

# Corporate Voting

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*Abstract: Discussion of shareholder voting frequently begins against a background of the democratic expectations and justifications present in decision-making in the public sphere. Directors are assumed to be agents of the shareholders in much the same way that public officers are representatives of citizens. Recent debates about majority voting and shareholder nomination of directors illustrate this pattern. Yet the corporate process differs in significant ways, partly because the market for shares permits a form of intensity voting and lets markets mediate the outcome in a way that would be foreign to the public setting and partly because the shareholders' role is more limited than that of citizens in the political process. The most developed theory of corporate voting, Easterbrook & Fischel's economic based theory from the 1980s, describes shareholder voting as the best means to fill gaps in incomplete contracts; shareholders as the residual owners have the best economic incentives to exercise such discretion. Such a theory supports unfettered shareholder action substantially broader than what actually exists.*

*In this article, we set out a new theory for shareholder voting based on information theory and more particularly voting as a method of error-correction. Like the prior theory, our approach explains why, among various corporate constituencies, only shareholders may vote. More importantly, our theory provides a more consistent theoretical foundation for explaining the few issues on which shareholders actually do vote. We use this approach to address the recent development of empty voting, a process where investors have used innovations in finance such as derivatives, equity swaps and share lending, to obtain voting rights in a corporation stripped of any financial interest in the company. The error-correction purpose of corporate voting requires that there be alignment between the voting right and the underlying financial interest of shares as has been illustrated in the traditional corporate law practices of one share/one vote and bans on vote buying and contracts that separate voting rights and financial interests. We propose that courts reinvigorate these principles to police empty voting. Our theory also provides a superior framework in which to assess proposals for increased shareholder power in corporate governance.*

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I. Introduction

What are we to make of shareholder voting? Delaware law presents voting as the ideological underpinning of a corporate governance system that gives directors wide control over other people's money.<sup>1</sup> In the legal commentary, there are recurring descriptions of corporations as representative democracies in which members act through their representatives,<sup>2</sup> reinforcing a legitimacy role for corporate voting allied to political theory. Yet there is reason to wonder if corporate voting requires such a broad foundation. Voting plays a limited role in corporate decision-making, much more limited than in the public sphere. Shareholders have binding votes on only two things, the election of directors and ratifying fundamental corporate changes such as mergers. Even in those two areas, legislatures and courts have permitted substantial limits on the exercise of the shareholder franchise. Shareholders seldom seem to care much about the vote even when they have it, usually preferring the "Wall Street rule" (i.e. sell) when they disagree with a decision made by the corporation's managers.

This reality should push any discussion of corporate voting away from a focus on democratic theory and legitimacy, which would imply voting is a way to aggregate the preferences of the rightful claimants as to who should run a corporation (or the country), and more toward a framework based on information theory in which voting is a means of error correction for decisions. The mere existence of markets for shares drives much of this movement. A corporate voter who has intense feelings about the matter to be determined can influence, if not control, the outcome by purchasing shares, an efficiency that would induce envy even in our richest presidential candidates. Our corporate law is not troubled that shares are purchased in the heat of a corporate election campaign; indeed this structure assumes that even non-selling voters will decide largely on the basis of price information provided by the market. Voting when it does occur is embedded in an intentional governance structure that usually trusts directors to make corporate decisions, subject to a bevy of interlocking constraints. Voting is saved for those few contexts that are so fraught with potential for insider conflict that a

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<sup>1</sup> *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests"); see also *MM Companies, Inc. v. Liquid Audio, Inc.* 813 A.2d 1118, 1127 (Del 2003) (Delaware courts "have remained assiduous in carefully reviewing any board actions designed to interfere with or impede the effective exercise of corporate democracy by shareholders, especially in the election of directors.")

<sup>2</sup> Scholars differ on where a framework of representative democracy might lead. Compare, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 837 (2005) (arguing for shareholder power not only to elect and replace directors but also to initiate and adopt rules of the game decisions) and Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 DEL J. CORP. L. 1, 28 (2002) (representative democracy as part of the "deep design" of Delaware corporate form but the shareholder choice provided is "the right to choose representative periodically not the right to perpetual self-government through instant polls and plebiscites.")

check by shareholders is needed. Our theory, therefore, does not start with shareholders as a plenary owner or decision-maker, but rather seeks to more precisely calibrate where shareholder voting improves the decision-making process.

If it is permissible to buy shares, why isn't it also permissible to buy the votes, separate from the shares, as yet another market based mechanism that can be used to reflect parties' intensities of views and their ability to place funds behind those intensities? Long-standing legal prohibitions against vote buying for corporate shares have withered in recent decades and courts have struggled to define a consistent theory supporting such a ban. Our approach suggests that there remains a need for a legal prohibition on vote buying, albeit one that does not look exactly the same as the traditional remedy of that name. For shareholder voting to play its assigned governance role as a check on directors in particular settings, voting must be linked to the underlying financial ownership rights of shares, as a way to ensure that the voters' interests align with the collective interest. Financial innovation in securities markets has now made it much easier to separate voting interests from the economic rights accruing to shares through derivatives, swaps and other complex instruments and transactions. The practical result has been to break the connection between voting and collective welfare on which the use of voting in traditional governance structure rests. This has been highlighted in recent "empty voting" episodes where investors have retained voting rights without the financial exposure so as to influence a particular vote to the financial detriment of the corporation as a whole.<sup>3</sup> The legal structure has not yet caught up to these financial developments.

In this article, we seek to provide a current view of the place of shareholder voting in corporate law. We begin with a brief discussion of the purposes that voting serves generally and the requirements that might follow from such a specification. Second, we identify how voting is different in a corporate setting. In subsequent discussion, we set out a general theory of shareholder voting that differs from the contractarian or anti-managerialists proposals that have dominated prior discussions. We conclude that voting retains an important, albeit limited role in corporate governance; that shareholder voting is not plenary but targeted; and, that for voting to play this role there must be alignment between the interest of those who are given the vote and the collective interest of shareholders. We discuss how financial innovation has decoupled that relationship but in a way that is different from voting trusts and vote buying which have been addressed by earlier case law. We then develop how the law can evolve to discourage such behavior.

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<sup>3</sup> This is discussed in more detail in Part V. See generally, Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Control*, 155 U. PA. L. REV. 1021 (2007); Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

This theory also suggests the items for which shareholder voting is most needed, as in replacing entrenched directors who are blocking a value-increasing transactions or in denying an empire-building merger proposed by directors and managers. As a descriptive matter most voting follows this specification. As a normative matter we suggest specifics as to where voting should expand (blocking poison pills) and where it is less necessary (shareholder nominations for directors.)

## II. Purposes of Voting

Voting can play a variety of different roles. At its most basic level, voting is a means to aggregate the preferences of a group when there is not necessarily a right or wrong answer. It is a way for a group with a multitude of opinions to decide on one. In a universe where there is no perfect method to aggregate individual preferences into a social preference,<sup>4</sup> voting remains a very common way of making decisions in a group. A pure democracy, such as a New England town meeting, is a classic example of this use of voting.

A different use of voting is as a method of decision-making that will ensure the selection of a right answer, that is, to reduce the likelihood of error that might otherwise occur in decision-making. This role goes back to the Marquis de Condorcet who showed that, under suitable hypotheses, a majority vote was more likely to select a correct answer than any individual acting alone.<sup>5</sup> To serve this role, there must be an agreed sense amongst the polity of what the right answer is. In this role, voting is no longer merely an aggregation of preferences, but rather an aggregation of information about the true state of the world. The choice to employ multi-judge appellate panels rather than a single appellate judge might be seen as an example of voting as error-prevention.<sup>6</sup>

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<sup>4</sup> See Kenneth J. Arrow, *THE LIMITS OF ORGANIZATION* 63 (1974) (discussing consensus and authority as decision-making models and the conditions for each).

<sup>5</sup> More formally, the Condorcet Jury Theorem can be stated as follows: Suppose that there are  $n$  voters who must decide between two alternatives, one of which is correct and the other incorrect. Assume that the probability that any given voter will vote for the correct alternative is greater than  $\frac{1}{2}$ . Then the probability that a majority vote will select the correct alternative approaches 1 as the number of voters gets large. Marquis de Condorcet, *Essay on the Application of Mathematics to the Theory of Decision-Making*, in *CONDORCET, SELECTED WRITINGS* (Keith Michael Baker ed., 1976). See also Paul H. Edelman, *On Legal Interpretations of the Condorcet Jury Theorem*, 31 *J. LEGAL STUD.* 327 (2002). The conclusion of the Condorcet Jury Theorem, that majority vote leads to more certainty about the correct outcome than do separate individual judgments, holds under a broad range of assumptions. In particular, one only needs that the *on average*, the voters are more likely correct than not. One can also relax the independence of the votes to allow for some level of correlation. Kishna K. Ladha, *The Condorcet Jury Theorem, Free Speech, and Correlated Votes*, 36 *AMER. J. OF POLITICAL SCIENCE* 617 (1992). It applies in weighted voting situations as well. For a more details see Bernard Grofman, Guillermo Owen & Scott L. Feld, *Thirteen Theorems in Search of the Truth*, 15 *THEORY AND DECISION*, 261 (1983).

<sup>6</sup> Of course this is only an example if one believes that there is a "correct" answer to the matter under dispute.

Third, in principal-agent settings, voting provides legitimacy to a system by which agents act for the larger group. It serves both to legitimize the choice of the agent as well as a means to monitor the work of the agent. In the public sphere, an official's accountability to the electorate is often the prime guaranty that policy-makers will act in the public good.<sup>7</sup> A free and uncorrupted choice by voters provides a guaranty of connection between citizens and policy-makers. An alternative legitimacy function can occur when voting is the means to a fair aggregation system among different groups in an entity or society.<sup>8</sup> In the corporate sphere a vote may act as way to cleanse behavior by an agent that would otherwise be suspect.<sup>9</sup>

Voting may also serve "the expressive interest in equal political standing that inheres to each citizen taken one by one."<sup>10</sup> The act of voting itself is emblematic of status within the polity. Casting a vote gives the voter the satisfaction of having her voice heard.

The ability of the vote to serve these assorted roles is dependent on to whom the franchise is extended. For example, in the principal-agent context, one might argue that the broader the franchise, the greater the legitimacy of the agent's actions. On the other hand, the broader the franchise the less likely there will be agreement on what a "right" answer might be, and so it would be less likely that the vote will serve an error-correcting function. Thus, a key to understanding what an election is doing is to understand how the polity is defined.

Of course the first decision to be made is who should be eligible to vote in any context. That is, whose preferences will warrant consideration? In the American political realm, the minimal threshold has expanded over time, moving from a franchise limited to whites, males and property owners as occurred in the 18<sup>th</sup> century to the current extension of the franchise to all citizens over 18.<sup>11</sup> Thus we have moved away from linking voting and economic interest to recognizing that

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<sup>7</sup> Samuel Issacharoff, *Gerrymandering and Political Cartels*, 116 HARV. L. REV. 593, 605 (2002).

<sup>8</sup> Richard H. Pildes, *What Kind of Right is the 'The Right to Vote* NYU School of Law, Public Law & Legal Theory Working Paper 07-08 available at <http://ssrn.com/abstract=987912>. (right to vote protects several distinct interests and emphasizing aggregate interests where in well-established, mature democracies, most actual conflicts will arise.)

<sup>9</sup> See e.g. Del Code Ann. tit. 8 § 144.

<sup>10</sup> Richard H. Pildes, *supra* note 8.

<sup>11</sup> See United States Constitution, amendment XIV (right of citizens to vote cannot be denied on the basis of race, color or previous condition of servitude); amendment);XXI (right of citizen to vote cannot be denied on the basis of sex; amendment); XXVI (right of citizen to over 18 to vote cannot be denied on the basis of age). See generally, Chilton Williamson, *AMERICAN SUFFRAGE: FROM PROPERTY TO DEMOCRACY 1760-1860* (1960).

individuals have value regardless of economic contribution.<sup>12</sup> Nevertheless, resident aliens and illegal immigrants cannot vote, even though they will be affected by many issues decided in a vote.<sup>13</sup> In addition, convicted felons lose voting rights to varying degrees.<sup>14</sup>

In addition to citizenship and age there are other qualifications defined for those who seek to vote. Residency is the most substantial of these requirements with citizens usually being able to vote in only one place, even if having attachments to several.<sup>15</sup> In a representative democracy in which representation is based on geographic districts, this requirement conforms with the view of the election as providing legitimacy to an agent of the people.<sup>16</sup>

But there are elections, such as referenda, in which the principal-agent model is not implicated. Then the residency requirement can be more puzzling. A referendum to raise property taxes affects the interests of all property owners, even those who do not reside in the jurisdiction. Why should their preferences not be accounted for?<sup>17</sup> Why should a college student's vote count on a referendum concerning some long-term development issue when that student has no intention in staying in the district after graduation?

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<sup>12</sup> Special purpose bodies still sometimes use property ownership as a requirement for voting. See *Ball v. James*, 451 U.S. 355 (1981) (state could rationally limit vote to landowners in election for directors of water reclamation districts).

<sup>13</sup> See e.g. *Cabel v. Chavez-Salido*, 454 U.S. 432, 439 (1982) ("exclusion of aliens from basic governmental process is not a deficiency in a democratic system but a necessary consequence of political self-definition.") Cf. In some jurisdictions, resident aliens are permitted to vote in local elections. See Jamin B. Raskin, *Legal Aliens, Local Citizens: The Historical Constitution and Theoretical Meanings of Alien Suffrage*, 141 U. PA. L. REV. 1391 (1993).

<sup>14</sup> *Richardson v. Ramirez*, 418 U.S. 29 (1994) (California constitutional provision banning felons from voting not a violation of the 14<sup>th</sup> amendment). See generally, Jeff and Christopher Uggen. *Locked Out: Felon Disenfranchisement and American Democracy* (Oxford Univ. Press 2006). See also Samuel Issacharoff, Pamela S. Karlen & Richard H. Pildes, *THE LAW OF DEMOCRACY: LEGAL STRUCTURE OF THE POLITICAL PROCESS* at 30 (2007) (observing that the United States is an outlier with regard to felony disenfranchisement practices).

<sup>15</sup> See 42 U.S.C. 1973aa-1 (residence requirement for voting). For a table as to state by state residency and registration requirements, see <http://www.infoplease.com/ipa/A0781452.html>. See also *Dunn v. Blumstein*, 405 U.S. 330 (1972) (declaring lengthy durational residency requirement for voting to be unconstitutional). Cf. *Glisson v. Mayor and Councilmen of Savannah Beach*, 346 F.2d 135 (5<sup>th</sup> Cir. 1963) and *Saphos v. Mayor and Councilmen of Savannah Beach*, 207 F.Supp. 688 (S.D.Ga) aff'd 371 U.S. 206 (1962) (upholding non-resident voting).

<sup>16</sup> It is a separate question and not a concern in this discussion as to whether residents should be divided into single member districts in voting and the configuration of those districts. See Samuel Issacharoff, Pamela S. Karlen & Richard H. Pildes, *THE LAW OF DEMOCRACY: LEGAL STRUCTURE OF THE POLITICAL PROCESS* at 30 (2007).

<sup>17</sup> See Jerry Frug, *Decentering Decentralization*, 60 U. CHI. L. REV. 253, 329 (1993) (proposing that voters be given the choice of which local election with which they have certain minimal contacts.). Cf. Americans abroad can vote in their home state. See 2008 Absentee Voting Information for American Aboard, [http://travel.state.gov/law/info/info\\_2964.html](http://travel.state.gov/law/info/info_2964.html).

One explanation for this, beyond the tautological response that we only care about the preferences of residents, is to view the election as error correction. By limiting the franchise to those residents in the district we attempt to ensure that those voting will be directly affected by the outcome and will thus have the incentive to invest the time in discovering the “right” answer. That is, the franchise is granted in such a way that the interests of the jurisdiction and the voters are aligned. A citizen who moves will no longer be subject to all of the benefits and costs of a decision and hence will not be allowed to vote, even if she retains an economic or social interest in the jurisdiction.<sup>18</sup> For similar reasons, political parties in many states restrict voting in their primaries so as to avoid cross-over voters with incentives different from those of the party.<sup>19</sup>

Apart from these status based requirements, regulation of voting behavior also occurs because of effort to insure the correct alignment between voting and the common welfare. This can include regulation designed to block rent-seeking by voters. Thus, most states criminalize vote buying because of adverse effect on the process.<sup>20</sup> This can include regulation of behavior that may skew the incentive structure of voters or to respond to the lack of sufficient incentives.<sup>21</sup>

### III. Voting in Corporations

Shareholder voting, discussed within the framework of the previous section, highlights certain differences of the vote in a corporate context. In corporations, the right to vote is granted solely to shareholders, to the exclusion of employees, creditors, communities and others who contribute assets to the enterprise and are affected by its decisions.<sup>22</sup> As noted above, the choice of the breadth of the franchise itself tells us something about the purpose voting serves. The most common justification for the narrow franchise is that the shareholders’ residual

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<sup>18</sup> The National Voter Registration Act, 42 U.S.C. sec. 1973 established requirements for state programs for removing persons from voting rolls beginning with use of postal change of address forms followed by certain required confirmation. Some local jurisdictions tell voters federal law requires that if moving, a voter must change his or her address before being able to vote. See e.g. [http://www.nashville.gov/vote/voter\\_reg.htm](http://www.nashville.gov/vote/voter_reg.htm). Cf. Some countries let expatriates vote: e.g. Mexico, Iraq. See generally, Peter J. Spiro, Perfecting Political Diaspora, 81 NYU L. Rev. 207 (2006).

<sup>19</sup> See <http://innovation.cq.com/primaries?tab=2>; for a tally of the closed and open primaries in the recent presidential primaries. See also *California Democratic Party v. Jones*, 530 U.S. 567 (state cannot mandate blanket primaries for political parties).

<sup>20</sup> See generally, Richard L. Hasen, *Vote Buying*, 88 CAL. L. REV. 1323, 1354 (2000).

<sup>21</sup> Given the remote likelihood that one person’s vote will make a difference in any particular vote, there often seems insufficient incentive for incurring any costs to exercise the franchise. Voting, in this sense, may be best explained by those who have a taste for voting or to view as something like a spectator sport in which providing provides an additional and intense connection to the proceedings.

<sup>22</sup> See, Mod. Bus. Corp. Act § 8.03(c) (directors elected at each annual meeting of shareholders).

interest gives them the best incentives to make decisions for the corporation.<sup>23</sup> As we later develop, we see a more limited role focused on error-correction.

Three other attributes that distinguish shareholder voting from the public franchise are relevant to voting in the corporate arena. First corporate voting is tied to shares, not shareholders. “One share, one vote” has a similar ring to “one man, one vote” but the difference identifies an economic link as the key alignment tool reflecting a desire to incorporate the incentives and monitoring that flows from an economic focus. Early American corporate law often specified one vote per shareholder and this might have been appropriate for a corporation with a small number of shareholders who interacted with and knew each other.<sup>24</sup> Indeed, shareholder voting serves a different purpose in a close corporation where there is no market for shares and a more intimate relationship among the participants.<sup>25</sup> In any event, with the coming of the industrial revolution and the growth of publicly held corporations, one share, one vote, and not one man, one vote, became the norm for corporate voting, enshrining an economic motivation for shareholder voting in public corporations.<sup>26</sup>

Second, the ability to buy and sell shares creates an additional dynamic permitting a shift in equity ownership driven by economics that simply is not possible in public voting. Moving the focus from a market for voters to a market for shares permits a more direct connection between costs and benefits that may counter the rational apathy of voters in public voting. At least where a change in control is possible, any shareholder has an incentive to investigate and vote given that all shareholders can share in the higher price available for an alternative strategy.<sup>27</sup> Even more, the result is to permit a form of intensity voting that does not exist in the public sphere. If you care enough to spend money to buy the shares (and if you have the money) you can increase your influence over the decision.<sup>28</sup> Moreover, larger shareholders have the incentive to incur the costs of research to decide which outcome of a vote will best increase the value of the company’s shares.

Third, shareholder voting is not the fount from which all corporate authority flows. Indeed corporations statutes uniformly provide that all corporate authority

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<sup>23</sup> See Frank Easterbrook & Daniel Fischel, *THE ECONOMIC STRUCTURE OF LAW*, 68 (1991) discussed in more detail in Part IV infra.

<sup>24</sup> David Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of ‘One Share, One Vote,’* 56 *CORNELL L. REV.* 1, 3-11 (1970) (outlining the development of the one share, one vote rule).

<sup>25</sup> See Part IV, infra.

<sup>26</sup> Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 *GEO. WASH. L. REV.* 687(1986).

<sup>27</sup> That there will be a discount reflecting the chance of obtaining control but this discount will not eliminate the absolute value of opting for a positive proposal.

<sup>28</sup> See Saul Levmore, *Voting with Intensity*, 53 *STAN. L. REV.* 11 (2000).

is in the board.<sup>29</sup> That shareholder voting is not designed as the plenary governance mechanism can be seen in the two major contexts in which shareholder voting is required-- election of directors and approval of mergers-- and three other areas in which voting is permissive—bylaw amendments, cleansing of conflicts, and precatory votes via non-binding shareholder resolutions.

*Election of directors.* Corporate law specifies the annual election of directors by shareholders, certainly the most visible statement of shareholder primacy in corporate decision-making.<sup>30</sup> The statement is less powerful than it first appears. Typically there is one slate of nominees, presented by the board itself and directors can be elected by a simple plurality.<sup>31</sup> If all shareholders but one were sufficiently unimpressed as to withhold their votes or not vote at all, the nominees would still be elected. Despite the hand-wringing that such corporate voting looks like the elections of the old time Soviet Union, the legitimacy of this system of corporate governance system is not compromised by limiting the ability of an individual to run for the a board seats in any particular election the way that any American child might aspire to grow up and to be able to run for president.<sup>32</sup> Indeed for most time periods, corporate law is satisfied to have a self-reproducing board. The other constraints on director behavior (e.g. markets, contracts, gatekeepers, norms) work sufficiently well for much of corporate governance. Markets permit a low cost exit to those who disagree with current corporate policy, an exit choice that is much less costly than what may exist in the public setting.<sup>33</sup> What is important about the vote is that shareholders are able to replace directors when they are blocking a value-increasing transaction for entrenchment reasons. Thus the vote by shareholders exhibits less of the legitimizing function in the selection of directors than one sees in a political election of a representative, but still a crucial error-correcting check on the directors' behavior.

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<sup>29</sup> See Mod. Bus. Corp. Act §8.01(b); Del Code Ann. tit. 8 §141.

<sup>30</sup> See Del Code Ann. tit. 8 § 211(b) (annual meeting of stockholders shall be held for the election of directors).

<sup>31</sup> Plurality voting is a default rule under statute statutes and in the face of sustained pressure from institutional shareholders in the last few years many corporations have added provisions to their bylaws or articles requiring a board member who fails to receive a majority of votes to resign. Delaware law permits a director to make an irrevocable resignation conditioned on failing to receive a specified vote. See Del Code Ann. tit. 8 §141(b). Efforts to mandate majority rule either by changes to state and federal law has been raised during this decade but have not succeeded.

<sup>32</sup> See Robert Charles Clark, CORPORATE LAW 398 (1986) (discussing solution to collective action problem of shareholder voting including takeovers: value “does *not* depend on whether the voting rights are ever exercised by the shareholders in ordinary times.”)

<sup>33</sup> Exit is possible in the public sector, but at a substantially higher costs. See Kirk Semple, Rise of Chavez Sends Venezuelans to Florida, N.Y. TIMES January 23, 2008 at A1 c. 3 (describing surge in immigrants to the United States).

The shareholder power to elect directors is further limited by the presence in a majority of American public corporations of a staggered board system in which only one-third of the board of directors is elected each year.<sup>34</sup> Thus, control often requires success in two voting cycles, and in the meantime any money spent by the insurgent to buy shares or finance the election contest provides no return or, even worse, the corporation to which the insurgent's money has been committed is being run by the very group against whom the insurgent has just campaigned. Efforts to speed up the timetable are hindered by legal limits on non-managers' ability to call a special meeting of shareholders<sup>35</sup> or to act by written consent.<sup>36</sup>

*Mergers.* The second place in corporations statutes where shareholder voting is specified occurs in sections relating to approval of mergers and similar fundamental changes.<sup>37</sup> The crucial governance fact here is that this shareholder vote can only occur if the board of directors decides to put the deal before the shareholders. The board thus has a gatekeeper power. If it does not wish for a merger to happen, it is not obligated to put the matter before the shareholders, hardly indicia of shareholder primacy.

Shareholder participation in this decision has evolved from a focus on property rights to error-correction. Until 1890 or so, mergers were only possible through the unanimous consent of all owners. The merger was seen as altering the property of each shareholder, which required each shareholder's assent.<sup>38</sup> Such a rule ill-served the needs of the American economy in the midst of the industrial revolution and so states were prompted to lower the required approval to a supermajority (and later a simple majority) of the shareholder vote.<sup>39</sup> To

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<sup>34</sup> Del Code Ann. tit. 8 § 141(d) (directors may be divided into 1, 2, or 3 classes). The number of large publicly-held corporations with staggered boards has been declining since 2003, and is now less than a majority of the largest American public corporations. Such a provision, like the constitutional structure provided for the U.S. Senate, slows change and provides continuity. See U.S. Constitution, Article I, section 3. Yet change of control is harder in most boards than in the public body. Unlike the Senate, most corporate insurgents start from a 0-100% split on the board and even if they were to win a landslide in the first election, they would only control one-third of the board, which itself operates by majority rule. See Mod. Bus. Corp. Act §8.62; Del Code Ann. tit 8 §141(b).

<sup>35</sup> Del Code Ann. tit. 8 §211(d) (special meeting called by board or such other person as authorized in the certificate). It is uncommon in Delaware public corporations for the certificate to authorize shareholders to call a special meeting. In contrast, the Model Business Corporation Act specifies that 10% of shareholders can call a special meeting, a number that can be raised no higher than 25% by the articles of incorporation. See Mod. Bus. Corp. Act §7.02(a)(2).

<sup>36</sup> Del Code Ann. tit. 8 § 228 (unless otherwise provided in the certificate, stockholder action may be taken by written consent). It is common among publicly held corporations to include a provision to limit such action by written consent.

<sup>37</sup> Del Code Ann. tit. 8 § 251(c) (merger must be approved by vote of majority of stockholders entitled to vote).

<sup>38</sup> Bayless Manning & James Hanks, *Legal Capital* (3d Ed. 1990).

<sup>39</sup> See Mod Bus. Corp. Act §11.04; Del Code Ann. tit. 8 §251(c).

compensate for lowering the threshold of the vote necessary to approve a merger, dissenting shareholders were offered the right to receive a cash payment from the corporation for the fair value of their shares if they did not wish to participate in the changed venture.<sup>40</sup>

The directors and transactional planners of the corporation have considerable flexibility to avoid this shareholder vote in most settings. Typically, American statutes do not require shareholders of the acquiring corporation to vote on stock deals in which the corporation's shares increase by less than 20%.<sup>41</sup> Directors get to make ordinary decisions including small acquisitions, but certain extraordinary matters must also be approved by the shareholders. Yet the directors for the acquiring company can avoid this requirement of shareholder voting entirely by structuring the transaction as a purchase of assets (which is often the financial equivalent of a merger)<sup>42</sup> or a triangular merger in which the actual merger is between the target corporation and a wholly owned subsidiary of the acquiring corporation.<sup>43</sup> Stock exchange listing standards, in a rare display of disagreement with the lenient standards of state law, require shareholder voting in a series of transactions in which the acquiring corporation's stock increases by more than 20%, which would take in many acquisitions done using the triangular method.<sup>44</sup> But even this requirement can be avoided by an acquiring corporation that acquires the target stock for cash as opposed to stock, as Time Inc. did in its well-publicized combination with Warner.<sup>45</sup> For acquiring corporations, therefore, the requirement for shareholder voting in mergers is now mostly optional.

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<sup>40</sup> See Robert B. Thompson, *Exit, Liquidity and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO L.J. 1 (1995) (describing the move by the states from unanimity requirements for merger to requirement for supermajority vote and appraisal rights for dissenting shareholders).

<sup>41</sup> Del Code Ann. tit. 8 § 251(f) (notwithstanding 251(c), no vote necessary if certificate not changed and shares do not increase more than 20%).

<sup>42</sup> See Del Code Ann. tit. 8 § 261 (approval of substantially all the corporation assets requires approval of the shareholders; no mention is made of the purchasing corporation).

<sup>43</sup> A triangular merger is not specifically identified by statute but comes from planners adding a third party to the buyer and seller discussing an acquisition. This third corporation is a wholly owned subsidiary of the buyer and the subsidiary becomes one of the two parties to what is otherwise an ordinary merger. The directors and shareholders of that subsidiary must approve the merger, but that is not a problem since the subsidiary has only one shareholder, the acquiring corporation. The result is that the shareholders of the acquiring company are excluded from voting on the transaction.

<sup>44</sup> See e.g. New York Stock Exchange Listing Standards 312.03(c) (shareholder vote required prior to issuance of stock in excess of 20% in any transaction or series of related transactions).

<sup>45</sup> See *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1149 (Del. 1990) (After Time negotiated a merger with Warner, Time stock was trading in the \$120 range, reflecting the benefits of that merger. Subsequently, Paramount proposed an acquisition of Time first at \$175 per Time share and then \$200; the effect was to make it unlikely that Time shareholders would approve the lower-valued deal with Warner. The requirement that Time shareholders vote on this deal actually came from the stock exchange listing standards, not state law, illustrating the point in the text.)

For the acquired or target corporation, the requirement for shareholder voting remains intact. Sellers of substantially all of the corporate assets (as opposed to buyers) have to follow the same voting rules as a merger participant.<sup>46</sup> The reasons for the distinction between the selling shareholders and the buying shareholders have been much debated over the years. The most plausible explanation, from Ron Gilson, is based on a difference in risk to the selling shareholders, given the other governance mechanisms that are available.<sup>47</sup> Shareholders in the acquiring corporation see a change in their investment, even a large change, but their managers remain subject to the same constraints provided by the market, voting and contracts. In contrast, the shareholders of the target face a different worry. Their managers are in a final period, compromised by a short time horizon and thus there is more reason to seek a specific shareholder check on that decision. While other explanations are possible, the central point is that voting by shareholders is best explained by error-correction of managers rather than an inherent shareholder right to participate.

When the market for corporate control developed to the point that bidders could purchase a majority of shares via a tender offer, voting rights attached to those shares permitted the bidder to gain control of the corporation without director participation. Delaware courts permitted boards to create barriers such as poison pills that effectively provided for a gate keeping role for the board in tender offers as well as the traditional merger transactions.<sup>48</sup> Early in the history of takeover litigation and the development of poison pills and other defensive tactics, the Delaware chancellor ruled there may come a time in a takeover saga when the directors must defer and allow the shareholders to decide,<sup>49</sup> but the Delaware's Supreme Court subsequently termed that reading too expansive.<sup>50</sup> What Delaware has settled on is that the board can use its normal corporate authority to implement defensive tactics that block shareholder decisions made via selling, as in a tender offer, so long as one avenue for shareholder voting vote remains open. In a later case the "opening" for shareholder voting sufficient to sustain a board's defensive action was so narrow that it would have required a

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<sup>46</sup> See Del Code Ann. tit. 8 §261. While target shareholders have a vote, they are denied appraisal rights in Delaware. See id §271.

<sup>47</sup> See Ronald J. Gilson & Bernard S. Black, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* (2d ed. 1995) at 721 (when market constraints fail, legal constraints play a crucial role; target shareholders subject to a final period problem and cannot rely on their management for protection and require instead "the barrier of a shareholder vote as protection against management.").

<sup>48</sup> Delaware courts developed an intermediate standard of review, to address director action. For example In *Unocal*, the Delaware Supreme Court found that defensive tactics, including poison pills, should be judged by a two step process, looking first to whether there was a threat and second whether the defensive tactic was a proportional response to that threat. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del 1985). In *Revlon* the same court required that the directors must get the best price for shareholders when the company is up for sale. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del 1986).

<sup>49</sup> *City Capital Assoc. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 781 (Del Ch. 1988).

<sup>50</sup> *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1149 (Del 1990).

hostile bidder to undertake and win two separate annual meeting elections to empanel a board that would remove a poison pill and approve a merger.<sup>51</sup> This increases the importance of the shareholder right to replace directors described above.

*Bylaws.* Corporations statutes specify shareholders voting to adopt, amend or repeal the corporations bylaw,<sup>52</sup> but this lacks the same mandatory bite of the two prior examples because the statute also permits the certificate to confer on the directors a parallel power to amend bylaws and this is how most bylaw amendments occur.<sup>53</sup> Shareholder voting to amend bylaws has been stunted by long-standing, but unresolved doubts that such a power could be used to produce bylaws that intrude into the area of director control of the corporation provided by section 141 of the Delaware statute.<sup>54</sup> In the last couple of shareholder proxy seasons, some shareholder governance proposals have been presented as binding bylaw amendments, such that additional litigation may soon occur on the extent of this form of shareholder voting.

*Cleansing.* Where directors have a conflict that would possibly taint their actions on behalf of the collective, corporations statutes permit a disinterested shareholder vote to substitute for the conflicted board action. This shareholder action is not the only method to address this conflict—action by disinterested directors or approval by a court can also accomplish the same result. Nevertheless this shows how shareholder voting can be used for corporate decision-making where there is a director conflict.<sup>55</sup> The vote in this situation is limited to disinterested shareholders, a requirement which insures that the voters' interests are aligned with the group.<sup>56</sup> While this safe harbor is provided in corporations statutes, the principle is provided more broadly in case law in various conflict settings.<sup>57</sup> Similarly, the Internal Revenue Code conditions tax deductions for certain manager compensation on prior approval by

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<sup>51</sup> Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del 1995).

<sup>52</sup> See Del. Code Ann. tit. 8 §109.

<sup>53</sup> Del Code Ann. tit. 8 §109(a).

<sup>54</sup> See Del Code Ann. §109(b) (“The bylaws may contain provisions not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees.”)

<sup>55</sup> Del Code Ann. tit. 8 § 144. The Delaware statute is written narrowly so as to only block the old common law impact finding such conflicted transactions to be void or voidable because of the conflict but the practical impact has been broader to narrow judicial review of such transactions.

<sup>56</sup> Delaware reached this result by a somewhat circuitous path. Its statute does not specify which stockholders may vote in a cleansing action in contrast to the parallel subsection immediately preceding which specifies that directors seeking to cleanse must be disinterested. Nevertheless, the Delaware court has in effect read “disinterested shareholder” into the statute. See Marciano v. Naksah, 535 A.2d 400 (Del 1987).

<sup>57</sup> See e.g. Fliegler v. Lawrence, 361 A.2d 218 (Del 1976).

shareholders.<sup>58</sup> The stock exchange listing standards similarly require shareholder approval for options.<sup>59</sup> Each of these seems motivated by the risk of conflict in these particular corporate decisions which shareholder voting can help correct.

*Precatory.* The most active issues of shareholder voting today arise under federal law in areas where the state corporations statutes are silent. During the New Deal, Congress and the administration chose not to federalize state corporations codes but rather to supplement state law with new federal rules, principally disclosure-based, in places where existing state law seemed inadequate.<sup>60</sup> Since 1934 federal securities regulation and the proxy rules in particular, have been focused on arming shareholders with enough information to vote on the issues put to them under state law, principally election of directors and merger transaction.<sup>61</sup>

During the SEC's first decade, the agency recognized that disclosure was insufficient if there was not an adequate supply of items on which to vote. The establishment of Rule 14a-8 extended the shareholder voice by permitting individual shareholders to propose agenda items for collective shareholder action beyond those directors have submitted to the shareholders.<sup>62</sup> In deciding what issues are appropriate for the shareholder ballot, Rule 14a-8 ostensibly defers to state corporate law, requiring that the proposal be one that is appropriate for shareholder action under state law.<sup>63</sup> State courts and legislatures have remained silent as to what is appropriate beyond the election of directors and approval of mergers previously discussed. In that vacuum, the SEC has greatly expanded the number of things on which shareholders can vote, so long as they are precatory or not binding.<sup>64</sup> These proposals express the views of the shareholders, but do not themselves determine corporate policy, which is left to the directors. In earlier years, many of these agenda items related to issues of

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<sup>58</sup> IRC § 162.

<sup>59</sup> See New York Stock Exchange Listing Standards §303A.08.

<sup>60</sup> See 1 L. Loss & J. Seligman, *Securities Regulation* 154.

<sup>61</sup> A key initial focus was shareholder voting, reflecting the premise that inadequate disclosure was permitting managers to gain shareholder approval without sufficient monitoring. See H.R. Rep. # 1383, 73<sup>rd</sup> Cong. 2d Sess 14 (Section 14(a) intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which...[had] frustrated the free exercise of voting rights of shareholders.")

<sup>62</sup> Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97 (1988).

<sup>63</sup> 17 CFR §240.14a-8(i) (company may exclude a proposal if not a proper subject of action by shareholders under the laws of the jurisdictions of the company's organization).

<sup>64</sup> 17 CFR §240.14a-8(i) Note to subparagraph (i)(1).

concern to the larger society, such as the Vietnam War or social issues,<sup>65</sup> but more recently, this forum has become a vehicle for efforts to change corporate governance and institute a greater sharing of power between shareholders and directors.

The challenge for any theory of shareholder voting, including those described in the following section is to explain such a pattern. As we develop below, we believe that this pattern is best explained by an error-correction purpose for shareholder voting, as opposed to one that derives from shareholder property rights or any related theory.

#### IV. Theories of Shareholder Voting

A variety of theories could explain some or all of the shareholder voting system just described, but none of the existing paradigms do particularly well in explaining the existing system or why we should expect shareholders to vote in some matters but not others. Anthropologically, the link to public voting provided something comforting, along with financial rights, for an investor thinking about investing money in an asset the investor would not control in an economy where separation of ownership and control was becoming widespread.<sup>66</sup> More generally, effective shareholder control over managers is regularly cited as a prerequisite to sound corporate governance,<sup>67</sup> echoing the legitimacy argument suggested in Blasius and quoted in our opening paragraph. Often in such arguments shareholders are cast as the necessary counterweight to a managerialist control of the corporation that has been the defining worry of corporate law since Berle and Means wrote of the separation of ownership and control in 1932.<sup>68</sup> Lucian Bebchuk argues for greater shareholder power to insure directors have incentives to serve the shareholder interest and to restore accountability of directors in a system where he sees a lack of other adequate mechanisms.<sup>69</sup> Bebchuk's argument, explicitly separated from reliance on the intrinsic value of corporate democracy and based rather on the role of the

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<sup>65</sup> See e.g. *Lovenheim v. Iroquois Brands, Ltd.*, 618 F. Supp. 554 (D.D.C. 1985) (shareholder proposal relating to procedure used to force-feed geese for production of pate de foie gras in France and imported by the company).

<sup>66</sup> See also Easterbrook & Fischel, *supra* note 23 at 70 (from the survival of voting one may infer that voting is beneficial).

<sup>67</sup> See e.g. EU Directive on Shareholder Rights, (July 11, 2007) 2007/36/EC available at [http://www.eurosif.org/eu\\_eurosif/lobbying/shareholders\\_rights/eu\\_directive\\_on\\_shareholders](http://www.eurosif.org/eu_eurosif/lobbying/shareholders_rights/eu_directive_on_shareholders).

<sup>68</sup> Adolf A. Berle & Gardner Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); see e.g. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 913 (2005) (absent shareholder power to initiate, the evolution of governance arrangements designed in part to constrain and regulate management have been left to a process controlled by management).

<sup>69</sup> Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675, 677, 732 (2007).

franchise in contributing to shareholder value,<sup>70</sup> has provoked challenge on the strength of the link to such value.<sup>71</sup> Other than telling us there is not enough shareholder voting, this theory does not tell us very much about when and how voting should be used. If we are to be able to explain why shareholders vote, when they should vote, and what information they need in order to effectively vote, we require a more robust theory of shareholder voting.

Easterbrook and Fischel present a more comprehensive theory of voting as filling the gaps that necessarily appear in contracts and assigning that gap-filling role to the group with the best economic incentive to do so. Grounded within their broader theory of contract and private ordering, they observe that where contracts are not complete, something must fill in the details. The shareholders hold the residual interest in the corporation and so “have the appropriate incentives ... to make discretionary decisions....The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.”<sup>72</sup> In their theory, therefore, this right to exercise discretion follows the residual claim. For practical reasons shareholders will delegate to managers but nevertheless “managers exercise authority at the sufferance of investors.”<sup>73</sup>

The reliance on shareholders as residual claimants has been challenged, particularly in the wake of development of options theory that has facilitated re-envisioning the firm with debt holders also as residual claimants.<sup>74</sup> More importantly for our analysis, the Easterbrook and Fischel focus on the residual holder’s right to delegate gap-filing would seem to support an expansive view of shareholder action,<sup>75</sup> broader than what we observe in the summary described above.<sup>76</sup> If stockholders merely delegate their roles to fill gaps, why should law

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<sup>70</sup> Bebchuk, supra note 69 at 678; Bebchuk, supra note 2 at 842.

<sup>71</sup> Jonathan Macey, *Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph II Kvetch About Contested Director Elections and Mozart’s Seraglio*, 93 Va. L. Rev. 759, 769 (criticizing lack of a baseline empirical measure specifying how many contested elections is enough); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 Va. L. Rev. 789, 799 (discussing the weak evidence favoring shareholder governance).

<sup>72</sup> Easterbrook & Fischel, supra note 23 at 68.

<sup>73</sup> Easterbrook & Fischel, supra note 23 at 67 (shareholder voting is expensive and generates collective action problems and managers serve as a collective information-generating agency).

<sup>74</sup> The development of options theory has led to a challenge to shareholders as residual owners and the argument that once a firm has issued debt the debt holders can be said to own the right to the corporation’s cash flow and sold a call option to the shareholder. “Put differently, options theory demonstrates that bondholders and equity holders each share contingent control and bear residual risk in firms.” Lynn A. Stout, *Bad and Not So Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1192 (2002)

<sup>75</sup> Easterbrook & Fischel, supra note 23 at 69 (for decisions like new products, new plants all of the actors except shareholders lack the appropriate incentives.)

<sup>76</sup> Their theory is consistent with their widely-noted but unadopted principle that directors should be passive in response to hostile takeovers Frank H. Easterbrook & Daniel R. Fischel, *Takeover*

prevent them from exercising their authority whenever they deem it appropriate? The Easterbrook & Fischel approach would seem to give shareholders carte blanche power to decide any issue, whether or not the directors approve.

Directors, however, are not agents in the pure sense of extending the reach of an asserted principal, the shareholders, to let the shareholders do what they don't have the time or expertise to do.<sup>77</sup> In the world specified in all American corporations statutes, directors, rather than shareholders, have the plenary governance role in the enterprise; all corporate power is placed in their hands.<sup>78</sup> There is efficiency in such a centralized authority structure that could not be replicated with shareholder decision-making except in the smallest of ownership structures. Stephen Bainbridge advocates for such a director-centric view of corporate governance based on the work of Coase<sup>79</sup> and the social choice theory developed by Arrow.<sup>80</sup> He argues that the economic efficiency of the corporate form hinges on the ability of the board to act with the power of fiat, as opposed to relying on some more democratic method of consensus.<sup>81</sup>

The advocates of both shareholder primacy and director primacy acknowledge the risk that directors may be diverted to empire building or toward entrenching action and fail to monitor sufficiently the managers of the corporation engaging in similar behavior. Following Easterbrook & Fischel and others, Bainbridge argues for having shareholders, and only shareholders, assume such a monitoring role. First, he argues that the monitor must be limited to a single constituency, since to do otherwise would produce mixed and possibly unstable signals, thus undermining the monitoring role.<sup>82</sup> Then, like Easterbrook and Fischel, he suggests that the shareholders are the right constituency to serve the role because they are "the only corporate constituent with a residual, unfixed, ex post claim on corporate assets and earnings."<sup>83</sup> As many have recognized, the

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*Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). The Delaware Supreme Court rejected any such notion, *Unocal*, 493 A.2d at 955 n.10 (observing that even the authors conceded that no court or legislature had adopted it.)

<sup>77</sup> Restatement, Third, of Agency (2006 §1.01, official comment (f)(2) (2006) (although the shareholders elect directors, the directors are neither the shareholders nor the corporations agents as defined in this section)); *Arnold v. Society for Savings Bank*, 678 A.2d 533.539 (Del 1995) (directors in the ordinary course are not agents of the corporation).

<sup>78</sup> See Del Code Ann. tit 8 §141.

<sup>79</sup> Ronald Coase, *The Nature of the Firm*, 4 *Economica* 386-405 (1937).

<sup>80</sup> Kenneth J. Arrow, *THE LIMITS OF ORGANIZATION* (Norton, 1974).

<sup>81</sup> Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 *UCLA L. REV.* 601, 621 (2006) ("Limited Shareholder Rights"); Stephen M. Bainbridge, *Investor Activism: Reshaping the Playing Field?* 5, preprint, 2008.

<sup>82</sup> *Id.* at 610.

<sup>83</sup> *Id.* at 613.

information costs and collective action problems associated with a shareholder vote are substantial and the board itself operates “within a pervasive web of accountability mechanisms that substitute for monitoring.”<sup>84</sup> For Bainbridge, these characteristics suggest a limited oversight role for shareholders, so weak, in fact, that for him “they scarcely qualify as part of corporate governance.”<sup>85</sup>

Other advocates of different versions of director primacy emphasize not so much the information costs of shareholder action or the other constraints on director action, but the longstanding concern that shareholders, if themselves empowered without check, would cause the corporation to opportunistically take advantage of other stakeholders. Much of the argument against unlimited shareholder power that fueled the antitakeover movement of the 1980 reflected such fears of shareholder self-interest.<sup>86</sup> The recent activities of hedge funds discussed in the next part of this article have provoked additional director primacy arguments by academics such as Iman Anabtawi<sup>87</sup> and practitioners such as Marty Lipton and his partners focused explicitly on the intra-shareholder conflict occurring when shareholders are given a larger franchise.<sup>88</sup>

This director primacy theory, in its various forms, is not sufficiently detailed to attack the problem we wish to address. Bainbridge accepts the shareholders as the constituency who should be able to vote for directors but finds it of so little use as compared to other possible accountability mechanisms that it is scarcely part of corporate governance. For him and for Anabtawi and Lipton et al., the one thing that is clear is that is that we should fear too much shareholder voting in the same way that Bebchuk concludes that we have too little shareholder voting.<sup>89</sup> What we should seek from any theory of shareholder voting is an

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<sup>84</sup> Id. at 625.

<sup>85</sup> Stephen M. Bainbridge, *Director Primacy: the Means and Ends of Corporate Governance*, 97 *Nw. U. L. Rev.* 547, 569 (2003); see also Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 *Del J. Corp. L.* 769, 812 (2006) (shareholder voting rights are properly seen as simply one of many accountability tools available, not as part of the firm’s decision-making system. In light of the limitations to which these rights are subject, shareholder voting rights are not a very important accountability tool.)

<sup>86</sup> See e.g. Martin Lipton, *Takeover Bids on Target Boardrooms*, 38 *Bus. Law.* 101, 104 (1979) (questioning “whether the long term interests of the nation’s corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprises in which they have bought shares, but only on a quick profit on the sale of those shares.”)

<sup>87</sup> Iman Anabtawi, *Some Skepticism About increasing Shareholder Power*, 53 *UCLA L. Rev.* 561 (more plausible that shareholders will use any incremental power conferred on them to benefit their private interests at the expense of the firm)

<sup>88</sup> See e.g. Theodore N. Mirvis et al, *A Response to Bebchuk’s, The Case for Increasing Shareholder Power*, 119 *Harv. L. Rev.* (2007). (“empowering shareholders under these circumstances...risks to destroy corporate value and compromise the interests of non-hedged shareholders, and is socially inefficient as well.”)

<sup>89</sup> Margaret Blair & Lynn Stout suggest another variation of director primacy that emphasizes the ability of a board to act as a mediating hierarch and thereby various constituents to contribute

explanation of when (and why) we would expect the shareholders to make better decisions than the board so that we might decide which issues are suitable for a shareholder vote and which are not.

We accept that much of the efficiency of the corporate form lies in having a central decision-maker, namely the board. Because of the separation of ownership and control inherent in the form and the possible self-interest that follows from it, some group must be authorized to monitor the behavior of the board. Consistent with several of the prior theories, we believe that the group in question should be homogeneous to avoid difficulties in achieving consensus and that shareholders are that group. But it is at this point in the argument that we diverge from the theories already presented in explaining why shareholders are the appropriate constituency for monitoring and how to determine the breadth of monitoring necessary. The costs of information and the barriers to collective action of shareholders are substantial, so any performance measure has to circumvent those problems. Stockholders are the appropriate group to monitor the board and correct errors where it is conflicted because shareholders are uniquely situated to be sensitive to the principal signal indicating a deviation of the board from its duty to the corporation, the market price of the corporation's stock.<sup>90</sup>

Note that our justification for shareholder voting is not based in any property right to residual value. It is founded on the assumption that the best signal for identifying board error is the stock price and that shareholders are the constituency with the most incentive to monitor that signal. This distinction is important since, in our model, any financial engineering that undercuts that signal can distort the incentives and undermine the value of the stockholder franchise. If the right to vote were solely based on property right, then financial engineering would be less of a concern.

Our view of the shareholder vote, then, is one of information aggregation and error correction. As we discussed earlier, in the situation in which there is an objectively "right" answer, a majority vote of independent voters, each of whom has a better than even chance of being correct, results in an outcome that is very likely correct—indeed the result of the vote is much more likely than the

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form-specific capital to the enterprise by minimizing free of being taken advantage of by other stakeholders. This view gives a more positive view of what directors do, but says very little about the role for the shareholder vote. See Margaret N. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247, 310 (1999)

<sup>90</sup> Stout has argued that stock price is the best available measure, albeit in a context in which she is generally skeptical of shareholder primacy and frames her positive statements in the context of judicial enforcement of director's duties toward shareholders rather than shareholder self-help via voting. She observes "[A] shareholder primacy rule leaves directors with far less leeway to claim that they are doing a good job for the firm when, in fact, they are doing well mostly for themselves." Stout, *supra* note 74 at 1200.

probability of any given voter being correct.<sup>91</sup> Here we have the “right” answer being the option which increases the share price. Shareholder voting will satisfy the necessary requirements to gain the information advantage as structured in the Condorcet theorem. Its premise that voters will expend effort to gather information is clearly satisfied by large shareholders who have an economic incentive to gather information, and sometimes a fiduciary duty to do so.<sup>92</sup> Even if small shareholders are not gathering information, or doing so in a random manner, there is still sufficient information being produced by the large shareholders so that a vote by the group is more likely to produce the correct outcome than any shareholder acting alone. Thus, this error-correcting approach can justify the claim that a shareholder vote is at least as likely to give the correct outcome as the decision of the board and thus a shareholder vote can act as an effective monitoring force.

Our shift in focus on the reason for shareholder voting gives us more traction on the type of issue which should be monitored. We agree with Bainbridge that the “[p]reservation of managerial discretion should always be the default presumption,”<sup>93</sup> and thus monitoring is only required when the board is obviously conflicted. But our focus on stock price as the signal of board error gives us some more information. The stockholders should only act in the role of monitor when the possible board conflict would result in a change in the stock price. If there is likely to be no signal from the market, then there is little reason to believe that the stockholders will be effective in their monitoring efforts. While the reliability of the market price as a signal for the need to monitor director decisions is good, and likely better than possible alternatives, there are times when this is not so. We discuss in Part VB, in the context of shareholder power to remove a poison pill, the likelihood of shareholder opportunism in some situations, the possible use of director power to restrain it, and the need to balance the two risks board selfish behavior and shareholder selfish behavior. But recognizing a system that takes into account these two core risks does not detract from the utility of focusing on error-correction as a theory for shareholder voting that provides the most explanatory power.

It is worth noting the bounds of what this theory seeks to explain, the role of voting in public corporations with dispersed shareholders, and not the contrasting nature of voting in close corporations or public corporations with a controlling shareholder. Not all corporations make use of the separation and specialization of function permitted by the corporate form. Close corporations and corporations with controlling shareholders are subject to the same statutory rules including voting procedures. But the use of voting by those entities does not necessarily

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<sup>91</sup> See *supra* note 5.

<sup>92</sup> The success of RiskMetrics’ Institutional Shareholder Services (ISS) and Governance Metrics International is an indication of the amount of resources institutional investors commit to securing securities information.

<sup>93</sup> Bainbridge, *Limited Shareholder Rights*, *supra* note 79 at 628.

tell us very much about the purpose of voting in the public corporation. Indeed corporate law is full of examples of enterprises that use the corporate form but desire to avoid some of the core corporate characteristics.<sup>94</sup> Voting within close corporations or by controlling shareholders is the mechanism to implement the property rights that follow from acquiring controlling interest in a corporate entity.<sup>95</sup> It serves to aggregate social preferences but does not aggregate information. The likelihood of the correct decision when there is a vote with a majority shareholder is exactly the likelihood of the majority shareholder alone getting the right answer; there has been no improvement in accuracy because of voting. The electoral process does provide a method in such a setting to aggregate social preferences and to permit the majority's preference to prevail (as opposed to some other system of aggregating social preferences which might let a monarch or dictator's social preference to prevail) What makes voting distinctive in a public corporation with a separation of ownership and control is to specify conditions in which shareholders can improve the decision-making function of directors.

Shareholder voting is sometimes conflated with broader views of shareholder primacy as illustrated in the oft-quoted legal principle that directors have a fiduciary duty to act in the best interests of shareholders. The two are not the same thing. When shareholder voting is possible, the decision is made by shareholders with no intermediation by directors or judges. In contrast, when a judge interprets fiduciary duty to limit actions directors may take, the involvement of both directors and judges usually operates to soften the degree of shareholder determination. Thus, fiduciary duty has sometimes been used to limit director actions that interfere with shareholder choice. The *Unocal* and *Revlon* decisions that provide a higher, intermediate level of review as to defenses to corporate takeovers are prominent such examples.<sup>96</sup> This difference between shareholder primacy enforced by judges through fiduciary duty and shareholder voting reflects the theory of voting we seek to develop here. There are times when voting will work better than judging in addressing decision-making within the corporation.

In summary, we have developed an alternative theory of shareholder voting, based on error-correction, capable of explaining more of the visible pattern of voting by shareholders. Shareholders are the unique homogeneous constituency

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<sup>94</sup> See F. Hodge O'Neal & Robert B. Thompson, CLOSE CORPORATIONS AND LLCs: LAW AND PRACTICE (Rev. 3d Ed 2004) §1.16 (describing how close corporations avoid core corporate characteristics).

<sup>95</sup> See Easterbrook & Fischel supra note 23 at 67 ("Voting serves its principal role in permitting those who have gathered up equity claims to exercise control.")

<sup>96</sup> Yet, the *Revlon* rule requiring the directors to get the best price for shareholders in an acquisition has been effectively made an option, avoidable by the planners choosing a share for share merger (except in the unusual situation in which the target is being sold to an acquirer with a controlling shareholder. See e.g. Sumner Redstone in *Paramount Communications, Inc. v. QVC Network, Inc.* 637 A.2d 34 (Del. 1994).

who are sensitive to the stock price, which is a decent proxy for the interests of the corporation. Restricting the vote to stockholders aligns the interest of the corporation with the voters. Because the vote is granted only to those who benefit from a higher stock price, there is an objective measure of “right” for the questions brought before them: the “right” answer is the one that increases the stock price. This assures that the decision of the stockholders can effectively act as a monitor for the actions of the board. Our theory allows us to examine questions such as which issues are appropriate for oversight -- those which will result in a change in the stock price) and what financial engineering arrangements act to undercut the value of this monitoring regime—those that separate ownership from financial interest. In the last section of this paper we will give examples of how to apply these insights in real-world situations.

## V. Applications

In this section we explore some of the consequences of our theory of corporate voting. In Subpart A we consider the appropriate response to “empty voting,” the phenomenon in which a stockholder has sold his or her economic interest in the stock but has retained the voting right. Our theory argues for a more active enforcement of the alignment between the voting interest and the financial interest of the shareholder. In Subpart B we apply our theory to the question of what issues are appropriate for a shareholder vote. Here we focus on the connection between the issue and the stock price, as well as the possibility that shareholders may be as compromised as the board.

### A. Shareholder Alignment and the New Technology

Innovations from technology and finance have made it easier to separate voting from financial interests of shares. This disconnect compromises the ability of voting to perform its assigned role. Like derivatives generally, we have seen new bundles of rights created and then marketed to investors whose risk preferences match those bundles. These innovations have challenged the early 20<sup>th</sup> century view that combined voting/financial interest was an essential attribute of shares. Twenty five years ago Easterbrook and Fischel began from a foundation that it was not possible to separate the vote from the equity interest, but that has been overtaken by new financial realities.<sup>97</sup> The financial innovation of recent decades has multiplied the possible strategies and effects; today the market is such that providers can slice and dice the shareholder’s interest in a variety of ways and investors are willing to buy such separate interests. Equity swaps occur in a variety of shapes and sizes. Lending of shares has become a massive business.<sup>98</sup>

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<sup>97</sup> Easterbrook & Fischel, note 23 supra at 74.

<sup>98</sup> A recent survey put the balance of outstanding stock loans as of mid-year-2005 at \$1.5 trillion. See John Hintze, Automation Has Greater Impact as Security Lending Increases, Securities Industries News (May 8, 2006).

These new slices make possible a variety of transactions that were not possible in earlier times, including voting transactions that may be the dark underbelly of these innovations. The Mylan/King Pharmaceuticals acquisition has become the most visible of these transactions, although Hu and Black in a recent paper list 80 examples in 20 countries.<sup>99</sup> That transaction involved a merger between two pharmaceutical companies by which Milan Laboratories would acquire King Pharmaceuticals in exchange for Mylan shares. As a merger, this action required approval by the shareholders of each company.<sup>100</sup> This deal reflected what is a typical division of gains in acquisitions where the target shareholders receive a premium for their shares, often 30% or more and the acquirer's shares stay the same or decline slightly.<sup>101</sup> Given the premium, approval by the King shareholders was likely; approval by the Mylan shareholders was more in doubt. Perry, operator of a hedge fund with about seven million shares in King and a possible \$28 million gain sought to improve the odds of receiving the premium for the King shares by purchasing 9.9% of the shares of Mylan prior to the vote. To hedge the economic risk of his purchase (including any additional possible loss to Mylan shares because of perceived negative economic effects of the merger), Perry entered into swap transactions in which he effectively disposed of the financial risk but kept the votes. The result then was that he could influence the outcome of the acquirer's votes even though he had no financial interest in the acquirer and in fact was operating at cross purposes to the interests of the acquiring shareholders as a whole.<sup>102</sup>

Allowing empty voting completely undercuts our justification of shareholder voting. Retaining the vote without a financial interest eliminates the error-correcting rationale of voting. To argue that "empty voting" is not a concern is to argue that there is no need for shareholder voting at all. Before presenting our suggestion for responding to empty voting, we first address two arguments that would remove the need for such action—first an economic based argument that vote buying transactions produce overall gains for society and the second, that disclosure can best address whatever problems arise because of empty voting.

More than 40 years ago, Henry Manne argued that allowing the unrestricted trading of votes would benefit shareholders in the same way that economic

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<sup>99</sup> Henry T.C. Hu and Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. 625 (2008).

<sup>100</sup> See note 39 supra.

<sup>101</sup> See Robert F. Bruner, *APPLIED MERGERS AND ACQUISITIONS*, (University Ed. 2004) at 736-40 (summary table of gains of acquirer and target returns upon acquisition).

<sup>102</sup> See generally, Kara Scannell, *How Borrowed Shares Swing Company Votes*, Wall St. J. Jan. 26, 2007 at A1); See also Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Control*, 155 U. PA. L. REV. 1021 (2007).

exchanges produce economic gains elsewhere in the economy.<sup>103</sup> Similar arguments can be made in the Mylan/King transaction. If the Mylan/King transaction produces net gains on the whole, apart from the distributional consequences for the shareholders of the two companies, vote buying which facilitates this result can be a positive for the economy. When the shareholder census consists of diversified investors such as institutional shareholders, they may well own shares in companies on both sides of the deal and would prefer a transaction where their net investment increases without worrying if that net is made up of a larger gain on the target side and a smaller loss on the acquirer side. Larry Ribstein and Bruce Kobayashi have shown that vote buying in a King/Mylan share prevents an undiversified shareholder, such as a Carl Icahn, from standing in the way of a beneficial total gain.<sup>104</sup>

We find these economic justifications for empty voting unconvincing for two reasons. The first is that, as we have argued earlier, the purpose of the vote is to act as error-correction for directors and management, with the goal of ensuring that the stock price of the company will increase. It is not to facilitate transactions that lose money for the shareholders but are part of a combined transaction that is efficient in the Kaldor-Hicks sense of that term. If the goal of the vote were to facilitate such transactions then there would be no reason to have voting done by companies or to limit the franchise to stockholders. Indeed, the pursuit of Kaldor-Hicks efficient transactions would almost surely entail giving influence to employees, bond holders, suppliers, and/or local government officials. Corporate law has rejected that approach—voting occurs by companies not by transactions and the franchise is limited to stockholders because the law has decided that each corporation is best served by focusing on its own stock price and not by looking at social welfare overall.

The other argument against using voting as a justification for an outcome that is bad for shareholders but economically more efficient is that this is exactly a situation in which the directors should be disciplined by their shareholders. If the deal truly produces a cooperative surplus, then it should be the responsibility of the directors to capture some of that surplus for the shareholders. To cede all of that surplus plus more to the other party, leaving the shareholders in a worse position than before, requires the sort of error correction that corporate voting provides.

Many institutional shareholders already find themselves in a position where they own shares in companies on both sides of a merger. It is likely that many base their vote on the net effect of the deal on their total holdings, a context that has not raised the same concerns as empty voting. It is less worrisome because

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<sup>103</sup> Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM L. REV. 1427 (1964).

<sup>104</sup> Larry E. Ribstein and Bruce H. Kobayashi, *Outside Trading as an Incentive Device*, 40 U. CAL DAVIS L. REV. 21 (2006).

such behavior will not create a systematic bias since the number of institutional investors who are unbalanced in the direction of the target should balance the numbers who are unbalanced in the direction of the bidder and all have an economic interest in both sides. While a vote buyer can move the vote in the direction of a value-increasing transaction just as the net institutional investors might, the buying of votes without economic interest means that this can also occur when there is not a net economic benefit, but only an effort to make money on one side.

In the several years since empty voting was first identified, academic commentary focused on disclosure. Kahan and Rock's innovative treatment of hedge funds and activists investors was skeptical of a need for anything more than disclosure.<sup>105</sup> Hu and Black's first set of papers on empty voting focused on transparency and disclosure.<sup>106</sup> Their integrated disclosure proposal suggests overhauling the principal federal disclosure requirements, under Sections 13D, 13F, 13G and 16 of the Securities Exchange Act and under mutual funds regulation to include relevant information about equity swaps and other derivatives. Additional disclosure relating to hedges and derivatives has been put in place in the last few years in the United Kingdom, Hong Kong and Switzerland.<sup>107</sup> In January, 2008 a group of Europe's largest hedge funds issued voluntary best-practice guidelines that could prompt greater disclosure from the funds.<sup>108</sup>

Why might one expect that increased disclosure would curb empty voting? Disclosure's effect might arise from a combination of several influences. Reflecting Brandeis' classic work from a century ago that sunlight is the best disinfectant,<sup>109</sup> disclosure by itself might cause some of the traders to eschew empty voting. It may also discourage the required counterparties from participating in such transactions. In addition, disclosure can provide necessary information for others in the market to adapt and counter the actions of empty voters, thus making the strategy less productive.

Disclosure, however, will not necessarily prevent the counterparty from agreeing to an empty voting transaction. Each of Perry's transactions had a counterparty, such as Goldman Sachs and Morgan Stanley, who may have a conflicting interest to the empty voter and there is also the possibility of another investor engaging in similar transactions on the opposite side. In the Mylan case,

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<sup>105</sup> See Kahan & Rock, *supra* note 3 at 1076.

<sup>106</sup> Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

<sup>107</sup> Hu & Black II, *supra* note 99.

<sup>108</sup> Cassell Bryan-Low, *European Hedge Funds Issue Disclosure Guidelines*, WALL ST. J. Jan. 23, 2008 at C6 c. 3.

<sup>109</sup> L. Brandeis, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1933).

Carl Icahn owned a large position in Mylan and was active in seeking to encourage a negative vote on the transaction by its shareholders.<sup>110</sup> Icahn apparently did not engage in vote buying although he was said to have taken a short position in King, enabling him to make money on both sides of the deal should the deal not be successful.

Even with complete and effective disclosure, however, there is reason to worry as to whether the counterparties have sufficient economic incentives to forgo a transaction that creates shares with empty voting. First, where the counterparty's transaction is motivated by share lending or hedging unrelated to voting, the economic incentives from those activities may drown out any incentives attributed to voting. To the extent that lending shares and swaps are embedded within a large and lucrative financial industry whose main purposes are unrelated to vote buying, the marginal incentives provided by voting will likely be insufficient to drive the transaction. In addition, the counterparty's possible economic loss will be muted to the extent that the market will already have anticipated much of the economic impact of the acquisition for the acquirer.<sup>111</sup> Thus, at the time of the swap transaction, the stock of the acquirer likely will already have fallen, given the prior public announcement of the takeover, such that the counterparty will not suffer further loss and will have less incentive to counter a Perry type strategy.<sup>112</sup> Further, to the extent that traders like Goldman Sachs and Morgan Stanley are not using their own money, there is an agency problem in which the costs of the swap will not become visible to the principal or the voting value can be buried within a larger trading strategy.

Professors Martin and Partnoy, who published the first work on this issue argued that encumbered shares, as they termed shares whose economic interest has been hedged, should carry no or little voting rights.<sup>113</sup> Professors Hu and Black have now gone beyond their initial disclosure proposal and recommended a host of structural changes including letting corporations amend their charter to limit empty voting; requiring attestation by large shareholders that their vote does not exceed their economic interest by more than 20%; barring voting with negative economic ownership; requiring derivatives dealers holding matched shares to hedge a short equity position held by an investor to pass through voting

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<sup>110</sup> The deal ended for other reasons when King reported unexpected earning changes.

<sup>111</sup> Fred J. West et al, TAKEOVERS AND RESTRUCTURING AND CORPORATE GOVERNANCE (4<sup>th</sup> Ed. 2004) at 596 (describing the effect of the merger arbitrage market that after the announcement of a merger, the price of the target typically trades at a small discount of 1-2% relative to the consideration offered by the acquirer.)

<sup>112</sup> There could be a loss to the extent that the current market price will reflect the expected financial impact of the transaction on the acquirer multiplied by the likelihood of the deal going through. To the extent that the probability is less than 100%, the current price will only reflect a percentage of that decline. As the takeover moves toward successful completion if it does, the gap between the entire change and the market price will narrow and to that extent counterparty in the acquirer side could face some additional loss.

<sup>113</sup> Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 ILL. L. REV. 775.

to counterparties; providing a safe harbor to permit institutional investors to recall shares without being subject to derivative suits for not lending; requiring institutional lenders to be able to recall lent shares; requiring record owners to recall a sufficient number of shares sufficient to honor anticipated voting instructions; limiting share loans by record owners; amending state law to permit proportionate voting when there is over voting; having voting agendas available before the record date; and separating dividend and voting record dates.<sup>114</sup>

The vast difference in size between the share lending transactions and hedging in the global market and the much smaller number of possible empty voting transactions means that for many of these proposals substantial large costs will be imposed on the larger business to address empty voting. We focus our proposed solution on a less complicated suggestion that reflect the law's traditional concern about alignment between economic and voting interest. We propose a modern adaptation of the traditional corporate law bans on agreements that separate voting from control and on vote buying.

As we have shown in Part III, voting in the corporate context is thought of as playing both an error-correcting and principal-agent monitoring role. In order for it to play this role effectively, there must be an alignment between the voter's interest and the common good. Even where the scope of shareholder voting is limited as previously set out, the essential nature of the remaining role for voting has long motivated legal efforts to prevent the disruption of the alignment between voting and financial interest. Such pro-alignment efforts include: (1) requiring one share/one vote; (2) a ban on agreements that separate voting from financial interests in shares; and (3) a ban on vote buying. In the following we will survey the judicial response to each of these methods of disconnecting voting interest from economic interest.<sup>115</sup>

#### 1. One share/ one vote requirements

The traditional requirement that every share have the same vote is perhaps the clearest example of the law's concern for separation between voting and financial interest in a public corporation. A voting system that gives some shareholders, for example, the founding family or management, multiple votes per share as compared to common shareholders means the decision-maker's incentives are not fully aligned with the financial results of the decisions. The

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<sup>114</sup> Hu & Black, Empty Voting II, *supra* note xx.

<sup>115</sup> In addition there are other legal rules that reflect similar concerns such as a prohibition of voting shares owned by the corporation (Del Code Ann. tit. 8 §160(c)), excluding votes by shareholders who are conflicted (Del Code Ann. tit.8 §144), and provisions requiring a majority of the minority vote for approval of a merger with a controlling shareholder (*In re Cox Communications Securities Litigation*, 879 A. 2d 604 (Del. Ch. 2005)).

requirement, however, is not found in any state or federal statute or regulation,<sup>116</sup> but rather in the listing standards of the New York Stock Exchange (and more recently in parallel provisions in Nasdaq and other exchanges).<sup>117</sup> The original provision resulted from populists efforts in the 1920s, (spurred by the arguments of a Harvard professor) at a time before there was any federal corporate law and when the stock exchange had a greater role in setting rules for corporate governance.<sup>118</sup> As a result, with rare exceptions, such as when Ford Motor Co. went public in 1956 and wanted to keep control within the Ford family, American public companies exhibited a firm alignment between voting interest and financial interest.<sup>119</sup>

In the 1980s, in the face of a wave of hostile takeovers and a swarm of defensive tactics that included an increased use of dual class shares, the New York Stock Exchange began to worry about its competitive position relative to other exchanges and pushed the Securities and Exchange Commission to adopt a rule for all American public companies.<sup>120</sup> After a federal appellate court struck down the agency's rule as beyond its power to regulate on corporate governance,<sup>121</sup> the SEC pursued (and was ultimately successful in) a lengthy effort to persuade the major American exchanges to each adopt a similar rule banning midstream adoption of dual class voting structures.<sup>122</sup> Although 8% of American companies, including well-known firms like Google, have dual class structures at the time they go public, one share one vote remains the standard, for reasons that parallel to vote/financial interest alignment discussed below.<sup>123</sup> The expectation is that the founders and other selling shareholders in the IPO will receive less money for the shares if the system is inefficient. To the extent that such inefficiencies lead later to poor performance, those companies remain

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<sup>116</sup> See e.g. Del Code Ann. tit. 8 §212(a) (providing a rule of one vote per share "unless otherwise provided" in the certificate),

<sup>117</sup> See note 44 supra.

<sup>118</sup> See Seligman, note 26 supra,

<sup>119</sup> See J. Livingston, *THE AMERICAN STOCKHOLDER* 166-77 (1958).

<sup>120</sup> 17 CFR §240.19c-4.

<sup>121</sup> *Business Roundtable v. Securities and Exchange Commission*, 906 F.2d 406 (D.C. Cir. 1990) (rule that directly controls the substantive allocation of power among shareholders in excess of commission's authority).

<sup>122</sup> Current NYSE Listing Standard 313.00 prohibits corporate actions or issuance of shares that disparately reduce or restrict voting rights of existing shareholders of publicly traded companies registered under Section 12 of the Exchange Act including the adoption of time phased voting plans or the issuance of super voting stock or similar actions. The actions by the stock exchanges, a semi-private "self regulatory organization" under the 1934 Act have not been held to be state action.

<sup>123</sup> Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Companies in the United States* (May 2007)(available at SSRN: <http://ssrn.com/abstract=562511>.)

vulnerable to economic pressure as the New York Times is now experiencing.<sup>124</sup> The recent takeover of the Dow Jones Company, despite its dual class structure privileging its founding families, shows the limits of these tactics.<sup>125</sup>

## 2. Ban on Separating the Vote and the Financial Interest

It was a common feature of American corporate law at the turn of the 20th century to ban devices such as voting trusts which separated the voting interest of shares from the financial rights of those shares as such a separation would disrupt the otherwise healthy result that would flow from voting.<sup>126</sup> While not detailed, it is clear that early courts had a clear understanding of the importance of the alignment of a shareholder voting and financial interests.<sup>127</sup> Arrangements which interfered with that alignment raised legal concerns.

The legal justification for interfering in what would normally be considered a legitimate contract between private parties was often framed as a public policy that each shareholder is entitled to rely on an independent judgment of fellow shareholders.<sup>128</sup> Courts in the early voting cases described this public policy as leading to a fiduciary duty owed by all shareholders to one another and that no shareholder by contract could disable herself from performing that duty. While fiduciary duty today is usually limited to agents such as managers and directors who have the centralized power to make decisions for the entity or to controlling shareholders wielding similar power, courts still apply a similar duty to individual non-majority holding shareholders in close corporations in contexts where the shareholder's vote gives her a veto on action beneficial for the corporation.<sup>129</sup>

These traditional bans on separation of voting from economic interest have been relaxed in recent decades. In large part, this reflects the realities of the close corporation context in which much of this discussion has occurred. An examination of those contexts is a useful guide to the continuing applicability of these concepts in contemporary public corporations.

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<sup>124</sup> Richard Perez-Pena, *New Challenges to Times Board: Dissidents with Large Stakes*, N. Y. TIMES March 10, 2008 at c1.; Emily Steel, *Investor Puts Pressure on New York Times-Nicely*, WALL ST. J. February 1, 2008 at c3, C. 1 (describing efforts of marketing professor who runs an investment firm to pressure the company).

<sup>125</sup> *Mogul's Dream*, News Corp.'s Success Follows Delicate Dance Between Suitor and Target, WALL ST. J., Aug 1, 2007; Page A1.

<sup>126</sup> See Folk, Ward & Welch, *FOLK ON THE DELAWARE GENERAL CORPORATE LAW* (2d Ed) at §218.2 (the legality of voting trusts at common law was not clearly determined by the Delaware courts until enactment of the first voting trusts statutes.)

<sup>127</sup> See e.g. *Lehrman v. Cohen*, 222 A.2d 800 (Del. 1966) (main purpose of statute to legalize voting trusts was to avoid secret combination of shareholders formed to acquire voting control to the possible detriment of non-participating shareholders).

<sup>128</sup> See, *Cone v. Russell*, 48 N.J. Eq. 208, 21 A.2d 847 (1891).

<sup>129</sup> See *Smith v. Atlantic Properties, Inc.* 12 Ma App Ct 201, 422 A.2d 798 (1981).

When there were only a small number of shareholders, courts were willing to permit voting agreements that facilitated an aggregation of preferences and an implementation of majority rule. The property interest of each shareholder provided a financial commitment that aligned the voters' interests to at least the majority of the shares. The small number meant there was no collective action problem to overcome as may exist in vote buying in public corporations. In these contexts, courts were willing to relax the traditionally restrictive approach to contracts that appeared to separate voting and financial interests of shares.

Other devices to accomplish a similar purpose have increasingly been permitted by legislatures and courts. Irrevocable proxies are authorized by statute so long as they are "coupled with an interest," a phrase that means the person receiving the vote has a financial interest of some sort in the shares, even if not necessarily proportional.<sup>130</sup> Voting trusts, putting voting power of a group of shares into the hands of a trustee, are permitted by statute, often subject to a time limit and disclosure.<sup>131</sup> Shareholder pooling agreements are permitted by statute or case law.<sup>132</sup>

This legislative and judicial easing of the earlier requirement of alignment of voting and financial interests has occurred within close corporations where the lack of a market for shares and the intimate nature of the relationship of many participants have broadened the need for private contracts that temper the usual corporate norms of majority control and entity permanence.<sup>133</sup> They do not reflect a view that voting without financial interests is not a concern.

### 3. Bans on Vote Buying

A third traditional legal effort to control actions that break the connection between voting and financial interest is the ban on vote buying. Such action is prohibited by statutes in some states<sup>134</sup> and by common law in others.<sup>135</sup> The rationale is similar to the distortion that can arise when voting rights are placed in the hands of one who lacks an economic interest in the business. Easterbrook & Fischel argue that separation of shares from votes introduces a disproportion between expenditures and rewards of those who are making decisions for the

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<sup>130</sup> Del Code Ann. tit. 8 §212(e).

<sup>131</sup> See e.g. Mod. Bus. Corp. Act §7.30 (10 year limit on voting trusts with a provision for renewal).

<sup>132</sup> See e.g. Mod. Bus. Corp. Act. §7.31 (agreement providing how shareholders may vote) & 7.32 (agreements covering a variety of governance issues including management, distributions, share transfers and dissolution; valid for 10 years unless the agreement provides otherwise).

<sup>133</sup> See e.g. Mod Bus Corp. Act §7.32 (containing a self-executing termination provision for shareholders agreement when the shares of the corporation become publicly traded).

<sup>134</sup> See e.g. NY Bus. Corp. L. §609(e).

<sup>135</sup> See e.g. *Macht v. Merchants Mortgage & Credit Co.*, 194 A. 19 (Del Ch. 1937).

corporation that results in inefficiency similar to what can occur with dual class voting.<sup>136</sup> Other arguments reflect a concern for misrepresentation and fraud.

An additional dimension is that vote buying is sometimes seen as helping overcome defensive tactics instituted by entrenched management resisting a takeover that would be possible for shareholders of a target company.<sup>137</sup> When the directors of a target implement take-over defenses, it is often the case that the acquirer is forced to try and unseat the board. Vote buying is seen as a way to overcome various collective action problems among the stockholders. The underlying assumption is that the takeover is in the interest of the shareholders,<sup>138</sup> and the advocates rely on the notion that the vote purchasers will vote in such a way as to maximize stock price.<sup>139</sup>

But as we have seen in the Perry/Mylan case, there is no guarantee that a non-shareholder would have the interest to serve such a function, and we have also seen that in some cases non-shareholders have incentives to promote errors on the part of directors.<sup>140</sup> These situations tend to occur when the vote is by the shareholders of an acquiring company in a merger. Typically, these votes are required not by state law but by the regulations of the listing stock exchange.<sup>141</sup>

Based on the analysis in Part III, the argument against vote buying in the corporate context is more compelling than the argument against vote buying in the political context. In our analysis, corporate voting is designed to correct errors by the directors of the corporation which would lead to a decrease in the value of the stock of the corporation. Shareholders are the constituency with the best incentive to perform this task.<sup>142</sup> The argument against vote buying in the

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<sup>136</sup> Easterbrook & Fischel, *supra* note 23 at 74 (attaching the votes firmly to the residual equity interests ensures that unnecessary agency costs will not occur).

<sup>137</sup> See generally, Thomas J. Andre, Jr. *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. CAL. L. REV. 533, 587 (1990)

<sup>138</sup> Levmore, *supra* note 28 at 137-38 (suggesting states have begun to allow vote buying as a useful safety valve when defensive tactics go too far in blocking desirable takeovers).

<sup>139</sup> Richard L. Hasen, *Vote Buying*, 88 CAL. L. REV. 1323, 1354 (2000) ("Thus, we need not worry, to paraphrase Sunstein, that shareholders will forget what voting in corporate elections is for; voting in corporate elections is for maximizing profit, and vote buying is fully consistent with this purpose.") Thomas J. Andre, Jr. *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. CAL. L. REV. 533, 587 (1990) ("Additionally, the permanent separation of ownership and control is unlikely to occur because the purchaser has every incentive to purchase the residual interests.")

<sup>140</sup> Another instance in which the shareholders of the acquirer had an incentive to vote in a way opposite to the financial interest of the company was a transaction involving AXA and Mony. See *in re MONY Group Inc. Shareholders Litigation*, 853 A.2d 661 (Del Ch. 2004). See generally Kahan & Rock *supra*, note 3.

<sup>141</sup> See text accompanying note 44 *supra*.

<sup>142</sup> See text accompanying note 90 *supra*.

political context is more problematic because there is no objective measure of “right.” Given the large number of constituencies and interests, voting can only aggregate preferences and there is little reason to prefer one person’s preferences over another’s. Democracy, in fact, eschews exactly these sorts of distinctions. Thus, if one voter does not care if his preferences are considered, or is willing to pass on the costs of voting to someone with similar preferences for a fee, it is not obvious from an aggregation of preferences or information perspective why an agreement to sell a vote is wrong.

This is not to say, of course, that there are not good reasons to limit vote buying in the political context that can also apply to shareholder voting. Richard Hasen’s work on vote buying has defined an inalienability purpose, seeing voting as belonging to the community as a whole.<sup>143</sup> Cass Sunstein develops an anti-commodification norm to encourage more public-regarding votes and less voting in individual self-interest.<sup>144</sup> Another approach analogizes vote selling to a restraint of trade that interferes with the market and would be banned by antitrust law. Sam Issacharoff’s concern for the vulnerability that the political marketplace shares with all other markets resonates here—“the possibility that anti-competitive behavior will compromise the ability of selection to reveal true consumer preference.”<sup>145</sup> These arguments against vote buying in the political context may further buttress the argument in the corporate sphere.

The most widely cited modern case on corporate vote buying, the 1982 Delaware decision in *Schreiber v. Carney*, provides a somewhat bewildering treatment of the topic. The court refused to find that vote buying was per se illegal and rejected efforts to define impermissible vote buying by reference to earlier public policy, that the agreement frustrated the shareholder’s exercise of his personal judgment.<sup>146</sup> The court refused to apply a per se rule to an agreement that it found “was entered into primarily to further the interests of [the corporation’s] other shareholders.”<sup>147</sup> Yet the Court held that vote-buying even for some laudable purpose, still is “so easily susceptible of abuse” that it must be viewed as a voidable transaction subject to a test for intrinsic fairness.<sup>148</sup>

In the wake of *Schreiber* many commentators saw the law as having pulled back from substantive regulation of vote buying and similar constraints that

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<sup>143</sup> Richard L. Hasen, *Vote Buying*, 88 CAL. L. REV. 1323 (2000) (describing equality, efficiency and inalienability reasons to ban vote buying).

<sup>144</sup> Cass Sunstein, *Incommensurability and Validation in Law*, 92 MICH. L. REV. 779 (1994).

<sup>145</sup> See Issacharoff, *supra* note 7 at 616.

<sup>146</sup> *Schreiber v. Carney*, 447 A.2d 17, 25 (Del Ch. 1982) (the potential injury that might flow to other stockholders as a result of the agreement forms the heart of the rationale underlying the breach of public policy doctrine).

<sup>147</sup> *Schreiber v. Carney*, 447 A.2d 17, 25 (Del Ch. 1982).

<sup>148</sup> *Schreiber v. Carney*, 447 A.2d 17, 26 (Del Ch. 1982).

limited separation of voting and economic interest.<sup>149</sup> The case law does not seem to support such a broad conclusion. *Schreiber* itself occurred in a context where the asserted agreement was fully disclosed and approved by disinterested shareholders. Moreover the vote buying agreement was a means to *better* align the financial interests of the warrant holder with that of the corporation.

In fact, an analysis of *Schreiber* and similar cases indicates that courts will allow vote buying only in those situations in which such a deal serves to align the financial interests of the shareholders with those of the corporation.<sup>150</sup> Similarly, there is little reason to apply a vote buying prohibition where the challenged conduct provides proxy votes during the period that the party has agreed to dispose of stock as part of a settlement of a failed proxy contest.<sup>151</sup> Nor should there be concern for the failure to apply a vote buying ban to close corporations where, as already discussed, the collective action problems of the shareholders pushed them toward an agreement in circumstances where they are perfectly capable of evaluating whether the incentives of their fellow shareholders creates a conflicted economic incentive for the good of the corporation.<sup>152</sup>

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<sup>149</sup> Levmore, *supra* note 28 at 138 (“Although there is not much law on the subject, I will go along with the current wisdom that vote buying in corporate law is now more acceptable than it once was and that we are soon likely to see more explicit legislative and judicial approval of trading in shareholder voting rights.”; Hasen, *supra* note 139; Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE WEST. L. REV. 776 (1979) (vote buying should be permitted if the purchaser has a substantial equity interest and seeks to profit solely by the change in the value of that holding,)

<sup>150</sup> *IXC Communications, Inc. v. Cincinnati Bell, Inc.*, 1999 Del Ch. Lexis 210 (Del Ch. October 27, 1999) (shareholders agreed to support merger in exchange for cash instead of stock for his stock; deal was disclosed and 60% of stock who could determine outcome of the merge); See also *Kass v. Eastern Air Lines*, 1986 WL 13008 (Del Ch. Nov. 14, 1986) (restructuring required vote of indenture holders; company offered cash/vouchers if they would agree to the amendments).

<sup>151</sup> *Weinberger v. Bankston*, Fed. Sec. L. Rptr (CCH) ¶ 93,539 (Del Ch. Nov. 19, 1987) (as settlement of failed proxy, insurgents took fees and agreed to dispose of stock within a year, given management irrevocable proxy in the meantime.) The closest example among recent cases to a situation where there may be some conflict of incentive between the holders of the votes and economic interest is *Wincorp Realty Inv., Inc. v. Goodtab, Inc.*, 1983 WL 8948 (Del. Ch. Oct. 13, 1983) (insurgent buys option for \$20,000 with \$17,000 kicker if buyer is successful in being elected.) The application for a preliminary injunction of the voting of the shares was denied because the plaintiff failed to show an irreparable injury if the shares were voted and, under *Schreiber*, such vote buying was not illegal *per se*. Moreover, the plaintiff failed to put on the record any evidence of a breach of good faith in the transaction. It is also worth noting that the court distinguished *Schreiber* from the case at hand in two ways: *Schreiber* “was an agreement between the corporation, . . . and a shareholder, the propriety of which was submitted to the other shareholders for approval” and it was “an agreement whereby one shareholder agreed to withdraw its opposition to a plan of management in return for a consideration given by the corporation.”

<sup>152</sup> See e.g. *Haft v. Haft*, 671 A.2d 413 (Del. Ch. 1995) (in which a family whose members entered into agreement controlled a majority of shares of public corporation; father could give shares to son and receive back irrevocable proxy; this wasn't going to affect any decision by public shareholders.)

As we have just shown, the courts have traditionally played a role in policing attempts to separate the financial and voting interest of stocks. Our proposed response requires that courts extend this concern to the arena of empty voting. The core legal principle that will need to be clarified, either by statute or by common law decision is a current manifestation of the traditional rule that voting requires a basic alignment with the collective interest. Contracts that are in disregard of that principle can be voided. Requiring shareholders to certify that they are voting no more shares than they have economic interests would be a helpful change and would support the effective working of the revised legal rule banning vote buying and separation of ownership and control of the vote. Just as we require some identification of voters in the public sector (recognizing the considerable controversy over the degree of identification that can be required<sup>153</sup>) there is a need for some parallel verification not of the body of the voter, but of the economic interest. In those contests where possible abuse has been alleged, examination can occur as in the Hewlett-Packard case. Delaware law already makes use of a certification in corporate voting as in §103 permitting short form mergers when one shareholder owns more than 90% of the shares.<sup>154</sup> A shareholder establishes the right to use the more favorable short form procedures by a certification from the shareholder as to the number of shares owned being more than 90%.<sup>155</sup> If there is a question about the validity, it can be tested in subsequent litigation. Empty voting broadens the search beyond management's voting; keeping the focus on voters without economic interest is likely to be a more effective way to police this conduct.

#### B. What shareholders vote on

The prior subpart describes how our theory of corporate voting leads to an effective response to empty voting. This subpart turns to the implications of our theory for which issues are appropriate for a shareholder vote. Given the corporate governance system described in Part III, we come to four core conclusions about the subjects on which shareholders should vote. We advocate in favor of increased shareholder voice in both removal of directors and in approving mergers. On the other hand, we see less reason to extend that voice to either board nomination or precatory votes. We will deal with each of these conclusions in turn.

First, shareholders need to have an unfettered ability to replace directors when there is a contested election. This often will occur when there is takeover that managers have rebuffed and so we may assume that the shareholders will be motivated by a potential change in the stock price. If shareholder voting is to

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<sup>153</sup> Crawford v. Marion County Election Board, No. 07-21 (case about the constitutionality of the Indiana vote identification law argued before the U. S. Supreme Court January 9, 2008).

<sup>154</sup> Del Code Ann. tit. 8 §103.

<sup>155</sup> Under the Delaware law applicable to short form mergers, planners are able to skip the shareholder voting step as part of the merger process. See Del. Code Ann. tit 8 §253.

mean anything, it should be used when directors and managers are conflicted and are using their gatekeeper position to block a takeover that shareholders believe is advantageous. There is always the possibility that shareholders themselves are not free of self-interested motivations, but without this ability to replace directors shareholder voting will serve no consistent, identifiable function. This is the one place where Delaware courts have most sought to preserve shareholder voting and it serves an error-correcting function. Delaware courts are most vigilant in preventing directors from changing the rules on the cusp of an election that insiders seem destined to lose.<sup>156</sup> They give directors a bit more freedom to make ministerial decisions about the time of the meeting, but still keep these decisions on a rather short leash.<sup>157</sup>

We depart from Delaware in proposing this right to remove directors ought to also include a direct means to remove the poison pill and the staggered board without the board's approval.<sup>158</sup> This flows from our belief of the core importance of the removal power to shareholder voting. Shareholder ability to replace the board can occur either through voting out the board or selling into a tender offer from a bidder who seeks to acquire a majority of the shares. A board seeking to protect itself from such adverse action must close off those two avenues of shareholder action. Poison pills effectively preclude the route of shareholder selling by making a hostile tender offer economically disadvantageous.<sup>159</sup> Staggered boards do a somewhat less complete job of shutting down shareholder voting by requiring two successful election victories in director election contests before an insurgent can get control of the board. Both defenses are in place in a majority of American public corporations.<sup>160</sup>

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<sup>156</sup> See e.g. *Aprahamian v. HBO & Co.*, 531 A.2d 1207 (Del Ch. 1987) (court blocked board's action moving date of annual meeting on the eve of the scheduled meeting when dissidents appeared to have a majority of proxies in hand); *Condec v. Lunkenheimer Co.*, 230 A.2d 769 (Del Ch. 1967) (blocking corporation's issuance of additional 15% of its shares immediately after a hostile bidder had acquired 51% of shares in a tender offer).

<sup>157</sup> See e.g. *Stahl v. Apple Bancorp*, 579 A.2d 1115 (Del Ch. 1990) (permitting board delay in calling an annual meeting whose date had not yet been set).

<sup>158</sup> Recall that the board has a gatekeeper position to block an amendment to the corporation's articles of incorporation and that courts have permitted it to effectively refuse to redeem a poison pill. See Part III *supra*.

<sup>159</sup> William J. Carney & Leonard A. Silverstein, *The Illusory Protection of the Poison Pill*, 79 NOTRE DAME L. REV. 179 (2003) (providing a numerical example of the dilution of a poison pill).

<sup>160</sup> See e.g. [www.sharkrepellant.net](http://www.sharkrepellant.net) (reporting that 803 of the S&P 500 had a classified board as of year-end, down from 902 at yearend 1998); See generally, Mira Ganor, "Why Do Managers Dismantle Staggered Boards?" (Working paper 2006). Available at SSRN: <http://ssrn.com/abstract=908668>.

The antidote to a poison pill has become an election to replace the board, which will then use the redemption power built into the pill.<sup>161</sup> Ostensibly, one election would be sufficient to replace the board and to get the new members to redeem the poison pill. But when the staggered board is also in place, it means that the poison pill cannot be removed for two annual meetings so that shareholder replacement of the board will be put off until at least that time. Because staggered boards are part of the firm's articles of incorporation, for which the board has a gatekeeper position, that provision cannot be removed without the board's consent until there have been back-to-back successful election campaigns to gain a board majority.<sup>162</sup>

To the extent that the motivation for such electoral campaigns derive from the economic incentive of a bidder who is willing to buy the shares for a premium, this combination means that non-friendly efforts are likely to succeed only when a bidder is willing to commit sufficient resources (and the economy is suitable for making such a commitment) over two annual meetings, which could stretch between 13 to 30 months or longer.<sup>163</sup>

Should shareholders be able to do in one step via direct initiative of an amendment to the articles what would take multiple steps over a much longer period? Or put another way, how much should directors be able to slow down shareholder efforts to remove them? The argument against quick shareholder action is likely to be that shareholders are motivated by a desire for a quick profit at the expense of other constituents whose contracts do not fully protect against such expropriation. That is, in this circumstance, the stock price may not act as a proxy for the overall health of the company and so the stockholders may not be acting as effective monitors of the directors. Instead, they may be abusing their oversight role for their own private benefit. Directors, who normally have the power to act for the collective, would argue for the power to protect against such selfish shareholder actions.<sup>164</sup> Thus, whether shareholders should have the power to unilaterally dismantle a poison pill involves a tradeoff between the likelihood of board's selfish behavior and the likelihood of shareholders' selfish behavior. The possible externalizing behavior of shareholders may justify

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<sup>161</sup> See *Moran v. Household int'l, Inc.*, 500 A.2d 1346 (Del 1985) (discussing board's obligation to consider redemption and effectively insuring that all poison pills would include the redemption feature included in the initial pill that secured judicial approval).

<sup>162</sup> This assumes that shareholders are unable to call a special meeting or act by written consent as is true in most public corporations. See note 36 *supra* and accompanying text.

<sup>163</sup> Shareholders' ability to get a court to order a shareholders meeting cannot occur unless no meeting date has been designated and 13 months have past since the last annual meeting (under Delaware law, see Del. Code Ann. tit. 8 § 211 or under the Model Act if 15 months have passed from the last annual meeting. See Mod. Bus. Corp. Act §7.03(a)(1).

<sup>164</sup> Cf. *City Capital Associates Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787 (Del Ch. 1988) (active negotiator with power may be able to extract a high option or arrange a modified business plan that will present a more valuable asset to shareholders).

permitting the board to slow down shareholder action, but, in our view, the greater need to monitor directors and managers ought to trump that risk.

Even with such a change, the shareholder power would be well short of instant plebiscites so that the board will not lack the time to develop alternative proposals that could provide a better deal for the entity. Most public companies have a staggered board, so that even with a direct initiative to change the articles without the boards' blocking power it would still be a two step process in which the shareholders agree to change the articles and then use their annual meeting electoral power to replace the entire board. To the extent that shareholders choose to remove a staggered board before a real takeover threat actually exists, they would shorten the time necessary to remove the board once a takeover has appeared. Other constituents of such a company would be on notice of such a change and could adjust their own contracts and behavior.

There has been a notable surge in the last three years in the willingness of many public companies to remove staggered boards from their charter in the face of aggressive institutional investor pressure.<sup>165</sup> Any further change toward permitting shareholders an immediate lever would require amendment of state corporate law to permit shareholders to initiate a binding change in the articles of incorporation without the board having its current blocking position. Given the increased willingness of directors to respond to institutional shareholder pressure, the time may have come for Delaware to consider such a change which would reflect the error-correction function of shareholder voting.

Second, shareholders should have the right to approve mergers and similar transactions which have been approved by directors just as they do now under corporate law and stock exchange listing standards but with the obvious loopholes closed. The separate shareholder vote on these transactions insures that director self-interest will not supersede the corporation's interest when the directors are in their final period on target side or empire-building on the acquirer

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<sup>165</sup> Data on shareholder voting for 2007 from shark.repellant.net shows 97 shareholder votes on removing classified boards. Almost two-thirds (52 plus 6 additional that were pending as of the reporting date) were management proposals such that they would be binding actions to amend the corporation's articles, and many of these followed shareholder proposals at prior meetings that had acquired a majority or substantial minority precatory votes from shareholders. About two dozen of the proposals were shareholder precatory proposals that received more than 50% of the vote, but had not lead to any management action to amend the articles. In another dozen the precatory shareholder proposal received less than a 50% shareholder vote. There were five other votes in which the results remained uncertain. This is a much higher number of binding classified board amendment than in any prior year and reflects director response to prior shareholder precatory proposals receiving a majority vote, than occurred even earlier in the decade. See Bebchuk, *supra* note 68 at 854 (reporting a high of eleven repeals of staggered boards after a majority vote on a precatory shareholder proposal in the years through 2003); Randall S. Thomas & James F. Cotter, *Shareholder Proposals Post-Enron: What's Changed What's the Same* (working paper 2005) (reporting that directors took action in only 26 of 223 corporate governance proposals that received a majority of shareholder vote in 2003).

side.<sup>166</sup> And if this limit is to have any consistent meaning, it would seem necessary to include financially equivalent transactions which accomplish the same economic result but which are done without a shareholder vote. As discussed earlier in this article, this would include the triangular mergers and also acquisitions of assets.<sup>167</sup>

The current statutory scheme is a hodgepodge that does not reflect the purpose for shareholder voting. Much of this can be laid at the feet of the Delaware doctrine of “independent legal significance,” which in turn, can be attributed to an effort to spare corporations the costs of having to provide shareholders the liquidity in arms length mergers required by the appraisal statutes.<sup>168</sup> Hariton, the case that applied this doctrine, is such a case.<sup>169</sup> There actually was a shareholder vote in that case, but the dissenters on the target side desired to have appraisal rights not provided in a sale of assets.<sup>170</sup> Appraisal serves less of a function today in arm’s length deals, but voting continues to have its traditional function. Other de facto merger cases reflect a need to avoid appraisal rights on the acquirer side, even when there is a vote.<sup>171</sup>

At this point, separating the voting purpose of shareholder participation in merger decisions and the liquidity function provided by appraisal likely requires legislative action in Delaware to overturn the misdirected development of the independent legal significance doctrine. Decoupling voting and exit would contribute toward a more meaningful and consistent understanding of shareholder voting and exit. At the same time such legislative action should also establish voting equivalency for similar kinds of financial transactions by which substantially equivalent economic combinations occur. This means that state law should cover shareholder participation in triangular mergers from which they are presently excluded because of the introduction of a wholly owned subsidiary in place of the parent company on the acquirer side of the transaction. The stock exchange rules currently cover this, but the stock exchanges are not likely to continue to provide rules of corporate governance. Creating a comprehensive rule within state law is likely to be the only practical route to consistency.<sup>172</sup> More

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<sup>166</sup> See text accompanying note 44 supra.

<sup>167</sup> See text accompanying note 43 supra.

<sup>168</sup> See Bayless Manning, *The Shareholder’s Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L. J. 223 (1962).

<sup>169</sup> Hariton v. Arco Electronics, 188 A.2d 123 (Del 1963). (80% of Arco shareholders, the target company in the combination, voted to approve the plan and the voluntary dissolution).

<sup>170</sup> Hariton v. Arco Electronics, 188 A.2d 123, 124 (Del 1963).

<sup>171</sup> Terry v. Penn Central Corp., 668 F.2d 188 (3d Cir. 1981) (triangular merger in which shareholders of the parent corporation of the acquiring corporation voted but a shareholder of the parent sought appraisal rights that were not provided to parent shareholders because only the subsidiary was a participant in the merger).

<sup>172</sup> See Robert B. Thompson, *Corporate Federalism and the Administrative State: The SEC’s Discretion to Move the Line Between State and Federal Realms of Corporate Governance*, 83

importantly, it would be worthwhile for state law to also cover acquisitions of assets by which a company substantially changes its size as happened to Time in the Time/Warner acquisition.<sup>173</sup>

Part of the dilemma here is that shareholder voting is required under the traditional merger statutes for a change as small as a 20% increase in the outstanding stock of the issuer. That is a holdover from the vestigial merger provisions when statutes moved from unanimity to a super majority requirement for shareholders approval and shareholders were offered voting and appraisal rights as a substitute for their veto. That threshold is likely too low to necessitate shareholder monitoring given other constraints on directors and it would be appropriate to move this number to 100%. The Model Business Corporations Act has moved substantially in this direction, but its changes have yet to be enacted in any substantial number of states.<sup>174</sup>

Third, while voting is effective on these two prior sets of decisions, shareholder nominations for directors are not nearly as important. To that extent recent SEC efforts to broaden the ability of shareholders to nominate directors<sup>175</sup> and to make recommendations for the rules as to the election process to permit shareholder nominations are second order problems.<sup>176</sup> In part it is that the nomination process is less suited to collective action vote than the election process itself which has a more definitive and often a bi-modal choice for which shareholder voting is sought. In the nomination process, shareholder action cannot effectively match the actions of the smaller group of better informed directors in an uncontested election where there is no obvious director self-interest. For a dispersed group of shareholders in an uncontested election, their incentives to gather information may be insufficient to offset the costs of the search. It is also far from clear that the stock price is sensitive to the nomination of directors. The nomination process does not as easily permit shareholders to

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NOTRE DAME L. REV. 1143 (2007) (describing the changing economic structure of stock markets and the likelihood of reduced governance listing standards from the exchanges).

<sup>173</sup> See text accompanying note 42 supra. Current corporations statutes distinguish between sale of substantially all of assets and purchase of large amounts of assets.

<sup>174</sup> See Mod. Bus. Corp. Act §11.04 (vote of shareholders of acquiring corporation not required for issuance of shares unless required by §6.21; section 6.21(f) requires a shareholder vote only if new shares to be issued total more than the existing number of outstanding shares.)

<sup>175</sup> Security Holder Director Nominations, Exchange Act Release No. 48,626 (Oct. 14, 2003).

<sup>176</sup> SEC Release 34-48626 (proposing a rule that would have required public companies to provide a mechanism to require companies to include director nominations from shareholders where evidence suggested companies had been unresponsive to shareholder opinions in the 14a-8 process.. Security Holder Director Nominations, Exchange Act Release No. 48,626 (Oct. 14, 2003). See also, Institutional Shareholder Services, *2006 Postseason Report*, at 16. For another reason to think that access to the nomination process is of secondary importance, see Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 Vand. L. Rev. 475 (2008).

perform an error-correcting function as the contested election or removal of directors.

More generally, this reflects a larger point that the shareholder election process in the initial and uncontested election of directors is not nearly as important to the purpose of shareholder voting as the ability to remove directors in a contested election discussed above. If it is acknowledged that shareholder voting does not arise from a plenary shareholder power to fill all gaps but performs a more specified error correction function where director decision-making is particularly questionable, the initial election process in an uncontested setting does not go to the core purpose of voting.

Finally, the existing precatory voting system that has grown up under federal proxy law presents a mixed bag in terms of its fit as part of a consistent theory of shareholder voting. For most of rule 14a-8's seven decades of existence, shareholder proposals related to general social issues on which some shareholders had intense feelings but overall the issues being voted on were in the core area of issues on which corporate law trusts directors. Absent a belief that shareholders should be able to make the residual decisions about what products to produce and which plants to close, shareholder voting on these issues contributes little to getting a more accurate answer and indeed few such provisions achieve a majority vote from shareholders. Their impact was greater on the larger social issues to which the particular corporation was often tangential. In the same way that we suggested above that shareholder voting on mergers is done on a company by company basis and not whether the transaction as a whole is a positive net present value transaction, there is less reason to encourage shareholder voting on issues where the interests of the particular company are not central and where the directors have no obvious disability that prevents them from making a decision.

Over the last decade or two, there has been a notable shift in Rule 14a-8 proposals with many more of them now addressing internal corporate governance, usually in an effort to shift the allocation of power in the direction of shareholders. To the extent that these proposals ask shareholders to vote on amendments to the articles to repeal a staggered board to block a poison pill, they fit within our second conclusion above and are consistent with the theory of shareholder voting that we develop here. When the proposals go beyond these questions to cover questions such as cumulative voting, separating the positions of board chair and chief executive officer and withholding votes, they fall further from the purpose of shareholder voting described here. Since shareholder action on all of these issues will have no operative effect and given that all of the decisions are within the plenary powers of directors in running the corporation, it is more difficult for these votes to support an error-reduction purpose. These votes can be supported, if at all, as an early-warning system to alert directors to what the shareholders perceive as a potential error. If the issues relate to ones on which the directors have a conflict or another disability, a shareholder vote

may increase the likelihood of getting the correct answer. This error-correction is likely to work in a more subdued manner, folded within the director decision-making process and various inputs that operate there. But even here, the theory of voting tells us something about what the purpose sought to be achieved. It is an early-warning corrective to director error, not as an exercise of plenary power by the shareholders.

## VI. Conclusion

Shareholder voting differs from public voting in that the shares on which the vote depends can be bought and sold. This necessarily reflects a conscious choice to take advantage of the economic incentives that will influence such decision-making and the markets within which such choices can be reflected. But it has also obscured any principled justification as to why parties cannot take their economic exchanges further and buy votes, not just shares. The economic innovations of recent years facilitate the trader's ability to buy and sell any combination of rights, including voting rights separated from the financial interests of shares. This financial innovation has occurred against a backdrop of legal developments in the second half of the 20<sup>th</sup> century that relaxed long-standing judicial restrictions on vote buying and arrangements to separate voting from the financial interests of shares.

The effect of these developments has been to undermine the role of voting in corporate governance and obfuscate any theory to describe the purposes of shareholder voting. Nor is it any clearer when we look at those questions on which shareholders vote. There are intense arguments about the need for a greater use of the shareholder franchise or for management discretion but they tend to go on outside of any discussion about the purpose we want voting to serve. In this article we seek to develop a theory of voting based on error-correction. That theory, in turn, tells us the decisions on which we want shareholders to participate and the characteristics that need to be maintained for the vote. Our theory does not put shareholder voting in a plenary position, deciding all residual questions. Rather we take as a starting point the corporate structure that puts all corporate decisions in the board of directors and confines shareholders to voting on two specified sets of questions. This structure reflects those questions where shareholder participation is most useful and defines those issues on which we should focus. Other functions linked to the shareholder franchise such as shareholder nominations or precatory votes of matters of social importance do not fit as well with this theory of corporate voting.

A decision-making system that relies on votes to determine the decision of the group necessarily requires that the voters' interest be aligned with the collective interest. It remains important to be able to require an alignment between share voting and the financial interest of the shares. Some of the traditional justifications, such as those from close corporations contexts, are less

salient in empty voting contexts where there remains a need to foster the traditional alignment between voting and financial interests of shares. We provide the outlines here of an ex post solution using courts so as to take advantage of economic incentives to prevent empty voting.