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Borrowed Voting

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AEI LEGAL CENTER

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PREFACE

Shareholder democracy provides an opportunity for shareholders to have a voice in the management of a company. But to the surprise of many shareholders, investment brokers can lease their votes out to parties interested in affecting the vote. Possession of the shares, even if temporarily “borrowed,” is all that is necessary to vote. This procedure raises interesting questions of corporate governance. Are voting rights legitimately severable from the bundle of economic rights associated with share ownership? Should the decision on such severability rest in the corporation’s by-laws or with the government? Do borrowed shares promote or distort mechanisms in the marketplace for corporate governance?

In this *Briefly*, William Tolbert, Leslie Lepow and John Cox discuss this increasingly common trend of borrowing votes from shareholders to influence company and shareholder decisions. After explaining the process by which borrowers rent shares—often without the knowledge of the shareholders—the authors ultimately adapt a medical policy to the financial world: informed consent. This *Briefly* argues that disclosure and awareness attained from informed consent can address many of the problems inherent in borrowed voting.

As with all previous publications of the former National Legal Center, and now the American Enterprise Institute Legal Center, this monograph is presented to encourage a greater understanding of an important public policy issue with a significant effect on the law and its processes. The views expressed in this monograph are those of the authors.

Theodore H. Frank

Director

AEI Legal Center for the Public Interest

INTRODUCTION

Borrowed Voting

By William L. Tolbert, Jr., Leslie H. Lepow and John F. Cox¹

Five years after the passage of the Sarbanes-Oxley Act, America's corporations are still considering how to deal with newly empowered shareholders. In addition to specific requirements designed to ensure that corporations comport themselves to minimum standards of corporate governance, American businesses are encountering greater and more sophisticated activist shareholders. The new standards, whether implemented through legislative directive, Securities and Exchange Commission ("SEC" or the "Commission") regulations, or the listing standards of the major exchanges, have resulted in greater oversight of management. This, in turn, has begun to establish a new equilibrium of corporate control between management and shareholders. The focus on governance practices of public companies after the implementation of Sarbanes-Oxley, including the expanded requirements and structures for issuers to communicate with investors, is designed to promote greater shareholder involvement.

At the same time that traditional shareholders are staking their claims to greater participation in the governance of their corporations, an interesting practice that allows other "investors" to borrow—or buy—the voting rights has begun to be employed more often. In effect, without owning any shares of a company, individuals and entities can attempt to affect the outcome of corporate actions that are put to a vote at shareholder meetings by borrowing a large number of shares for a relatively nominal fee and then using those borrowed shares to cast a corresponding number of votes.²

¹ Messrs. Tolbert, Lepow, and Cox are Partners at Jenner & Block LLP. The authors gratefully acknowledge the assistance of L. Taylor Hall, an Associate at Jenner & Block LLP, and Rochelle Lundy, a third-year law student at Columbia University Law School, in preparation of this *Briefly*.

² See Mark Hulbert, *Strategies: One Borrowed Share, but One Very Real Vote*, N.Y. TIMES, Apr. 16, 2006, available at <http://www.nytimes.com/2006/04/16/business/yourmoney/16stra.html>.

This *Briefly* will review some of the current developments in shareholder activism as it relates to opportunities to give a voice to shareholder interests. It will then review the mechanism by which “investors” are able to acquire disproportionate voting rights and discuss several options to address the relevant issues proposed by commentators and practitioners who oppose the strategy. As borrowed voting is enabled by many of the same structures that also support hedging and derivative trading, to the extent that any changes affecting borrowed voting are made, it is important that they not imperil other useful economic activity.

Background

It is difficult to argue that shareholders shouldn't be actively involved with fundamental issues affecting the companies they own. It is axiomatic that ownership of a corporation's shares carries with it certain rights and privileges. While it is customary to talk of shareholder apathy as the number of investors in the marketplace grows and resulting percentage ownership shrinks, it does not follow that shareholders should take no interest or have no say in corporate affairs. As the recent corporate governance changes underscore, there must be an effective balancing of the right of shareholders with the requirements of managing the corporation. Shareholders must have a voice in decisions that affect them as owners, and one of the responsibilities of management is to ensure that it conducts daily business in an efficient and responsive manner. Shareholders do not run corporations, but because of their ownership, they have the right to select those who will oversee the management of their interests.

The focal point for shareholder voting is the corporation's annual Shareholders meeting. Shareholder meetings present an opportunity, at least annually, where shareholders and others have a chance to speak directly with the company boards and management in a public forum and to cast their votes in response. Traditionally, the main purpose of these meetings is to elect directors, but shareholder action may be required to accomplish certain organic corporate issues, such as amending the articles of incorporation, or to approve major initiatives, such as a merger or reorganization of the corporation. Shareholder approval is also generally required for the issuance of certain securities or the adoption of stock option and equity compensation plans.

Shareholders have begun to demand a more meaningful voice in electing directors. Shareholders must now nominate candidates on separate proxy ballots and in the process, incur the associated printing and mailing costs.³

³ It should be noted that the SEC has lightened this burden to some degree with their adoption of amendments to Rule 14a-3, the so-called “E-Proxy” rule. The E-Proxy rule requires corporations and all others conducting proxy solicitations to post their proxy materials on a specified, publicly accessible Internet Web site and provide shareholders with notice informing them that the materials are available and how to access them. 17 C.F.R. § 240.14a-3 (2007). According to the final SEC rule release, the “amendments [were] designed to enhance the ability of investors to make informed voting decisions and to expand use of the Internet to ultimately lower the costs of proxy solicitations.”

In response, many investor advocates lobbied for the ability both to nominate directors on company ballots and permit shareholder-nominated director candidates to appear in the corporate proxy statement and proxy card. As explained by the American Federation of Labor and Congress of Industrial Organizations (the “AFL-CIO”) in its 2003 petition to the SEC requesting it to adopt proxy access rules:

Granting institutional shareholders the ability to economically run independent candidates for boards of directors is a key response to both the broader corporate crisis and the specific longstanding problem of corporate boards ignoring investor concerns. Although state law permits shareholders to run director candidates, this fundamental shareholder right remains effectively unavailable so long as shareholders’ nominees are denied equal access to the corporate proxy. As a result, incumbent directors can freely spend the corporate treasury to get re-elected while shareholders are forced to mount costly proxy contests that are difficult for particular investors to justify absent a battle for corporate control.⁴

The SEC has long been attempting to construct an acceptable shareholder access rule. In 2003, the Commission proposed a rule that generally would have permitted certain significant, long-term shareholders to include their nominees in a company’s proxy, as long as the shareholder was not seeking control of the company’s board of directors. While the proposal received thousands of public comments and was thoroughly debated, the Commission only recently reached an agreement on the proposal.

On November 28, 2007, the SEC voted to adopt an amendment to Rule 14a-8(i)(8), that strengthens the statutory prohibition on shareholders’ ability to nominate directors on the corporate proxy ballot.⁵ Rule 14a-8(i)(8) always permitted a company to omit from its proxy materials any

Shareholder Choice Regarding Proxy Materials, Exchange Act Release 34-56135, Investment Company Act Release IC-27911 (Jul. 26, 2007), available at <http://www.sec.gov/rules/final/2007/34-56135.pdf>.

⁴ Rulemaking Petition dated May 15, 2003 from Richard L. Trumka, Secretary–Treasurer, AFL-CIO to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609, Re: File No. S7-10-03, available at <http://www.sec.gov/rules/petitions/petn4-491.htm>.

⁵ Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56914, Investment Company Act Release No. IC-28075 (December 6, 2007), available at <http://www.sec.gov/rules/final/2007/34-56914.pdf>.

proposal that “relates to an election for membership on the company’s board of directors or analogous governing body.”⁶ However, the newly adopted language takes an even stronger approach by permitting the company to omit any proposal that “relates to a nomination or an election for membership on the company’s board of directors or analogous governing body or a procedure for such nomination or election.”⁷ Thus, the amendment preserves a company’s right to exclude a shareholder’s nomination for the board of directors from the corporate proxy ballot, and more significantly, codifies the practice of excluding shareholder access resolutions from the proxy material. However, this does not appear to be the SEC’s final word on the matter, as Chairman Christopher Cox noted that the SEC plans to “re-open this discussion in 2008 to consider how to strengthen the proxy rules to better vindicate the fundamental state law rights of shareholders to elect directors.”⁸

Shareholders, however, have not remained idle. They have, with varying degrees of success, attempted to redefine their rights, particularly the value of their voting rights, in a variety of governance areas. Perhaps the best illustration of shareholder action in this regard is the push to ensure the election of directors by a majority vote of the shareholders. Underpinned by the theory of “one share-one vote,” its proponents argue that the current system where shareholders can withhold their votes but cannot vote against directors is merely a symbolic process and that majority voting is necessary for a meaningful election.⁹ Supporters of majority voting believe that it makes directors truly accountable to shareholders because the directors would, for the first time, face the real risk of losing an election and thus their seat on the board.¹⁰

Given the title of a recent Institutional Shareholder Services Institute for Corporate Governance (“ISS”) white paper, *Majority Voting in Director*

⁶ 17 C.F.R. § 240.14a-8(i)(8).

⁷ Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56161, Investment Company Act Release No. IC-27914 (July 27, 2007), available at <http://www.sec.gov/rules/proposed/2007/34-56161.pdf>.

⁸ Press Release, Securities Exchange Commission, SEC Votes to Codify Longstanding Policy on Shareholder Proposals on Election Procedures (November 28, 2007), <http://sec.gov/news/press/2007/2007-246.htm>.

⁹ Institutional Shareholder Services Institute for Corporate Governance, *Majority Voting in Director Elections—From the Symbolic to the Democratic* 1 (2005), <http://www.issproxy.com/pdf/MVwhitepaper.pdf>.

¹⁰ *Id.*

Elections—From *the Symbolic to the Democratic*, it should be no surprise that the advisory service's stated policy is to endorse majority voting proposals. It recommends a vote "For" both precatory and binding resolutions requesting that the board change the company's bylaws to stipulate that directors need to be elected with an affirmative majority of votes cast, provided it does not conflict with the state law where the company is incorporated.¹¹

The "one share-one vote" principle has been used by those who advocate the abolishment of staggered boards. A staggered board is typically comprised of three classes of directors, with the term of each class expiring in successive years. The annual election, therefore, is only for the directors whose term is expiring—not for the entire board. Staggered boards can provide for corporate stability and continuity because, unlike traditionally-elected boards, only a minority of the board is elected at any given time, thereby functionally serving as an anti-takeover device because acquirers have a difficult time gaining control. Opponents of staggered boards, however, argue that these arrangements make directors less accountable to shareholders than annually elected boards.

The push for a greater shareholder role goes beyond voting for directors—shareholders are getting more information about companies' governance processes and the compensation of those who are responsible for producing results. For 2007, the SEC expanded its rules for executive compensation disclosure in proxy statements by adopting requirements designed to allow shareholders to better monitor the link between pay and performance.¹²

Even so, executive compensation continues to be a hot topic for shareholders and some shareholder groups would like a more active voice. In the 2007 proxy season, activists, primarily union pension funds, have submitted approximately sixty "say on pay" proposals that would give shareholders advisory votes on executive pay. Results show that this issue has considerable support, but the proposals have yet to be adopted. Nevertheless, the

¹¹ Institutional Shareholder Services Institute for Corporate Governance, *ISS 2007 Proxy Voting Guidelines Summary* (2006), <http://www.issproxy.com/pdf/2007USSummaryGuidelines.pdf>.

¹² Executive Compensation and Related Person Disclosure, Securities Act Release No. 33-8732A, Exchange Act Release 34-54302A, Investment Company Act Release 27444A (Aug. 29, 2006), available at <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

U.S. House of Representatives recently passed legislation which would mandate advisory shareholder votes on executive pay plans, and the U.S. Senate is considering a similar measure introduced by Senator Barack Obama.¹³

The "say on pay" bill would require that beginning in 2009, corporations must give shareholders the right to an advisory vote in two situations: First, the bill requires public companies to submit the compensation of their proxy officers to their shareholders for a non-binding approval each year. Second, the bill requires that when a new or enhanced change-in-control agreement is contemplated, the agreement must be included in the company's proxy statement and be subject to a non-binding shareholder vote.

While the fate of the "say on pay" act is uncertain, it is an indication that many shareholders are no longer content to be passive. All these initiatives—shareholder access to the proxy statement, majority elections, annual elections for all directors, and shareholder advisory votes on pay—are based on the underlying principle that owners have a right to vote because it protects their economic interests. For these and other reasons, the Council of Institutional Investors adopted a policy statement that the shareholders' right to vote is inviolate and should not be abridged.¹⁴

It is interesting, therefore, that a market has developed where certain shareholders sell (knowingly or unknowingly) their right to vote. How this happens, and what commentators and practitioners who oppose the strategy recommend in response, is discussed below.

As reviewed in the background section, the power to vote on corporate decisions is linked to economic ownership under traditional corporate law principles, as well as the movements supporting shareholder democracy. However, in recent years, methods have emerged by which votes can be borrowed, allowing a party that does not own a correspondent economic stake in a corporation to participate in decisions that can directly impact not only its governance, but the corporation's very existence. Although "borrowed voting" has a number of consequences for those shareholders who both own and vote their shares, most shareholders or companies do

¹³ Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (2007); Shareholder Vote on Executive Compensation Act, S. 1181, 110th Cong. (2007).

¹⁴ See Council of Institutional Investors, *Council Policies—Shareowner Voting Rights* (on file with author).

not widely recognize the practice. Nor is borrowed voting significantly restricted by current federal or state law.

The practice of borrowing votes was brought to the attention of the general business public in a 2006 New York Times article.¹⁵ The author, Mark Hubert, reviewed an academic study of vote trading that explained the borrowed voting strategy:

[A]ny investor[], no matter how few of a company's shares they own, [may] . . . profoundly affect the outcome of corporate resolutions that are put to a vote at the annual shareholder meeting. In effect, a shareholder can borrow a large number of shares for a nominal fee and use them to cast a corresponding number of votes.¹⁶

Hubert continued, that:

[T]he right to vote on a corporate resolution comes from possession, not ownership, of shares. That means a trader can borrow shares and thus be temporarily eligible to vote on corporate resolutions. The number of votes he can acquire is limited only by his ability to put up collateral—which is required to be 102 percent of the value of shares borrowed—and the number of shares available on the securities lending market.¹⁷

On the topic of the cost of renting a vote, Hubert explained that:

As long as you have the collateral, borrowing shares is very inexpensive. The annual cost can be as low as 20 basis points, or two-tenths of a percentage point, on the cash that is put up. And because the borrower must hold the shares for just one day in order to have voting rights, the interest can be almost nothing. The cost to borrow \$1 million of stock for one day, for example, could be less than \$6.00.¹⁸

As mentioned above, changes to the regulations governing the disclosure required when voting power is transferred have been proposed as a means

of addressing the “one share-one vote” policy that underlies traditional corporate law and the emphasis on shareholder democracy. However, it is not clear that enhanced disclosure would do more than expose the extent of the use of this strategy (or actually encourage more short term investors to adopt strategies that increase the practice). An adaptation of the notion of “informed consent” with respect to the lending of votes presents an alternative approach that might be considered by parties seeking to minimize the availability of borrowed voting.

¹⁵ Hulbert, *supra* note 2.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

How Are Votes Borrowed?

Corporate votes are borrowed through a variety of techniques that effectively separate a share's economic ownership from its voting interest. The most straightforward of these involves temporarily obtaining shares through the share lending market for a period of time sufficient to allow the borrower to vote at a shareholder meeting. According to Delaware corporate law, votes may be cast by whoever holds the stock on a "record date" set by the corporation prior to a shareholder vote, whether the current holder is a permanent owner or only possesses the stock through a loan.¹⁹ Shares are generally loaned through the brokers and institutional investors that manage the funds in which private individuals invest. Investment contracts grant these parties the right to earn a fee by lending the shares of their clients, who must affirmatively request the recall of the shares if they wish to exercise their voting power. As individual investors are usually unaware that their stock is on loan, recalls rarely affect the borrower's ability to use the shares for voting purposes.²⁰

¹⁹ Henry T.C. Hu & Bernard Black, *The New Vote-Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 832-33 (2006); Hulbert, *supra* note 2.

²⁰ Jonathan J. Katz, *Barbarians at the Ballot Box: The Use of Hedging to Acquire Low Cost Corporate Influence and its Effect on Shareholder Apathy*, 28 CARDOZO L. REV. 1483, 1500 (2006); Kara Scannell, *How Borrowed Shares Swing Company Votes*, WALL ST. J., Jan. 26, 2007, at A1.

Borrowed Voting Consequences

Some authors propose that the use of these borrowed voting techniques creates negative consequences.²¹ The most pronounced of these consequences is the potential effect on the shareholder role in corporate governance. The utilization of votes that lack a corresponding economic interest adds an interesting dynamic to the link between stock ownership and the ability to influence corporate governance. The fact that outside parties seek to obtain votes rather than the shares themselves suggests that borrowed votes may not always be used to further the interests of those with a true ownership stake in the corporation.²² "Indeed, the only reason such a person would purchase [or pay to borrow] votes would presumably be if he or she could obtain a return on the investment in vote-buying through exploitation of the corporate control."²³

Moreover, as one author has noted, "if hedge funds are permitted to continue to 'hijack' shareholder elections for their own private gain, shareholders are likely to lose confidence in the notion of a corporate democracy."²⁴ To put this in a more conventional and contemporary political context, consider the dissatisfaction and discouragement engendered by complaints of voters being placed on election rolls with no identification and minimum residency requirements. Corporate voters could conceivably be similarly discouraged from taking the trouble to vote in shareholder elections when a significant number of votes are controlled by parties who are unaffected by any resulting changes to stock value.²⁵

One author has also suggested that borrowed voting may have a negative impact on shareholders' overall wealth. According to Jonathan Katz, hedging or vote-borrowing could, in certain situations, reduce the value of the control premiums that accrue to shareholders owning a significant portion

²¹ See, e.g., Douglas R. Cole, *E-Proxies for Sale? Corporate Vote-Buying in the Internet Age*, 76 WASH. L. REV. 793, 836-41 (2001); Katz, *supra* note 20, at 1515-18; Peter Safirstein and Ralph Sianni, *Is the Fix In?—Are Hedge Funds Secretly Disenfranchising Shareholders?* BLOOMBERG L. REP.: CORPORATE GOVERNANCE, Jan. 2005 at 1, http://www.milbergweiss.com/files/tbl_s47Details%5CFileUpload265%5C188%5CBloombergLawReport0105.pdf.

²² Cole, *supra* note 21, at 839.

²³ Cole, *supra* note 21, at 820.

²⁴ Katz, *supra* note 20, at 1516.

²⁵ *Id.*

of a corporation's stock.²⁶ Reasoning that votes obtained through borrowing or hedging can overcome the influence of even a large shareholder during the corporate decision-making process, he concludes that the value of owning a controlling amount of stock could be effectively negated.²⁷

²⁶ Katz, *supra* note 20, at 1515.

²⁷ *Id.*

Current Regulations

To date, there appears to have been no judicial pronouncement on the legal implications of borrowed voting.²⁸ However, it appears to be generally accepted that while both state and federal legal regimes supply some checks on the practice, the current legal rule is that the practice of borrowing votes is permissible.²⁹

Federal regulations promulgated by the SEC place some limits on vote borrowing conducted through "hedging" techniques, which utilize the short-selling market.³⁰ Section 16(c) of the Securities Exchange Act of 1934 (the "Exchange Act") prohibits short-selling by an entity that owns more than ten percent of a given corporation's stock, effectively limiting the amount of votes that can be borrowed through hedging. However, in a closely contested vote, the votes associated with ten percent of the relevant stock could certainly impact the outcome.

The Perry/Mylan transaction, one of the most frequently cited instances of borrowed voting, illustrates the potential for a relatively small number of votes to alter the outcome of a shareholder decision. There, acquiring 9.9% of Mylan stock through hedging techniques made Perry the corporation's largest single shareholder. Its votes resulted in Mylan shareholder approval of a proposed merger with a corporation in which Perry owned a substantial stake and a subsequent increase in the value of that corporation's stock to Perry's benefit.³¹

Like federal regulations, the Delaware General Corporation Law similarly provides no explicit rule addressing borrowed voting. Traditional common law held all vote-buying per se illegal on the grounds that it violated a fiduciary duty owed from one shareholder to another.³² *Schreiber v. Carney*, a Delaware court decision, represents a modern rejection of that principle and shift toward broader acceptance of arrangements transferring voting

²⁸ Katz, *supra* note 20, at 1505.

²⁹ Cole, *supra* note 21, at 858; *see also, generally*, Safirstein and Sianni, *supra* note 21.

³⁰ Katz, *supra* note 20, at 1506-07.

³¹ Ianthe Dugan, *Hedge Funds Draw Scrutiny over Merger Play*, WALL ST. J., Jan. 11, 2006, http://online.wsj.com/public/article/SB113695140652343511-SleT9ssozbnQ8DNwRMjq_ ndhJMY_20060118.html; Hu and Black, *supra* note 19, at 816.

³² Cole, *supra* note 21, at 819.

power.³³ The *Schreiber* court found that the policy reasons discouraging these arrangements were no longer as relevant as they had previously been, noting that the modern corporation is an entity owned by large numbers of stockholders dispersed across a broad geographic area and experiencing little-to-no personal interaction.³⁴ In this context, the court found the notion of a fiduciary duty between all of a corporation's stockholders had been largely abandoned; the court shifted its evaluation of vote buying to a new test that defines the legality of these arrangements by their purpose, rather than by the techniques employed or the potential consequences. Under *Schreiber* and the cases that follow it, an arrangement to acquire votes is illegal only if it is made with a specific purpose to defraud or disenfranchise the non-participating shareholders. Borrowed voting would rarely be considered illegal under such a test,³⁵ as it “occurs through share lending—an ordinary activity with legitimate uses unrelated to vote buying.”³⁶

³³ *Schreiber v. Carney*, 447 A.2d 17, 24 (Del. Ch. 1982).

³⁴ *Id.* at 24; Safirstein and Sianni, *supra* note 21;

³⁵ It should also be noted that, since *Schreiber*, no arrangement involving the acquisition of votes has been found illegal, suggesting that a party seeking to invalidate transactions of this sort must meet a very high standard under Delaware law. Joe Pavelich, *The Shareholder Judgment Rule: Delaware's Permissive Response to Corporate Vote-Buying*, 31 J. CORP. L. 247, 258 (2005).

³⁶ Hu and Black, *supra* note 19, at 818.

Proposed Methods of Addressing Borrowed Voting

Increasing Disclosure Requirements

Enhanced disclosure has often been suggested by commentators and practitioners who oppose borrowed voting as a method by which to address its consequences.³⁷ Jennifer Spiegel, for instance, specifically recommended that detailed descriptions of hedging transactions and short positions involving borrowed shares be made public through SEC filings.³⁸ However, it has also been noted that requiring more substantial disclosure with regard to vote borrowing would not have any impact on the issue. Whenever additional disclosure is suggested as a potential remedy, a corresponding concern of information overload must be considered. Not only must the new disclosure be made in a timely manner, but it must be accomplished through means that would provide conspicuous notice.

In addition, disclosure provides no guarantee that some shareholders or outside parties will be prohibited from attempting to profit at the expense of others, especially if regulators are unable to design provisions that ensure that information about vote possession is available in time for shareholders to react to it.³⁹ One author points out that increased disclosure may even contribute to one of the problems created by borrowed voting—shareholder apathy—stating that enhanced disclosure “ignores the rational response of shareholders that learn of the intricacies of hedge fund involvement in their corporate elections—abstention from voting.”⁴⁰ Noting these drawbacks, Hu and Black proposed increased disclosure as an interim approach, followed at some point by more stringent measures: “[T]he near term need is for enhanced ownership disclosure (crafted with sensitivity to the costs of disclosure), to let regulators assess how often . . . [borrowed voting] occurs and how it affects shareholder vote outcomes.”⁴¹

³⁷ See, e.g., *id.* at 864; Jennifer A. Spiegel, *The Mylan-King Legacy*, CORPORATE DEALMAKER, Sept. 12, 2005, http://www.thedeal.com/corporatedealmaker/2005/10/the_mylanking_legacy.php

³⁸ Spiegel, *supra* note 37.

³⁹ Hu and Black, *supra* note 19, at 885-87.

⁴⁰ Katz, *supra* note 20, at 1516-17.

⁴¹ Hu and Black, *supra* note 19, at 819.

Changing the Time Requirements for Section 13 Disclosures

The requirements of Section 13 of the Exchange Act provide a partial solution to some of the issues raised by borrowed voting by requiring detailed disclosure once an investor surpasses five percent direct or indirect beneficial ownership. Yet, “with some attention paid to legal niceties, [borrowed voting positions] . . . can often be structured to arguably evade 13D/13G disclosure,” or at least to limit the amount of disclosure that is necessary.⁴² However, by merely shortening the amount of time which some investors have in order to disclose their position, many of the existing loopholes could be closed.

Consider Rule 13d-1(b), which allows certain types of “Qualified Institutional Investors,” who would otherwise be required to file a Schedule 13D within ten days of becoming the beneficial owner of more than five percent of a class of securities, to file a short form Schedule 13G.⁴³ The benefit of such a provision for an investor seeking to vote shares solely for the purpose of effecting an upcoming election is clear. So long as the investor stays below ten percent ownership, it is not required to file a Schedule 13G until forty-five days after the end of the calendar year in which it becomes required to file such a disclosure.⁴⁴ Thus, an investor could conceivably enter into an agreement to borrow shares to vote on an issue to be decided well before the investor is required to disclose his position and alert other shareholders. However, by adopting an approach similar to that of Rule 13d-1(c), it would be possible to retain the benefits of the short form Schedule 13G, while still facilitating reform in the realm of borrowed voting.

Rule 13d-1(c), permits any investor, including those who do not qualify under Rule 13d-1(b), that beneficially owns more than five percent of a class of securities, which are not held for the purpose of “changing or influencing the control of the issuer,” to file a Schedule 13G in lieu of the more cumbersome Schedule 13D.⁴⁵ However, under this provision investors are required to file an initial 13G within ten days of their qualifying acquisi-

⁴² *Id.* at 818. See also Schedule 13D, 17 C.F.R. § 240.13d-101 (2007); Schedule 13G, 17 C.F.R. § 240.13d-102.

⁴³ 17 C.F.R. § 240.13d-1(b).

⁴⁴ *Id.*

⁴⁵ *Id.* § 240.13d-1(c).

tion or any acquisition over ten percent. Following a similar approach under Rule 13d-1(b) would permit fellow investors to receive notice of a “Qualified Institutional Investor” and their direct or indirect beneficial ownership in a much timelier fashion. To take this a step further, it might also be worth considering moving towards much more timely disclosure for all qualifying Section 13 acquisitions, in lieu of the ten day grace period currently in place. The SEC might consider importing the two day filing period applied to the filing of a Form 4 required for qualifying “Insider” transactions pursuant to Rule 16a-3(g)(1).⁴⁶ Another possible course of action would be to require “prompt” disclosure, similar to the filing standard that is required for amendments made to a Schedule 13D pursuant to Rule 13d-2(a).⁴⁷ Such a standard would allow the SEC room to adapt as necessary in order to address the problems associated with the practice of borrowing shares. Once again, this would simply be another way of providing shareholders with information regarding an acquirer’s motives in a more judicious manner.

Holding Borrowed Voting Transactions Void

An alternative to increased disclosure suggests a legal determination that borrowed voting transactions designed to influence corporate votes be null and void.⁴⁸ Katz suggests that Delaware courts specifically recognize borrowed voting and the resulting vote influences illegal under state law on a public policy grounds. Another alternative suggested is the implementation of regulations under the Exchange Act that restrict the practice of borrowing votes through the short-selling market, effectively invalidating transactions that seek to manipulate shareholder votes.⁴⁹

Informed Consent as a Method of Addressing Borrowed Voting

A further approach discussed by commentators and practitioners is the adoption of the notion of “informed consent” used in the medical arena. As noted earlier, the contracts through which hedge funds and other invest-

⁴⁶ *Id.* § 240.16a-3(g).

⁴⁷ *Id.* § 240.13d-2(a).

⁴⁸ Katz, *supra* note 20, at 1517.

⁴⁹ *Id.*

ment vehicles are managed allow brokers to lend out the shares of their clients in exchange for a fee.⁵⁰ Shareholders technically remain capable of recalling and voting stock that is on loan, but do so only infrequently, as they are rarely aware that the votes associated with their stock are in the possession of third parties.⁵¹ According to Katz, adopting a modified version of informed consent that requires shareholders to receive information and approval authority regarding the potential loan of their shares, would remedy this lack of awareness and likely lead to greater reflection on the drawbacks of borrowed voting for those who maintain an economic interest in the relevant corporation. In addition, if those seeking to borrow shares were required to pay fair value to those from whom they seek informed consent (or such owners had an opportunity to negotiate a fee), it would likely foster a greater desire on behalf of the shareholders to become actively involved in this process, while potentially forcing borrowers to be more judicious in determining how often to insert themselves into the voting process.

The notion of informed consent is considered “a natural outgrowth of the common law tort of battery that prohibits intentional unauthorized bodily contact.”⁵² Under the informed consent doctrine in the medical arena, physicians have a duty to communicate the risks and benefits associated with potential treatment options to the patients under their care.⁵³ The scope of the physician’s duty requires disclosure of information that the patient would find material to making a treatment decision, to weighing the risks associated with having or not having the treatment, and to decide on any alternative treatment.⁵⁴ Once this information has been disclosed, responsibility for choosing a treatment option then shifts to the patient.⁵⁵

Adapting the informed consent approach to the borrowed voting context could remedy the lack of awareness among shareholders with regard to how the loan of their votes affects the entities in which they retain an economic interest. By mandating that a shareholder indicate that he or she

⁵⁰ *Id.* at 1500-01; Scannell, *supra* note 20.

⁵¹ Scannell, *supra* note 20.

⁵² Barbara L. Atwell, *The Modern Age of Informed Consent*, 40 U. RICH. L. REV 591, 593 (2006).

⁵³ *Id.*

⁵⁴ *Canterbury v. Spence*, 464 F.2d 772, 782 (D.C. Cir. 1972).

⁵⁵ *Id.*

understands the implications of a decision to allow another party to vote on his or her behalf, an informed consent approach could conceivably cause shareholders to realize that they have an incentive to ensure that voting is carried out with the corporation’s best interests in mind.

In the medical context, responsibility for obtaining informed consent lies with physicians. In the borrowed voting context, responsibility should lie with the fund brokers and managers who serve a similar function with respect to the clients whom they serve. Like physicians, brokers are familiar with the choices available to the shareholders to whom they are responsible and have the specialized knowledge to explain the advantages and disadvantages of each option.⁵⁶ Moreover, like physicians, brokers and fund managers already owe some duty of care to the clients by whom they are employed, anchoring the informed consent requirement in a previously existing legal relationship.⁵⁷

Requiring the informed consent of a shareholder prior to lending the votes associated with his or her shares is a more active approach than disclosure alternatives because the consent provides shareholders not only with information about how their shares are being used, but with a straightforward mechanism to affect this pattern of use if they object to it. Moreover, while disclosure would only make information on borrowed votes available to someone who seeks it, informed consent would mandate that it be drawn to the attention of the parties upon whom it will have the greatest impact and who are thus, most likely to take action to remedy it. An informed consent approach would not go so far as to place a legal prohibition on borrowed voting (as would a judicial determination voiding borrowed voting transactions or SEC restrictions on the practice of borrowing votes), but it could also have an impact on the practice while avoiding the possibility of unduly hindering other borrowings.

It is also suggested that the informed consent approach could serve to encourage a sense of fiduciary responsibility among minority shareholders while remaining consistent with the rights enjoyed by these shareholders under modern case law. As noted above, the *Schreiber* decision marked a shift away from the enforcement of fiduciary duty between minority

⁵⁶ Linda P. McKenzie, *Federally Mandated Informed Consent—Has Government Gone Too Far?*, 20 J.L. & HEALTH 267 (2007).

⁵⁷ *Id.*

shareholders, leaving it intact only between minority and majority shareholders.⁵⁸ In fact, minority shareholders now enjoy well-established rights to compete with the corporation in their other business ventures, to withhold opportunities from the corporation, and to engage in transactions that may harm the corporation.⁵⁹ The introduction of an informed consent approach can force minority shareholders to be more aware of the impact of the loan of their votes on their fellow shareholders without interfering with their ability to benefit from these rights should they choose to do so. If changes are made to borrowed voting status, one transitional/administrative benefit to choosing the informed consent approach might be that the concept of informed consent is established and carries pre-existing case and statutory law upon which courts and legislatures can rely in crafting a doctrine that will effectively address the issues associated with borrowed voting.

⁵⁸ *Schreiber v. Carney*, 447 A.2d 17, 24 (Del. Ch. 1982); *see also Kahn v. Lynch Comm'n Sys., Inc.*, 638 A.2d 1110, 1113-14 (Del. 1994) (describing the fiduciary duty that exists between minority and majority shareholders).

⁵⁹ *Cole*, *supra* note 21, at 821.

CONCLUSION

Borrowed voting can be accomplished through a variety of techniques that separate the voting interest in a corporate entity from the economic ownership interest that usually accompanies it. A number of commentators and practitioners believe that no matter what technique is used, negative consequences result (e.g., the value of control premiums decrease, the shareholder role in corporate governance is undermined and incentives to participate in the corporate voting process diminish). Because current state and federal laws leave gaps in the regulation of borrowed voting, new approaches would be required if federal and state authorities were to concur that this issue should be addressed. Under that scenario, while heightened or timelier disclosure may serve to increase knowledge and understanding of borrowed voting, alternative measures might be needed to address some of its effects. An adaptation of the concept of informed consent targeted at borrowed voting is one feasible means of providing a method that allows borrowed voting transactions to continue, while avoiding some of the controversy currently surrounding them.

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