# Management Always Wins the Close Ones

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## Abstract:

While much has been made of the shareholder franchise as a lever of corporate governance, there is little evidence about the efficacy of voting. This paper empirically examines votes on management sponsored resolutions and finds widespread irregularities in the distribution of votes received by management. Management is overwhelmingly more likely to win votes by a small margin than to lose by a small margin. Explanations for this irregularity include management's ability to spend corporate funds on campaigning, management's superior access to information about voting outcomes, "vote buying", and selective vote counting and poll closing decisions. All of these explanations suggest that the value of voting on management sponsored resolutions is adulterated. The paper identifies several policy changes to improve the quality of the shareholder voting process.

# I. Introduction

Voting is a "fundamental shareholder right."[1] Given the importance attached to shareholder voting, (Easterbrook and Fischel 1983, Grossman & Hart 1988, Black and Hu 2006), the lack of attention to the mechanics of shareholder voting is surprising (Bethel and Gillan 2002, Kahan and Rock 2007). The heralded benefits of shareholder voting can only be realized if votes accurately reflect the preferences of shareholders. If managers can disproportionately sway close votes, then the shareholder franchise is less than it's cracked up to be.

This paper demonstrates that shareholder voting on proposals almost certainly does not reflect shareholder preferences. Instead, voting outcomes are tilted in favor of management. If voting was not tilted, then we would expect a smooth distribution of voting outcomes for two reasons. First, there is considerable noise in the outcome of a shareholder vote; second, a vote is the cumulative effect of many independent shareholder decisions-- without a coordinator there should be no "jumps" in the distribution of voting (Snyder 2006).

Voting results from the relatively small number of votes on management sponsored proposals that are competitive, however, show stark discontinuities. Management sponsored proposals (the vast majority of which concern the approval of stock options or other bonus plans) are *overwhelmingly more likely to win a corporate vote by a very small amount than to lose by a small amount*-- to a degree that cannot occur by chance. (See Figure 1.) For example, management exceeded its necessary vote requirement by less than 1% thirty three separate times in the dataset, while management

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[1] In re Gaylord Container Corp. Shareholders Litigation, 747 A.2d 71, 81 (Del. Ch. 1999).

missed the vote requirement by less than 1% only 5 times. Such a distribution should occur by chance less than 1 in 1 billion times. These results indicate strong management influence on corporate voting of some form or another. Moreover, the results are not simply due to quorum requirements and shareholder indifference. Management enjoys these stunningly high rates of victory in elections even where the number of votes against the management sponsored proposal is extremely high.

Why does management do so well? First, management chooses what issues to put forth to shareholders, so management should win more often than it loses because it will only submit proposals likely to win. But management almost always submits a definitive proxy at least 15 days before the vote is cast,[2] and it is extremely improbable that management can predict voting outcomes precisely so far in advance--many large shareholders refuse to inform management about their intended vote direction, many votes are received in the final day or days (Wilcox 2006), and the counting procedure itself introduces some noise into the voting process (Kahan and Rock 2007)-- so selection of votes likely to win does not explain the discontinuity occurring at 50%.

Management enjoys several other significant advantages in close votes that help explain the discontinuity. Management, unlike opponents of many proposals, enjoys the benefit of realtime voting updates. In addition, management can expend corporate funds and time hiring proxy soliciting companies and campaigning, while opponents must dip into their own pockets. As one industry observer put it, management and proxy firms "beat the bushes" until they can attain victory (Wilcox 2006). If heavy campaigning alone

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[2] A definitive proxy must be submitted before it is mailed and most legal advisers insist on mailing at least 30 days before the meeting. See Planning And Conducting The Annual Shareholders' Meeting, 1579 PLI/Corp 739, 767 (2006). The new e-proxy SEC regulations require proxy materials to be available online 40 days before the meeting. See "SEC Votes to Adopt E-Proxy Rule Amendments and Propose Mandatory Model," at http://www.sec.gov/news/press/2006/2006-209.htm.

is not enough, management may revert to extraordinary measures. In the hotly contested Hewlett Packard purchase of Compaq, for example, shareholders accused HP management of threatening to withdraw investment banking business from Deutsche Bank if Deutsche Bank Asset Management did not follow HP management's recommendation on the merger vote.[3]

These advantages explain why management might win close votes more often than they lose with a degree of precision better than simply choosing which votes to put in front of shareholders, but it cannot explain why management is so good at it— management and proxy firms should miscalculate at least occasionally given the noise inherent in the voting process, (as described by Kahan and Rock (2007)). Management oversight over the ballot counting procedure, such as whether to count improperly filled out proxies, may allow enough "play in the joints" to raise the probability of management victory in exceedingly close votes. Similarly, management can "adjourn" votes on a proposal if it sees that the proposal will not emerge victorious.[4] If management chooses when to close the polls, then it can win a disproportionate number of very close elections as it can simply stop counting when it attains an extremely narrow majority or continue counting when it is narrowly behind.

Delaware courts have suggested that such tilting of close votes may be a breach of fiduciary duty. In *SWIB*, the management of the Peerless corporation adjourned a close vote on the issuance of new stock related to an executive stock option plan when it

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[3] Hewlett v. Hewlett Packard, CIV.A. 19513-NC. (Del. Ch. 2002). The court did not find sufficient evidence for this claim.

[4] For example, Outback Steakhouse (OSI) recently delayed a vote on a takeover proposal for one week when it appeared that it did not have sufficient support so that "more votes could be solicited." See http://www.reuters.com/article/mergersNews/idUSWNAS030220070508.

appeared that the proposal was about to lose. [5] Management then campaigned over the adjournment period by contacting shareholders likely to vote management's way, and subsequently won the vote. In a shareholder suit, the Delaware Chancery held that these actions "frustrated the shareholder franchise" and held that it was a breach of management's fiduciary duty absent compelling justification.

Management's extremely high success rate in close votes also suggests the existence of some inefficiencies. Shareholder voting is seen as an efficient means of aggregating shareholder preferences and engendering efficient decisions (Fedderson and Pesendorfer 1997, Schwartz and Gilson 2001, Goshen 2001). If the voting outcome does not reflect underlying shareholder preferences—which will be the case if management has greater ability to drum up votes in close elections than dissident shareholders do— then the efficiency of shareholder voting is undermined.

This paper is organized as follows. Section II describes the complex mechanics of shareholder voting. Section III presents a simple model of expected voting outcomes under different conditions. Section IV presents summary statistics, while Section V presents the data revealing that management wins a disproportionate number of close votes. Section VI examines several potential explanations for these results in light of the data. Section VII proposes several policy interventions and concludes.

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[5] State of Wisconsin Investment Board ("SWIB") v. Peerless Systems Corp., 2000 WL 1805376 (Del. Ch. 2000).

## II. The Mechanics of Voting on Management Sponsored Proposals

Conducting a vote on a management sponsored resolution, such as one mandated by NYSE and NASDAQ rules on approval of stock option plans, is not a straightforward task. Most beneficial owners of a company are not registered owners (Wilcox & Purcell 2004). Instead, the registered owner is typically the Depository Trust Corporation (DTC), which owns shares under the name of "Cede & Co." In turn, the DTC holds stock in accounts for its "participants", which include large banks and brokerage firms. Beneficial owners typically arrange for the purchase of shares through these participants. Thus, there are at least two levels of intermediaries (the DTC and the brokerage or bank) between the beneficial owner and the corporation. This structure facilitates record keeping and clearing and minimizes the transaction costs of exchanging stocks (Wilcox and Purcell 2004).

The structure complicates the process of allowing beneficial owners to vote their shares, however. When management wants to alter a stock option plan, it will typically attempt to canvass the beneficial shareholders, often by hiring a proxy solicitation firm, before submitting the proposal. Management cannot obtain a precise measure of the likely vote outcome at this stage, but it can get a sense of whether there is significant opposition to a proposal (Wilcox 2006). If management gets the sense that it cannot win the proposal, it will often withdraw or alter the proposal (Roiter 2006). If management is confident it will win or strongly desires the proposal in spite of significant beneficial owner opposition, it will typically submit a definitive proxy proposal 30 days before an actual vote.

Of course, the registered owner of most of the corporation's shares is the DTC. When a proxy proposal comes to the DTC, it delegates its voting rights by submitting an omnibus proxy for all of its shares in a single corporation to its participant banks and brokerages. The banks and brokerages are then in charge of ensuring that the interests of the beneficial owners are followed. Frequently, the banks and brokerages hire ADP's Investor Communication Division to administer the process of distributing the proxy materials and tabulating the beneficial owner's votes. ADP tabulates all the votes it receives and gives a running count of the vote totals, broken down by bank or brokerage rather than by beneficial owner, to the tabulator, who is an agent of management. The votes typically come in two waves, one when the proxy materials are sent out and another very shortly before the last voting day (at the annual meeting) (Wilcox 2006).

Management should experience at least some degree of uncertainty about the vote totals before the polls close for several reasons. First, with most votes submitted at a late date (or even the last day or hour) and many managers refusing to reveal their intended vote direction (Wilcox 2006), the precise outcome of votes should be in doubt until the last moment. The Hewlett Packard case provides evidence for the existence of uncertainty. HP took "extraordinary measures" to sway the vote of Deutsche Bank, measures that ultimately provoked contentious litigation. And yet Deutsche Bank's votes ultimately proved unnecessary for HP's victory. The fact that HP took such risks suggests that management has real uncertainties about the outcome of some contentious votes.[6] Uncertainty also results from the lack of precision inherent in the voting process due to share lending and short selling, which often causes multiple parties to believe that they are entitled to vote on an issue, as well as mistakes in counting

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[6] Hewlett v. Hewlett-Packard Co., 2002 WL 818091 (Del.Ch. 2002).

Second, even after the ballots close there is noise introduced by the highly imperfect counting and aggregation procedures used in corporate voting (Kahan and Rock 2007). As one scholar has observed, "[C]orporate voting does not work. It might seem incredible but shareholder voting in developed countries is more tainted than political voting in undeveloped ones. Some shareholders' votes are counted; others are not. Many investors are permitted to vote even though they have no such right. Smart parties manipulate the voting system to their own advantage. And the total number of votes cast is often greater than the total number of shares (Partnoy 2006)." These opinions are echoed by a Delaware corporate lawyer, who notes that that in a contest that is closer than 55% to 45%, there is no verifiable answer to the question "who won?" (Kahan and Rock 2007).

## III. A Model of Corporate Voting Outcomes

To fix ideas about the expected vote distribution that will be observed given the voting mechanics described above, this section develops a simple mathematical of voting when management can expend time and money influencing the vote.

Assume that management values the passage of the proposal at $W_M$. If no proposal is passed management gets no utility.

Any proposal has a continuously distributed initial level of support $\theta \in [0,1]$. Proposals win if $\theta > .5$.

Management can attempt to convince voters to change their votes by incurring cost $c$, expenditures change preferences according to $v(c)$, where $v' > 0$ and $v'' < 0$. Post effort level of support is thus $\theta + v(c)$.[7]

Management gets a noisy signal, $\theta_M = \theta + \varepsilon$ of the underlying support for the vote, where $\varepsilon$ has a c.d.f of $F(\cdot)$ and a p.d.f. of $f(\cdot)$ with mean zero.

Management first chooses whether to conduct a vote on a proposal. Assume that if management is indifferent between conducting a vote and not conducting a vote, then it will not conduct a vote. Thus, management's minimum expected utility is 0. Subject to this constraint, management chooses its effort to maximize the following problem:

$$\max_{c \geq 0} \ W_M * \Pr(\theta > .5) - c = \max_c W_M * \Pr(\theta_M - \varepsilon + v(c) > .5) - c = \max_c W_M * F(\theta_M + v(c) - .5) - c$$
(1)

Before solving this maximization, it is useful to consider the case of no uncertainty. $\theta_M = \theta$. In this case, management exerts no effort if $\theta_M > .5$ -- it is guaranteed to win without exerting any costly effort. If $\theta_M < .5$, then, if $W_M > c^*$, management chooses $c^*$ where $v(c^*) + \theta_M = .5$. Otherwise management chooses no effort, and therefore no vote.

Under no uncertainty, this would yield the following distribution of voting outcomes. There would be no management losses. Anytime $\theta_M < .5$, management would either not hold a vote or would expend effort $c^*$ to enable a victory. There would be a large number of votes at or just above .5, representing all votes that had underlying support level of .5 and all votes that had a lower initial support level, but in which management exerted the

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[7] Note that this corresponds to a game wherein management has the last move and therefore seeks to attain the minimum level of support, in contrast to Groseclose and Snyder (1996), wherein the player exerting effort is not the final mover.

necessary effort to attain a narrow victory, creating a discontinuity at .5. Finally, there would be a continuous distribution of votes above .5, as management exerts no effort to win in these cases, so the distribution of observed votes is the same as the continuously distributed initial level of support.

Adding uncertainty, which according to most accounts reflects reality more accurately, changes the expected distribution of observed votes. Solving (1) with respect to $c$ yields the following first order condition:

$$W_M\left[v'(c)f\left(\theta_M + v(c) - .5\right)\right] = 1. \tag{2}$$

Intuitively, management exerts effort until the marginal value of that effort, represented by the value of a victory to management times the increase in probability associated with a small change in effort, equals the marginal cost of effort.

This yields a different vote distribution than the case of no uncertainty. First consider a case where, with no uncertainty $\theta_M < .5$ and $c = c^*$. Adding some uncertainty changes management's optimal effort level, as demonstrated by (2). If $W_M\left[v'(c^*)f\left(\theta_M + v(c^*) - .5\right)\right] > 1$, for example, then management exerts more effort until (2) is satisfied. (Management actually exerts less effort if the marginal value of effort is less than the marginal cost of effort.) Moreover, the amount of additional effort management expends depends upon the initial level of support $\theta_M$. Other things equal, lower $\theta_M$ leads to lower expected levels of support since $v'' < 0$, meaning that there will no universally desired expected vote outcome for all cases.

Thus, with uncertainty about vote outcomes there should be no sharp discontinuity around .5. First, the expected vote distribution should be less discontinuous than the expected vote distribution with certainty, as sometimes the expected vote after

management effort will be considerably greater than .5 (for example, if management has high $W_M$ and wants to be sure of victory even if support is less than expected). Second, the existence of uncertainty (and a continuously distributed error term) means that the observed vote distribution should be even less discontinuous than the expected vote distribution. If uncertainty is sufficient—and recall that one observer believes one obsene observer believes that the counting uncertainty is on the order of 10%-- then there should be little or no discontinuity around 50%.

The paper now explores actual vote outcomes to determine how they compare with these predictions.

## IV. Data and Summary Statistics

The Investor Responsibility Research Center (IRRC) collected data on corporate votes on shareholder proposals sponsored by management or other parties from 1997 through 2004.[8] The collected votes occurred in over 2700 different companies, including all companies in the Fortune 500 and S&P 500. The dataset includes 16,099 management sponsored proposals and 2,795 shareholder sponsored proposals.[9] Because multiple proposals (such as a stock option plan for both executives and directors) are sometimes decided with one vote, there are 12,917 unique votes on management sponsored proposals. From 1997 to 2000, there were approximately 2,000 unique votes on management sponsored resolutions per year. This number dropped each year between 2001-2004. In 2004, there were only 1,152 votes on management sponsored resolutions.

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[8] For 1991-1996 and 2005, the IRRC collected data on shareholder proposals, but not management-sponsored proposals.
[9] Proposals with missing sponsors were dropped from the sample.

This decrease may reflect the fact that it was more difficult for management to get resolutions passed in the post-Enron, post internet-bubble environment.

The most common management sponsored proposals (see Table I) concerned stock option plans for executives and directors (Martin and Thomas 2005). Proposals to adopt or amend stock incentive plans for management or directors constituted 8,056 of the 16,099 (50%) of the management-sponsored proposals.[10] Other common management sponsored proposals were proposals to increase the amount of authorized common stock (1,870 proposals, 11.6% of the sample), adopt or extend an employee stock purchase plan (1,299 proposals, 8.1% of the sample), approve a merger or acquisition (954 proposals, 5.9% of the sample), and approve long-term or annual bonus plans (936 proposals, 5.8% of the sample).

Different issues must meet different voting thresholds for approval. For example, Delaware corporate default law requires a majority of shares outstanding for a charter amendment or sale of assets to pass, but a majority of votes cast for other issues.[11] Some companies change the default law to require two-thirds or even 80% supermajorities for a proposal to pass. Companies also divide in their treatment of abstaining votes. Some count abstentions as votes against, while others do not.

Many of the votes on management sponsored resolutions in the sample, including votes on stock issuance for executives, occur because they are mandated by the listing requirements of the NYSE or NASDAQ. For the purpose of maintaining a listing, management-sponsored resolutions pass on the basis of a majority of votes cast rule.

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[10] Note that Table I describes all proposals, not all unique votes.
[11] See DGCL § 242(b)(1) (charter amendments); DGCL § 251(c) (mergers); DGCL § 271(a) (asset sales) DGCL § 216(2) (Other matters).

Pursuant to state default rules and stock exchange listing requirements, more than three quarters of the management sponsored proposals in the data (12,329 out of 16,049) used the number of ballots cast or shares present as the voting population. Of these 12,329, approximately 99% required some form of simple majority of ballots cast in order to pass. There are two types of simple majority rules. The most common rule counts abstentions as negative votes, while the other rule excludes abstentions from the vote population (the denominator).

The remaining 3,720 proposals used the number of shares outstanding as the voting population. Note that it is typically harder to achieve this standard for any given percentage requirement, since there are more shares outstanding than votes cast—some shares are not voted in every election. Of the proposals using shares outstanding as the voting population, approximately 88% required a simple majority of outstanding shares to win. The remaining proposals required supermajorities of shares outstanding to garner passage. 374 required two thirds of outstanding shares to vote in favor of a proposal to guarantee passage, while 63 required 80% of shares outstanding to vote in favor.

Table II presents mean voting outcomes for the entire sample as well as selected subgroups. The mean management proposal in the dataset received approximately 83% of votes in favor, 12% of votes against, and about 1% abstentions. These numbers do not sum to 100% because some votes are counted as a percentage of outstanding shares.[12] When the sample is divided by voting population, the mean management proposal gets about 85% favorable votes, 14% negative votes, and 1% abstentions if the voting population is votes cast. When the voting population is shares outstanding, the mean

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[12] Non-votes and abstentions constitute different categories. Non-votes are shares that never submitted proxies, while abstentions are shares that submitted proxies but declined to register a vote on the issue.

management proposal gets approximately 75% of the vote, with about 7% of ballots cast against the proposal and a negligible number of abstentions. Not surprisingly, the mean favorable percentage for management sponsored amendments is lower when the voting population is the number of shares outstanding-- the voting population is larger when it includes all shares outstanding, making it more difficult to garner a high percentage of positive votes.

Although management sponsored proposals typically pass easily, they do not always do so. About 6.5% of the management sponsored resolutions in which the voting population is the ballots cast, and 11% of management sponsored resolutions in which the voting population is the total shares outstanding, become close votes, where close is defined by winning or losing by less than 10 percentage points from the cutoff point. The vast majority (over 94%) of these proposals concern executive or director stock option plans. Close votes on management sponsored resolutions have different meanings depending on a company's voting requirement. This paper focuses on cases where the voting population is votes cast to examine issues where there is substantial shareholder opposition to a management proposal, rather than simply a lack of interest (as might be the case when the voting population is total shares outstanding).

Close votes are not randomly distributed across companies. The first row of Table III demonstrates that small companies, companies with lower governance indexes (i.e. better governed companies) (Gompers Ishii Metrick 2003), and companies with relatively high levels of institutional ownership are more likely to have a close vote than other companies.[13]

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[13] Even though a company with below median levels of institutional ownership is more likely to have a close vote than a company with above median levels, the average level of institutional ownership for firms

The next section examines these close votes in more detail and finds stark irregularities in the results of close elections.

## V. Outcomes of Close Votes

Figures 1a, 1b, and 1c display histograms of the number of votes for management sponsored proposals decided by a simple majority of votes for various ranges of votes and intervals. They all show strong discontinuities at the 50% mark—which is the minimum needed for a management sponsored proposal to pass. Figure 1a, which shows the frequency of votes that receive support between 30% and 70% support in 2% intervals, reveals that over a relatively wide range of voting outcomes, there is a clear break at 50%, with many votes receiving greater than 50% and very few votes less than 50%. There are more votes that receive between 50% and 53% of the votes than votes that receive between 0 and 50% of the vote. Other than around 50%, there are no obvious discontinuities.

Figures 1b and 1c focus more closely on votes near the 50% mark. Rather than disappearing when we look with a finer lens, the discontinuity remains, and even grows more pronounced. While there are 47 votes that receive between 50 and 51% of the vote, there are only 5 that receive between 49 and 50. The discontinuity at 50 persists even for intervals of smaller than 1% (Figure 1c), with 28 votes receiving support levels between 50% and 50.5%, while only two receive support between 49.5 and 50.

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that have close votes is higher than the average level of institutional ownership for the entire sample. If a firm has unusually high amounts of institutional ownership (in the top 10% of the distribution), it is more likely to have a close vote than the typical firm.

Using the caliper test suggested by Gerber and Malhotra, the probability of such a discontinuity occurring can be roughly estimated.[14] The caliper test assumes that the underlying distribution of voting outcomes can be modeled using the distribution of voting outcomes between 53 percent and 70 percent—all of these outcomes bring management the same result, so there is little reason to suspect a divergence between underlying shareholder preferences and voting outcomes. This distribution is then extrapolated to the area around 50 percent. The caliper test indicates that the probability of getting the observed 15 votes that receive between 47 and 50 percent support and 100 votes between 50 and 53 percent, given that no discontinuities exist at 50% is less than one in one billion. Clearly, there is a non-random discontinuity in the data around 50%. Management sponsored proposals get just over 50% support far more often than they "should" and get just under 50% support far less often than they should.

Note that all of the proposals in Figure 1a-1c are decided by simple majority rules. Therefore the discontinuity cannot be due to the fact that management gets to a certain level and stops pursuing votes. This strategy works when the voting population is a fixed size (e.g., the proposal requires a majority of total shares outstanding rather than a

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[14] In the limit as the size of an interval goes to zero, the probability of an observartion falling on one half of the interval or another is binomially distributed with probability of .5. In larger intervals, the curvature of the density function can affect the probability of falling into an interval. To adjust for the curvature of the density function, the probability was estimated as follows. First, I obtain a predicted number of votes that should fall within any specified interval near 50 by regressing the number of votes in a given interval on the level of support for intervals of 1% between 53 and 70 percent. $f_i = \alpha + \beta p_i + \varepsilon_i$, (a linear approximation of the density function) where $f_i$ is the frequency of votes within interval $i$, where $p_i$ is the value of the lower bound of the interval $i$, and $\varepsilon_i$ is an error term. (This assumes that the vote frequencies between 53 and 70 can predict the underlying vote preferences for votes closer to 50.) Then I obtain predicted probability (q) of having a vote in the interval (50-x, 50) given that there is a vote in the interval (50-x, 50+x), which is $q = \hat{f}_{50-x,50}/(\hat{f}_{50-x,50} + \hat{f}_{50,50+x})$. This adjusts for the curvature of the density function in the interval under study. The probability of getting m votes in the interval (50-x, 50) and n votes in the interval (50, 50+x) will be Binomial(m+n, m, q).

majority of total votes cast, and management stops when it gets the votes of more than half the shares). When the voting population is the number of votes cast, however, there will be uncertainty about how many votes are needed because the voting population is itself uncertain. As a result, management does not have a clear target beyond which it can stop seeking votes.

## VI.  What is Causing the Discontinuity?

Figures 1a, 1b and 1c are partially consistent and partially inconsistent with both perfect management information and imperfect management information about the course of voting.  On the one hand, the sharpness of the discontinuity at 50% strongly suggests that management has near perfect information about the outcome of voting at a time when management can do something to change the outcome of votes headed in the undesirable direction. At the same time, the discontinuity at 50% is not large enough to be consistent with perfect information. With perfect information, managers should always stop at just over 50% because it is costly to shift votes. Therefore, there should be more votes at just over 50% than there are votes that receive a more comfortable margin of victory. Figure 1 shows, however, that, while just over 50% has many more votes than just under 50%, there are still more votes with a few percentage points over 50%, suggesting that the perfect information model described above provides an incomplete description of the data. The perfect information model is also at odds with most observers' beliefs about the voting process, which suggests considerable uncertainty near the end of the voting process and even after voting has stopped.

Evidence from *shareholder* sponsored resolutions further deepens the puzzle. If shareholder preferences are discontinuous at 50%, we would expect them to be

discontinuous for shareholder sponsored resolutions in addition to management sponsored resolutions. If management efforts to win management sponsored resolutions are what is causing the discontinuity, however, then we would expect shareholder resolutions to exhibit no discontinuity at 50% because the vast majority of shareholder sponsored resolutions are precatory; if getting more than 50% means nothing, then we would expect no discontinuity at 50%. Figure 2 shows that this is the case. There is no discontinuity around 50% that cannot be attributed to chance. This suggests that the discontinuity around 50% for management sponsored proposals is caused by specific behaviors associated with the fact that 50% is the minimum support necessary for the passage of most management sponsored proposals.

Further anecdotal evidence for this assertion comes from a rare mandatory shareholder resolution (bylaw amendment) sponsored by shareholders of Honeywell International. This resolution received 49% of the vote, falling just short of passage.[15]

## *A. Management Campaigning*

A simple, but incomplete explanation for these results is that management campaigns heavily in close elections, using corporate investor relations departments as well as proxy solicitors to target undecided voters as well as likely nonvoters and convince them to vote management's way. (Some rationally uninformed voters may decide it is easier to simply vote in favor of management than be pestered by proxy solicitors.) As one industry participant put it, management "beats the bushes" to find the necessary votes (Wilcox 2006).

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[15] ISS, "Vote Results for Majority Vote Proposals," at
http://blog.issproxy.com/files/Vote%20Results%20for%20Majority%20Vote%20Proposals.pdf

There is nothing illegal about management campaigning for a particular position with shareholders. Nevertheless, there are several asymmetries in the voting process that suggest that certain management campaign practices may lead to inefficient decisions. Management expends corporate funds on campaigns, while shareholders that oppose management's proposal must expend their own funds—a classic free rider problem (Bebchuk and Kahan 1990). Moreover, management has much better information about the course of the voting as it occurs in realtime because the vote tabulator is typically management's agent. Thus, management can tailor its effort to the closeness of the vote to a much greater degree than opponents can, giving management another advantage. If campaigning sways some preferences and the goal of a vote is to aggregate informed shareholder preferences, then management's budgetary advantage will lead to shareholder votes that are asymmetrically informed. Similarly, the informational value of a pro-management vote that is submitted by someone who would not have voted had they not been contacted by management is likely to be low. Thus, there will be votes won by management that might not go management's way if shareholders had access to information and campaigning from forces that were both in favor and against the management proposal, making corporate voting less efficient as an aggregation mechanism (Fedderssen and Pesendorfer 1997, Gilson and Schwartz 2001).

Poorly governed companies should be more likely to exploit these advantages to dominate close votes. To examine this question, Table IV presents results from the following logit regression of "close" votes where management received between 40% and 60% support for a management sponsored proposal:

$$Y_i = X_i'\beta + e$$

where $Y_i$ is a dummy variable indicating whether or not a management sponsored proposal at company $i$ passed and $X_i$ is a vector of variables that might affect management's ability to win a very close election, including the governance index for company $i$, the size of company $i$, and the percentage of company $i$ owned by institutional investors.

The logit regression results presented in Table IV show that better governance is not associated with lower management success rates in close elections. Well governed companies are no more likely to lose close votes than other companies (the coefficient and marginal effect of a change in governance index is practically and statistically insignificant, as is the effect of an increase in institutional investors. Larger companies are significantly more likely to win a disproportionate number of close votes than smaller companies, reflecting the fact that larger companies can spend more to hire the most sophisticated proxy solicitors and campaigners. selectively solicit votes than other companies.

## B. Vote Buying and Logrolling

If heavy campaigning and selective solicitation do not work (the trees have been shaken but there are not enough votes), then management may resort to other measures to ensure passage of a hotly contested proposal. For example, vote buying, whereby management offers some voters money or other inducements in exchange for their vote on a closely contested issue, could explain the discontinuity observed in the data. Vote buying is expensive. Therefore, a minimal winning coalition (50+e) is desirable as it is the cheapest way for the vote buyer to attain its desired outcome. Vote buying is a breach

of fiduciary duty.[16] Vote buying need not take the form of cash for votes or business for votes that was the subject of the *Hewlett Packard* litigation.[17] Instead, it can take more subtle forms that resemble logrolling in the legislative context. To illustrate, management may agree to take an action desired by some institutional shareholder, such as a dividend increase, in exchange for a vote on a hotly contested proposal. Because the dividend increase is not the result of a disinterested managerial decision, it may not be efficient.

Evidence of vote buying or logrolling, aside from direct (though unproven) allegations such as the HP-Deutsche Bank example, is hard to come by. If companies with poor corporate governance are more likely to breach their fiduciary duty, then the discontinuity at 50 should be more pronounced for poorly governed (high G) firms—a result contradicted by the data in Table IV, which show no connection between governance and the discontinuity.

Some types of vote buying work quickly, and may therefore explain the sharpness of the discontinuity at exactly 50%. Management can obtain a very reliable signal of likely vote outcomes shortly before the vote finishes and then buy votes to change the election if it is close. If management must arrange vote buying well in advance, however, then vote buying cannot explain the discontinuity at 50%. Given uncertainty about the number of shares for and against a controversial management proposal, how can management know exactly how many votes to buy?

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[16] Schreiber v. Carney, 447 A.2d 17, 26 (Del.Ch. 1982).
[17] Hewlett v. Hewlett-Packard Co., 2002 WL 818091 (Del.Ch. 2002). See Section II.

## C. Broker Non-Votes

Before a rule change in mid 2003, brokers were allowed to vote the shares of some beneficial owners for some management sponsored resolutions whenever the beneficial owner failed to inform the broker of the shareholder's desired vote within ten days of the voting date (Bethel and Gillan 2002).[18] Because the vast majority of broker votes are cast in management's favor, broker voting of undirected shares may account for some of the voting discontinuity at 50%. If management only seeks as many broker votes as needed to garner a victory, then there would be many more votes with slightly more than 50% than votes with slightly less than 50%.

This explanation is not supported the data for at least two reasons. First, if it were true, then we would expect management's success rate in close elections to decline after the rules were changed in 2003 to prohibit broker voting on many types of executive compensation plans. Table V suggests that broker non voting is not the primary cause of management's high success rates—management's high success rates continued even after the exclusion of broker non votes-- though small sample concerns preclude confident conclusions. Second, the uncertainty about the outcome of close elections should lead management to encourage brokers to vote whenever there is significant opposition to a management sponsored proposal. How is management able to cut it so close, with a discontinuity at exactly 50%, and why would management want to cut it so close when lots of broker votes could be obtained cheaply and easily? All of these factors suggest that broker voting is not the most important explanation for the voting discontinuity at

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[18] See NYSE Rule 452 (2006) and NYSE Commentary on Rule 303(A)(8).

50%, although broker voting may certainly have played a role before it was eliminated in 2003.

## D. Asymmetric Vote Counting and Balloting Procedures

Management controlled vote counting procedures offer another explanation for the voting discontinuity. The corporate voting process, detailed in Section II above, is quite complex and shareholders may fail to abide by all proxy requirements. For example, in the SWIB case a number of technical snafus led to a divergence between the desired votes of some investors and the actual totals.[19] In addition, the closing date and time for the polls is fixed by an agent of management. If the vote tabulator (typically an agent of management) or ADP Investor Services excludes votes for technical reasons and disproportionately excludes no votes on closely contested management sponsored proposals, then management will win many more close votes than they lose.[20] Even without such behavior, management also enjoys a superior ability to challenge votes than dissident shareholders. Similarly, if management closes the polls when it is narrowly leading a vote but keeps them open and solicits votes when management is narrowly behind, then management will win a disproportionate number of close votes. The SWIB case strongly suggests that such asymmetric poll closing and counting procedures would be a breach of fiduciary duty if they were intended to frustrate the shareholder franchise.

*It should be emphasized that the author has no direct evidence about such vote-counting irregularities* other than cases such as SWIB. Nevertheless, a few circumstantial factors suggest that vote-exclusion may be playing a role. Vote-counting irregularities

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[19] *See SWIB*, supra note 5, at *4.
[20] Vote tabulators, as agents of management, have an obvious incentive to disproportionately exclude votes against management. ADP Investor Services, which processes the vast majority of votes, has no obvious incentive to favor management.

explain the sharpness of the discontinuity at 50% despite the uncertainty about shareholder votes and votes that arrive on the last day. Vote tabulators or individuals making decisions about vote inclusion or exclusion have excellent information regarding the number of votes needed by management and can apply exclusion standards accordingly. Moreover, because excluding votes has some costs (e.g. shareholder grumpiness), the tabulators will attempt to make the minimum number of exclusions, again leading to an abrupt change at 50%. In addition, the number of votes made under questionable circumstances or subject to a change in outcome by changing the poll closing time and date will typically be limited. As a result, disproportionate vote-exclusions cannot change outcomes where the vote was strongly against a management sponsored proposal. This may explain why there are more votes with approximately 45% support for management than votes with 48% or 49%, a fact that runs strongly against the trend in the data toward lower frequency for lower support levels.  (See Figure 1).

One would expect asymmetric vote counting and balloting to be more prevalent in poorly governed companies. Table IV demonstrates that this is not the case, however. Governance has no effect on the ability to win close votes. All companies, well governed and poorly governed, have overwhelming success rates in close votes.

## VII.   Conclusion and Policy Recommendations

All of the aforementioned explanations probably play some role in causing the discontinuity in voting on management sponsored proposals at 50%. Such abrupt discontinuities rarely come about because of only one cause. Fortunately, however, many of the policy recommendations that ameliorate a problem identified by one hypothesis also remedy problems highlighted by other explanations.

First, however, it must be emphasized that the size of the discontinuity is quite small relative to the total number of votes in the sample. In considering policy proposals, one must consider whether proposals that might affect a small number of votes are cost justified when they may add costs to all votes.

The probable effects of tilted outcomes on incentives for dissident shareholders to campaign in close elections suggests that the efficiency impacts of the overwhelming advantage enjoyed by management in close elections are greater than the number of votes directly affected. Consider a shareholder debating whether or not to mount a campaign against a management sponsored proposal. This shareholder will know that management can almost always pull out a victory even if the shareholder's campaign persuades many other shareholders. As a result, the shareholder may decide not to campaign because victory is unlikely; management's overwhelming success in the few close elections that are observed may cause there to be fewer close campaigns by diminishing the incentives for shareholders to fight against management. As a result, the added costs of any policy proposal should not be viewed merely in light of the number of votes that would actually have been affected but also the number of votes that might be affected in a dynamic context.

If voting on management sponsored resolutions is to be a serious part of corporate governance, [21] several policy changes appear warranted. First, funding asymmetries between management and opponents of a management sponsored amendment are an important cause of the voting discontinuities. Management spends corporate funds soliciting yes votes; opponents outlay their own funds in search of "no"s. Given this

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[21] This does not need to be the case. For example, the number of votes could be curtailed if they are viewed as not worth the expense of the following proposals. Holding fewer votes, but conducting them properly, may well be the best solution.

asymmetry, it is not surprising that voting results may not accurately reflect the preferences that would be expressed by a fully informed shareholder electorate. In order for voting on items such as stock option plans to effectively aggregate shareholder preferences, the funding asymmetries should be changed.

The simplest way to equalize pro and anti management sponsored resolution information and campaigning is to fund opponents of management sponsored resolutions to the same degree as management. This proposal has the benefit of simplicity, but it will be very costly. Most management sponsored resolutions pass by overwhelming margins, and there is no reason to waste corporate funds on frivolous opposition. A better proposal, originally made by Bebchuk and Kahan, is to reimburse opponents of management sponsored resolutions if they receive a certain percentage of the votes (Bebchuk and Kahan 1990). Even this proposal, however, may have the negative effect of overly subsidizing campaigns against management sponsored proposals. Therefore, an even more conservative possibility is to partially subsidize opponents who receive a certain threshold. This guarantees that shareholders will only oppose management proposals when they truly believe that the proposals are inefficient.

Second, the informational asymmetries between management and potential opponents should be mitigated by allowing anyone to obtain a real-time update of the voting. The status quo allows management to obtain frequent vote updates, while shareholder opponents of management often have no comparable knowledge. This allows management to win votes when underlying shareholder preferences are against a proposal because management can tailor its expenditures as needed; if management sees that it is well behind, it can undertake an extraordinary effort, while its opponents have no obvious

way of responding. If all parties had the same knowledge about the likely outcome of the vote, then managerial opponents could respond and potentially neutralize management's efforts to push the vote in a particular direction. [22] Full observability would also have the advantage of helping to detect fraud. If one side or another picked up a disproportionately large number of votes in the last few minutes of the election, then this would call for further investigation.

A third desirable policy change is the introduction of more regulation to this area by either the states or the SEC. Corporate voting is "fundamental", yet corporate votes are lightly regulated and non-standardized. Many institutional investors have no way of confirming that their vote was recorded as instructed. ADP Investor Services, which plays the central role in administering corporate voting, is unregulated, and some investors fret about the lack of a paper trail from their mailings of preferences to ADP to the ultimate corporate vote (Wilcox 2006). In addition, voting procedures and tabulators are irregular. Some companies count the votes in house; others contract this process out to a third party. Given the importance of corporate voting and the irregularities described above, more regulation and standardization, such as a mandatory SEC requirement that an independent firm count and inspect votes and periodic SEC audits of closely contested votes, may be justified.

One risk of mandatory SEC regulation is that it is a costly means to solve a problem of uncertain magnitude (even after the dynamic effects described above are

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[22] Another possibility would be to hide information about vote outcomes from all parties. This policy, however, might lead to wasteful expenditures on polling that, given management's funding advantages, might approximate the status quo at greater expense. One fear of the full information proposal is that management would be the only party looking, so that full information would effectively mean only full managerial information. So long as the opponents of proposals are reasonably well organized, which t hey will almost always need to be to make a vote on a management sponsored proposal a close one and obtain partial reimbursement, then the risk of full information meaning only full management information seems relatively small,

accounted for). Therefore, another possibility would be to have standardized voting

procedures enacted as a state statutory default rule. This proposal would have the benefits

of establishing a coherent and consistent procedure that would raise confidence in voting

procedures, while allowing companies that find the law excessively costly to opt-out

through a shareholder vote.[23]

This paper demonstrates that corporate voting outcomes are tilted in

management's favor to a degree that cannot occur by chance. In light of corporate

voting's salience, the recommendations made here seem a small price to pay to restore

confidence in the outcomes of close corporate votes.

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[23] Because the statute would be a default law, a corporate vote to opt-out of the statute would be subject to the enhanced election requirements specified in the law. Therefore, management would not have the same ability to tilt the opt-out vote that it has in the votes studied above.

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# Table 1: Most Common Proposals

| Specific Proposal | Relating to Executive or Board Compensation | Number of Proposals | Percent of Total |
|---|---|---|---|
| Adopt or Amend Exec. Stock Option Plan | Yes | 5,342 | 33.1% |
| Adopt or Amend Dir. Stock Option Plan | Yes | 2,714 | 16.9% |
| Approve Bonus Plan | Yes | 936 | 5.8% |
| Increase Common Stock | Maybe | 1,870 | 11.6% |
| Adopt Employee Stock Purchase Plan | Maybe | 1,299 | 8.1% |
| Approve Merger or Acquisition | No | 954 | 5.9% |
| Total Number of Proposals | | 16,099 | 100% |

This table presents data from the IRRC on the most common types of management sponsored proposals in the sample. The table indicates that proposals that are either certainly or potentially related to managerial or board compensation are the most common type of management sponsored proposals by a large margin. Note that this table presents data on proposals and not unique votes—in some cases two related proposals, such as new executive and director option or bonus plans, may be combined into one vote.

**Table 2: Votes For and Votes Against Proposals**

| Voting Population | Statistic | % Votes For Proposal | % Votes Against Proposal | % Abstentions |
|---|---|---|---|---|
| Ballots Cast | Mean | 85.2 | 14.1 | 1.1 |
| | Sd | 13.1 | 12.9 | 2.2 |
| | N | 9948 | 9927 | 5952 |
| | | | | |
| Shares Outstanding | Mean | 74.8 | 6.7 | .69 |
| | Sd | 12.3 | 8.8 | 1.9 |
| | N | 2969 | 2919 | 2806 |
| | | | | |
| Total | Mean | 82.8 | 12.4 | .98 |
| | Sd | 13.6 | 12.5 | 2.1 |
| | N | 12917 | 12846 | 8758 |
| | | | | |

This table presents the mean percentage, standard deviation, and number of observations for the number of votes for, votes against and abstentions from management sponsored proposals in the sample. These statistics are displayed for all the votes in the dataset in the total row, and for two different voting population groups (voting population of ballots cast and voting population of shares outstanding) in the other rows. All the percentages are calculated using the appropriate denominator (counting or not counting abstentions and non-votes). This provides a partial explanation for the large number of missing observations in the abstentions category—for some of the proposals decided by simple majority, abstentions are simply not counted as part of the voting population.

# Table 3: Close Votes and Firm Characteristics

| | Governance Index (G) | | Market Value | | % Institutional Ownership | |
|---|---|---|---|---|---|---|
| | Firms Below Median | Firms Above Median | Firms Below Median | Firms Above Median | Firms Below Median | Firms Above Median |
| **Number of "Close Votes" (Support between 40 and 60 percent)** | 288 | 213 | 329 | 173 | 214 | 288 |
| **Close wins for management (50 to 53 percent support)** | 53 | 37 | 61 | 29 | 39 | 51 |
| **Close losses for management (47 to 50 percent support)** | 10 | 4 | 12 | 2 | 8 | 6 |

This table exhibits the number and outcome of "close votes" disaggregated by particular firm characteristics. All votes in the table are decided by majority of actual votes. The Gompers et al governance index (G) has a median of approximately 9, the table indicating that firms with a below median G (better governed firms) have more close votes, and tend to lose close votes relatively more often that firms with a high G. Smaller firms have more close votes and lose close votes more often than large companies. Firms with high levels of institutional ownership have more close votes and lose close votes more frequently, than firms with lower levels of institutional ownership.

**Table 4: Close Vote Outcomes and Firm Characteristics**

| | |
|---|---|
| Governance Index | -0.021 |
| | (0.039) |
| | [-.0034] |
| Log of Market Value | 0.252 |
| | (0.060)** |
| | [.041] |
| Log of Institutional Investors | -0.023 |
| | (0.136) |
| | [-.0037] |
| Observations | 744 |

Results of logit regression with management victory in a close election
as the dependent variable. Standard errors in parentheses. Marginal
Effects, when other values are at their mean, in brackets.
* significant at 5% level; ** significant at 1% level

**Table 5: Voting Outcomes and Stock Exchange Rules Re: Broker Voting**

| | Executive Compensation Votes (Broker Votes permitted before 6/30/03, prohibited afterwards) | |
|---|---|---|
| | Through June 30, 2003 | After June 30, 2003 |
| Close wins for management (50 to 53 percent support) | 51 | 10 |
| Close losses for management (47 to 50 percent support) | 6 | 1 |

This table divides the management sponsored proposals sample into two separate time periods. The first time period consists of all votes that took place before June 30, 2003, in which brokers could vote the shares of individuals who had failed to signal a voting preference. This policy was changed after June 30, 2003.

**Figure 1a**



Histogram of Vote Percentages for Management-Sponsored Proposals
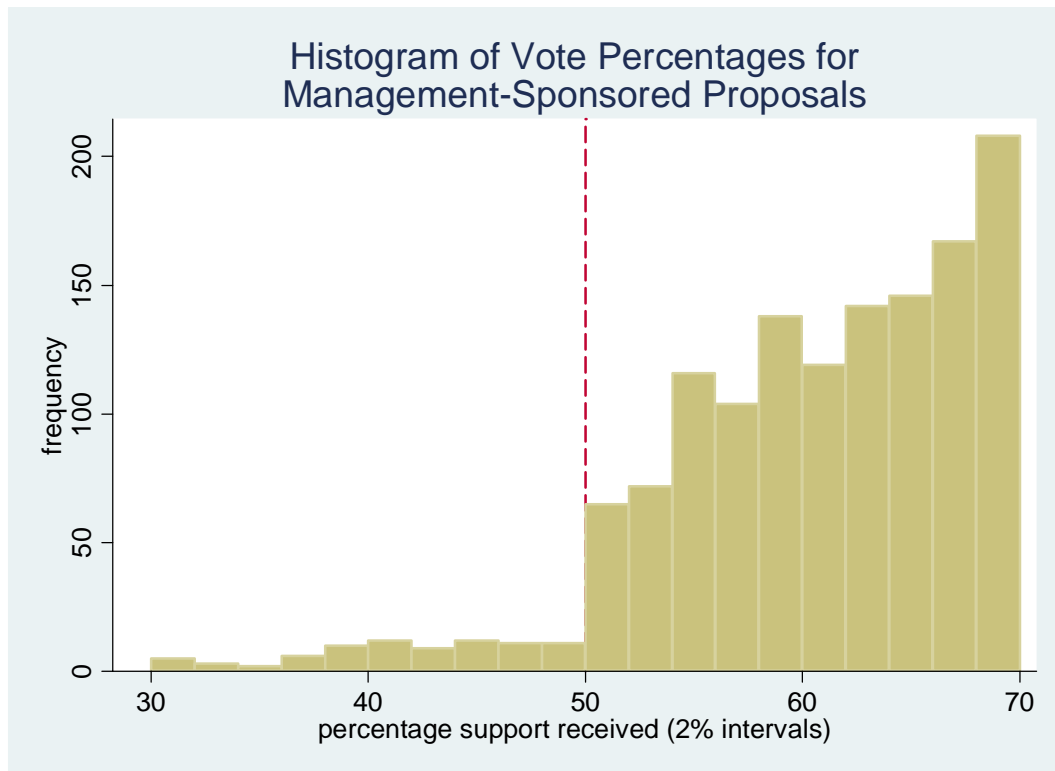
All votes presented in figures 1a-1c were decided on the basis of majority of votes cast or eligible to be cast. Thus, 50% means that a management sponsored proposal received 50% of the votes actually cast on the issue.
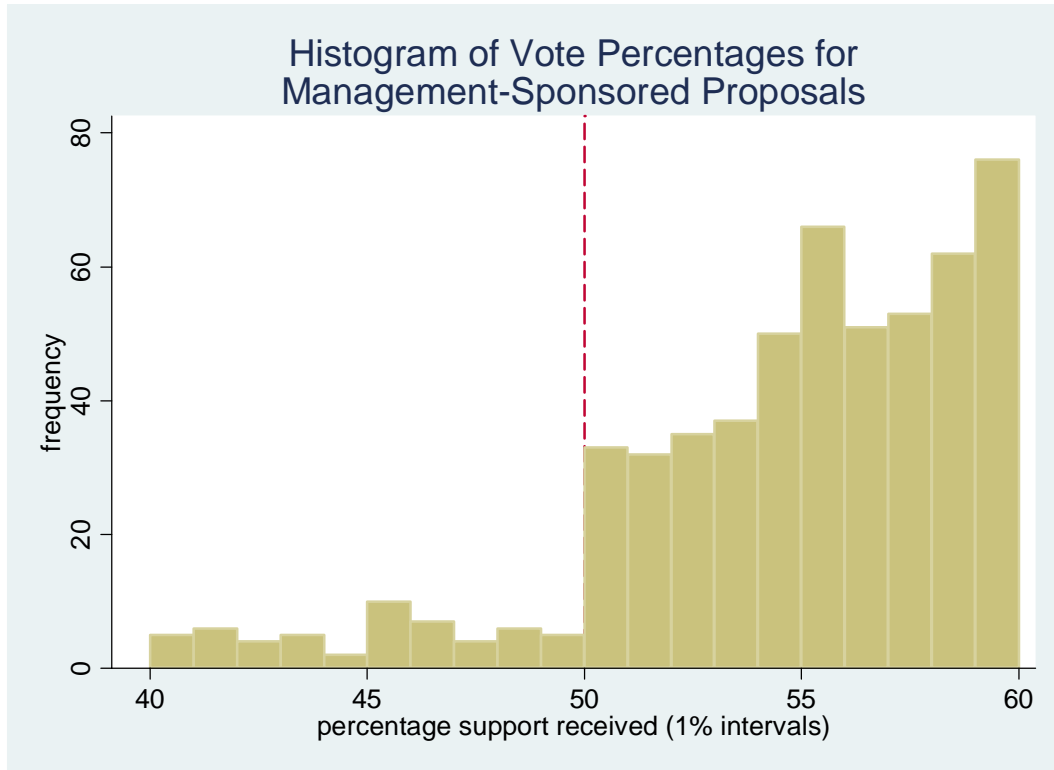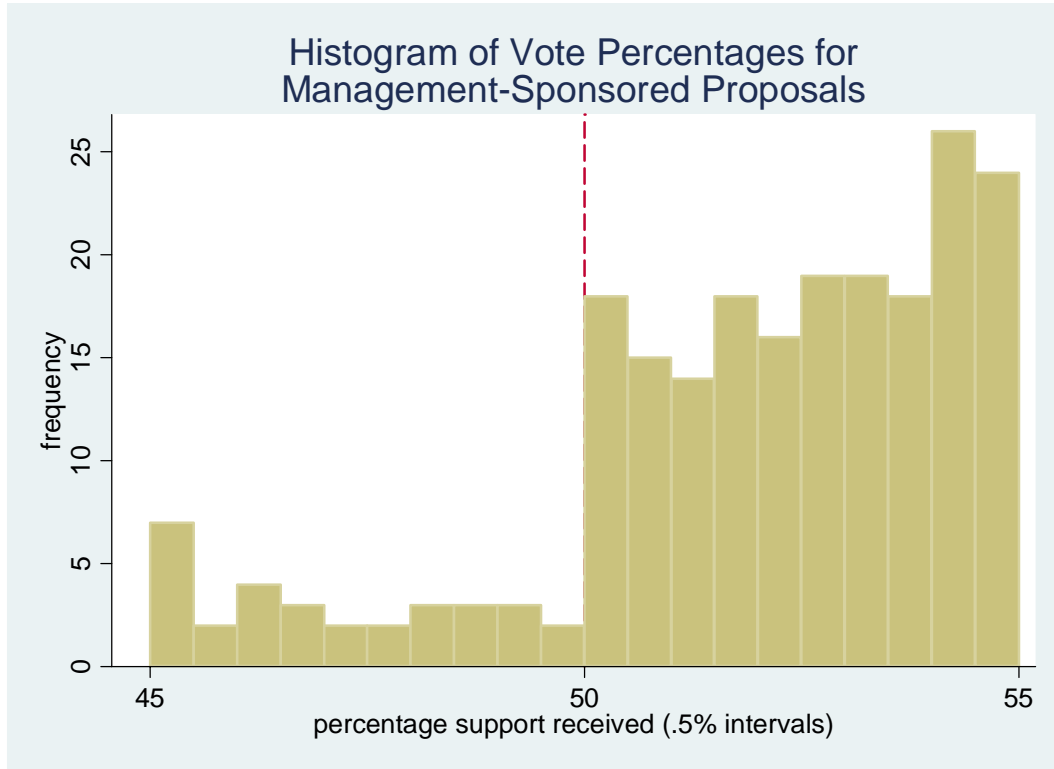
**Figure 1b**



Histogram of Vote Percentages for Management-Sponsored Proposals

**Figure 1c**



Histogram of Vote Percentages for
Management-Sponsored Proposals

**Figure 2**



Histogram of Vote Percentages for Shareholder-Sponsored Proposals