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Shareholder Voting as Veto

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Shareholder Voting as Veto

MICHAEL S. KANG*

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INTRODUCTION

Never before has corporate shareholder voting received so much attention from lawyers, scholars, and policymakers, nor have the possibilities for shareholder voting reform seemed so vast in the political wake of the financial crises of the past decade. The Delaware Chancery Court has famously declared that the “shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests,”¹ but the effective practice of the shareholder franchise to constrain board discretion under current law is “largely a myth” in practice.² Reform advocates are pushing for a major expansion in shareholder authority through shareholder voting and proxy access that would give shareholders greater ability to influence management.³ Advocates of shareholder activism, including Lucian

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1. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988); *see also Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985) (advising that “[i]f the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out”).

2. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 732 (2007).

3. *See* Marcel Kahan & Edward B. Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1350 (2011) (quoting one expert, among several of the same opinion, as characterizing current reform efforts as “the biggest change relating to corporate governance ever proposed by the SEC”); Mark J. Roe, *The Corporate Shareholder’s Vote and Its Political Economy, in Delaware and in Washington*, 2 HARV. BUS. L. REV. 1, 1 (2013) (describing current efforts at proxy reform as potentially “revolutioniz[ing] American corporate governance”).

Bebchuk, call for increased shareholder voting prerogatives, such as the recent Securities and Exchange Commission (SEC) proposals and majority voting rules, as a means for restoring accountability to shareholders.⁴

However, the case against shareholder voting reform rests on an apparent trump card in the debate—the well-recognized problem of rational ignorance that limits the effectiveness of shareholder involvement. As Stephen Bainbridge and other skeptics on shareholder voting argue, shareholders tend to be rationally apathetic in letting management run the company and deferring to their recommendations in the usual course of things.⁵ Information is costly, but the returns to the individual shareholder for improving corporate performance are distributed pro rata, such that shareholders rarely have individual economic incentive to engage more than casually on questions of corporate management. Opponents of reform efforts argue that “shareholders lack both the information and the incentives necessary to make sound decisions”⁶ and thus are rationally ignorant voters who would be better off vesting authority in management’s hands.⁷ For this reason, shareholders generally do not possess any detailed affirmative vision of how the company should operate itself, nor do they typically wish for greater direct ability to instruct management on how specifically to run the company.⁸ Even when given the limited chance to vote on corporate matters, shareholders defer to management in almost every case. Many commentators therefore oppose shareholder voting reform and instead advocate for a model of “director primacy” that places virtually unreviewable, centralized corporate control in the hands of the board.⁹

In this Article I offer a very specific response, based in political science, to the case against shareholder voting reform based on this critique of shareholders’ rational ignorance. The challenges of rational ignorance, as well as related problems of collective action, that corporate scholars identify as impediments to sensible shareholder voting are not at all particular to corporate voting. They are basic constraints that confront all types of voting by large, diffuse electorates, including voting in democratic government on candidates and policy questions on the ballot. Voters overcome these constraints, however imperfectly, by gravitating toward heuristic voting strategies that may work equally well in shareholder voting and, indeed, may explain why shareholder voting works as it does as currently practiced.

The best example of such strategies are models of retrospective voting from political science by which voters vote on the basis of global, ex post assessments of

4. See Bebhuk, *supra* note 2.

5. See, e.g., Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 623–24 (2006); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 985 (2001).

6. Bainbridge, *supra* note 5, at 624.

7. See, e.g., Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003); Robert S. Saunders, *Why Majority Voting in Director Elections Is a Bad Idea*, 1 VA. L. & BUS. REV. 107 (2006).

8. See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402–03 (1983).

9. See, e.g., Lipton & Rosenblum, *supra* note 7.

incumbent performance. Just like the typical shareholder, the typical citizen is rationally ignorant and knows little about the specifics of government policy. But even rationally ignorant citizens can monitor the general state of affairs at low cost and reward incumbents for good times, while punishing them for bad times. Of course, this manner of retrospective voting is quite imprecise and fails the highest aspirations of deliberative democracy, but as a model of inducing the right incentives for officeholders, it works reasonably well as a second-best heuristic strategy and overcomes pervasive rational ignorance. As voting theorists have observed, retrospective voting provides the basic opportunity for even uninformed voters to impose democratic accountability by ousting badly performing incumbents on the simple basis of ex post results.¹⁰

I argue that it is useful to view shareholder voting through a similar lens. Shareholders are rationally ignorant in the sense that they are unlikely to possess ex ante sophisticated information or detailed affirmative preferences about the best course of company action. For this reason, shareholders are overwhelmingly willing to defer to management's leadership and to its recommendations on shareholder votes. However, even rationally ignorant shareholders can monitor their company's performance at low cost with reference to simple proxies like share price. Shareholders need not have well-developed affirmative preferences about company direction in any specific sense to know when management is doing poorly and may need to be thwarted. Indeed, the average shareholder of a public company is much more likely, with attention to the company's share price, to have salient negative preferences about management than to have developed affirmative preferences about what the board ought ideally to do. What is more, relative to voting contexts where many nonfinancial interests may complicate voting decisions, shareholder voting is narrowly focused on the maximization of company value.

Shareholders therefore are capable of exercising a degree of ex post accountability through retrospective voting, despite their rational ignorance. To do so, shareholders need only to keep a running tally about management's competence, informed in large part by the company's share price, which serves as a reliable heuristic about whether to defer to management on the discrete binary questions presented to them.¹¹ When the company's direction changes and status quo deference to management is less justified, shareholders can exercise negative

10. See, e.g., MORRIS P. FIORINA, RETROSPECTIVE VOTING IN AMERICAN NATIONAL ELECTIONS (1981); Donald R. Kinder & D. Roderick Kiewiet, *Economic Discontent and Political Behavior: The Role of Personal Grievances and Collective Economic Judgments in Congressional Voting*, 23 AM. J. POL. SCI. 495 (1979); Gregory B. Markus, *The Impact of Personal and National Economic Conditions on the Presidential Vote: A Pooled Cross-Sectional Analysis*, 32 AM. J. POL. SCI. 137 (1988).

11. See, e.g., Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 149 (2009) (identifying the "principal signal indicating a deviation of the board from its duty to the corporation [as] the market price of the corporation's stock"); Henry Hansmann & Reinier Kraakman, Essay, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001) ("[T]he market value of the publicly traded corporation's shares is the principal measure of its shareholders' interests."). But see William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010) (criticizing the accuracy of share price as a measure of company performance).

preferences—a veto against poor management’s recommendation. When management performs poorly, shareholders are more likely to discard deference and vote in a negative consensus against management’s position.¹² That is, shareholders are capable of providing management a great deal of discretion in the usual case, but exercising a limited veto when necessary.¹³

In fact, this pattern arguably characterizes a great deal of shareholder voting as currently practiced. As I describe later, shareholders defer to management recommendations in shareholder voting as a basic default choice, consistent with their informational disadvantages relative to management. However, when shareholders identify poor performance by management, shareholders appear to punish management and buck its recommendations at a far greater rate. In short, shareholders use their confidence in management as a cue for how to vote in relation to management’s recommendation. Shareholders give management wide berth, deferring in the vast majority of cases, and exercise their voting rights against management only when necessary to defend themselves against discredited management.

Of course, a basic obstacle to retrospective voting of the type seen in government elections is that shareholders have little ability to vote out incumbent management. Citizens have ample capacity to oust incumbent politicians from government office, but the removal of incumbents from the board of directors is much more difficult. As the Delaware Supreme Court recently acknowledged about board elections, the restrictions on board nomination that enable most candidates to run unopposed threaten to render shareholder voting “an empty exercise.”¹⁴ State and federal corporate law provides virtually no practical way for shareholders to defeat a management nominee for the board, at least short of a very expensive proxy contest.¹⁵ It is this regulatory framework that is contested today. Although the SEC’s recent effort to expand shareholder access to the company’s proxy materials for nominating board candidates failed,¹⁶ it is clear that the political debate about shareholder voting will continue, and this issue of what shareholder voting reform would achieve is one of the most important matters in corporate law at the moment.¹⁷

A limited objective here is to highlight the distinction between the affirmative preferences and negative preferences, as I have sketched out so far. What I call “affirmative preferences” represent the familiar notion of most preferred outcomes that voters might seek as ideal goals for corporate policy in voting on shareholder matters. For instance, pursuing an influential, innovative agenda for corporate reform, Lucian Bebchuk advocates the expansion of shareholder prerogatives to

12. See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 862 (2005); see also Bebchuk, *supra* note 2, at 680.

13. See Bebchuk, *supra* note 12, at 862.

14. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 237 (Del. 2008).

15. Bo Becker, Daniel Bergstresser & Guhan Subramanian, *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge 5* (Harvard Bus. Sch., Working Paper No. 11-052, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1695666.

16. *Id.* at 6.

17. See Bratton & Wachter, *supra* note 11, at 655–56.

permit new affirmative rights of initiation that would allow shareholders to propose and dictate major corporate actions that have traditionally been entrusted to the board's discretion. However, most shareholders are typically passive investors with incomplete and mainly "negative preferences." They appear to vote mainly on the basis of latent negative preferences against the recommendations of what has proved to be bad management, without necessarily possessing any clear affirmative vision for what management ought to do in most cases. Shareholder voting based on negative preferences, rather than affirmative ones, defines what shareholder voting does best.

In other words, any debate over shareholder voting can be about not only the quantum of power that shareholders ought to hold *vis-à-vis* the board, but also about how well the *shape* of shareholder voting maps onto what shareholders do well. The debate over shareholder voting is focused almost entirely on the balance of power between shareholders and management, more specifically the limited amount of control afforded shareholders.¹⁸ The debate contemplates a simple tradeoff between giving more power to shareholders and granting discretion to management, but as I have argued, shareholders can possess substantively distinct types of preferences. If shareholder power should be increased, shareholder voting power could be increased in accordingly affirmative or negative directions. If shareholders' salient voting preferences are mainly negative in nature, reforms may be most useful when reinforcing shareholder capacity to enforce those negative prerogatives without any necessary connection to the ability to effectuate affirmative preferences.

As a consequence, even if critics of shareholder voting are correct that shareholders are rationally ignorant, rarely develop specific preferences about what the company ought affirmatively to do, and prefer management discretion in almost every matter, a case for shareholder voting reform still emerges. Shareholders may benefit collectively from stronger veto rights to defend their real and basic negative preferences. Recent movement toward majority voting rules and shareholder access to the board nomination process are aimed at shoring up the currently marginal ability of shareholders to effectuate what can be quite salient negative preferences against unwanted board candidates.¹⁹ Of course, a model of shareholder voting structured and exercised only as veto is less ambitious than what is typically contemplated by aspirational democratic theory, but it reflects the basic reality of shareholder voting and conforms to the cost-benefit calculus of shareholders. Indeed, structuring shareholder prerogatives in terms of ex post oversight and negative veto are likely to impose less intrusive interference with centralized management by the board than affirmative rights of initiation might. Structuring shareholder voting as veto minimizes the theoretical tradeoff between accountability and managerial discretion.

The consequences of shareholder voting as veto are simple but useful. First, in spite of the alleged deficiencies of shareholders as voters, shareholders generally can be trusted to make sensible veto decisions. Shareholders have the capacity and

18. See, e.g., Milton Harris & Artur Raviv, *Control of Corporate Decisions: Shareholders vs. Management*, 23 REV. FIN. STUD. 4115 (2010).

19. See *infra* notes 71–74 and accompanying text.

information to make these simpler decisions based largely on variable deference to management, based on its performance, as a voting cue. As a result, shareholders do not vote foolishly as a group against strong management in favor of value-reducing measures.²⁰ Instead, they tend to vote conservatively, in favor of management proposals and board nominees, and against shareholder proposals, just as critics of shareholder voting would commend.²¹ What is more, when shareholders vote in favor of shareholder proposals, shareholders tend to vote predictably for corporate governance proposals that are value enhancing.²²

Second, shareholder voting reform should play to the reality of shareholder voting as veto. That is, shareholder voting reform is on its strongest ground when it accommodates shareholders' limited attention and economized approach to voting as a veto decision in response to management. Under these constraints, shareholders manage to apply their veto sensibly when they can, but they sometimes find insufficient opportunity to apply it at all. For instance, the say on pay provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act require advisory shareholder votes on executive compensation.²³ Despite a great deal of criticism of say on pay, shareholders are likely to perform well in evaluating executive compensation and less likely to interfere unduly with corporate management, particularly given that these say on pay votes are merely advisory.²⁴ Furthermore, shareholders likely would perform sensibly in checking executive compensation even if the say on pay votes were binding because shareholders would tend to defer to management except in the most egregious cases where a check might be useful.²⁵

Third, shareholder voting as veto helps identify a different type of shareholder voting reform that presents a more complicated case—affirmative rights of shareholder initiation. Lucian Bebchuk and others advocate the expansion of shareholder prerogatives to permit new affirmative rights of initiation that would allow shareholders to propose and dictate major corporate actions that have

20. See Mario Schijven & Michael A. Hitt, *The Vicarious Wisdom of Crowds: Toward a Behavioral Perspective on Investor Reactions to Acquisition Announcements*, 33 STRATEGIC MGMT. J. 1247 (2012).

21. One empirical study finds that even when shareholders are dissatisfied with firm governance, “average votes of the poorly performing and poorly governed firms are higher than 90% across all categories of performance.” Jie Cai, Jacqueline L. Garner & Ralph A. Walkling, *Electing Directors*, 64 J. FIN. 2389, 2402 (2009).

22. See John M. Bizjak & Christopher J. Marquette, *Are Shareholder Proposals All Bark and No Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills*, 33 J. FIN. & QUANTITATIVE ANALYSIS 499, 520 (1998) (“[S]hareholders, rather than being a weak link in the chain of corporate governance, can and do become active when there is reason to be concerned about managerial activities.”).

23. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. § 5301).

24. Randall S. Thomas, Alan R. Palmiter & James F. Cotter, *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1216 (2012) (finding shareholders generally give “broad support to management pay packages”). *But see* Jie Cai & Ralph A. Walkling, *Shareholders' Say on Pay: Does It Create Value?*, 46 J. FIN. QUANTITATIVE ANALYSIS 299 (2011).

25. See Thomas et al., *supra* note 24, at 1216.

traditionally been entrusted to the board's discretion.²⁶ These rights of initiation can be distinguished as a break from the usual understanding of shareholder voting as veto and present different challenges for shareholders and companies. In other words, at a critical moment in the debate over shareholder voting, this type of reform may be headed in a wrong direction, when the salience of negative preferences in shareholder voting suggests the better direction for reform. Unlike efforts to reinforce the shareholder veto, rights of initiation may require shareholders to obtain more information and go beyond the limited veto function that they may prefer. None of this decisively cuts against such proposals, but understanding shareholder voting as veto helps identify the distinct challenges and opportunities that rights of initiation present.

Part I presents the basics of shareholder voting in corporate governance and then describes the problem of rational ignorance by shareholders that limits their engagement with corporate governance. Part II offers a perspective from political science for how shareholders might overcome the problem of rational ignorance. It describes retrospective voting in which voters need not know *ex ante* specifics about how to vote, provided they can monitor incumbent officeholders at low cost and punish them *ex post* based on their results. Part III explains how retrospective voting translates to shareholder voting and argues that it helps explain the empirical evidence describing how shareholders vote. It argues that shareholders generally defer to management and, as skeptics on shareholder voting argue, appear not to have real preferences in the typical case. However, shareholders rise up in reaction to poor performance, develop "negative preferences" against further management by those incumbents, and vote those preferences by voting against, or vetoing, the incumbents' recommendations. Finally, Part IV offers a few directions for shareholder voting reform based on this model of shareholder voting as veto.

I. SHAREHOLDER VOTING AND RATIONAL IGNORANCE

The primacy of the shareholder franchise is widely understood as a myth in practice under current law.²⁷ Shareholders of publicly traded companies rarely do more than rubber-stamp decisions by management, the rhetoric of the Delaware court notwithstanding.²⁸ However, these reform efforts are vehemently resisted by corporate law scholars and practitioners wedded to a particular vision of the "rational, ignorant" shareholder.

A. The Basics of Shareholder Voting

Under American corporate law, shareholders vote on company affairs in two main instances: they elect the board of directors and vote on proposals by management and fellow shareholders.²⁹ Shareholder voting occurs predominantly by proxy in advance of the company's annual meeting. Shareholders, in response to the company's proxy materials, grant a proxy for their shares to vote in a

26. See, e.g., Bebchuk, *supra* note 12, at 869–70.

27. Bebchuk, *supra* note 2, at 732.

28. See, e.g., *id.* at 676.

29. See generally Easterbrook & Fischel, *supra* note 8, at 400.

designated manner on a slate of candidates for the board and either up or down on a series of proposals by management and, in certain instances, proposals by other shareholders.³⁰ Most shareholders of public companies do not appear physically to vote their shares at the annual meeting, and overwhelmingly, shareholders tend to vote in accordance with management's recommendations as specified in the company's proxy materials.³¹

The ability of shareholders to elect the board of directors appears superficially as an important check on management discretion. In the classic account, shareholders must delegate management of the company to a centralized group of professionals.³² Ownership of the company is thus separated from its control. Shareholders are the residual owners of the company and at least putatively have interests most tightly aligned with the best long-term interests of the company.³³ However, management in the form of the directors and officers of the company may not be properly aligned with the company. The directors and officers may wish to promote themselves financially, personally, or professionally at the shareholders' expense through excessive salaries, empire building, or many other means that may not benefit the shareholders over the long run.³⁴ Shareholders as principals of the company, the argument goes, must exercise discipline over its management agents through indirect means, the most prominent of which is board elections.³⁵

The board of directors manages the business and affairs of the company in its discretion. The board selects and delegates its formal authority to the chief executive officer and a set of company officers, who in turn manage the company on an everyday basis under the board's review and must seek the board's approval for major decisions.³⁶ The directors on the board are formally accountable to the shareholders, in the sense that the shareholders hold the right to elect directors on an annual basis and, at least in theory, replace directors of whom they disapprove.³⁷ As the Delaware Supreme Court famously explained, "If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out."³⁸

As a practical matter, however, the ability of shareholders to hold directors accountable is very much limited by the usual fact that only candidates nominated by the board itself are included in the company's proxy materials.³⁹ The combination of federal and state law, at least at the moment, conspire to deny shareholders access to the company's proxy materials distributed at company expense to shareholders in advance of annual board elections.⁴⁰ Board challengers

30. *See id.* at 399–400.

31. *See id.* at 400.

32. *See id.* at 403.

33. *See id.*

34. *Bebchuk, supra* note 2, at 679.

35. *See id.* at 680.

36. *Id.* at 679–80.

37. *Id.* at 680.

38. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984)).

39. *See Easterbrook & Fischel, supra* note 8, at 424–25.

40. *See Bechuk, supra* note 2, at 696.

cannot force the corporation, which is of course managed by the incumbent board, to include alternative candidates on the corporate ballot.⁴¹ As a result, shareholders who wish to nominate an alternate candidate for the board, other than the ones nominated by the incumbent board, must pay for the independent solicitation of proxies from the shareholders.⁴² They must pay to have proxy materials mailed to shareholders, which in most cases is prohibitively expensive and in excess of any expected financial return from successfully replacing the board, as well as provide for the legal and administrative costs associated with the proxy filing and challenge process with the SEC.⁴³ The regular staggering of board elections over several years multiplies the costs of winning board control by requiring two or more challenges, a year or more apart.⁴⁴ Given these expenses of nominating a candidate without the board's cooperation, the incumbent board's nominee is usually the only candidate for a given board seat.⁴⁵ Shareholders, therefore, are rarely presented with more than one candidate per seat even when dissatisfied with that candidate's performance.⁴⁶

The shareholder power to vote on management and shareholder proposals also is quite limited as a practical matter. Shareholders cannot direct their board to adopt any particular course of action. Shareholders hold only a reactive right to approve or reject management decisions.⁴⁷ This right allows the shareholders a veto right that blocks management from adopting value-reducing changes without shareholder agreement, but it vests the board with nearly exclusive agenda-setting power. As a result, when management refuses to adopt value-enhancing changes from the status quo, there is no formal mechanism in shareholder voting that enables shareholders to force the board to consider them or present them for shareholder approval.

Shareholders have only a limited opportunity for initiating action through the shareholder proposal process. Under Rule 14a-8, shareholders have the ability to propose "that the company and/or its board of directors take action" by including a recommendation or requirement for a shareholder vote at the company annual meeting.⁴⁸ However, this ability is severely circumscribed by a number of

41. *See id.*

42. *See generally id.* at 688–94 (reviewing obstacles, legal and practical, to shareholder electoral challenges).

43. *See id.* at 688 n.21 (citing a study finding that the average cost of a proxy contest was \$368,000).

44. *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002).

45. *See* Bebchuk, *supra* note 2, at 702 ("Under existing default arrangements, shareholders do not have any meaningful power to veto candidates put forward by the board in an uncontested election.").

46. *See* Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1775 (2006) ("These pro-incumbent features combine with the costs of running a proxy contest to produce a corporate election process that functions essentially only when a takeover bidder funds a slate to get around a poison pill."); *see also* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45–46 (2003).

47. *See* Bebchuk, *supra* note 2.

48. 17 C.F.R. § 240.14a-8 (2012).

exceptions that permit the company management to exclude a shareholder proposal. On the one hand, a shareholder proposal must not deal with “a matter relating to the company’s ordinary business operations,” but on the other hand, a proposal must not regard operations that are not “significantly related to the company’s business.”⁴⁹ The company management is entitled also to exclude shareholder proposals that relate to an election for membership on the company’s board of directors or “directly conflict[] with one of the company’s own proposals to be submitted to shareholders at the same meeting.”⁵⁰ As a result, the shareholder proposal process by design offers a narrow window for shareholder-initiated action.

Of course, shareholders always possess the option of selling their shares if they are unhappy with corporate performance. Although shareholders have little effective ability to depose the incumbent board under the current law, dissatisfied shareholders can simply follow the “Wall Street” rule and sell off their shares.⁵¹ Indeed, opponents of shareholder activism argue that this threat of exit imposes a necessary level of discipline on the board even absent board elections.⁵² The fear of shareholders selling off their stakes, and therefore depressing the company’s value in the capital markets, motivates the board to perform well for fear of losing access to capital or even a potential takeover. On this extreme end, company underperformance that leads to depressed share price attracts hostile bidders who might buy control of the company and fire the incumbent management when they do.

However, there is an enormous academic debate over how well the capital markets impose board discipline in the absence of accountability to shareholders through shareholder voting. Many commentators argue that greater shareholder input into corporate management is necessary to provide what they see as an utter absence of institutional accountability of directors and officers.⁵³ These commentators offer empirical evidence that boards are able to insulate themselves sufficiently from takeover threats through the use of staggered boards, poison pills,

49. *Id.*

50. *Id.*

51. *See, e.g.,* Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 41 (1993) (explaining the Wall Street Rule that “it is more efficient to sell a particular stock than it is to try to reform the company”). *But see* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1339–41 (1991) (explaining that opportunity for exit is limited for indexed and long-term investment strategies).

52. *See* FRANK H. EASTERBOOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 70–71 (1991); Bainbridge, *supra* note 5, at 607–23.

53. *See generally* LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); Bebchuk, *supra* note 2; Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CALIF. L. REV. 1671 (1985); Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. REV. 1; Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. REV. 1 (1992); Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53 (2008); Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982); Julian Velasco, *Taking Shareholder Rights Seriously*, 41 U.C. DAVIS L. REV. 605 (2007).

and other familiar defenses,⁵⁴ and to safely engage in activity that does not maximize shareholder value without fear of sanction from shareholders or markets.⁵⁵

The concern about board accountability gained special salience during the financial crisis in 2008. Highly publicized failures of Lehman Brothers, A.I.G., and Bear Stearns, among others, precipitated deep worries about how well corporate boards were managing risk on behalf of shareholder interests and inspired heightened attention to the lack of functional accountability of directors to shareholders through board elections.⁵⁶ Then-SEC chair Mary L. Schapiro noted that “[t]his crisis has led many to raise serious questions and concerns . . . about whether Boards are exercising appropriate oversight of management, whether Boards are appropriately focused on shareholder interests and whether Boards need to be more accountable for their decisions”⁵⁷ Indeed, in April 2009, the State of Delaware had already beat the SEC to the punch and amended its corporate code to make it easier for shareholders to nominate director candidates. Delaware law changed to permit, but not require, Delaware corporations to adopt bylaws that authorize shareholders under certain circumstances to include board nominees in the company proxy materials and that allow the company to reimburse shareholders for the expense of an independent proxy solicitation.⁵⁸

Shortly after Delaware’s reforms, the SEC released new proposed rules that also would have amended the federal proxy rules and made it easier under certain circumstances for shareholders to nominate a candidate for a company’s board of directors.⁵⁹ New Rule 14a-11 would have required a company to include in the company’s proxy materials a board candidate nominated by a shareholder who owns—subject to certain conditions—at least 3% of the company’s securities entitled to vote on the election of directors.⁶⁰ The amendment to Rule 14a-8(i)(8) proposed relaxation of the “election exclusion” such that a company would not be

54. See, e.g., Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775 (2002); Bebchuk et al., *supra* note 44; Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795 (2002).

55. See, e.g., Kenneth A. Borokhovich, Kelly R. Brunarski & Robert Parrino, *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495 (1997); Gerald T. Garvey & Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J. FIN. 519 (1999); Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003).

56. See, e.g., JOHN GILLESPIE & DAVID ZWEIG, *MONEY FOR NOTHING: HOW THE FAILURE OF CORPORATE BOARDS IS RUINING AMERICAN BUSINESS AND COSTING US TRILLIONS* (2010).

57. Mary L. Schapiro, Chairman, SEC, Statement at SEC Open Meeting on Facilitating Shareholder Director Nominations (May 20, 2009). Of course, putting aside the political dynamics, there is great question whether increased opportunities for shareholder activism would have prevented the recent financial failures. See Bratton & Wachter, *supra* note 11.

58. H.B. 19, 145th Gen. Assemb. (Del. 2009).

59. Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024 (proposed June 10, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249 & 274).

60. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,787–88 (Sept. 16, 2010) (adopted Aug. 25, 2010), *vacated in part* by *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011). This ownership threshold was later reduced from 5% to 3%. *Id.*

permitted to exclude a shareholder's proposal and supporting statement in its proxy materials to amend the company's nomination procedures or disclosures with respect to shareholder nominations.⁶¹ Together, these proposed rules allowed greater shareholder access to the company's proxy materials with respect to board nominations and greater shareholder ability to fight off company attempts to disallow such access.

The SEC presented its proposals as necessary for board accountability to shareholders. As Schapiro explained, the SEC intended these proposed rules to "turn what would otherwise be a somewhat illusory right to nominate into something that is real—and has a real chance of holding boards of directors accountable to company owners."⁶² Shareholders who own a nontrivial stake in a company would have had the right under the proposed new Rule 14a-11 to include board nominees in the company proxy materials and need not have incurred the costs of a separate proxy solicitation.⁶³ New Rule 14a-11 would have dramatically reduced the cost of challenging incumbent directors and therefore would have introduced new competition to what were usually noncompetitive elections. The SEC's proposals followed two attempts during the previous six years to change the proxy rules,⁶⁴ but they were not implemented because of a successful legal challenge by the U.S. Chamber of Commerce and the Business Roundtable.⁶⁵ The future of proxy access is therefore still very much up in the air.

The federal government has acted with respect to say on pay reform. Say on pay is a corporate governance measure that requires a nonbinding advisory vote by shareholders on a company's executive compensation.⁶⁶ Although say on pay has

61. See Robert B. Ahdieh, *The Dialectical Regulation of Rule 14a-8: Intersystemic Governance in Corporate Law*, 2 J. BUS. & TECH. L. 165 (2007) (describing the politics of Rule 14a-8 leading to the SEC proposal).

62. Schapiro, *supra* note 57.

63. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240 and 249).

64. See Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 43,488 (proposed July 27, 2007) (to be codified at 17 C.F.R. pt. 240); Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 14, 2003) (to be codified at 17 C.F.R. pts. 240, 249 & 274). In 2003, the SEC also proposed inclusion in the company's proxy materials of shareholder nominees for the board, but conditional on the previous occurrence of certain triggering events that suggested shareholder dissatisfaction with the board. Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003); see also Strine, *supra* note 46, at 1778–82 (proposing that qualified shareholders of public companies be allowed periodically to add slates of director candidates to the company proxy card). Shareholders could include director nominees only if 35% of shareholder votes cast were withheld from one or more of the company's nominees in the previous two years or if a shareholder proposal endorsing proxy access received majority shareholder support during the previous two years. The SEC abandoned its 2003 effort when the Commission could not reach agreement on how to proceed, and a later 2007 effort that resembles the 2009 proposals also was abandoned under similar circumstances. See Carolyn M. Check & Michael R. Miller, Empirical Study, *Determining Shareholder Access: Examining Shareholder-Management Relationships Through the Differing Lenses Used by the SEC and the "Common Law" of Corporate Bylaws*, 44 WAKE FOREST L. REV. 297, 297–303 (2009) (describing these developments).

65. Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

66. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-

been suggested for years, it was implemented in the United States on a comprehensive basis only recently as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.⁶⁷ The say on pay provisions of Dodd-Frank require that at least once every three years, every public reporting company under the 1934 Act must include in its proxy statement a nonbinding resolution subject to a shareholder approval on the compensation of the named executive officers as disclosed in the company's annual report.⁶⁸ The theory of say on pay was to interject a requirement of shareholder consent, albeit nonbinding, into company decision making about escalating executive compensation.

Shareholders also have pushed for voting reform with increasing success when it comes to majority voting rules. Although corporate law before the 1980s typically required a majority vote for election of a director to the board, Delaware and most states now require only that a board nominee receive a plurality of shareholder votes for election to the board, notwithstanding abstentions or withheld votes.⁶⁹ As a result, if the incumbent board nominates only one candidate, that candidate's election is a *fait accompli* with nothing more than a single vote. The barriers to candidate nomination, combined with the plurality rule, conspire to assure the incumbent board's preferred result—typically the reelection of incumbent directors—and quash all electoral pressure in all but the rarest, costliest circumstances. But large institutional investors, such as the California Public Employees' Retirement System (CalPERS), have pressured companies to adopt majority voting rules for board elections.⁷⁰ Under a majority voting rule, even an uncontested candidate for the board must receive at least a majority of the shareholder votes cast to gain or retain a board seat.

Given the difficulty of challenging the board's nominees, institutional investors argued that a majority voting rule is necessary in uncontested elections to ensure that unhappy shareholders are able to veto the election of disfavored candidates.⁷¹ In 2005, Pfizer Inc. led the way in requiring that a director who fails to receive a majority of shareholder votes resign from the board.⁷² By 2009, roughly two-thirds of the companies comprising the S&P 500 had adopted some form of majority

203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. § 5301).

67. *Id.*

68. Securities and Exchange Act § 14A(a)(1), 15 U.S.C. § 78n-1 (Supp. 2012).

69. DEL. CODE ANN. tit. 8, § 216(3) (2011) (“Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors”); COMMITTEE ON CORPORATE LAWS, ABA SECTION OF BUSINESS LAW, REPORT OF THE COMMITTEE ON CORPORATE LAWS ON VOTING BY SHAREHOLDERS FOR THE ELECTION OF DIRECTORS 6 (2006) (reporting that thirty-five jurisdictions provide expressly that directors be elected by plurality vote).

70. *See, e.g.*, Press Release, CalPERS, Graco Shareowners Back CalPERS Proposal for Majority Vote in Board Elections (Apr. 30, 2012), available at <http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2012/april/graco-backs-calpers.xml>.

71. *See generally* Jay Razzouk, *The Momentum, Motive, and Mouse-Kapades of the Majority Vote Movement*, 1 J. BUS. ENTREPRENEURSHIP & L. 391 (2008) (discussing the “majority vote movement” in corporate law).

72. *See* Lisa M. Fairfax, *Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power*, 3 VA. L. & BUS. REV. 1, 6 (2008).

voting for board elections,⁷³ leading one leading practice guide to conclude recently that “[i]t is clear today that majority voting will become universal.”⁷⁴

It is no surprise that institutional investors are leading the charge on majority voting rules and other governance reforms.⁷⁵ Institutional investors now own roughly two-thirds of the outstanding shares of public equity, compared to less than 10% in 1950.⁷⁶ Just as importantly, a number of institutional investors, including CalPERS, have become increasingly activist in publicly campaigning against board decisions, engaging in proxy fights, and pressing for a greater role for shareholders in corporate governance.⁷⁷ These groups have been influential in not only the widespread adoption of majority voting rules, but also efforts on shareholder access to the proxy ballot, elimination of staggered boards, and executive compensation.⁷⁸ What is more, these groups have successfully coordinated their efforts with one another with the help of entities such as Institutional Shareholder Services, which acts as an advisory service among institutional investors on shareholder concerns.⁷⁹

In short, academic and political debate over the proper measure of shareholder influence through shareholder voting, and the shape it should take, is hotly contested. Advocates for greater shareholder influence have gained a great deal of ground against traditional resistance, with majority voting rules perhaps only an early sign of several reforms to follow. As Marcel Kahan and Ed Rock observe, “[n]ever has voting been more important in corporate law.”⁸⁰

B. The Rationally Ignorant Shareholder

As a general matter, the debate over shareholder voting in corporate law centers on the amount of control shareholders should exercise over directors. As Adolph Berle and Gardiner Means set out the basic problem of corporate law, shareholders are the residual owners of the corporation, but as a large, diffuse group beset by collective action problems, shareholders of public corporations delegate and centralize management authority under corporate law to a board of directors.⁸¹ This

73. Jay Cai, Jacqueline Garner & Ralph Walkling, *Democracy or Disruption: An Empirical Analysis of Majority Elections for Directors* 5 n.7, available at <http://ssrn.com/abstract=1491627>.

74. James Cole, Jr. & Igor Kirman, *Takeover Law and Practice*, in *DOING DEALS: UNDERSTANDING THE NUTS & BOLTS OF TRANSACTIONAL PRACTICE* 11, 37 (2008). *But cf.* William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 *CONN. L. REV.* 459 (2007) (arguing that majority voting rules do not shift power to shareholders).

75. *See generally* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 *UCLA L. REV.* 811 (1992); Coffee, *supra* note 51 (discussing the greater monitoring incentives for institutional investors).

76. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 *STAN. L. REV.* 1255, 1275 (2008).

77. *Id.* at 1276.

78. *See* Fairfax, *supra* note 72, at 5–12.

79. International Shareholder Services, *Proxy Voting Services*, ISS, <http://www.issgovernance.com/proxy/voting>.

80. Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 *GEO. L.J.* 1227, 1229 (2008).

81. ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND*

separation of ownership and control of the company, between shareholders and the board, poses a principal-agent problem for which shareholder voting is one solution.⁸² Corporate law sets the balance between accountability and authority for the board, and as Stephen Bainbridge puts it, “[e]stablishing the proper mix of discretion and accountability thus emerges as the central corporate governance question.”⁸³

Many corporate law scholars, as well as corporate law practitioners, argue that this balance should always be set in favor of authority for the board, rather than accountability through shareholder voting. They argue that accountability to shareholders, at least any greater accountability than currently provided by corporate law, would be counterproductive because of the inherent challenges of collective decision making that beset shareholders of large, publicly traded companies.⁸⁴ At least for such public companies with dispersed ownership, it is highly unlikely that the multiplicity of shareholders will remain well informed about the company’s affairs and then achieve collective agreement on the best course of action for their company.⁸⁵

First, the high costs of information and coordination quickly outweigh the pro rata benefits a single shareholder will receive as a function of her ownership stake. Any shareholder must invest real resources into monitoring the company’s operations and business, as well as developing a plan for future action. Determining the best course of action for a public company in a complex, international economy filled with contingency is difficult to achieve from outside the unique position and information of company management. Particularly for investors in public corporations with dispersed ownership, it does not usually make economic sense to develop an affirmative agenda for the corporation when the directors and officers of the corporation have better information and more resources to do so on an ongoing basis. What is more, any benefits that the company realizes from following the shareholder’s designs would accrue to the shareholder on only a pro rata basis, proportionate to her shareholdings, while the costs would be borne entirely by herself. As a result, Bainbridge argues that shareholders quite naturally become “rationally apathetic.”⁸⁶

Second, even if shareholders decided against economic interest to remain well informed about their companies, shareholders as a large group face classic collective action problems. The large size of any shareholder group complicates its ability to achieve consensus about even simple decisions. As the number of shareholders increases, the diversity of interests, expertise, and information among shareholders also increases, as does then the diversity of their preferences with

PRIVATE PROPERTY (rev. ed., Transaction Publishers 1991) (1932).

82. The reference to ownership here can be misleading. To be more precise, shareholders own only securities in the corporation, which carry with them a legally defined set of rights that may or may not track one’s colloquial sensibility about what ownership entails. See Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190–92 (2002). However, I adopt the terminology of Berle and Means in their presentation of the basic relationship between shareholders and the board.

83. Bainbridge, *supra* note 5, at 626.

84. *Id.*

85. *Id.*

86. Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1745 (2006).

respect to the company. What is more, as the number of shareholders increases, so too do the basic challenges of communication and coordination among the group. For all these reasons, Bainbridge concludes that “at the most basic level, the mechanical difficulties of achieving consensus among thousands of decision-makers impede shareholders from taking an active role.”⁸⁷

By contrast, management by the board places centralized control in a small, specialized group armed with the best information about the corporation’s performance, opportunities, and best interests over the long run.⁸⁸ Bainbridge explains that “[t]he chief economic virtue of the public corporation is . . . that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs.”⁸⁹ In the view of Bainbridge and other opponents of shareholder activism, “directors cannot be held accountable without undermining their discretionary authority.”⁹⁰ Reforms that would increase board accountability to the shareholders also necessarily threaten the critical benefits of centralized discretion in the board. Opponents of reforms such as the Rule 14a-11 amendments and majority voting requirements argue that centralized corporate management by directors and officers of the public corporation is critical to American corporate success.⁹¹ In their view, rather than assume the costs of managing the company for themselves, shareholders are better off delegating management *ex ante* and simply selling their stakes in companies if company performance is bad.⁹²

Based on these concerns, critics of shareholder voting oppose expansion of shareholder influence through shareholder voting and the proxy process.⁹³ The insulation of management from shareholder influence allows the board to act with centralized authority in the best interests of the company without the irrational or

87. Bainbridge, *supra* note 5, at 622.

88. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) [hereinafter Bainbridge, *Director Primacy*]; Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

89. Bainbridge, *supra* note 5, at 626.

90. *Id.*

91. *See, e.g.*, Lipton & Rosenblum, *supra* note 7.

92. Shareholders dissatisfied with management of a corporation may have little direct means to exercise “voice” within corporate management, but they can exercise “exit” and leave their troubles behind by simply selling their shares. *See, e.g.*, Bainbridge, *supra* note 5, at 619 (reciting the Wall Street Rule). However, the opportunity for exit may be less for certain institutional investors. *See* Coffee, *supra* note 51, at 1339–41 (arguing that opportunity for exit is limited because approximately one-third of equity investments are indexed and represent long-term holdings that cannot be shed). In addition, the opportunity for voice may be greater for large institutional investors. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 874–76 (1992); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

93. *See, e.g.*, Joshua R. Mourning, Note, *The Majority-Voting Movement: Curtailing Shareholder Disenfranchisement in Corporate Director Elections*, 85 WASH. U. L. REV. 1143, 1174–81 (2007) (discussing arguments against majority voting).

narrowly self-interested pressures from shareholders. Bainbridge argues that “the substantial efficiency benefits that follow from the separation of ownership and control justify retaining the current regime of limited shareholder voting rights as, at the very least, the default rule.”⁹⁴ Lynn Stout similarly criticizes recent calls for shareholder voting reform as ignorant of the need for management discretion and simply “driven by sentiment and the unspoken assumption that shareholder democracy, like Mom and apple pie, must be a good thing.”⁹⁵ Bainbridge, Stout, and others, in other words, approve of the status quo in shareholder voting. The status quo offers strict limitations on shareholder influence and therefore preserves the broad managerial discretion that they so value.⁹⁶

II. VOTING AS VETO AND RATIONAL IGNORANCE

The standard critique of shareholder voting draws strength from the notion that shareholders are rationally ignorant about the affirmative management of the company, are content to defer to the board, and therefore add no value in actively participating in corporate governance.⁹⁷ However, shareholders need not satisfy the informational and coordination requirements described by critics of shareholder voting. In fact, voters in other contexts engage effectively in what I describe here as retrospective voting despite similar constraints on information and coordination.

Corporate scholars and practitioners are correct to argue that shareholders of public companies generally do not have well-developed affirmative preferences about the management of those companies. That is, average shareholders of major public corporations generally do not possess particular designs for the company’s best course of action, nor may they want to consider and invest in developing a sense of such.⁹⁸ Shareholders, as Bainbridge and others explain, tend to be rationally ignorant regarding the optimal course of action for a corporation because

94. Bainbridge, *supra* note 86, at 1758.

95. Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 809 (2007).

96. Critics of shareholder voting struggle to explain why shareholder voting exists at all. They generally believe that efficient markets dictate and therefore justify the status quo on efficiency grounds. The efficiency of the market, in their view, demonstrates that shareholders do not demand a high level of control over management, or else they would insist on more through the market before investing in a company. But on these very terms, it is difficult for these critics of shareholder voting to explain the universality of shareholder voting in corporate governance given that they have little good to say about shareholders voting at all, given their concerns.

97. See Bainbridge, *supra* note 5.

98. See Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 742 (2007) (arguing that there is “no market demand for the ‘franchise reform’ Bebchuk advocates”); Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of The New Corporate Governance in Theory and Practice*, 34 DEL. J. CORP. L. 139, 165 (2009) (doubting that shareholders would seek to “micromanage ordinary business decisions in large public corporations”); see also Thompson & Edelman, *supra* note 11, at 130 (“Shareholders seldom seem to care much about the vote even when they have it, usually preferring the ‘Wall Street rule’ (i.e., sell) when they disagree with a decision made by the corporation’s managers.”).

the information costs are extremely high and the pro rata benefits unlikely to be commensurate.⁹⁹

However, shareholders as voters are little different in this sense than voters in many other contexts. Citizens voting in government elections and choosing among candidates for public office face almost the identical calculus of rational ignorance. The cost of information for citizen voters is high, ranging across many government issues of immense complexity, and the average individual payoff from a voter's preferred outcome is terribly small. Indeed, the material incentive for an individual voter to attend to her vote in government election may be lower on average than in shareholder elections for public companies. Unlike the general rule of one vote per share in shareholder voting, each citizen in the typical government election is constitutionally limited to only one vote per election, which means that the likelihood any individual citizen's vote choice will be decisive and therefore matter at all is negligible for all practical considerations.

Voting in government elections nonetheless effectively translates public preferences. Voters manage to overcome rational ignorance by developing certain shortcuts for generating rational voting preferences that map their interests and voting those preferences in elections. Accounts of retrospective voting, as articulated by Morris Fiorina and others, explain that voters need not develop deeply informed opinions about specific issues and candidates' stances on them.¹⁰⁰ Instead, voters can keep a running tally of retrospective evaluations of the parties' performances and promises, and then apply the running tally as a basic voting guide for or against candidates of those parties. Even more simply, retrospective voters may simply assess the state of the country as a proxy for the incumbent's performance and then vote accordingly for or against the incumbent based on that assessment.¹⁰¹ Although this type of retrospective voting may fail deliberative ideals about civic engagement and voting, it enables rationally ignorant voters to know enough to identify how they should vote and to protect their interests by voting out unsatisfactory officeholders.

Models of retrospective voting are voters' creative response to the problem of rational ignorance. As Fiorina explains, even uninformed voters "typically have one comparatively hard bit of data: they know what life has been like during the incumbent's administration."¹⁰² This bit of data about incumbent performance serves as a useful information shortcut about the how the voters should vote in the

99. See, e.g., Bainbridge, *supra* note 5, at 623–24; K.A.D. Camara, *Shareholder Voting and the Bundling Problem in Corporate Law*, 2004 WIS. L. REV. 1425, 1472–76; Easterbrook & Fischel, *supra* note 8, at 402–03. It is important to acknowledge, however, the increasing concentration of shareholding in public companies into the hands of institutional investors for whom the calculus tilts further in the direction of activism than for the average retail investor. See, e.g., Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1961–64 (2010) (describing this trend); see *supra* notes 75–79 and accompanying text (describing the different incentives for institutional investors).

100. See FIORINA, *supra* note 10.

101. See, e.g., Morris P. Fiorina, *Economic Retrospective Voting in American National Elections: A Micro-Analysis*, 22 AM. J. POL. SCI. 426 (1978); Kinder & Kiewiet, *supra* note 10; Markus, *supra* note 10.

102. FIORINA, *supra* note 10, at 5.

coming election. Voters can hold the incumbent accountable for her performance ex post through their next vote and thereby induce the right incentives ex ante for the incumbent without collecting the necessary information to make a fully informed decision at the beginning. In this view, voters care more about results than the specific policies used to reach those results.¹⁰³ When things are going well, voters are likely to keep the incumbent in office as a default choice without knowing much about policy specifics, but when things are going poorly, voters can drop their usual deference to the incumbent and replace her.

One consequence of retrospective voting is that elections often are effectively a referendum on the incumbent's performance, particularly when the incumbent is in the race. To give one salient example, the 1984 presidential election was almost entirely a referendum on voters' feelings about incumbent President Ronald Reagan.¹⁰⁴ Almost all surveyed respondents who voted for President Reagan explained that they voted primarily for him, rather than against the challenger Walter Mondale. However, almost half of the surveyed respondents who voted for Mondale explained that they were voting *against* Reagan instead of primarily in support of Mondale. The challenger Mondale was largely a standby alternative to be considered only by voters dissatisfied by the incumbent as a threshold matter. This type of incumbent-based shortcut for voters generalizes far beyond the 1984 presidential elections to help explain election outcomes based on voter perceptions of incumbent performance, usually based on economic conditions, in the United States at both the national and state level.¹⁰⁵

Even further, voters defer to the incumbent's recommendations when the incumbent is seen as performing well. Voters economize not just in their election choices among candidates, but also in their decisions on specific policy questions put to them on the ballot. In direct democracy, voters face the same daunting informational challenges that they do for candidate elections, and they opt for a similar strategy of heuristic voting in deciding how to vote on a specific ballot question over public policy. When the incumbent is performing well, voters defer to the incumbent's endorsement and take her cue on how to vote on specific ballot questions.¹⁰⁶ Of course, this type of heuristic voting makes basic sense for rationally ignorant voters. They defer to the more informed judgment of an incumbent who has earned their trust by way of past performance and deviate from

103. *Id.* at 8.

104. See generally Lee Sigelman & Michael M. Gant, *Anticandidate Voting in the 1984 Presidential Election*, 11 POL. BEHAV. 81 (1989).

105. See generally James D. King, *Incumbent Popularity and Vote Choice in Gubernatorial Elections*, 63 J. POL. 585 (2001); Patrick J. Kenney & Tom W. Rice, *Popularity and the Vote: The Gubernatorial Case*, 11 AM. POL. Q. 237 (1983); Susan E. Howell & James M. Vanderleeuw, *Economic Effects on State Governors*, 18 AM. POL. Q. 158 (1990); Robert C. Lowry, James E. Alt & Karen E. Ferree, *Fiscal Policy Outcomes and Electoral Accountability in American States*, 92 AM. POL. SCI. REV. 759 (1998).

106. See, e.g., Jeffrey A. Karp, *The Influence of Elite Endorsements in Initiative Campaigns*, in CITIZENS AS LEGISLATORS: DIRECT DEMOCRACY IN THE UNITED STATES 149 (Shaun Bowler, Todd Donovan & Caroline J. Tolbert eds., 1998); David M. Paul & Clyde Brown, *The Dynamics of Elite Endorsements in Professional Sports Facility Referendums*, 6 ST. POL. & POL'Y Q. 272 (2006); Lee Sigelman, *Voting in Gubernatorial Succession Referenda: The Incumbency Cue*, 51 J. POL. 869 (1989).

the incumbent's judgment mainly when past performance no longer inspires the same confidence. Voters execute the basic strategy of deferring to incumbent officeholders, both in returning them to office and in voting for their policy recommendations, when they appear to be doing a good job.

Just like retrospective voters in government elections, shareholders generally defer to incumbents in office. In shareholder voting on management's board nominees, major transactions, and management proposals, shareholders overwhelmingly tend to defer by voting to approve management's direction.¹⁰⁷ For shareholder proposals, shareholders again defer overwhelmingly to management's position and vote against such proposals consistent with management direction.¹⁰⁸ This general deference to the board, coupled with the institutional advantage of management, means that board-nominated candidates for director and proposals from management tend overwhelmingly to win approval from shareholders, just as management recommends.¹⁰⁹ Without knowing much detail about the company, shareholders defer in the usual course to management.

However, this deference can be overcome when company performance is disappointing. Despite rational ignorance on details, shareholders are excellently positioned to monitor company performance because "they are uniquely sensitive to the principal signal indicating a deviation of the board from its duty to the corporation: the market price of the corporation's stock."¹¹⁰ When company performance is disappointing, shareholders appear to use company performance as a proxy for management performance and punish management accordingly.¹¹¹ For instance, when company performance lags by objective measures, shareholders become less deferential to management and are more likely to vote for a shareholder proposal against management's recommendation.¹¹² Deference appears to wane in particular when a trusted institutional investor takes the lead and advocates the passage of a shareholder proposal against management's recommendation.¹¹³

Shareholder voting in these basic respects resembles models of heuristic voting from political science. Identification of an affirmative preference for the corporation in terms of corporate strategy may require new information and consideration of all feasible alternatives that voters simply may not care enough to engage. However, shareholders need far less information to monitor management

107. See Bainbridge, *supra* note 5.

108. *Id.*

109. *Id.*

110. Thompson & Edelman, *supra* note 11, at 149.

111. See *infra* Part III.

112. See, e.g., James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1 (2010) (documenting how shareholders vote against management recommendations to a much greater degree when proxy voting advisory firm ISS Corporate Governance Services advises so); Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 371 (2007) (reporting increasing shareholder support for shareholder proposals that would remove anti-takeover devices).

113. See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 571-72 (1990).

and apply certain negative preferences against management when appropriate. Shareholders need not develop costly affirmative preferences about company affairs by keeping informed about the details of the corporation's business operations and specific management decisions.¹¹⁴ Instead, they simply maintain a standing opinion about management and the company's overall performance under its control, which serves as a heuristic for shareholders' voting judgments. Shareholders shake out of their general deference to management when their retrospective assessment of the management's performance is negative.

This negative, retrospective model of voting also helps ease problems of collective action among voters. Rather than purporting to identify a single affirmative preference among many shareholders, shareholder voting might be best structured to track a more modest objective—vetoing only those choices that are unacceptable to an overlapping consensus among those shareholders. Not only can shareholders overcome the cost of information for important questions of negative preference, consensus among shareholders is easier when framed as a question of negative preference. Shareholder voting, even with a large number of shareholders, need not dissolve into an Arrovian voting paradox that many critics of shareholder voting imagine.

Indeed, certain classic treatments of democratic theory and public choice contend that elections can establish accountability only through such negative, retrospective accounts of voting. Joseph Schumpeter identified in his critique of democracy the same problems of rational ignorance and collective action that critics of shareholder voting allege, claiming that the average citizen is “a member of an unworkable committee, the committee of the whole nation, and this is why he expends less disciplined effort on mastering a political problem than he expends on a game of bridge.”¹¹⁵ As a consequence, it was impossible to speak of officeholders carrying out an affirmative popular will, which required far greater motivation and coordination among average citizens than practiced democracy could support. Schumpeter, and later William Riker, along similar lines, thus challenged what they saw as this “populist” understanding of democracy that set its goals as the realization of voters' affirmative preferences through voting and elections.¹¹⁶

However, Schumpeter and Riker did not dismiss voting and democracy as unworkable. Instead, they argued that democratic government does not collapse, despite the problems of rational ignorance and collective action, because the mass public readily accepts elected incumbents and generally defers to its leadership.¹¹⁷ Voting and democracy provide accountability in a much more limited but important sense than in the populist understanding. Voting produces accountability in the

114. See Bainbridge, *supra* note 5, at 624 (explaining that the market is a reliable indicator of performance and that to gauge management performance, “[a]n occasional glance at the stock market listings in the newspaper is all that is required”).

115. JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 261 (3d ed. 1950).

116. See *id.* at 250–64 (criticizing the “classical doctrine” of democracy); Michael S. Kang, *Voting as Veto*, 108 MICH. L. REV. 1221, 1228 n.11 (2010) (noting Riker's populist interpretation of democracy and citing predecessors).

117. SCHUMPETER, *supra* note 115; WILLIAM H. RIKER, LIBERALISM AGAINST POPULISM (1982).

public's conditional, intermittent power to end the incumbents' reign. As William Riker put it in his similar critique, "[l]iberal democracy is simply the veto by which it is sometimes possible to restrain official tyranny."¹¹⁸

Along related lines, I argue in recent work that positive and normative conceptions of voting are fixated on affirmative preferences and neglectful of these negative preferences.¹¹⁹ The most familiar voting tool for effectuating negative preferences is the formal right of unilateral veto, where one voter can block a particular alternative from winning approval. But collective voting can be oriented to aggregate negative preferences of many voters and decide by election what choices will *not* be made. Under this reversal of the usual assumptions, voting offers no guarantee that the electorate's most preferred choice will be selected or realized, but instead, voting is designed to block the electorate's least or lesser preferred outcomes from coming to pass.

In fact, voters often subjectively care more about vetoing unwanted outcomes than they care about achieving their most desired outcomes. Voters at times have less idea about what they most prefer, in terms of affirmative preferences, than what they do not want and would veto if they had the chance.¹²⁰ Indeed, a wide body of research from psychology finds that people place greater value, importance, and weight on events that have negative, rather than positive, consequences for them.¹²¹ As a cognitive matter, people appear to decide upon their negative preferences before their affirmative preferences and rely upon them more heavily to reach all types of decisions.¹²² Voters within a particular context therefore may be sensibly efficient to satisfice and focus mainly on fulfilling their negative preferences rather than developing clear affirmative preferences.

Voters' negative preferences, such as anticandidate feelings, are often the most salient, intensely held preferences that voters hold at all in a particular voting

118. RIKER, *supra* note 117, at 244.

119. Kang, *supra* note 116.

120. *Stancil v. Bruce Stancil Refrigeration, Inc.*, 344 S.E.2d 789 (N.C. Ct. App. 1986), offers a humorous example of negative preferences in shareholder voting. The case featured a woeful misunderstanding of cumulative voting by the plaintiff shareholder and his attorneys. Although the defendant and plaintiff shareholders each owned the same number of shares, the plaintiff failed to vote his shares cumulatively. His error allowed the defendant to take over the company as a practical matter. On appeal, the plaintiff inventively claimed that he wished to vote his shares negatively. The plaintiff wanted not to vote for his own nominees, but instead to vote against the defendant shareholder's nominees and cancel out the defendant shareholder's votes for those nominees. The company's bylaws appeared not to have accounted for such negative preferences, nor did the *Stancil* court seem eager to explore the validity of the plaintiff's negative preferences. It is interesting to note that nothing in state law expressly prohibited a corporation from permitting vote by negative preference if the corporation so provides, such as sequential vetoes until the remaining nominees matched the number of seats to be filled.

121. See Kang, *supra* note 116, at 1229–31 (discussing research from psychology on negativity bias).

122. Amrisha Vaish, Tobias Grossmann & Amanda Woodward, *Not All Emotions Are Created Equal: The Negativity Bias in Social-Emotional Development*, 134 PSYCHOL. BULL. 383, 383 (2008). See generally Roy F. Baumeister, Ellen Bratslavsky, Catrin Finkenauer & Kathleen D. Vohs, *Bad Is Stronger than Good*, 5 REV. GEN. PSYCHOL. 323, 362 (2001) (summarizing a review of the literature).

context.¹²³ Voters in a political election, for instance, may care much more about ensuring the defeat of a particular candidate, or type of candidate, than they care about the individual victory of their most preferred candidate.¹²⁴ Voters may care little in particular about most judicial races, content to reelect or retain almost all incumbents, but nonetheless may have very intense negative preferences against certain judges who become individually controversial or salient.¹²⁵ Along the same lines, rationally ignorant shareholders, who know little about the specifics of the company's business or what specifically the company ought to change, can develop clear negative preferences against poorly performing management and act on those preferences in shareholder voting.

This negative conception of voting as veto is actually more familiar than it might initially seem across many different voting contexts. As I document elsewhere, voting systems from contemporary run-off elections to the ancient Greek practice of ostracism have been oriented to recognize mainly negative, oppositional preferences of voters.¹²⁶ Even in voting systems that are not so clearly designed to track negative preferences, negative preferences still decide voting behavior on a regular basis. Indeed, in some contexts, negative preferences may be the only meaningful preferences that voters hold. Voters in judicial retention elections, for example, appear to vote almost unthinkingly to retain as a default, with very little information about individual judges, except that they occasionally vote very real negative preferences about particular judges whose performances become publicly controversial.¹²⁷

Of course, adopting an explicitly negative orientation for voting as veto makes much less sense in certain voting contexts. Public elections are often hoped to be collective participatory processes that foster collective affiliation, community bonding, and civic efficacy. Orienting voters to think and vote negatively against their least preferred choices, instead of mobilizing behind a most affirmatively preferred candidate, diminishes these positive qualities of public elections and directs public affairs instead in negative directions. What is more, a focus on negative preferences can be socially disruptive when voters are required to identify their least preferred choices and vetoed candidates may carry a particular stigma from being chosen as the worst alternative among the eligible. Voting as veto and formal recognition of negative preferences, instead of affirmative ones, does not always make sense.

However, the costs of orienting voting toward negative preferences are not likely to be worrisome in the context of corporate shareholder voting. The aspirational expectations of public elections are simply absent for shareholder voting because it tends to be so focused narrowly on instrumental concerns about

123. See Kang, *supra* note 116, at 1229.

124. See *id.* at 1246–49 (discussing anticandidate voting in political elections).

125. See *id.* at 1243–44 (discussing low-intensity judicial races as an example).

126. See *id.* at 1232–40.

127. See, e.g., David E. Pozen, *Judicial Elections as Popular Constitutionalism*, 110 COLUM. L. REV. 2047, 2071 n.88 (2010); George W. Soule, *Judicial Elections 2010*, BENCH & B. MINN., Jan. 2011, at 28, 31–32.

company value.¹²⁸ In addition, social disruption among shareholders and management is not a significant concern in large public corporations where shareholders and management have little personal contact, and a certain level of disagreement is untroubling between shareholders and management.

To a significant degree, corporate shareholder voting follows the same pattern as negative, retrospective voting in other contexts. The rational ignorance of shareholders does not necessarily doom the development of negative preferences which voting can be structured to recognize. Shareholders may thus have an incomplete set of preferences but still have salient preferences about the worst-case scenarios.¹²⁹ Shareholders who generally would defer to management when things are going well might still hold very negative preferences against management's direction once the company performs poorly over time. Shareholders need not understand everything to know how they feel about a few things, particularly when company performance is bad.

III. VOTING AS VETO IN SHAREHOLDER VOTING

Shareholders passively defer to management direction an overwhelming portion of the time, but at the same time, they can monitor company performance at low cost and punish management when they perceive the company to be managed poorly. Shareholders who regularly defer to management when the company is performing well, and appear not to have real preferences about company direction, can develop negative preferences against management when the company performs poorly and act on those very real preferences through shareholder voting. This understanding of how shareholder voting works in practice suggests why shareholder voting works where it does and guides shareholder-voting reform positively toward the realities of how shareholders vote.

A. The Structure of the Shareholder Veto

Under current American corporate law, whatever influence shareholders exercise over the company's affairs can be understood as structured mainly in terms of negative rights. There is little pretense of shareholder rights of affirmative initiation in corporate management. As Lucian Bebchuk summarizes, a "central and well-settled principle of U.S. corporate law is that all major corporate decisions must be initiated by the board [of directors]."¹³⁰ The board, and corporate officers subordinate to the board, manages corporate affairs without shareholder discretion or affirmative authority to command particular action. Besides the ability to vote on election of directors to the board, shareholders possess only limited rights to deny action on fundamental matters of corporate policy proposed by the officers and

128. See, e.g., Donald J. Smythe, *Shareholder Democracy and the Economic Purpose of the Corporation*, 63 WASH. & LEE L. REV. 1407 (2006) (describing the historical shift in shareholder voting to a focus on economics).

129. See Kang, *supra* note 116, at 1242–45 (discussing negative preferences as incomplete preferences in the face of limited information).

130. Bebchuk, *supra* note 12, at 836.

directors of the company.¹³¹ The requirement of shareholder approval for certain corporate actions effectively constitutes at best a shareholder veto with respect to a limited set of actions.

This legal structure, as it currently stands, is tailored to shareholders' rational ignorance. The limited category of questions presented for a vote to shareholders, at least for publicly traded companies, effectively binds the range of issues that shareholders need to consider. Most of these decisions are presented to shareholders for a vote as a binary choice—shareholders either vote for or against candidates for the board, for or against shareholder proposals or corporate transactions, for or against the appointment of auditors, and so on. This structure accommodates the fact that shareholders are a collective “whose vocabulary is limited to two words, ‘Yes’ and ‘No.’”¹³² The narrow framing of both the types of decisions presented to shareholders and the range of alternatives offered on those decisions limits the challenges of collective choice.¹³³

Opponents of shareholder activism, such as Bainbridge, argue that extension of shareholder voting under current reform proposals would interfere with the board and management's centralized operation of the company. In Bainbridge's view, for instance, “directors cannot be held accountable without undermining their discretionary authority.”¹³⁴ Most proposals for shareholder reform provide stronger ex post oversight rather than ex ante control over management decisions, but Bainbridge argues that this distinction is one in form only because “giving investors this power of review differs little from giving them the power to make management decisions in the first place.”¹³⁵ In his view, there is a zero-sum distribution of power between shareholders and the board along a single continuum—any serious reform that gives stronger oversight to shareholders threatens in equal measure to undermine the critical value of centralized management discretion.¹³⁶ For this reason, Bainbridge concludes that “[t]here ought to be a rebuttable presumption in favor of preservation of managerial discretion.”¹³⁷

Underlying such a presumption must be a faith that current law strikes a reasonably efficient balance between accountability and managerial discretion. Of course, ignoring any tradeoff between accountability and managerial discretion and single-mindedly maximizing shareholder accountability without considering the reduction in managerial discretion would be a mistake. None of the current reform proposals, however, come close to doing so. As one commentator explains, current

131. See Easterbrook & Fischel, *supra* note 8, at 400.

132. E.E. SCHATTSCHEIDER, PARTY GOVERNMENT 52 (1942).

133. See, e.g., Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 364 (1991) (“If the ‘policy space’ of shareholder choice has only a single dimension, cycling would be relatively rare, assuming shareholders voted rationally.”); Grant Hayden & Matthew Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise*, 62 VAND. L. REV. 1217 (2009) (arguing that corporate scholars overestimate the likelihood of preference cycling in shareholder voting).

134. Bainbridge, *supra* note 5, at 626.

135. *Id.*

136. *Id.*

137. STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 113 (2008).

proposals operate in a middle ground and are “reform[s] in favor of somewhat more accountability at the expense of some, but far from a total, loss in authority.”¹³⁸ The relevant question is the identification of the most efficient balance between the values of accountability and managerial discretion and how well current law and reform proposals approach that optimal balance.

On this question, current law fares only so well under the empirical research to date. A rich body of work suggests that the balance set by current law is too far in favor of managerial discretion, at the expense of shareholders. Lucian Bebchuk and Jesse Fried, for instance, argue that excessive discretion, and lack of accountability to shareholders, on the part of management helps explain the extremely high levels of executive compensation relative to that in other industrialized countries.¹³⁹ Bebchuk, in other work with Guhan Subramanian and John Coates, finds staggered board arrangements—which make it more difficult to replace the incumbent board—depress shareholder value by increasing the likelihood that company management is insulated against hostile bids for control.¹⁴⁰ Nonetheless, more than two-thirds of companies whose shareholders had passed precatory resolutions to repeal their respective company’s staggered board arrangement from 1997 to 2003 had *not* repealed their staggered board.¹⁴¹ In other words, a comfortable majority of companies whose shareholders voted to repeal staggered boards had defied their shareholders by retaining a feature of corporate governance that insulates management and thereby depresses shareholder value. It is far from obvious that current law sets the right balance between accountability and managerial discretion when managers exercise not only centralized authority, as prescribed by Bainbridge and others, but also enjoy such deep insulation from shareholders.

However, an emphasis on shareholders’ negative preferences, as a right of veto, may be the most promising path to preserving the traditional advantages of the separation between ownership and management. Oversight through negative veto allows the board to operate on a regular basis without the interference of the shareholders, who lack the information and operational expertise of the company’s board and management. Requirements of shareholder approval instantiates only a periodic opportunity for the protection of the shareholders’ negative preferences. Oversight through negative veto, in other words, empowers the board to act on its discretion, just what advocates of “director primacy” so value about the American corporate model, subject only to the possibility of veto in the background.¹⁴² By contrast, affirmative rights of initiation for shareholders appear to pose clearer *ex ante* interference with the management discretion in the best interests of the corporation.¹⁴³

138. McDonnell, *supra* note 98, at 143.

139. BEBCHUK & FRIED, *supra* note 53.

140. Bebchuk et al., *supra* note 44; *see also* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005); Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUDIES 783 (2009).

141. Bebchuk, *supra* note 12, at 854.

142. *See* Bainbridge, *supra* note 86; Bainbridge, *Director Primacy*, *supra* note 88.

143. *See* Easterbrook & Fischel, *supra* note 8, at 396, 396–408 (acknowledging the argument that shareholders are “unlikely to know better than the managers how to run the firms” but concluding that shareholder voting induces healthy incentives for managers and produces more efficient companies).

Indeed, reinforcing shareholders' veto rights may be the best way to balance board accountability and discretion in a way that closely fits shareholders' interests as a class. Because of the calculus of rational ignorance, shareholders do not necessarily want the burdens of becoming more informed and developing affirmative preferences about the best designs for the corporation. A simple but effective right of veto would be enough for many shareholders as a check on management.¹⁴⁴

Robert Thompson and Paul Edelman argue along similar lines that shareholder voting occurs, and should occur, only when it advances the goal of "error correction" *vis-à-vis* corporate management.¹⁴⁵ Thompson and Edelman clarify that shareholder voting improves the corporate decision-making process when it permits shareholders to correct errors by corporate management,¹⁴⁶ but not necessarily when it goes beyond this capacity.¹⁴⁷ Notably, though, Thompson and Edelman do not understand their approach in terms of shareholder preferences. In fact, they

144. A shareholder veto right protects shareholders not only from management, but also from each other. A requirement of majority shareholder approval allows the shareholders to block value-reducing proposals introduced by other shareholders. Shareholders are a heterogeneous group in important ways and do not always share the same interests with respect to the corporation. See Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445 (2008). Institutional shareholders such as hedge funds possess high levels of information and expertise about company affairs, but they also are more likely to have economic interests that diverge from the typical shareholder with respect to the direction of the company. Cross-shareholder divergences of interest raise concerns about rent-seeking in the venture capital context, see Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 113 (2006), and opponents of shareholder activism see these concerns as prominent in the public company context. See, e.g., Anabtawi, *supra* note 7, at 564–92; Stout, *supra* note 95. In the context of shareholder voting across a heterogeneous electorate, the protective benefits for shareholder interests through veto rights may be particularly useful in negotiating conflicts of interest among differently positioned shareholders.

Assuming effective veto rights, anything that does not benefit at least a majority of shares should not be approved by the shareholders. Shareholder voting as veto has a political analog in this narrow respect in consociationalism. Consociationalism is a system of national governance that permits rival socio-ethnic groups a mutual veto, among other things, over sensitive issues of government policy. See AREND LIJPHART, *POWER-SHARING IN SOUTH AFRICA* 6 (Inst. of Int'l Studies, Policy Papers in International Affairs Ser. No. 24, 1985) (defining consociationalism as (i) executive power sharing, (ii) internal autonomy for groups, (iii) proportional representation and allocation of civil service positions, and (iv) a minority veto on vital issues). This form of consociational democracy protects groups in a divided polity by providing a unilateral veto to block legislation inimical to their vital interests. Just so, shareholder veto rights allow shareholders to protect themselves by blocking management or shareholder proposals that would reduce company value. Of course, there is a critical difference between shareholder vetoes and consociational democracy—only a majority of the outstanding shares can effectuate a veto, while consociationalism by design vests the minority with a veto right over the majority. *Id.* However, shareholder voting uses veto rights to serve mainly as a familiar form of self-protection for shareholder groups within a heterogeneous electorate.

145. Thompson & Edelman, *supra* note 11, at 146–52.

146. *Id.* at 151.

147. *Id.* at 173.

argue that shareholder voting should be understood as “no longer merely an aggregation of preferences, but rather an aggregation of information” about what will maximize share price.¹⁴⁸ Assuming that shareholder preferences are generally driven by a focus on share price, as I do, there is no real difference between their focus on “error correction” and my focus on negative preferences.

Thompson and Edelman’s real point, I think, is that shareholders are well positioned to develop and vote on negative preferences about corporate management in ways that they are not similarly positioned with respect to affirmative preferences. I agree. However, Thompson and Edelman strain to articulate their approach as one focused on error correction and information, in contradistinction to shareholder preferences, in the absence of a conceptual vocabulary of affirmative and negative preferences.

Shareholder voting can achieve an important measure of shareholder accountability, despite the challenges of rational ignorance, once the normative focus is shifted to a model of shareholder voting as veto. Shareholder-voting reforms that focus on negative preferences, rather than their affirmative preferences, are less likely to run into the costs of reform commonly identified by opponents of shareholder activism while going a long way toward satisfying real concerns of shareholders and proponents of shareholder activism. Understanding negative preferences and their role in this context provides a better guide to what should be the effective goals of shareholder voting and the best directions for any efforts at reform to achieve those goals.

B. The Shareholder Veto in Practice

How well do shareholders exercise their veto, at least where they have it, under current law? Shareholders face voting decisions about two major categories of choices: First, shareholders vote on board nominees, major transactions, and management proposals, all of which are sponsored by management; second, shareholders vote on certain proposals by qualified shareholders, principally about matters of corporate governance, which management generally opposes. In both cases, shareholders overwhelmingly tend to defer to the board except under limited circumstances when deference rationally is less deserved.

This general deference to the board, coupled with the institutional advantage of management, means that board-nominated candidates for director and proposals from management tend overwhelmingly to win approval from shareholders, just as management recommends.¹⁴⁹ That is, in the context of large, publicly held companies, shareholders very rarely oppose management’s direction on proposals presented for a vote. Yair Listokin reports that management proposals receive on average 85% favorable votes and only 14% negative votes out of total votes cast.¹⁵⁰ By contrast, shareholder-sponsored proposals that do not usually enjoy management support receive on average just less than 32% favorable votes.¹⁵¹

148. *Id.* at 133.

149. See Easterbrook & Fischel, *supra* note 8.

150. Yair Listokin, *Management Always Wins the Close Ones*, 10 AM. L. & ECON. REV. 159, 170 (2008).

151. *Id.*

What is more, even when the vote is close, Listokin finds that management proposals are overwhelmingly more likely to win votes by a small margin than to lose by a small margin.¹⁵² Indeed, other studies find that proposals from shareholders receive majority support less than 5% of the time.¹⁵³ Management, in short, exercises sufficient control over the shareholder voting process that it usually can monitor, influence, and mobilize enough shareholder votes as needed, when needed, to win approval of proposals that it favors.

However, shareholders shake out of their regular deference when company performance is poor. Shareholders, for instance, are least likely to defer to management and most likely to vote in favor of shareholder proposals when the company has underperformed.¹⁵⁴ Although shareholders tend to defer as a general matter to management, shareholders' trust in management erodes when the company performs badly and management's competence appropriately comes into question. When deciding whether to defer to or veto management's recommendations, shareholders focus on a discrete question informed by a standing opinion about management's competence, which is in turn based heavily on retrospective information about share price. Share price offers a salient, accessible measure of performance that shareholders, even unsophisticated shareholders with relatively little information, can readily monitor over time as a proxy for competence.

Shareholders are more likely, as a result, to engage in a proxy contest to challenge the incumbent board, and are also more likely to vote for challengers in a proxy contest, when company performance has been weak. The empirical literature is clear that companies are much more likely to face a proxy contest when their recent performance lags behind the industry standard. One study estimates that companies that face a proxy contest to the incumbent board have experienced 34.4% lower stock returns and 39.3% lower income growth on average than comparable firms over the previous five years.¹⁵⁵

There is much less research about the degree to which shareholder support for a proxy challenger depends on the past performance of the incumbent board. Part of the reason for the paucity of research is that proxy contests are reasonably rare,

152. *See id.* at 172–80.

153. *See* Lilli A. Gordon & John Pound, *Information, Ownership Structure, and Shareholder Voting: Evidence from Shareholder-Sponsored Corporate Governance Proposals*, 48 J. FIN. 697 (1993) (finding 4.51% of proposals were approved in 1990); Jonathan M. Karpoff, Paul H. Malatesta & Ralph A. Walkling, *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 J. FIN. ECON. 365 (1996) (finding 4.2% of proposals were approved from 1986 to 1990).

154. *See* David Ikenberry & Josef Lakonishok, *Corporate Governance Through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 432 (1993).

155. *Id.* at 406–07. *See generally* Joel Hasbrouck, *The Characteristics of Takeover Targets: q and Other Measures*, 9 J. BANKING & FIN. 351 (1985); Larry H.P. Lang, René M. Stulz & Ralph A. Walkling, *Managerial Performance, Tobin's q , and the Gains from Successful Tender Offers*, 24 J. FIN. ECON. 137 (1989); Randall Morck, Andrei Shleifer & Robert W. Vishny, *Alternative Mechanisms for Corporate Control*, 79 AM. ECON. REV. 842 (1989); J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279 (1998).

given the legal impediments to bringing a proxy challenge.¹⁵⁶ However, as a rough descriptive statistic, one recent study finds that companies in which a proxy challenger wins the contested board's seats experienced roughly 10% worse than average performance, as measured by five-year share price return indexed against the S&P 500, compared to roughly 5% better than average performance by companies where the proxy challenge was unsuccessful.¹⁵⁷

We know a great deal more about shareholder voting for shareholder proposals, and the available empirical literature finds conclusively that shareholder support for shareholder proposals is predictably associated with corporate underperformance.¹⁵⁸ Compared to proxy contests, the costs of making shareholder proposals are substantially lower, and shareholders' proposals are much more commonly presented for shareholder votes than for proxy contests. Lilli Gordon and John Pound study the relationship between shareholder support for shareholder proposals and the company's long-term market return, and they find that poor stock market performance by the company is significantly related to voting support for shareholder proposals.¹⁵⁹ As they summarize, "the worse is the long-term performance of the firm, the higher is the vote for shareholder proposals."¹⁶⁰ Another study reaches essentially the same conclusion over a longer period of company performance and concludes that "[t]he poorer the performance over the previous five years, the higher the number of votes in favor of the shareholder proposal."¹⁶¹ In other words, shareholders are most likely to buck management by voting for shareholder proposals against management's usual recommendation when company underperformance seems to have undercut shareholders' usual posture of deference.

Shareholders also sensibly submit more shareholder proposals to underperforming companies.¹⁶² When the company performs poorly, not only are shareholders more likely to vote for shareholder proposals, management tends to be challenged by a greater number of proposals as well, usually from shareholders who hope to change the company's direction. One study finds that the likelihood

156. *See supra* Part I.A.

157. *See* Lee Harris, *The Politics of Shareholder Voting*, 86 N.Y.U. L. REV. 1761, 1797–99 (2011). Harris also argues that five-year share performance is uncorrelated to the success of the challenger, but his performance measure may be too highly correlated with his variable of interest, challenger campaign expenses, to draw definitive conclusions across the forty or so cases studied. *Id.* at 1799–1800; *see also* Richard M. Duvall & Douglas V. Austin, *Predicting the Results of Proxy Contests*, 20 J. FIN. 464, 467 (1965) ("[T]he results of control contests probably depend on the rate of return of the firm relative to its industry.").

158. *See, e.g.*, Gordon & Pound, *supra* note 153, at 712.

159. *Id.*

160. *Id.*

161. Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 295 (2000).

162. George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 135 (2010); *see also* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 183–84 & nn.21–25 (2001) (summarizing the research that finds targets of shareholder activism tend to be poor performers on a variety of measures); Deon Strickland, Kenneth W. Wiles & Marc Zenner, *A Requiem for the USA: Is Small Shareholder Monitoring Effective?*, 40 J. FIN. ECON. 319 (1996).

that a company receives a shareholder proposal is inversely proportional to important measures of company performance during the three preceding years, such as market-to-book ratio, operating return on sales, and recent sales growth.¹⁶³ Another study finds that companies targeted by shareholder proposals performed significantly worse—indeed 22% worse—than the average market performance during the previous year.¹⁶⁴

However, shareholders do not reflexively support greater shareholder control, but instead shareholders' preferences over process appear to depend on whether the company is managed well. At least when limited to simple binary questions that lend themselves to a veto choice, shareholders appear to behave rationally in favor of measures that generally benefit shareholders and enhance the value of their companies.¹⁶⁵ Studies likewise show that shareholders appear to be sensitive to the sponsorship of a shareholder proposal in deciding whether to support it.¹⁶⁶ Specifically, studies find that proposals sponsored by institutional investors and prominent financial figures enjoy significantly greater support.¹⁶⁷ Like voters in political elections, shareholders respond to the informational signal from counter-endorsements against management's position by trusted sources. This counter-endorsement serves as a voting cue not to trust management's position on the proposal and helps overcome shareholders' usual deference.

The one area where shareholders are most likely to buck management's recommendation, even when company performance is satisfactory, actually strengthens the case for shareholder voting. Shareholders are most likely to vote in favor of a shareholder proposal over management objection when the proposal is familiar and empirically shown to enhance shareholder value. For instance, shareholders vote most consistently in support of well-known corporate governance proposals that dismantle a company's anti-takeover devices.¹⁶⁸ Anti-takeover devices insulate directors and officers from replacement by bidders who identify underperformance by the company and seek to capture gains from better management by taking over the company. This threat of a takeover better incentivizes managers and is associated empirically with shareholder value, while the presence of anti-takeover devices that deter takeovers is empirically associated with managerial underperformance.¹⁶⁹ Shareholders, therefore, rationally should oppose anti-takeover devices and support measures to remove them in companies whose shares they own. That is what they do.

Shareholders, for another example, oppose staggered boards and vote for proposals to eliminate them.¹⁷⁰ Staggered boards, as empirical research has

163. See Karpoff et al., *supra* note 153, at 366, 380, 392.

164. See Thomas & Cotter, *supra* note 112, at 374–75.

165. See McDonnell, *supra* note 98, at 178.

166. Gillan & Starks, *supra* note 161, at 285–88.

167. See *id.*; Karpoff et al., *supra* note 153; Thomas & Cotter, *supra* note 112, at 371.

168. Thomas & Cotter, *supra* note 112, at 389.

169. See, e.g., Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting?: A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999); Garvey & Hanka, *supra* note 55; Gompers et al., *supra* note 55; Re-Jin Guo, Timothy A. Kruse & Tom Nohel, *Undoing the Powerful Anti-Takeover Force of Staggered Boards*, 14 J. CORP. FIN. 274 (2008).

170. See Guo et al., *supra* note 169, at 275.

demonstrated, depress the return to shareholders of takeover targets and are correlated with lower firm value.¹⁷¹ Staggered boards, by spreading out the term of individual directors and by staggering their election years, require any hostile bidder for a company to replace the incumbent board over a longer period of time. This elongation of the process raises costs and deters bidders and, therefore, reduces the threat of a takeover that would discipline managers and enhance shareholder value. In the most comprehensive study of staggered boards, Lucian Bebchuk, John Coates, and Guhan Subramanian document the negative effect of staggered boards on shareholder value and conclude that “staggered boards are the most powerful anti-takeover device in the current arsenal of takeover defense weapons.”¹⁷² For this reason, shareholder activists and corporate governance reformers advocate for the de-staggering of a company’s board as a way of removing obstacles to takeover bids and reinforcing shareholder value. Shareholders rationally tend to vote in favor of such proposals, and in fact, the approval rates for such proposals are often the highest for any category of shareholder proposal.¹⁷³ Furthermore, shareholders also buck management opposition to these proposals because they know that the usual deference to management would be counter to their interests. Not only do shareholders support the de-staggering of boards, shareholders tend to provide strong support for the removal of other anti-takeover devices as well, such as poison pills.¹⁷⁴

However, shareholders do not vote indiscriminately for proposals styled as corporate governance reform and instead tend to vote against proposals with little or no empirical support as value enhancing for shareholders. Shareholders discriminate among corporate governance reforms and appear to support them selectively based at least in part on whether there is powerful consensus about their value.¹⁷⁵ Shareholders support de-staggering boards on one hand, but on the other hand, shareholders are decidedly and rationally ambivalent, for instance, about say on pay advisory voting on executive compensation. Jie Cai and Ralph Walkling find that adoption of say on pay appears disfavored by the equity markets and companies.¹⁷⁶ Consistent with this finding, proposals for say on pay generally do not receive majority support of shareholders.¹⁷⁷ Cai and Walkling also find,

171. See Lucian A. Bebchuk & Ehud Kamar, *Bundling and Entrenchment*, 123 HARV. L. REV. 1549, 1561–62 (2010); Bebchuk et al., *supra* note 44; Guo et al., *supra* note 169, at 276.

172. Bebchuk et al., *supra* note 44, at 950; see also Guo et al., *supra* note 169, at 276.

173. See, e.g., GEORGESON, 2009 ANNUAL CORPORATE GOVERNANCE REVIEW 20–21 (2009); see also Guo et al., *supra* note 169, at 275.

174. Although the empirical literature is not always as clear regarding the benefit of various anti-takeover devices, dependent at least in part on individual firm characteristics, it is reasonable for shareholders to support measures that, in theory, would increase share value. See James A. Brickley, Jeffrey L. Coles & Rory L. Terry, *Outside Directors and the Adoption of Poison Pills*, 35 J. FIN. ECON. 371 (1994) (finding positive price effects for some firms and negative ones for other types); Gordon & Pound, *supra* note 153, at 712; Romano, *supra* note 162, at 224 (“It is . . . altogether reasonable for investors to believe that the removal of a pill will be beneficial for some firms, and to support such proposals . . .”); Strickland et al., *supra* note 162.

175. See Bizjak & Marquette, *supra* note 22, at 521.

176. See Cai & Walkling, *supra* note 24.

177. *Id.* at 330.

however, that shareholders depart from the usual disapproval for say on pay and tend to vote for say on pay's institution when the CEO of the company is overpaid.¹⁷⁸ Shareholder support for say on pay therefore appears to be tepid in most cases when say on pay would do little good, but shareholder support for its institution rationally increases when say on pay is responsive to excessive executive compensation.¹⁷⁹ Other proposals that receive weak shareholder support "can be viewed as more qualitative and difficult for shareholders to analyze," such as measures to change the compensation of executives, the selection of auditors, and the composition of the board.¹⁸⁰

A criticism of expanded proxy access for shareholders is that it would place too much leverage in the hands of a few major shareholders who can exploit their consolidated control and the diffusion of the remaining market capitalization.¹⁸¹ This worry may be particularly acute today with the rise of activist hedge funds eager to take large positions in a company and to use that leverage to dominate corporate policy.¹⁸² Activist hedge funds might be motivated to sponsor proposals, under expanded proxy access provided by current reforms, that benefit their narrow interests rather than shareholders as a class. Bainbridge argues that proxy reform that would expand shareholder voting rights "seems likely to disrupt the very mechanism that makes the widely held public corporation practicable: namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors."¹⁸³ Intrusive activism by hedge funds is a relatively new phenomenon and may well become problematic, perhaps even requiring new legal inventions, such as fiduciary duties for activist shareholders, as some argue.¹⁸⁴

There is thus far, however, only limited evidence of the costs of hedge fund activism. More important, shareholders generally do not appear unduly attracted to value-reducing measures when asked to vote on them and appear to vote rationally in favor of many significant measures that appear to advantage shareholders as a class. In other words, simply because shareholders are presented with value-reducing proposals does not mean that shareholders will vote for and approve them. Shareholders defend their negative preferences against harmful or wasteful proposals reasonably well. This is particularly so when management regards certain proposals as harmful or wasteful and communicates that opinion to shareholders. If anything, the principal concern today appears to be that shareholder voting tends to defer to management too much.

178. *Id.*

179. See Andrew C.W. Lund, *Say on Pay's Bundling Problems*, 99 KY. L.J. 119 (2010) (reporting that shareholders in the United Kingdom used say on pay votes to discipline the management of poorly performing firms but not management of high performing firms).

180. Gordon & Pound, *supra* note 153, at 712.

181. See, e.g., Lipton & Rosenblum, *supra* note 7; Strine, *supra* note 46, at 1765.

182. See Anabtawi & Stout, *supra* note 76 (discussing activist hedge funds and proposing the imposition of fiduciary duties on them).

183. Bainbridge, *supra* note 86, at 1749.

184. Anabtawi & Stout, *supra* note 76.

IV. THE REFORM IMPLICATIONS OF SHAREHOLDER VOTING AS VETO

The practice of shareholder voting as veto offers a few suggestions about how sensibly shareholders can exercise their veto and thus provides a model upon which to build reform. Shareholder-voting reform that builds upon the strengths of shareholders is likely to be more successful than blanket critics of shareholder voting currently allege.

However, the prognosis is less clear for shareholder-voting reform that goes beyond the revealed strengths of shareholders as defenders of the negative preferences through veto voting. Shareholder-voting reform that asks shareholders to make more difficult judgments beyond their veto oversight of management presents challenges that shareholders have less experience in handling. In short, the practice of shareholder voting as veto, once understood as such, demonstrates what works about shareholder voting and where it can build in terms of reform, and it also makes clear where shareholder-voting reform might go wrong.

A. Building on the Shareholder Veto

Any reform of shareholder voting can effectively build on the strengths of shareholders as veto decisionmakers in response to management. Shareholders effectively monitor management and sensibly exercise their veto in light of that monitoring. The usual critiques of shareholder voting fall away to a significant degree if shareholders are competent at exercising their veto and if voting decisions are structured to suit that competence.

Most prominent among new voting matters for shareholders in recent years is say on pay. As described earlier, say on pay requires a company to hold a nonbinding shareholder vote on the company's executive compensation. Say on pay as a concept dates back at least to the early 1990s¹⁸⁵ but was only recently adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.¹⁸⁶ Dodd-Frank requires both an inaugural vote on companies' executive compensation, as well as a separate shareholder vote on how frequently say on pay votes should be held going forward.¹⁸⁷

Early criticism of say on pay in its first year of practice focused on the fact that shareholders actually tended not to reject executive pay even after receiving the opportunity to vote against it. John Helyar reported that Institutional Shareholder Services (ISS) advised its clients to vote no on executive pay for 293 companies, accounting for roughly 12% of its recommendations, midway through 2011.¹⁸⁸ However, only thirty-two companies received a negative shareholder vote on executive pay, out of a total of 1998 companies that held annual meetings midway

185. See, e.g., Jeffrey N. Gordon, Essay, "Say on Pay": *Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 341-42 (2009) (describing the early history of say on pay legislation in the United Kingdom).

186. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. § 5301).

187. Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010) (codified as amended at 15 U.S.C. § 78n-1).

188. John Helyar, *After Much Hoopla, Investor 'Say on Pay' Is a Bust*, BLOOMBERG BUSINESSWEEK, June 20, 2011, at 23, 23.

through 2011—just 2% of those companies.¹⁸⁹ Nearly three-quarters of companies in the Russell 3000 passed their executive compensation with more than 90% shareholder approval.¹⁹⁰ As one proxy advisor observed, the big institutional investors “won’t vote against management . . . unless they’re really bad.”¹⁹¹

This pattern of shareholder deference in the absence of poor management performance is perfectly predictable. Shareholders are unlikely to prioritize executive compensation, which generally accounts for a very small percentage of any public company’s expenses.¹⁹² As a result, shareholders are unlikely to intervene unless management performance is sufficiently bad that it forces shareholders to pay greater attention as a general matter and contemplate the more aggressive exercise of a veto even on executive compensation. An earlier empirical study on say on pay indicated accordingly that proposals to institute say on pay from 2006 to 2008, before the passage of Dodd-Frank, did not tend to receive majority shareholder approval and averaged less than 30% of shareholder support.¹⁹³ In other words, shareholders did not reflexively vote for measures to curb executive pay. Shareholder support for instituting say on pay increases almost exclusively when the company’s CEO actually is overpaid.¹⁹⁴ In short, shareholder voting in support of instituting say on pay is fairly reasonable so far as it goes.

The widespread introduction of say on pay actually channels shareholder dissatisfaction with executive compensation into more manageable, less intrusive directions. Say on pay allows shareholders a direct channel of expression about executive compensation that was previously unavailable. Before say on pay, shareholders who wished to vent frustration with executive compensation were forced to express their discontent only indirectly, by withholding support from director candidates and compensation committee nominees. With the introduction of say on pay, those crude expressions of shareholder dissatisfaction decreased.¹⁹⁵ As ISS reported, “[t]he advent of ‘say on pay’ has contributed to a significant decline in shareholder opposition to director elections at U.S. firms in 2011.”¹⁹⁶

For precisely these reasons, sweeping criticism of say on pay is difficult to understand. Stephen Bainbridge argues that say on pay, by involving even this limited measure of shareholder preference into corporate decisionmaking, “seems likely to disrupt the very mechanism that makes the public corporation practicable;

189. *Id.*

190. SEMLER BROSSY CONSULTING GRP., LLC, 2011 SAY ON PAY RESULTS: RUSSELL 3000 (2011), available at <http://www.semlerbrossy.com/pages/htindex.php>.

191. Helyar, *supra* note 188, at 24.

192. See Michael B. Dorff, *Confident Uncertainty, Excessive Compensation & the Obama Plan*, 85 IND. L.J. 491, 545–46 (2010) (“[I]t would be difficult to avoid the reasoning that even seemingly astronomical sums are insignificant when compared to the cost of having inadequate leadership.”).

193. Cai & Walkling, *supra* note 24, at 330.

194. *Id.*

195. TED ALLEN, JOLENE DUGAN, ERIK MELL, CAROLYN MATHIASSEN, EDWARD KAMONJOH, ROEL DELGADO & OGUZ TOLON, INSTITUTIONAL S’HOLDER SERVS. INC., 2011 U.S. POSTSEASON REPORT 30 (2011) (reporting the number of directors receiving less than 50% nosedived from 93% in 2009 and 51% in 2010 to just 45% in 2011).

196. *Id.*

namely, the vesting of ‘authoritative control’ in the board of directors.”¹⁹⁷ This intrusion by shareholders is disruptive because “[f]or the average shareholder, the necessary investment of time and effort in making informed voting decisions simply is not worthwhile.”¹⁹⁸ But it is for this reason that the average shareholder is quite unlikely in the usual case to depart from the dominant pattern of deferring to management, just as Bainbridge would advise. In this case, shareholders would defer to authoritative board control, just as shareholder voting in 2011 appears to bear out, rather than disrupt it.¹⁹⁹ If “executive perks seem to be set with shareholder interests in mind,”²⁰⁰ as Bainbridge contends, then shareholders are rightly endorsing management’s position on the issue. Shareholders would tend to vote against management’s proposed executive compensation mainly when company performance has been rocky enough to jar shareholders’ attention and trigger potentially negative preference and scrutiny about management suggestions.

Shareholder voting, on say on pay and otherwise, is heavily influenced by the recommendation of important proxy advisors. Proxy advisors—most prominently ISS but also PROXY Governance, Inc., Glass, Lewis & Company, and others—make recommendations to their institutional clients about how they should cast their proxy in shareholder voting matters.²⁰¹ ISS, for instance, offers its clients voting recommendations on all shareholder voting questions as well as a research report supporting those recommendations.²⁰² ISS’s recommendations in particular carry great weight among its clients and are credited with being able to sway as much as 30% of the vote in any proxy contest.²⁰³ One study of mutual fund voting observes that “mutual funds tend to vote in line with ISS recommendations across the board.”²⁰⁴

The fact that shareholders might rely on a heuristic voting cue from the endorsements of proxy advisors is utterly unsurprising. Voters in similar large-scale electorates regularly rely on heuristic cue-taking from credible agents who are perceived to have the same values and can be reasonably trusted to offer the recommendation that the voter would have reached with the investment of time and thought.²⁰⁵ These agents in the context of political voting are called political parties, trusted political endorsers, and various media figures among others. When

197. Stephen M. Bainbridge, *Is ‘Say on Pay’ Justified?*, REG., Spring 2009, at 42, 46.

198. *Id.* at 47.

199. See, e.g., Jeremy Ryan Delman, Note, *Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation*, 2010 COLUM. BUS. L. REV. 538, 609–13 (finding that European shareholders reliably defer to management on say on pay-style votes).

200. Bainbridge, *supra* note 197, at 44.

201. See Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 649 (2009).

202. *Id.* at 652.

203. *Id.* at 657.

204. Cotter et al., *supra* note 112, at 2.

205. See generally SAMUEL L. POPKIN, *THE REASONING VOTER* (1994); Michael S. Kang, *Democratizing Direct Democracy: Restoring Voter Competence Through Heuristic Cues and “Disclosure Plus,”* 50 UCLA L. REV. 1141 (2003); Arthur Lupia, *Shortcuts Versus Encyclopedias: Information and Voting Behavior in California Insurance Reform Elections*, 88 AM. POL. SCI. REV. 63 (1994).

a popular politician, respected pundit, or trusted interest group whose position the voter values offers a voting recommendation, the voter can rely on that recommendation as an economizing device. Just so, shareholders rely on ISS's recommendation to the degree that they trust ISS's judgments to be consistent with their own. Of course, shareholders cannot be confident that ISS's recommendation is always perfectly consistent with what would be their independent judgment. To the degree that ISS's recommendations prove unreliable over a longer period, shareholders will lose confidence in ISS and depart from their recommendation in favor of greater independence, or more likely a different proxy advisor. To expect shareholders to depend less on heuristic cues than voters in virtually every other mass voting context is simply unrealistic and unproductive.

As a result, it is difficult to sympathize with the abstract concerns about say on pay, particularly structured as a nonbinding veto of management decision making. What is more, the success of shareholder voting as veto should bode well for the sensibility of shareholder voting on other potential avenues of reform that take a similar path. Most prominently, corporate governance reformers have pushed for shareholder rights of approval for corporate campaign expenditures in the wake of *Citizens United v. FEC*.²⁰⁶ That Supreme Court decision held that longstanding government prohibitions on corporate expenditures on political campaigning were unconstitutional under the First Amendment.²⁰⁷ The decision therefore raised the possibility that the usual principal-agent concerns about management discretion would extend to corporate campaign spending against the preferences of company shareholders.²⁰⁸

The Shareholder Protection Act would require shareholder approval of a company's campaign contributions and expenditures in a binding vote that basically follows the model of say on pay.²⁰⁹ Management would need to obtain majority shareholder approval in advance of corporate campaign contributions or expenditures. This requirement again enables shareholders to reject management's recommendations through a shareholder veto, but it would not by itself empower shareholders to propose any corporate contributions or expenditures as an alternative to management's preference.

The Shareholder Protection Act's requirement of shareholder approval for corporate electioneering is consistent with the model of shareholder voting as veto. Shareholders are likely to defer overwhelmingly to management, particularly when the company is performing well, regardless of their individual political preferences distinct from the company's political agenda. Rationally ignorant shareholders would go along with management recommendations except when poor company performance alerts them to closer monitoring of management and activates potential negative preferences against management's recommendations.

206. 558 U.S. 310 (2010).

207. See generally Michael S. Kang, *After Citizens United*, 44 IND. L. REV. 243 (2010) (describing *Citizens United* and its consequences for campaign finance law).

208. See generally Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83 (2010) (advocating for disclosure of corporate campaign expenditures and other politically related spending as well as required shareholder approval of corporate political spending).

209. Shareholder Protection Act of 2011, H.R. 2517, 112th Cong. (2011).

Indeed, this pattern is exactly what Ciara Torres-Spelliscy and Kathy Fogel find in their study of the United Kingdom's parallel experience with the U.K. Companies Act.²¹⁰ Like the Shareholder Protection Act, the enacted U.K. Companies Act requires British companies to seek shareholder approval of their political budgets.²¹¹ Although several companies avoided the Act's requirements by proposing no political spending at all, British companies tended overwhelmingly to seek and obtain shareholder approval for more political spending than they actually ended up making. On average, companies received 94%–97% approval for their proposed budgets from shareholders voting their shares, with an annual average of a third to half of shares abstaining or otherwise failing to vote.²¹² Shareholders deferred to management in almost all cases such that any disruption is likely to be minimal in all but the exceptional case. And the empirical evidence from shareholder voting suggests that the exceptional case is likely to be one where shareholders sensibly intervene more aggressively against management.²¹³

Admittedly, campaign spending in the United Kingdom is much less than in the United States,²¹⁴ but it is precisely with respect to political concerns where shareholders are likely to be most deferential to management. Shareholders are very hostile to political appeals that do not relate directly to returns on shareholder value.²¹⁵ Shareholders vote in waves against shareholder proposals based on so-called social responsibility and political concerns.²¹⁶ Shareholders tend to be narrowly focused on maximizing their returns and accordingly defer to management on most politically salient matters that are unlikely to involve serious issues of corporate profitability. It is with respect to corporate governance matters, where shareholders' financial interests can conflict most acutely with management's, that shareholders pay special attention and are most likely to vote against management's recommendations.

B. Reinforcing the Shareholder Veto

Where the shareholder veto is practically ineffective under current law, shareholder-voting reform directed toward the effective exercise of a shareholder veto plays to the strengths of shareholders as veto overseers of management. Shareholder-voting reform can unlock the ability of shareholders to defend their interests effectively through their veto, just as they do effectively in other areas of corporate governance.

210. See Ciara Torres-Spelliscy & Kathy Fogel, *Shareholder-Authorized Corporate Political Spending in the United Kingdom*, 46 U.S.F. L. REV. 525, 545–47 (2011).

211. See *id.* at 545.

212. See *id.* at 568.

213. See *supra* note 150 and accompanying text.

214. Torres-Spelliscy & Fogel, *supra* note 210, at 537–38.

215. See, e.g., Cotter et al., *supra* note 112, at 15 (finding political proposals receive only 5% of shareholder votes, compared with 59% for anti-takeover proposals).

216. See, e.g., Thomas & Cotter, *supra* note 112, at 389 (finding that shareholders vote strongly against social responsibility proposals that bear little relationship with shareholder value).

One opportunity for reinforcing shareholder veto rights is board elections. As a formal matter, shareholders have the right to withhold their votes from management nominees for the board of directors. They can thus formally express a negative preference against management in the formal sense. However, this formal ability to withhold their votes and express disapproval has little practical consequence. The reason for this fact is that under current law, it is very costly, and therefore extremely rare, for shareholders or other interests to run competing candidates against management's nominees in a proxy fight. As a result, almost all management nominees run unopposed even when there is dissatisfaction with those nominees among shareholders.²¹⁷

In this situation, when only management's nominees are presented for a proxy vote, management's nominee wins with even a single vote as the highest eligible vote getter. Shareholders can vote against the nominees presented by management, but the effect of that nay vote is formally negligible. Without any effective veto power, dissatisfied shareholders have increasingly voted against or withheld their votes for board nominees as a show of dissatisfaction, even though virtually all of those nominees would be elected regardless of their votes or nonvotes.²¹⁸ While these campaigns to withhold votes may spur management to negotiate with dissatisfied shareholders, there is no formal mechanism by which shareholders can exercise a veto in the same way that they can on other management proposals.

The SEC's proposed amendments to Rules 14a-8 and 14a-11 were aimed at reinforcing the shareholder veto when it comes to board elections. The amendments would have given shareholders much greater leverage to veto management nominees for the board by making it much easier for qualified shareholders to offer alternative candidates for the board of directors against management's nominees.²¹⁹ Shareholders who have owned, individually or as part of a shareholder group, at least 3% of outstanding shares for the previous three years, would have been able to nominate a nominee for the board of directors to be included in the company's proxy materials, subject to certain limitations.²²⁰ This qualification of ownership stake would help ensure that only significant shareholders with financial interests in the company exercise this option. Those nominating shareholders would need to make certain disclosures in advance, as well as promise to hold their shares through the annual meeting.²²¹ The critical element of the SEC's proposed amendments was the nominating shareholders' right to include their nominee in the company's proxy materials, distributed to all shareholders at the company's cost.²²² This right of inclusion in the company's proxy materials avoided the need for the nominating shareholders to distribute their own proxy materials, subject to federal securities law, at high, usually prohibitive financial cost.

217. See Bebchuk, *supra* note 2, at 679–87 (2007) (finding electoral challenges extremely rare, with only thirty contested solicitations per year, on average).

218. See GEORGESON, *supra* note 173, at 5.

219. See Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024 (proposed June 10, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249 & 274).

220. See Facilitating Shareholder Director Nominations, 75 Fed. Reg. 55,668, 56,672–75 (2010) (to be codified at 17 C.F.R. pt. 240).

221. Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,037.

222. *Id.* at 29,049.

Although it is easy to see these proposals as aimed at empowering shareholders to name their ideal set of candidates, they are better understood in light of the fact that current law provides little opportunity for shareholder veto in board elections. As such, the SEC's proposals served a more modest, and more important, purpose. The proposed changes to Rules 14a-8 and 14a-11 would have made it more likely, when shareholders are unhappy with the board, to have a real chance to veto the board's nominee by voting for an alternate candidate. If shareholders are able to include competing nominees against the management candidates in the company's proxy materials, shareholders as voters will have a true alternative, and therefore the chance to veto when the circumstances are right. Management candidates would need to receive more votes than a competing nominee, and the number of shareholder votes against them would matter. The nomination proposals therefore made more meaningful the shareholders' right of veto that they have in theory, but not in practice, under current law.

To honor the negative preferences of shareholders, corporate democracy should permit shareholders to effectively veto some meaningful level of management discretion with which they do not agree.²²³ That is, even under Stephen Bainbridge's most skeptical account, shareholder voting must serve at least as "an accountability device of last resort" that can be exercised effectively in practice, if shareholder voting is to be useful at all.²²⁴ Where management nominees run unopposed under plurality voting rules, shareholders have virtually no ability to impose any accountability or exercise the necessary veto power.²²⁵ If shareholder interests in corporate governance are primarily negative preferences at their heart, then shareholders may desire stronger mechanisms for veto oversight on matters they already vote on but have little practical veto power over.²²⁶

The D.C. Circuit, however, enjoined SEC implementation and enforcement of its amendments to Rules 14a-8 and 14a-11 in *Business Roundtable v. SEC*.²²⁷ The decision found that the SEC acted arbitrarily and capriciously, in violation of the Administrative Procedure Act, in failing to consider adequately the economic

223. See, e.g., Bainbridge, *supra* note 86, at 1750 (acknowledging that shareholder voting is useful, perhaps necessary, as a means of enforcing the norm of shareholder wealth maximization); Strine, *supra* note 46, at 1762 ("These constraints—that stockholders approve certain important transactions such as mergers [and] vote for directors annually . . . are vital.").

224. Bainbridge, *supra* note 86, at 1750.

225. Under a simple plurality voting rule, shareholders elect directors with only a plurality of the eligible votes either present or represented by proxy at the shareholder meeting and entitled to vote. See Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 904–05 (1993) (explaining how plurality voting rules thwart shareholder efforts to vote down management nominees).

226. Robert Thompson and Paul Edelman propose that shareholder approval should be required for transactions that are the financial equivalent of mergers, such as triangular mergers and acquisition of assets. See Thompson & Edelman, *supra* note 11, at 170, 173–174. Expansion of the shareholders' right of veto is consistent with what they call the "error correction" role of shareholders, without increasing the shareholders' affirmative powers of initiation. See *id.*

227. 647 F.3d 1144 (D.C. Cir. 2011).

consequences of the amendments pursuant to federal law.²²⁸ The amendments, by expanding shareholders' access to the company's proxy materials, would have increased the number of contested board seats and generate company expense to the degree that management chose to oppose shareholder nominees through active solicitation and campaigning for its nominees. These costs would be minimized, according to the SEC, by the fact that shareholder access to the company's proxy would be limited under the amendments to shareholders with sufficient stake in the company such that frequent or wasteful nominations would be unlikely.²²⁹ Any costs from frequent or wasteful nominations, the theory for the amendments went, should be offset by shareholder gains in spurring board performance through better incentives and membership. That, of course, is the theory for encouraging shareholder nominations adopted by the SEC. However, in light of what the court viewed as "admittedly (and at best) 'mixed' empirical evidence," the court ruled that the SEC had not sufficiently supported its judgment that shareholder nomination through expanded proxy access would "result in improved board and company performance and shareholder value."²³⁰

The D.C. Circuit penalized the SEC for the relative lack of existing empirical research on shareholder nominations through greater proxy access.²³¹ The court acted on its concerns about encouraging shareholder nominations, siding with the Business Roundtable, in the absence of powerful evidence in either direction.²³² There is evidence that the SEC proposals were valued by the financial markets for their potential to improve company performance and shareholder value.²³³ The SEC announced in October 2010 that it would be forced to delay implementation of its proposals as a result of the *Business Roundtable* litigation.²³⁴ The announcement provided a natural experiment that revealed the degree to which the markets valued the SEC proposals' effect on affected companies.²³⁵ Bo Becker, Daniel Bergstresser, and Guhan Subramanian found that firms with substantial institutional ownership, the companies likely to be most affected by the SEC proposals, lost market value following the announcement.²³⁶

As the market response suggests, the SEC's proposals need not burden companies and board management as much as the D.C. Circuit feared in *Business Roundtable*. Of course, the board would still present its nominees, and an overwhelming amount of the time, those nominees will win board seats whether the

228. *Id.* at 1156.

229. *Id.* at 1150.

230. *Id.* at 1151.

231. *Id.* at 1150.

232. *Id.* at 1151.

233. See Becker et al., *supra* note 15.

234. *Id.* at 2–3.

235. *Id.* at 3.

236. See *id.* at 3–4; see also Jonathan B. Cohn, Stuart L. Gillan & Jay C. Hartzell, *On Enhancing Shareholder Control: A (Dodd-) Frank Assessment of Proxy Access* (Dec. 7, 2012), available at http://papers.ssrn.com/so13/papers/cfm?abstract_id=1742506 (reaching similar conclusions in looking market reaction to several SEC announcements relating to its proxy access proposals). But see Thomas Stratmann & J.W. Verret, *Does Shareholder Proxy Access Damage Share Value in Small Companies?*, 64 STAN. L. REV. 1431 (2012) (finding negative returns for small firms covered by the SEC's proxy access rule).

election is contested or not. Any competing candidates nominated separately by shareholders would need to win a plurality of votes from voters who tend in the normal course to be rationally ignorant about company specifics and reluctant to deviate from the board's recommendations. The important effect of the SEC proposals would have been that unhappy shareholders would have had a meaningful outlet for their dissatisfaction when they were not pleased with company performance. They would have had the option of voting for someone else, namely the shareholder's nominee, and thus had the opportunity for a real veto that they almost never possess in board elections.

Majority voting rules for board elections serve a similar purpose in reinforcing shareholders' negative preferences. They require director candidates to receive at least a majority of eligible shareholder votes for election to the board.²³⁷ Under the traditional plurality rule, even if every shareholder vote but one is withheld—that is, not cast for the lone candidate as the only available signal of disapproval—the board's candidate still will be elected. The requirement that uncontested candidates receive at least a majority of shareholder votes cast helps unhappy shareholders to veto the election of disfavored candidates.²³⁸ For this reason, Senator Charles Schumer included a mandatory majority voting rule in his "Shareholder Bill of Rights," introduced in May 2009 just ahead of the SEC proposals.²³⁹

Majority voting rules, in fact, have their roots in earlier shareholder movements to withhold votes from underperforming boards purely as an expression of negative preference.²⁴⁰ Withholding votes from a nominee running in an uncontested election had little formal consequence under plurality voting rules, but institutional investors nonetheless hoped that withholding votes from board candidates would publicly signal some critical mass of shareholder discontent. Withholding votes offered a way to communicate a negative preference, where no other avenue for shareholder negative expression and veto was available, that might prod the incumbent board into greater responsiveness to shareholder concerns. If nothing else,²⁴¹ majority voting rules offer an outlet to highlight such lack of support for candidates by denying majority approval.

237. See Bebchuk, *supra* note 2, at 702; Velasco, *supra* note 53, at 641–42. A number of major companies have adopted instead by law or charter a modified plurality rule that requires directors to proffer their resignation if they receive less than a majority of votes.

238. See generally Razzouk, *supra* note 71 (discussing the "majority vote movement" in corporate law).

239. Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. § 5(4)(A) (2009).

240. See J.W. Verret, *Pandora's Ballot Box, or a Proxy With Moxie?: Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1007, 1012–18 (2007) (describing the early withhold vote campaigns by institutional investors); Grundfest, *supra* note 225 (proposing that dissatisfied shareholders should "just vote no" as an expression of disapproval for directors of underperforming companies).

241. A significant practical problem with proposals for a majority voting requirement is that, under the default holdover rule, incumbent nominees who fail to receive majority approval would nonetheless be likely to continue in office until a new nominee, one who is able to garner majority approval, is elected as replacement. For this reason, some commentators conclude that majority voting provisions are "smoke and mirrors" in practice. William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 486–89 (2007).

Again, majority voting rules need not extend the scope of shareholder involvement in company affairs when applied only to situations where shareholder approval is already required. Majority voting rules do not provide shareholders new opportunities to propose new courses of action or interfere with the daily operations of the company. They mainly offer shareholders greater opportunity to veto the board's nominees in those limited circumstances when the shareholders are sufficiently dissatisfied to act against the board. What is more, the swift adoption of majority voting rules by so many companies in recent years suggests that shareholder demand for this type of limited reinforcement of shareholder veto rights has increased.

Of course, there remains considerable room for debate about the optimal level of shareholder oversight and opportunity for veto. None of this dictates the precise amount of shareholder leverage over the board that would be optimal for maximizing shareholder value. In Bebchuk's view, almost any empowerment of shareholder activism is a move in the right direction because the balance of power is swung so harmfully in the direction of board autonomy under current law. In the view of Bainbridge, Lynn Stout, and other opponents of shareholder activism, almost any empowerment of shareholder prerogatives is a move in the wrong direction. They view any increase in shareholder leverage over the board as a threat to centralized management in the best interests of the company.²⁴² These two sides, proponents and opponents of shareholder activism, stand far apart in their views.

However, an emphasis on shareholders' negative preferences and veto rights comes closer to addressing the concerns of both sides. Shareholders as a class can effectively exercise their negative preferences, without excessively interfering with management, only if their option of negative veto has some teeth. Only shareholders with even more vehement objections to board decision making must sell their shares.

C. Shareholder Rights of Initiation Versus Shareholder Voting as Veto

A final lesson from an understanding of negative preferences is a distinction between reform that effectuates shareholders' affirmative preferences and shareholders' negative preferences. On one hand, as I describe above, shareholder voting power could be increased by reinforcing their rights of oversight and veto over the board. There may be need to reinforce shareholder power, and expand it, but to do so mainly by bolstering the shareholders' familiar veto rights, which effectuate only negative, not affirmative, authority. On the other hand, shareholder voting power could be increased by providing greater ability for shareholders to effectuate their affirmative preferences over company policy through new rights of initiation. Such reforms would not only increase shareholder control but would do so by expanding shareholder prerogatives beyond the usual shareholder veto, and instead look more squarely to shareholder affirmative preferences about the best paths for the company, irrespective of management direction.

Most prominently, Lucian Bebchuk advocates "[i]ncreasing shareholder power to intervene" affirmatively, giving shareholders the power "to initiate and vote on

242. See *supra* Part I.B.

proposals regarding specific corporate decisions.”²⁴³ The shareholder veto “does not help shareholders to effect changes when the board prefers the status quo,” nor does it “secure the arrangement that would best serve shareholder interests.”²⁴⁴ Bebchuk proposes reforms that would expand shareholder power beyond effectuation of negative preferences to the direct effectuation of affirmative preferences through rights of initiation. For instance, Bebchuk proposes that, subject to certain conditions, shareholders be empowered to initiate “rules-of-the-game decisions” to amend the corporate charter or reincorporate in another state, in addition to “game-ending” decisions, and “scaling-down” decisions.²⁴⁵ Bebchuk therefore suggests that shareholders be permitted to override management discretion over fundamental affirmative decisions, such as putting the company up for sale, beginning a process of dissolution, distributing dividends, and accepting particular merger or consolidation proposals offered by a bidder—all decisions currently entrusted to management’s exclusive initiation.²⁴⁶

Other proposals are less sweeping but similar in their affirmative spirit. Even before Bebchuk, Robert Thompson and Gordon Smith had earlier proposed that shareholders be able to “initiate action that would put the company up for sale.”²⁴⁷ Along similar lines, Julian Velasco proposes that shareholders be authorized to initiate an auction of the company by a majority vote of outstanding shares.²⁴⁸ Shareholders would be able to demand that the board sell all the company’s shares or assets to the highest bidder. For his part, Lawton Hawkins proposes that, as a response to excessive executive compensation, shareholders be empowered by bylaw to appoint nonexecutive compensation representatives.²⁴⁹ The three largest eligible shareholders of the company would gain the power to appoint a representative who would act at their direction on all compensation committee meetings and all board of directors meetings that concern CEO compensation.²⁵⁰

These proposed reforms seek to grant shareholders a different kind of prerogative than reforms that seek mainly to reinforce a shareholder veto. Such a change would more clearly alter the traditional split of authority between shareholders and management, and it is useful to distinguish between this move and efforts simply to reinforce shareholder veto rights with reference to the different type of shareholder preference they seek to effectuate. Rights of initiation by shareholders represent a more direct intrusion on management’s centralized control and unique expertise regarding company affairs. As such, proposals such as Bebchuk’s are motivated by a vision of shareholder voting directed toward shareholders’ affirmative preferences over the best course of action for the company, rather than a simple veto over management discretion. To the point,

243. Bebchuk, *supra* note 12, at 836.

244. *Id.* at 838.

245. *Id.* at 837.

246. *Id.* at 895–907.

247. Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers*, 80 TEX. L. REV. 261, 308 (2001).

248. Velasco, *supra* note 53, at 669–72.

249. Lawton W. Hawkins, *Compensation Representatives: A Prudent Solution to Excessive CEO Pay*, 72 BROOK. L. REV. 449, 470–87 (2007).

250. *Id.* at 473.

Bebchuk's major concern about the negative structure of shareholder voting is that "veto power does not help shareholders to effect changes" and "would not secure the arrangement that would best serve shareholder interests."²⁵¹

Of course, there are times when shareholders may wish to override management's discretion in value-enhancing directions that management, for self-interested reasons, would otherwise oppose. Here, a wider and more far-reaching range of shareholder rights of initiation might be attractive. What is more, the opportunity for motivated shareholders to propose affirmative actions by the corporation under Bebhuk's proposal might put before the shareholders more value-enhancing options that the shareholders might happily embrace, even if they would not have invested the resources to develop as a collective. Shareholders might then have greater ability to approve value-enhancing measures that would otherwise be discouraged by current law and blocked by management efforts.

However, it is important to underscore the difference between stronger rights of oversight and veto aimed at negative preferences on one hand, and Bebhuk's proposal for rights of initiation on the other hand. Bainbridge argues that "giving investors [the] power of review differs little from giving them the power to make management decisions in the first place."²⁵² But there are important differences in the (i) degree of ex ante interference with management direction and (ii) the informational demands on shareholders as voters.

First, rights of initiation do more than simply require management to obtain some requisite level of ex post shareholder consent for their decisions. They permit shareholders to direct the company in the first instance toward choices that the management opposes, and they tend to require extensive efforts from some initiating shareholder who is likely to emerge only because her economic motivations diverge from the average shareholder's interests. By contrast, oversight through negative veto should pose less interference with the benefits of centralized board management than the affirmative rights of initiation that Bebhuk proposes. Rights of negative veto can be structured such that shareholders as a class are presented with binary choices that require little more than a single-shot ex post decision on an agenda shaped largely by management. This economy of decision making allows shareholders to delegate operation of the company to specialized management, but retain some meaningful check on management necessary in light of the inherent agency problem in corporate governance. The negative structure of shareholder voting better negotiates this tension between managerial discretion and accountability that Bainbridge and others identify.

Second, proposals for new rights of initiation by shareholders present a materially different framework for shareholder voting. As I have explained, the veto structure of shareholder voting conforms to the preferences of shareholders. Shareholders generally limit their decision making to whether to veto management in a simple binary choice—for any action recommended by management, shareholders' usual deference to management is guided in large part by their standing opinion of management. Beyond these management proposals, the only voting matters that garner serious consideration from shareholders pertain to

251. Bebhuk, *supra* note 12, at 838.

252. Bainbridge, *supra* note 5, at 626.

corporate governance measures about which shareholders, particularly institutional shareholders, tend to have their own standing opinions. As Brett McDonnell explains, shareholders are “likely to be rather well-informed on such issues” because “many corporate governance issues . . . are likely to arise at many different corporations, raising the same general questions at each.”²⁵³ In other words, shareholders are able to decide almost every question of shareholder voting under current law based largely on their standing opinions about management and well-established corporate governance measures such as de-staggering boards and poison pills.

By contrast, wider rights of initiation for shareholders potentially complicate this neat economy of decision making. For example, Bebchuk’s proposal would empower a qualified shareholder to propose putting the company up for sale, or begin a process of dissolution, among other things.²⁵⁴ To decide how to vote on such matters, shareholders can again refer to management’s position on the question, but when shareholder proposals go beyond established measures of corporate governance, shareholders need more information to evaluate such questions of business strategy on their substantive merits. On such questions, as critics of shareholder voting reform argue, shareholders do not enjoy any informational advantages over management. Nor are shareholders as easily able to fall back on their heuristic judgments about the proposers’ credibility. Shareholders are unlikely in these cases to know much about the proposing shareholders’ competence or motivations, relative to what they know about management. Shareholders may need instead to engage in the open-ended inquiry necessary to determine one’s affirmative preference about the company’s best course of action.

None of this is necessarily to say conclusively that Bebchuk’s proposal, nor other proposals for wider rights of initiation by shareholders, are bad ideas. Such approaches may be useful, but they complicate the usual economy of decision making by shareholders. They require judgments from shareholders about not only management, but assessments of their fellow shareholders’ credibility and motivations across a wide range of potential issues. Rights of initiation diverge from the usual strengths of shareholder voting as veto and require more difficult judgments. Bebchuk’s proposal would present voting decisions that are at least as complicated as the most difficult judgments that shareholders currently make, and at their most complicated, much more difficult judgments than shareholders currently make. Shareholders would need to develop something closer to affirmative preferences and therefore would need better information, or at least alternative heuristics that can be cheaply and reliably acquired. In this sense, rights of affirmative initiation for shareholders represent a bigger break from the usual understanding and practices of shareholder voting.

253. Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 242 (2005).

254. Bebchuk, *supra* note 2.

CONCLUSION

The lasting value of understanding shareholder voting as veto is a re-orientation of the debate about shareholder voting. This active debate, as it always has been, pits those who desire a higher quantum of shareholder influence against those who fear any increase of shareholder influence over corporate management. This Article argues that the shape of shareholder influence through shareholder voting matters as much as its quantity. Shareholder-voting reform that builds upon this model of shareholder voting as veto offers the most certain path to balancing the basic tension between shareholder oversight and an efficient norm of management of discretion. The insights of shareholder voting as veto provide a useful model as pressure builds for shareholder-voting reform and as new iterations of reform become politically viable as never before, particularly at the federal level.