is clear: shareholder voting is not constant. There is a significant variation in the voting patterns of investors along the three examined dimensions: proxy fights, shareholder proposals, and Say on Pay proposals. While the percentage of shareholders who are willing to side with management may vary over the years based on certain factors, including the subject matter and the recommendations of proxy advisors, the data clearly show that investors do not always stick in the pocket of management. Such variation stimulates the competition for votes.

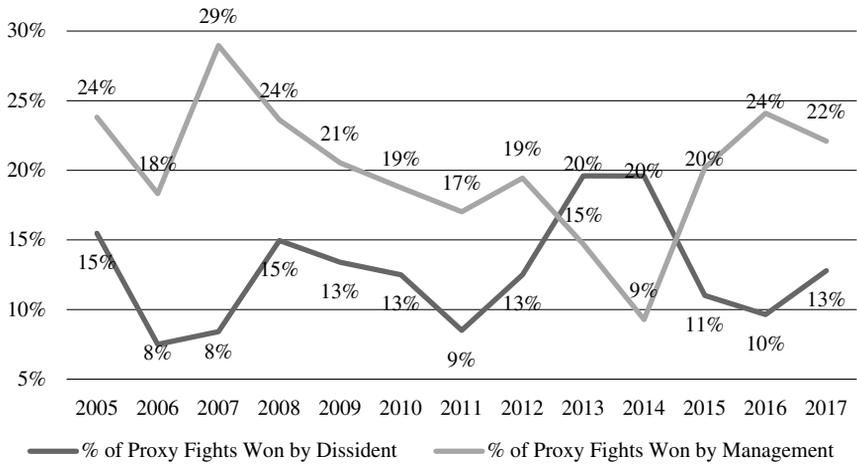
#### 1. Proxy Fights

Proxy fights, where a competing slate of directors is put against the company's slate,<sup>135</sup> establish the first method of measuring voting fluctuation. In many cases, the dissident and the company settle before a vote, but in the cases where a vote occurred, the variance is noticeable. Between 2005 and 2017, the overall percentage of proxy fights won by the dissident has been as low as 7.5% in 2006 and as high as 19.6% in 2013. Reciprocally, the overall percentage won by management in this time period dipped as low as 9.3% in 2014 and climbed as high as 29.0% in 2007.

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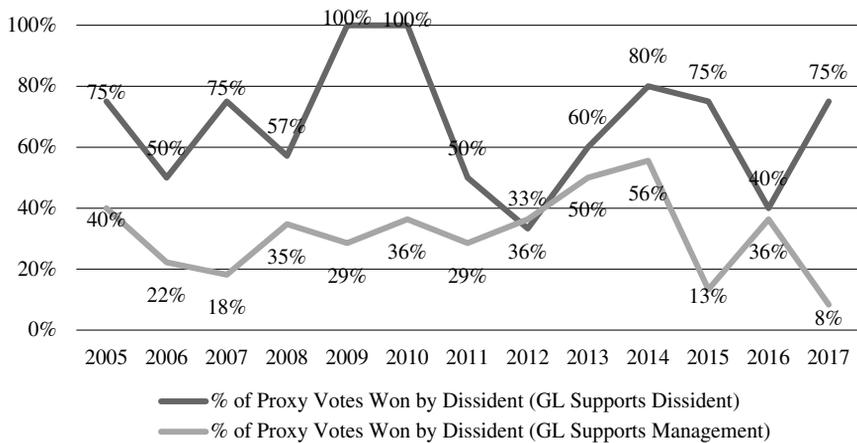
<sup>135</sup> See Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CALIF. L. REV. 1071, 1073 (1990); Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1267–68 (2009); Scott Hirst, *Universal Proxies*, 35 YALE J. ON REG. 437, 439 (2018); Steven M. Davidoff, *Revisiting the Proxy Contest*, DEALBOOK (Mar. 2, 2009, 9:30 AM), <https://dealbook.nytimes.com/2009/03/02/revisiting-the-proxy-contest/>.

FIGURE 1: PROXY FIGHTS OUTCOMES



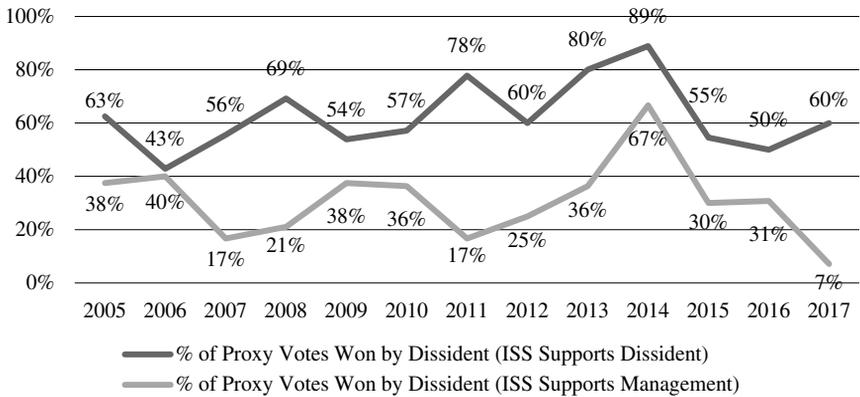
The voting recommendations of prominent proxy advisory firms are also an important factor affecting shareholders’ vote in the proxy fight context. As Figure 2 demonstrates, when Glass Lewis supports the dissident in a proxy fight, the success rate has reached as high as 100%, as in 2009 and 2010. When Glass Lewis supports management, the average dissident’s success rate dips as low as 13% or 8%, as in 2015 and 2017, respectively.

FIGURE 2: GLASS LEWIS SUPPORT AND PROXY VOTE OUTCOMES



Likewise, when ISS supports a dissident, average success rates reach as high as 88.89%, as in 2014, but when ISS supports management, average dissident success rates dip as low as 7.14%, as in 2017.

FIGURE 3: ISS SUPPORT AND PROXY VOTE OUTCOMES



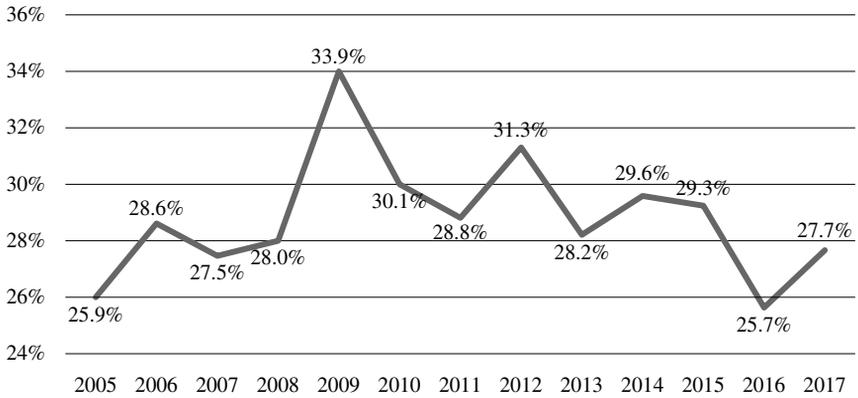
Proxy fights, however, do not tell us the whole story. A further look at shareholder and Say on Pay proposals' success rates also sheds light on the variable way in which shareholders express their votes.

## 2. Shareholder Proposals

Shareholder proposals represent an additional gauge of the large fluctuation in shareholder voting trends.<sup>136</sup> Overall investor support, as a percentage of votes cast for shareholder proposals in which management has recommended “no,” increased slightly between 2015, when it rested at 25.95%, and 2018, when it reached 27.68%. Though overall, this is a decrease from its peak of 33.92% in 2009.

<sup>136</sup> The non-binding shareholder proposal rule relies on SEC Rule 14a-8, under which an individual shareholder can submit a shareholder proposal if they continuously hold at least \$2,000 in market value or 1% of the company's stock for at least one year prior to the shareholder meeting. See Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2011). Others have written about shareholder proposals. See, e.g., Paul Rose, *Shareholder Proposals in the Market for Corporate Influence*, 66 FLA. L. REV. 2179, 2185 (2014); Kobi Kastiel & Yaron Nili, *The Giant Shadow of Corporate Gadflies*, S. CAL. L. REV. 2021 (forthcoming).

FIGURE 4: SUPPORT FOR SHAREHOLDER PROPOSALS WITH MANAGEMENT RECOMMENDATION OF NO



These numbers can be further broken down, based on the matter that was up for a vote, into the following categories: shareholder corporate governance proposals, shareholder executive compensation proposals, and shareholder environmental and social proposals. Each category has experienced unique voter patterns.

Support for shareholder corporate governance proposals has remained comparatively high, remaining consistently between 31% and 41% overall, with the percentage of passing proposals ranging from 13.79% to 25.70% since 2005. Over this same period, the percentage of proposals that received a high level of support (more than 40% support) has continued to fluctuate, with over 50% of proposals receiving high support in 2009 but less than 30% receiving high support in 2014.

Though it experienced a brief uptick in 2009, support for shareholder executive compensation proposals has fallen steadily since 2005, when 26.01% of the proposals garnered more than 40% support as a percentage of votes cast; in 2017 only 3.03% of these proposals had garnered more than 40% support.<sup>137</sup> Finally, support for shareholder environmental and social proposals experienced a large increase between 2005 and 2017. In 2005, average support as a percentage of votes cast sat just below 9%, and none of the proposals passed. This number has climbed steadily to 20.67% support as a percentage of votes cast and 2.26% of proposals passing in 2017.

Overall, voter support for shareholder proposals varies widely, further indicating the presence of a competition for votes based on a multitude of factors.

<sup>137</sup> We note that such decline is correlated with the introduction of mandatory Say on Pay votes. See *infra* note 162.

### 3. Say on Pay Votes

The competition for votes can also be detected in shareholders' fluctuating support for proposed management compensation packages. Companies are now required to bring their executive pay packages to a non-binding shareholder vote at least once every three years, and in most cases, annually, in what is termed "Say on Pay."<sup>138</sup> While in many cases these pay packages receive strong support from shareholders, there are a non-trivial number of companies in which management fails to receive significant support.<sup>139</sup> Often the lack of significant shareholder support is tied to overall shareholder dissatisfaction with management.<sup>140</sup> Moreover, in many cases, management views a vote of at least 20% against a non-binding Say on Pay proposal as significant.<sup>141</sup> Such a level of dissent is substantially more likely to generate a company response.<sup>142</sup> As Figure 5 below shows, shareholder support in Say on Pay votes has been far from constant. When the Say on Pay mandate took effect in 2011, 251 S&P 1500 companies received less than 80% support, decreasing to 159 companies in 2015 and trending back up to 183 companies in 2019.<sup>143</sup>

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<sup>138</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) (requiring the SEC to set rules with regard to executive compensation and shareholder ratification of such compensation ("Say on Pay")); Fabrizio Ferri & Robert Göx, *Executive Compensation, Corporate Governance, and Say on Pay*, 12 *FOUND. & TRENDS IN ACCT* 1 (2018) (reviewing the history of the Say on Pay vote and current U.S. practices).

<sup>139</sup> Laura Elmore, Henry Mbom & Brian Myers, *Executive Pay Matters—Say-on-Pay 2019 Annual Update*, HARV. L. SCH. F. ON CORP. GOV., <https://corpgov.law.harvard.edu/2020/03/17/executive-pay-matters-say-on-pay-2019-annual-update/>.

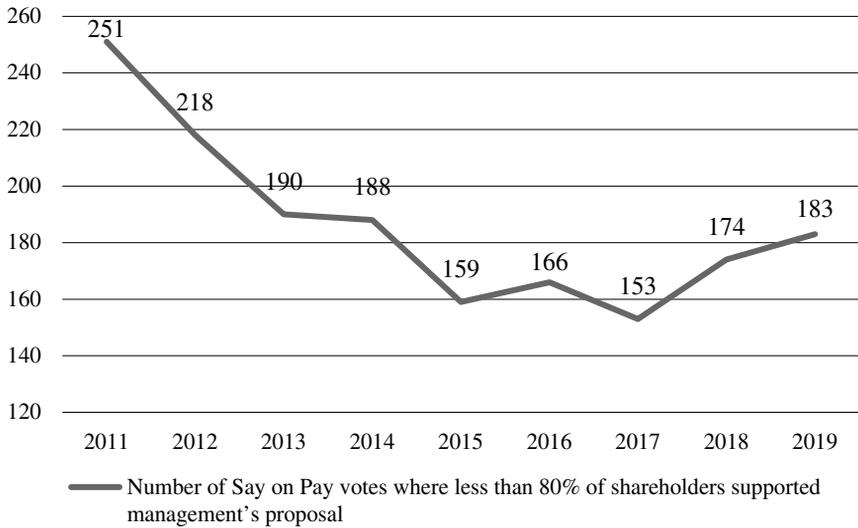
<sup>140</sup> Jill E. Fisch, Darius Palia & Steven Davidoff Solomon, *Is Say on Pay All About Pay? The Impact of Firm Performance*, 8 HARV. BUS. L. REV. 101 (2018).

<sup>141</sup> *Id.* at 113. The authors define "low say on pay vote" as a dummy variable equal to "1" if the "against" vote is greater than or equal to 20%. They explain that it is consistent with the methodology of prior academic studies that characterize a high level of dissent as receiving less than 80% of the vote.

<sup>142</sup> *Id.*

<sup>143</sup> This data is consistent with existing research finding that 13.6% of Say on Pay proposals submitted to S&P 1500 companies between 2010 and 2015 received less than 80% support. *Id.*

FIGURE 5: SAY ON PAY SUPPORT



### B. Existing Studies also Establish Voting Variance

Other empirical studies examining the voting patterns of institutional investors and voting recommendations of proxy advisors further corroborate our results. In particular, these studies show that there is significant variance in the vote of institutional investors as well as in the recommendations of proxy advisors. In addition, while the most deferential investors do tend to vote with management more often, they do not always vote in one direction, and occasionally they vote against management. The rest of this section will present this evidence.

#### 1. Variation in Institutional Investors' Votes

A recent study by Emiliano Catan and Ryan Bubb analyzed a comprehensive dataset of votes cast on 33,262 proposals from 3844 portfolio companies from 2010 to 2015 by 3617 mutual funds, which in total hold almost 80% of mutual fund industry assets.<sup>144</sup> They find that the “Big Three” passive asset managers—BlackRock, Vanguard, and State Street—follow corporate management’s recommendations at much higher rates than other investors, and generally oppose shareholder proposals at far higher rates than other investors. However, even mutual funds in the most deferential group, which they define as the “Managerialist Party,” do not always support management. Across all management proposals, members of the Managerialist Party vote in favor 82% of the time, and they vote in favor of shareholder

<sup>144</sup> Bubb & Catan, *supra* note 66.

proposals (and hence generally against management's wishes) 19% of the time. In comparison, these rates across all mutual funds are 70% and 47%, respectively.

The two other groups of investors, which Catan and Bubb define as the "Shareholder Intervention Party" and the "Shareholder Veto Party," vote against management at much higher rates.<sup>145</sup> Their data shows that the Shareholder Intervention Party supports shareholder proposals at a rate of 84%, compared to only 50% for the Shareholder Veto Party. In contrast, the Shareholder Veto Party supports management proposals at a rate of only 50%, compared to 62% support for the Shareholder Intervention Party.<sup>146</sup>

An additional study by Morningstar surveyed the largest index funds and exchange traded funds, twelve in total, across three regions—the United States, Europe, and Asia—as of late 2017. This study shows that the starting position for all surveyed asset managers is support of company management and boards, as most votes are linked to routine administrative matters. However, "as voting records show, there are significant differences among firms in how they voted, especially with respect to voting against management."<sup>147</sup> In particular, the survey shows that from 2016 to 2017, BlackRock voted against management in 9% of the cases, Vanguard in 6%, State Street in 14%, Schwab in 15%, and Deutsche AM in 23%. One recent high-profile case mentioned in the study involves Exxon Mobil. In that case, BlackRock and Vanguard supported a shareholder proposal seeking greater disclosure of climate-related risks, against the Exxon board's recommendation.<sup>148</sup>

In sum, recent empirical evidence presented in this subsection clearly shows that a competition for votes is vibrant and kicking. There is a significant variation in the voting patterns of institutional investors based on the issue at stake and the type of investors. Moreover, even mutual funds in the most deferential group do not always support management.

Furthermore, the percentages of votes against management present the lower bound of opposition to management for two main reasons. First, many of the management proposals pertain to procedural issues, such as the nomination of uncontroversial board members. If these run-of-the-mill management proposals are excluded from the sample, the competition for votes is expected to exhibit more heterogeneity. Second, some of the proposals might receive investors' support only after some engagement with management, as well as the commitment of the latter to submit follow-up manage-

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<sup>145</sup> Bubb & Catan, *supra* note 66, at 36. The Shareholder Intervention Party supports efforts to actively intervene in corporate affairs, including by supporting shareholder-initiated reforms to basic corporate governance rules and activist investor proxy contests for board seats. The Shareholder Veto Party focuses on monitoring corporate management and vetoing management's proposed courses of actions when they raise concerns.

<sup>146</sup> Bubb & Catan, *supra* note 66, at 17.

<sup>147</sup> Hortense Bioy et al., *Passive Fund Providers and Investment Stewardship*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (Dec. 21, 2017), <https://corpgov.law.harvard.edu/2017/12/21/passive-fund-providers-and-investment-stewardship/#more-103685>.

<sup>148</sup> *Id.*

ment proposals that promote changes that would be beneficial to shareholders. Thus, even when the impact of the competition for votes is not reflected in the actual outcome, it could still have an important *ex ante* effect by increasing the bargaining power of these asset managers vis-à-vis management.

## 2. Variation in Proxy Advisors' Recommendations

During the past decade, it has been argued that proxy advisory firms, such as ISS and Glass Lewis, have dramatic influence on vote outcomes.<sup>149</sup> If this is indeed the case, one could claim that such outsized influence negatively affects the competition for votes. In this subsection, we show that (i) the data on the potential influence of proxy advisors on shareholder voting patterns is mixed, at best; and (ii) there is also significant variation in the recommendations of proxy advisors, so that even if these advisory firms have outsized influence on investors' votes, this does not necessarily suggest that such influence will always be in favor of management. The activity of proxy advisors, thus, does not significantly inhibit the competition for votes.

The literature shows mixed evidence on the likely impact of proxy advisory firms on shareholder voting. For example, a recent extensive review of the empirical evidence, conducted by Larcker and Tayan,<sup>150</sup> provides that an "against" recommendation is associated with a reduction in the favorable vote count by 10% to 30%.<sup>151</sup> On the other hand, an article by Choi, Fisch, and Kahan concludes that researchers overstate the influence of proxy advisory firm recommendations. Controlling for observable factors related to governance quality, these authors estimate that the recommendations of ISS shift investor votes by 6% to 10%. They conclude, "[t]o the extent that the information provided by a proxy advisor affects the shareholder vote, the proxy advisor has some limited influence, but inferring from this correlation that the advisor has power over the shareholder vote is an overstatement."<sup>152</sup>

In another study from 2015, McCahery, Sautner, and Starks, using a sample of 143 institutional investors, find that just over half (55%) agree or strongly agree that proxy advisory firms help them make more informed voting decisions.<sup>153</sup> The authors conclude that institutional investors rely on the advice of proxy advisors to complement their decision-making, rather than relying on them exclusively as a substitute for their decision-making.<sup>154</sup>

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<sup>149</sup> For a review of this literature, see Asaf Eckstein & Sharon Hanes, *A Long/Short Incentive Scheme for Proxy Advisory Firms*, 53 WAKE FOREST L. REV. 787, 795–801 (2018).

<sup>150</sup> Larcker et al., *supra* note 108.

<sup>151</sup> *Id.*

<sup>152</sup> Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 882 (2010).

<sup>153</sup> Joseph A. McCahery, Zacharias Sautner & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2928 (2016).

<sup>154</sup> *Id.* at 2929.

Indeed, the disagreement in the empirical literature about the degree to which proxy advisors influence vote outcomes is largely due to measurement: it is impossible to know how institutional investors would have voted on the same ballot if proxy advisors did not issue a recommendation or if they had made a different recommendation. Furthermore, it is impossible to know the degree to which institutional investors take into account the same information that ISS and Glass Lewis use to arrive at their recommendations, thereby reaching the same conclusion about how to vote on specific issues without actually indiscriminately relying on the proxy advisors.<sup>155</sup>

There is also some evidence showing that even the most deferential asset managers do not always blindly follow proxy advisors' recommendations. For example, a recent study examines the alignment between the votes of the Big Three and the recommendations of ISS and Glass Lewis.<sup>156</sup> The study shows that in 2017, BlackRock voted in line with a "for" recommendation by ISS or Glass Lewis in 88% and 83% of the votes, respectively; State Street voted in line with a "for" recommendation in 88% and 80% of the votes, respectively; and Vanguard voted in line with a "for" recommendation in 86% and 82% of the votes, respectively. The data also show that these alignments decrease significantly when it comes to "against" recommendations made by proxy advisors. BlackRock voted in line with an "against" recommendation by ISS or Glass Lewis in 69% and 52% of the votes, respectively; State Street voted in line with an "against" recommendation in 80% and 62% of the votes, respectively; and Vanguard voted in line with an "against" recommendation in 59% and 44% of the votes, respectively.<sup>157</sup>

Thus, the data clearly suggest that concerns of proxy advisors having significant influence over the votes are overstated. Even the votes of the largest and most influential investors often deviate, sometimes significantly, from the recommendations of proxy advisors.

Regardless, even if one believes that proxy advisors do influence vote outcomes significantly, this does not suggest that they will always exercise their influence in favor of management. For example, Alexander, Chen, Seppi, and Spatt study the role of ISS recommendations in proxy contests.<sup>158</sup> Their sample includes 198 proxy contests between 1992 and 2005. In 55% of cases, ISS recommends in favor of management's nominations to the board; in 45%, they recommend in favor of the dissident slate. The authors also find that ISS recommendations for the dissident slate increase the probability of victory by 14% to 30%, and that these recommendations are

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<sup>155</sup> Larcker et al., *supra* note 108.

<sup>156</sup> Timothy M. Doyle, *The Conflicted Role of Proxy Advisors*, AM. COUNCIL FOR CAP. FORMATION (May 22, 2018), <https://corpgov.law.harvard.edu/2018/05/22/the-conflicted-role-of-proxy-advisors/>.

<sup>157</sup> *Id.*

<sup>158</sup> Cindy R. Alexander et al., *Interim News and the Role of Proxy Voting Advice*, 23 REV. FIN. STUD., 4419, 4443 (2010).

associated with positive shareholder returns. The authors conclude that “proxy advice may facilitate informed proxy voting.”<sup>159</sup>

Relatedly, other studies have also found that ISS recommendations that were unfavorable to management had a negative impact on the votes cast in favor of management. For example, Bethel and Gillan found that “ISS recommendations unfavorable to management were associated with 13.6% to 20.6% fewer votes cast in favor of management, depending on proposal type.”<sup>160</sup> A 2013 study by Ertimur, Ferri, and Oesch found that negative ISS and Glass Lewis recommendations are associated with 25% and 13% more votes against executive compensation plans, respectively.<sup>161</sup> Finally, a 2015 study by Nadya Malenko and Yao Shen also found that negative ISS recommendations reduce the votes in favor of Say on Pay proposals by approximately 25%.<sup>162</sup> In all of those situations, ISS influence could actually cultivate the competition for votes as it counterbalances management’s excessive power.

### 3. Directors Failing to Receive Majority Support

Recent data also demonstrate the importance of the market for votes on contemporary director elections. In fact, by all metrics, the number of directors failing to receive significant support from their shareholders has risen, meaning that shareholders have used their votes to meaningfully express dissatisfaction with directors with increasing frequency. For example, the number of directors failing to receive majority support from their shareholders rose from 345 in 2015 to 478 in 2019, even though fewer directors stood for election in 2019 than in 2015.<sup>163</sup> The number of directors failing to receive at least 70% support rose by over 45% in the same time period—from 1185 in 2015 to 1726 in 2019.<sup>164</sup>

The upward trend in directors failing to receive majority support extends even to the largest corporations, demonstrating the wide and influential reach of the market for votes. In fact, the 500 most widely held companies (which are generally also the largest) experienced a larger growth rate in directors failing to receive majority support compared to the entire population of directors. Specifically, the number of directors failing to receive ma-

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<sup>159</sup> Cindy R. Alexander et al., *The Role of Advisory Services in Proxy Voting* (NBER Working Paper Series, Working Paper No. 15143, 2009), <https://www.nber.org/papers/w15143>.

<sup>160</sup> Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29, 30 (2002).

<sup>161</sup> Yonca Ertimur, Fabrizio Ferri & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51(5) J. ACC. RES. 951, 953 (2013).

<sup>162</sup> Nadya Malenko & Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*, 29 REV. FIN. STUD. 3394, 3424 (2016).

<sup>163</sup> Theo Francis, *Corporate Board Elections Getting a Little Less Cozy*, WALL ST. J. (Oct. 8, 2019), <https://www.wsj.com/articles/corporate-board-elections-getting-a-little-less-cozy-11570532400?shareToken=st2ed2c1ac99bb4aa499e918c327ffefb>.

<sup>164</sup> *Id.*

majority support jumped significantly between 2015 to 2019 from fifteen to fifty, respectively.<sup>165</sup>

The correlation between companies experiencing a Say on Pay proposal failure and at least one director failing to attain majority support is also noticeable. For example, in the 2019 proxy season, 27% of companies failing to receive majority support for Say on Pay had at least one director also failing to receive majority support.<sup>166</sup> The trend is also clear among companies with at least one director failing to attain 70% favorability, as 36% also failed to attain 70% favorability for their Say on Pay votes.<sup>167</sup>

This rise in negative votes is an important indicator of the market for votes, as it appears to discredit the familiar idea that “[i]f they don’t like a stock, they’ll vote with their feet.”<sup>168</sup> Shareholders are no longer simply using the “Wall Street walk” to express their dissatisfaction with directors. Instead of voting with their feet, they are voting with their votes. In some cases, this is because managed index funds or portfolios obligate them to stay.<sup>169</sup> This, in turn, requires boards to effectively engage with investors in the shadow of negative votes.<sup>170</sup>

#### IV. IMPLICATIONS FOR CURRENT GOVERNANCE DEBATES

Our analysis of the competition for votes has important policy implications on major corporate governance debates that have taken place in the past decades.<sup>171</sup> While the competition for votes has naturally arisen through shareholder involvement, there are a number of governance arrangements that could either encourage or inhibit this market from progressing. Going

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> Francis, *supra* note 163.

<sup>169</sup> *Id.*

<sup>170</sup> *See id.*; BROADRIDGE & PWC PROXY PULSE, 2013 PROXY SEASON RECAP (3d ed. 2013), at 3 (“ESG matters continue to be a topic of engagement for institutional investors. BlackRock reported that it engaged with 256 companies globally on ‘environmental risks and opportunities.’ State Street reported that it had 89 engagements on climate risk/reporting alone. Additionally, State Street launched R-Factor™ in 2019—the ‘Responsibility-Factor Score[.]’—a measure of a company’s operations and governance related to ‘financially material ESG challenges facing the company’s industry.’”).

<sup>171</sup> *See* Brief for Harvard Law School Professor as Amici Curiae Supporting Appellants, *AFSCME v. AIG*, 462 F.3d 121 (2d Cir. 2006); Bebchuk, *Myth of Shareholder Franchise*, *supra* note 14, at 732 (calling for increased shareholder prerogatives and outlining various markets such as the market for new capital and the Product Market); Bainbridge, *Shareholder Disempowerment*, *supra* note 42; *see generally* Bebchuk, *Case for Increasing*, *supra* note 42; Lucian A. Bebchuk, *Response to Increasing Shareholder Power: Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006) [hereinafter Bebchuk, *Letting Shareholders Set the Rules*]. *But see* Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006) (countering Bebchuk); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 623–24 (2006) (finding that shareholders tend to be rationally apathetic in letting management run the company and deferring to their recommendations in the usual course of things).

forward, investors and policymakers should examine a governance issue not only in light of the actual issue at stake, but also in light of its implications on the competition for votes; in particular, whether the adopted governance arrangement could also foster or stifle the competition for votes. This Part highlights these potential implications.

Several heated governance debates are enriched by the competition for votes. These debates include the appropriateness of using dual-class structures at the IPO stage, the proper role of “passive investors,” reforms aimed at increasing the participation of retail investors, the long-standing debate over vote buying, reforms that aim to increase the barriers for submitting shareholder proposals, recent proposals to regulate the activity of proxy advisors, and recent proposal to amend the proxy contest reimbursement rule. In all of these cases, we analyze the proposed reforms and initiatives, as well as their potential implications, through the competition for votes framework, showing how this new theoretical framework impacts these debates.

### A. Dual-Class Structures

A dual-class structure enables founders of public companies to retain a lock on control while holding a minority of the company’s equity capital. Since Google went public with dual-class stock in 2004, IPOs have increasingly featured dual-class stock: 19% of the companies listed on U.S. exchanges in 2017 used a dual-class structure, compared with just 1% in 2005.<sup>172</sup> This growing use of dual-class structures has rekindled the long-standing heated debate about the desirability of these structures.<sup>173</sup> On one side of the debate stand those who believe that dual-class structures should be permitted, as they enable talented founders with superior skills to lead the company without being subject to short-term market pressures.<sup>174</sup> On the other side stand some leading institutional investors, their advisors, prominent governance thought leaders, and some academics who express strong

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<sup>172</sup> *Investors Petition NYSE, NASDAQ to Curb Listings of IPO Dual-Class Share Companies*, COUNCIL OF INSTITUTIONAL INV. 3 (Oct. 24, 2018), <https://www.prnewswire.com/news-releases/petition-nyse-nasdaq-to-curb-listings-of-ipo-dual-class-share-companies-300737019.html>.

<sup>173</sup> See Lucian Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 596–601 (2017).

<sup>174</sup> See, e.g., Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560, 567–68 (2016) (arguing that it could be value enhancing to provide a talented founder with a lock on control, as it enables that founder to freely implement her strategy and “utilize” her skills to produce superior returns); Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 137–38 (1987) (raising the claim that dual-class stock facilitates long-term planning); Wilson Sonsini Goodrich & Rosati, *Dual-Class Stock and Private Ordering: A System That Works*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (May 24, 2017), <https://law.harvard.edu/2017/05/24/dual-class-stock-and-private-ordering-a-system-that-works/>.

opposition to the use of dual-class structures, who believe they “pose a serious risk to a company’s public shareholders.”<sup>175</sup>

In 2017, some institutional investors sought to limit the use of dual-class shares via private ordering. As part of this effort, one of the world’s largest index providers, Standard & Poor’s, excluded new IPO companies with multiple-class share structures from its index.<sup>176</sup> Around the same time, another leading index provider, FTSE Russell, decided to exclude companies with extremely low voting rights, or nonvoting rights, from its indices.<sup>177</sup> However, at this stage, it is not clear whether and to what extent these exclusions will discourage companies from going public with dual-class structures.<sup>178</sup>

Our analysis adds an additional layer to the debate over the desirability of the dual-class structures by focusing on the impact of these structures on the competition for votes. Dual-class shares stifle the competition for votes as they discourage competition over the votes of public shareholders. With dual-class structures in place, insiders have little incentive to be attentive to shareholder demands, as these insiders fully control the company decision-making. These insiders also do not need to solicit the support of other shareholders in order to pass decisions or to defeat a proxy fight.

Moreover, a dual-class structure enables the controller to obtain the liquidity and diversification benefits that come from unloading shares without bearing the costs of losing control. This, in turn, encourages the persistence of more controlling shareholder structures<sup>179</sup> and eliminates the impact of the competition for votes, except in the narrow context of some specific related-party transactions.<sup>180</sup> Thus, supporters of the competition for votes should generally oppose the perpetual use of dual-class structures.

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<sup>175</sup> Kimberly Gladman, *The Dangers of Dual Share Classes*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (May 21, 2012), <https://corpgov.law.harvard.edu/2012/05/21/the-dangers-of-dual-share-classes/>. For a review of the strong opposition to dual-class structures, see Bebchuk & Kastiel, *supra* note 173, at 596–99. For a discussion of the agency costs generated by dual-class structures with small-minority controllers, see Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 GEO. L.J. 1453 (2019).

<sup>176</sup> Davis Polk & Wardwell LLP, *Snap Decision: Leading Index Providers Nix Multi-Class Shares*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (Aug. 2, 2017), <https://corpgov.law.harvard.edu/2017/08/02/snap-decision-leading-index-providers-nix-multi-class-shares/>.

<sup>177</sup> After the adoption of the new exclusion rules, companies seeking inclusion in FTSE Russell’s indices will need to have at least 5% of voting rights held by unaffiliated public shareholders.

<sup>178</sup> For analysis of the impact of index exclusions, see Hirst & Kastiel, *supra* note 52, at 131–44. See also Wilson Sonsini Goodrich & Rosati, *The Continuing Support for Dual-Class Stock by Companies and Investors* (Oct. 17, 2017), <https://www.wsg.com/WSGR/Display.aspx?SectionName=/PDFSearch/wsgalert-dual-class-stock-1017.htm> (“multi-class stock structures will continue to be adopted by emerging growth companies”).

<sup>179</sup> Bebchuk & Kastiel, *supra* note 173, at 613–618.

<sup>180</sup> For example, the Delaware courts have encouraged controllers to obtain the approval of unaffiliated shareholders to the terms of a freeze-out merger by holding that transactions not enjoying such approval would be subject to strict scrutiny. See, e.g., *M&F Worldwide Corp.*, 88 A.3d at 644 (affirming MFW, 67 A.3d 496 (Del. 2013)).

### B. Passive Investors

In the past two decades, there has been a substantial shift from active management to index management. Mutual funds are the largest investors in U.S. corporations, and index funds—particularly those managed by the Big Three—are growing rapidly.<sup>181</sup> Not surprisingly, the increasing importance of these funds has generated a heated debate as to the benefits and costs of the shift toward passive investing and the role these investors should play in the public market.

In particular, this debate has focused on whether passive index funds have incentives to monitor insiders. Lucian Bebchuk and Scott Hirst provide comprehensive analysis showing that index funds have poor incentives to engage in stewardship activities that could improve governance and increase value.<sup>182</sup> On the other hand, Jill Fisch, Assaf Hamdani, and Steven Davidoff Solomon argue that index fund managers compete for funds “not only with each other but also with . . . active funds,” and therefore, “have an incentive to take measures to neutralize the comparative advantage enjoyed by sponsors of active funds.”<sup>183</sup> They do so by exercising their “voice” to prevent asset outflow and devoting increasing resources to engagement with portfolio companies.<sup>184</sup>

We suggest tackling this heated and important debate via our competition for votes framework. From a competition for votes perspective, the question of whether passive investors properly invest in monitoring and stewardship activities is of less importance. What is important is that passive investors do not always side with management.<sup>185</sup> The existence of competition for passive investors’ pivotal votes, and the fact that they do not consistently vote with management, are important factors that provide managers with strong ex ante incentives to perform well, disclose information, and internalize the interests of public shareholders.

As we have shown in the previous Part, passive index funds do not always vote with managers: there are clearly certain governance matters on which they vote with proponents. Occasionally, they also support activist hedge funds, but the data on contested elections reflect the lower bound. This is because many of the activist engagements settle before going to a vote.<sup>186</sup> One could assume that prior to settling, insiders had estimated that activists have a high likelihood of success, which is likely to be the case if

<sup>181</sup> See Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017); Jan Fichtner, Eelke M. Heemskerck & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. POL. 298, 299 (2017).

<sup>182</sup> Bebchuk & Hirst, *supra* note 26.

<sup>183</sup> Fisch, Hamdani & Davidoff Solomon, *supra* note 18, at 32, 35.

<sup>184</sup> *Id.*

<sup>185</sup> On the pivotal role of passive investors, see Kahan & Rock, *supra* note 26; Hamdani & Hannes, *supra* note 27.

<sup>186</sup> Bebchuk et al., *Dancing with Activists*, 137 J. OF FIN. ECON. 1 (forthcoming July 2020).

activists were able to gain significant support from investors. Those settlements with activists are, therefore, another indication of the existence of a competition for votes.

Another concern that has been expressed in the literature is that large passive investors are likely to exercise uninformed votes that could harm the corporation and its investors.<sup>187</sup> For that reason, Dorothy Lund Shapiro argues that passive investors should not be able to vote their shares.<sup>188</sup> Sean Griffith provides a similar proposal, arguing that mutual funds ought not to exercise voting discretion over governance issues because they do not have adequate information to decide these matters.<sup>189</sup>

Our analysis, however, shows that a vibrant competition for votes is likely to provide management and activist shareholders with incentives to produce and disseminate more information to shareholders, which would enable them to cast their votes intelligently.<sup>190</sup> And as Kahan and Rock argue, the massive size and scope of the prominent passively-managed funds and their ability to play a pivotal role in voting outcomes enhances passively-managed funds' incentives to acquire information, engage, and vote intelligently both in contested situations and on votes related to market-wide governance standards.<sup>191</sup>

Moreover, to cast informed votes, passive investors use the services of proxy advisors that supply them with voting related information and analysis. These investors can also follow the voting patterns of actively-managed funds (especially if they belong to the same fund family), which obtain firm-specific information in the course of their investment activities that can be material on some of the issues that come up to a vote.<sup>192</sup>

A proposal to prevent index funds from voting has another problematic effect on the competition for votes: it will reduce the available public float and limit the number of players that can participate in the voting process. The more a marketplace for votes is saturated with voting opportunities, the higher the likelihood that management and its opponents would have a fierce competition for the market shares they need, increasing market robustness

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<sup>187</sup> See, e.g., Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 761 (2017).

<sup>188</sup> See Lund, *supra* note 26, at 493 (claiming that passive investors should not vote because managers of passive funds are unlikely to thoughtfully engage with the companies and are likely to follow low-cost voting strategies, resulting in uninformed voting).

<sup>189</sup> Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, TEX. L. REV. (forthcoming, 2020). He does, however, believe that mutual funds ought to vote in contested situations because meaningful information is produced in those cases.

<sup>190</sup> See *supra* Part II.A.1.

<sup>191</sup> Kahan & Rock, *supra* note 26, at 3–4.

<sup>192</sup> *Id.* at 35–39 (arguing that with regard to routine monitoring, large actively-managed funds will often be in a better position to monitor because of their firm-specific knowledge, and explaining how passively managed funds enjoy such spillover knowledge generated by active managers).

and therefore the ex ante incentives to improve the governance of the corporation.

A third concern that has been expressed in the literature is related to the increasing concentration of ownership in the U.S. capital market, created mostly by the substantial shift from active management to index management. John Coates refers to it as the “Problem of Twelve”; that is, the likelihood that in the near future roughly twelve individuals will have practical power over the majority of U.S. public companies.<sup>193</sup> Indeed, the rise in ownership concentration will reduce the number of players that can participate in corporate elections, and calls to limit the size of investors may be desirable to prevent this.

However, the number of players participating in the corporate election is only one factor in our framework. An equally important building block is the question of whether and how often these pivotal investors, who have the power to determine the vote outcome, switch their vote and do not blindly support one side. As long as the vote of mutual funds is not one-sided—and evidence we present in Part III supports this view—then a competition over the votes of these twelve passive investors will emerge.

Thus, supporters of the competition for votes should generally oppose recent proposals to prevent index funds from voting their shares, or to otherwise limit their power, because they are generally uninformed or have limited incentives to become informed, which in turn puts their votes largely “up for grabs.”

### C. Retail Investors

Retail investors make up a significant portion of the U.S. public market, and therefore are essential to the competition for votes.<sup>194</sup> Corporate law scholars have taken investors’ rational apathy for granted for decades, considering it unavoidable once ownership is no longer closely held. The traditional explanation is well known: diversified retail investors, who individually hold small fractions of a firm’s equity capital, have “notoriously poor incentives to cast an informed vote,” as they know that their vote probably will not affect the outcome.<sup>195</sup> Since the process of informing and expressing one’s preferences is more costly than one’s potential gain, these investors often rationally choose to refrain from any involvement in the gov-

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<sup>193</sup> Coates, *supra* note 18.

<sup>194</sup> See, e.g., Geoffroy, *supra* note 105, at 2 (stating that total equity held by retail investors could be between 23% and 38% of the market).

<sup>195</sup> Kahan & Rock, *supra* note 26; see also Black, *supra* note 67, at 584–91 (discussing rational apathy and shareholders’ incentives to become informed); Christopher John Gulinello, *The Retail Investor Vote: Mobilizing*, 2010 UTAH L. REV. 547 (2010) (discussing rational apathy of retail investors).

ernance of the corporation.<sup>196</sup> Indeed, an average of only 30% of “retail” or individual holdings were voted at annual meetings.<sup>197</sup>

The absence of retail investors from the voting process has also been highlighted by the SEC as an issue that merits close attention. Recent e-proxy initiatives have attempted to mitigate the rational apathy of retail investors by streamlining the voting process.<sup>198</sup> Motivating retail investors, the missing voters, can have a substantial impact on election results, as reflected in the proxy wars referenced in the Introduction to this Article. In some instances, retail investors have the power to tip the scales in favor of management or the challenger.<sup>199</sup>

However, it is not clear that current proposed methods, including the use of online voting, have increased voter participation, or even shifted the balance of incentives that lead retail investors to be apathetic about their role.<sup>200</sup> For one, increased disclosure measures have swamped investors in lengthy, attorney-crafted standardized wording in proxy disclosures. In addition, the prevalence of online information and communication has led to drawn out information campaigns between sides in proxy wars, such that retail investors may feel overly inundated with information.<sup>201</sup> If the premise of rational apathy is that retail investors are not incentivized to inspect the information available to them in the first place, an exponentially growing pile of information will not solve that problem.<sup>202</sup>

In an earlier work, we presented a potential solution that could substantially mitigate, if not fully eliminate, the long-standing problem of retail investors’ rational apathy, with minimal regulatory burden.<sup>203</sup> This solution is based on the premise that the high economic and information costs associated with voting could be dramatically reduced by providing retail investors with a “nudge.” This “nudge” would come in the form of highly visible voting default arrangements that would allow (or force) them to choose from a menu of voting shortcuts. By allowing retail investors to choose the best agent to make an informed decision on their behalf and by increasing the visibility of the potential voting shortcuts (for example, through the use of

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<sup>196</sup> For a review of the long-standing problem of retail investors’ rational apathy, see Kobi Kastiel & Yaron Nili, *In Search of the “Absent” Shareholders: A New Solution to Retail Investors’ Apathy*, 41 DEL. J. CORP. L. 55, 55 (2016).

<sup>197</sup> BROADRIDGE & PWC PROXYPULSE, *supra* note 170.

<sup>198</sup> See SEC Press Release, SEC to Hold Roundtable on Proxy Voting (Jan. 27, 2015), <https://www.sec.gov/news/pressrelease/2015-15.html>.

<sup>199</sup> Kastiel & Nili, *supra* note 196, at 75–83.

<sup>200</sup> See, e.g., Geoffroy, *supra* note 105, at 7–8; Kastiel & Nili, *supra* note 196, at 66–70.

<sup>201</sup> See Kastiel & Nili, *supra* note 196; Flaherty, *supra* note 77 (“‘The intent of both sides is very clear,’ said Frank Rhodes, 84, who retired from P&G in 1989 and lives in Crestview Hills, Kentucky, a short drive from the company’s Cincinnati, Ohio headquarters. ‘I just don’t understand why they’re sending all of this mail.’”).

<sup>202</sup> Kastiel & Nili, *supra* note 196, at 69 (detailing that in 1994, Apple’s proxy statement was eighteen pages and had two shareholder proposals, while in contrast, twenty years later, the statement was ninety pages with eleven proposals).

<sup>203</sup> Kastiel & Nili, *supra* note 196.

pop-up screen and opt-out option), our proposed solution has the potential to increase shareholder involvement significantly.

Under our proposed solution, by checking a box, a retail investor could instruct that her shares be voted in the same manner as a specific large and sophisticated shareholder, with management, in accordance with the recommendation of a proxy advisor, or in accordance with the majority vote of institutional investors not affiliated with management.<sup>204</sup> Jill Fisch suggested a similar proposal: increase the level of retail investor participation by permitting them the opportunity to submit standing voting instructions.<sup>205</sup>

The absence or presence of retail investors from the voting process is directly tied to the efficacy of the competition for votes. As explained in Part II, the market competition for votes would operate more effectively with greater liquidity. Retail investors can significantly enhance such liquidity. Therefore, supporters of the competition for votes framework should be concerned with retail investors' rational apathy, and generally support proposals to incentivize these investors to vote. One major way of doing so will be by facilitating the legal ability to use highly visible voting default arrangements that would allow (or force) retail investors to choose their preferred votes from a menu of voting shortcuts, as we suggested in our earlier work.

#### D. Vote Buying

Though there is no express rule in the United States prohibiting shareholder vote buying, the general perception is that vote buying is not permitted. For example, under Delaware law, it is illegal to buy votes when the purpose is "to defraud or in some way disenfranchise the other stockholders."<sup>206</sup> Moreover, a voting agreement can be annulled if its object and purpose fail the test of intrinsic fairness.<sup>207</sup> Furthermore, the SEC has imposed disclosure duties for investors regarding their share position.<sup>208</sup>

Vote buying is generally not permitted, since it imposes high risks for publicly traded companies. When a shareholder has more votes than economic stake in the company, she can easily make decisions against the interest of the company, eventually reducing its value.<sup>209</sup> Furthermore, vote buying can lead to secret ownership of big corporations, which is politically undesirable.<sup>210</sup>

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<sup>204</sup> *Id.* at 59, 89, 97.

<sup>205</sup> Fisch, Palia & Davidoff Solomon, *supra* note 140.

<sup>206</sup> Schreiber v. Carney, 447 A.2d 17, 25 (Del. Ch. 1982).

<sup>207</sup> *Id.* at 26.

<sup>208</sup> *E.g.*, SEC Form 13F, Information Required of Institutional Investment Managers Pursuant to Section 13(f) of the Securities Exchange Act of 1934 and Rules Thereunder, 17 C.F.R. § 249.325 (2005); Exchange Act 16, 15 U.S.C. § 78p (2000 & Supp. 2002).

<sup>209</sup> Henri Hu & Bernard Black, *The New Vote Buying: Empty and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

<sup>210</sup> *Id.*

Our competition for votes analysis offers a new perspective on the question of whether vote buying should be permitted. On the one hand, investors who pay for votes, rather than investors who suffer from rational apathy, are more likely to exercise these votes. Allowing retail investors to sell their votes to a third party that is more likely to exercise the vote will lead to a more robust competition for votes.

However, vote buying can stifle the competition for votes as well. If vote buying is permitted, insiders or activist hedge funds could aggregate votes before an important election and increase their influence over the company decision-making. Suppose a controlling shareholder holds 30% of the company's voting rights—if that controller could purchase an additional 10% or 20% of the votes immediately before an important election, such controller could be effectively shielded from any disciplinary effect. Massive vote buying could also reduce the available public float and limit the number of players that can participate in the corporate election.

Therefore, supporters of the competition for votes may agree to some vote buying arrangement, but only if it is subject to certain limitations. First, insiders should not be permitted to engage in vote buying. Because insiders already exercise significant influence over company decision-making, their ability to purchase additional votes and amplify their voting power could have a chilling effect on the competition for votes. Second, there should be a cap on the number of votes that an activist shareholder will be permitted to purchase as well as on the total percentage of votes that such shareholder will hold following the vote buying. For example, such limit could be 5% of the company's outstanding votes, and following that purchase, an activist shareholder could be prohibited from holding more than 15% of the company's outstanding voting power (so that a 12% holder could only purchase 3% of the votes). Here, again, this would help protect against the concern that permitting shareholders to purchase a block of votes that is too large would stifle the activity of the markets for votes.

### *E. Shareholder Proposals*

A widely used shareholder tool for improving corporate governance is the submission of shareholder proposals to a vote at the company's annual meeting. This is generally accomplished using Rule 14a-8 of the Securities Exchange Act.<sup>211</sup> Shareholder proposals advocating governance changes that receive majority support commonly lead to companies adopting such changes.<sup>212</sup>

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<sup>211</sup> 17 C.F.R. § 240.14a-8 (2017).

<sup>212</sup> For empirical evidence, see Yonca Ertimur, Fabrizio Ferri & Stephen R. Stubben, *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals*, 16 J. CORP. FIN. 53, 54 (2010).

The ability of shareholders with a relatively small investment in a company to submit shareholder proposals has long been the subject of controversy and has recently generated calls for change. The Business Roundtable, an association of chief executive officers of major U.S. corporations,<sup>213</sup> has advocated for strengthening the disclosure and resubmission requirements and raising the eligibility requirements.<sup>214</sup> At the same time, the U.S. Chamber of Commerce, one of the largest business-oriented lobbying groups in the United States, has waged a campaign against the submission of shareholder proposals by individuals, calling them “zombie proposals” and arguing that “[i]t is time to enact real shareholder proposal reform to bring an end to these zombies, for good.”<sup>215</sup>

These lobbying efforts have not been fruitless. The Financial CHOICE Act, first introduced in 2017, would have limited shareholders’ ability to submit proposals by increasing the minimum holding period from one year to three years, as well as increasing the level of support an unsuccessful proposal must have received to be eligible for resubmission from 3% to 6%.<sup>216</sup> Although attempts to increase the investment threshold by statute have not yet been successful, achieving this goal by SEC rulemaking is a stated near-term priority of the agency and has already resulted in concrete steps.<sup>217</sup> In November 2019, the SEC voted three-to-two to propose amendments to rules governing shareholder proposals.<sup>218</sup>

More specifically, the SEC proposed updating the ownership thresholds from \$2,000 or 1% of a company’s voting stock for one year to \$2,000 of voting stock for at least three years, at least \$15,000 for two years, or at least \$25,000 for one year. Additionally, the proposed amendments would raise the resubmission thresholds for matters voted on once, twice, or three or more times in the last five years to thresholds of 5% (from 3% under the

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<sup>213</sup> *About Us*, BUSINESS ROUNDTABLE, <https://www.businessroundtable.org/about-us> (last visited Feb. 24, 2020).

<sup>214</sup> BUSINESS ROUNDTABLE, RESPONSIBLE SHAREHOLDER ENGAGEMENT & LONG-TERM VALUE CREATION: MODERNIZING THE SHAREHOLDER PROPOSAL PROCESS 1 (2016), <https://www.businessroundtable.org/archive/resources/responsible-shareholder-engagement-long-term-value-creation>.

<sup>215</sup> CENTER OF CAPITAL MARKETS COMPETITIVENESS, RAISING THE SEC’S RESUBMISSION THRESHOLDS: “ZOMBIE PROPOSALS” AND THE NEED TO MODERNIZE AN OUTDATED SYSTEM 1 (2017), [https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/10/CCMC\\_ZombieProposal\\_Digital.pdf](https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/10/CCMC_ZombieProposal_Digital.pdf).

<sup>216</sup> H.R. REP. NO. 115-904 (2018), available at <https://www.congress.gov/bill/115th-congress/house-bill/5756/text>. The bill stalled in the Senate, although parts of it (unrelated to shareholder proposals) were incorporated into subsequently enacted legislation. Shearman & Sterling LLP, *First Major Dodd-Frank Reform Bill Signed Into Law* (May 25, 2018), <https://www.shearman.com/perspectives/2018/05/first-major-dodd-frank-reform-bill>.

<sup>217</sup> Jay Clayton, Chairman, Sec. Exch. Comm’n, SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks (Dec. 6, 2018), <https://www.sec.gov/news/speech/speech-clayton-120618> (“It is clear that we should consider reviewing the ownership and resubmission thresholds for shareholder proposals. A lot has changed since . . .”).

<sup>218</sup> Press Release, SEC Proposes Amendments to Modernize Shareholder Proposal Rule (Nov. 5, 2019), available at <https://www.sec.gov/news/press-release/2019-232>.

current rule), 15% (6%), and 25% (10%), respectively. The proposals would also prohibit the resubmission of a proposal that has been voted on three or more times in a five-year period if it has not received majority support or has experienced a decline in support of 10% or more compared to the immediately preceding vote.<sup>219</sup> These regulatory efforts could severely limit the ability of gadflies in particular to engage in the submission of shareholder proposals.<sup>220</sup>

Our analysis suggests that any effort to limit shareholders' ability to submit proposals will have a negative impact on the competition for votes for two main reasons. First, subjecting more governance matters directly to a shareholder vote fosters the competition for votes and enables shareholders to express their views on, and participate in the design of, the company's major governance terms.

The second, more nuanced, reason stands at the heart of our Article. An increase in governance matters brought to shareholder vote facilitates competition over attracting investor votes that is more robust. This competition, in turn, creates *ex ante* incentives for insiders to perform well, to disclose information to shareholders, and to engage with them and maintain close relationships, so that investors who determine the destiny of the votes will vote with insiders.

Consider the example of a Say on Pay vote. While the overwhelming majority of these votes receive strong shareholder support,<sup>221</sup> the mere existence of such a vote creates the concern from receiving a significant percentage of negative votes and causes insiders to be more attentive to shareholder demands, to disclose more information, to engage with major shareholders before the proxy season, and to conduct negotiation behind the scenes.

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<sup>219</sup> *Id.*

<sup>220</sup> Robert J. Jackson, Jr., Comm'r, Sec. Exch. Comm'n, Data Appendix to Statement on Proposals to Restrict Shareholder Voting (Dec. 6, 2018), <https://www.sec.gov/news/statements/2019/jackson-data-appendix-on-proposals-to-restrict-shareholder-voting.pdf> ("The proposed rules would also exclude up to 35% of independent Chair shareholder proposals, 40% of proxy access proposals, 50% of board diversity proposals, and nearly 65% of report on climate change proposals, and 40% of political spending disclosure proposals."); see also Andrew Ackerman, *Corporations Take Swats at a Gadfly*, WALL ST. J. (Mar. 16, 2014, 7:11 PM), <https://www.wsj.com/articles/corporations-take-swats-at-a-gadfly-1394664978> (stating that a substantial increase of the submission threshold would triple the number of excluded proposals). The rule will also limit the ability of other investors, such as public pension funds, to submit shareholder proposals. See David Webber, *Big Corporations Are Trying to Silence Their Own Shareholders*, WASHINGTON POST (Apr. 13, 2017), [https://www.washingtonpost.com/opinions/voter-suppression—corporate-style/2017/04/13/bbe62880-1ed5-11e7-be2a-3a1fb24d4671\\_story.html?noredirect=on](https://www.washingtonpost.com/opinions/voter-suppression—corporate-style/2017/04/13/bbe62880-1ed5-11e7-be2a-3a1fb24d4671_story.html?noredirect=on).

<sup>221</sup> Subodh Mishra & Institutional Shareholder Services, Inc., *2017 Proxy Season Review: Compensation*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (Oct. 6, 2017), <https://corpgov.law.harvard.edu/2017/10/06/2017-proxy-season-review-compensation/> ("Since the introduction of say-on-pay, average support levels have remained consistently high. The 2017 proxy season was no exception, with average vote support of 92.1 percent, the highest to date. Failed votes remained a rare occurrence and the failure rate of 1.3 percent for 2017 was the lowest yet.").

This important disciplinary force also exists in the context of hedge fund activism, but there is a limited number of hedge fund engagements each year, and many companies are not subject to the risk of activist intervention.<sup>222</sup> Therefore, supporters of the competition for votes should generally oppose any regulatory reforms that impose additional burdens on shareholders' ability to submit (or resubmit) shareholder proposals.

#### F. Proxy Advisors

ISS and Glass Lewis, the two major proxy advisors, provide analyses and support to institutional investors in connection with their vote. This role, according to insiders and their advisors, gives proxy advisors significant power and control over many voting decisions in the market.<sup>223</sup> As then-Chief Justice of the Delaware Supreme Court Leo Strine noted: "powerful CEOs come on the bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills."<sup>224</sup>

Because of this outsized influence, there have been growing pressures to regulate the activity of proxy advisors. Those attempts began with House Report 4015, which aims to amend the Securities Exchange Act of 1934 and impose regulation on proxy advisors.<sup>225</sup> Most recently, in a divided vote, the SEC elected to propose additional regulations over proxy voting.<sup>226</sup> This rule would impose further filing and information requirements upon proxy advisors and subject them to the Exchange Act Rule 14a-9 prohibiting any false or misleading statements.<sup>227</sup> To qualify for exemptions to reporting requirements, the proposed rule would require proxy advisory services to allow businesses to review and give feedback on the proxy advisory drafts before sending them to clients.<sup>228</sup> Supporters of proxy advisor regulation claim that proxy advisors suffer from conflicts of interest, lack transparency, and enjoy too much influence on the market to be self-regulated.<sup>229</sup> Proxy advisory

<sup>222</sup> Bebchuk & Hirst, *supra* note 26.

<sup>223</sup> Doyle, *supra* note 156, at 7, 11.

<sup>224</sup> Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2005); *see also* Eckstein & Hannes, *supra* note 149, at 8–13 (describing the increasing power of proxy advisors).

<sup>225</sup> H.R. REP. No. 4015 (2018), available at <https://www.congress.gov/bill/115th-congress/house-bill/4015>.

<sup>226</sup> Frank M. Placenti, *The SEC's Evolving Views Regarding Proxy Advisors*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (Nov. 23, 2019), <https://corp.gov.law.harvard.edu/2019/11/23/the-secs-evolving-views-regarding-proxy-advisors/>.

<sup>227</sup> *Id.*; Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, 84 Fed. Reg. 66518 (proposed Nov. 5, 2019) (to be codified at 17 C.F.R. pt. 240).

<sup>228</sup> Press Release, Council of Institutional Investors, SEC should Consider Narrower Mandated Review for Proxy Advice (Jan. 31, 2020), [https://www.cii.org/files/about\\_us/press\\_releases/2020/01\\_31\\_20\\_presser\\_sec\\_proxy\\_proposals\(1\).pdf](https://www.cii.org/files/about_us/press_releases/2020/01_31_20_presser_sec_proxy_proposals(1).pdf).

<sup>229</sup> Doyle, *supra* note 156, at 7; Eckstein & Hannes, *supra* note 149.

firms, in contrast, insist that investors tend not to follow their advice blindly and that investors lead the governance policy themselves.<sup>230</sup>

Our framework offers a fresh and different perspective on this heated debate. According to our analysis, two major factors are important to a vibrant competition for votes. The first is whether proxy advisors are likely to increase the percentage of shareholders participating in the voting process, thus making the competition for votes more vibrant. The answer to this question is clearly yes. Proxy advisors reduce the costs of collecting and analyzing information, which increases the likelihood that shareholders will vote in the first place. Proxy advisors' recommendations are especially necessary when the vote requires in-depth analysis, as in areas of executive compensation, conflicted transactions, or contested situations. In these cases, the information and analysis that these proxy advisors provide in connection with their recommendations reduce the costs of voting for previously under-informed investors.

The second factor is that proxy advisors do not side consistently with insiders. If proxy advisors swing the directions of the votes, they generate ex ante incentives for insiders to perform well and to act to the benefit of other shareholders in order to receive the support of proxy advisors. When the vote is not one-sided, the market for votes requires both sides to exercise efforts in order to collect votes.

As shown in Part III.B.2, the extent to which ISS and Glass Lewis influence the vote outcome is subject to much debate and is difficult to examine, as shareholders could vote the same way as proxy advisors even without blindly relying on their bottom-line conclusions.<sup>231</sup> To the extent such an outsized influence exists, it could indeed reduce the competition for votes. However, as long as proxy advisors do not always support insiders, as evidence we presented in Part III demonstrates, these advisors could generate an active competition for votes.

Therefore, supporters of the competition for votes should generally oppose any efforts to impose constraints on the activity of proxy advisors. Moreover, to the extent that evidence demonstrates proxy advisors exercise outsized influence over the outcome of the votes, we suggest an intermediate

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<sup>230</sup> Gary Retelny & Institutional Shareholder Services, Inc., *ISS Senate Hearing Statement*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (July 12, 2018), <https://corp.gov.law.harvard.edu/2018/07/12/iss-senate-hearing-statement/#6b>; Letter from Kenneth A. Bertsch et al., Council of Institutional Investors, to Rep. Hensarling, Chair of House Committee on Financial Services (June 13, 2016); Letter from Erik Breen, Chairman, International Corporate Governance Network Board, to Jeb Hensarling, Chairman of the House Committee on Financial Services & Maxine Waters, Ranking Member House Committee on Financial Services (June 14, 2016) ("We are concerned that the Bill overstates the practical influence of proxy agencies relative to a company's actual investors. ICGN investor members use proxy advisors to help them gather data and assess governance issues voting decisions on thousands of voting items at company annual and extraordinary general meetings. Ultimately investors, not PAs, are accountable for their voting decisions.").

<sup>231</sup> See *supra* notes 155–173.

solution pursuant to which proxy advisors will continue to provide detailed analysis, information, and reports to investors without providing a bottom-line recommendation. Such a solution would decrease the impact of proxy advisors on investors. At the same time, it would still ensure that proxy advisors provide investors with important information, summaries and analyses, and thereby continue to reduce the costs associated with exercising an informed vote.

### G. *The Froessel Rule*

Earlier, we explained how activist investors fostered the creation of a vibrant competition for votes.<sup>232</sup> However, there are certain structural barriers that discourage frivolous proxy challenges. Specifically, the Froessel Rule allows incumbent directors, whether successful in thwarting challengers or not, to receive full reimbursement for reasonable and proper expenditures from the corporate treasury.<sup>233</sup> However, proxy challengers may only receive reimbursement if they are successful in gaining shareholder support, and subject to subsequent shareholder approval.<sup>234</sup> Based on the rationale that sitting directors have a duty to inform the shareholders and help them cast an intelligent vote, the court will deprive reimbursement from incumbents only when their expenses arise from a personal matter (as opposed to a contest over corporate policy) or in the case of bad faith expenses not in the best interest of the shareholders.<sup>235</sup>

Because challengers are only likely to be reimbursed if they are successful in the proxy battle, shareholders wanting to challenge the board must take on the risk of going uncompensated for any expenses incurred in a proxy battle.<sup>236</sup> Incumbent directors, on the other hand, have access to corporate funds to defend their position in a proxy battle even if they are operating sub-optimally.<sup>237</sup> Moreover, while proxy contestants must take on the risk of paying proxy expenses personally, any benefits from improving corporate performance must be shared among all shareholders, further discouraging proxy challenges.<sup>238</sup> This power dynamic already forces activist investors to consider the costs and benefits of challenging an incumbent board, often promoting challenges only in the most serious situations where they have

<sup>232</sup> See *supra* note 69.

<sup>233</sup> *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 309 N.Y. 168 (N.Y. 1955).

<sup>234</sup> *Id.*

<sup>235</sup> *Id.* at 173–74. In practice however, the “personal matter” limitation rarely allows for disallowance of reimbursements because “a whole complex of factors, both business and personal, may prompt a group of stockholders to start a proxy fight with management.” See *Cent. Foundry Co. v. Comm’r of Internal Revenue*, 49 T.C. 234, 249 (1967).

<sup>236</sup> Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 Ala. L. Rev. 879, 896 (1994).

<sup>237</sup> Faith Stevelman, *Globalization and Corporate Social Responsibility: Challenges for the Academy, Future Lawyers, and Corporate Law*, 53 N.Y.L. SCH. L. REV. 817, 841 (2009).

<sup>238</sup> Bo Becker et. al., *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable’s Challenge*, 56 J.L. & ECON. 127, 130 (2013).

deemed company mismanagement to be extremely costly to shareholder value.

Scholars have long criticized the proxy contest reimbursement rules. Extending back to the 1990s, there have been proposals to make compensation of both incumbents and challengers contingent upon receiving a threshold percentage of votes and by providing potential compensation to challengers in contests over matters other than the election of directors.<sup>239</sup> These proposals, however, have not yet been implemented.

Supporters of a vibrant competition for votes should generally support these proposed reforms to expand the ability of challengers to receive expense reimbursement upon receiving a threshold percentage of votes (which can be anywhere between 30% and 50% of the votes). These proposals will incentivize investors to engage in all sorts of value-enhancing corporate changes (that are likely to garner sufficient shareholder support), from submitting shareholder proposals to replacing directors, thus enhancing the competition for votes. However, the cost of proposals that are of a nuisance nature will still fall fully on the shoulders of the proposing shareholder. Expense reimbursement would also level the playing field by ensuring that both incumbents and challengers receive equal support from the corporation for proposals that were well supported by shareholders.

#### CONCLUSION

Corporate law scholars have traditionally focused on a variety of market forces, such as the labor market, the market for corporate control, the equity and debt market, and the product market, as a means of curbing the long-standing agency problem between managers and shareholders in widely held public corporations. Yet, for various well-documented reasons, these market forces provide, at best, an incomplete answer.

This Article depicts the emergence of a new force that could be effective in curbing managerial entrenchment—the competition for votes. In a world where shareholder voting is becoming increasingly more powerful—and where highly incentivized and sophisticated players, such as hedge funds, aggressively solicit the support of fellow shareholders—the importance of votes is heightened.

We argue that a vibrant market where management and dissidents compete for the votes of the shareholder base may lead to better governance. This is because competition over the swing voters generates *ex ante* incen-

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<sup>239</sup> See, e.g., Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy towards Proxy Contests*, 78 CALIF. L. REV. 1071 (1990) (analyzing the rules governing the allocation of costs in proxy contests and suggesting making challenger compensation contingent on the fraction of votes received). For a recent interesting proposal that the corporation compensate investors for successfully initiating any corporate changes, including those that extend beyond proxy contests, see Scott Hirst, *The Under-Initiation of Corporate Change 4* (2020) (unpublished working paper) (on file with author).

tives for management to perform well, to disclose information to shareholders in advance, and to engage with large institutional investors periodically in order to persuade them to vote with management. This positive effect will be applied across the board to all public companies. Through this prism of the competition for votes, we shed a new light on major governance debates that have taken place in the past decade, highlight some important policy implications for lawmakers and investors, and discuss additional avenues to further foster the competition for votes.

