

**CORPORATE DEMOCRACY –
WHAT IT IS, WHAT IT ISN'T, AND WHAT IT SHOULD BE**

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The term “corporate democracy” is widely invoked by shareholder activists and others as a justification for change in the way we select directors of public corporations and the power we vest in those directors once we elect them.² It is also a concept heralded by the courts as a justification for the extensive power given to directors under state corporate law.³ Understandably, in a political society founded upon democratic principles and ideals, there is a natural tendency to analogize and even to seek to export those concepts to the governance of business corporations. However, since nations and business corporations are fundamentally

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² See, e.g., Stephen Deane, The ISS Institute for Corporate Governance, *Majority Voting in Director Elections: From the Symbolic to the Democratic*, at 1 (noting that advocates who favor majority voting in director elections view the issue as a “question of democratic principle” and, if implemented, majority voting “would transform the current symbolic process, in which shareholders can withhold their votes but cannot vote against directors, to a democratic and meaningful election”), available at <http://www.issproxy.com/pdf/MVwhitepaper.pdf>; Lucian Arye Bebchuk, *The Case For Increasing Shareholder Power*, 118 HARVARD L. REV. 833, 850 (Jan. 2005) (arguing that U.S. corporation law should “distance itself” from viewing the modern corporation as a “purely representative democracy,” and advocating reforms that would allow stockholders to unilaterally adopt charter amendments to dictate a company’s course of action on certain governance issues and important business decisions).

³ See, e.g., *Blasius Indus. Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (“The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”); *MM Companies, Inc. v. Liquid Audio*, 813 A.2d 1118, 1127 (Del. 2003) (“Maintaining a proper balance in the allocation of power between the stockholders’ right to elect directors and the board of directors’ right to manage the corporation is dependent upon the stockholders’ unimpeded right to vote effectively in an election of directors.”).

different, to do so in a blanket and unconsidered fashion poses real dangers to corporations as long-term creators of wealth. Understanding those differences is a first step to understanding what a sound definition of corporate democracy should be.

A Comparative Overview Of The Key
Elements of U.S. Political And Corporate Democracy

Having taken only the obligatory introductory undergraduate courses in political science, I do not profess to any general expertise in the field of political democracy. However, common sense and a lifetime of citizenship in the United States permits one to observe some fundamental comparative facts underlying our political system as compared to the corporate governance system. First, by its nature the voting public is much more stable than the corporate electorate. While each year some new citizens are naturalized or come of voting age and existing citizens die or occasionally lose their citizenship, by and large the national electorate varies little from election to election. By contrast, millions of shares of corporate voting stock are traded for short- or long-term gain (or loss) every day, such that corporate “citizenship” changes dramatically from election to election. I submit that this fundamental fact, by its very nature, tends to promote a shorter term view and a certain comparative level of disinterest in the corporate electorate as compared to registered voters in the political electorate, who cannot enter or exit so freely from citizenship and, by definition, are essentially in the game for a long-term voting lifetime.

As both a citizen and an occasional investor with more than a passing interest in corporate governance, I know that I give much more thought to how I will cast my political vote every two years than how to fill out one of the many proxy cards that come across my desk every proxy season, whether or not contested. I cannot imagine that my reaction is atypical of the individual investor. This is explained in part by the attention overload of being a “citizen” of

many corporations at the same time, and in part by the principle, articulated by others, that as the ability to “exit” a relationship increases, the need for and use of “voice” to influence the relationship decreases.⁴

Arguably, the disinterest level is even greater among institutional investors. Such investors, who include government pension funds, labor unions, corporate pension funds, mutual funds, insurance companies and bank trust departments, hold more than 60% of the voting shares of major U.S. corporations.⁵ Some do not hold a particular stock long enough to truly engage in governance issues pertaining to a particular corporation. In sharp contrast to the intensely personal nature of voting rights in the political realm, many are not the ultimate “owners” of the stock they hold and therefore may lack incentives to vote as a true owner would.⁶ And, as a practical matter, many institutional investors do not see corporate governance as a profit center meriting the investment of time and effort required to make informed voting decisions.

⁴ See Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street*, 73 TUL. L. REV. 409, 449 (Dec. 1998) (citing Albert O. Hirschman, *Exit, Voice and Loyalty: Responses to Declines in Firms, Organizations and States* 40 (1970)).

⁵ Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 9-10 (Nov. 2004) (assembling data on institutional holdings).

⁶ This phenomenon has been characterized as a “separation of capital from capital.” See, e.g., William T. Allen and Leo E. Strine, Jr., *When the Existing Economic Order Deserves a Champion: The Enduring Relevance of Martin Lipton’s Vision of the Corporate Law*, 60 BUS. LAW. 1383, 1390 (Aug. 2005). Two scholars have also questioned the extent to which state law and regulatory authorities may rely on the assumption that stockholders exercise their voting rights to enhance the value of company stock because hedge funds and the holders of derivative securities, among others, may actually vote in a manner adverse to one company’s interest in order to enhance other financial interests personal to that investor. Henry T.C. Hu and Bernard S. Black, *Hedge Funds, Insiders, and Decoupling of Economic and Voting Ownership in Public Companies* (Draft: Jan. 6, 2006), available at <http://papers.ssrn.com/abstract=874098>.

It is this latter phenomenon which has given rise in the corporate election arena to proxy advisory firms such as ISS and Glass, Lewis and Co., which develop voting positions and pass them on as recommendations to their institutional investor clients. The long-term significance of this relatively recent form of outsourcing is not yet fully understood. At one level, these institutions can be loosely analogized to political parties which prepare platforms and recommend to their members how to vote. On the other hand, they can also be viewed as potentially powerful, unregulated, private institutions with no real analog in the public voting sector, and not clearly answerable to anyone. As just one example of the expanding policy role of those new institutions ISS, which on its website characterizes itself as “the world’s leading corporate governance thought leader,”⁷ has taken a clear leadership position in driving and shaping the ongoing debate as to whether directors should be elected by a majority as distinguished from a plurality voting system.⁸

Yet another distinguishing feature between the two systems is the frequency of elections. In the national system, we elect our congressmen every two years, our President every four, and our senators every six on a staggered basis. In the corporate world, we hold an election every year for every seat in what is essentially a unicameral board, unless the board is staggered, in which case one-third of the directors are elected each year. Whether staggered or not, corporate elections occur much more frequently, also injecting a shorter term perspective into the system, while at the same time imposing upon the electorate, already faced with multiple

⁷ See <http://www.issproxy.com/governance/index.jsp>.

⁸ See, e.g., Deane, *supra*; ISS, *Majority Elections: Questions and Answers on ISS 2006 Voting Policy* (Dec. 2005), available at <http://www.issproxy.com/pdf/FAQMVPolicy2006.pdf>.

elections as a result of stockholdings in multiple corporations, with an added decision-making burden.

It is also worth taking a moment to compare the two systems in terms of the role assigned to elected officials versus directors. At least if one compares the national system with the corporate governance system, there are more similarities than differences. Leaving aside the extreme remedy of impeachment and the corporate analog of removal for cause, once elected, a congressman or senator is free to vote his or her conscience, with the only restraint being the need to face the voters again in two or six years. Similarly, unless managerial power and responsibility is granted to other persons pursuant to the certificate of incorporation, directors are by statute vested with the right and obligation to direct the management of a corporation, as distinguished from shareholders.⁹ The significant difference is that directors are subject to

⁹ See, e.g., 8 *Del. C.* § 141(a) (specifying that a corporation shall “be managed by or under the direction of a “board of directors”). The recent lower court decision in *Unisuper Ltd. v. News Corp.*, 2005 WL 3529317 (Del. Ch. Dec. 20, 2005), to the extent it suggests that directors are agents of stockholders and are bound to act in accordance with shareholder instructions, is contrary to Delaware Supreme Court authority, has subsequently been limited, and should be disregarded. See *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1291 (Del. 1998) (“One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation”); *Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. 1990) (stating that a “basic principle of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation”); *Adams v. Clearance Corp.*, 121 A.2d 302, 305-306 (Del. 1956) (stating that it is “well settled” that “directors may not delegate their duty to manage the corporate enterprise” and that the “general rule forbidding the directors to delegate managerial duties applies as well to a delegation of a single duty as to the delegation of several or of all duties”); *Paramount Communications, Inc. v. Time Inc.*, C.A. Nos. 10866, 10670, 10935, 1989 WL 79880, at *30 (Del. Ch. 1989), *aff’d*, 571 A.2d 1140 (Del. 1990) (“The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares.”); *Unisuper Ltd. v. News Corp.*, 2006 WL 207505 (Del. Ch. Jan. 20, 2006) at *3 (characterizing earlier opinion’s reference to agency law principles as having been utilized only to “illustrate by analogy the gap filling nature of fiduciary duties”). See generally Deborah DeMott, “Shareholders as Principals,” *Key Developments in Corporate*

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fiduciary duties to the corporation they serve and all of its shareholders, such that they are potentially exposed to personal liability for monetary damages in a direct or derivative action for decisions made in breach of their duty of loyalty or for actions taken in bad faith.

Finally, in the political system there are two major parties, each of which vets potential candidates in a nominating process, both at the state and federal levels, and then raises large sums of money to promote the candidacies of the nominees. There is no counterpart in the corporate election system. Instead, the corporation's slate is nominated by a committee of the incumbent board. In the rare case when one or more investors choose to run a competing slate, the cost is borne by those investors, and the incumbents are financially supported by the corporate treasury. While some criticize this as unfair, any proposal for change to more closely emulate the political system should take into account that the present system is in place because, absent a permanent party structure to support competing slates, it would be unrealistic to expect incumbent directors campaigning for a part-time job to finance their own reelection, and there is insufficient interest in the corporate electorate to create a funding mechanism for insurgent candidates, a market reality which counsels against artificial corporate subsidization to create contests where none presently exist.

The Role Of Corporate Elections In Disciplining Directors

The principle thesis of this article is that, whether characterized as corporate democracy or simply "the way we do things," the present system of corporate governance is

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Law and Equity: Essays in Honour of Professor Harold Ford, Ian Ramsay ed., Sydney, Butterworths, 2001 available at <http://ssrn.com/abstract=275049>; RESTATEMENT OF AGENCY (SECOND) § 14C ("Neither the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members").

sufficiently robust to support the role which legislators and the courts have assigned to directors and that the very imperfect political democracy analogy described above provides no basis to argue for fundamental change in the director election system or a reallocation of power from directors to shareholders. In advancing that thesis, I exclude the current debate as to whether directors in an uncontested election should be elected by a majority as distinguished from a plurality vote.¹⁰ However that debate resolves itself will not satisfy those who rely on the political democracy analogy to encourage “reforms” designed to increase the number of contested corporate elections.¹¹

The present corporate election system, divorced from the political democracy analogy, is best viewed as a two-part exercise conducted every year, rather than every two, four or six years as in the political system. First, in a system analogous to a successor trustee model, incumbent, non-employee board members sitting on a nominating committee select a director slate. Were this the only step in the process, coupled with some level of judicial oversight, and a reserved right of stockholders to remove directors, it would not be inherently wrong and, assuming a requisite level of independence on the part of the decision-makers, could on a clean slate be viewed as a reasonable way of governing a business entity without more. Indeed, recent reforms have sought to invigorate this stage of the process both by assuring the independence of

¹⁰ For a recent summary of the history of that debate, see Preliminary Report of the Committee on Corporate Laws on Voting By Shareholders for the Election of Directors (Jan. 17, 2006), available at <http://www.abanet.org/dch/committee.cfm?com=CL270000>.

¹¹ See, e.g., *AFSCME Plan 2006 Shareholder Proposals: Board Accountability Needed to Reign in Excessive Executive Pay* (Dec. 7, 2005) available at <http://afscme.org/press/2005/pr051207.htm> (announcing shareholder proposals both for majority voting for directors and for recouping solicitation expenses in proxy contests that do not seek board control); Deane, *supra*, at Appendix at iv (“majority voting represents the next step in the evolution of director elections from the symbolic to the democratic”).

the nominating committee¹² and by exposing the work of the nominating committee to public scrutiny.¹³

Second, the slate proposed by the nominating committee is presented to shareholders, in each case with the theoretical opportunity for shareholders to field a competing slate. That no such slate is normally put forth does not, I submit, make this system unworthy of respect as legitimizing the election of board members. When economic circumstances clearly dictate that assets are being undermanaged, both the tender offer and proxy contest have been historically available to effect change instigated by someone who believes they can better manage a company. With the dramatic increase in focused capital available in the hands of hedge funds and other private equity enterprises, that potential means of changing corporate management and policy is becoming more rather than less real. Moreover, even in the absence of a contest, the annual meeting together with dissemination to stockholders of the proxy statement associated therewith constitutes a significant transparency event. Finally, if the broader investor marketplace (as distinguished from narrower interest groups) truly demanded an across-the-board increase in contested elections, institutional investors could, with a minute percentage of total invested capital under management, create a fund to be used to subsidize selected contest activity. To my knowledge, no steps have been taken in this direction. In short, the annual nominating process, the director monitoring provided by the class and derivative

¹² See N.Y. STOCK EXCHANGE MANUAL, § 303A.04 (requiring listed companies to have a nominating or corporate governance committee “composed entirely of independent directors”); NATIONAL ASSOCIATION OF SECURITIES DEALERS INC., Rule 4350(c)(4) (requiring director nominees to be selected or recommended by either “a majority of the independent directors” or by a committee “comprised solely of independent directors”).

¹³ Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Republication, 68 Fed. Reg. at 69,204. For a concise summary of these requirements, see Karmel, *supra*, at 12.

litigation threat, the reputational pressures of the marketplace, and the availability of the proxy contest mechanism broadly define a regime of “corporate” democracy which does not require an increase in contested elections to be legitimate.

On the other hand, non-market driven stimulants to contested director elections, such as requiring corporations to subsidize insurgent slates, carry with them a broad range of risks to corporate wealth creation. First, the general level of investor disinterest in the election process discussed at the outset of this paper creates a risk of uncertain dimension that such elections would provide leverage to activist special interest groups within the larger and largely disinterested shareholder electorate, permitting them to impose their agenda on the broader shareholder base. Second, the short-term view of a large segment of the electorate may result in additional and undesirable pressures upon management to maximize short-term gains at the expense of long-term wealth creation. Third, such a “reform,” without a concomitant and significant reduction of the frequency of corporate elections, could have the same effect. Finally, and perhaps of greatest significance, given the high disinterest level in the corporate electorate at large, such a “reform” would significantly shift agenda-setting power from directors acting under fiduciary duty restraints to some combination of activist shareholders and non-regulated intermediaries such as ISS owing no fiduciary duties, with uncertain results. I suggest that the overwhelming historical success of the existing governance system does not merit taking the risk of such fundamental change in the corporate electoral system. At the very least, we should not let those who advocate such change do so by invoking a false analogy to political democracy.