The Hanging Chads of Corporate Voting

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Never has voting been more important in corporate law. With greater activism among shareholders and the shift from plurality to majority voting for directors, the number of close votes is rising. But is the basic technology of corporate voting adequate to the task? In this Article, we first examine the incredibly complicated system of U.S. corporate voting, a complexity that is driven by the underlying custodial-ownership structure, by dispersed ownership and large trading volumes, and by the rise in short-selling and derivatives. We identify three ways in which things predictably go wrong: pathologies of complexity; pathologies of ownership; and pathologies of misalignment of interests. We then discuss the current legal treatment of these pathologies and consider a variety of directions for reform, ranging from incremental modifications to fundamental redesign. We show that, absent a fundamental reconstruction of the ownership structure, the existing system will continue to be noisy, imprecise, and disturbingly opaque. The problems with the existing system pose fundamental challenges for both proponents of direct shareholder democracy, who advocate more-extensive voting rights for shareholders, and for proponents of indirect shareholder democracy, who advocate deference to a board of directors, the legitimacy of which ultimately rests on shareholder elections.

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INTRODUCTION

Never has voting been more important in corporate law. As Eileen Nugent, a leading mergers and acquisitions (M & A) lawyer commented, “When you are in the trenches, every vote counts.”

With the activism of institutional investors and hedge funds in corporate governance and corporate control, there are more and more closely fought merger votes. The controversial merger between Compaq and HP squeaked through with the approval of 51.4% of the shares. The AXA/MONY merger was only approved after a change in the record date, and then only by a margin of 1.7 million shares (for a total of 53.8%) at a time when 6.2 million shares were out on loan. The Transkaryotic merger was approved by just 52% of the shares.

Director elections have likewise become much more important. In takeover contests, Delaware law, by upholding the poison pill, has channeled the decision on bids for control into the annual meeting, with the prevailing mode of hostile acquisitions becoming a bid coupled with a proxy contest to replace the directors. With the rise of hedge funds, the number of regular proxy contests unrelated to takeovers has also gone up. In a 2006 proxy contest, Nelson Peltz succeeded in electing two of five candidates to Heinz’s board. The margin of victory by the Peltz nominees was about 8 million shares out of 250 million

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1. E-mail from Edward B. Rock to Eileen Nugent, Skadden, Arps, Slate, Meagher & Flom LLP (May 21, 2007) (on file with author) (discussing Ms. Nugent’s comment at an earlier roundtable discussion).
voted, or 3.2%. At El Paso Corp., a Houston-based energy company, incumbent directors were reelected by approximately 17.2 million votes at a time when the latest figures showed active short sales of almost 76 million borrowed shares. Director elections have also become an important arena for the expression of shareholder discontent. Starting with the “just vote no” campaigns, shareholder activists have now extended the strategy towards pushing firms to adopt a “majority of the votes cast” standard for director election in place of the plurality standard. At CVS Caremark, which has adopted a “majority vote” rule for director elections, Roger Headrick was narrowly reelected to the board on the basis of votes cast by brokers who had not received instructions from their clients.

Finally, shareholder proposals at annual meetings, both mandatory and precautionary, are now a fixture of the landscape and an important part of the governance structure, with numerous close contests. For example, at Alaska Air Group’s May 2005 meeting, a bylaw amendment requiring shareholder approval for anti-takeover plans fell 2.4 million votes short of the required 75% approval at a time when 4 million shares had been sold short. More recently, a “say on pay” proposal at Merck failed with 49.2% of the shares in favor and passed at Verizon with 50.18%.

But is the existing voting system up to the task? Can it meet the demands that are placed on it? How confident can we be that the reported outcomes of close corporate votes reflect the votes actually cast and that the right set of shareholders was afforded effective voting rights?

The 2000 presidential election in Florida revealed that the technology of punch card ballots was not sufficient to determine the outcome of a close political election. The degree of precision, we discovered to our chagrin, was less than the 0.03% margin of victory. We learned that the voting system could

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6. See H.J. Heinz Co., Quarterly Report (Form 10-Q), at 33 (Nov. 1, 2006), available at http://www.sec.gov/Archives/edgar/data/466440/000095015206009785/233861ae10q.htm (Our estimate is derived from the difference between the votes for Peltz—136 million—and the votes of three board nominees that Peltz wanted to replace but that were elected—128 million for Bunch, Drosdick, and Reilley.). It is likely that the board candidate with the next-lowest vote (who was not elected) had approximately the same votes as these three.

7. Drummond, supra note 3, at 102.


9. According to Yair Listokin, between 1997 and 2004, there were 714 “close votes” on proposals put to shareholders, where a vote is defined as “close” if the margin of victory or defeat is 10% or less. Yair Listokin, Management Always Wins the Close Ones 11, 14, 32 tbl.3 (John M. Olin Ctr. for Studies in Law, Econ., and Pub. Policy, Research Paper No. 348, 2007), available at http://ssrn.com/abstract=980695.

10. Drummond, supra note 3, at 102.


not answer the question "who won?" and then had to improvise a procedure to break the statistical tie. What are the "hanging chads" of corporate voting? And do we have adequate procedures for breaking statistical ties?

In Part I, we provide background on when shareholders vote, which shareholders have a right to vote, how votes are counted, and how voting disputes are resolved. In Part II, we discuss how shares are actually held, transferred, and voted in the U.S. system, in which approximately 80% of the shares are held by nominees. In Part III, we analyze the various pathologies that infect the shareholder voting system and review the legal treatment of the problems that arise. The pathologies of voting arise from three separate, but overlapping sources: the multiple tiers of custody ("pathologies of complexity"); uncertainties as to who owns a particular share ("pathologies of ownership"); and the potential misalignment between voting rights and economic interests ("pathologies of misalignment").

Part IV considers a variety of directions for reform, ranging from increased judicial scrutiny to a fundamental redesign of the system. Although a fundamental redesign would significantly improve matters, even a major reform will not eliminate all problems because many of the pathologies we discuss are intrinsic to a system in which shares are widely but indirectly held and in which thousands of votes are taken every year.

Our analysis poses challenges for proponents of shareholder rights as well as advocates of managerialism. The inescapable complexity combined with the already well-studied issues of shareholders' rational apathy and free rider problems detract from the case for shareholder voting. To what extent should we put matters to a shareholder vote if we cannot trust in the outcome? By the same token, however, the legitimacy of the exercise of governance powers by the board of directors, and by management appointed by the board, rests on the fact that directors have been elected by shareholders. If board elections either take the form of Soviet-style votes—with one candidate per open seat who is elected with a huge margin—or of contested elections with a close outcome, why is it that management should call the shots?13

I. CORPORATE VOTING LAW: A BRIEF INTRODUCTION

In this Part, we briefly review the legal structure of corporate voting, as a preliminary to describing the existing voting system. We leave the gory details of the structure to later when we discuss specific duties and examine a variety of voting pathologies.

A. WHEN DO SHAREHOLDERS VOTE?

Shareholders vote in a variety of circumstances, most set by Delaware law, some by tax law, and some by stock-exchange rules. Under Delaware law, shareholders elect the board of directors.14 While a director is generally elected by a plurality of the votes cast,15 many companies have recently opted to require the vote of a majority of the shares cast.16 For matters other than the election of directors—such as bylaw amendments17 or precatory shareholder resolutions—the basic decision rule is the affirmative vote of a majority of shares present.18 Mergers, a sale of all or substantially all the assets, and amendments to the certificate of incorporation, however, require the approval of a majority of the shares entitled to vote.19 Finally, Delaware case law, while not requiring shareholder approval of self-dealing transactions or executive compensation, provides a variety of inducements for it.20

Under New York Stock Exchange (NYSE) rules, shareholder approval is also required if a transaction involves the issuance of stock that increases the number of outstanding shares (or voting power) by 20% or more.21 In addition, NYSE listing requirements and the federal tax code encourage shareholder votes on executive compensation. Under I.R.C. § 162(m), for an incentive-compensation plan to qualify for optimal tax treatment, it must be approved by the shareholders.22 Similarly, and without regard to tax treatment, the NYSE Listing Requirements require that equity-compensation plans be approved by the shareholders of listed companies.23

B. WHO GETS TO VOTE?

With annual turnover of shares in a public company around 99%, the shareholder base is constantly in flux.24 It is thus necessary to define both a date

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14. DEL. CODE ANN. tit. 8, §211(b) (2001); id. § 216 (Supp. 2006).
15. Id. § 216(3).
16. Delaware permits companies, for these and other matters, to adopt a higher approval threshold than the one provided by Delaware law. See id. § 216. Note that Delaware recently made changes to its statute regarding director elections. See id. § 141(b) (Supp. 2006) ("A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable."); id. § 216 ("A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.").
17. Id. § 109 (2001).
18. Id. § 216(2).
19. Id. § 251(c) (2001 & Supp. 2006) (mergers); id. § 271 (sale of all or substantially all assets); id. § 242(b) (2001) (charter amendments).
as of which a list of shareholders qualified to vote is determined and a mechanism for
determining the identity of the shareholder entitled to vote as of that date.

State corporate law supplies both. Under Delaware General Corporate Law
(DGCL) § 213, a "record date" is fixed in advance of any vote and "shall not be
more than 60 nor less than 10 days before the date" of the meeting. The
persons who, as of the record date, are listed as registered owners of the shares
on the company's books are entitled to notice of, and to vote at, the shareholder
meeting.

Delaware corporate law thus puts record ownership, rather than beneficial
ownership, at the center of the system. Firms are entitled to rely on the list of
registered owners in determining who is entitled to vote. To be sure, record
owners may authorize others to vote in their stead by means of a proxy. In the
absence of a transfer by proxy, however, the record owner of the shares is
titled to vote the shares held even when the person holds the stock in a
fiduciary capacity.

Delaware has steadfastly refused to modify its reliance on record ownership
in the voting context. It has done this not because it is unaware of custodial-
ownership structures discussed below, but because of several concerns. First,
there is a statutory and judicial concern for definiteness which is maximized by
a system of reliance on the stock list. Whatever flaws are generated by giving
entitlements to record owners, it has the benefit that the owner is clearly
specified and known to the company.

Second, Delaware views custodial arrangements as matters solely between
shareholders and their agents, which do not involve the firm. To the extent that
things go wrong, Delaware views that as a problem for the shareholder, not for
the company. Going back at least to 1945, the Delaware Supreme Court
reasoned in Salt Dome Oil Corp. v. Schenck that "[t]he corporation ought not
to be involved in possible misunderstandings or clashes of opinion between the
non-registered and registered holder of shares. It may rightfully look to the
corporate books as the sole evidence of membership." The law governing

27. Berlin v. Emerald Partners, 552 A.2d 482, 494 (Del. 1988); Schott v. Climax Molybdenum Co.,
154 A.2d 221, 224 (Del. Ch. 1959).
28. DEL. CODE ANN. tit. 8, § 212(c) (2001).
29. Id. § 217(a).
30. 41 A.2d 583 (Del. 1945).
31. Id. at 589. This focus has continued. For example, in Enstar Corp. v. Senouf, 535 A.2d 1351,
1354–55 (Del. 1987), the Delaware Supreme Court reiterated this bright-line view: "In making that
choice, the burden must be upon the stockholder to obtain the advantages of record ownership.
The legal and practical effects of having one's stock registered in street name cannot be visited upon the
issuer. The attendant risks are those of the stockholder, and where appropriate, the broker" (citing Lewis
v. Corroon & Reynolds Corp., 57 A.2d 632, 634 (Del. Ch. 1948); Nickles v. United Nuclear Corp., 192
A.2d 628 (Del. Ch. 1963)). See also Am. Hardware Corp. v. Savage Arms Corp., 136 A.2d 690, 693
(Del. 1957); In re Giant Portland Cement Co., 21 A.2d 697 (Del. Ch. 1941).
appraisal rights follows a similar pattern.\footnote{With regard to appraisal rights, title 8, section 262(a) of the Delaware Code explicitly defines a stockholder entitled to appraisal as "a holder of record of stock in a stock corporation," thus making record ownership the key measure. \textit{Del. Code Ann.} tit. 8, \textsection 262(a) (2001). Accordingly, an appraisal action can only be brought by or on behalf of the record owner. \textit{Enstar Corp.}, 535 A.2d at 1356; Carl M. Loeb, Rhoades & Co. v. Hilton Hotels Corp., 222 A.2d 789, 792 (Del. 1966); Olivetti Underwood Corp. v. Jacques Coe & Co., 217 A.2d 683, 686 (Del. 1966); Coyne v. Schenley Indus., 155 A.2d 238, 240 (Del. 1959); Raynor v. LTV Aerospace Corp., 331 A.2d 393, 394 (Del. Ch. 1975); \textit{In re Gen. Realty Utils. Corp.}, 42 A.2d 24, 25 (Del. Ch. 1945); see also \textit{R. Franklin Balotti & Jesse A. Finkelstein, Delaware Law of Corporations and Business Organizations} §§ 9.43[B] and 44[F] (2007); Rodman Ward, Jr. \textit{et al.}, \textit{Folk on the Delaware General Corporation Law} § 262.5 (15th ed. 2006 & Supp. Dec. 2007). This can work to the benefit of beneficial owners. In a recent case, \textit{In re Appraisal of Transkaryotic Therapies, Inc.}, the Delaware Chancery Court permitted hedge funds, which had acquired shares post record date, to pursue appraisal in reliance on the fact that the record holder (Cede & Co.) had a sufficient number of shares that had not been voted for the merger, without establishing that the shares that the hedge funds had acquired were themselves among the shares that qualified for appraisal. No. Civ.A. 1554-CC, 2007 WL 1378345, at *3 (Del. Ch. May 2, 2007). The Chancellor quite explicitly noted that the effect of the ruling would be to allow arbitrageurs to "buy into appraisal suits by free-riding on Cede's votes on behalf of other beneficial holders," \textit{id.} at *5, but held that the statute's focus on record holders dictated the outcome: "Only the record holder possesses and may perfect appraisal rights. The statute simply does not allow consideration of the beneficial owner in this context." \textit{Id.}

By contrast, the courts show more flexibility in other contexts. With regard to acting by consent under DGCL § 228, "[generally] only persons whose names appear on the stock ledger as stockholders or hold proxies from record holders are qualified to execute a written consent." \textit{Ward, supra}, § 228.4 (also citing cases). On the other hand, Delaware courts have held that beneficial owners may execute the consent so long as they indicate who the record holder is and have the right to vote the shares. Olson v. Buffington, No. 8042, 1985 WL 11575, at *3 (Del. Ch. July 17, 1985). In the case of shareholder derivative suits, an equitable remedy, the Delaware statute does not specify whether record ownership is required and the courts have not generally required it. See, e.g., Gamble-Skogmo, Inc. v. Saks, 122 A.2d 120 (Del. 1956); Rosenthal v. Burry Biscuit Corp., 60 A.2d 106 (Del. Ch. 1948); Balotti & Finkelstein, \textit{supra}, § 13.10 ("An equitable owner of shares is considered a stockholder and may maintain a derivative action.") In litigation under DGCL § 225 (Contested Election of Directors; Proceedings to Determine Validity), both record holders and beneficial holders may bring suit. Rosenfield v. Standard Elec. Equip. Corp., 83 A.2d 843, 845 (Del. Ch. 1951).

Federal securities law is even less focused on record ownership. With regard to shareholder proposals, Securities and Exchange Commission (SEC) rules provide that, in order for a shareholder holding in nominee name to put a proposal on the issuer's proxy statement, it must prove its eligibility either by submitting a written statement from the record holder verifying that the proponent, at the time the proposal was submitted, had held continuously for at least one year or, if it has filed 13Ds, 13Gs, or other SEC reports indicating ownership, by means of those filings. 17 C.F.R. § 240.14a-8 (2007). Under sections 10(b) and 16(b), suit can typically be brought by either the beneficial or record owner. Securities Exchange Act of 1934, §§ 10(b), 16(b), 15 U.S.C. §§ 78j, 78p (2000); Blau v. Lamb, 314 F.2d 618, 620 (2d Cir. 1963).}

\footnote{\textit{Del. Code Ann.} tit. 8, \textsection 212(b) (2001).}
valid proxy is given for a share, the later proxy revokes the earlier proxy. Determining the validity of proxies and the tally of votes is the responsibility of the inspector, appointed by the corporation.\textsuperscript{34}

D. RESOLVING CLOSE CONTESTS UNDER CURRENT DELAWARE LAW

Not surprisingly, Delaware has encountered close contests. In resolving controversies, Delaware has adopted a formalistic approach that promotes certainty and speed over accuracy and perfection.\textsuperscript{35}

In contested votes, an independent inspector is appointed by the company.\textsuperscript{36} The inspector’s role is “ministerial,” not “judicial.”\textsuperscript{37} That is, the inspector is expected to examine the proxies, determine if they meet the formal criteria, and report the tally, but the inspector is not to resolve any disputed issues. Those are to be recorded and, if the outcome is challenged, resolved by the court. The report of the inspector is presumed to be correct.\textsuperscript{38}

Under section 231(d), the inspector is limited in the materials he may use in determining the validity of proxies to “the proxies, any envelopes submitted with those proxies, any information provided in accordance with § 211(e) [electronic transmission] or § 212(c)(2) [electronic transmission] of this title, or any information provided pursuant to § 211(a)(2)(B)(i) or (iii) of this title [remote communication at meetings], ballots and the regular books and records of the corporation.”\textsuperscript{39} This part of section 231(d) largely codifies longstanding Delaware practice.\textsuperscript{40} In addition, the inspector may consider other reliable information, but only for “reconciling proxies and ballots submitted by or on behalf of banks, brokers, their nominees or similar persons which represent more votes than the holder of a proxy is authorized by the record owner to cast or more votes than the stockholder holds of record.”\textsuperscript{41} This exception recognizes that the realities of custodial ownership increase the likelihood of clerical and other errors and grants inspectors some latitude in resolving overvotes. But even this latitude is constrained. In Seidman

\textsuperscript{34} Id. § 231.
\textsuperscript{35} See id. § 225 (providing the statutory basis for judicial review of contests).
\textsuperscript{36} BALOTTI ET AL., supra note 2, § 10.1.
\textsuperscript{37} Berlin v. Emerald Partners, 552 A.2d 482, 491 (Del. 1989).
\textsuperscript{38} Id.
\textsuperscript{39} Del. Code Ann. tit. 8, § 231(d) (2001). Of the sections referred to, § 211(e) permits electronic voting, § 212(c)(2) permits electronic transmission of proxies, and § 211(a)(2)(b)(i) permits participation by remote communication. These provisions were added in 2000.
\textsuperscript{41} § 231(d) (emphasis added). Up until 1990, Delaware took an even narrower view on what materials may be considered. Under the doctrine of Williams v. Sterling Oil of Okla., 273 A.2d 264, 265-66 (Del. 1971), the inspector could not look to any extrinsic evidence at all. In 1989, in Concord Fin. Group v. Tri-State Motor Transit Co. of Del., 367 A.2d 1, 13 (Del. Ch. 1989), the Delaware Chancery Court reaffirmed the Williams court’s refusal to consider extrinsic evidence and held that the inspector erred in considering extrinsic evidence of an obvious clerical error to resolve an outcome-determinative overvote. In response, in 1990, the Delaware legislature amended § 231 to provide the exception discussed in text. See 67 Del. Laws 810 (1990).
Proxies

Figure 1. Voting by Registered Owners

& Associates v. G.A. Financial, the court invalidated proxies for 233,376 shares because the inspector was not able to obtain reliable information from the proxy clerk to resolve an overvote of 824 shares.

E. VOTING BY REGISTERED OWNERS: THE DELAWARE PARADIGM

The Delaware voting paradigm described in the previous sections is, thus, straightforward. The corporation sends out proxy cards, a proxy statement, and the annual report to its registered owners. The registered owners execute the proxy to indicate how they wish to vote their shares (never mind how they decide that). The proxies are then returned to a tabulator who, after checking their formal validity (but not, for example, whether they reflect the voting instructions of beneficial owners) and comparing them to the share register, reports the outcome to the board of directors. Figure 1 outlines this process.

The only problem with this paradigm is that it is totally unreal: it willfully ignores how shares are actually held and voted.

II. CUSTODIAL OWNERSHIP: HOW SHARES ARE HELD, TRANSFERRED, AND VOTED IN THE PUBLICLY HELD CORPORATION

The implicit model of corporate voting that emerges from the Delaware statute assumes, as in a typical close corporation, that shareholders hold shares directly. This, of course, is not what happens in publicly held corporations, in which around 70–80% of the shares are held by nominees.

42. 837 A.2d 21 (Del. Ch. 2003).
43. Id. at 24, 28.
A. SHARES HELD IN "STREET NAME"

During 2006, the NYSE reported average daily volume of approximately 2 billion shares, in approximately 5 million separate trades, with a dollar volume of around $86 billion.45 With volume of this magnitude, the "old fashioned" system—in which shareholders held share certificates that were registered with the issuer and transferred by the transfer agent upon delivery of the certificate after a sale—is unworkable.46

Indeed, forty years ago, the "paperwork crunch" of certificated shares caused the system to crash.47 In response, the United States adopted a policy of "immobilization" of share certificates through a depository system.48 Since then, it has become United States government policy to encourage custodial ownership to facilitate clearing and settlement of securities trades.49 By now, most shares of publicly held corporations are held in "street name" through custodians such as banks and brokerage firms, with the custodians, in turn, holding the shares through accounts at Depository Trust Company (DTC), a depository institution and the record owner registered on the books of the


47. See U.C.C. art. 8 prefatory note (amended 2003).

48. As described in the prefatory note to Uniform Commercial Code (U.C.C.) Article 8:

Transfer of securities in the traditional certificate-based system was a complicated, labor-intensive process. Each time securities were traded, the physical certificates had to be delivered from the seller to the buyer, and in the case of registered securities the certificates had to be surrendered to the issuer or its transfer agent for registration of transfer. As is well known, the mechanical problems of processing the paperwork for securities transfers reached crisis proportions in the late 1960s, leading to calls for the elimination of the physical certificate and development of modern electronic systems for recording ownership of securities and transfers of ownership.

Id.


In Section 17A of the Act Congress directed the Commission to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions. The Commission believes that the practice of registering securities in other than the name of the beneficial owner is essential at this time to the establishment and refinement of such a system and is consistent with the purposes of the Act, with particular reference to Section 17A.

Without such a system of custodial ownership, implementing a system to settle securities within five business days (T+5), much less today’s norm of T+3 or the current goals of T+1 or T+0, would simply be impossible.

Because there are important differences between bank and brokerage custodians, we will discuss them separately. Figure 2 provides an overview of a hypothetical situation in which JP Morgan and its customers hold 450,000 shares and Morgan Stanley and its customers hold 530,000 shares.

1. Bank Custodians

Bank custodians mostly hold shares for mutual funds, pension funds, insurance companies, endowments, and trusts. The leading custodian banks are Bank of NY Mellon, JP Morgan, State Street, and Citigroup which, collectively, hold about $30 trillion in assets.  

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50. U.C.C. art. 8 prefatory note (amended 2003). Although there were once other depositories, DTC is now the sole U.S. depository institution.

The bank custodians are, in turn, participating members of DTC, which holds the actual shares. The DTC account holds all the bank’s shares in fungible bulk, without any subdivision into separate accounts of the custodian’s customers. Only the bank custodian’s records indicate how many shares are held in which accounts and who has voting and trading authority. Often an institutional investor will allocate money to various asset managers—some with only trading authority, and others with both trading and voting authority. The allocation of voting and trading authority is a matter of contract between the investor, the asset manager, and the custodian.

Because custodial services is a specialized and highly competitive function, many small banks that take custody of assets will deposit those assets with another, larger, specialized bank custodian. This “piggybacking” can involve three or four tiers. These “respondent” banks keep track of their own customer accounts, with the larger bank simply recording on its records how many shares it is holding for the respondent bank.

Bank custodians provide a variety of services to their customers, including asset safekeeping, trade processing and settlement. When, for example, an account holder sells shares, the custodian bank will process and clear the trade. When the trade clears, DTC will shift shares by book entry from the selling custodian bank’s account to the acquiring custodian’s account.

Custodian banks also provide securities lending services. With their enormous holdings, the custodian banks are well positioned to offer this service. When a custodian bank “lends” out shares, a notation is typically made in the account of the customer whose shares have been lent. If this is done, then the loan will be transparent to customers when they check online or receive monthly statements. The allocation of the fees generated by securities lending between the custodian and the customer is a matter of negotiation, and the amounts involved can be substantial. According to a 2001 estimate, beneficial owners earn about $5 billion a year in fees from securities lending. For the year ending March 31, 2006, CalPERS alone made $129.4 million on its securities lending business.

2. Broker Custodians

Brokers also act as custodians for their customers. Like bank custodians,

52. See Wilcox et al., supra note 46, at 12-9 n.24.
53. See id.
54. See id. at 12-9.
55. As will be discussed below, a securities loan is not really a loan but is a sale coupled with an obligation to return fungible shares.
brokers will have accounts at DTC where their shares are held in fungible bulk.

Among broker customers, one can distinguish between the large customers such as hedge funds and smaller retail customers. The hedge funds, and other very large customers, will receive “prime brokerage” services, which provide a variety of services, including share borrowing and financing of trades.

Some individual customers hold their shares in margin accounts, which allow them to borrow against the shares and to receive a variety of services. As a matter of contract, the shares held in a margin account are generally available to be lent out by the broker. 58 Brokers do not typically identify or attribute the shares lent to specific margin accounts, 59 and the broker retains all the proceeds from the lending, whether or not any margin debt is outstanding. 60 When shares are held in regular, non-margin accounts, the broker typically may not lend out the shares without permission of the account holder.

B. WHO OWNS SHARES HELD IN STREET NAME?:
AN INTRODUCTION TO U.C.C. ARTICLE 8

In corporate law, we have a conception of who the shareholder is (the beneficial owner), and what the shareholder has (a right to vote, a right to seek appraisal, a right to sue, a right to dividends, a right to sell, etc.). Much of corporate law thinking and scholarship in the academy, the courts, the legislatures, agencies, newspapers, and elsewhere, proceeds from some version of this “beneficial-owner-as-shareholder paradigm.”

Earlier, we showed that under the Delaware law of corporate voting, the


You agree that Securities and Other Property held in your margin account, now or in the future, may be borrowed (either separately or together with the property of others) by us (acting as principal) or by others. You agree that Schwab may receive and retain certain benefits (including, but not limited to, interest on collateral posted for such loans) to which you will not be entitled. You acknowledge that in certain circumstances, such borrowings could limit your ability to exercise voting rights or receive dividends, in whole or in part, with respect to the Securities and Other Property lent. You understand that for Securities and Other Property that are lent by Schwab, the dividends paid on such Securities and Other Property will go to the borrower. No compensation or other reimbursements will be due to you in connection with such borrowings. However, if you are allocated a substitute payment in lieu of dividends, you understand that such a payment may not be entitled to the same tax treatment as may have been applied to the receipt of a dividend. You agree that Schwab is not required to compensate you for any differential tax treatment between dividends and payments in lieu of dividends. Schwab may allocate payments in lieu of dividends by any mechanism permitted by law, including by using a lottery allocation system.

Id.
beneficial owner is not exactly treated like the “shareholder” of this paradigm. In this section, we turn to the structure of property rights under Article 8 and show that it, too, substantially diverges from the beneficial-owner-as-shareholder paradigm. Understanding both the legal structure of corporate voting and the legal structure of share ownership is necessary in order to comprehend the pathologies we discuss below and the potential solutions.

The vast volume of securities trading has led to a transformation of the structure and content of property law as it applies to securities. Since 1973, there has been a concerted effort to change property law in order to minimize the number and impact of failed trades. Article 8 of the U.C.C. establishes a property rights regime for securities that is designed for modern, indirect shareholding. See Figure 3. Under Article 8, the beneficial owner of the shares held in a custodial account with an intermediary (such as a broker) is considered to be the holder of a “securities entitlement” in a “financial asset” which is

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61. U.C.C. § 8-102(a)(7) (amended 2003) (“‘Entitlement holder’ means a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary. If a person acquires a security entitlement by virtue of Section 8-501(b)(2) or (3), that person is the entitlement holder.”).

62. “Financial assets” include shares. Id. § 8-102(a)(9).
ultimately held by a depositary. A customer becomes an entitlement holder as soon as the intermediary makes a book entry indicating that the customer has bought shares. One important effect of this structure is that a brokerage customer can become an entitlement holder even if the broker has not, in fact, acquired the shares credited to the customer's account, and even if the broker does not own a single share of the security.

Article 8 then defines the nature of the "property interests" created and the priority of claims on financial assets held by securities intermediaries. Section 8-503 makes clear that the interest of the customers who hold a certain security is not an interest in any particular item of property, but rather is a pro rata interest in all like securities of the intermediary held in common by all other customers who own the same security. As a "securities entitlement holder," the customer has a superior claim in the securities against general creditors of the securities intermediary. Its claim, however, is inferior vis-à-vis a purchaser of that security from that intermediary and any creditor of the intermediary who has obtained a security interest.

The U.C.C., unlike the Delaware voting paradigm, thus explicitly takes account of the modern system of custodial ownership. But, by adapting to the

63. **Id.** § 8-501(b)(1).
64. **Id.** § 8-501(c).
65. **Id.** § 8-503(c)–(e). Moreover, in order to prevent the shortfall of an intermediary's securities holdings from leading to the failure of securities trades—the minimization of such failures being the paramount goal of Article 8—section 8-503(c) to (e) sharply limits the methods by which an entitlement holder may enforce its rights. These sections provide:

(c) An entitlement holder's property interest with respect to a particular financial asset under subsection (a) may be enforced against the securities intermediary only by exercise of the entitlement holder's rights under Sections 8-505 through 8-508.

(d) An entitlement holder's property interest with respect to a particular financial asset under subsection (a) may be enforced against a purchaser of the financial asset or interest therein only if:

(1) insolvency proceedings have been initiated by or against the securities intermediary;
(2) the securities intermediary does not have sufficient interests in the financial asset to satisfy the security entitlements of all of its entitlement holders to that financial asset;
(3) the securities intermediary violated its obligations under Section 8-504 by transferring the financial asset or interest therein to the purchaser; and
(4) the purchaser is not protected under subsection (e).

The trustee or other liquidator, acting on behalf of all entitlement holders having security entitlements with respect to a particular financial asset, may recover the financial asset, or interest therein, from the purchaser. If the trustee or other liquidator elects not to pursue that right, an entitlement holder whose security entitlement remains unsatisfied has the right to recover its interest in the financial asset from the purchaser.

(e) An action based on the entitlement holder's property interest with respect to a particular financial asset under subsection (a), whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against any purchaser of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the securities intermediary in violating the securities intermediary's obligations under Section 8-504.

**Id.**
66. **Id.** § 8-511 (amended 2003).
complexities created by custodial ownership, it loses determinacy with respect to the key shareholder rights in corporate law. While the informal corporate law paradigm views the shareholder as the owner of a thing—a share—the U.C.C. has customers who jointly own an interest in a fungible mass, with no specific shares attributed to any specific customer. The misalignment between the property rights implicit in the beneficial-owner-as-shareholder paradigm and the property concepts from Article 8 comes to the fore in the problem of overvoting.

C. HOW NOMINEE SHARES ARE VOTED

That shares are held in street name greatly complicates the voting process. Before votes can be tabulated, one must identify and locate the beneficial owners, distribute proxy materials to them, and collect their votes. In this section, we discuss these steps in greater detail.

1. Step 1: Finding the Beneficial Owners

To find the beneficial owner, the issuer sends an inquiry to DTC in which it asks for a list of participant custodians who hold shares of the issuer in its account (Figure 4). Depositories are obligated to identify participants promptly and to indicate the number of shares owned by each as of the date of the
inquiry. If there is a discrepancy between the number of shares held by DTC as indicated by the corporation's share register and the number as it appears on DTC's records, such discrepancies are not typically reconciled at this stage.

After receiving information from DTC, the issuer will send a "search card" to all bank and broker nominee holders in which it asks for the number of proxies and other materials needed (Figure 5a). Upon receipt of the search card, banks and brokers must provide the information requested (Figure 5b). Most custodians delegate the task of processing proxies and other corporate communications to Broadridge (known as ADP Shareholder Services until its recent spinoff), the dominant provider of proxy services. Broadridge then provides this information to the issuer.

Custodians operate on a tight schedule. Brokers must respond to search-card inquiries within seven business days of receipt. Banks must identify all respondent banks within one business day of receipt of the search card. They then have seven business days to indicate the approximate number of beneficial owners holding the issuer's shares directly with that bank (in other words, not counting respondent banks). When the issuer receives the initial response from banks identifying respondent banks, it sends search cards to the respondent banks, and the process is then repeated for subsequent layers until the lowest tier of respondent bank has provided the issuer with the number of its customers holding stock of the issuer.

Part of this complexity is due to the fact that issuers do not know with precision who their shareholders are. Under the NOBO/OBO system, the banks and brokers must provide the identity of the account holders to the issuer unless an account holder has affirmatively opted to be an "objecting beneficial owner" (OBO). Approximately 75% of beneficial owners object to disclosure of their names, with the result that roughly 52–60% of the shares of public companies are held by OBOs. Issuers, thus, cannot communicate directly with this large

70. See Chris Kentouris, Swingvote Morphs into Full-Service Proxy Provider, Sec. INDUS. NEWS, Nov. 13, 2006, at 12; see also Broadridge Fin. Solutions, L.L.C., Amendment to Registration of Securities (Amend. 4 to Form 10), at 3, 65 (Mar. 16, 2007) [hereinafter Broadridge, Amend. 4 to Form 10].
72. Id. § 240.14b-2(b)(6).
73. Id. § 240.14b-1(b)(1)(i).
74. See id. § 240.14b-1(b)(3) (brokers); id. § 240.14b-2(b)(4)(ii)(B) (banks).
segment of shareholders. Broadridge, however, as an agent of the custodians, has access to this information even for OBOs and thus plays the critical role of distributing the proxy materials.

2. Step 2: Distributing the Material, Soliciting the Vote

Once the issuer has identified its beneficial owners, it must provide each custodian with sufficient copies of the proxy packet (proxy cards, annual report,
and proxy statement). Upon receipt of the materials, custodians have five business days to forward them to beneficial owners. Typically, Broadridge performs all of these tasks as an agent for the custodians. See Figure 6. The issuer is also required to pay the costs of this distribution. The NYSE and NASD have rules setting the charges that Broadridge, acting on behalf of brokers, may charge listed firms. Banks, with no similar organization to set rates, typically follow the NYSE rates.

The “notice and access” model of delivery of proxy material, which arrived on July 1, 2007, may change things dramatically. The SEC’s recent amendments to the proxy rules permit public companies to furnish proxy materials to shareholders by posting them on a website and providing the shareholders with notice of the internet availability of the materials. If shareholders have previously elected to receive proxy materials by electronic delivery, this notice will be sent by email. If not, it will be sent by regular mail. Shareholders will then have the option to request paper copies of the proxy materials. When a company chooses to use “notice and access,” custodians will have to send their own

76. 17 C.F.R. § 240.14b-1.
77. Id. § 240.14b-1(b)(2); id. § 240.14b-2(b)(3).
78. Id. § 240.14a-13(a)(5).
80. 17 C.F.R. § 240.14b-2(c)(3).
notices to their customers, the beneficial owners, and a beneficial owner may then request written materials. This new model, like many other aspects of the internet, creates a great deal of uncertainty over what the system will look like going forward. 82

3. Step 3: Voting

At the beginning of the process, DTC executes an omnibus proxy in favor of its participant firms. In the case of bank custodians, the custodian will execute an omnibus proxy in favor of the respondent banks who, in turn, will execute omnibus proxies in favor of their (second tier) respondents, and so forth.

To enable the ultimate beneficial owners to vote, banks and brokers must provide them either with an executed proxy card or a request for voting instructions. 83 They typically do the latter. Broadridge is again the key player at this stage. When everything works perfectly, Broadridge receives voting instructions, verifies receipt, verifies that the signatories have voting authority, executes the proxy on behalf of its custodian (bank or broker) principal aggregating the instructions it has received, and then forwards the proxies to the “tabulator.” See Figure 7.

4. Step 4: Tabulation

The final step in the process is the tabulation of the votes. The tabulator is charged with the task of checking the validity of proxies received—many of

82. See, e.g., Broadridge, Amend. 4 to Form 10, supra note 70, at 11. Broadridge’s registration statement describes how the new model may affect its business:

The adopted changes, and the proposed changes, if adopted, will have a significant effect on our business. For those companies that choose the notice and access option, we will continue to mail notices to those stockholders who have not elected to receive proxy materials electronically. Therefore, the volume of items to be mailed will most likely remain unchanged. However, the weight of the packages will be less, resulting in lower revenues per distribution. At the same time, some stockholders may elect to continue to receive paper copies of proxy materials. Certain of these mailings may not receive the benefit of volume discounts, resulting in higher revenues per distribution. We also anticipate deriving additional revenue from the fulfillment services that we expect to provide for individually ordered paper proxy materials and for the establishment of procedures such as toll-free numbers and websites to accommodate the requests of stockholders to receive paper proxy materials for up to one year after the conclusion of the meeting or corporate action to which the materials relate. Additionally, we may derive revenue from new services such as the creation of access notices and the creation and maintenance of a new database of stockholders requesting paper proxy materials. We do not at this time know how many companies will choose the notice and access option, nor do we know how many stockholders will elect to continue to receive paper copies of proxy materials. As a result, we cannot at this time predict the net effect of the SEC’s new electronic access rules on our Investor Communication Solutions business.

Id.


84. Id. § 240.14b-1(b)(2) (for brokers); id. §240.14b-2(b)(3) (for banks); see BAlOTTI ET AL., supra note 2, § 10.7; Wilcox et al., supra note 46, at 12-8 to 12-10.
which will have been executed by Broadridge—and checking to make sure that the number of nominee shares voted equals the number of shares that DTC indicates are held in nominee name. The issuer retains the tabulator which is often the issuer’s transfer agent. More recently, Broadridge has also been expanding into this business. In contested votes, an independent inspector is often retained to count the proxies. IVS Associates is the leading firm.

III. PATHOLOGIES OF SHAREHOLDER VOTING: WHAT CAN AND DOES GO WRONG

A comparison of Figures 1 and 7 shows the source of the problems that we discuss below. The complexity of the custodial ownership system, combined with the pressure of numerous shareholder votes, creates a system that is far more complex and fragile than the one anticipated by the Delaware legal

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structure. There are somewhere around 17,000 reporting companies.\textsuperscript{88} Most of these companies are subject to the SEC proxy rules when they solicit proxies.\textsuperscript{89} Finally, annual meetings are seasonal, with most taking place during the second quarter of the calendar year.\textsuperscript{90} Broadridge delivers more than one billion communications to investors per year.\textsuperscript{91} It is an accident waiting to happen.

An aggravating factor is that, for both issuers and custodians, the voting process is a necessary chore, not a profit center. The issuers must solicit proxies because they need a quorum to act. Federal law requires custodians to assist in the identification of beneficial owners, distribution of materials, and collection of proxies. Custodians typically delegate that task to Broadridge, which is in the happy position of being hired by the custodians but presenting its bill to the issuers.

This system produces three types of pathologies. First, there are pathologies caused by the sheer complexity of the system. Second, there are pathologies caused by a misalignment of the property concepts implicit in the beneficial-owner-as-shareholder paradigm and the property rules that, in fact, govern the ownership of shares held by nominees. Third, there are pathologies caused by a misalignment between voting rights and economic interests.

A. PATHOLOGIES OF COMPLEXITY

1. Pathology 1: Materials Don’t Arrive

The corporate voting system operates on a tight schedule. As noted earlier, the record date, under Delaware law, cannot be more than sixty days before the meeting. For shares held in nominee name, the following steps must occur before the materials are mailed out: the issuer sends an inquiry to DTC; DTC responds; the issuer sends out search cards to the custodians; the custodians respond; often this process has to be repeated for multiple tiers of custodians; then, and only then, can the issuer mail the materials to Broadridge, which then distributes them to the shareholders. Given this complexity, there will be numerous cases in which the proxy materials and the request for voting instructions simply do not make it to the beneficial owner in time for the beneficial owner to vote.

Why does it matter if materials do not arrive? Most obviously, it deprives the

\textsuperscript{88} There is no official figure of the number of public companies in the U.S., and estimates vary. For one estimate, see Thomas J. Donohue, President & CEO, U.S. Chamber of Commerce, Remarks at the Three Sector Summit—Hitachi Found. (July 14, 2003), available at http://www.uschamber.com/press/speeches/2003/030714tjd_hitachi.htm.

\textsuperscript{89} Some companies are reporting companies under section 15(d) of the Securities Exchange Act, 15 U.S.C. § 78o(d) (2000), without also being registered under section 12, 15 U.S.C. § 78l(a) (2000), such as privately held companies with public debt. Id. §§ 78l, 78o(d). Those companies are subject to part of the mandatory disclosure system (for example, Rule 15d-1, 17 C.F.R. § 240.15d-1 (2007), requires that annual reports be filed), but are not subject to the proxy rules that only apply to companies registered under section 12 of the Act. Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (2000).

\textsuperscript{90} Id., Amend. 4 to Form 10, supra note 70, at 46.

\textsuperscript{91} Id. at 3.
beneficial owners of their right to vote. Moreover, it is likely that the beneficial owners most affected by materials not arriving are individual investors. The failure of materials to arrive will correspondingly increase the relative influence of the institutional shareholders.

But the effects are more complex. "Non-votes" resulting from the non-delivery of proxy materials are, for legal purposes, treated identically with non-votes resulting from apathy or carelessness. Under NYSE Rule 452, brokers may use their discretion to vote shares on routine and uncontested matters as to which the broker does not receive instructions ten days in advance of the meeting. At least until recently, brokers have tended to vote uninstructed shares in accordance with recommendations of the board of directors. Thus, with respect to such shares, any non-arrival of materials translates into more pro-management votes.

Bank custodians, however, are not covered by this rule and the agreement between the custodial bank and its customer typically does not permit banks to vote uninstructed shares. Thus, with respect to shares held by banks, and for non-routine matters also with respect to shares held by brokers, any non-arrival of materials translates into the shares not being voted at all.

What, in turn, is the effect of a failure to vote? First, it may make it more difficult for issuers to meet their quorum requirements. Second, for matters requiring an affirmative vote by a majority of the shares entitled to vote—such as mergers or charter amendments—a failure to vote is equivalent to a "no" vote. Since these matters are generally proposed by the board, any

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92. NYSE, Inc., Rule 451 (Mar. 6, 2003); NYSE, Inc., Rule 452 (Mar. 6, 2003). Rule 452 states: [A] member organization . . . may give or authorize the giving of a proxy to voted such stock, provided the person in the member organization giving or authorizing the giving of the proxy has no knowledge of any contest as to the action to be taken at the meeting and provided such action is adequately disclosed to stockholders and does not include authorization for a merger, consolidation or any other matter which may affect substantially the rights or privileges of such stock.

93. Scannell, supra note 8 ("Brokers generally vote for management, partly, they say, because if clients wanted them to oppose management they would let them know.").


95. See Wilcox et al., supra note 46, at 12-9 to 12-10.

96. The default quorum requirement is set at 50%, but it can be lowered by a charter provision to as little as 33.3%. DEL. CODE ANN. tit. 8, § 216 (2001 & Supp. 2006).

97. Id. § 251(c).

98. Id. § 242(b).
non-arrival of materials translates into a vote against management recommendations.

Matters are even more complex where some of the items on the ballot are routine and others are non-routine. As long as brokers continue to exercise their authority on routine matters, the respective shares will count towards the quorum requirements and be deemed present at the meeting, but will abstain from casting a vote on the non-routine matters. For some purposes, such abstentions are treated differently from a failure to send in any ballot. For example, in uncontested director elections, an "abstention" takes the form of "withholding" of authority to vote in favor of the nominee and is thus indistinguishable from a vote by a holder who is affirmatively opposed to the nominee.99 The number of votes withheld is the key indicator of shareholders’ dissatisfaction with the incumbent management. Moreover, for companies that have adopted a “majority vote” requirement for director election, sufficient withhold votes have the legal effect of the director not being elected or forcing him to resign. For director elections, abstentions thus are, in effect, anti-management votes. Shareholder proposals, similarly, require a majority of shares voting,100 so that abstentions have a similar effect as “no” votes. But because shareholder proposals are typically opposed by management, an abstention on them is equivalent to a pro-management vote.

2. Pathology 2: Votes That Are Not Counted

Consider the following incident.101 A 9% holder received proxy materials from Broadridge for an “uncontested” election of directors that indicated that voting instructions had to be received by 11:59 p.m. on the day before the annual meeting. At 11:00 p.m., to show its displeasure with current management, the holder gave instructions that its votes should be withheld from all nominees. When the results were announced, the company stated that 95% of shares voted had been cast for the nominees. When the holder inquired, it discovered that the tabulator had stopped tabulating votes at 4:00 p.m. on the day before the meeting in order to prepare its report in a timely manner. As a result, the holder’s votes were not included.102 When, as is apparently currently the case, shareholders change their votes up to the last minute, the votes

99. Wilcox et al., supra note 46, at 12-11 to 12-12.
101. The following is based on a confidential personal communication with one of the authors.
102. The law governing the appointment and role of inspectors is surprisingly sparse. Title 8, section 231 of the Delaware Code requires that inspectors be appointed in advance of all meetings of publicly held corporations and gives them the responsibility for ascertaining the number of shares outstanding, determining the shares represented at the meeting and the validity of proxies counting votes and ballots, and certifying their determination of the number of shares represented and the count. Del. Code Ann. tit. 8, § 231(a)-(c) (2001). Section 231 further provides:

The date and time of the opening and the closing of the polls for each matter upon which the stockholders will vote at a meeting shall be announced at the meeting. No ballot, proxies or votes, nor any revocations thereof or changes thereto, shall be accepted by the inspectors after
counted may have actually been revoked.

Early closing is only one aspect of a more-general problem of votes not being counted. Consider a tabulation anecdote involving a routine annual meeting at Unilever:

The agenda included no contentious issues, and there was no sign of shareholder unrest. But executives at the Anglo-Dutch consumer products company, maker of Dove soap, Hellmann's mayonnaise and Lipton tea, noticed that the shareholder vote total was suspiciously low. So they called major institutional investors and discovered that seven of them had simply not bothered to take part, and that votes from another three had never been delivered to Unilever because of a coding error by Institutional Shareholder Services... 103

Oesterle and Palmiter recount the earlier, nightmare 1993 proxy season:

The leaky dam of proxy tabulation burst in the 1993 proxy season when various institutional investors blew the whistle on Broadridge, a tabulation firm that handles over seventy percent of all corporate proxy solicitations. Several investors claimed Broadridge had not tallied their proxies in a "just vote no" campaign against Paramount Communications. The Paramount miscount was only the tip of the iceberg. During the solicitation period before the 1993 spring annual meetings, Broadridge had experienced significant difficulties: Proxy materials were sent out late or not at all; Broadridge received proxy tabulations late or not at all, causing several firms to struggle to meet quorum requirements or to postpone meetings; electronic tabulation systems failed to function; and proxy solicitors had to solicit proxies several times. 104

the closing of the polls unless the Court of Chancery upon application by a stockholder shall determine otherwise.

Id. § 231(c).

Typically, the polls are opened officially during the meeting to receive proxies and ballots (from those shareholders present). BALOTTI ET AL., supra note 2, § 8.12. The official closing of the polls is more complicated. "In a simple, uncontested meeting..., the results of any vote often may be tabulated and announced without any adjournment of the meeting." Id. On the other hand, when a vote is close, the polls can be kept open while the company's proxy solicitor works to find more votes. This discretion likely explains Listokin's finding that management is overwhelmingly likely to win close contests. See Listokin, supra note 9, at 1; see also discussion supra note 9 and accompanying text. If, at the beginning of a meeting, management is short votes, the polls can be held open while the solicitors continue soliciting votes. The situation is more complicated when a meeting is adjourned (for example, for thirty days) in order to allow management to round up additional votes for a specific matter. In State of Wisconsin Investment Board (SWIB) v. Peerless Systems Corp., the Chancery Court considered such a situation under a Blasius analysis, No. Civ. A. 17637, 2000 WL 805376, *3–4, *7–8, *19 (Del. Ch. Dec. 4, 2000) (discussing Blasius Indus. v. Atlas Corp., 564 A.2d 651 (1998)), and while not granting summary judgment for SWIB, was extremely skeptical of whether Peerless could sustain its burden of establishing a "compelling justification" for interfering with the shareholders' franchise. Id.


What is the effect of the non-counting of votes? If votes are not counted by mistake, the effect is similar to the non-arrival of materials. But even if the tabulator stops counting early because there are already enough votes in to determine the outcome, there may be an important, albeit symbolic, effect: the margin of victory (in particular the percentage of withheld votes in director elections or the percentage supporting a shareholder resolution) can be an important indicator of the support that management enjoys.

3. Pathology 3: The Nightmare of Verification

The most troubling pathology of complexity is the system's inability to provide vote verification and an end-to-end audit trail. Any voting system is only as good as its post-voting system of verification. The complex system of holdings, combined with the circuitous system of distributing materials, soliciting proxies and collecting voting instructions, creates a nightmare of verification. The first complexity arises because shareholders may hold shares both directly and in street name, and some shareholders, such as banks and brokers, may hold shares directly, in street name for their own accounts, and in street name for customer accounts. Broadridge, as the votes come in, records them and sends a "multiple proxy" to the tabulator. The first multiple proxy is typically issued fifteen days prior to the meeting with daily updates from the ninth day. Banks and brokers frequently use so-called "partials"—"proxies voting less than all of the shares they are entitled to vote." These partials are cumulative, which means that substantial care is required to prevent the custodian from voting more shares than it is entitled to. With respect to nominee shares, the custodians are voting on behalf of their customers who may have differing views. The proxies will thus be split between "for," "against," and "abstain."

With this complexity, problems are common. The leading treatise on shareholder meetings recounts the following (illustrative but hardly exhaustive) problems:

- Because of the multiple mailings by each side and the increased pressure placed on the brokers by proxy solicitors, there are some banks and brokers who overvote their position. Some bank brokers [sic] will vote all their shares for both sides; others will change their vote without revoking previously voted shares of varying amounts.

105. BALOTTI ET AL., supra note 2, § 10.7.
106. Id.
107. Id.
108. Id.
109. Id. § 10.8. In these cases, the inspector contacts the proxy clerk to resolve the overvote, as permitted by title 28, section 231 of the Delaware Code. See DEL. CODE ANN. tit. 8, § 231 (2001). "Some firms cooperate with the inspectors when they overvote; others refuse to change their vote, maintaining that they hold the number of shares they voted . . . . Any broker or bank proxies that cannot
• [B]anks sometimes combine accounts at will in voting proxies. The best
the inspectors can do is match proxies by account numbers and vote the
latest dated proxy for each account. However, banks frequently return
proxies for large numbers of shares which do not bear an account
number. Upon investigation, the inspectors are told that these proxies
are a combination of accounts which the banks can or cannot identify at
this time.110

• [In] a new practice known as piggybacking,111 ... [a]ll of the shares of
the small bank are given one account number by the large bank, even
though there are a number of beneficial owners represented by the small
bank. The result is that inspectors receive bank proxies with the same
account number bearing varying numbers of shares.112

Verification is made more complicated by inconsistent records. As John Wilcox
explains:

The “shareholder list” used for solicitation and tabulation of votes at share-
holder meetings is actually a compilation of public and non-public data
collected from different sources on the record date—the Depository Trust
Company (DTC) participant position listing (the Cede list), the share register
maintained by the issuer or its transfer agent, the customer account records of
banks and brokers, and the internal records of investment managers and their
agents. As these records are being assembled, no effort is made to conduct an
audit or reconcile inconsistent share positions. For example, the number of
shares on the DTC omnibus proxy invariably differs from the shares in the
Cede account on a company’s share register. No procedure is available to
reconcile the discrepancy.113

Finally, any meaningful verification efforts are hampered by the presence of two
parallel tabulation systems: one for registered holders where the inspector
matches proxies against a shareholder list and a second for voting instructions
by beneficial holders tabulated by Broadridge.114 How Broadridge and its
customers—the bank and broker custodians—adjust overvotes, revocations, and
other problems within its system is entirely opaque. Even less is known about
how often Broadridge makes clerical errors in compiling its proxy based on the
numerous voting instructions provided by beneficial holders or in verifying that

be resolved by telephone are not counted, but reported as unresolved.” BALOTTI ET AL., supra note 2,
§ 10.8.
110. BALOTTI ET AL., supra note 2, § 10.8.
111. See supra text accompanying notes 52–54.
112. BALOTTI ET AL., supra note 2, § 10.8.
113. John C. Wilcox, Shareholder Nominations of Corporate Directors: Unintended Consequences
and the Case for Reform of the U.S. Proxy System, in SHAREHOLDER ACCESS TO THE CORPORATE BALLOT 6
(Lucian A. Bebchuk ed., 2004).
114. Id. at 7.
the person giving the instructions had proper voting authority. Delaware courts’ reluctance to look beyond the tabulation system for registered owners further complicates matters.

The verification nightmare suggests that there may well be discrepancies—sometimes significant ones—between the ballots cast and the voting instructions given by the beneficial holders. This generates random “noise” in the tabulation of votes, which may sometimes favor and sometimes disfavor management, but which always makes the reported results less reliable. If one believes not only that a decision by shareholders (when they are entitled to vote) is important for legitimacy purposes, but also that shareholder support is related to whether a decision is a good one, then even random noise will increase the error rate. Worse decisions will be certified as having received the requisite shareholder support.

B. PATHOLOGIES OF OWNERSHIP: CONFUSIONS AS TO WHO “REALLY” OWNS THE SHARES

The second set of pathologies arises because of a misalignment of the property concepts implicit in the beneficial-owner-as-shareholder paradigm and the property rules that, in fact, govern the voting of shares held by nominees, combined with widespread securities lending and short selling. As we show in this section, when this framework is combined with modern custodial practices, there can be surprising results with unclear legal guidance.

1. Pathology 4: Securities Lending Surprise

Suppose that an institutional investor wishes to vote its shares only to discover that they have been “lent out”? This happens. There is a story, perhaps apocryphal, of a prominent institutional investor who had sponsored and campaigned vigorously for a shareholder proposal under Rule 14a-8 only to discover after the record date had passed that it had no shares to vote because it had “lent” them out and that another institution loaned the sponsoring institution shares to prevent the proposal from being disqualified. (Alas, this story makes no sense because the rule requires a proponent to be a shareholder and then to hold the shares through the date of the meeting.)

To understand this pathology, we need to discuss a bit of detail. There is an active market for the borrowing and lending of securities. Securities lending serves a variety of purposes, including importantly that it enables short selling. When an investor believes that shares are over-valued and will soon decline in price, it can profit by selling the shares now (at the high price) and then covering the position later once the price has declined. Because “naked” short selling is illegal, the investor must “borrow” shares in order to sell them now at the high price. Later, it will buy the same shares, hopefully at a lower price,

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115. Confidential Communication to author.
and restore them to the lender.

As this example demonstrates, the terms "lending" and "borrowing" are not accurate. The standard form contract governing equity lending prepared by the Securities Industry and Financial Markets Association (SIFMA) is a "Master Repurchase Agreement."\(^\text{118}\) The securities "loan" is really a transfer by a seller (for example, an institutional investor) of full legal title in securities to a buyer (for example, a hedge fund). In exchange, the buyer promises to sell back equivalent (but different) shares in the future, to make the lender whole for any dividends paid during the loan period,\(^\text{119}\) to pay a fee, and to provide collateral. If a shareholder "lends" its shares out before the record date, the shareholder is not a shareholder as of the record date and is not entitled to vote,\(^\text{120}\) whether or not the "returned" shares are received prior to the meeting.\(^\text{121}\)

As noted earlier, securities lending is a huge market and a highly profitable business.\(^\text{122}\) Firms make an estimated $5 billion per year from securities lending,\(^\text{123}\) with CalPERS alone making about $130 million per year from its operations.\(^\text{124}\) Typically, large institutional investors will either have the custodian bank handle the securities lending or will put the business out to bid to a third-party specialist. As a result, the personnel in the institutional investor with responsibility for voting the shares may not even be aware that the shares are out "on loan."

Institutional investors have access to records of their securities-lending operations and can, if they choose, decline to lend out their shares or recall them in advance of record dates for meetings at which they intend to raise issues or want to vote. But doing so would sacrifice substantial revenue. Most securities


\(^{119}\) See Annex VIII, supra note 118, para. 4(a).

\(^{120}\) With regard to ERISA fiduciaries, the Department of Labor addressed the fiduciary's duties in a 1992 letter in which it concluded that "potential inability to vote on proxy proposals that may arise while the loan is outstanding... should be considered by a fiduciary as part of the decision to loan shares of stock." Wilcox et al., supra note 46, at 12-19 (alteration to the original in the quoted text) (quoting Letter from Ivan L. Strasfeld to James E. Heard dated Feb. 20, 1992). Wilcox et al. report that "[t]he DOL's letter has been interpreted as requiring ERISA fiduciaries to have some system in place to ensure they are in physical possession of shares on the record date for meetings at which significant proposals are being considered." Id.

\(^{121}\) Annex VIII provides: "Except as otherwise agreed by the parties, Seller waives the right to vote, or to provide any consent or to take any similar action with respect to, Purchased Securities that are Equity Securities in the event that the record date or deadline for such vote, consent or other action falls during the term of a Transaction." Annex VIII, supra note 118, para. 7.

\(^{122}\) According to a 2004 survey, the total securities lending volume with all U.S. counterparties is estimated to be approximately $1.94 trillion. Bond Mkt Ass'n, Repo & Securities Lending Survey of U.S. Markets Volume and Loss Experience 3 (2005), available at http://www.sifma.net/assets/files/repoSurvey0105.pdf (last visited Mar. 17, 2008). Of that, about $275 billion comes from margin accounts. Id.

\(^{123}\) Faulkner, supra note 56.

\(^{124}\) CalPERS, supra note 57.
lending programs combine the shares of a large number of customers. Recalls of lent shares or freezes on lending increase the transaction costs of the entity that handles the lending program. If a participant in a securities-lending program regularly recalls or freezes shares in advance of a record date, that entity will simply give preference to the many participants who do not impose such limitations and will not lend the participant's shares out unless no other shares are available. The effect of such a policy would thus be to opt out of securities lending, a very expensive decision.  

A solution is further complicated by the gap between fixing the record date and the date on which the agenda for the meeting is announced. Suppose that the board announces on January 20 that the record date is February 1. On February 15, it announces—consistent with the bylaws which typically allow the board to fix the date of the annual meeting—that the annual meeting will be April 1 and only then discloses the agenda. If an institution learns at this point that there is an item on the agenda that it wants to vote on, it will be too late to put a freeze on lending the shares of the issuer; any shares that were lent out as of February 1 will not be available to be voted.

What is the effect of the securities lending surprise? For one, the lender—although economically a beneficial owner of the shares—will not be able to vote. Instead, as an initial matter, the borrower obtains the voting right. When the whole transaction is done to enable a short sale, the borrower, however, has no beneficial interest in the shares either; to the contrary, the borrower benefits when the share price declines. But then again, if the borrower sells the shares prior to the record date as part of the short sale, the borrower will not have any voting rights either. In that event, voting rights are de facto transferred from one entity with a beneficial interest—the lender—to another entity with a beneficial interest—the person who acquires the shares from the borrower.

So why does this matter? Much securities lending is done on behalf of institutional investors. Recent reforms have rested on the assumption that institutional investors are potentially more-engaged shareholders than individual investors. Securities lending may thus result in the transfer of votes from institutional investors to shareholders who are, on average, less engaged and informed.

125. Nor can the securities lender solve the problem by retaining the vote by securing a proxy from the record holder. The borrower may want to sell the shares prior to the record date in the public market. Requiring the anonymous purchaser of these shares to execute a proxy is impracticable.

126. Under New York Stock Exchange rules, the issuer must announce the record date ten days in advance. NYSE, Inc., Listed Company Manual § 204.21 (2006). Under title 8, section 213 of the Delaware Code, the board of directors must fix the record date between ten and sixty days before the meeting and not before the date of the board resolution. DEL. CODE ANN. tit. 8, § 213 (2001).

127. These problems, of course, can be lessened to the extent that proponents of shareholder proposals publicize their intention to make a proposal well in advance of the meeting. In proxy contests, however, the challengers may not want to provide that warning.
2. Pathology 5: Overvoting when There Is Short-Selling

The "securities lending surprise" arises on the custodial bank side where the customers maintain control over their shares but may choose to lend them out for some extra money. On the custodial broker side, the potential mischief is more troubling and less easily resolved. Specifically, securities lending can result in brokers soliciting votes, and receiving instructions, for more shares than are entitled to vote.\footnote{See Randall S. Thomas & Catherine T. Dixon, Aranow & Einhorn on Proxy Contests for Corporate Control § 15.05[C] (3d ed. 1998 & Supp. 1999); see also Balotti et al., supra note 2, § 10.7; Henry T.C. Hu & Bernard Black, Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 61 Bus. Law. 1011 (2006) (discussing issues of overvoting).}

As noted earlier, the standard margin-account agreement between brokers and customers grants the broker the right to "lend" out shares in the account and to keep the fees for doing so without notifying the customer.\footnote{Schwab Margin Agreement, supra note 60, para. 8.} Moreover, it is also standard practice for the broker not to identify from which accounts "lent" shares have been taken.

These standard practices can and do cause significant problems. Consider Figures 8 and 9. Suppose that Morgan Stanley has 1 million shares of Delaware, Inc. in its DTC account, while Smith Barney has 500,000 shares in its account.

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**Figure 8. Selling Short**

- **500,000 Shares**
  - S1, S2, S3, S4, S5
  - **Sells 100k to S5**
  - Smith Barney

- **1,000,000 Shares**
  - C1, C2, C3, C4, C5
  - **Borrows 100k shares**

- **Hedge Fund**

- **Depository Trust Company**

- **Smith Barney's DTC Account**
  - 500,000

- **Morgan Stanley's DTC Account**
  - 1,000,000

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A hedge fund customer "borrows" 100,000 shares from Morgan Stanley and, to go short, sells them to a customer of Smith Barney. Once that sale is completed, the DTC records will show that Smith Barney has 600,000 shares, while Morgan Stanley now has 900,000 shares.

As illustrated in Figures 10 and 11, DTC's omnibus proxy will transfer the right to vote 900,000 shares to Morgan Stanley and will inform Broadridge of this. Morgan Stanley, however, will give Broadridge a list of all its customers' holdings in Delaware, Inc. for a total of 1 million shares. Broadridge will then send out proxy materials according to the brokers' customer lists, with the result that it will solicit voting instructions for more shares than are in fact entitled to vote.

What if Morgan Stanley customers return sufficient instructions so that Morgan also receives voting instructions for more than 900,000 shares? Broadridge clearly should only cast votes for 900,000 shares, since casting a higher number may result in all of Morgan Stanley's votes being invalidated. But

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130. This happened, for example, in Seidman & Assocs., L.L.C. v. G.A. Fin., Inc., 837 A.2d 21, 24–25, 28 (Del. Ch. 2003) (invalidating proxies for 233,376 shares when unable to resolve an 824-share overvote). When there is no reconciliation, there is no standard industry practice for what the tabulator should do. As the NYSE pointed out: "Tabulators may respond to over-votes with a variety of vote-counting procedures, including counting votes on a first in-first voted or last in-first voted basis, or disregarding altogether a vote submitted by a broker dealer." In re Deutsche Bank Securities Inc., NYSE Decision 05-45, para. 11 (Feb. 2, 2006).
cutting down the number of voting instructions to the number of shares the broker is entitled to vote means that someone (who?) must decide whose votes count.131

Current practice during proxy contests is that when the independent inspector of elections identifies a discrepancy between the number of shares voted and the number of shares that DTC indicates are held for the broker, it contacts the broker directly.132 At that point, it is the responsibility of the broker to reconcile the two. Sometimes, the broker simply refuses to do so, as Deutsche Bank Securities did from 1998 to 2003.133 The Deutsche Bank case gives some indication of the dimensions of the problem. According to the NYSE report summarizing the NYSE’s Division of Member Firm Regulation’s (MFR’s) examination:134

For 2003, the MFR Examination identified 12 instances, out of 15 tested, in which Respondent over-voted, that is, Respondent submitted more proxy
votes than it was entitled to cast, in connection with proxy matters. For example, in March 2003, Respondent cast a total of 8,537,151 shares in a proxy matter involving “XYZ” (record date March 4, 2003). As of the record date, according to the information maintained at [DTC], Respondent in fact was eligible to vote only 4,232,867 shares. Thus, the over-vote in this matter was 4,304,284 shares. The over-votes submitted by Respondent in the other 11 proxy matters in 2003 ranged from 16,710 shares to 2,152,721 shares.

... Enforcement’s investigation disclosed that, in 2002, Respondent overvoted in 11 instances out of 12 tested. For example, in March 2002, Respondent cast a total of 11,168,338 shares in a proxy matter involving “XYZ” (record date March 5, 2002). As of the record date, according to the information maintained at [DTC], Respondent in fact was eligible to vote only 6,679,676 shares. Thus, the over-vote was 4,488,662 shares. The over-votes submitted by Respondent in the other 10 proxy matters in 2002 ranged from 31 shares to 1,876,283 shares.

... Respondent’s failure to reconcile the stock record in connection with proxy voting instructions was a central cause of the over-votes set forth above. In these uncontested matters, Respondent voted shares up to its unreconciled unadjusted long position, which was generally greater than its [DTC] position.
But how *should* the broker reconcile the overvote? The Securities Industry Association (SIA), 135 in cooperation with the NYSE and the SEC, recently examined the alternatives for resolving overvoting in an attempt to establish industry best practices. 136 In principle, there are two ways to reconcile any mismatch: pre-mailing or post-mailing. 137 If reconciled pre-mailing, the number of shares for which voting instructions are solicited is adjusted downward to match the number of votable shares. If reconciled post-mailing, the broker waits to see if the number of shares for which voting instructions are received exceeds the number of votable shares and makes a downward adjustment only if it does. In effect, in post-mailing, any lent shares are first assigned to the accounts of customers who did not return voting instructions. 138 Any downward adjustment (whether pre- or post-mailing) must be made in a manner that is "proportional and equitable among all clients." 139 Two methods that meet this goal are an impartial lottery among customers and proration (in other words, proportional reduction of each margin account).

There are advantages and disadvantages to pre- and post-mailing reconciliation. Pre-mailing reconciliation allows the client to know from the voting card precisely how many shares it may vote. On the other hand, because only 35% of clients usually vote, 140 pre-mailing reconciliation is more costly because it requires reconciliation in a large number of cases where, in fact, the number of shares for which (unreconciled) voting instructions are received does not exceed the total number of shares in the brokerage account. Post-mailing reconciliation has the opposite advantages and disadvantages. In addition, waiting for instructions to be received before making a reconciliation means that the broker has a very short time window in which to reconcile an overvote, a process that requires a large number of adjustments.

Moreover, post-mailing reconciliation generates another type of problem. Because any lent shares are, in effect, first assigned to the accounts of customers

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137. Broadridge provides a service (the "Over Reporting Prevention Service") that compares "a participant's reported position to its DTC position, flags any differences, and enables the participant to make appropriate adjustments." SIA Letter, supra note 136, at 2. In 2005, 100 brokers representing more than 90% of street positions used the service. *Id.*

138. The NYSE appears to permit the practice of assigning voting instructions to shares with respect to which voting instructions have not been received, so long as there is no "overvote"—in other words, the votes do not exceed the shares in the broker's possession on the record date. Wilcox et al., supra note 46, at 12-20 (citing Letter from the NYSE to the Commerce, Consumer & Monetary Affairs Subcomm. of the Comm. on Gov't Relations (Feb. 19, 1991)).

139. SIA Letter, supra note 136, at 3; see SIA, PROXY PRACTICES, supra note 136, at 3 n.7.

140. SIA, PROXY PRACTICES, supra note 136, at 3.
who did not return voting instructions, the number of votes cast will be
systematically greater and the number of non-votes correspondingly lower
than in the case in which there has been no lending. The effects of this bias
in favor of more votes are exactly the opposite of the effects of fewer votes
resulting from materials not arriving: any matters where a failure to vote or
to submit instructions is equivalent to a "no" vote become easier to pass.
This makes it easier for managers to obtain the requisite votes on mergers,
charter amendments, and director elections, but also makes it easier for share-
holder proponents to secure the vote needed for the passage of a shareholder
resolution.141

The interaction between the accuracy of the vote count and the level of short
selling explains why, in close votes, we may have little reason to trust the
outcome. When, for example, the AXA/MONY merger was approved by 1.7
million shares at a time when 6.2 million shares were out on loan,142 can we be
confident that it was approved by the votes of people who actually owned the
shares?

C. PATHOLOGIES OF MISALIGNMENT BETWEEN VOTING RIGHTS AND ECONOMIC
INTEREST

The concepts of record dates and record holders—albeit necessary (to some
extent) to make a voting system for public corporations workable—result in a
discrepancy between beneficial economic stakes in the company and voting
rights. Voting rights rest with the record holder on the record date. But that
record holder may not have any beneficial economic ownership in the company
for three reasons:

- The record holder is a street-name holder (a bank or broker) who never
  had a beneficial economic interest.
- The shares have been sold after the record date and before the vote.
- The holder has hedged its economic exposure to the company.

By the same token, a holder may have a beneficial economic interest, but no

141. The pre-mailing proration approach is consistent with the U.C.C. article 8 structure of property
rights. U.C.C. section 8-503(b), provides that when the broker does not have enough shares to cover all
of the securities entitlements:

An entitlement holder's property interest with respect to a particular financial asset under
subsection (a) is a pro rata property interest in all interests in that financial asset held by the
securities intermediary, without regard to the time the entitlement holder acquired the security
entitlement or the time the securities intermediary acquired the interest in that financial asset.
U.C.C. § 8-503(b) (amended 2003). However, because U.C.C. article 8 is designed to govern custodial
arrangements and to minimize failed securities transactions, it is not clear whether it should be viewed
as a source for more-general obligations between brokers and customers. Thus, we do not mean to
suggest that the pre-mailing proration approach is required by the U.C.C.

142. Drummond, supra note 3, at 96; Floyd Norris, Holders of MONY Approve $1.5 Billion Sale to
voting rights (because it is not a record holder, because it has bought the shares after the record date, or because it is a counterparty to a hedging transaction).

The various regulations discussed above are designed (largely, but not wholly, successfully) to deal with the first of these reasons. But they do not begin to address the other two reasons for the discrepancy. Thus, in the present regime, there will be some persons with voting rights and no beneficial interest, and others with a beneficial interest and no voting rights. The more liquid the market for the shares, and the larger the market for derivatives, the more often this will occur.

Discrepancies between voting rights and beneficial interests can arise in two contexts: first, as an unintended consequence of a transaction undertaken for other reasons (for example, when a person buys shares after the record date because she believes the stock price will increase); second, for the purpose of obtaining votes without an equivalent economic exposure (for example, when a person buys shares before and sells them after the record date so that she can vote the shares without having any economic exposure). We will use the term "incidental discrepancies" to connote the former and the term "empty voting"—coined by our colleagues Henry Hu and Bernie Black—to connote the latter.

1. Pathology 6: Incidental Discrepancies

To examine the effect of incidental discrepancies, one has to engage in two inquiries: first, how will investors vote who have votes but no economic interest; and second, how would the investors have voted who have an economic interest but do not have votes?

As to investors with voting rights and no economic interest, one possibility is that they will not bother to vote at all. In fact, some institutional shareholders have a policy of not voting in such situations.144 As discussed with respect to pathologies related to materials not arriving and votes not being counted, a failure to vote can be, depending on the issue voted on, equivalent to the pro-management vote, equivalent to an anti-management vote, or neutral. Another possibility is that the investor will cast a less-informed vote.145 Again,

145. As discussed earlier, Delaware focuses on record ownership. See supra text accompanying notes 24–32. In two cases, Chancellor William T. Allen suggested some equitable limits to voting such shares. In Commonwealth Associates v. Providence Health Care, Inc., Chancellor Allen presumed that a post-record-date sale of shares would carry with it the right to vote the shares. 641 A.2d 155, 155–58 (Del. Ch. 1993). Indeed, he suggested that any contractual agreement to permit the selling shareholder to retain the votes without also retaining "an interest sufficient to support the granting of an irrevocable proxy with respect to the shares" would not be enforceable. Id. at 158. In an earlier opinion, Chancellor Allen stated:

[T]he 'seller' of stock loses the equitable interest once a specifically enforceable contract of sale is formed. It is the binding nature of this contract and its specific enforceability under the law that gives to the "buyer" the present equitable right as it may be deemed to have, such as
depending on the issue, this may be a pro- or anti-management vote. Third, in some instances in which there is a relationship, the investor with the voting rights may look to the investor with the economic stake for suggestions on how to vote. Finally, the investor’s vote may be influenced by extrinsic factors (for example, by an attempt to curry favor with management).

As to investors who have an economic interest but no votes, there is no particular reason to believe that their votes would differ from similar investors with both a vote and an economic interest. But even so, the fact that some investors with a beneficial stake have no vote would add noise to the voting outcome which may result (on average) in an inferior outcome.

Since institutional investors trade more frequently than individual investors, they are more likely to find themselves in a position in which they have purchased shares after the record date, and thus have an economic stake and no voting rights. Though institutions are also more likely to sell shares between the record date and the meeting, they often do not vote in such a situation. Incidental discrepancies, therefore, are likely to reduce the relative influence of institutional investors.

2. Pathology 7: Empty Voting

Of late, an esoteric and theoretically interesting pathology has emerged which goes by the name of “empty voting” or “encumbered shares.” “Empty voting” refers to instances in which some shareholders have more votes than economic interest. This can occur through a variety of different techniques and can be intentional or unintentional. We address empty voting briefly here because it illustrates a particular sort of gaming of a complex system. We do not address it in detail because it has already been the subject of substantial scholarly attention and because we are uncertain of its real world significance, at least in the United States.

The most notorious example of intentional empty voting arose in the pro-

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Len v. Fuller, No. Civ. A. 15352, 1997 WL 305833, at *3 (Del. Ch. May 30, 1997). Neither opinion, however, bars empty voting and, in impersonal markets, the post-record-date buyer will not be able to execute a proxy.

146. For example, counterparties in swap transactions, typically banks, may look to the holder of the economic interest to get a “wink or a nod” on how to vote. Andrew Ross Sorkin, A Loophole Lets a Foot in the Door, N.Y. TIMES, Jan. 15, 2008, at C01.

147. Roiter, supra note 144.

148. Hu & Black, supra note 128, at 1014.


150. Hu & Black, supra note 128, at 1014.

151. The market for record-date ownership is described and discussed in Susan E.K. Christoffersen et al., Vote Trading and Information Aggregation, 62 J. FIN. 2897 (2007), and in Christopher C. Geczy et al., Stocks Are Special Too: An Analysis of the Equity Lending Market, 66 J. FIN. ECON. 241 (2002). The issues relating to empty voting are extensively discussed in Martin & Partnoy, supra note 149, and in Hu & Black, supra note 128.
posed Mylan King merger. In July 2004, Mylan Laboratories entered into a merger agreement with King Pharmaceutical, according to which, subject to shareholder approval, Mylan would acquire King for Mylan shares.152 Perry Corp., a hedge fund, was a large shareholder in King and supported the merger.153 While the deal was seen as favorable to King, the market reaction to the merger for Mylan was negative, and some large shareholders of Mylan, including Carl Icahn, threatened to vote against it.154 As a result, approval of the merger by Mylan shareholders was in doubt.155 Perry then acquired 9.9% of Mylan’s shares and entered into “equity swaps” with Bear Stearns and Goldman Sachs which fully hedged its economic exposure to Mylan’s share price.156 As a result, Perry acquired shares—and votes—in Mylan which it could vote purely on the basis of its interest as a King shareholder. See Figure 12.

The divergence between the interests of Perry and those of other Mylan shareholders is obvious. If the merger was good for King but bad for Mylan, as many Mylan shareholders felt, Perry would still vote its sizeable position in Mylan in favor of the merger and could help push it through. As it happened,

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154. See id.
155. See id.
156. See Steyer, supra note 152.
Mylan management terminated the merger agreement because negotiations fell through after King restated its earnings.\textsuperscript{157} The success, and legal validity, of Perry's strategy thus was not tested.\textsuperscript{158}

Intentional empty voting has different, and more disconcerting, ramifications than incidental discrepancies. In economic effect—albeit not in legal structure\textsuperscript{159}—it resembles vote buying. An investor who goes out of its way to buy votes is likely to vote the shares, and because that investor decided to divest its economic interest in the company, it may well vote them in a manner that reduces the value of the company.\textsuperscript{160} Intentional empty voting, to the extent it occurs, will thus tend to result in systematically inferior voting outcomes.

D. THE EFFECT OF THE PATHOLOGIES ON CORPORATE VOTES

As the preceding discussion shows, the various pathologies have different, and complex, effects on corporate votes. Specifically, the effects of the pathologies can be grouped into several categories. First, whether the pathology increases the error rate (or generates "noise")—that is, yields a voting outcome that is less reflective of the outcome that a majority of well-informed shareholders would have voted for. Second, whether the pathology results in fewer shares being voted or in more shares being voted. Third, whether the pathology empowers or disempowers certain groups of shareholders. And fourth, whether the pathology biases the voting outcome in a pro- or anti-management direction.

Table 1 summarizes the effects of each pathology with respect to each of these categories. A few comments on the Table are in order. Almost by definition, each pathology generates some noise as each results in discrepancies between investors with effective voting rights and investors with a beneficial stake in the company. In the case of votes not being counted due to early closing, this "noise" is mainly symbolic as inspectors will only close the polls


\textsuperscript{158} Other, more-traditional conflicts of interest in voting were also present. Icahn had a stake of about ten percent in Mylan, both in terms of economic exposure and in terms of voting rights. But Icahn also had shorted 5.3 million shares of King stock. \textit{Id.} Icahn could thus have an economic interest to oppose the merger, even if the merger were in the interest of Mylan, as long as the market thought that the merger would be significantly more beneficial to King. In that event, Icahn would gain more from a defeat of the merger through his short position in King than he lost on account of his long position in Mylan. For example, suppose Icahn shorted the King shares at $30 per share, so that the shares would go up to $40 per share if the merger was completed but down to $20 per share if the merger failed. Icahn would then profit from defeating the merger if his profits from shorting were greater than the increase in the value of his Mylan stake from approving the merger.

\textsuperscript{159} Vote buying traditionally involves an acquisition of votes without an acquisition of an economic stake. Empty voting typically involves an acquisition of shares—vote plus stake—and a separate transaction to divest the economic stake.

\textsuperscript{160} Empty voting also results in investors who have an economic interest but no voting rights. As to them, the analysis is the same as for incidental discrepancies.
Table 1. The Effect of the Pathologies

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<td>Anti-Management</td>
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<td>Pro-Management</td>
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early if the outcome is not in question. For incidental discrepancies and, even more so, for intentional empty voting, the degree of noise is likely to be high. These pathologies result not only in some investors with economic stakes having no effective voting rights, but in other investors that have no economic stakes but do have votes, and, at least in the case of intentional empty voting, those others are likely to exercise their voting rights.

161. Discussed infra section IV.B.
162. Discussed infra section IV.C.
Some, but not all, of the pathologies affect the total number of shares that are likely to have effective votes. Specifically, if materials do not arrive in time or some votes are not counted, the affected shareholders are deprived of effective voting rights. Overvoting means that voting instructions are solicited from more shareholders than are entitled to vote, which will tend to raise the number of shares being voted, but if proper adjustments are not made, overvoting can lead to a wholesale disqualification of votes and thus to fewer shares being effectively voted. Incidental discrepancies can reduce the number of shares being voted because record owners who do not have a beneficial stake are less likely to bother to vote than beneficial owners.

The number of shares with effective votes, in turn, relates to whether certain shareholder groups gain or lose power. The pathology of materials not arriving is likely to primarily affect individual shareholders. By contrast, institutional shareholders are more likely to be affected by incidental discrepancies because they trade more frequently than individual holders and are thus more likely to acquire shares between the record date and the meeting date. Pathologies 4 and 5, respectively, relate to the lending of shares mostly held in institutional and individual accounts and thus reduce the voting power of the respective shareholder group. Moreover, securities lending can result in short-sellers having voting rights (if they do not sell the “borrowed” shares prior to the record date). To the extent that some shareholder groups are more likely to vote a certain way than another, the shareholder-group effect will also bias the outcome of a vote.

Finally, the number of shares with effective votes has direct and complex effects on the outcome of a vote. To the extent that brokers have discretionary voting authority over shares for which they receive no voting instructions (and because brokers tend to vote in accordance with management recommendations), having fewer shares for which instructions are received biases the outcome in favor of the outcome desired by management.

To the extent that adopting a proposal requires a majority of the shares entitled to vote—as is the case for mergers and charter amendments—a non-vote is equivalent to an “against” vote. Fewer shares with effective votes result in more non-votes, which makes passage of these proposals more difficult. More shares with effective votes result in fewer non-votes, and makes passage easier.

Yet other matters are both non-routine and require a majority of the shares present at the meeting. This tends to be the case for shareholder proposals under Rule 14a-8163 (which are generally opposed by management) and uncontested director elections under a majority-voting rule (where management favors the election of the nominees). With respect to these matters, shares that are not at all present at the meeting do not affect the outcome, but shares that are present and abstain are equivalent to “against” votes. Because brokers will often continue to

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enjoy discretionary voting authority over some matters on the ballot, fewer shares with effective votes can result in more shares being present but not voting on these matters.\textsuperscript{164} As a result, the effective rule for electing directors under a nominal "majority-voting" rule and for the passage of a shareholder proposal is, in fact, a \textit{supermajority} of the votes cast.

IV. IMPLICATIONS AND AVENUES OF REFORM

A. INCREMENTAL IMPROVEMENTS

There are a variety of incremental changes to the system that should be considered.

1. Adjusting the Relation Between the Record Date and the Meeting Announcement

The non-delivery of materials is aggravated by the relatively compressed time frame between the record date and the meeting. Although this problem could be ameliorated by increasing the time between the record date and the meeting date, the longer the time between the record date and the meeting, the more shares will have been sold and the larger the percentage of record-date shareholders without any economic interest.

Consider another possibility. The "securities lending surprise" pathology derives from the practice of setting the record date before the meeting and its agenda are announced. In order to allow share lenders to recall their shares in advance of meetings in which they would like to vote, one could require that the board announce the date of the meeting and its agenda at the same time as it announces the record date.\textsuperscript{165} Apart from permitting investors to decide whether to freeze/recall shares with greater knowledge of what they will be asked to vote on, this would limit the discretion of management to set a record date strategically in order to affect the outcome of the vote. Prior announcement of the agenda would also enable other investors to buy shares \textit{in order to} influence the outcome of the meeting. As one informed observer commented, "If you did that, can you imagine the volume of trading in advance of the record date?"\textsuperscript{166} Although this could make issuers nervous, it could also invigorate annual meetings.

\textsuperscript{164} This, however, will not be the case where votes are not counted (Pathology 2). Also, with respect to incidental discrepancies (Pathology 6), the anti-management effect of fewer shares with effective votes for director election may be made up by a possible tendency of record owners without economic stakes to vote in favor of management's nominees.

\textsuperscript{165} The company may, at that point, not know which shareholder proposals will be on the agenda. But with respect to shareholder proposals, shareholder activists can announce well in advance of a meeting that they intend to pursue some issues. This, in theory, provides an opportunity for fellow shareholders to recall their shares.

\textsuperscript{166} Confidential oral communication to author.
2. Encouraging Improvements Through Judicial Eyebrows

Delaware seeks to maximize certainty by adopting presumptions and ignoring the complexity of indirect ownership. The result, as described above, is a system without vote verification or an effective audit trail. What if Delaware were to shift its presumptions slightly, and instead imposed the burden of establishing that the requisite margin had been achieved on the proponent of a transaction (for example, a party claiming that a merger has been approved)?

Such a shift could lead to a transformation of the system. One of the reasons that the system is inadequate is that no one has an incentive to make it better. Close and skeptical scrutiny by the Delaware courts in voting disputes could create such an incentive. If participants thought that there was a chance that a vote would be rejected because of an inadequate audit trail, they would take greater care at earlier stages to assure proper documentation. But, for Delaware, close scrutiny may have a significant drawback: in addition to reducing certainty, it would reveal the inadequacy of the voting system and thus potentially impair its legitimacy. Delaware hardly has an incentive to undermine public confidence in a key legitimating practice that is fundamental to the structure of corporate law.

B. RENOVATING THE STRUCTURE: THE BUSINESS ROUNDTABLE/GEORGESON PROPOSAL

In connection with the shareholder ballot access proposal, the Business Roundtable, together with Georgeson, a leading proxy-solicitation firm, proposed returning primary voting responsibility to the beneficial owners. The BRT/Georgeson proposal entails the following steps:

- On the record date, DTC would (as it does now) issue omnibus proxies to its members. These members would then (contrary to present practice) pass proxies down the chain, eventually arriving at the beneficial owners.
- At the same time, brokers, banks, or their agents would generate lists of beneficial owners as of the record date and indicating the number of shares held. These lists would be integrated and verified to create a list of shareholders who are entitled to receive proxy materials, make voting decisions, and sign proxies.

168. See Wilcox, supra note 113, at 10.
169. See id.
The shareholder list would be available to the issuer and to any dissidents running a solicitation, who could distribute the proxy materials directly to the beneficial owners.\(^{170}\)

Beneficial owners would return proxies directly to the tabulators.\(^{171}\)

There are several notable features of this proposal. See Figure 13. It takes broker and bank custodians out of the process of collecting and processing voting instructions.\(^{172}\) It increases ownership transparency, and it eliminates the existing NOBO/OBO structure. Shareholders who wished to remain anonymous would have to establish nominee accounts with banks or brokers.

The proposed system would ameliorate several of the voting pathologies discussed above. By simplifying the system of distributing proxy materials and collecting votes, it would reduce the likelihood of materials not arriving or of votes not being counted. By requiring up-front attribution of shares to owners by intermediaries, it would eliminate overvoting. By increasing transparency, it would improve the ability to provide vote confirmation and an audit trail.

What are the difficulties in the way of such a reform? One key effect is to

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170. See id.
171. Id.
172. As a result, the proposal would eliminate "broker non-votes."
remove Broadridge from its position as the key, monopolistic actor at the center of the spiderweb. Under the current system, Broadridge is hired by the custodians but is able to bill the issuers, with some price regulation by the NYSE. By all accounts, this is a very profitable business for Broadridge, and one would thus predict that Broadridge would oppose any substantial reform.

The reform also requires that custodians cooperate in the creation of a single list of shareholders entitled to vote as of the record date. Specifically, brokers would have to identify which shares have been lent out. This could lead margin-account holders (who at present are blissfully unaware whether and how often their shares are lent out) to demand a share of the fees generated. Indeed, the Securities Industry Association, the broker-dealers’ trade association, opposed the BRT proposal, arguing that no fundamental change was necessary.

Finally, the elimination of the NOBO/OBO system would expose beneficial owners to more direct lobbying by issuers and others, such as unions and environmental groups. While holders who wish to retain their anonymity may create nominee accounts to disguise their ownership, this is more expensive than merely checking the OBO box and some holders may feel that taking that affirmative step will subject them to more criticism than under the existing NOBO/OBO system.

C. REDESIGNING THE ARCHITECTURE: VOTING IN A DIRECT REGISTRATION CLEARING AND SETTLEMENT SYSTEM (THE “SPANISH” MODEL)

As our earlier discussion shows, the problems with the corporate voting system derive from the complexity of our system of custodial ownership, a system adopted to deal with the “paper crunch” and to prevent systemic risk from widespread failure of clearing and settlement. In responding to these problems, the United States chose “immobilization” of securities through the depositary system: by having DTC keep securities certificates in its vaults, we controlled the risk of non-delivery of certificates and failed trades. More subtly, because the certificates still existed, we did not need to become accustomed to the concept of securities that are not evidenced by certificates, or move completely to a book-entry system.

No one designing a system today from the ground up would (or, in fact, does) adopt this structure. The necessity of immobilizing securities certificates

175. UNIDROIT (the International Institute for the Unification of Private Law) is currently developing a legal framework for the cross-border clearing and settlement of intermediated securities with the goal of producing a convention that will be adopted by states. UNIDROIT, Substantive Rules Regarding Intermediated Securities (Study 78), available at http://www.unidroit.org/english/workprogramme/
yielded the cumbersome system of custody, clearance, and settlement that complicates voting as well. The BRT/Georgeson proposal, taking this fundamental architecture of ownership as given, offers a change to the voting architecture that promises some improvements. A more-fundamental reform would entail a "dematerialization," rather than a mere "immobilization," of securities. This makes possible the creation of a share registry that can show all current holders and quickly reflect changes in securities positions.

Interestingly, the Spanish system of shareholding took that route and, thus, offers an interesting alternative. For listed shares, Spain has a pure book-entry system with share dematerialization mandatory for publicly traded firms. The key player is IBERCLEAR, the Spanish equivalent of DTC. "IBERCLEAR is in charge of both the Register of Securities, held in book-entry form, and the Clearing & Settlement of all trades from the Spanish Stock Exchanges." In order to issue securities that will be validly issued and tradable, the issuer must inform IBERCLEAR that the steps for listing a security have been completed and provide relevant details. At this point, the securities are "deemed to be

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176. In the SEC's 1976 report on nominee ownership, the SEC recognized the trade-off between incremental and fundamental reform. See SEC, SEC STREET NAME STUDY: FINAL REPORT TO CONGRESS, No. 672. One potential reform considered was termed the "transfer agent depository concept" which "would replace the certificate with computerized stockowner lists, maintained by the transfer agent, which would serve as both the issuer's stock records and the shareowner's evidence of ownership." Id. at 60. But the SEC did not embrace the proposal, noting:

The Commission has concluded that no alternative approach would facilitate shareowner communications without disrupting the current system of clearance and settlement, imposing significant costs and recordkeeping requirements on participants, or involving major computer development . . . . The [transfer agent depository] concept exhibits promise as an important long-term alternative. It is not, however, a system for streamlining communications but rather an approach to a national clearance and settlement system which, as a by-product, would improve issuer-shareowner communications.

Id. at 62.


180. EUROPEAN COMM'N, supra note 178, at para. 2.7.2.
duly recorded in the accounts held by IBERCLEAR as CSD [Central Securities Depositary] and its participant entities," and the investors have full property rights in the shares. The act of recording creates a direct legal relationship between the issuer and the investor.

Transfer of securities is by book entry, without any requirement of "delivery" of share certificates (which, in this system, do not exist). This same principle applies to the creation of security interests in the shares. In practical terms, when an order to transfer is received from a seller, and the ownership of the seller and payments by the buyer are verified, the transfer occurs and the share registry is immediately adjusted. Unlike in the U.S. system, there is no netting of securities but only of cash. In this system, transfers are irrevocable. The buyer takes the shares subject to any recorded interests.

In a book-entry system, the question arises whether to have a one-tier or two-tier registry. In the Spanish system, the registry is structured as a two-tier system. In the top tier, IBERCLEAR maintains accounts for securities owned by its participants. In the lower tier, participants maintain accounts for other investors. The introduction of a second tier complicates the voting process and is not an intrinsic part of the system. Indeed, one suspects that the reason for the two-tier system is to maintain the link between the participant firms and their customers. Were IBERCLEAR to control the sole and complete registry—which, as a data processing matter, would be straight-
forward and advantageous—customers could go to any broker to sell their securities.

There are numerous advantages to a book-entry system. First, because the investors have clear property rights in the shares, problems of the bankruptcy of the intermediary disappear. Second, because transfers are final only after checking on the ownership of the seller and the available cash of the buyer, failed transfers should not occur. Third, shortfalls, in principle, should not occur either. Fourth, the system simplifies the payment of dividends and other cash distributions.190 On the record date, IBERCLEAR certifies to the issuer the balance of securities that each participant has. The issuer then pays each participant an amount equal to the dividend per share times the number of shares evidenced in the IBERCLEAR certification.191

Most pertinently, from our perspective, the Spanish model simplifies voting. Consider Figures 14 and 15. With a book-entry system, whether one- or two-tier, creation of a common comprehensive registry is straightforward.192 Once this real-time registry exists, creating a record-date shareholder list is

190. Id. para. 34.7.
191. Id. para. 34.7.1.
192. In Spain, IBERCLEAR certifies to the issuer how the securities are distributed among the participants in the system. Id. para. 36.7. Then, for voting, the issuer sends an “attendance card” to the investor. Id. para. 34.7.1. Since 2003, issuers have been obliged to provide for “distance voting” through mail or electronic means. Id.
also straightforward. Indeed, in Spain, the record date is mere five days in advance of the meeting.\footnote{Art. CIV of the Public Companies Act.} The processor, an agent of the issuer, would send out proxy materials according to a preliminary shareholder list, supplement with changes as of the record date, collect proxies, check the proxies against the record-date list, tabulate the results and report them to the board of directors.

The Spanish model easily solves some of the most difficult problems identified above. The share registry, combined with IBERCLEAR’s obligation to assure that no more than 100% of issued securities are recorded in the system,\footnote{Id. para. 36.7.} solves the overvoting problem. The existence of an up-to-date, comprehensive share registry also cuts through the complexity in the distribution of materials, solicitation of voting instructions, collection of proxies, and the verification and audit of votes. A shorter period between the record and the meeting date made possible by the Spanish model would reduce the degree of incidental discrepancies between voting rights and beneficial ownership. Finally, because the share registry is continuously updated, it would be relatively simple—if the substantive corporate law demanded it—to enforce a system in which only shares that were held on the record date and then continuously held
between the record date and the meeting date could be voted.\textsuperscript{195} This would further reduce incidental discrepancies and foreclose some avenues to obtain “empty votes.” Finally, a late record date would make it easier for investors to avoid the securities lending surprise.\textsuperscript{196} Indeed, the structure of the Spanish system, with its genuine share registry, could be developed far beyond what has been done in Spain to make voting even more efficient.

There are few legal or practical obstacles to switching to a Spanish-style system. U.C.C. Article 8 already permits uncertificated securities and provides a legal structure for transfer.\textsuperscript{197} Under states’ corporate laws, corporations may issue uncertificated equity securities.\textsuperscript{198} Uncertificated bonds are already very common.\textsuperscript{199}

As a practical matter, a move to uncertificated securities would also not pose many problems, even for existing companies with outstanding certificated shares. To start, the board of directors of a company would pass a resolution providing that all classes and all series of its stock shall be uncertificated shares. At that point, DTC would surrender all its certificates to the corporation, instantly converting around 80% of the shares to book-entry. While other shareholders may not surrender their certificates, it would matter little: those shareholders are already registered owners and listed on the company’s share registry. As a result, the company can already, and could continue to, communicate with them directly. Moreover, when their shares were eventually sold or transferred (through probate or otherwise), the securities would likely be surrendered at that time, either directly or through DTC. Over time, the number of outstanding share certificates would quickly dwindle. All new securities would be issued in uncertificated form.

Of course, there are some downsides to a book-entry system. As with the BRT/Georgeson proposal, it is inconsistent with the existing NOBO/OBO system. In the Spanish system, if investors wish to remain anonymous, they

\begin{itemize}
\item \[195\] It thus could solve one version of empty voting (record-date capture), but not other versions (for example, hedging while retaining ownership).
\item \[196\] Note how securities “lending” occurs in this system. Because securities “lending” is really a transfer of a security subject to an obligation to retransfer an equivalent security later, the securities “loan” itself would be recorded on the registry as a transfer (with the “return” similarly recorded). Thus, the system forces an attribution of “lent” shares to specific accounts, with notice to the account holder, while also ensuring that no more than 100% of the shares appear. Because each securities loan involves an actual recorded transfer of shares on the registry, the cost of securities lending may increase, as intermediaries will not be able to lend securities out of the “float”—the aggregate of shares which are unlikely to be sold during a given period.
\item \[197\] U.C.C. art. 8 prefatory note (amended 2003).
\item \[198\] Delaware, for example, provides:

\begin{quote}
The shares of a corporation shall be represented by certificates, provided that the board of directors of the corporation may provide by resolution or resolutions that some or all of any or all classes or series of its stock shall be uncertificated shares. Any such resolution shall not apply to shares represented by a certificate until such certificate is surrendered to the corporation.
\end{quote}

\begin{quote}
DEL. CODE ANN. tit. 8, § 158 (Supp. 2006).
\end{quote}
\item \[199\] U.C.C. art. 8 prefatory note.
\end{itemize}
must hold their shares through a nominee. But that seems like a small price to pay given the multiple advantages that a book-entry system offers.

The principal obstacles to reform are political. Broadridge, with its monopoly under the current system, has an incentive to oppose a reform such as this that would displace it from the center of the spider web. Brokers, unless the system is set up to protect their customer relationships, are also likely to oppose a change. Brokers may further oppose a change because it would eliminate their ability to lend out margin securities without telling the account holder and thus increase their costs.

CONCLUSION: IMPLICATIONS FOR SHAREHOLDERS’ ROLE

The existing system of shareholder voting is crude, imprecise, and fragile. Gil Sparks, a leading Delaware lawyer, estimates that, in a contest that is closer than 55 to 45%, there is no verifiable answer to the question “who won?” Suppose that Gil Sparks is right. Does it matter?

One might well argue that, ex ante, the inadequacies of the Florida punch-card ballot system in the 2000 presidential election were evenly distributed between Bush and Gore, and that the infirmities had an equal chance of tilting the election towards one or the other. But that is hardly an adequate response to the challenge posed by that election—or to a corporate vote with a close outcome. Whatever the overall distribution of errors, the participants in a specific vote have a large stake in the accuracy of the outcome. This is true regardless of whether the voting pathologies generate a bias or merely noise, whether they empower or disempower certain shareholder groups or merely fail to provide vote confirmation and an audit trail. Delaware’s “not my problem” establishment of legal presumptions cannot forever paper over the embarrassment of our present voting system.

One response, discussed earlier, is to improve the technology so that it would function more reliably and accurately. Improvements are possible—and necessary—but some problems are bound to persist. What one should strive for is a system adequate for the tasks given it.

This takes us back to the fundamental question of the role of voting in corporate law. As noted earlier, shareholders vote on very few things. Most importantly, shareholders vote for directors and have a veto over fundamental changes to the corporation (mergers) or to its constitutional documents (amendments to the certificate of incorporation).

This sharply limited role for shareholder voting is consistent with the board-centered model of corporate governance. In such a system, one could be rather complacent about voting problems in mergers and charter amendments, regardless of the direction of distortion. If the board recommends a merger, and,

200. European Comm’n, supra note 178, para. 35.7.
201. Gilchrist Sparks III, Partner, Morris, Nichols, Arshe & Tunnell LLP, Wilmington, Delaware, Personal Oral Communication to Author.
through some voting failure, the merger is approved even though a proper count would have led to a rejection, a proponent of board-centered corporate governance can argue that the result is acceptable: after all, the board did in fact recommend the merger and many (if not quite the requisite majority) of shareholders voted in favor. Similarly, when a merger is rejected even though an accurate count would have resulted in approval, one could be comfortable with this result too: in the extreme case in which the board is so out of step with the shareholders that it tries to push a deal over determined opposition of more than 45% of the shareholders, it is no tragedy that the deal fails, even if, in fact, more than 50% of the votes were cast in favor. Put differently, the veto role of shareholder voting in mergers or charter amendments may not really require complete accuracy.

But what about director elections? Here, complacency is harder to sustain, even from a board-centered view. The board of directors have significant managerial powers and enjoy the protections of the business judgment rule. Elections to the board, as the sole governance check on the board, play a central ideological and monitoring role within corporate governance. An election system that generates inaccurate results and fails to provide transparency and verifiability will eventually undermine its own legitimacy.

A recognition of the problems and limits of the corporate voting system has three implications for the current place of shareholder voting in the Delaware jurisprudence. First, as Gilson and Schwartz pointed out, much of Delaware's approach to takeovers post-Moran has had the effect, and arguably the purpose, of channeling disputes over control from market contests (tender offers) to election contests (proxy fights over the advisability of pulling the poison pill).\(^{202}\) The infirmities of the voting system provide support for Gilson and Schwartz's skepticism of this shift.

Second, the traditional Delaware default rule, which requires only that directors receive a plurality of the votes cast rather than a majority,\(^ {203}\) minimizes the occasions in which a director contest ends indecisively. By changing to a majority rule, the potential for uncertain outcomes increases. Under plurality voting, the number of votes received in director elections—and thus the need for accuracy and verifiability—matters only in the relatively few contested elections. With majority voting, the number of votes matters in every single election, and the number of close votes is bound to increase dramatically. This will greatly increase the pressure to find a better way to deal with the hanging chads of corporate voting.

Finally, given the problems with the existing system, one should not rush to expand the opportunities for shareholder voting in corporate governance. The question whether to expand the opportunities for shareholders to vote is inescap-


\(^{203}\) DEL. CODE ANN. tit. 8, § 216(3) (Supp. 2006).
ably linked to the quality of the corporate voting system. If we want shareholders to vote on more things, we need to improve the system. But, as we have shown here, substantially improving the system is non-trivial. Although marginal ameliorations are clearly possible, a fundamental transformation requires a realignment of our system of securities ownership, a change that is expensive and uncertain, both practically and politically. In the absence of such restructuring, we would be well advised to channel our limited resources into ensuring accurate and verifiable results for the votes we already have, rather than expanding the number of issues on which shareholders vote.