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Corporate Voting

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Corporate Voting

Robert B. Thompson
Paul H. Edelman
62 Vand. L. Rev. 129 (2009)

Discussion of shareholder voting frequently begins against a background of the democratic expectations and justifications present in decisionmaking 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 and 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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Corporate Voting

Robert B. Thompson[*] *& Paul H. Edelman*[**]

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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.[1] In the legal commentary, there are recurring descriptions of corporations as representative democracies in which

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** Professor of Mathematics and Law, Vanderbilt University. We have benefited from the comments of Jeff Gordon, Sam Issacharoff, Curtis Milhaupt, Larry Ribstein, Lynn Stout, and participants at workshops at New York University, the University of Connecticut, and Emory University, colloquia at Columbia University, Fordham University, the University of Illinois, and the University of Iowa, and the Conference on Shareholder Roles, Shareholder Voting and Corporate Performance at the University of Cagliari.

1. 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 Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003) (noting that 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").

members act through their representatives,[2] 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 decisionmaking, 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, which treats voting as 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. Even our richest presidential candidates cannot directly buy such power over the electorate. 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 not to sell 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 check by shareholders is needed. Our theory, therefore, does not start with shareholders as plenary owners or decisionmakers, but rather seeks to more precisely calibrate where shareholder voting improves the decisionmaking process.

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2. 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), *with* Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1, 28 (2002) (arguing that representative democracy is part of the "deep design" of Delaware corporate form and that the shareholder choice provided is "the right to choose representatives periodically, not the right of perpetual self-governance through instant polls or plebiscites").

If it is permissible to buy shares, why isn't it also permissible to buy votes, separate from shares, as yet another market-based mechanism to reflect parties' intensities of views and to permit them to place funds behind those intensities? Longstanding 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. This ensures 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 is highlighted in recent "empty voting" episodes: investors have retained voting rights without the financial risk attendant to the shares, allowing them to influence a particular vote to the possible detriment of the corporation as a whole.[3] 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 specifications. 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-managerialist 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

3. This is discussed in more detail in Part V. *See generally* Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006) (analyzing the incentives created when companies own disproportionate shares of voting rights to economic interests and proposing a mandatory disclosure requirement to correct the negative effects); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Control*, 155 U. PA. L. REV. 1021 (2007) (discussing the possibility that hedge funds owning corporate shares and voting rights may maximize short-term profits at the expense of the corporation's long-term vitality).

the collective interest of shareholders. We discuss how financial innovation has decoupled that relationship but in a way that is different from the voting trusts and vote buying contexts addressed by earlier case law. We then suggest how the law can evolve to discourage such behavior.

This theory also suggests the items for which shareholder voting is most needed: replacing entrenched directors who are blocking a value-increasing transaction and blocking an empire-building merger proposed by directors and managers. As a descriptive matter, most voting follows these specifications. As a normative matter, we suggest instances as to when 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,[4] 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 decisionmaking that will ensure the selection of a right answer; that is, to reduce the likelihood of error that might otherwise occur in decisionmaking. 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.[5] To serve this role, there

4. *See* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 63–79 (1974) (discussing consensus and authority as decision-making models and the conditions for each).

5. 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 one-half. Then the probability that a majority vote will select the correct alternative approaches one as the number of voters gets larger. MARQUIS DE CONDORCET, *Essay on the Application of Mathematics to the Theory of Decision-Making*, *in* SELECTED WRITINGS 33, 33–71 (Keith Michael Baker ed., 1976) (1785). *See generally* Paul H. Edelman, *On Legal Interpretations of the Condorcet Jury Theorem*, 31 J. LEGAL STUD. 327 (2002) (analyzing the assumptions of the Jury Theorem and discussing the mechanics of aggregating individual choices into probabilities). 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 to assume that *on average*, the voters are more likely correct than not. One can also relax the independence of the votes to allow

must be an agreed sense among 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 an error-prevention tool.[6]

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 agent's choice and to monitor the work of the agent. In the public sphere, an official's accountability to the electorate is often the prime guarantee that policymakers will act for the public good.[7] A free and uncorrupted choice by voters ensures the effectiveness of this oversight. Voting can serve an alternative legitimacy function when invoked to produce a fair aggregation of preferences among different groups in an entity or society.[8] In addition, in the corporate sphere, a vote may act as a way to cleanse behavior by an agent that would otherwise be suspect.[9]

Voting may also serve "the expressive interest in equal political standing that inheres to each citizen, taken one by one."[10] 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 a "right" answer, and so it would be less likely that the vote will serve an error-correcting function. Thus, a key to

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for some level of correlation. Kishna K. Ladha, *The Condorcet Jury Theorem, Free Speech, and Correlated Votes*, 36 AM. J. POL. SCI. 617, 617–34 (1992). It applies in weighted voting situations as well. For descriptions of thirteen mathematical theorems premised on the implications of the Condorcet Jury Theorem, see Bernard Grofman, Guillermo Owen & Scott L. Feld, *Thirteen Theorems in Search of the Truth*, 15 THEORY & DECISION 261, 261–78 (1983).

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

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

8. Richard H. Pildes, Response, *What Kind of Right is the "The Right to Vote"?*, 93 VA. L. REV. IN BRIEF 45, 46–47 (2007) (noting that although "the right to vote protects several distinct interests," aggregate interests should be emphasized "in well-established, mature democracies, [where] most actual conflicts will arise").

9. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (2008) (providing the remedy of ratification through voter approval to absolve directors of any liability for certain suspect transactions).

10. Pildes, *supra* note 8, at 46.

understanding what an election is doing is to understand how the polity is defined.

Of course the first decision to be made in any context is who should be eligible to vote. 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 white male property owners in the eighteenth century, to the current extension of the franchise to all citizens over eighteen.[11] Thus we have moved away from linking voting and economic interest to recognizing that individuals have value regardless of economic contribution.[12] Nevertheless, resident aliens and illegal immigrants cannot vote, even though they will be affected by many issues decided in a vote.[13] In addition, convicted felons lose voting rights to varying degrees.[14]

There are other voting qualifications in addition to citizenship and age. Residency is the most substantial of these requirements; citizens are usually able to vote in only one place, even if they have attachments to several.[15] In a representative democracy based on

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11. *See* U.S. CONST. amend. XV (right of citizens to vote cannot be denied on the basis of race, color, or previous condition of servitude); *id.* amend. XIX (right of citizen to vote cannot be denied on the basis of sex); *id.* amend. XXVI (right of citizen over eighteen to vote cannot be denied on the basis of age). *See generally* Chilton Williamson, AMERICAN SUFFRAGE FROM PROPERTY TO DEMOCRACY 1760–1860 (1960) (describing the expansion of voting rights in the United States and analyzing whether the expansion corresponded with changing notions of property rights).

12. Special purpose bodies still sometimes use property ownership as a requirement for voting. *See* Ball v. James, 451 U.S. 355, 371 (1981) (holding that the state could rationally limit the vote to landowners in election for directors of water reclamation districts).

13. *See, e.g.*, Cabell v. Chavez-Salido, 454 U.S. 432, 439 (1982) ("The exclusion of aliens from basic governmental process is not a deficiency in the democratic system but a necessary consequence of the community's process of political self-definition."). In some jurisdictions, resident aliens are permitted to vote in local elections. *See* Jamin B. Raskin, *Legal Aliens, Local Citizens: The Historical, Constitutional, and Theoretical Meanings of Alien Suffrage*, 141 U. PA. L. REV. 1391, 1397–1417, 1460–67 (1993) (describing the prevalence of resident alien voting from the beginning of the American Republic until the beginning of the twentieth century and analyzing the reemergence of the practice in small localities in the state of Maryland).

14. For a general description and criticism of the practice of denying convicted felons the right to vote in this country, see JEFF MANZA & CHRISTOPHER UGGEN, LOCKED OUT: FELON DISENFRANCHISEMENT AND AMERICAN DEMOCRACY (2006). Scholars have noted that the United States is an outlier compared to other countries with regard to felony disenfranchisement practices. SAMUEL ISSACHAROFF, PAMELA S. KARLEN & RICHARD H. PILDES, THE LAW OF DEMOCRACY: LEGAL STRUCTURE OF THE POLITICAL PROCESS 30–31 (2007). Despite the academic criticism, the courts have upheld statutory and constitutional measures prohibiting convicted felons from voting. *See, e.g.*, Richardson v. Ramirez, 418 U.S. 24, 56 (1974) (upholding California constitutional provision banning felons from voting).

15. *See* 42 U.S.C. § 1973aa-1(d)–(e) (2000) (requiring states to provide for registration of "all duly qualified residents" of the states to vote in general elections and restricting a voter's eligibility either to her current state of residence or her previous one). For a table listing residency and registration requirements for each state, see Residency Requirements for Voting,

geographic districts, this requirement conforms with the view of elections as providing legitimacy to agents of the people.[16]

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?[17] Why should a college student's vote count on a referendum concerning some long-term development issue when that student has no intention of staying in the district after graduation?

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.[18] For similar reasons, political parties in many states

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http://www.infoplease.com/ipa/A0781452.html (last visited Jan. 5, 2009). The Supreme Court has strengthened the connection between a person's current place of residence and her right to vote in that jurisdiction by declaring lengthy durational residency requirements for potential voters to be unconstitutional. Dunn v. Blumstein, 405 U.S. 330, 360 (1972); *cf.* Glisson v. Mayor of Savannah Beach, 346 F.2d 135, 136–37 (5th Cir. 1965) (upholding non-resident voting); Saphos v. Mayor of Savannah Beach, 207 F. Supp. 688, 692 (S.D. Ga. 1962) (same), *aff'd*, 371 U.S. 206 (1962).

16. 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* ISSACHAROFF, KARLEN & PILDES, *supra* note 14, at 540–41.

17. *See* Jerry Frug, *Decentering Decentralization*, 60 U. CHI. L. REV. 253, 329–30 (1993) (proposing that voters be given the power to choose to vote in the local elections that most affect their individual interests). Americans abroad can vote in their home states. *See* U.S. Dep't of State, 2008 Absentee Voting Information for Americans Abroad, http://travel.state.gov/law/info/info_2964.html (last visited Jan. 5, 2009) (providing instructions to U.S. citizens living abroad regarding the process of how they can vote in the 2008 election).

18. The National Voter Registration Act, 42 U.S.C. §§ 1973gg to 1973gg-10 (2000), established requirements for state programs to use when removing persons from voting rolls, beginning with use of postal change of address forms and followed by certain required confirmation. In contrast, some countries, such as Mexico and Iraq, let expatriates vote. *See generally* Peter J. Spiro, *Perfecting Political Diaspora*, 81 N.Y.U. L. REV. 207, 211–17 (2006) (surveying the countries that allow nonresident citizens to vote and analyzing some of the methods used).

restrict voting in their primaries so as to avoid crossover voters with incentives different from those of the party.[19]

Apart from these status-based requirements, regulation of voting behavior also occurs to ensure 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 its adverse effect on the process.[20] These restrictions regulate behavior that may skew the incentive structure facing voters.[21]

III. VOTING IN CORPORATIONS

Shareholder voting, discussed within the framework of the previous Section, highlights certain differences of voting 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.[22] 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 corporate electorate is that the shareholders' residual interest gives them the best incentives to make decisions for the corporation.[23] As we later discuss, we see a more limited role based 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 and the incorporation of the incentives and monitoring that flow from an

19. For information about each state's Republican and Democratic primaries and whether they are open or closed, see CQ Politics, 2008 Primary Guide, http://innovation.cq.com/primaries?tab=2 (last visited Jan. 5, 2009). The Supreme Court has upheld the right of the political parties in each state to hold closed primaries under the First Amendment's guarantee of freedom of association. Cal. Democratic Party v. Jones, 530 U.S. 567, 586 (2000).

20. *See generally* Richard L. Hasen, *Vote Buying*, 88 CAL. L. REV. 1323, 1323–38 (2000) (analyzing the various rationales offered for banning vote buying in the political arena).

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

22. *See* MODEL BUS. CORP. ACT § 8.03(c) (2008) (requiring directors to be elected at each annual meeting of shareholders).

23. FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF LAW 68 (1991). Theories of shareholder voting are discussed in more detail in Part IV *infra*.

economic focus. Early American corporate law often specified one vote per shareholder, which might have been appropriate for a corporation with a small number of shareholders who interacted with and knew each other.[24] Indeed, shareholder voting today serves a different purpose in a close corporation where there is no market for shares and a more intimate relationship among the participants.[25] After 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.[26]

Second, the ability to buy and sell shares creates an additional dynamic, 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 alternative control.[27] 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.[28] 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 is in the board.[29] That shareholder voting is not designed as the plenary governance mechanism can be seen in the two major contexts in which shareholder voting is

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24. 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).

25. *See infra* Part IV.

26. Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 693 (1986).

27. 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.

28. *See* Saul Levmore, *Voting with Intensity*, 53 STAN. L. REV. 111, 137 (2000) (describing situations where buying corporate votes may be "useful and desirable").

29. *See* DEL. CODE ANN. tit. 8, § 141(a) (2008) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."); MODEL BUS. CORP. ACT § 8.01(b) (2008) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors . . . .").

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 nonbinding shareholder resolutions.

Election of directors. Corporate law provides for the annual election of directors by shareholders, certainly the most visible statement of shareholder primacy in corporate decisionmaking.[30] However, the statement is less powerful than it first appears. Typically there is only one slate of nominees, presented by the board itself, and directors can be elected by a simple plurality.[31] 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 overall system of corporate governance is not compromised by frequent uncontested elections.[32] 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.[33] 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, and more of the error-correcting purpose as to directors' behavior.

The shareholder power to elect directors is further limited by the presence of "staggered boards" in a majority of American public

30. *See* DEL. CODE ANN. tit. 8, § 211(b) (requiring that an annual meeting of shareholders be held for the election of directors).

31. Plurality voting is a default rule under state 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. *Id.* § 141(b). Efforts to mandate majority rule either by changes to state or federal law have been made during this decade but have not succeeded.

32. *See* ROBERT CHARLES CLARK, CORPORATE LAW 398 (1986) (discussing solutions to collective action problem of shareholder voting including takeovers and arguing that value "does *not* depend . . . on whether the voting rights are ever exercised by the shareholders in ordinary times").

33. Exit is possible in the public sector but at substantially higher costs, such as the cost of moving. *See* Kirk Semple, *Rise of Chavez Sends Venezuelans to Florida*, N.Y. TIMES, Jan. 23, 2008, at A1 (describing surge in immigrants to the United States escaping the political market of Venezuela).

corporations; by which, only one-third of a board of directors is elected each year.[34] 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. Even worse, the corporation to which the insurgent's money has been committed continues to be 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[35] or to act by written consent.[36]

Mergers. Corporations statutes also specify shareholder voting for approval of mergers and similar fundamental corporate changes.[37] 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 an indication of shareholder primacy.

Shareholder participation in merger decisions has evolved from an early focus on property rights to what now can be better described as a desire for error correction. Until 1890 or so, mergers were only possible through the unanimous consent of all owners. The merger was seen as altering the contract rights of each shareholder,

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34. DEL. CODE ANN. tit. 8, § 141(d) (allowing directors to be divided into one, two, or three classes). Such a provision, like the constitutional structure provided for the U.S. Senate, slows change and provides continuity. *See* U.S. CONST. art. I, § 3, cl. 2 (providing tenure classifications for U.S. Senators). Yet a change of control is harder in most boards than in the public body. Unlike the Senate, most corporate insurgents start from a zero to one hundred percent 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 operates by majority rule. *See* DEL. CODE ANN. tit 8, § 141(b) ("The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors . . . ."); MODEL BUS. CORP. ACT §8.24(c) ("If a quorum is present when a vote is taken, the affirmative vote of a majority of directors present is the act of the board of directors . . . ."). 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. Mira Ganor, *Why Do Managers Dismantle Staggered Boards?*, 33 DEL. J. CORP. L. 149 , 150 (2008).

35. DEL. CODE ANN. tit. 8, § 211(d) (providing that a special meeting may be called by the board or any person authorized by the certificate of incorporation or bylaws). 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 ten percent of shareholders can call a special meeting, a number that can be raised no higher than twenty-five percent by the articles of incorporation. MODEL BUS. CORP. ACT § 7.02(a)(2).

36. DEL. CODE ANN. tit. 8, § 228 (authorizing shareholder action to take place through written consent unless otherwise provided in the certificate). It is common among publicly held corporations to include a provision to limit such action by written consent.

37. *Id.* § 251(c) (mandating that a merger be approved by the vote of a majority of shareholders entitled to vote).

which required each shareholder's assent.[38] Such a rule ill-served the needs of the American economy during the Industrial Revolution, and so states lowered the required approval to a supermajority (and later a simple majority) of the shareholder vote.[39] To compensate for lowering the threshold of votes necessary to approve a merger, states offered dissenting shareholders the right to receive the fair value of their shares if they did not wish to participate in the changed venture.[40]

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 twenty percent.[41] Directors get to make ordinary decisions, including small acquisitions, but certain extraordinary matters must also be approved by the shareholders. Yet the directors of the acquiring company can avoid shareholder voting entirely by structuring the transaction as a purchase of assets (which is often the financial equivalent of a merger)[42] or a triangular merger in which the actual merger is between the target corporation and a wholly owned subsidiary of the acquiring corporation.[43] 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 twenty percent, which would take in many acquisitions done using the triangular method.[44] An acquiring corporation can avoid even this requirement by acquiring the target stock for cash rather than stock, as Time Inc.

38. NORMAN LATTIN, LATTIN ON CORPORATIONS 571 (1971).

39. DEL. CODE ANN. tit. 8, § 251(c); MODEL BUS. CORP. ACT § 11.04.

40. *See* Robert B. Thompson, *Exit, Liquidity and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO L.J. 1, 3–4 (1995) (describing the move by the states from unanimity requirement for merger to requirement for supermajority vote and appraisal rights for dissenting shareholders).

41. DEL. CODE ANN. tit. 8, § 251(f) (providing that, notwithstanding section 251(c), no vote is necessary if the certificate of incorporation is not changed and if the number of shares does not increase more than twenty percent).

42. *See id.* § 271 (requiring approval of the shareholders for the sale of substantially all the corporation's assets without mentioning the purchasing corporation).

43. A triangular merger is not specifically identified by statute but is the result of the addition of a third party to the plan of merger. This third corporation, a wholly owned subsidiary of the buyer, becomes one of the two parties to what is otherwise an ordinary merger. The directors and shareholders of the subsidiary must approve the merger, but this is a mere formality because 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.

44. *See, e.g.*, NYSE LISTED COMPANY MANUAL § 312.03(c) (2007) (requiring shareholder vote prior to issuance of stock in excess of twenty percent in any transaction or series of related transactions).

did in its well-publicized combination with Warner.[45] For acquiring corporations, therefore, the requirement for shareholder voting in mergers is now mostly optional.

For the acquired corporation, the requirement for shareholder voting remains intact. Sellers of substantially all of the corporate assets have to follow the same voting rules as a merger participant.[46] 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 recognizing a difference in risk to the selling shareholders, given the other available governance mechanisms.[47] 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 the managers' decisionmaking. While other explanations are possible, the central point is that voting by shareholders is best explained as error correction of managers rather than as 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, the 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 a gatekeeping role for the board in tender offers as well as traditional merger transactions.[48] Early in the history of

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45. Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1147–49 (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 at $200, making it unlikely that Time shareholders would approve the lower-valued deal with Warner. Because the directors of Time favored a merger with Warner despite Paramount's higher bid, they restructured the Warner deal into a tender offer to avoid a shareholder vote. *Id.* The requirement that Time shareholders vote on the merger deal actually came from the stock exchange listing standards, not state law, illustrating the point in the text. *Id.* at 1146.

46. *See* DEL. CODE ANN. tit. 8., § 271 (requiring shareholder approval for the sale of substantially all the corporation's assets). While target shareholders have a vote, they are denied appraisal rights in Delaware. *Id.* § 262.

47. RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 721 (2d ed. 1995). When market constraints fail, legal constraints play a crucial role; when target shareholders are subject to a final period problem and cannot rely on their management for protection, they require instead "the barrier of a shareholder vote as protection against management." *Id.*

48. Delaware courts developed an intermediate standard of review to address director action. For example, in *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court found

takeover litigation and the development of poison pill 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,[49] but the Delaware Supreme Court subsequently termed that reading too expansive.[50] 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, provided the avenue for shareholder voting is not completely closed. The opening that must remain does not have to be very great. In a later case, the court approved defensive tactics in which the only way that shareholders could prevail would be if a hostile bidder were to undertake and win two separate annual elections to empanel a board that would remove a poison pill and approve a merger.[51] This increases the importance of the shareholder right to replace directors described above.

Bylaws. Corporations statutes authorize shareholder votes to adopt, amend, or repeal the corporation's bylaws.[52] The impact of this vote, however, is diminished because statutes typically also provide directors a parallel power to amend bylaws. Indeed, this is how most bylaw amendments occur.[53] Shareholder voting to amend bylaws has been stunted by longstanding but unresolved doubts over whether such power could be used to produce bylaws that intrude into director control of the corporation, provided by section 141 of the Delaware statute.[54] In recent shareholder proxy seasons, some shareholder governance proposals have been presented as binding bylaw amendments, leading to a 2008 Delaware Supreme Court decision that reaffirmed both shareholder power to amend bylaws and section 141's limits on such power.[55]

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that defensive tactics, including poison pills, should be judged by a two step process, determining first whether there was a threat and second whether the defensive tactic was a proportional response to that threat. 493 A.2d 946, 955 (Del. 1985). In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the same court required that directors get the best price reasonably available for shareholders when the company is up for sale. 506 A.2d 173, 182 (Del. 1986).

49. City Capital Assocs. L.P. v. Interco, Inc., 551 A.2d 787, 798 (Del. Ch. 1988).

50. *Paramount*, 571 A.2d at 1152–54.

51. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387–91 (Del. 1995).

52. DEL. CODE ANN. tit. 8, § 109(a) (2008).

53. *Id.*

54. *See id.* § 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.").

55. *See* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 231–33 (Del. 2008) (answering two questions certified by the Securities and Exchange Commission).

Cleansing. When directors have a conflict that may 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 provides an additional setting for shareholder voting.[56] The vote in this situation is limited to disinterested shareholders, a requirement which ensures that the voters' interests are aligned with the group.[57] This statutory safe harbor is consistent with case law in various conflict settings.[58] Similarly, the Internal Revenue Code conditions tax deductions for certain manager compensation on prior approval by shareholders.[59] Stock exchange listing standards similarly require shareholder approval for options.[60] Each of these requirements 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 Roosevelt Administration chose not to federalize state corporations codes but rather to supplement state law with new federal rules, principally disclosure-based, where existing state law seemed inadequate.[61] Since 1934, federal securities regulation and proxy rules in particular have focused on arming shareholders with enough information to vote on the issues put to them under state law, namely elections of directors and merger transactions.[62]

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56. DEL. CODE ANN. tit. 8, § 144. The Delaware statute is written narrowly so as to block only the old common law rule deeming such conflicted transactions void or voidable because of the conflict, but the broader practical impact has been narrower judicial review of such transactions.

57. Delaware reached this result by a somewhat circuitous path. Its statute does not specify which shareholders may vote in a cleansing action, but the parallel and immediately preceding subsection does specify that directors seeking to cleanse must be disinterested. *Id.* Nevertheless, the Delaware court has in effect read "disinterested shareholder" into the statute. *See* Marciano v. Naksah, 535 A.2d 400, 404–05 (Del. 1987) (stating that "interested director transactions were deemed voidable only after . . . a determination of whether the disputed conduct received the approval of a noninterested majority of directors or shareholders").

58. *See, e.g.*, Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976) (holding that shareholder ratification is ineffectual when a majority of votes were cast by interested managers of the company).

59. I.R.C. § 162(m)(4)(C)(ii) (2000).

60. NYSE LISTED COMPANY MANUAL § 303A.08 (2007).

61. *See* 1 LOUIS LOSS ET AL., SECURITIES REGULATION 178 (3d ed. 1989).

62. A key initial focus was shareholder voting, reflecting the premise that inadequate disclosure permitted managers to gain shareholder approval without sufficient monitoring. *See* H.R. REP. NO. 73-1383, at 14 (1934) ("[Section 14(a) is intended to] control the conditions under

The Securities and Exchange Commission ("SEC") recognized in its first decade that disclosure was insufficient without an adequate supply of items on which to vote. Rule 14a-8 extended the shareholder voice by permitting individual shareholders to propose agenda items for collective shareholder action beyond those submitted by directors.[63] In deciding what issues are appropriate for the shareholder ballot, Rule 14a-8 ostensibly defers to state corporate law by requiring that the proposal be appropriate for shareholder action under state law.[64] State courts and legislatures have remained silent as to what proposals are appropriate, beyond the election of directors and approval of mergers just discussed. In this vacuum, the SEC has greatly expanded the number of things on which shareholders can vote, so long as they are precatory (i.e., suggestive and nonbinding).[65] These proposals express the views of the shareholders, but do not determine corporate policy, which is left to the directors. In earlier years, many of these agenda items related to issues of concern to the larger society, such as the Vietnam War or animal protection.[66] More recently, precatory proposals have focused on 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 this voting pattern. As we develop below, we believe that this reality on the ground is best explained by an error-correction purpose for shareholder voting, as opposed to a purpose grounded in shareholder property rights or any related theory.

IV. THEORIES OF SHAREHOLDER VOTING

None of the existing approaches to shareholder voting do particularly well in explaining the existing system or why we should expect shareholders to vote in some matters but not others. Anthropologically, voting paired with the typical financial rights

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which proxies may be solicited with a view to preventing the recurrence of abuses which . . .[have] frustrated the free exercise of the voting rights of stockholders.").

63. Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 109–12 (1988).

64. 17 C.F.R. § 240.14a-8(i)(1) (2008) (providing that a company may exclude a proposal if it is not a proper subject of action by shareholders under the laws of the jurisdiction of the company's organization).

65. *Id.* § 240.14a-8(i) note to ¶ (i)(1).

66. *See, e.g.*, Lovenheim v. Iroquois Brands, Ltd., 618 F. Supp. 554, 556 (D.D.C. 1985) (considering a shareholder proposal relating to the procedure used to force-feed geese for production in France of pate de foie gras imported by the company).

attached to shares provided comfort to individuals considering the purchase of an ownership stake in an entity the investors would not control, as separation of ownership and control became widespread throughout the economy.[67] More generally, effective shareholder control over managers is regularly cited as a prerequisite to sound corporate governance,[68] echoing the legitimacy argument suggested in *Blasius* and quoted in our opening paragraph. In such arguments, shareholders are often cast as the necessary counterweight to the managerialist corporate control that has been the defining worry of corporate law since Adolf Berle and Gardner Means wrote of the separation of ownership and control in 1932.[69] Lucian Bebchuk argues for greater shareholder power to give directors incentives to serve the shareholder interest and to restore directors' accountability in a system lacking other adequate mechanisms.[70] Bebchuk's argument, based on the role of the franchise in contributing to shareholder value, rather than the intrinsic value of corporate democracy,[71] has provoked challenges as to the strength of the link to such value.[72] Other than telling us there is not enough shareholder voting, Bebchuk's 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 vote effectively, we need a more robust theory of shareholder voting.

Frank Easterbrook and Daniel Fischel present a more comprehensive theory of voting as filling the gaps that necessarily appear in contracts and assigning the gap-filling role to the group with the best economic incentive to do so. Grounded within their broader

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67. *See also* EASTERBROOK & FISCHEL, *supra* note 23, at 70 (asserting that from the survival of voting one may infer that voting is beneficial).

68. *See, e.g.*, Council Directive 2007/36, The Exercise of Certain Rights of Shareholders in Listed Companies, 2007 O.J. (L 184/17) 1, *available at* http://www.eurosif.org/eu_eurosif/lobbying/shareholders_rights/eu_directive_on_shareholders_rights (follow "Directive 2007/36/EC" hyperlink) ("[E]ffective shareholder control is a prerequisite to sound corporate governance and should, therefore, be facilitated and encouraged.").

69. ADOLF A. BERLE & GARDNER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119–25 (1933); *see, e.g.*, Bebchuk, *supra* note 2, at 913 (2005) (asserting that 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).

70. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 677, 732 (2007).

71. Bebchuk, *supra* note 2, at 842–43; Bebchuk, *supra* note 70, at 678.

72. 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 (2007) (criticizing the lack of a baseline empirical measure specifying how many contested elections are enough to establish a board's legitimacy); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 798–99 (2007) (discussing the weak evidence favoring shareholder governance).

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."[73] In their theory, 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."[74]

The emphasis on shareholders as residual claimants has been challenged, particularly after the development of options theory, which posits debt holders as residual claimants as well.[75] More importantly for our analysis, Easterbrook and Fischel's focus on the residual holder's right to delegate gap-filling would seem to support a more expansive view of shareholder action[76] than what we describe above.[77] If shareholders merely delegate their roles to fill gaps, why should the law prevent them from exercising their authority whenever they deem it appropriate? The Easterbrook and 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 shareholders (as principals) to do what they lack the time or expertise to do.[78] In all American corporations

73. EASTERBROOK & FISCHEL, *supra* note 23, at 68.

74. *Id.* at 67 (noting that shareholder voting is expensive and generates collective action problems and that managers serve as a "collective information-generating agency").

75. The development of options theory has challenged the position of shareholders as sole residual owners and has created 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 to have sold a call option to the shareholders. "Put differently, options theory demonstrates that bondholders and equity holders each share contingent control and bear residual risk in firms." Lynn A. Stout, *Lecture and Commentary on the Social Responsibility of Corporate Entities: Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1192 (2002).

76. EASTERBROOK & FISCHEL, *supra* note 23, at 68 (explaining that, for decisions like new products and new plants, all of the actors except shareholders lack the appropriate incentives).

77. Their theory is consistent with the widely noted but unadopted principle that directors should be passive in response to hostile takeovers. 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, 1164 (1981); Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1750 (1981). The Delaware Supreme Court rejected any such notion. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 n.10 (observing that even Easterbrook and Fischel conceded that no court or legislature had adopted their theory).

78. Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 539 (Del. 1996) (holding that directors acting in the "ordinary course of their service as directors" are not agents of the

statutes, directors, rather than shareholders, have the plenary governance role in the enterprise; all corporate power is placed in their hands.[79] This centralized authority structure provides efficiency that cannot be replicated with shareholder decisionmaking except in the smallest of ownership structures. Stephen Bainbridge advocates for such a director-centric view of corporate governance based on the work of Ronald Coase[80] and the social choice theory developed by Kenneth Arrow.[81] He argues that the economic efficiency of the corporate form hinges on the ability of the board to act by fiat rather than some more democratic method of consensus.[82]

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 will fail to monitor sufficiently the managers engaging in similar behavior. Following Easterbrook and Fischel and others, Bainbridge argues that shareholders, and only shareholders, assume such a monitoring role, albeit a limited one. He argues that the monitor must be limited to a single constituency because to do otherwise would produce mixed and possibly unstable signals, thus undermining the monitoring role.[83] 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."[84] As many have recognized, the 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."[85] For Bainbridge, these characteristics suggest a limited

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corporation); RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. (f)(2) (2006) ("Although a corporation's shareholders elect its directors . . . , the directors are neither the shareholders' nor the corporation's agents as defined in this section.")

79. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2008) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

80. Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 386–405 (1937).

81. ARROW, *supra* note 4, at 15–29.

82. Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 621–22 (2006) [hereinafter Bainbridge, *Limited Shareholder Rights*]; Stephen M. Bainbridge, *Investor Activism: Reshaping the Playing Field?* 5 (UCLA Sch. of Law, Law-Econ Research Paper No. 08-12, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1130969.

83. Bainbridge, *Limited Shareholder Rights*, *supra* note 82, at 610.

84. *Id.* at 613.

85. *Id.* at 625.

shareholder oversight role, so weak, in fact, that for him "they scarcely qualify as part of corporate governance."[86]

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 empowered without check, would cause the corporation to take opportunistic advantage of other stakeholders. Much of the argument against unlimited shareholder power that fueled the antitakeover movement of the 1980s reflected such fears of shareholder self-interest.[87] 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[88] and practitioners such as Martin Lipton and his partners. These arguments focus explicitly on the intra-shareholder conflict that occurs when shareholders are given a larger franchise.[89]

This director primacy theory, in its various forms, is not sufficiently detailed to attack the problem we wish to address. Bainbridge accepts shareholders as the constituency who should be able to vote for directors but believes this process is of so little use 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 we should fear too much shareholder voting, just as Bebchuk concludes that we have too little shareholder voting.[90] What we should seek from any theory of

86. 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.

87. *See, e.g.*, Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 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 in a quick profit on the sale of those shares").

88. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. Rev. 561, 561 (2006) ("[I]t is more plausible that shareholders will use any incremental power conferred on them to benefit their private interests at the expense of the firm . . . .").

89. *See, e.g.*, Theodore N. Mirvis et al., *Bebchuk's Case for Increasing Shareholder Power: An Opposition* 8 (Harvard Law & Econ. Discussion Paper No. 586, 2007), *available at* http://ssrn.com/abstract=990057 ("Empowering shareholders under these circumstances . . . risks destroying corporate value and compromising the interests of non-hedged shareholders, and is socially inefficient as well.").

90. Margaret Blair and Lynn Stout suggest another variation of director primacy that emphasizes the ability of a board to act as a mediating hierarch, thereby allowing various constituents to contribute form-specific capital to the enterprise by minimizing their fear of being

shareholder voting is an explanation of when (and why) we would expect the shareholders to make better decisions than the board. Only then can we 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 decisionmaker, the board. Because of the separation of ownership and control inherent in the form and the concomitant possibility of self-interest, some group must be authorized to monitor the behavior of the board. Consistent with the various prior theories, we believe that group should be homogeneous to avoid difficulties in achieving consensus; we believe shareholders are that group. But here 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 shareholder action are substantial, so any performance measure has to circumvent those problems. Shareholders are the appropriate group to monitor the board and correct errors because they are uniquely 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.[91]

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 because any financial engineering that undercuts that signal can distort the incentives and undermine the value of the shareholder franchise. If the right to vote were solely based on property rights, then financial engineering would be less of a concern.

Our view of the shareholder vote, then, turns on information aggregation and error correction. As we discussed earlier, if 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

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taken advantage of by other stakeholders. This variation 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) (asserting that "the nominal existence of shareholder voting rights . . . does not pose a serious challenge to the mediating hierarchy model").

91. 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 from the perspective of judicial enforcement of directors' 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 75, at 1200.

an outcome that is very likely correct—indeed the majority vote is much more likely to be correct than any given voter.[92] Here the "right" answer is the option that increases the share price. Shareholder voting will satisfy the necessary requirements to gain the information advantage as structured in the Condorcet theorem. The theorem's 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.[93] Even if small shareholders are not gathering information, or are doing so in a random manner, large shareholders still produce sufficient information so that a vote by the group is more likely to produce the correct outcome than any shareholder acting alone. 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 as to the defining reason for shareholder voting gives us more traction on the types of issues that should be monitored. We agree with Bainbridge that the "[p]reservation of managerial discretion should always be the default presumption,"[94] and thus monitoring is only required when the board is obviously compromised. But our focus on stock price as the signal of board error gives us some more information. The shareholders should only act as monitors when the possible board conflict would change the stock price. If there is no signal from the market, then there is little reason to believe that the shareholders will effectively monitor the board. 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. In Part V.B, we will discuss the likelihood of shareholder opportunism in the context of removing a poison pill, the possible use of director power to restrain opportunism in this context, and the need to balance the two risks of selfish board behavior and selfish shareholder behavior in poison pill disputes. But recognizing a system that takes into account these two core risks does not detract from the utility of focusing on error correction as the theory for shareholder voting with the most explanatory power.

92. *See supra* note 5 (explaining the Condorcet Jury Theorem).

93. The success of RiskMetrics's Institutional Shareholder Services ("ISS") and Governance Metrics International indicates the amount of resources institutional investors commit to obtaining securities information.

94. Bainbridge, *Limited Shareholder Rights*, *supra* note 82, at 628.

It is worth noting the bounds of what this theory seeks to explain. We seek to explain the role of voting in public corporations with dispersed shareholders; the contrasting nature of voting in close corporations or public corporations with a controlling shareholder is beyond the theory's scope. 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 regarding voting procedures. But the use of voting by those entities does not necessarily 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.[95] Voting within close corporations or by controlling shareholders is the mechanism to implement the property rights that follow from acquiring the controlling interest in a corporate entity.[96] 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; voting does not improve accuracy. 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 preference prevail). What makes voting distinctive in a public corporation with a separation of ownership and control is that it specifies conditions in which shareholders can improve the decisionmaking 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 without 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 sometimes limits director actions that interfere with shareholder choice. The

95. *See* F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE § 1.16 (rev. 3d ed. 2004) (describing how close corporations avoid core corporate characteristics).

96. *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.").

Unocal and *Revlon* decisions that provide a higher, intermediate level of review to defenses to corporate takeovers are prominent examples.[97] 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 decisionmaking 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 who are sensitive to the stock price, which is a decent proxy for the interests of the corporation. Restricting the vote to shareholders 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 shareholders' decision effectively monitors the actions of the board. Our theory allows us to examine questions such as which issues are appropriate for oversight—those which will change the stock price—and what financial engineering arrangements act to undercut the value of this monitoring regime by separating ownership from financial interest. In the next Section, we 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 shareholder 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

97. Yet the *Revlon* rule requiring the directors to get the best price for shareholders in an acquisition effectively has been 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.*, Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 43 (Del. 1994) (holding that in light of the change of control to be effected by the Paramount-Viacom combination, the Paramount directors were obligated to secure the best price for shareholders).

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 in technology and finance have made it easier to separate voting from the financial claims 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 marketed to investors whose risk preferences match those bundles. These innovations have challenged the early twentieth-century view that a combined voting and 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 this view has been overtaken by new financial realities.[98] The financial innovation of recent decades has multiplied the possible strategies and effects; today the market permits providers to slice and dice the shareholder's interest in a variety of ways, and investors are willing to buy these separate interests. Equity swaps occur in a variety of shapes and sizes. Lending of shares has become a massive business.[99]

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 Henry Hu and Bernard Black in a recent paper list eighty examples in twenty countries.[100] The Mylan/King transaction involved a merger between two pharmaceutical companies in which Mylan Laboratories would acquire King Pharmaceuticals in exchange for Mylan shares. As a merger, this action required approval by the shareholders of each company.[101] This deal reflected a typical division of gains in acquisitions where the target shareholders receive a premium for their shares, and the acquirer's shares retain the same value or decline slightly.[102] Given the premium, approval by the King

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98. EASTERBROOK & FISCHEL, *supra* note 23, at 74.

99. A recent survey put the balance of outstanding stock loans as of mid-year 2005 at $1.5 trillion. John Hintze, *Automation Has Greater Impact as Securities Lending Increases*, SEC. INDUSTRY NEWS, May 8, 2006, at 33.

100. Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 661–81 (2008).

101. *See supra* note 39 and accompanying text (explaining the threshold of votes necessary to approve a merger).

102. *See* ROBERT F. BRUNER, APPLIED MERGERS AND ACQUISITIONS 568–70 (University ed. 2004) (providing a summary table of acquirer and target returns upon acquisition).

shareholders was likely; approval by the Mylan shareholders was more in doubt. Perry, operator of a hedge fund with about 7 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 percent of the Mylan shares 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 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.[103]

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 suggested response to empty voting, we address two arguments that would remove the need for a response: first, an economic based argument that vote buying transactions produce overall gains for society, and second, that disclosure can best address whatever problems arise because of empty voting.

More than forty years ago, Henry Manne argued that allowing the unrestricted trading of votes would benefit shareholders in the same way that economic exchanges produce economic gains elsewhere in the economy.[104] 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 that facilitates this result can be a positive for the economy. When the shareholder census consists of diversified investors such as institutional shareholders, these investors may well own shares in companies on both sides of the deal and would prefer a transaction where their net investment increases without regard to whether there is 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 Mylan/King scenario

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103. *See* Kahan & Rock, *supra* note 3, at 1072–77 (2007) (explaining that hedge funds are set up to profit their investors, not shareholders generally); Kara Scannell, *How Borrowed Shares Swing Company Votes*, WALL ST. J., Jan. 26, 2007, at A1 (discussing a study by Henry Hu and Bernard Black that finds a rise of "empty voting" by which hedge funds borrow shares and use them to swing votes in their favor).

104. Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427, 1428 (1964).

prevents an undiversified shareholder, such as a Carl Icahn, from standing in the way of a beneficial total gain.[105]

We find these economic justifications for empty voting unconvincing for two reasons. The first is that, as we argued above, 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, there would be no reason to limit the franchise to shareholders. Indeed, the pursuit of Kaldor-Hicks efficient transactions would almost surely entail giving votes 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 shareholders because the law has decided that each corporation is best served by focusing on its own stock price, not overall social welfare.

The second argument against using voting to justify 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 the directors should have a responsibility to capture some of that surplus for the shareholders. To cede all of that surplus and 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 phenomenon that has not raised the same concerns as empty voting. It is less worrisome because such behavior does not create a systematic bias; the number of institutional investors who are unbalanced in the direction of the target should balance the number 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 separation of votes from economic interest permits voting for an outcome in which there is not an economic benefit, but only an effort to make money on one side.

105. Bruce H. Kobayayshi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 42–44 (2006).

In the several years since empty voting was first identified, academic commentary focused on disclosure. Marcel Kahan and Edward Rock's innovative treatment of hedge funds and activist investors was skeptical of a need for anything more than disclosure.[106] Hu and Black's first set of papers on empty voting focused on transparency and disclosure.[107] Their integrated disclosure proposal suggests overhauling the principal federal disclosure requirements under sections 13(d), 13(f), 13(g), and 16 of the Securities Exchange Act and under mutual funds regulation to include relevant information about equity swaps and other derivatives.[108] Additional disclosure requirements relating to hedges and derivatives have been put in place in the last few years in the United Kingdom, Hong Kong, and Switzerland.[109] In January 2008, a group of Europe's largest hedge funds issued voluntary best-practice guidelines that could prompt greater disclosure from the funds.[110]

Why might one expect that increased disclosure would curb empty voting? Disclosure's effect might arise from a combination of several influences. Reflecting Brandeis's classic work from a century ago that sunlight is the best disinfectant,[111] disclosure by itself might cause some 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 had a conflicting interest to the empty voter. There is also the possibility of another investor engaging in similar transactions on the opposite side. In the Mylan/King case, Carl Icahn owned a large position in Mylan and was active in encouraging a negative vote on the transaction by its shareholders.[112] Icahn

106. Kahan & Rock, *supra* note 3, at 1077.

107. Hu & Black, *supra* note 3, at 819.

108. Hu & Black, *supra* note 100, at 682–84.

109. *Id.* at 684.

110. Cassell Bryan-Low, *European Hedge Funds Issue Disclosure Guidelines*, WALL ST. J., Jan. 23, 2008, at C6.

111. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Nat'l Home Library Found. 1933) (1913).

112. The deal ended for other reasons when King reported unexpected earnings changes. For an overview of the Perry-Mylan Laboratories transaction, see Hu & Black, *supra* note 3, at 828–29, and Kahan & Rock, *supra* note 3, at 1075–76.

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 transaction not be successful.

Even with complete and effective disclosure, however, there is reason to doubt that the counterparties have sufficient economic incentives to forgo a transaction that creates shares with empty voting. 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 if the market has already anticipated much of the economic impact of the acquisition for the acquirer.[113] 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. Thus, the counterparty will not suffer further loss and will have less incentive to counter a Perry-type strategy.[114] Further, to the extent that traders like Goldman Sachs and Morgan Stanley are not using their own money, there is an agency problem: the costs of the swap will not become visible to the principal or the voting value can be buried within a larger trading strategy.

Shaun Martin and Frank 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 little or no voting rights.[115] Hu and Black have now gone beyond their initial disclosure proposal and recommended a host of structural changes, including letting corporations amend their charters to limit empty voting, requiring attestation by large shareholders that their vote does not exceed their economic interest by more than twenty percent,

113. J. FRED WESTON ET AL., TAKEOVERS, RESTRUCTURING, AND CORPORATE GOVERNANCE 596 (4th ed. 2004) (explaining that after the announcement of a merger, the stock price of the target typically trades at a small discount of one to two percent relative to the consideration offered by the acquirer).

114. 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 one hundred percent, the current price will only reflect a percentage of that decline. As the takeover moves toward successful completion, the gap between the entire change and the market price will narrow, and to that extent the counterparty on the acquirer side could face an additional loss.

115. Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 787–804 (2005).

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 to counterparties, providing a safe harbor to permit institutional investors to recall shares without being subject to derivative suits for not lending, allowing institutional lenders to recall lent shares, requiring record owners to recall a 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.[116]

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 costs will be imposed on the larger business to address empty voting. We focus our proposed solution on a less complicated suggestion that reflects 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 plays both an error-correcting and principal-agent monitoring role. To play this role effectively, the voter's interest and the common good must be aligned. Even where the scope of shareholder voting is limited, the essential nature of the remaining role for voting has long motivated legal efforts to prevent disrupting the alignment between voting and financial interest. Such pro-alignment efforts include (1) requiring one share/one vote, (2) banning agreements that separate voting from financial interests in shares, and (3) banning vote buying. We now survey the judicial response to each of these alignment methods.[117]

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

116. Hu & Black, *supra* note 100, at 694–721.

117. In addition, there are other legal rules that reflect similar concerns. *See, e.g.*, DEL. CODE ANN. tit. 8, § 160(c) (2008) (prohibiting voting shares owned by the corporation); *id.* § 144 (excluding votes by shareholders who are conflicted); *In re* Cox Commc'ns Sec. Litig., 879 A.2d 604, 614–18 (Del. Ch. 2005) (discussing provisions requiring a majority of the minority vote for approval of a merger with a controlling shareholder).

corporation. A voting system that gives some shareholders—for example, the founding family or management—multiple votes per share disconnects the decisionmaker's incentives from the financial results of the decisions. The one share/one vote requirement, however, is not found in any state or federal statute or regulation,[118] but rather in the listing standards of the New York Stock Exchange (and more recently in parallel provisions in Nasdaq and other exchanges).[119] The original provision resulted from Populist 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.[120] As a result, with rare exceptions, such as when Ford Motor Company 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.[121]

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 SEC to adopt a rule for all American public companies.[122] After a federal appellate court struck down the agency's rule as beyond its power to regulate on corporate governance,[123] the SEC pursued (and was ultimately successful in) a lengthy effort to persuade the major American exchanges to each implement a similar rule banning midstream adoption of dual class voting structures.[124] Although eight

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118. *See, e.g.*, DEL. CODE ANN. tit. 8, § 212(a) (providing a rule of one vote per share "unless otherwise provided" in the certificate).

119. *See supra* note 44 and accompanying text (describing stock exchange listing standards).

120. *See* Seligman, *supra* note 26, at 693–99 (summarizing William Ripley's criticism of nonvoting common stock and its connection to the NYSE's initial refusal to list such stock).

121. *See* JOSEPH A. LIVINGSTON, THE AMERICAN STOCKHOLDER 166–77 (1958) (explaining that when the Ford Motor Company went public, the shareholders were given Class A shares with circumscribed voting power, making it extremely difficult to rally enough votes to oust the Ford family).

122. 17 C.F.R. § 240.19c-4 (2008).

123. Bus. Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990) (holding that Rule 19c-4 directly controls the substantive allocation of power among shareholders in excess of commission's authority).

124. Current NYSE Listing Standard 313A 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. NYSE LISTED COMPANY MANUAL § 313A (2007). The actions by the stock exchanges, semi-private "self regulatory organizations" under the 1934 Act, have not been held to be state action. *See, e.g.*, Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 206 (2d Cir. 1999) (reiterating its prior ruling "that the New York Stock Exchange–a self-regulatory private organization like the

percent 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 the vote/financial interest alignment discussed below.[125] The expectation is that the founders and other selling shareholders in the initial public offering will receive less money for the shares if the system is inefficient. If these inefficiencies lead later to poor performance, those companies remain vulnerable to economic pressure, as the New York Times is now experiencing.[126] The recent takeover of the Dow Jones Company, despite its dual class structure privileging its founding families, shows the limits of these tactics.[127]

2. Ban on Separating the Vote and the Financial Interest

It was a common feature of American corporate law at the turn of the twentieth century to ban devices that separated the voting interest of shares from the financial rights, like voting trusts, because such a separation would disrupt the otherwise healthy result that would flow from voting.[128] Early courts had a clear, though not detailed, understanding of the importance of the alignment of shareholder voting and financial interests.[129] 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.[130] Courts in the early voting cases described this public policy as leading to a fiduciary duty

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NASD–is not a state actor" (citing United States v. Solomon, 509 F.2d 863, 867-71 (2d Cir. 1975))).

125. Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Companies in the United States* 3 (Rodney L. White Ctr. for Fin. Research, Paper No. 12-04, 2008), *available at* http://ssrn.com/abstract=562511.

126. Richard Perez-Pena, *New Challenges to Times Board: Dissidents with Large Stakes*, N.Y. TIMES, Mar. 10, 2008, at C1; Emily Steel, *Investor Puts Pressure on New York Times—Nicely*, WALL ST. J., Feb. 1, 2008, at C3 (describing efforts of marketing professor who runs an investment firm to pressure the company).

127. *Mogul's Dream: News Corp.'s Success Follows Delicate Dance Between Suitor, Target*, WALL ST. J., Aug. 1, 2007, at A1.

128. *See* 1 EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 218.2 (Aspen Publishers 5th ed. 2006 & Supp. 2008-1) (explaining that the legality of voting trusts at common law was not clearly determined by the Delaware courts until enactment of the first voting trusts statutes.)

129. *See, e.g.*, Lehrman v. Cohen, 222 A.2d 800, 807 (Del. 1966) (explaining that the main purpose of the 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).

130. *E.g.*, Cone v. Russell, 21 A. 847, 848–50 (N.J. Ch. 1891).

owed by all shareholders to one another, and that no shareholder by contract could disable herself from performing that duty.[131] 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 extend a similar duty to individual non-majority holding shareholders in close corporations in contexts where the shareholder's vote gives her a veto over action beneficial for the corporation.[132]

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 contexts in which much of the separation has occurred. An examination of those contexts is a useful guide to the continuing applicability of these concepts in contemporary public corporations.

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 voter's interests to at least the majority of the shares. The small number meant that unlike in public corporations, there was no collective action problem to overcome. In these contexts, courts were willing to relax the traditionally restrictive approach to contracts that appeared to separate voting and financial interests of shares.

Legislatures and courts have increasingly permitted other devices to accomplish a similar purpose. 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 a proportional one.[133] Voting trusts putting voting power of a group of shares into the hands of a trustee are permitted by statute, but often subject to a time limit and disclosure.[134] Shareholder pooling agreements are permitted by statute or case law.[135]

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131. *E.g.*, Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 801 (Mass. App. Ct. 1981) (citing Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975)).

132. *E.g.*, *Atlantic Properties*, 422 N.E.2d at 801–04.

133. DEL. CODE ANN. tit. 8, § 212(e) (2008).

134. *See, e.g.*, MODEL BUS. CORP. ACT § 7.30 (2008) (providing for a ten-year limit on voting trusts with a provision for renewal).

135. *See, e.g.*, *id.* § 7.31 (permitting an agreement amongst shareholders as to how to vote their shares); *id.* § 7.32 (permitting agreements covering a variety of governance issues including management, distributions, share transfers and dissolution, all valid for ten years unless the agreement provides otherwise).

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 broadened the need for private contracts that temper the usual corporate norms of majority control and entity permanence.[136] This easing does 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. Vote buying is prohibited by statutes in some states[137] and by common law in others.[138] The rationale is similar to that described above: distortion arises when voting rights are placed in the hands of one who lacks an economic interest in the business. Easterbrook and Fischel argue that separation of shares from votes introduces a disproportion between expenditures and rewards for those who make decisions for the corporation, which results in inefficiency similar to what can occur with dual class voting.[139] 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 profitable for shareholders of a target company.[140] When the directors of a target implement takeover defenses, the acquirer must often try to unseat the board. Vote buying may overcome various collective action problems among the shareholders. The underlying assumption is that

136. *See, e.g., id.* § 7.32 (authorizing a variety of shareholder control agreements). Similar provisions exist in a majority of American states.

137. *See, e.g.*, N.Y. BUS. CORP. LAW § 609(e) (McKinney 2003) (prohibiting shareholders from selling their votes or proxies to vote).

138. *See, e.g.*, Macht v. Merchs. Mortgage & Credit Co., 194 A. 19, 22 (Del. Ch. 1937) (holding that allowing purchased voting rights to be exercised violates public policy and defrauds other shareholders).

139. EASTERBROOK & FISCHEL, *supra* note 23, at 74 (arguing that attaching the votes firmly to the residual equity interests ensures that unnecessary agency costs will not occur).

140. 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).

the takeover is in the interest of the shareholders[141] and that the vote purchasers will vote in such a way as to maximize stock price.[142]

But as we have seen in the Perry/Mylan case, there is no guarantee that a non-shareholder has the interest to serve such a function, and we have also seen that non-shareholders sometimes have incentives to promote errors on the part of directors.[143] 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.[144]

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 directors that 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.[145] The argument against vote buying in the 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 aggregated preferences or information perspective why vote buying is wrong.

This is not to say, of course, that there are not good reasons to limit vote buying in the political context that also apply to shareholder voting. Richard Hasen's work on vote buying defines an inalienability

141. Levmore, *supra* note 28, at 137–38 (suggesting that states have begun to allow vote buying as "a useful safety valve where defensive tactics go too far in blocking desirable takeovers").

142. Andre, *supra* note 140, at 587 ("Additionally, the permanent separation of ownership and control is unlikely to occur because the purchaser has every incentive to purchase the residual interests."); 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.").

143. Another instance in which the shareholders of the acquirer had an incentive to vote in a way contrary to the financial interest of the company was a transaction involving AXA and MONY. *In re* MONY Group Inc. S'holders Litig., 853 A.2d 661, 667–70 (Del. Ch. 2004); *see also* Kahan & Rock, *supra* note 3, at 1073–74 (using the MONY and AXA merger to illustrate how the interests of hedge funds diverge from those of their fellow shareholders).

144. *See supra* note 44 and accompanying text (describing stock exchange listing standards).

145. *See supra* note 91 and accompanying text (describing the importance of the stock price as a measure of board performance).

purpose, treating voting as belonging to the community as a whole.[146] Cass Sunstein develops an anti-commodification norm to encourage more public-regarding votes and less voting in individual self-interest.[147] Another approach analogizes vote selling to a restraint of trade that interferes with the market and would be banned by antitrust law. Samuel Issacharoff's concern for the vulnerability that the political marketplace shares with all other markets resonates here—there is a "possibility that anti-competitive behavior will compromise the ability of selection to reveal true consumer preferences."[148] 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. It declined to define impermissible vote buying by reference to earlier public policy that these transactions frustrated the shareholder's exercise of his personal judgment.[149] 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."[150] 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.[151]

In the wake of *Schreiber,* many commentators saw the law as having pulled back from substantive regulation of vote buying and similar constraints that limited separation of voting and economic interest.[152] The case law does not seem to support such a broad conclusion. *Schreiber* occurred in a context where the asserted

146. Hasen, *supra* note 142, at 1327–38 (describing equality, efficiency, and inalienability reasons to ban vote buying).

147. Cass Sunstein, *Incommensurability and Valuation in Law,* 92 MICH. L. REV. 779, 785–90 (1994).

148. Issacharoff, *supra* note 7, at 616.

149. Schreiber v. Carney, 447 A.2d 17, 25 (Del. Ch. 1982) ("[T]he potential injury or prejudicial impact that might flow to other stockholders as a result of such an agreement forms the heart of the rationale underlying the breach of public policy doctrine.").

150. *Id.*

151. *Id.* at 26.

152. Hasen, *supra* note 142, at 1348–49; Levmore, *supra* note 28, at 138 (adopting "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"); *see also* Robert Charles Clark, *Vote Buying and Corporate Law,* 29 CASE W. RES. L. REV. 776, 806–07 (1979) (arguing that 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).

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 shareholder with that of the corporation.

In fact, an analysis of *Schreiber* and similar cases indicates that courts will allow vote buying only when such a deal aligns the financial interests of the shareholders with those of the corporation.[153] 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.[154] Nor should there be concern for the failure to apply a vote buying ban to close corporations where, as already discussed, the shareholders are perfectly capable of evaluating whether the incentives of their fellow shareholders create a conflicted economic incentive against the good of the corporation.[155]

As we have just shown, courts have traditionally policed 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

153. *See* IXC Commc'ns, Inc. v. Cincinnati Bell, Inc., No. C.A. 17324, C.A. 17334, 1999 WL 1009174, at *8–9 (Del. Ch. Oct. 27, 1999) (allowing vote buying agreement in which shareholders agreed to support merger in exchange for cash because the deal was adequately disclosed and an independent majority of shareholders (owning nearly sixty percent of all IXC shares) could determine the outcome of the merger); *see also* Kass v. E. Air Lines, 1986 WL 13008, at *2–5 (Del. Ch. Nov. 14, 1986) (mem. opinion) (restructuring required vote of debenture holders and the company offered cash/vouchers if they would agree to the amendments; vote buying allowed because each holder had an economic incentive to evaluate whether any threat to the value of bonds posed by the amendment was more or less valuable than the consideration offered for his consent, and he could accept or reject in accordance with this decision).

154. Weinberger v. Bankston, 1987 WL 20182, at *1, *4–5 (Del. Ch. Nov. 19, 1987) (mem. opinion) (settling a failed proxy contest; insurgents took fees and agreed to dispose of stock within a year, giving management irrevocable proxy in the meantime). The closest example among recent cases of a situation involving potential conflict of incentive between the holders of the votes and economic interest is *Wincorp Realty Invs., Inc. v. Goodtab, Inc.*, No. 7314, 1983 WL 8948, at *3 (Del. Ch. Oct. 13, 1983) (involving an insurgent that bought option for $20,000 with $17,000 kicker if buyer was successfully 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. *Id.* at *5–6. Moreover, the plaintiff failed to put on the record any evidence of a breach of good faith in the transaction. *Id.* at *5. 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." *Id.*

155. *See, e.g.*, Haft v. Haft, 671 A.2d 413, 415–16, 421–23 (Del. Ch. 1995) (holding that, where a family controlled a majority of shares of a public corporation and entered into an agreement, the father could give shares to his son and receive in return an irrevocable proxy, as this would not affect any decision by public shareholders).

clarified, either by statute or common law, 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 in would be a helpful change and would advance 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[156]), there is a need for some parallel verification not of the person of the voter, but of the economic interest. Where abuse is alleged, examination can occur, as it did in the Hewlett-Packard case.[157] Delaware law already makes use of certification in corporate voting; section 103 permits short form mergers when one shareholder owns more than ninety percent of the shares.[158] A shareholder establishes the right to use the more favorable short form procedures by producing certification that the proportion of owned shares is more than ninety percent.[159] If there is a question about the validity of the certification, 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 determining 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

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156. Crawford v. Marion County Election Bd., 128 S. Ct. 1610 (2008) (upholding the constitutionality of an Indiana law requiring citizens voting in person to present a government-issued photo identification).

157. Hewlett v. Hewlett-Packard Co., No. CIV.A. 19513-NC, 2002 WL 818091, at *12–15 (Del. Ch. Apr. 30, 2002) (finding in favor of Hewlett-Packard on vote buying claims brought as a challenge to the vote by Hewlett-Packard shareholders to approve a merger with Compaq).

158. DEL. CODE ANN. tit. 8, § 103 (2008).

159. *See id.* § 253 (providing that for short form mergers, planners are able to skip the shareholder voting step as part of the merger process).

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 managers have rebuffed a takeover, so we may assume that the shareholders will be motivated by a potential change in the stock price. If shareholder voting is to mean anything, it should at least be required 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 its 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.[160] 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.[161]

We depart from Delaware in proposing that the right to remove directors also ought to include a direct means to remove the poison pill and the staggered board without the board's approval.[162] This flows from our belief in 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 actions must close off those two avenues. Poison pills effectively preclude the route of shareholder selling by making a hostile tender offer economically disadvantageous.[163] Staggered boards do a somewhat less complete job

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160. *See, e.g.*, Aprahamian v. HBO & Co., 531 A.2d 1207, 1208–09 (Del. Ch. 1987) (blocking board's postponement of the annual meeting on the eve of the scheduled meeting when dissidents appeared to have a majority of proxies in hand); Condec Corp. v. Lunkenheimer Co., 230 A.2d 769, 777 (Del. Ch. 1967) (blocking corporation's issuance of additional fifteen percent of its shares immediately after a hostile bidder had acquired fifty-one percent of shares in a tender offer).

161. *See, e.g.*, Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1124 (Del. Ch. 1990) (permitting board delay in calling an annual meeting whose date had not yet been set).

162. 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 supra* notes 48–51 and accompanying text.

163. William J. Carney & Leonard A. Silverstein, *The Illusory Protections of the Poison Pill*, 79 NOTRE DAME L. REV. 179, 186–97 (2003) (providing a numerical example of the dilution of a poison pill).

of shutting down shareholder voting by requiring two successful director election victories before an insurgent can get control of the board. Both defenses are in place in a majority of American public corporations.[164]

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.[165] Ostensibly, one election would be sufficient to replace the board and to get the new members to redeem the poison pill. But when a staggered board is also in place, the poison pill cannot be removed for two annual meetings. Consequently, shareholder replacement of the board will be put off until at least that time. Because staggered board provisions are part of the firm's articles of incorporation, for which the board has a gatekeeper position, the provisions cannot be removed without the board's consent until there have been back-to-back successful election campaigns to gain a board majority.[166]

To the extent that the motivation for such electoral campaigns derives from the economic incentive of a bidder who is willing to buy the shares for a premium, this combination of poison pills and staggered boards 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 thirteen to thirty months or longer.[167]

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

164. *See* SharkRepellant.net, www.sharkrepellant.net (last visited Jan. 5, 2009) (reporting that 803 of the S&P 1500 had a classified board as of year-end, down from 902 at year-end 1998). *See generally* Mira Ganor, *Why Do Managers Dismantle Staggered Boards?*, 33 DEL. J. CORP. L. 149 (2008) (stating that the majority of U.S. publicly traded companies have charter-based staggered boards).

165. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (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).

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

167. Shareholders cannot get a court to order a shareholders' meeting unless no meeting date has been designated and thirteen months have passed since the last annual meeting. DEL. CODE ANN. tit. 8, § 211 (2008); *see also* MODEL BUS. CORP. ACT § 7.03(a)(1) (2008) (requiring that fifteen months have passed since the last annual meeting).

against such expropriation. That is, the stock price may not act as a proxy for the overall health of the company, so the shareholders may not be acting as effective monitors of the directors. Instead, shareholders 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.[168] Thus, whether shareholders should have the power to unilaterally dismantle a poison pill involves a tradeoff between the likelihood of the board's selfish behavior and the likelihood of shareholders' selfish behavior. The possible externalizing behavior of shareholders may justify 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, shareholder votes would be well short of instant plebiscites, so the board will not lack time to develop alternative proposals that could provide a better deal for the entity. Most public companies have a staggered board, thus even a direct initiative to change the articles without the board's blocking power would be a two step process in which the shareholders agree to change the articles and then use their annual meeting to replace the entire board. If 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 company constituents 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 charters in the face of aggressive institutional investor pressure.[169] Any further change toward permitting shareholders an

168. *Cf.* City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 798 (Del. Ch. 1988) (explaining that "an active negotiator with power, in effect, to refuse the proposal may be able to extract a higher or otherwise more valuable proposal, or may be able to arrange an alternative transaction or a modified business plan that will present a more valuable option to shareholders").

169. Data on shareholder voting for 2007 from SharkRepellent.net shows ninety-seven shareholder votes on removing classified boards. Almost two-thirds (fifty-two plus six 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 of precatory votes from shareholders. About two dozen of the proposals were shareholder precatory proposals that received more than fifty percent 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 fifty percent shareholder vote. There were five other votes in which the results remained uncertain. This is a much higher number of binding classified board amendments than in any prior year and reflects director response to prior shareholder precatory proposals receiving a majority vote. *See* Bebchuk, *supra* note 2, at 854 (reporting a high of eleven repeals of staggered

immediate lever would require amending 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 retain their existing right to approve mergers and similar transactions that have been approved by directors, but with the obvious loopholes closed. The separate shareholder vote on these transactions ensures that director self-interest will not supersede the corporation's interest when the directors are in their final period on the target side or empire building on the acquirer side.[170] If this limit is to have any consistent meaning, it would seem necessary to extend the shareholder vote to financially equivalent transactions that accomplish the same economic result. As discussed earlier, this would include triangular mergers and acquisitions of assets.[171]

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 arm's length mergers required by the appraisal statutes.[172] *Hariton v. Arco Electronics*, the case that applied this doctrine, provides an example.[173] There actually was a shareholder vote in *Hariton*, but the opponents on the target side desired appraisal rights, which were not provided in a sale of assets.[174] Appraisal serves less of a function today in arm's length deals, but voting continues to have its traditional

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boards after a majority vote on a precatory shareholder proposal in the years through 2003); Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response and Market Reaction*, 13 J. CORP. FIN. 368, 377 (2007) (reporting that the percentage of times that directors took action in response to corporate governance proposals that received a majority of the shareholder vote increased from 15.49% in 2002 to 50.42% in 2004).

170. *See supra* note 44 and accompanying text (noting the disagreement between stock exchange listing standards and state law standards requiring shareholder voting).

171. *See supra* note 43 and accompanying text (describing triangular mergers).

172. *See* Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 244–50 (1962) (explaining the development of the corporation as an independent legal entity and the effects of this status on mergers).

173. 188 A.2d 123, 124 (Del. 1963) (involving a shareholder vote in which eighty percent of the target company shareholders approved the plan and the voluntary dissolution).

174. *Id.*

function. Other de facto merger cases reflect a need to avoid appraisal rights on the acquirer side, even when there is a vote.[175]

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 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 involving substantially equivalent economic combinations. This means that state law should extend shareholder participation to triangular mergers from which shareholders 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 the only practical route to consistency.[176] More importantly, state law should also cover acquisitions of assets by which a company substantially changes its size, as happened to Time in the Time/Warner acquisition.[177]

Part of the dilemma here is that shareholder voting is required under the traditional merger statutes for a change as small as a twenty percent increase in the outstanding stock of the issuer. That requirement is a holdover from the vestigial merger provisions in which statutes moved from requiring unanimity to a supermajority for shareholder approval and offered shareholders voting and appraisal rights as a substitute for their veto. That twenty percent threshold is likely too low to necessitate shareholder monitoring given other constraints on directors, and it would be appropriate to move this number to one hundred percent. The Model Business Corporations Act

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175. *See* Terry v. Penn Cent. Corp., 668 F.2d 188, 189–92 (3d Cir. 1981) (involving a triangular merger in which shareholders of the parent of the acquiring corporation voted but were denied appraisal rights because only the subsidiary was a participant in the merger).

176. *See* Robert B. Thompson, *Corporate Federalism and the Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance*, 82 NOTRE DAME L. REV. 1143, 1174–85 (2007) (describing the changing economic structure of stock markets and the likelihood of reduced governance listing standards from the exchanges).

177. *See supra* note 42 and accompanying text. Current corporations statutes distinguish between the sale of substantially all of a corporation's assets and the purchase of large amounts of assets.

has moved substantially in this direction, but its changes have yet to be enacted in a significant number of states.[178]

Third, while voting is effective in these two decisional settings, shareholder nominations for directors are not nearly as important. Recent SEC efforts to broaden shareholders' ability to nominate directors[179] and to make recommendations regarding the election process to permit shareholder nominations are attempts to address second order problems.[180] In part, the nomination process is less suited to a collective action vote than the election process itself, which has a more definitive and often a bimodal choice. 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, the 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 perform the error-correcting function they carry out in 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. If it is acknowledged that shareholder voting does not arise from a plenary shareholder power to fill all gaps but rather performs a more specified error-correction function where director decisionmaking is particularly questionable, the initial election process in an uncontested setting does not go to the core purpose of voting.

Finally, the 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

178. *See* MODEL BUS. CORP. ACT § 11.04 (2008) (providing that the vote of shareholders of the acquiring corporation is not required for issuance of shares unless required by *id.* § 6.21(f), which requires a shareholder vote only if new shares to be issued total more than the existing number of outstanding shares).

179. Security Holder Director Nominations, Exchange Act Release No. 34-48626, 68 Fed. Reg. 60,784 (Oct. 14, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

180. *Id.* (proposing a rule that would require public companies to provide a mechanism for nominees of long-term security holders with significant holdings to be included in company proxy materials where evidence suggested companies had been unresponsive to shareholder opinions in the 14a-8 process); *see also* INSTITUTIONAL S'HOLDER SERVS., 2006 POSTSEASON REPORT 16 (2006). 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, 475 (2008).

decades of existence, shareholder proposals related to general social issues on which some shareholders had intense feelings, but overall the issues were in the core area of decisions that corporate law trusts directors to make.[181] Absent a belief that shareholders should 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. Indeed, few such provisions achieve a majority vote from shareholders, and the particular corporation's actions are often tangential to the issues. In the same way that we suggested above that shareholder voting on mergers is done on a company by company basis and not on whether the transaction as a whole is a positive net benefit, 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. When these proposals ask shareholders to vote on article amendments to repeal a staggered board or 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 error-correcting purpose of shareholder voting. 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 running the corporation, it is more difficult for these votes to effectuate error reduction. 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 are 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 decisionmaking process and various inputs that operate there. But even here, our theory of voting tells us something about the purpose sought to be achieved. It is an early warning corrective to director error, not an exercise of plenary power by the shareholders.

181. *See supra* notes 62–66 and accompanying text.

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 choice to take advantage of the economic incentives that will influence such decisionmaking and the markets that facilitate this choice. 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 financial 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 twentieth century that relaxed longstanding 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 does a consistent theory emerge 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 these arguments tend to omit 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 in 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 sub-issues on which we should focus. Other functions linked to the shareholder franchise, such as shareholder nominations or precatory votes on matters of social importance, do not fit as well with this theory of corporate voting.

A decisionmaking 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 require an alignment between share voting and the financial interest of the shares. Some of the traditional justifications against alignment, such as in 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, that takes advantage of economic incentives to prevent empty voting.

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