EMPTY VOTING: A LOOMING THREAT TO CORPORATE GOVERNANCE?

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Abstract

Executive Summary

This present paper seeks to establish the impact of empty voting on corporate governance. It will do so by examining the direct consequences of empty voting as well as its underlying causes. Subsequently, an analysis of the importance and role of the shareholder vote as an institution across jurisdictions will be conducted in order to properly assess the gravity of the problem. Finally, possible solutions to this problem will be examined and evaluated.

The term "empty voting" is used to describe situations where shareholders' voting rights exceed their financial interest in a company. Such instances might arise in several different ways, of which trade in derivatives seems to be the most prevalent. Furthermore, evidence suggests that it is a relatively common occurrence, especially because of the recent development in the field of financial instruments.

Empty voting is cause for concern as it threatens to undermine the shareholder vote's function as a control mechanism due to the potential misalignment of interests between the company and the voting shareholders. Seeing as shareholder voting holds a prominent position in the current corporate governance paradigm, the gravity of this problem should not be underestimated.

Instances of empty voting arising as the result of record date capture can easily be avoided by adopting a real time voting system. Other causes for this phenomenon might prove harder to combat but improved disclosure regimes might deter the underlying behavior and simultaneously provide the information needed in order to deal with the problem more effectively.

1. INTRODUCTION

Empty voting is a term used to describe situations where shareholders' voting rights exceed their financial interest in a company. In other words, their votes have (at least to some extent) been "emptied" of economic interest.[1]

There seems to be common consensus among legal scholars, politicians and economists alike that empty voting constitutes a serious threat to corporate governance. However, it is entirely possible that risk decoupling can have positive consequences as well.[2]

This paper will seek to examine the phenomenon of empty voting and establish whether it constitutes a threat to corporate governance in listed companies, and if so how it should be dealt with, by analyzing the role of and rules on shareholder voting across jurisdictions.

2. HOW AND WHY DOES EMPTY VOTING OCCUR?

Overall, the phenomenon occurs for three reasons: Firstly, because of the relatively recent development in the area of financial instruments such as derivatives and the growing importance hereof, secondly, because of the increase in securities lending and thirdly, as a result of record date capture.[3] Apparently, derivatives are the primary cause of decoupling even though borrowing shares is generally quite easy and cheap.[4][5]

An investor might benefit from risk decoupling in several ways. These include taking advantage of the disparity between the individual and collective value of votes to acquire control for a disproportionate price, circumventing disclosure rules and exploiting the company for personal gain.[6]

The latter is obviously regarded as particularly problematic from a corporate governance perspective.[7] An example of such negative economic interest could be short selling. In this scenario, an investor borrows shares before the record date and then sells

[1] Black p. 344.
[2] Mittermeier pp. 5.
[3] Mittermeier pp. 2.
[4] Black p. 356.
[5] Barry p. 4.
[6] Black pp. 359.
[7] ESMA p. 7.

them in the time between the record date and the vote. Consequently, the investor retains voting rights but has a negative economic interest in the company, as it would be cheaper to fulfill the obligation of returning the shares to the lender if the stock price decreases.[8]

A real life example is that of Mylan Laboratories and Perry Hedge Fund. The hedge fund had a significant economic interest in a merger between Mylan Laboratories and King Pharmaceuticals and made use of equity swaps to gain voting rights in Mylan without the normally attached risk of a drop in share value.[9] This case of merger arbitrage provides us with an example where the interests of the company and the voter are not necessarily aligned.

3. WHY DOES THIS POSE A THREAT TO CORPORATE GOVERNANCE?

Empty voting is generally thought to give rise to problems concerning transparency of voting structure, corporate governance and the market for corporate control.[10]

The shareholder vote undoubtedly plays an important role in corporate governance. Theoretically and traditionally, shareholder voting was meant to ultimately place the power in the hands of the owners who presumably had a positive economic interest in the company.[11] The connection between voting rights and economic ownership is therefore a prerequisite for the current corporate governance paradigm, a prerequisite that might no longer exist following the increase in risk decoupling.[12]

Shareholders have binding votes on the election and dismissal of directors and in ratifying fundamental corporate changes. The shareholder vote thus helps shape governance structure, increase accountability by managers and directors to shareholders and generally safeguard the functioning of the company.[13] [14]

In other words, the primary function of shareholder voting is to ensure good management along with adaptability and flexibility in a dynamic corporate reality. A

[8] Clottens p. 450.
[9] Neville & Black pp. 348.
[10] ESMA pp. 6.
[11] Black p. 344.
[12] Black p. 363.
[13] Thompson pp. 130.
[14] Nathan p. 1.

disruption in this balance therefore threatens to undermine the good functioning of companies.[15]

Accordingly, the rationale behind shareholder voting is that it can be used as a disciplinary tool, which is based on the assumption of a correlation between control rights and financial interest in the value of the company. Based on the development in the US corporate landscape in the 70's and 80's, shareholder control is crucial as a disciplinary tool as the "original" separation between control and ownership – between managers and shareholders – led to poorly governed companies due to managers' lack of financial interest in the good functioning of the company.[16]

Consequently, the decoupling of economic exposure from company control risks undermining the institution of shareholder voting itself as it would be lacking the theoretical basic assumption of correspondence between company interest and shareholder interest.

In the US, shareholder interests are at the very core of corporate law. Managers are accountable to the board of directors who themselves are accountable to the shareholders. Furthermore, both groups are legally obligated to further the interest of the shareholders.[17] The rationale behind this is obviously that historically the shareholder's interest has been aligned with that of the company as the shareholder had a financial stake in the company directly proportionate to their say in the governance of the company – an approach known as the one share, one vote doctrine. In other words, this approach operates under the assumption that a shareholder has a positive economic interest in the company. However, it is entirely possible (and in fact highly likely) that empty voting gives rise to situations where the shareholder has a negative economic interest in the company. The best-case scenario (notwithstanding possible acts of altruism) would probably be if the empty voter refrained from voting as a result of having no economic interest in the company even though this might also constitute a problem in regards to for example qualified majority voting. The same problem would arise if the voting rights were to be suspended. Not voting would also distort the general voting power[18] and be counterproductive in terms of corporate governance.

Generally, there is not a corresponding fiduciary duty for shareholders but under Danish law; a shareholder decision that gives some shareholders an improper advantage

[15] Mittermeier pp. 3.
[16] Blair pp. 195.
[17] Barry p. 9.
[18] Clottens pp. 472.

at the expense of the company or the other shareholders is void.[19] In Germany and in the US, shareholders do however have fiduciary duties in some instances.[20]

Furthermore, the Delaware courts have developed a test to establish the legality of vote buying based on fraudulent intent and intrinsic fairness. In Kurz v. Holbrook, the Delaware Chancery Court held that empty voting should be impermissible as far is it is detrimental to the company thus not allowing a voter to pursue a negative economic interest. The abuse of rights doctrine in France partially serves as a functional equivalent to this test. Vote buying, however, is generally not allowed in Europe.[21]

On the other hand, empty voting can theoretically have positive effects as well. This could for example be the case if active investors with a high level of insight into the operations of the company would acquire a disproportionate amount of votes in order to ensure the good functioning of the company.[22] However, this potential benefit is countered by the notion that insider entrenchment deters investors and consequently reduces company value. Furthermore, a decoupling scheme that for example employs non-voting shares, could allow the active shareholders to pursue time sensitive business opportunities as it can take a substantial amount of time to organize the collective action of shareholders. In addition, some risk decoupling regimes would allow investors to retain control while freeing up equity in order to pursue other business ventures.[23]

Moreover, it is necessary to consider the practical importance of shareholder voting. Empty voting is presumably common[24], although the reasoning behind this assumption appears rather speculative in nature as it is based primarily on analyses of the behavior of legal actors.

There is also a possibility that shareholders might have little interest in voting and that they would rather "vote with their feet" by selling their shares if they are discontent with the way the company is being run – a phenomenon known as the "Wall Street Rule".[25] This theory seems especially apt in regards to smaller investors as they have little influence individually.

The other side of the empty voting issue is that it almost inevitably also gives rise to so-called hidden owners, i.e. investors whose economic interest exceeds their control

[19] Selskabsloven § 108
[20] Clottens p. 452.
[21] Clottens pp. 464.
[22] Barry p. 6.
[23] Black pp. 356.
[24] Black p. 353.
[25] Thompson p. 130.

rights.[26] From a corporate governance perspective, one of the problems associated with this, lies in the fact that the hidden owner cannot effectively protect his investment. Another problem is that hidden ownership makes it easier to circumvent regulation on disclosure of ownership.[27] Hence, the differing and more literal definition of hidden owners by Hu and Black as owners not covered by a disclosure regime.[28]

The question that remains is if risk decoupling actually affects the performance of a company. The ISS study from 2007 concluded that that is in fact not the case.[29] However, it must be borne in mind that it undoubtedly is possible that it can and will in some instances.

4. POSSIBLE SOLUTIONS

The situation is complex and empirical knowledge is at a minimum so therefore it is hard to determine the best course of action in dealing with this problem.[30][31] Disclosure rules might facilitate the obtainment of the necessary empirical data. Disclosure could quite possibly also act as a deterrent and give investors a possibility of assessing the situation more accurately.[32]

So far, most attempts to deal with this issue have been reactionary rather than preemptive thus rendering them rather ineffective.[33]

The Transparency Directive of the European Union offers little transparency in the field of empty voting and it does especially not help disclose risk decoupling in regards to share borrowing. Generally, the European initiatives have been more centered on hidden ownership than empty voting.[34]

One of the major sources of empty voting is record date capture. Share blocking rules that bar shareholders from selling their shares in the time between the record date and the general meeting would solve the problem. However, such rules pose a threat to the financial markets and to corporate governance themselves, as share blocking would

[26] Barry p. 14 & ESMA p. 6.
[27] Barry pp. 20.
[28] Black p. 348.
[29] Neville.
[30] Black p. 353.
[31] Mittermeier p.6.
[32] Black pp. 359.
[33] Barry pp. 5.
[34] Clottens pp. 454 and ESMA p. 7.

discourage institutional investors from voting.[35] Share blocking is also banned under EU law.[36] The better option would be to set the record date closer to the general shareholders meeting or ideally make it real time as it would make it significantly harder or even impossible to make use of record date capture.[37] In this day and age, an electronic real time voting record system should be a realistic possibility.

In the area of derivatives and securities, Barry, Hatfield and Kominers argue for an intricate, mandatory disclosure regime for ownership, which would only allow for decoupling in situations where it would be beneficial for society.[38] This appears to be an excellent idea in theory but it is uncertain if it is feasible in reality.

A situation that gives rise to similar issues is the A and B share system, which is not widespread in the US[39] but very common in especially the Nordic countries. An attempt to deal with the decoupling of risk relating to these instances was made with the take-over directive. However, the initiative was not well received.[40] It is possible that this - combined with the other general tendencies outlined in this paper - can be interpreted as highlighting a difference in the fundamental approach to shareholder democracy between the US and Europe. It appears as if shareholder democracy is generally not perceived as being as essential for corporate governance in Europe as in the US.

Another way to deal with empty voting is simply to limit shareholder activism.[41] This is, nevertheless, a very dangerous path and should be a last resort. This is the case because it, as exemplified earlier, can lead to poor governance due to a dispersion of interests.

Alternatively, you could impose (extended) fiduciary duties on shareholders or banning negative voting.[42] [43] Such an initiative would ironically enough almost certainly meet resistance in the corporate world, as it constitutes a severe intrusion into the free market and is therefore probably not a realistic solution.

Some scholars also contemplate making it possible for the board to overrule a shareholder decision if said decision is not deemed to be in the company's best interest.[44] However,

[35] Tucker p. 1.
[36] Shareholder's directive article 7 (1)(b)
[37] Clottens p. 476.
[38] Barry p. 65.
[39] Black p. 343.
[40] Neville.
[41] Neville.
[42] Neville.
[43] Clottens p. 473.
[44] Neville.

this would fundamentally disrupt the relationship between shareholders and the board and would jeopardize the very rationale behind shareholder voting as a disciplinary measure. Furthermore, it would be extremely hard to impose and uphold such a rule in practice. This idea should therefore be dismissed.

A theoretical possibility is to ban certain transactions. Nevertheless, you should be careful in banning transactions as it can have immense consequences for the economy. Therefore, a ban on transactions that can give rise to empty voting is not a viable solution. It might also be considered disproportionate.[45]

In the US, Schedule 13 of the SEC rules provide for some disclosure of empty voting. However, the substantial lag[46] pertaining to the current US disclosure rules seems to counter their purpose, as it allows investors to "operate under the radar" in a substantial time interval. Overall, the US disclosure rules seem quite apt at disclosing empty voting and hidden ownership formed on the basis of derivatives but rather inefficient when it comes to share borrowing and lending.[47]

Black and Hu therefore suggests adopting a coherent disclosure system that covers share borrowing and lending[48], both economic and vote ownership as well as short and long-term positions[49]. Nevertheless, disclosure rules seems to primarily address the problem of hidden ownership and only to a lesser extent empty voting.[50]

Other possible solutions are to suspend voting rights or to establish a waiting period between the obtaining of shares and voting which would make empty voting generally less attractive.[51] As previously demonstrated, these approaches are not without flaws.

[45] Clottens pp. 469.
[46] Clottens p. 477.
[47] Black pp. 360.
[48] French law provides for some disclosure of share lending, Clottens p.457
[49] Such an obligation has subsequently been imposed in the US and French as well as German law already requires major investors to reveal their intentions, Clottens p. 458.
[50] Black pp. 361.
[51] Clottens p 478.

5. CONCLUSION

It is clear from the foregoing that empty voting threatens to undermine the institution of shareholder voting, which is a fundamental part of corporate governance.

It is not clear, however, how this problem should be dealt with. Disclosure rules might go a long way but they will not eliminate empty voting completely. On the other hand, they might provide legislators with the data needed to eradicate the problem. In all circumstances, the record date system should be revised and updated to avoid record date capture.

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