
Can Borrowing Shares Vindicate Shareholder Primacy?

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Recent academic literature and financial press has voiced concerns over so-called “empty voting” — the exercise of voting rights disproportionate to economic interest to influence the outcome of proxy contests and takeovers. In particular, these commentators worry about the consequences of freely decoupling the economic interests and voting power of shares. I argue that a transparent market for borrowing public shares, if made available to institutional shareholders committed to long-term wealth maximization, could allay many of these concerns. Moreover, this market could empower institutional shareholders to take steps to improve corporate governance without the need to expand shareholder rights. I consider the impact of a market for share borrowing, inter alia, on the debate between directorial discretion and shareholder voice and on social welfare in various “empty voting” transactions.

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INTRODUCTION

Scholars vigorously debate the extent to which shareholders should be able to use their voting power to participate in corporate governance.¹ In recent years, the theory that shareholder voting is the best guarantor of long-term shareholder wealth maximization — the

¹ See, e.g., Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1758 (2006) (arguing that “substantial efficiency benefits” flow from limiting shareholder voting rights); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005) (presenting case for allowing shareholders to initiate and vote to adopt changes in corporate charters and bylaws); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1783 (2006) (expressing doubt that financial intermediaries will respond to system of incentives or duties to take more “far-sighted view” of their fiduciary obligations); see generally Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006); Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033 (1994); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 814-20 (1992) (describing “promise of institutional voice” in monitoring corporate managers); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881; Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006); Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994); Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987); John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313 (1992); John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003 (1993); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998).

theory of “shareholder primacy”² — has gained ground as shareholdings in public corporations have gravitated from diffuse individuals to institutional shareholders.³ Building upon increased institutional shareholder activism in corporate governance, federal regulators, state legislatures, and self-regulatory bodies have pursued initiatives that would afford greater voice to shareholders in corporate governance decisions, such as the nomination and election of directors, bylaw amendments, and executive compensation.⁴

At the same time, the theory of shareholder primacy has come under assault from the growing threat of transactions that appear to dissociate voting power and economic interest.⁵ Commentators have identified an increasing number of transactions where hedge funds and other interested parties have been able to exercise significant voting power in a corporation without a proportionate economic interest in that corporation. Professors Hu & Black refer to this phenomenon as “empty voting.”⁶ A person may engage in “empty

² Bainbridge defines “shareholder primacy” as the principle that shareholders have the greatest incentive to maximize firm value because their economic interests are aligned with those of the firm. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 573 (2003) (describing two principles of “shareholder primacy” as shareholder wealth maximization norm and principle of ultimate shareholder control). Other scholars define “shareholder primacy” more loosely to refer to the shareholder wealth maximization norm without explicit reference to the means by which the norm is enforced. Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1189 (2002) (defining as “the view that the corporation exists only to make money for its shareholders”); see also Fisch, *supra* note 1, at 637 (defining as “the objective of the corporation as maximization of shareholder wealth”); Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 535 (2006) (defining as “view that managers’ fiduciary duties require them to maximize the shareholders’ wealth and preclude them from giving independent consideration to the interests of other constituencies”).

³ See *infra* Part I.B.

⁴ See *infra* notes 52, 196.

⁵ Douglas R. Cole, *E-Proxies for Sale? Corporate Vote-Buying in the Internet Age*, 76 WASH. L. REV. 793, 800 (2001); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983); Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule?*, 70 S. CAL. L. REV. 741, 743 (1997); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006); Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 779; Joe Pavelich, Note, *The Shareholder Judgment Rule: Delaware’s Permissive Response to Corporate Vote-Buying*, 31 J. CORP. L. 247, 250 (2005).

⁶ See generally Hu & Black, *supra* note 5 (systematically addressing “new vote buying,” which they define to encompass both “empty voting” and hidden (morphable) ownership of shares, and its corporate governance implications).

voting” in any number of ways, including the outright purchase of votes from shareholders; the purchase of voting shares hedged with derivatives that reduce or eliminate the purchaser’s economic exposure to the value of the shares; or the borrowing of voting shares (to which this Article refers as “share borrowing”).

Some commentators fear that allowing persons to vote shares without an economic interest allows them to engage in rent-seeking behavior — extracting value from the corporation for themselves at the expense of other shareholders.⁷ Even worse, this rent-seeking behavior may well occur without significant warning to the disadvantaged shareholders.⁸ Other commentators have expressed qualified support for such “vote buying” or “vote rental” transactions as a way of allocating voting rights to those best able to exercise them intelligently.⁹ For example, the ability to purchase votes may help reduce the obstacles to harnessing the collective power of shareholders.¹⁰ Vote-buying transactions may also provide shareholders with financial incentives to vote or tender shares in favor

⁷ Examples of shareholder rent-seeking include (i) election of the shareholder’s cronies to the board in order to effect transactions that divert wealth to the shareholder at the expense of or the detriment to the corporation’s other shareholders (e.g., self-dealing), (ii) divestiture of long-term productive assets to cause short-term distributions of corporate wealth, and (iii) causing the corporation to merge with another entity controlled by the shareholder on terms that benefit the latter entity at the expense of the corporation. Part III considers how a market for borrowing public shares might address these issues.

⁸ See, e.g., Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism*, 32 J. CORP. L. 681, 706-08 (2007) (recommending reforms to disclosure rules for proxy solicitations and major shareholders to address potentially negative consequences of hedge fund activism); Hu & Black, *supra* note 5, at 836-41 (describing how “[e]quity derivatives can . . . be used to avoid disclosing economic ownership under disclosure rules that turn largely on voting rights rather than economic ownership”); see also Andrew Ross Sorkin, *A Loophole Lets a Foot in the Door*, N.Y. TIMES, Jan. 15, 2008, http://www.nytimes.com/2008/01/15/business/15sorkin.html?_r=1&dlbk.

⁹ Thomas J. André, Jr., *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. CAL. L. REV. 533, 636 (1990) (concluding that “vote buying does not differ fundamentally from some other recent restructuring transactions” and that “allowing firms to purchase the votes of their own public stockholders could provide those public stockholders with a financial alternative that they cannot presently be offered”); Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 807 (1979) (concluding that “the encouragement of responsible vote buying is a worthy project”); Saul Levmore, *Voting with Intensity*, 53 STAN. L. REV. 111, 136-39 (2000) (suggesting that “it may be no accident that vote selling has appeared in corporate law because the competition among buyers allays sellers’ fears of selling too cheaply because of their collective action problem”).

¹⁰ Levmore, *supra* note 9, at 136-39.

of transactions that, while socially efficient, might otherwise reduce shareholder value.¹¹

As “empty voting” transactions recur with greater frequency, legislators, regulators and corporate managers must consider whether to take measures to counteract the threats they pose. Traditionally, corporation law policy makers have considered two alternatives. One alternative is to build the regulatory apparatus necessary to ensure that voting power is coupled with a proportionate economic interest, in an effort to preserve the traditional paradigm of “one share/one vote.” A second alternative is to shift power away from shareholders and towards directors, for example, under the various theories that support preserving board discretion (such as “director primacy” or “team production”).¹² This Article proposes a third alternative: crafting rules to create a market that permits shareholders who are committed to maximizing the corporation’s wealth to increase their voting power (or as Professor Levmore puts it, to “vote with intensity”) on the same (or better) terms as hedge funds and other activists.¹³

The conceit of the Article may be expressed as follows: if long-term institutional shareholders have an interest in long-term wealth maximization, they should be willing to incur short-term costs (e.g., the cost of acquiring additional voting power) to serve that interest. If this were the case, a market for borrowing public shares, as described herein, should develop over time as a means to harness shareholder power to improve corporate governance.¹⁴ Shares held in retail accounts — those held by individuals or nonprofessional investors — might be available for borrowing, for example, either at the initiative of the retail shareholder or in the absence of contrary voting instructions. Institutional shareholders, activist shareholders (e.g.,

¹¹ André, *supra* note 9, at 636.

¹² See *infra* Part I.A.

¹³ See Clark, *supra* note 9, at 807 (suggesting that vote buying should be permitted if buyer establishes, among other defenses, that there is no “clear, substantial danger that the corporation or some of its shareholders will be unfairly treated,” demonstrates “a reasonable basis for believing that the vote buying will facilitate action that will increase the corporation’s value,” and “attempted his vote buying publicly and made his offer available to all shareholders on equal terms”).

¹⁴ Of course, in most cases, the mere threat of doing so should be enough to deter special interest investors from incurring the borrowing costs of mounting a challenge, particularly if there is broad shareholder support for management. See, e.g., Daniel Thomas, *Vodafone Holders Reject Activist Plan*, WALL ST. J., July 25, 2007, at C3 (noting that less than 5% of proxy shareholders voted in favor of resolution sponsored by Efficient Capital Structures, which “call[ed] for the British company to spin off . . . [or issue a tracking stock for Vodafone’s] 45% stake in U.S. mobile operator Verizon Wireless”).

hedge funds and unions), and insiders would be eligible to bid for the use of shares held by nonprofessional investors (specifically the right to vote) for specified shareholder actions, such as voting contests and participation in tender offers.

Although this alternative is unlikely to come to fruition, the exercise of thinking through how such a market would function serves as a novel lens through which to ponder the validity of the shareholder primacy theory. If share borrowing may be harnessed in a way that promotes aggressive participation by long-term investors with significant shareholdings, there should be no need to curtail shareholder power to minimize the dangers that “empty voting” presents. Rather, legislative and regulatory policy should preserve the role shareholders currently play in corporate decision making and co-opt “empty voting” by encouraging institutional shareholders to borrow shares consistent with their fiduciary duties. Conversely, if insufficient shareholders are prepared to participate in a share borrowing market, the fundamental premise of shareholder primacy — that shareholder control is the ultimate guarantor of shareholder wealth maximization — is starkly called into question.

This Article begins by discussing the contemporary debate over the role of shareholders in corporate governance and the impact of “empty voting” on the exercise of the shareholder franchise. Part I of this Article thus describes the basic tension between those schools of academic thought that advocate greater board discretion in corporate decision making and those that advocate greater shareholder voice in corporate governance. Part II examines the phenomenon of empty voting, how it fits into traditional jurisprudence on vote-buying transactions, and whether it is preferable from a policy perspective to limit or, alternatively, to expand opportunities for acquiring “empty votes.” In Part III, I turn to a more formal description of how a hypothetical market for borrowing public shares would operate, and consider the practical benefits from and obstacles to constructing such a hypothetical market. Finally, Part IV discusses how the hypothetical market might help to reconcile the tension between board discretion and shareholder voice.

I. THE ROLE OF SHAREHOLDERS IN CORPORATE GOVERNANCE

Public debates over the role of shareholders in corporate governance — and particularly the link between voting power and economic interest — often begin with analogies to voting in the civil or political

context.¹⁵ Attempts to alienate voting rights from economic interests appear to undermine the sense of collective determination at the heart of shareholder or civic democracy because legitimizing vote buying would relieve each shareholder from her duty to utilize “independent judgment” in voting shares for the general welfare.¹⁶ Allowing votes to be purchased also tends to favor the interests of wealthier entities (who are able to buy votes) over less wealthy individuals (who are only able to hold or sell votes). Vote buying also encourages special interests to cause corporations to enter into transactions that reward them disproportionately relative to other shareholders in order to compensate for the cost of campaigns.¹⁷

This analogy to civic voting is misplaced, at least to a degree. In the context of economic policy making, elected officials and representatives must consider both the impact and allocation of social wealth among constituents.¹⁸ By contrast, the relative claims of

¹⁵ See, e.g., Colleen A. Dunlavy, *Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights*, 63 WASH. & LEE L. REV. 1347, 1350, 1366-67 (2006) (describing twentieth-century shareholder empowerment movement in United States and Europe as reaction to plutocratic or oligarchic conceptions of corporations). Shareholder voting power reflects the historical expectation that owners of a corporate enterprise would participate in the management of its affairs. See, e.g., Blair & Stout, *supra* note 1, at 258-59, 285-86 (describing “principal-agent” rationale for shareholder voting power); Martin & Partnoy, *supra* note 5, at 781 (describing historical corporate voting practices in which shareholders had equal voice regardless of economic interest).

Modern proposals to return such control to significant shareholders through board representation — such as through cumulative voting — are predicated on engaging influential shareholders who are able to overcome the traditional impediments to effective voting by diffuse shareholders. Gordon, *supra* note 1, at 130, 141; see Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1946-47 (1996) (recommending cumulative voting as norm for corporation law in emerging countries without developed markets or strong regulatory traditions).

¹⁶ See *In re IXC Commc'ns, Inc. S'holders Litig.*, No. C.A. 17324, 1999 WL 1009174, at *8 (Del. Ch. Oct. 27, 1999) (unpublished opinion) (“Generally speaking, courts closely scrutinize vote-buying because a shareholder who divorces property interest from voting interest, fails to serve the ‘community of interest’ among all shareholders, since the ‘bought’ shareholder votes may not reflect rational, economic self-interest arguably common to all shareholders.”); Levmore, *supra* note 9, at 114 (cataloguing arguments against corporate vote buying).

¹⁷ Levmore, *supra* note 9, at 114.

¹⁸ See ROBERT B. REICH, *SUPERCAPITALISM: THE TREATMENT OF BUSINESS, DEMOCRACY, AND EVERYDAY LIFE* 4 (2007) (“Capitalism’s role is to enlarge the economic pie. How the slices are divided and whether they are applied to private goods like personal computers or public goods like clean air is up to society to decide. This is the role we assign to democracy.”); see also Usha Rodrigues, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389, 1404-05 (2006)

shareholders are fixed when the shares are issued by the terms of the issue, the organic documents of the corporation, and its governing law.¹⁹ Efforts to expand shareholder power or limit the board's discretion after shares have been publicly issued are thus "fraught with tension."²⁰ Concerns about transactions that seek to allocate wealth disproportionately among different classes or groups of shareholders, when they arise, are subject to judicially constructed doctrines of fairness and specific statutory remedies.²¹ Finally, shareholders hold

(summarizing scholarly debate over whether cost of empowering large shareholders, i.e., risk of disproportionate distribution of corporate wealth among shareholders, outweighs benefits, i.e., greater pressure on management to maximize shareholder wealth).

¹⁹ The realm of actions that may be taken by shareholder initiative without prior board action varies from state to state, but has been limited. Some states permit shareholders to initiate amendments to corporate bylaws. See, e.g., CAL. CORP. CODE § 211 (West 2007) (permitting adoption, amendment, or repeal of bylaws by approval of outstanding shares); DEL. CODE ANN. tit. 8, § 109 (2007) (allocating power to adopt, amend, or repeal bylaws to shareholders); see also MODEL BUS. CORP. ACT § 10.20 (2007) (enabling shareholder to adopt, amend, or repeal bylaws). Shareholders may also have the right to call special shareholder meetings for that purpose. CAL. CORP. CODE § 600(d) (West 2007) (enabling shareholders entitled to vote 10% or more of shares entitled to vote at meeting to call special shareholder meeting); DEL. CODE ANN. tit. 8, § 211(d) (2007) (permitting shareholder meetings to be called by such persons as may be authorized by certificate of incorporation or bylaws); see also MODEL BUS. CORP. ACT § 7.02 (2007) (enabling holders of 10% or more of votes entitled to be cast on issue, or such threshold as may be established by articles of incorporation, to demand special meeting).

²⁰ *Bebchuk v. CA, Inc.*, 902 A.2d 737, 742 (Del. Ch. 2006). How this tension should be resolved is the subject of significant academic commentary. See, e.g., John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 613-14 (1997) (suggesting, among other possible lines for distinguishing permissible bylaw amendments from impermissible ones that invade board authority, whether such bylaws relate to "[o]rdinary versus '[f]undamental'" business decisions, "[a]ffirmative [o]rders versus [n]egative [c]onstraints," rules of "[p]rocedure versus [s]ubstance," and "[c]orporate [g]overnance vs. [b]usiness [d]ecisions"); Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 425-67 (1998) (analyzing whether shareholder-initiated bylaw amendments should be permissible under controlling statutes, as matter of reinterpretation along lines of Professor Coffee's suggested classifications, or from "the perspectives of law and economics, public choice theory, and political direct democracy"); Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835, 835, 837 (1998) (arguing that shareholder-initiated bylaw amendments that disarm poison pills and other defensive measures employed by corporate managers "should be upheld in order to protect shareholder interests in takeover actions").

²¹ See, e.g., *infra* text accompanying notes 138-47 (discussing judicial review of transactions involving intracorporate allocations of benefits under Delaware law); notes 128-31 *infra* and accompanying text (discussing various federal and state

shares at their pleasure, with exit rights backed by the liquidity of the marketplace, whereas individuals are less able to escape the consequences of bad political decision making.²² As a result, debates about the role of shareholder voting power among corporate law scholars focus less on the substance of corporate decision making than on the appropriate ground rules for corporate governance.

Theories of shareholder voting can thus be divided into two general categories: Those that advocate greater board discretion and less shareholder interference, and those that advocate a limited role for shareholders in setting the parameters within which directors exercise discretion. Each school of thought, moreover, comprises a set of views on the institutional competence of the directors, officers, shareholders and other stakeholders in a corporation; the manner in which shareholders are able to influence corporate governance; and the resources at the disposal of shareholders to exercise their voting rights intelligently. Subpart A of this section describes the various schools of thought advocating limited shareholder participation in governance. Subpart B describes the school of thought that emphasizes the role institutional and other professional investors may play in setting the ground rules of corporate governance.²³ This Part concludes with some brief observations on the implications of this debate for the “empty voting” phenomenon and, more generally, the relevance of the hypothetical market proposed herein.

A. *Limiting Shareholder Participation in Governance*

Various theories of corporate governance espouse limits on the role of shareholders in corporate decision making. Many of these theories draw on longstanding insights about the shortcomings of shareholder voting and the incentives of shareholders. Three specific theories merit special consideration because of their prominence in the contemporary debate over the proper role of shareholders in corporate governance. First, Professor Bainbridge, advocating a theory of “director primacy,” has maintained that granting deference to the

statutory and regulatory protections for shareholders); *see also supra* note 7 (discussing various rent-seeking transactions).

²² *See* Rodrigues, *supra* note 18, at 1398-1402 (noting, among other differences between corporate and political voting processes, that investment in shares is voluntary and that shareholders in public shares can exit cheaply).

²³ *See, e.g.,* Matheson & Olson, *supra* note 1, at 1323-24 (characterizing evolution of shareholder voting power as “dialectic” between managerial and shareholder primacy); Pound, *supra* note 1, at 1011-13 (describing tension as one between “political” and “takeover” models of corporate governance).

business judgment of the board of directors free from undue shareholder interference best maximizes shareholder wealth.²⁴ Second, Professors Blair and Stout justify vesting final authority in the board because it is the organ charged with mediating the interests of competing constituencies in the “team production” made possible through aggregation of capital, labor, and other resources.²⁵ A third school of theorists advocates limiting the role of shareholders in corporate governance to participation in the “market for corporate control,” where the disciplinary effect imposed by proxy contests and hostile acquisitions can be used to oust underperforming directors.

There is much scholarship on the shortcomings of shareholder voting. First, free-riding problems can arise because of the cost of gathering and analyzing information regarding management performance. Smaller investors are expected to exhibit “rational apathy” in making voting decisions because they have no incentive to vote intelligently if their votes have minimal impact.²⁶ Conversely, the shareholder voting process does not properly incentivize larger shareholders to expend the resources necessary to initiate a proxy contest as they often do not reap all of the benefits conferred by improvements in corporate governance.²⁷ Second, coordination

²⁴ Bainbridge, *supra* note 2, at 604-05.

²⁵ Blair & Stout, *supra* note 1, at 248-57.

²⁶ ROBERT C. CLARK, CORPORATE LAW 390-93 (1986); Dent, *supra* note 1, at 903; Easterbrook & Fischel, *supra* note 5, at 402. Proposals have been made to encourage shareholder participation through “turnout incentives” in corporate proxy contests. See, e.g., Cole, *supra* note 5, at 853-54 (arguing that shareholders would have incentive to review proxy materials and participate in proxy contests if they received incentive fee for returning proxies, independent of how they voted).

²⁷ Black, *supra* note 1, at 822; Clark, *supra* note 9, at 783. In some cases, outsourcing of such research to “independent third-party proxy services” may be desirable when, for example, institutional managers do not have the resources or may have business relationships with issuers of the securities they hold. See Robert D. Hershey, Jr., *A Little Industry with a Lot of Sway on Proxy Votes*, N.Y. TIMES, June 18, 2006, § 3, at 6 (describing outsourcing of fiduciary duty to third party services, such as Institutional Shareholder Services; Glass, Lewis & Company; and Proxy Governance); see also GAO, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 9-12 (2007) (discussing potential conflicts of interest). But see Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 906-16 (2007) (questioning efficacy or desirability of this practice). Even if the costs of research may be reduced by outsourcing to institutional proxy services, the expense and uncertainty traditionally associated with the solicitation of proxies makes attempts to propose affirmative changes much more difficult. Lucian Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control* 19-22 (Nat'l Bureau of Econ. Research, Working Paper No. 86330, 2001) (noting low success rate for proxy contests conducted in isolation, as compared to proxy contests coupled with proposed acquisition or specific business plan). While the SEC has taken steps to

problems may result from excessive diffusion of voting interests and the differing “time horizons, risk preferences, and beliefs” that make efforts to craft a unitary policy futile.²⁸ Third, rent-seeking problems may result when certain shareholders have a disproportionate concentration of voting power or economic influence.²⁹ Finally, the degree to which informational asymmetries³⁰ and myopia³¹ affect the

facilitate the solicitation of proxies by Internet, such efforts do not eliminate the cost of mounting a campaign to encourage solicited shareholders to act on a dissident proposal. See *Shareholder Choice Regarding Proxy Materials*, 72 Fed. Reg. 42,222, 42,223 (Aug. 1, 2007) (to be codified at 17 C.F.R. pt. 30) (adopting amendments to SEC’s proxy rules, inter alia, (i) to require issuers to post proxy materials on publicly accessible Internet website and (ii) to require issuers and intermediaries to provide notice of availability of such materials and to explain how to access them); *Internet Availability of Proxy Materials*, 72 Fed. Reg. 4,148, 4,150-51 (Jan. 29, 2007) (to be codified at 17 C.F.R. pts. 240, 249, 274) (adopting amendments permitting issuers and other persons to furnish proxy materials via notice and Internet access).

²⁸ Jeffrey N. Gordon, *Shareholder Initiatives: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 368 (1991); see Bainbridge, *supra* note 2, at 557-58; Lynn A. Stout, *Are Stock Markets Costly Casinos? — Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 615-17 (1995).

²⁹ Larger shareholders may seek to use their voting power to obtain private benefits rather than maximize wealth for all shareholders. Clark, *supra* note 9, at 784-85; Gordon, *supra* note 28, at 375. For example, higher voting thresholds may increase the incentive for significant shareholders to “hold out” for private rents as a condition of consenting to actions that otherwise increase shareholder wealth. See, e.g., Goshen, *supra* note 5, at 793-94 (advocating “simple majority” rule in most voting transactions to address abuses of hold-out power). Conversely, lower voting thresholds may increase the incentive for significant shareholders to pursue bylaw amendments or other initiatives inimical to management with a view to extorting concessions or extracting private rents, regardless of their impact on shareholder wealth. *Id.* at 800.

³⁰ Advocates for shareholder democracy recognize that shareholder decision making may be costly and unreliable, as compared to decision making by managers or a board of directors. Bebchuk, *supra* note 1, at 880-92. Shareholders, at least relative to management, have imperfect information about the business of the corporation. Bebchuk & Hart, *supra* note 27, at 14-16; Susan E.K. Christoffersen et al., *Vote Trading and Information Aggregation*, 62 J. FIN. 2897, 2914-26 (2007) (hypothesizing that share lending in vicinity of record dates for shareholder votes may be explained by asymmetric information); Gordon, *supra* note 28, at 353. In the context of hostile takeovers, for example, courts have suggested that shareholders may be “substantive[ly] coerced” into taking an inadequate offer because of their inability to determine the value of their shares. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1384 (Del. 1995); *Paramount Commc’ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1152-53 (Del. 1989).

³¹ Shareholders are often said to view investment decisions from a “short-term” perspective, at least relative to management or other constituencies that have long-term relationships with corporations. Lucian Arye Bebchuk, *The Myth of Shareholder Voting Power*, 93 VA. L. REV. 675, 723 (2007); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 189 (1991).

outcome of shareholder voting depends on the relative sophistication of investors and the size and expected duration of their shareholdings.

Building upon these insights, various schools of thought have emerged that offer different justifications for limiting shareholder power. I describe three of these in turn.

1. Director primacy.

In his theory of “director primacy,” Bainbridge argues that the shortcomings of the shareholder voting process have led lawmakers, by “fiat,” to vest exclusive managerial authority in the board to the exclusion of shareholders.³² While acknowledging that shareholder wealth maximization is the appropriate objective for corporate governance, Bainbridge argues that corporate executives and directors have equal, if not better, incentives to maximize shareholder value than shareholders.³³ Unlike shareholders, who are able to reduce firm-specific risks through diversification, corporate executives and directors have concentrated exposure to their firms (through incentive-based compensation packages and stock ownership and holding requirements for executives and directors) and are therefore more sensitive to long-term performance.³⁴ Moreover, executives and

Short-termism is often the result of investors' preference for liquidity. John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1318-21 (1991). For example, mutual funds may prefer to liquidate shares underperforming in the short-term rather than sacrifice short-term gains for long-term profits. *But see* Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1504-05 (1991) (suggesting that historical aversion to “large block” funds could be overcome if designated and regulated as separate industry). For example, according to the Federal Reserve Board's data for the third quarter of 2007, approximately 65% of mutual fund shares are held by the household sector, whose focus on short-term returns may require mutual fund managers to be similarly responsive. FEDERAL RESERVE BOARD, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES 90 tbl.L.214 (2007), available at <http://www.federalreserve.gov/releases/z1/Current/z1r-4.pdf>. Some commentators have, for example, proposed to phase in voting rights based on the length of shareholding, akin to the idea of “relational investing” described above. Charles M. Nathan, Latham & Watkins LLP, “Empty Voting” and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds (Apr. 2007), http://www.lw.com/upload/pubContent/_pdf/pub1878_1.Commentary.Empty.Voting.pdf.

³² Bainbridge, *supra* note 1, at 1751-57.

³³ *Id.* at 1739-41.

³⁴ Bainbridge, *supra* note 2, at 576-77; *see also* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 710 (1995) (arguing that “most promising solution” to motivating better management by the board is to establish and maintain “substantial equity ownership on the part of the outside directors”). *But see* Rajesh Aggarwal, *Executive Compensation and Corporate Controversy*, 27 VT. L. REV. 849, 869 (2003) (arguing that use of stock options is

directors who demonstrate competence at one firm thereby become more valuable in the market for managerial talent and are able to ascend to larger firms or command higher compensation.³⁵

2. Team production.

The “team production” school of thought advanced by Blair and Stout goes further to dispute the traditional conception that shareholders are the owners of the modern corporation.³⁶ Corporation law commentators, who argue that the modern public corporation is more appropriately viewed as “a nexus of contracts” among various constituencies, distinguish the concept of shareholder control from the overriding purpose of maximizing shareholder wealth.³⁷ In such models, corporate decision-making authority may be allocated pursuant to any number of rules that advance the interests of the corporation or increase social wealth.³⁸ In light of this nexus of competing stakeholders — creditors, shareholders, employees, suppliers, customers, and communities, among others — Blair and Stout elevate the directors as “the mediating hierarchs whose job is to balance team members’ competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.”³⁹

associated with better firm performance, if used “appropriately,” but that disproportionately large grants may be “symptomatic” of deeper corporate governance problems).

³⁵ See Bainbridge, *supra* note 2, at 576-77; see also Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 294 (1980) (observing that market for executive and managerial talent may discipline officers and directors).

³⁶ Blair & Stout, *supra* note 1, at 278 (suggesting that “it is misleading to view a public corporation as merely a bundle of assets under common ownership”); Stout, *supra* note 2, at 1190 (describing concept of “ownership” as “the most common, and the worst, of the standard arguments for shareholder primacy”).

³⁷ See, e.g., Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 789 n.14 (1972); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302-03 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976).

³⁸ *Paramount Commc’ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1152-53 (Del. 1989) (suggesting that board may take interests of other constituencies into account in taking defensive measures against hostile acquisition, including measures that may be perceived as disenfranchising shareholders); ABA Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2257, 2261-63 (1990) (discussing history of state law statutes permitting or requiring consideration of constituencies other than shareholders in board decision making).

³⁹ Blair & Stout, *supra* note 1, at 280.

3. Market for corporate control.

The third school of theorists views the role of shareholders as limited to passive participation in a “market for corporate control.” In this school of thought, outsiders provide a monitoring function by comparing a corporation’s “potential value with its value (as reflected by share prices) under current management,” and initiating a hostile bid or proxy contest when the divergence between the two values makes it profitable to do so.⁴⁰ Shareholders agree to vote for outsider groups or to be bought out by outsiders who are able to signal their relative competence to manage the affairs of the corporation.⁴¹ Voting power, like other attributes of share ownership is “justified primarily by the relatively rare transfers of corporate power it makes possible” from incumbent directors to challengers in a contest for control.⁴²

These three schools of thought may differ as to the ends of corporate governance, but each views the board of directors as the organ primarily charged with making decisions about corporate policy. In their view, traditional corporation law appropriately limits the role of shareholders outside the context of challenges to control, by structuring shareholder voting rights as a series of veto powers or as mere ratification of board decisions.⁴³ The shareholder vote is a

⁴⁰ See, e.g., 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, 1173 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 841-44 (1981); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965).

⁴¹ Easterbrook & Fischel, *supra* note 40, at 1196 (“[T]he ability of shareholders freely to trade their shares, and thereby vote on current management, is no doubt the most powerful check on agency costs.”); Gilson, *supra* note 40, at 845-48 (noting “[g]eneral [p]rinciple” that “[s]hareholders [m]ust [m]ake the [d]ecision” on a tender offer if management rejects merger or sale of assets proposal for its own interests). As managers adapt to new takeover strategies, insurgents oscillate between these two strategies. Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1078-79 (1990) (observing that takeovers suffer from problems of financing, distorted choice resulting from potential coercion of shareholders, and defensive strategies).

⁴² Clark, *supra* note 9, at 787; see Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 24-25 (1990). But see John C. Coffee, Jr., *Regulating the Market for Corporate Control*, 84 COLUM. L. REV. 1145, 1153 & n.15 (1984) (critiquing effectiveness of hostile takeovers as tools of corporate accountability); Manne, *supra* note 40, at 112 (observing that “market for corporate control” gives “[small] shareholders both power and protection commensurate with their interest in corporate affairs” in face of underperforming, entrenched managers).

⁴³ Anabtawi, *supra* note 1, at 570. Common shareholders generally have the right to vote on a number of corporate matters, generally after the board has taken some

“safety valve”⁴⁴ or “self-help” measure invoked to constrain self-dealing or entrenchment.⁴⁵

To the extent that the theories discussed above focus on the relative competence of boards at making *substantive* decisions, advocates of greater shareholder participation in governance have focused on mechanisms to improve the *process* by which boards carry out corporate policy. The persuasiveness of these theories of shareholder voice turns on the competence of major institutional investors to make informed decisions about best practices for corporate governance as well as to identify critical business decisions in which shareholders can play a consultative role. Such theories also rely on the ability of

action — in the form of a board resolution — and extensive disclosure prepared on the subject of the vote. These matters include the periodic election of the corporation’s board of directors, DEL. CODE ANN. tit. 8, § 211(a)(2)(b) (2007), the ratification of amendments to the corporation’s certificate of incorporation, *id.* § 242 (2007), and the consummation of certain “end-game” transactions such as statutory mergers and consolidations, a sale of substantially all corporate assets, and dissolution. *See id.* § 251(c) (2007) (requiring shareholder vote on agreement of merger or consolidation); *id.* § 271(a) (2007) (requiring shareholder adoption of resolution to effect sale, lease or exchange of substantially all corporate property and assets); *id.* § 275(b) (2007) (requiring shareholder vote on proposed dissolution of corporation). Many, but not all, such transactions have further prophylactic restrictions, such as heightened scrutiny of fiduciary duties and an opportunity to seek appraisal rights. *See id.* § 262(a)-(b)(2) (2007) (providing appraisal rights in various transactions); *Paramount Commc’ns, Inc. v. QVC Networks, Inc.*, 637 A.2d 34, 42–46 (Del. 1994); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986).

Transactions involving a director’s conflict of interest may also be put to a shareholder vote to avoid a heightened degree of judicial scrutiny. *See, e.g.*, CAL. CORP. CODE § 310(a)(1) (West 2007) (providing procedure for approval of contracts in which director has material financial interest through vote of disinterested shareholders); DEL. CODE ANN. tit. 8, § 144(a)(2) (2007) (providing procedure for approval of contracts or transactions in which corporate officers or directors have interest through good faith shareholder vote); N.Y. BUS. CORP. LAW § 713(a)(2) (McKinney 2007) (providing procedure for approval of contracts or transactions in which corporate directors have interest through shareholder vote).

⁴⁴ Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 736 (2007).

⁴⁵ Robert B. Thompson, *The Mystery of the Success of Delaware Law: Delaware’s Disclosure: Moving the Line of Federal-State Corporate Regulation*, 2009 U. ILL. L. REV. 167, 178 (2009). Boards may also bypass many of these measures, for example, if the benefits of shareholder legitimization are outweighed by the cost or uncertainty of conducting a vote. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a)(1), (3) (immunizing transactions involving interested officers or directors from challenge without necessity of shareholder vote, through majority vote of disinterested directors or by demonstration that contract or transaction is “fair as to the corporation”); MODEL BUS. CORP. ACT § 8.61(b)(1), (3) (2007) (immunizing “director’s conflicting interest transaction” from challenge without necessity of shareholder vote if there is effective “directors’ action” or transaction is established to have been “fair to the corporation”).

institutional shareholders to represent the interests of shareholders fairly. These approaches are discussed in the next subpart.

B. *Increasing Shareholder Voice*

Despite a perceived historical resistance to concentrated institutional ownership of corporate equities,⁴⁶ the increasing percentage of corporate equities held by institutional shareholders has focused attention on the role these investors should play in corporate governance.⁴⁷ Because the fiduciary duties and economic interests of institutional investors are generally aligned with the shareholder wealth maximization norm, advocates of shareholder primacy have asserted that concerted groups of institutional investors might have the incentive to use their power to intervene in the affairs of corporations in a legal environment conducive to these

⁴⁶ One commentator has argued that, for a significant part of U.S. history, federal and state lawmakers sought to prevent financial institutions from acquiring significant holdings in public companies, for fear that concentration of ownership would lead to domination of U.S. industry by the “money trust” financial elite. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 31-53 (1991).

⁴⁷ See, e.g., Gordon, *supra* note 28, at 347-48 (discussing rise of institutional shareholders and implications for whether shareholders may be organized to “act against management to effect corporate change”); Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 18-21 (2004) (arguing that increased equity holdings of institutional investors led them to place greater pressure on management to improve corporate earnings in 1990s, without corresponding duties to ensure that such pressure is exercised in interests of corporation and to police management for abusive practices in service of that goal); Matheson & Olson, *supra* note 1, at 1317 (“Accompanying institutional investors’ growth and concentration of share ownership is their desire and ability to participate meaningfully in governance issues.”). For purposes of this Article, “institutional shareholders” comprise those U.S. financial institutions eligible to file summary shareholder reports on Schedule 13G. These include registered broker-dealers, federal- and state-regulated banks and savings associations, insurance companies, registered investment companies (including mutual funds and exchange-traded funds), registered investment advisers, ERISA plans, public employee pension plans, and their holding companies. 17 C.F.R. § 240.13d-1(b)(ii) (2008).

According to data gathered by the Federal Reserve as presented in Table 1 and Graph 1 (see appendix), direct institutional holdings of corporate equities continue to displace holdings by U.S. individual households and now represent approximately two-thirds of direct U.S. shareholdings in corporate equities. For purposes of comparison, the total market capitalization of tradable shares comprised in the Dow Jones Wilshire 5000 Composite Index (which measures “the performance of all U.S. equity securities with readily available price data”) was \$15.1 trillion on January 31, 2008. See Wilshire Associates, *The Dow Jones Wilshire 5000 Composite Index*, <http://www.wilshire.com/Indexes/Broad/Wilshire5000/Characteristics.html> (last visited Apr. 2, 2009).

interventions.⁴⁸ In particular, shareholder monitors might be very effective at improving the incentives for good governance.⁴⁹

Commentators supporting greater institutional involvement view shareholder voting power as an avenue to improve corporate governance through incremental, process-based reforms, and not to micromanage business affairs. This model generally acknowledges the limited attention institutions can devote to building relationships with individual companies because of their limited ownership interest in any specific company.⁵⁰ Institutional shareholders therefore focus their intervention on governance provisions that create incentives for better managerial performance.⁵¹ These might include bylaw provisions that eliminate or prohibit the creation of defenses against hostile acquisitions (e.g., poison pills or staggered boards), or that facilitate replacement of insiders who are not acting in good faith.⁵²

⁴⁸ See, e.g., Black, *supra* note 1, at 814-19 (describing theory of institutional voice, in which “six to ten” institutional shareholders could, in absence of other effective monitors and if legal environment were conducive, collectively occupy monitoring role short of “control”); Dent, *supra* note 1, at 906-08 (suggesting that “a committee of the ten or twenty largest shareholders” might be best suited to overseeing corporate proxy solicitation process because “they are the most knowledgeable, have the greatest stake in the firm and therefore should be the most diligent in improving corporate performance”); Rock, *supra* note 1, at 452-53 (noting that “increased concentration of shareholding makes shareholder activism more rational,” but is unlikely to impact corporate governance significantly in absence of “economic or legal incentives to discipline corporate management actively”).

⁴⁹ See Ayres & Cramton, *supra* note 1, at 1052-54 (arguing that long-term relationship between shareholders and managers can better overcome moral-hazard problems than threat of replacement in hostile takeover); *id.* at 1063-65 (comparing potential role of institutional shareholders to disciplinary role played by creditors and venture capital investors).

⁵⁰ Black, *supra* note 1, at 834-35 (arguing that “shareholders have stronger incentives to take an active interest on issues for which scale economies will partly offset the incentives for passivity created by fractional ownership”); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 866-67 (1991) (arguing that passive institutional investors invested in diversified portfolio can only plausibly improve corporate performance “by improving the corporate governance system rather than by attempting to improve the management of particular companies”); Pound, *supra* note 1, at 1042-43 (arguing that institutional investment has changed “cost calculus” of attempting “incremental change” in concert with others).

⁵¹ Black, *supra* note 1, at 834-36 (arguing that institutional investors can focus on “process and structure issues” that make manager incentives “more congruent” with shareholder incentives).

⁵² Some have advocated greater power for shareholders to vote on charter and bylaw amendments with respect to dividend policy, the use of poison pills and other takeover defenses, and director qualifications. JOHN C. BOGLE, *THE BATTLE FOR THE SOUL OF CAPITALISM* 64 (2005) (dividend policy and takeover defenses); Bebchuk,

The appeal of a model in which institutional shareholders actively monitor corporate performance is straightforward. Proponents argue that the relatively small number of major financial services firms that manage institutional funds reduces the transaction costs of collective action.⁵³ While actively managed funds may exhibit high turnover and thus prefer greater liquidity,⁵⁴ pension funds and mutual funds geared toward retirement planning must often hold significant stakes in equity securities for extended periods of time.⁵⁵ As such, these

supra note 1, at 837; Hamermesh, *supra* note 20, at 482-83 (director qualifications); Macey, *supra* note 20, at 835-38 (takeover defenses). Proposals have been made to permit nomination of shareholder representatives for inclusion in management's proxy ballot. MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 117-20 (1976); Gilson & Kraakman, *supra* note 50, at 880 (suggesting that institutional shareholders focus efforts on developing pool of talent for independent directors). Some have even proposed for consideration periodic ratification of value-decreasing charter provisions. Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1857 (1989).

Delaware, for example, has recently amended its General Corporation Law to permit corporations to adopt bylaws that require the corporation to include in its proxy materials one or more nominees submitted by stockholders in addition to individuals nominated by the board of directors under certain conditions. DEL. CODE ANN. tit 8, § 112 (2009) (eff. Aug. 1, 2009). It has also permitted corporations to adopt bylaws that provide for reimbursement of expenses incurred by shareholders for the solicitation of proxies under specified conditions. *Id.* § 113 (eff. Aug. 1, 2009). Proposed Commission Rule 14a-11, which was published in 2003, would have required companies to include in their proxy materials security holder nominees for election as director if nominated by significant shareholders eligible to disclose their holdings on Schedule 13G. Security Holder Director Nominations, Release No. 34-48626 (Oct. 14, 2003), 68 Fed. Reg. 60,784, 60,787, 60,794 (Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274). The SEC offered a second proposal in 2007, which would have permitted a shareholder who makes full disclosure in connection with a bylaw proposal for director nomination procedures to have that proposal included in the company's proxy materials. Shareholder Proposals, Release No. 34-56160, 72 Fed. Reg. 43,466, 43,487 (Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240).

⁵³ Rock, *supra* note 1, at 447-49.

⁵⁴ See, e.g., Coffee, *supra* note 31, at 1318-19 (noting that open-ended mutual funds cannot commit to long-term investments because of their customers' right to redeem fund shares on daily basis and need to compete for investors based on quarterly performance).

⁵⁵ Ayres & Cramton, *supra* note 1, at 1033-36 (defining "relational investing" as commitments to buy and hold significant blocks of shares); Gilson & Kraakman, *supra* note 50, at 863 (measuring long-term interest via portfolio turnover); Gordon, *supra* note 1, at 129 (identifying key elements of "relational investing" as (i) "substantial share ownership," (ii) "a commitment to an extended holding period," and (iii) "reciprocal engagement with management over the business policy"). *But see* Lipton & Rosenblum, *supra* note 31, at 205-13 (maintaining that institutional shareholders "focus . . . on the current market price of [a] corporation's stock" and

investors must consider whether it “becomes rational to focus energies and resources on particular battles to establish precedents for future battles” in corporate governance rather than to exit via a block sale or tender offer.⁵⁶ To the extent that institutional shareholders are highly diversified, their efforts may be more likely to focus on general reforms to corporate governance rather than firm-specific measures.⁵⁷ Finally, empirical evidence suggests that efforts to expand the reach of shareholder governance correlate with increased shareholder value.⁵⁸

The regulatory framework for proxy voting has adapted somewhat to the theory of enhanced institutional voice. Through various initiatives designed to reduce the cost of direct solicitation and to initiate action through proxy statements prepared by management, current law encourages increased shareholder participation in corporate governance.⁵⁹ Recent reform efforts have sought to grant

would “support a hostile takeover, a sale of assets, a leveraging recapitalization, or any other transaction that boosts [its] immediate price,” with “little incentive or inclination . . . to work actively towards the long-term operating success of the corporation”).

⁵⁶ Rock, *supra* note 1, at 484-89.

⁵⁷ See, e.g., Anabtawi, *supra* note 1, at 583-86 (observing that diversified shareholders “are likely to favor activities of firms in which they own shares that minimize negative externalities (and maximize positive ones) to the extent that those activities impose costs on (or can be captured by) other firms in which they own an interest”); see also Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1024-25 (1994) (observing that concentration of shareholdings creates additional cost for investors because it subjects them to large amount of unsystematic risk resulting from firm-specific variables, and asserting that enhancing investment value through monitoring may be profitable only if monitoring shareholder concentrates its portfolio substantially).

⁵⁸ Robert C. Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251, 305-07 (2005) (citing several research studies by legal and economic researchers on impact of increased shareholder rights — as opposed to other initiatives of improving corporate governance — on earnings, firm valuation, and strength and growth of securities markets).

⁵⁹ See, e.g., 17 C.F.R. § 240.14a-1(l) (2007) (defining “solicitation” for purposes of communications requiring filing of proxy statement); *id.* § 240.14a-2(b) (2007) (providing exemption for certain shareholder communications); *id.* § 240.14a-8 (2007) (providing procedure by which certain shareholder proposals may be included in management’s proxy card); see also Regulation of Communications Among Shareholders, Release No. 34-31326, 57 Fed. Reg. 48,276, 48,276 (Oct. 22, 1992) (codified at 17 C.F.R. pts. 240, 249) (adopting amendment to definition of “solicitation” in Rule 14a-1 “to specify that a shareholder can publicly announce how it intends to vote and provide the reasons for that decision without having to comply with the proxy rules”); *id.* (adopting exemption under Rule 14a-2 from proxy disclosures for communications with shareholders, but only if person soliciting “is not seeking proxy authority” and “does not have a substantial interest in the matter subject to a vote”); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 550-

major institutional shareholders further privileges with respect to corporate governance with the expectation that they will exercise such privileges for the benefit of all shareholders.⁶⁰

On the other hand, rules of investment management in many respects may discourage attempts by institutional shareholders to undertake contests for control, directly or indirectly.⁶¹ Shareholders seeking to challenge management through proxy contests may have to file and make public disclosures regarding their communications.⁶² Moreover, shareholders must take collective efforts to improve governance carefully; the intent to vote or even to hold shares in concert with others may trigger enhanced disclosures.⁶³

73 (5th ed. 2004) (describing evolution of Exchange Act Rule 14a-8).

⁶⁰ See *supra* note 52 (discussing recent Delaware legislation and SEC proposed rulemaking regarding shareholder access to corporation's proxy materials for purpose of nominating directors). In the related context of shareholder litigation, the Private Securities Litigation Reform Act has famously conferred lead plaintiff status on the shareholder with the "largest financial interest in the relief sought by the class" in private class actions premised on violations of the antifraud provisions of federal securities law. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (2006).

⁶¹ One such rule requires institutional shareholders to intend to "acquir[e] such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect." 17 C.F.R. § 240.13d-1(b)(i) (2008). Institutional shareholders subject to fiduciary duties to the persons on whose behalf they manage investments might also be deemed to breach such duties if they participate in change-of-control transactions. *Leigh v. Engle*, 727 F.2d 113, 132 (7th Cir. 1984) (finding risk of drop in share prices in event of takeover attempt sufficient to conclude that ERISA plan's decision to affirmatively seek control was not prudent "investment" decision consistent with its fiduciary's responsibilities, at least where plan fiduciary had "intimate involvement with and interest in the other parties to the struggle for control"). Commentators have also noted other barriers to institutional control. Black, *supra* note 1, at 816 (suggesting need to reduce barriers to institutional control); Gilson & Kraakman, *supra* note 50, at 896 (same).

⁶² 17 C.F.R. § 240.14a-1(l) (defining "solicitation" subject to proxy rules of section 14 of Exchange Act and rules promulgated thereunder to include "other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy"). The definition of "solicitation" may thus prevent shareholders from publicly communicating their voting intentions to each other in an effort to promote collective action, absent regulatory relief. See, e.g., Regulation of Communications Among Shareholders, Release No. 33-19031, 57 Fed. Reg. 48,276, 48,276 (Oct. 22, 1992) (codified at 17 C.F.R. pts. 240, 249) (adopting various amendments to proxy rules designed to "remov[e] unnecessary government interference in discussions among shareholders of corporate performance and other matters of direct interest to all shareholders").

⁶³ 17 C.F.R. § 240.13d-5(b)(1) (2007) ("When two or more persons agree to act together for the purpose of acquiring, *holding*, *voting* or *disposing* of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of sections 13(d) and (g) of the Act, as of the date of such

Beyond the increased transaction costs from disclosure requirements, conflicts of interest also pose significant impediments to institutional activism. Managers of privately managed pension and mutual funds, which account for the vast majority of institutional investment in corporate equities in the United States, may have substantial conflicts of interest.⁶⁴ Moreover, private asset managers are not necessarily the most assiduous overseers of boards, given the significant number of corporate holdings and the limited attention investment managers can devote to each. This problem is further compounded by the growing number of passively managed index funds, which despite their commitment to hold certain securities for extended periods of time, are unlikely to serve as effective monitors given the appeal of maintaining lower fee schedules.⁶⁵

Despite these impediments, regulators have sought to prod asset managers into taking a more active role in corporate governance. Both the Securities and Exchange Commission (“SEC”) and the Department of Labor, for example, have taken steps to pressure managers of both mutual funds⁶⁶ and plans subject to the Employee Retirement Income

agreement, of all equity securities of that issuer beneficially owned by any such persons.” (emphasis added)).

⁶⁴ Grundfest, *supra* note 1, at 919 (noting “considerable influence” corporate managers have over money managers that benefit financially from services they provide corporations); Rock, *supra* note 1, at 469-71 (discussing conflicting interests of private money managers); Strine, *supra* note 1, at 1765 (remarking that money managers “have little desire to spend money on stockholder activism or offend corporate management”). *But see* Roe, *supra* note 31, at 1503 (downplaying risk of conflicts in mutual fund industry given comparatively limited range of services mutual fund companies offer industrial firms). A corporate issuer’s management, for example, may appoint the advisors of such funds or plans as the money manager for its corporate employee defined benefit or defined contribution plans. Global banking firms that offer a broad range of financial services may also have professional relationships with issuers that taint the bona fides of their voting decisions, even with internal processes designed to insulate voting from other businesses. *See generally* Hewlett v. Hewlett-Packard Co., CIV.A. 19513-NC, 2002 WL 818091 (Del. Ch. Apr. 30, 2002) (unpublished opinion) (finding plaintiffs failed to meet burden of proving that defendant’s management “improperly coerced and enticed Deutsche Bank” to vote 17 million shares under management in favor of merger with Compaq Computer Corp.).

⁶⁵ Gilson & Kraakman, *supra* note 50, at 866 (observing that institutions managing portfolios based on index would sacrifice “most of the transaction cost savings that motivated adopting an indexing strategy” if they engaged in monitoring each portfolio company); *see* Louis Lowenstein, *Why Managements Should (and Should Not) Have Respect for Their Shareholders*, 17 J. CORP. L. 1, 19-20 (1991).

⁶⁶ For example, the SEC recently adopted rules requiring mutual fund management companies to disclose their voting policies and voting records on corporate proxies. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No.

Security Act (“ERISA”)⁶⁷ to vote shares consistent with long-term shareholder wealth.⁶⁸ Regulators have also sought to redefine traditional fiduciary standards of investment management in a way that promotes greater shareholder activism. For example, the Department of Labor has permitted ERISA plans to expend resources to monitor corporate governance if there is a “reasonable expectation” that enhancements to the value of the corporation will justify the cost.⁶⁹

In addition to conflicts of interest faced by institutional shareholders, other categories of activist shareholders may hijack corporate governance processes to effect transactions that reduce shareholder wealth. Among the ranks of these activist shareholders are public and union pension funds, and more recently, hedge funds. While managers of public pension funds enjoy significant investment

25922, 68 Fed. Reg. 6564, 6566-67 (Feb. 7, 2003) (codified at 17 C.F.R. pts. 239, 249, 270, 274) (adopting final rule requiring registered management investment companies to disclose their proxy voting policies and proxy voting records). As one commentator has asserted, the rule was a “long overdue first step in increasing the motivation of financial intermediaries to participate in governance matters.” BOGLE, *supra* note 52, at 50.

⁶⁷ Harvey Bines & Steve Thel, *Investment Management Arrangements and the Federal Securities Laws*, 58 OHIO ST. L.J. 459, 490 (1997). For ERISA plans, for example, the Department of Labor has stated that “[t]he fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock.” 29 C.F.R. § 2509.08-2 (2008); *see also* 15 Pen. & Ben. Rep. (BNA) 391 (Feb. 29, 1988) (letter written by Department of Labor to Avon Products, Inc.) (stating plan fiduciary had duty to vote shares on proposals to change corporation’s state of incorporation and to rescind “poison pill” arrangements with regard to various corporations in which plan is invested). With respect to share lending, for example, loans of portfolio securities by investment companies are generally conditioned on the requirement that they recall shares to vote on material events. Morgan Guaranty Trust Co. of New York, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,212 (Apr. 17, 1996); *see* State Street Bank & Trust Co., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,676, 1971 WL 6511, at *1 (Dec. 27, 1971).

⁶⁸ 29 C.F.R. § 2509.94-2 (2007). As discussed above, asset managers may establish independent proxy committees for purposes of voting shares under management or entering into arrangements with third-party proxy services for this purpose. *See supra* note 27.

⁶⁹ Permitted “investment polic[ies]” of ERISA plans may “contemplat[e] activities [that are] intended to monitor or influence . . . management of corporations” if there is a “reasonable expectation” that such activities will enhance the value of the corporation after considering costs. 29 C.F.R. § 2509.94-2. Because investment decisions are often made on an account-by-account basis, however, funds can justify even contradictory voting decisions based on the impact of shareholder decision making on particular accounts, rather than the corporation generally. *See, e.g.*, ROBERT A.G. MONKS & NELL MINOW, WATCHING THE WATCHERS: CORPORATE GOVERNANCE FOR THE 21ST CENTURY 108-09 (1996) (discussing T. Rowe Price’s decision making regarding voting of Texaco shares in different accounts).

clout and relative independence from corporate interests,⁷⁰ skeptics note that political pressure⁷¹ and other social objectives compete with fiduciary duties to plan beneficiaries.⁷² Similarly, commentators have observed that pension plans managed by employee unions or with union representatives on their boards may have a strong incentive to employ their leverage to achieve collective-bargaining objectives “detrimental” to the interests of the corporation.⁷³

⁷⁰ See MONKS & MINOW, *supra* note 69, at 108-09 (noting activism of California Public Employees Retirement System (“CalPERS”) and New York State Common Retirement Fund).

⁷¹ Trustees of public pension funds may be elected public officials or political appointees, who may be beholden to special interests that may not serve the interest of maximizing plan value. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 801-20 & n.20 (1993). For example, political leaders may pressure asset managers of public funds to focus greater investment or intervention within the geographic region they represent. *Id.* at 796-98. Recent scandals involving the management of CalPERS and TIAA-CREF illustrate both the divergent interests such persons may serve as well as the means by which they may be held accountable. Laura Kabler, *Money in the Game: Executing a Governance-Based Hedge Fund Strategy*, 12 STAN. J.L. BUS. & FIN. 121, 131 (2007).

⁷² See, e.g., Deborah J. Martin, *The Public Piggy Bank Goes to Market: Public Pension Fund Investment in Common Stock and Fund Trustees’ Social Agenda*, 29 SAN DIEGO L. REV. 39, 39-40 (1992) (arguing that “use of public pension funds for [such social objectives] violates numerous state and federal statutes as well as the United States Constitution”); Rock, *supra* note 1, at 471-72 (using example of divestment from South Africa as social goal with short-term benefits for incumbent manager without commensurate responsibility for long-term impact); Craig Karmin, *Missouri Treasurer’s Demand: ‘Terror-Free’ Pension Funds*, WALL ST. J., June 14, 2007, at C1 (discussing legislative efforts in various states to require public pension funds to divest themselves from investments associated with countries deemed to sponsor terrorism).

Many public pension funds, moreover, lack the size, staff, or resources to warrant active participation in corporate governance. See Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 317-18 (2008). In their study of public pension fund activism, Professors Choi and Fisch observed that “activity levels vary dramatically” among public pension funds, with the size of assets under management being the “most significant factor” in distinguishing active funds from less active funds. With respect to the use of the shareholder franchise, they found that public pension funds rarely played a formal or informal role in the nomination of director candidates; that “very few other funds have followed [CalPERS’s] example” of using the shareholder proposal process to advance corporate governance objectives; and that “[f]or the most part, public pension fund activism is limited to low-visibility activities, such as participat[ing] in corporate governance organizations or withholding votes from a management nominee,” often on the advice of a proxy advisory service. *Id.*

⁷³ See, e.g., Anabtawi, *supra* note 1, at 590 (discussing CalPERS’s announcement of its intention to withhold votes from Safeway director because, in view of some observers, he had taken hardline stance in negotiations with United Food and Commercial Workers); Schwab & Thomas, *supra* note 1, at 1026-27 (noting that, in

Hedge funds, a class of activist shareholders not bound by the regulatory constraints of institutional investors or pension funds, have received particularly critical attention.⁷⁴ Unlike traditional investors, hedge funds typically seek to increase returns from equity investment in various ways. These include both traditional value-oriented investing strategies and strategies arbitraging stock price movements between firms that are in merger negotiations or in related industries.⁷⁵ Because they are not subject to the pressure to diversify, hedge funds often take concentrated positions in a few target

labor dispute between UFCW and Albertson's, UFCW's "apparent goal was to increase its organizing power," as it sought to pressure management by soliciting proxies for proposals "targeted at corporate-governance reforms that were not directly beneficial to narrow, worker-related union goals"); Strine, *supra* note 1, at 1765 (suggesting that "institutions most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest"). Other commentators, however, have suggested that union-sponsored shareholder proposals relating to corporate governance reforms — even if intended to pressure management on unrelated collective-bargaining initiatives — fare better than proposals relating to collective-bargaining because corporate governance reforms are able to gain broad-based support from other shareholder constituencies. Schwab & Thomas, *supra* note 1, at 1060-61 (using empirical data to confirm).

⁷⁴ See generally *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearings Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enters. of the H. Comm. on Financial Services*, 108th Cong. (2003) (discussing, inter alia, short-selling activities of hedge funds). The 100 largest hedge funds ranked by *Institutional Investor* and *Alpha* magazine, as of December 31, 2007, range in size from \$6.3 billion to \$44.7 billion in firm capital. Institutional Investor, 2008 Hedge Fund 100 (Dec. 31, 2007), <http://www.iimagazinerankings.com/rankingsHeFu100RGlobal08/Rankings.asp>. Although there is no precise definition of a hedge fund, the SEC, in its original attempt to subject hedge funds advisors to registration under the Investment Advisers Act, focused on unregistered investment companies that generally require investors to make commitments of capital for no more than two years. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054, 72,074 (Dec. 10, 2004), *vacated by* Goldstein v. SEC, 451 F.3d 873, 877, 882-84 (D.C. Cir. 2006).

⁷⁵ William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1382-83 (2007). Traditional "merger" or risk-arbitrage transactions entail establishing a short position in an acquiring company and a long position in its target, with the expectation that as negotiations progress, target company shareholders are likely to obtain a greater share of the gains from the transaction. See Dana Cimilluca et al., *As Deals Crash, Investors Flee Hedge Funds*, WALL ST. J., Mar. 29, 2008, at B1 (describing such transactions and recent performance of such funds). In theory, a hedge fund could bet on failure of a merger by reversing these positions. See Hu & Black, *supra* note 5, at 842-43. It has also been suggested that hedge funds may pursue a "governance" arbitrage strategy through long-short risk arbitrage transactions that hold a "short" economic interest in poorly governed companies against a "long" portfolio of their peers. Kabler, *supra* note 71, at 151-54.

companies on which they can focus their attention.⁷⁶ Moreover, because hedge funds do not have the same investment objectives as traditional institutional investors, commentators note that hedge funds may seek to attain superficial changes in corporate governance that improve short-term price movements.⁷⁷ These incentives combine to make hedge funds a threat to managers that seek to maximize shareholder wealth in the long run.

Other commentators, however, argue that the effects of hedge fund activism have been benign.⁷⁸ In recent years, hedge funds have increasingly used the threat of proxy contests to demand board seats,⁷⁹ corporate governance changes, or specific business decisions, such as consenting to an acquisition, selling underperforming assets, or returning excess cash to shareholders through dividends or stock buybacks.⁸⁰ One commentator has suggested that, to the extent that

⁷⁶ Bratton, *supra* note 75, at 1389 (observing that, in sample of target companies, hedge funds took median stake of 6.7% in targeted large-capitalization companies and 9.8% in targeted small-capitalization companies); *see also* Bebchuk, *supra* note 31, at 727 (citing evidence that “hedge funds tend not to choose as targets for their activism firms in top quintile in terms of market capitalization”).

⁷⁷ *See, e.g.*, Anabtawi, *supra* note 1, at 579-80; Andrew M. Kulpa & Butzel Long, *The Wolf in Shareholder’s Clothing: Hedge Fund Use of Cooperative Game Theory and Voting Structures to Exploit Corporate Control and Governance*, 6 UC DAVIS BUS. L.J. 4 (2005); Lipton & Savitt, *supra* note 44, at 745-47.

⁷⁸ *See, e.g.*, Bratton, *supra* note 75, at 1381 (concluding that, “based on the record so far, hedge fund activism is a more benign phenomenon than its critics would have us believe”); Briggs, *supra* note 8, at 722 (noting that “it is too early to say” whether hedge fund activism is beneficial for corporations or society, but that “this much seems certain: hedge fund activists do sometimes come up with ‘eminently sensible ideas,’ and the pressure they bring is forcing managements . . . to come up with their own good ideas”); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1091 (2007) (asserting that, despite concerns, “hedge funds hold great promise as active shareholders” because they are “highly incentivized, mostly unconflicted, and largely unencumbered by regulatory constraints”).

⁷⁹ *See, e.g.*, Bratton, *supra* note 75, at 1427-28 (noting that hedge funds sought to acquire board seats in 40% of hostile takeover cases studied); Kaja Whitehouse, *CEO Compensation Survey (A Special Report) — Stiffed Board: Shareholders Angry About Executive Pay Are Targeting the People Responsible: Directors*, WALL ST. J., Apr. 9, 2007, at R4 (discussing increasing “success rate” for shareholder activists in negotiating dissident seats on corporate boards and contribution to this trend of hedge funds “willing . . . to spend the money associated” with such contests).

⁸⁰ *See, e.g.*, Bratton, *supra* note 75, at 1390-96, 1401 (describing sale of firm, unbundling of firm’s underperforming assets, or return of firm’s excess cash to shareholders as hedge fund tactics); Briggs, *supra* note 8, at 714, apps. at 727-37 (surveying consequences of hedge fund activism, including blocking or forcing sales, stock buybacks, asset sales, and dividends); *see also* Kahan & Rock, *supra* note 78, at 1087-88 (asserting that hedge funds may pursue such goals, inter alia, for short-term gain).

hedge funds seek gains from the sale of assets, distribution of cash, or sale of the firm, poorly performing firms “make[] for a better target.”⁸¹ Another commentator has suggested that hedge funds are rarely willing to “pursue strategies that cannot withstand the light of day” because of the deterrent effect imposed by existing disclosure requirements and proxy rules.⁸² Hedge funds might thus pose a minimal threat to well run corporations and prod poor managers into improving corporate governance.

Where one stands on the debate over the proper role of shareholders in corporate governance is likely to dictate where he or she comes out on the question of “empty voting.” For advocates of limiting shareholder participation, the rise of “empty voting” may simply confirm the basic intuition that shareholder voting is prone to abuses that interfere with long-term wealth maximization. On the other hand, proponents of shareholder activism face more of a dilemma. While in theory empty voting provides opportunities for shareholders to influence corporate governance in a positive way, they must confront the reality that the persons who vote shares may not have the best interests of the corporation at heart. One possible conclusion is that “empty voting” poses a threat to responsible use of the shareholder franchise that regulators must curtail. Another possible conclusion is that “empty voting” will have a neutral or even perhaps beneficial impact on the exercise of shareholder decision making, which regulators should incubate and tame through the tools of transparency and access. The next section considers the potential impact of “empty voting” on corporate governance in this vein.

⁸¹ Bratton, *supra* note 75, at 1397-1401 (noting that agency law would predict that activists would target underperforming firms and that his data neither falsified nor confirmed that proposition).

⁸² Briggs, *supra* note 8, at 703-04 (arguing that “a competently advised fund that is truly bent on behavior that might not do well in the sun is simply not going to purchase enough shares to . . . [trigger disclosure], let alone start a high-profile proxy fight”); *cf.* Bebchuk, *supra* note 1, at 883-84 (arguing that only special interest or activist shareholder proposals that systematically obtain support are those that are “viewed as value-enhancing by a wide range of institutions”).

II. THE IMPACT OF “EMPTY VOTING” TRANSACTIONS ON CORPORATE GOVERNANCE⁸³

As opportunities for shareholder participation in corporate governance increase, concerns arise about the possible abuse of that power by constituencies who do not act in a manner that increases long-term shareholder wealth. In particular, as discussed above, commentators have recently revived historical concerns about the decoupling of voting and economic interests.⁸⁴ In their seminal work on the topic, Professors Hu and Black have identified a range of recent “empty voting” transactions, in which interested parties have acquired significant voting interest through derivatives or securities-lending transactions.⁸⁵ As noted above, such transactions, when coupled with the potential evasion of beneficial ownership reporting requirements, constitute what they describe as “the new vote buying.”

This “new vote buying” differs from traditional vote-buying transactions in at least two ways. First, these transactions are effected not by insiders and controlling shareholders, but by activist shareholders. In traditional vote-buying transactions, insiders and controlling shareholders seek to impair the voting power of outside shareholders using devices such as voting trusts and vote pooling agreements; pyramid structures; and issuance of supervoting shares, nonvoting shares, or classes of shares with special voting rights.⁸⁶ The

⁸³ Hu and Black define “empty voters” as “persons whose voting rights,” including both formal rights to vote and the de facto power to instruct others how to vote, “substantially exceed their net economic ownership” in the company. Hu & Black, *supra* note 5, at 825. The concept of “net economic ownership” is akin to similar concepts used throughout federal securities regulation to distinguish economic interests from ownership of shares or voting power. See, e.g., 17 C.F.R. § 240.3b-3 (2004) (determining net position for purposes of short sale rule); *id.* § 240.14e-4(a) (2007) (calculating “net long position” in connection with partial tender offers); *id.* § 240.16a-1(a)(2)(i), (b), (h) (2007) (defining “pecuniary interest,” “call equivalent position” and “put equivalent position” respectively for purposes of rules under section 16 of the Exchange Act governing insider ownership and trading); *id.* § 242.200(f) (2007).

⁸⁴ See André, *supra* note 9, at 545-51; M. Thomas Arnold, *Shareholder Duties Under State Law*, 28 TULSA L.J. 213, 226-28 (1992); Cole, *supra* note 5, at 824-31.

⁸⁵ Hu & Black, *supra* note 5, at 829-35 (describing recent transactions).

⁸⁶ See, e.g., *Chew v. Inverness Mgmt. Corp.*, 352 A.2d 426, 429-30 (Del. Ch. 1976) (disenfranchising approximately 30,000 votes because such votes “were obtained by the giving of irrevocable proxies in return for a cash consideration” and thus contrary to public policy); *Wincorp Realty Invs., Inc. v. Goodtab, Inc.*, 1983 WL 8948, at *5-6 (Del. Ch. Oct. 13, 1983) (unpublished opinion) (finding irrevocable proxy valid when coupled with economic interest consisting of deeply out-of-the-money option to purchase shares trading at \$30 at exercise price of \$41.50, for which option purchaser

new vote-buying transactions are initiated by outside shareholders, using derivatives and securities lending markets to acquire voting power disproportionate to their economic interest in the corporation. Unlike traditional “vote-buying” transactions, modern “empty voting” fact patterns therefore do not fit easily into traditional corporation law jurisprudence because they do not typically involve traditional breaches of fiduciary duty owed to public shareholders.⁸⁷

Second, the new vote-buying transactions are not necessarily motivated by a desire to extract benefits at the expense of public shareholders. Hu & Black’s critique of “empty voting,” echoed by other commentators, focuses on the use of surreptitiously borrowed votes by entities with no ownership interest in a corporation because such transactions have the *potential* to harm shareholder interests.⁸⁸ Some commentators, however, have suggested that limited vote buying may be wealth neutral or even have beneficial consequences for other shareholders or society generally. These benefits may include reducing the costs of collective action in shareholder decision making⁸⁹ or facilitating contests for control in the face of defensive tactics.⁹⁰ As a result, proponents of such transactions have cautiously advocated alienation of voting interest,⁹¹ while others perhaps less

paid \$20,000); *see also* Simeon E. Baldwin, *Voting-Trusts*, 1 YALE L.J. 1 (1891) (describing “voting trust” as “remedy” to “evil” occasioned by vacillations in policy resulting from frequent changes in management of publicly held corporations without controlling shareholder); Hu & Black, *supra* note 5, at 855-61. In particular, dual-class recapitalizations and other defensive restructurings, in which managers obtain shareholder consent to reclassify their shares in exchange for a dividend payment or other consideration, have been analogized to managerial “vote buying.” André, *supra* note 9, at 614-21; *see, e.g.*, Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1246 (Del. Ch. 1988) (describing management’s attempted use of recapitalization transaction to purchase sufficient block of shares to exercise effective voting “control” in response to threatened takeover bid).

⁸⁷ Hu & Black, *supra* note 5, at 861-62; *see also* Arnold, *supra* note 84, at 226 (noting that “improper consideration promised or provided to a shareholder in return for his or her vote can include money, employment by the corporation, employment of a family member by the corporation, or any further consideration personal to the shareholder” (internal citations omitted)).

⁸⁸ *See supra* notes 7-8.

⁸⁹ *See* Hu & Black, *supra* note 5, at 852.

⁹⁰ *See* André, *supra* note 9, at 557-600; Clark, *supra* note 9, at 807; *see also* Douglas Blair et al., *Unbundling the Voting Rights and Profit Claims of Common Shares*, 97 J. POL. ECO. 420, 442 (1989) (positing that, in context of hostile takeovers, vote-selling market would improve efficiency of market for corporate control).

⁹¹ André, *supra* note 9, at 636; Clark, *supra* note 9, at 806-07; Levmore, *supra* note 9, at 137-40; Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427, 1436 (1964).

enthusiastically have long warned of its inevitability and counseled a rethinking of the role and purpose of shareholder rights.⁹²

This Part considers the relative merits of scaling back, or expanding, opportunities for “empty voting” consistent with these observations. Subpart A reviews the current regulatory framework for derivative transactions and securities-lending transactions with a view to identifying the difficulties inherent in prohibiting or restricting “empty voting” transactions. To the extent that “empty voting” is inevitable, subpart B considers whether broader participation in “empty voting” transactions by a cadre of committed long-term institutional shareholders might neutralize some of the perceived dangers of “empty voting.”

A. “Empty Voting” Is a Necessary Consequence of Giving Corporations and Shareholders Freedom to Alienate Voting Rights and Economic Interests

Commentators opposed to vote buying often seek ways to re-align voting and economic interests to minimize the risk that voters will abuse the shareholder franchise.⁹³ This argument presupposes, however, that corporation law, securities regulation, and listing standards can maintain an alignment of economic and voting interests. The one-share/one-vote paradigm, while ensconced in hortatory stock exchange rules and perpetuated by the *noblesse oblige* of major U.S.-listed corporations, no longer conforms to shareholder expectations.⁹⁴

⁹² See, e.g., André, *supra* note 9, at 544 n.33 (citing PETER F. DRUCKER, *THE NEW SOCIETY* 340-42 (1951) (suggesting that “future age” should see “divorce of ownership control from investment”).

⁹³ Black & Kraakman, *supra* note 15, at 1946-47 (advocating one-share/one-vote rule for “self-enforcing” corporation law statutes in emerging markets); Stephen Fraidin & Daniel S. Hoverman, *Hedge Fund Activism*, 1571 *PLI/CORP.* 401, 413-16 (2006) (discussing tactics corporation might employ to deter empty voting); Martin & Partnoy, *supra* note 5, at 804-06 (advocating reassignment of voting rights associated with security to nonshareholders with net long positions in a security); see also EASTERBROOK & FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 74-76 (1991) (restating general tenet of corporation law that “[i]t is not possible to separate the voting right from the equity interest” in corporate shares, while apparently conceding possible benefits from vote buying if certain collective action problems could be overcome).

⁹⁴ See Martin & Partnoy, *supra* note 5, at 786 (suggesting that “dominant practice” of one share/one vote is due to fear of regulation or direct regulatory initiative, rather than market-based alignment of economic and voting interest); Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 *GEO. WASH. L. REV.* 687, 708-21 (1986); Stephen M. Bainbridge, *The Scope of the SEC’s Authority over Voting Rights* 2-5 (UCLA Sch. of Law Research Paper No. 07-16,

Corporations, for example, are free to issue multiple classes of securities that do not have proportionate economic and voting rights prior to listing their common stock, often to preserve supervoting power for founders or managers at the expense of public shareholders.⁹⁵ To the extent that institutional and retail investors participating in the public offerings of such companies have become comfortable with the loss of voting rights proportionate to economic interest, it seems antiquated to retain “one share/one vote” as the paradigm for shareholder governance.

Although controversial, shareholders may logically wish to alienate title, voting, and other noneconomic rights associated with an equity security from economic interest for legitimate reasons, such as to finance inventory by transferring title of shares or calibrate economic exposure to a particular issuer’s securities by hedging some of the risk.⁹⁶ Shareholders can currently accomplish these goals through derivatives and share-lending markets.⁹⁷ Some commentators have

2007), available at <http://ssrn.com/abstract=985707> (unfolding history of “one-share, one-vote” concept in U.S. corporation law).

⁹⁵ See, e.g., NYSE, Inc., Listed Company Manual § 313.10 (2006) (“The restriction against the issuance of super voting stock is primarily intended to apply to the issuance of a new class of stock, and companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super voting stock without conflict with this [p]olicy.”).

⁹⁶ For example, repurchase transactions — transactions in which a party in need of cash may sell a portfolio of securities to a securities intermediary subject to an agreement to repurchase equivalent securities at a price based on the duration of the transaction, and not the change in the price of the securities — are an important financial tool for financing securities inventory. See, e.g., *In re Beville*, Bresler & Schulman Asset Mgmt. Corp., 878 F.2d 742, 746 (3d Cir. 1989) (describing operation of repo market).

⁹⁷ For example, a person may create empty votes in a given equity security by (i) purchasing a block of shares and simultaneously entering into a total-rate-of-return swap with a financial institution; (ii) purchasing a block of shares and purchasing a put option and/or writing a call option, and (iii) purchasing a block of shares (or a basket of securities mimicking an index containing the security) and simultaneously selling the security short. See, e.g., Martin & Partnoy, *supra* note 5, at 779-80 (describing these transactions as economically encumbering shares); Anish Monga, *Using Derivatives to Manipulate the Market for Corporate Control*, 12 STAN. J.L. BUS. & FIN. 186, 205-06 (2006) (describing use of options, forwards, and futures to effect “de facto” vote buying). The same effect may be achieved by borrowing a block of shares from another person or purchasing the shares subject to an agreement to resell them to the original seller. Martin & Partnoy, *supra* note 5, at 798 (describing these transactions as legally encumbering shares).

Derivatives also make it possible to slice interests in corporate equity that make it difficult to ascribe a “long,” “short,” or “neutral” position to an investor’s ownership interest. For example, a range forward contract or zero-cost collar (e.g., a long put at

advocated curtailing the use of these markets as a means to prevent vote buying.⁹⁸ Others have noted that the availability of derivatives or securities loans without the intermediation of financial institutions is limited, and that practical limitations on acquiring significant voting power in this manner, including the cost of entering into derivative transactions to hedge controlling blocks and the possibility that borrowed shares may be recalled, would prevent activists from accomplishing that objective.⁹⁹ Regardless of the force of these arguments, it is difficult to justify limiting shareholders' ability to enter into such transactions *solely* on the grounds that they may interfere with the integrity of a shareholder vote.

Regulating "empty voting" through the use of share-lending and derivatives markets would in any event require financial regulators to roll back much of the deregulatory initiatives of the past decade. The effect of legislation and regulatory initiatives regarding derivatives and securities lending has had the incidental effect of limiting the authority of financial regulators to adopt special rules for the purpose of deterring vote buying or the compliance mechanisms to enforce them effectively.¹⁰⁰ The scope of vote-buying markets may also make

\$50 and a short call at \$60) may create a range of prices within which the shareholder maintains some exposure to fluctuations in the value of the security (in this example, between \$50 and \$60), while protecting the shareholder against extreme fluctuations (in this example, below \$50 or above \$60). Zero-cost collars are so termed because the initial value of the call sold by the shareholder equals the initial value of the put purchased by the shareholder. JOHN C. HULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVES* 458 & n.2 (3d ed. 1989). To the extent that funds can "modulate their ownership rights" in this manner, it is difficult to see how corporation law can develop a system of rules that legitimize shareholder voting based on "an identity of voting and economic interests." Nathan, *supra* note 31, at 6.

⁹⁸ See, e.g., Hu & Black, *supra* note 5, at 902-06 (discussing various tax and regulatory strategies that could "make share lending or equity swap transactions less attractive" in effort to curb their use in "empty voting" transactions); Martin & Partnoy, *supra* note 5, at 799 (arguing that "restricting, or even suspending, the lending and shorting of shares might reduce costs and improve liquidity by forcing investors away from the path-dependent lending and shorting approach to a more sensible and lower-cost approach they otherwise might not undertake"); Geert T.M.J. Raaijmakers, *Securities Lending and Corporate Governance*, in TUSSEN THEMIS EN MERCURIUS (2005), available at <http://ssrn.com/abstract=928312> (asserting that "an explicit ban on the borrowing of shares for voting purposes is inevitable" in spite of difficulties of enforcement).

⁹⁹ Dale Oesterle, *Regulating Hedge Funds*, 1 *ENTREPREN. BUS. L.J.* 1, 24-28 (2006) (citing Christopher C. Geczy et al., *Stock Are Special Too: An Analysis of the Equity Lending Market*, 66 *J. FIN. ECON.* 241, 244 (2002)). Hedge funds have nevertheless been able to exert significant pressure on corporate issuers and mount proxy contests without such controlling blocks. See *supra* note 76.

¹⁰⁰ The D.C. Circuit's opinion vacating the Commission's "one-share/one-vote"

it inefficient for exchanges or state regulatory bodies to adopt these rules, given the significant benefits these markets provide, and the difficulty of tracing and unwinding transactions intended to facilitate “empty voting.”¹⁰¹ As I argue below, modifying the regulatory framework for either derivatives markets or share-lending markets would be cumbersome and largely ineffective.

rule in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), for example, suggests that the Commission generally does not have the authority to promulgate rules that directly promote fair “corporate suffrage,” as distinct from disclosure as to how proxies are voted. *Id.* at 410-13.

¹⁰¹ These difficulties are aptly illustrated by a recent case, *CSX Corp. v. Children’s Investment Fund Management (UK) LLP*, in which CSX accused two hedge funds of amassing beneficial ownership of CSX shares in concert without disclosing such ownership as required under the disclosure requirements of Williams Act. 562 F. Supp. 2d 511, 516-17 (S.D.N.Y. 2008). Defendants acquired a significant economic interest in CSX shares both through purchases of actual CSX shares and through cash-settled total return equity swaps negotiated with Deutsche Bank AG and other financial institutions; in particular, The Children’s Investment Fund ultimately disclosed the existence of swap positions conferring an economic exposure to approximately 11% of CSX shares through various counterparties. *Id.* at 521, 536. Such financial institutions as a matter of course hedged their corresponding short positions under the swap agreements by purchasing CSX shares directly (though not in quantities sufficient individually to trigger the reporting requirements of section 13(d)); CSX alleged that the funds therefore had “a significant ability to affect how voting power or investment power will be exercised” with respect to the CSX shares held by such banks. *Id.* at 541-42. The court acknowledged that such an arrangement “confers [a] potential advantage on a . . . party that contemplates a tender offer, proxy fight, or other corporate control contest,” to the extent that, “when it judges the time to be right, [it may] unwind those swaps by acquiring the referenced shares from . . . [the swap] counterparties in swiftly consummated private transactions.” *Id.* at 523.

In the absence of any legal obligation on the part of the defendants’ swap dealers to hedge the swap agreements with a position in the underlying securities, or to vote the underlying securities in a manner directed by the defendants, the court refused to decide whether defendants were “beneficial owners” of CSX shares by virtue of possessing direct or indirect “investment power” with respect to such shares under SEC Rule 13d-3(a), 17 C.F.R. § 240.13d-3(a) (2008). *Id.* at 541-48. The court concluded, however, that under Rule 13b-3(b), 17 C.F.R. § 240.13d-3(b) (2008), the defendants should be deemed “beneficial owners” at the time they entered into the swap agreements because such agreements constituted a “contract, arrangement, or device . . . with the purpose o[r] . . . effect of . . . preventing the vesting of such beneficial ownership . . . as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the Act.” *Id.* at 548-52. The court nevertheless refused to enjoin voting of the defendants’ shares because it found that the defendants’ Schedule 13D disclosure was not “false, misleading, or otherwise inadequate as to a material fact” and that defendants had not violated section 14(a) or Rule 14d-9. *Id.* at 568. The Second Circuit affirmed the district court’s decision not to enjoin the voting of the shares. *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 292 Fed. App’x 133 (2d Cir. 2008).

1. Derivatives markets.

The deregulation of derivatives markets at the turn of the millennium has permitted eligible contract participants to enter into transactions that allow virtually unlimited rearrangement of voting and economic interests. Much of this activity is effected in private, over-the-counter transactions, many of which take place with offshore derivatives counterparties not subject to regulatory oversight by U.S. authorities. As a result, regulators cannot systemically determine the net voting power or economic interest of a corporation's shareholders. While there are proposals afoot to scale back some of these deregulatory efforts, they are aimed at containing the aggregate "systemic risk" of such contracts. Moreover, such proposals may well reduce the ability of securities regulators to devote significant effort to policing "empty voting" to the extent that they focus on risks posed by portfolios of securities rather than monitor ownership of individual securities. It is therefore unlikely that derivatives regulators will want to build an apparatus for aligning voting power and economic interest.

Equity derivatives allow contract participants to create "long" and "short" economic exposure to an equity security without conferring other share attributes. Investors use these markets either to "hedge" the economic exposure of securities in an investor's portfolio or to acquire long economic interests independent of share ownership.¹⁰² Contracts may be entered into either through an organized options or futures market (subject to SEC and Commodity Futures Trading Commission ("CFTC") regulation, respectively) or, for bilateral contracts between "eligible contract participants," through the over-the-counter derivatives market.¹⁰³

Prior to 2000, regulators might have been able to monitor or neutralize vote-buying effected through exchange-traded

¹⁰² Professors Hu and Black note that "morphable" ownership may be created by entering into a long equity swap with a financial institution as counterparty (who will typically hedge its short exposure by holding the actual shares) and subsequently unwinding the position by purchasing the same shares from its counterparty. Hu & Black, *supra* note 5, at 836-37. The principal concern they express with this type of transaction is their use "to avoid disclosing economic ownership under disclosure rules that turn largely on voting rights rather than economic ownership," which they note may be adequately addressed by extending existing disclosure requirements. *Id.* at 836, 820. Other uses may include avoiding mandatory bidding rules or preventing a run-up in market prices resulting from disclosure of concentrated ownership. *Id.* at 836-42.

¹⁰³ See, e.g., 1 PHILIP M. JOHNSON & THOMAS L. HAZEN, DERIVATIVES REGULATION § 1.18[6] (2004) (describing over-the-counter markets and eligible contract participants).

derivatives,¹⁰⁴ given that over-the-counter derivatives remained subject to regulatory exemptions administered by the CFTC.¹⁰⁵ That changed, however, with the Commodity Futures Modernization Act of 2000, which provided legal certainty to over-the-counter swap agreements and other derivative transactions¹⁰⁶ by excluding such bilateral, individually negotiated transactions from securities regulation and commodity regulation.¹⁰⁷ Thus, a vote buyer might completely escape

¹⁰⁴ Professors Martin and Partnoy have suggested that voting rights be reassigned from what they term “encumbered” shareholders to nonshareholders with net long positions. Martin & Partnoy, *supra* note 5, at 804-06; *see also supra* note 97 (describing their concept of “encumbered” shares). While it may well be desirable to prevent individuals with net short positions from voting, given the limited time horizons of investors in synthetic positions (at least on organized derivatives markets), it may not be worth the effort to identify individuals with net “long” positions for the purpose of granting them voting rights. *Cf.* Hu & Black, *supra* note 5, at 888.

¹⁰⁵ Prior to the Commodity Futures Modernization Act of 2000, swap agreements (such as total-rate-of-return equity swaps, which allow participants to exchange to gains and dividends from an equity position for a fixed income stream) could have been deemed off-exchange futures transactions in commodities prohibited by the Commodity Exchange Act; such contracts might therefore have been declared illegal and unenforceable by a court of law. 1 JOHNSON & HAZEN, *supra* note 103, § 1.02[8][A] (observing that “a court might reach a different conclusion” as to question whether swaps and hybrids were within coverage of the Commodity Exchange Act). The Commodity Futures Trading Commission (“CFTC”) later exempted such instruments from the Act pursuant to authority granted by Congress in 1992. *See* Futures Trading Practices Act of 1992, Pub. L. No. 102-546, § 502(a)(2), 106 Stat. 3590 (1992) (codified at 7 U.S.C. § 6(c)(5)(B)); Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587-01, 5587 & n.5 (Jan. 22, 1993) (codified in 17 C.F.R. pt. 35). Industry observers testified before Congress that the exemption remained subject to CFTC reconsideration and expressed concern that a CFTC concept release that sought to reexamine the Commission’s policy on OTC derivatives might lead to such a result. S. REP. NO. 106-390, at 13-16 (2000) (discussing “risk of trillion dollar [swap] industry moving off-shore” if CFTC were to revisit question whether OTC derivatives were off-exchange futures contracts); *see also* Over-the-Counter Derivatives, 63 Fed. Reg. 26,114 (May 12, 1998), *withdrawn by* Concept Release Concerning Over-the-Counter Derivatives, 64 Fed. Reg. 65,669 (Nov. 23, 1999).

¹⁰⁶ Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, app. E, tit. III, secs. 301-04, 114 Stat. 2763, 2763A-449 to 457 (2001).

¹⁰⁷ Specifically, such transactions are exempt from regulation either by the SEC or the CFTC. *See* 7 U.S.C. § 2(g) (2006) (excluding bilateral, individually negotiated swap transactions in nonagricultural commodities not executed on trading facility from Commodity Exchange Act); 15 U.S.C. § 78c-1 (2006) (excluding swap agreements from definition of “security” in Securities Exchange Act of 1934 and generally prohibiting SEC from “promulgating, interpreting or enforcing rules; or . . . issuing orders of general applicability . . . in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement”); *see also* 1 JOHNSON & HAZEN, *supra* note 103, at § 1.18[6][C]

regulatory oversight by entering into a series of bilateral contracts with a range of financial institutions and institutional shareholders.

Efforts to deregulate margin or collateral requirements for eligible securities customers further removed impediments to the use of derivatives in this manner. Until very recently, the margin requirements for offsetting stock and derivative positions were determined exclusively pursuant to “strategy”-based formulae under stock exchange rules.¹⁰⁸ With the authorization of portfolio margining for securities accounts, more substantial reductions are possible, particularly in large, highly diversified portfolios.¹⁰⁹ Transactions involving U.S. securities effected outside of a securities account carried by a U.S. broker-dealer might further escape regulation (or at least enforcement).¹¹⁰

In light of the role that derivatives contracts have played in the recent international financial crisis, efforts are underway to subject participants to swap agreements and other derivative transactions to greater regulatory scrutiny and disclosure requirements.¹¹¹ These efforts focus on aggregate financial responsibility of the financial intermediaries who deal in derivatives transactions, rather than the allocation and exercise of voting or consent rights to the clients of those dealers who may use these transactions to effect “empty voting” transactions.¹¹² Moreover,

(noting that CFTC has at present “no authority whatsoever” over swap transactions in nonagricultural products).

¹⁰⁸ See NYSE, Inc., Rule 431(f) (2008) (prescribing margin requirements for options and futures). While equity derivatives may be excluded from the definition of “security” in the Exchange Act, 15 U.S.C. § 78c-1 (2006), and thus from federal margin requirements under 15 U.S.C. § 78g (2006), a leveraged long position in the underlying security (necessary to exercise voting rights) would remain subject to margin requirements.

¹⁰⁹ See Peter McKay, ‘Margin Debt’ Hits Record \$353 Billion on NYSE, WALL ST. J., July 12, 2007, at C2, available at <http://online.wsj.com/article/SB118420803042864362.html> (noting that NYSE officials attributed trend to introduction of portfolio margining pilot program); see also NYSE, Inc., Rule 431(g) (2008) (setting forth portfolio margining regime).

¹¹⁰ In particular, a non-U.S. hedge fund not controlled by or acting on behalf of or in conjunction with U.S. persons and financing its transactions outside the U.S. might escape U.S. margin regulation entirely, even when holding positions in U.S. securities. See Regulation X, 12 C.F.R. § 224.1(b) (2007).

¹¹¹ See, e.g., Derivatives Market Reform Act of 1999, H.R. 7266, 110th Cong. (2008) (as referred to H. Comm. on Fin. Servs., Oct. 3, 2008) (proposing to confer additional authority on SEC to enhance oversight over derivatives dealers and hedge funds and to reduce potential for such entities to increase systemic risk in financial markets).

¹¹² See *id.* sec. 203 (proposing to require Commission to prescribe rules and regulations for brokers and dealers respecting “maintenance of sufficient capital levels

key proposals — such as the Treasury Department’s *Blueprint for a Modernized Financial Regulatory Structure* — would confer greater authority to aggregate information on overall risk in the financial sector to the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”), rather than the SEC or the CFTC.¹¹³ Such a shift in authority — though arguably justified by the comparatively greater need for the Federal Reserve Board to preserve the health of the nation’s financial markets — would substantially reduce the information available to the SEC and CFTC that would be necessary to enforce any prohibition against “empty voting.”

2. Securities lending.

Like deregulation of derivatives markets, the deregulation of securities lending markets may also have permitted “empty voting” transactions to occur with greater frequency. Historically, these transactions have enabled securities dealers to facilitate execution of short sales and to avoid “fails to deliver” in the routine course of clearance and settlement of securities transactions. Like derivatives transactions, securities loans have traditionally been individually negotiated transactions outside the direct oversight of federal regulators, who have been more concerned with the economic consequences of securities lending rather than the impact on voting. Regulating securities lending to prohibit “empty voting” would entail a significant expansion of regulatory authority without necessarily guaranteeing that voting abuses will not occur.

Financial institutions and asset managers with substantial long-term holdings in equity securities profit from the ability to lend shares to broker-dealers. In such transactions, the broker-dealer typically deposits cash or government securities as collateral for a loan of a

taking into account the financial activities conducted by, the customary sources of capital and funding of, and the credit risk and aggregate leverage of, any derivatives dealer that is a material associated person of the broker or dealer”); *id.* sec. 301 (proposing to require “unregistered hedge funds” to submit quarterly reports including, for each pooled investment vehicle, financial statements prepared in accordance with U.S. GAAP, “description of the models and methodologies . . . [it] uses to calculate, assess, and evaluate market risk,” and such other information as SEC may require by rule regarding “sudden changes in net asset value,” its “leverage ratio,” and “total notional amount of . . . [its] exchange-traded and over-the-counter derivatives positions”).

¹¹³ DEP’T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 146-56 (2008), available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf> (describing role of “market stability regulator” that would be undertaken by Federal Reserve Board).

particular security; the lender, as compensation, keeps a portion of the income generated from the deposited collateral.¹¹⁴ Banks have long acted as lending agents in securities loans on behalf of their institutional customers, but strict collateral requirements, among other restrictions, make it difficult to establish leveraged positions in securities-lending transactions.¹¹⁵ To the extent that such transactions present little economic risk and the possibility of enhancing profits, financial institutions and asset managers are unlikely to forgo securities lending opportunities in the absence of an express regulatory mandate.

More recently, the deregulation of securities credit extended to certain exempted broker-dealers has made lawful securities lending by those broker-dealers for the purpose of borrowing votes.¹¹⁶ While formally similar to financing arrangements, securities loans arranged by broker-dealers have historically been restricted to certain “permitted purposes,” such as facilitating a short sale or delivery of a specific security, to avoid indirect extensions of credit.¹¹⁷ Share lending by broker-dealers was

¹¹⁴ See, e.g., SIFMA, 2000 Master Securities Loan Agreement, §§ 4.1, 5.1, available at <http://www.sifma.org/services/stdforms/msla.html> [hereinafter MSLA] (requiring Lender of Loaned Securities to pay Borrower Cash Collateral Fee, representing income on cash or other securities deposited as collateral for loaned securities).

¹¹⁵ See, e.g., Class Exemption to Permit Certain Loans of Securities by Employee Benefit Plans, 46 Fed. Reg. 7527 (Jan. 23, 1981), as amended, 52 Fed. Reg. 18,754 (May 19, 1987) (establishing terms and conditions for securities lending by ERISA plans to certain broker-dealers and banks, including collateral and documentation requirements and right of recall).

¹¹⁶ Attempts to use stock borrowing for other purposes analogous to borrowing voting rights were prohibited prior to the National Securities Markets Improvement Act of 1996. For example, in 1992, the SEC brought an enforcement action against a firm that sought to enter into an arrangement with a customer to borrow shares over the “record date” for dividends in order to participate in “dividend reinvestment programs,” or “DRIPs,” sponsored by various corporations as a way to encourage reinvestment of dividends in their stock. *In re Shearson Lehman Bros., Inc.*, Exchange Act Release No. 31196, 52 SEC Docket 1995, 1995-97 (Sept. 17, 1992). The Federal Reserve Board had refused to permit such transactions for lack of a permitted purpose. See Staff Op. of July 6, 1984, Fed. Res. Reg. Serv. 5-615.01; Staff Op. of Mar. 2, 1984, Fed. Res. Reg. Serv. 5-615.1; see CHARLES F. RECHLIN, *SECURITIES CREDIT REGULATION*, § 7:15, at 7-19 to 7-20 (2d ed. 2006).

¹¹⁷ RECHLIN, *supra* note 116, § 7:12, at 7-14; see 12 C.F.R. § 220.10 (2007) (permitting borrowing or lending of securities for such purposes, “[w]ithout regard to the other provisions” of Regulation T). Under Regulation T, for example, a customer that seeks credit from a broker-dealer against a margin security held in a margin account may not receive credit amounting to more than 50% of the current market value of the security on the date of the transaction, 12 C.F.R. §§ 220.4(b)(1), 220.12(a) (2007), whereas a customer that “lends” the security collateralized by cash must generally receive collateral equal to 100% or more of the security’s current

significantly liberalized following the 1996 amendments to the Securities Exchange Act of 1934.¹¹⁸ Broker-dealers may now borrow money against securities without restriction, and therefore engage in the economically equivalent process of lending securities against cash collateral, as long as they are engaged in a substantial public customer business or borrow in connection with their market making or underwriting activities.¹¹⁹ Remaining regulatory restrictions on share borrowing are largely directed at restricting indirect extensions of securities credit to persons other than broker-dealers and protecting other shareholders from manipulative conduct.¹²⁰

It would be impracticable to regulate securities lending to prevent or deter the borrowing of voting rights because of the collateral impact on the efficiency of the national clearance and settlement system for securities. Some commentators have considered efforts to restrict share lending, whether through regulatory action or through bylaws or charter amendments.¹²¹ The Commission has resisted these efforts

market value marked-to-market at the close of each day. 17 C.F.R. § 240.15c3-3(b)(3)(iii)(B) (2007).

¹¹⁸ Prior to 1996, broker-dealers were only permitted to borrow in the ordinary course of business as a broker or dealer against securities from or through banks or from other broker-dealers. Former section 8(a) of the Exchange Act, 15 U.S.C. § 78h(a) (1994), *repealed by* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 104(b), 110 Stat. 3416, 3422-23 (1996); *see* RECHLIN, *supra* note 116, § 9:1, at 9-4. Accordingly, the Federal Reserve Board also prohibited broker-dealers from lending securities against cash deposited as collateral unless the loan was effected for one of several “permitted purposes” (such as delivery into a short sale or into a long sale where the selling customer has “failed to deliver” the securities to the broker). *See* RECHLIN, *supra* note 116, § 7:13, at 7-15.

¹¹⁹ *See* 15 U.S.C. § 78g(c)(3) (2006) (exempting credit extended, maintained, or arranged to or for registered broker-dealer, substantial portion of whose business consists of transactions with persons other than broker-dealers or to finance activities as market maker or underwriter); *see* 12 C.F.R. § 220.2 (2007) (defining “exempted borrowers”).

¹²⁰ *See* RECHLIN, *supra* note 116, § 7:17, at 7-22 (discussing Regulation T’s continuing prohibition on borrowing securities from customers that are not exempted borrowers “to prevent circumvention of the Board’s margin rules”); *infra* note 176 (discussing restrictions on tender of borrowed shares in context of partial tender offers under Rule 14e-4, 17 C.F.R. § 240.14e-4 (2007), which were ostensibly adopted to prevent certain shareholders from obtaining disproportionate acceptance of their tendered shares); *see also* Christoffersen et al., *supra* note 30, at 2902 (noting that legal issues relating to securities lending in United States were “minor consideration” in their study of the aggregation of voting rights through securities lending markets because their study period took place after the amendments to the Exchange Act discussed above).

¹²¹ Martin & Partnoy, *supra* note 5, at 799 (suggesting that regulators consider “restricting, or even suspending, the lending and shorting of shares” in light of

because the contractual restrictions necessary would impair the borrowing of shares to effect short sales.¹²² Moreover, it would be impracticable to mandate the recall of borrowed shares over record dates to prevent securities-lending transactions driven by the desire to acquire voting power. Any rule that would require broker-dealers or clearing agencies to return shares over record dates or during tender offers would force such intermediaries to assume significant economic risk (regardless whether the lender of securities has any interest in voting the loaned shares).¹²³ As a result, an active securities lending market is likely to persist.

emergence of other hedging strategies); *see also* Hu & Black, *supra* note 5, at 891-92 (discussing various strategies by which corporation may limit empty voting by outside investors through bylaws or charter amendments).

¹²² For example, in response to attempts by issuers to impose contractual restrictions on share lending via the Depository Trust & Clearing Corporation (“DTCC”) or other financial institutions in order to deter short selling, the Securities and Exchange Commission adopted Exchange Act Rule 17Ad-20, which prohibits registered transfer agents from transferring any class of registered equity security “if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary in its capacity as such.” 17 C.F.R. § 240.17Ad-20(a) (2007). The Commission justified its regulatory action on the ground that it was following the “Congressional mandate” to use its authority to facilitate the establishment of the national system for clearance and settlement “by facilitating access to the national system for clearance and settlement that is not impeded by restrictions on transfers to or from securities intermediaries.” Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries, Exchange Act Release No. 50758, 69 Fed. Reg. 70,852-01, 70,858 (Dec. 7, 2004). If anything, the Commission is concerned about the potential lack of borrowing opportunities: The Commission has recently engaged in rulemaking to reduce excessive “naked short selling,” in which broker-dealers fail to borrow shares within the settlement cycle for a short sale (currently, three business days under 17 C.F.R. § 240.15c6-1 (2007)) and thus rely on DTCC’s stock borrow program. Short Sales, Exchange Act Release No. 50103, 69 Fed. Reg. 48008, 48028 (Aug. 6, 2004) (codified at 17 C.F.R. pt. 242) (adopting Regulation SHO).

¹²³ The SIFMA Master Securities Loan Agreement, for example, requires Lenders to waive their voting or consent rights during the period the loaned securities are lent to the Borrower. *See* MSLA, *supra* note 114, § 7.1 (“Lender hereby waives the right to vote, or to provide any consent or to take any similar action with respect to, the Loaned Securities in the event that the record date or deadline for such vote, consent or other action falls during the term of the Loan.”). In related circumstances, if voting securities are transferred as *collateral* for a loan of cash or other securities, any covenant to require the pledgee to vote the collateral securities in a manner directed by the pledgor of the collateral securities could impair the pledgee’s security interest in the collateral. *See* SIFMA, 2000 MASTER SECURITIES LOAN AGREEMENT GUIDANCE NOTES § 7.2, at 10 (2000), available at http://www.sifma.org/services/stdforms/pdf/guidance_notes_to_master_securities_loan_agreement.pdf [hereinafter MSLA GUIDANCE NOTES] (“Parties should also consider the effect that any covenants of Lender the parties may wish to adopt regarding the exercise of voting or similar rights with respect to the Collateral may have from a corporate law and governance

B. “Empty Voting” Transactions Do Not Necessarily Yield Detrimental Results If Long-Term Committed Shareholders Can Participate in Similar Transactions

Even if empty voting is inevitable, it should not necessarily yield detrimental results if all interested constituencies can participate and other corporation law mechanisms exist to contain its more perverse consequences. Reflexive prohibitions against vote buying by corporate insiders, for example, have yielded over time to judicial analysis of the motives of the purposes of such transactions and the sophistication of the participants buying and selling votes. Moreover, concerns about empty voting focus on the surreptitious acquisition of voting power, rather than the consequences of the transactions that they are used to influence, which may or may not be detrimental to the interests of the shareholders of the affected corporation(s).¹²⁴

Prohibitions against vote buying are artifacts of common law. Over time, the view of courts with respect to vote-buying transactions has evolved as they have reflected on the rationale for granting shareholders the right to vote. Older cases held that vote buying was per se antithetical to shareholder democracy and the right of shareholders to “rely upon the independent judgment of [their] fellow stockholders.”¹²⁵ Under modern paradigms of shareholder voting power, courts increasingly view vote buying as acceptable “unless the object or purpose is to defraud or in some way disenfranchise the other stockholders.”¹²⁶ These cases have focused on vote buying by

perspective and on whether Lender has a perfected security interest in the Collateral under applicable law.”).

Consequently, it may well be better to reaffirm the fiduciary duty of institutional shareholders to recall loaned shares through written policies and share lending agreements, rather than adopt regulations that disrupt the existing share lending market. See, e.g., INT’L CORPORATE GOVERNANCE NETWORK, STOCK LENDING CODE OF BEST PRACTICE 3, http://www.icgn.org/organisation/documents/slc/code_final.pdf (last visited Apr. 15, 2009) (advocating that institutional shareholders adopt “lending policy [that] clearly state[s], *inter alia*, the lender’s policy with regard to recall of lent shares for the purpose of voting them”).

¹²⁴ Cf. Briggs, *supra* note 8, at 722 (observing that hedge fund activists “paradoxically practice ‘shareholder primacy’ but cannot believe in it as a theory lest it empower the large and frequently conflicted institutional investors . . . sufficiently to allow them to take a competing seat at the corporate governance table”).

¹²⁵ *Schreiber v. Carney*, 447 A.2d 17, 24 (Del. Ch. 1982).

¹²⁶ *Id.* at 25-26; cf. Earl Sneed, *The Stockholder May Vote as He Pleases: Theory and Fact*, 22 U. PITT. L. REV. 23, 54 (1960-61) (concluding that prohibition against vote selling is grounded in “triumvirate of fiduciary admonitions: (1) the stockholder cannot defraud his fellow-stockholders; (2) the dominant stockholder is a fiduciary; and (3) the majority owes a fiduciary duty to the minority”); see, e.g., 5 FLETCHER

management or vote selling by controlling shareholders. As a result, the propriety of vote buying has more recently been analyzed through the lens of management's fiduciary duties, or the fiduciary duties of controlling shareholders.¹²⁷

Empty voting entails a related, though slightly different, analysis. Empty voting is often associated with shareholder-initiated transactions such as proxy contests and tender offers, or approval of bylaw initiatives that do not require a board resolution. Unlike in the context of traditional vote buying, the complicity of the board or of a controlling shareholder does not necessarily come into play. Indeed, initiatives supported by empty votes may be hostile to incumbent managers' interests. Herein lies the true strength and peril of legalized vote buying — while it enables shareholders efficiently to achieve consensus without the intermediation of the board, it also threatens to eliminate the direct judicial review currently available for vote-buying transactions. In these transactions, rules governing proxy disclosures,¹²⁸ management responses to tender offers,¹²⁹ or post-transaction appraisal rights¹³⁰ may be the primary protection available to aggrieved shareholders.¹³¹

Moreover, in setting the ground rules of corporation law, the phenomenon of empty voting compels a reconsideration of the balancing of shareholder wealth and the wealth of nonshareholder constituencies, or the wealth of society in general. Judicial review of fiduciary duties focuses on the impact of managerial decisions on

CYCLOPEDIA OF CORPORATIONS § 2066 (2008) (describing view that voting agreements are per se invalid as generally "obsolete" for large publicly held corporations). *But see In re IXC Commc'ns, Inc. S'holders Litig.*, No. C.A. 17324, 1999 WL 1009174, at *8 (Del. Ch. Oct. 27, 1999) (unpublished opinion).

¹²⁷ See, e.g., Hu & Black, *supra* note 5, at 894.

¹²⁸ 17 C.F.R. § 240.14a-3 (2008) (requiring any person soliciting proxies to furnish each person solicited with preliminary or definitive proxy statement containing information specified under Commission rules).

¹²⁹ 17 C.F.R. § 240.14e-2 (2008) (requiring company that is subject of tender offer to disseminate statement regarding its, i.e., its management's, position with respect to tender offer); *id.* § 240.14d-9 (requiring any such recommendation or other statements by target's management to be filed with Tender Offer Solicitation/Recommendation Statement on Schedule 14D-9).

¹³⁰ See, e.g., DEL. CODE ANN. tit. 8, § 262 (2007) (granting appraisal right to stockholders of record who do not vote in favor of certain merger transactions under certain conditions); MODEL BUS. CORP. ACT § 13.02 (2007) (granting appraisal rights to shareholders in certain transactions).

¹³¹ Of course, courts may review transactions effected by a board dominated by insurgents following a proxy contest.

shareholders.¹³² Empty voting transactions, by contrast, often entail the interests of other constituencies — bondholders, creditors, potential bidders, or even the public interest, among others.¹³³ This is not to say that the effect of such transactions on shareholder wealth is unimportant, or that shareholders should have no recourse to challenge unfair transactions that otherwise result in net gains in social wealth. It may nevertheless be worthwhile to take into account the net impact of empty-voting transactions on aggregate firm wealth or social wealth, while monitoring the impact of such transactions on shareholder wealth and remediating instances of unfair treatment.

Without resolving this debate, I argue that empty voting need not be dismissed as undesirable if it is designed to promote corporate transactions that increase social wealth¹³⁴ and if auxiliary mechanisms exist to ensure that shareholders are not treated unfairly (*vis-à-vis* other stakeholders or third parties who may wish to purchase votes).¹³⁵ In other words, I argue that empty voting is not detrimental to social wealth if (i) a “significant” percentage of institutional shareholders are committed to maximizing the long-term wealth of the individual firms in which they invest; (ii) those institutional shareholders are empowered to borrow empty votes in opposition to or in support of, and on equal (or better) terms with, insurgents; (iii) the fiduciary duties of these institutional shareholders to their clients, and the manner in which they communicate and consult with the firms in which they invest, are reimagined in a way to give them sufficient incentive to buy votes; and (iv) courts continue to scrutinize transactions effected with the use of empty votes and intervene in instances of substantial unfairness to affected shareholders.

Put yet another way, let us classify corporate transactions involving the specter of empty voting based on whether they increase or

¹³² See, e.g., Fisch, *supra* note 1, at 662-68 (noting that fiduciary duties are consistent with shareholder primacy because “interests of managers, customers, and employees . . . are protected effectively through mechanisms other than fiduciary duty litigation”).

¹³³ See *id.* at 643-44 (describing how “[w]ithin a framework of welfare economics in which the goal is societal wealth maximization, firm value is conceptually distinct from shareholder value”).

¹³⁴ Gordon, *supra* note 28, at 377-79; see also Bebchuk & Kahan, *supra* note 41, at 1090-91 (defining “desirable” or “efficient” proxy challenge as one in which challenger’s victory increases social wealth).

¹³⁵ One commentator has suggested that courts should be the “institution of first instance” in dealing with the potential abuses of empty voting transactions. Kevin C. Cunningham, Note, *Examination of Judicial Policy on Corporate Vote Buying in the Context of Modern Financial Instruments*, 64 N.Y.U. ANN. SURV. AM. L. 293, 333-41 (2008) (advocating an “intrinsic fairness” standard for such transactions).

decrease firm wealth and whether they increase or decrease social wealth. From the perspective of shareholder wealth maximization, transactions that increase firm wealth are always desirable, as long as traditional federal and state law mechanisms continue to exist to ensure that the transaction does not treat any one class of shareholder unfairly. From a societal perspective, transactions that decrease firm wealth but increase social wealth are beneficial, as long as traditional federal and state law mechanisms continue to exist to neutralize or mitigate any substantial unfairness to the shareholders of the firm.¹³⁶ Transactions that neither increase firm wealth nor increase social wealth are the greatest threat posed by empty voting. I consider in turn the hypothetical reaction of long-term shareholders to each of these categories.

1. Transactions that increase net firm wealth.

Some transactions, such as recapitalizations and debt restructurings, may benefit the corporation as a whole, but those benefits may disproportionately benefit certain shareholders at the expense of others. Because the sole purpose of vote buying in these cases is to support or oppose board-sanctioned allocations of benefits, courts assess whether the intracorporate allocation of the resulting benefits is fair.¹³⁷ Provided this fairness requirement is met, vote buying should be least problematic in those transactions that are expected to increase firm wealth but require the consent or approval of individual classes of shareholders or other stakeholders.

The Delaware courts' approach to vote-buying in these circumstances illustrates the nature of the fairness inquiry. In *Schreiber v. Carney*,¹³⁸ often cited as the core of Delaware's modern jurisprudence on vote buying,¹³⁹ the reviewing court acknowledged that the proposed restructurings were beneficial to the corporation's long-term interests, and that management designed the consideration

¹³⁶ I do not address transactions that increase firm wealth at the expense of social wealth; these are appropriate subjects for regulation of specific lines of business or activity (e.g., bankruptcy, antitrust, creditor/debtor law) rather than corporation or securities law.

¹³⁷ Cf. Fisch, *supra* note 1, at 673 (questioning measurement of efficiency of corporate transactions by their impact on shareholder wealth rather than firm wealth).

¹³⁸ 447 A.2d 17 (Del. Ch. 1982).

¹³⁹ See, e.g., André, *supra* note 9, at 545-50 (describing *Schreiber v. Carney* as "seminal case"); Hu & Black, *supra* note 5, at 818 (describing *Schreiber v. Carney* as "leading Delaware case").

afforded to a specific class of stakeholder to secure its cooperation.¹⁴⁰ In other vote-buying cases involving public corporations, the Delaware Supreme Court and Court of Chancery have considered factors such as the net benefit of the transaction to residual common shareholders,¹⁴¹ the fairness of the transaction through which the votes are purchased,¹⁴² the sophistication of the affected stakeholders,¹⁴³ and the opportunity for similarly situated stakeholders to participate in the transaction.¹⁴⁴ Such inquiry into fair consideration and fair dealing is common to corporations with multiple classes of stakeholders.¹⁴⁵

¹⁴⁰ *Schreiber*, 447 A.2d 17 at 19, 26 (upholding loan by corporation to preferred shareholder who controlled enough preferred shares to veto merger transaction essential to planned restructuring to spare preferred shareholder “intolerable income tax burden” resulting from exchange or early exercise of its warrants); see *Kass v. E. Air Lines, Inc.*, 1986 WL 13008, *4-5 (Del. Ch. Nov. 14, 1986) (unpublished opinion) (denying plaintiffs’ request to enjoin corporation from offering cash payment or equivalent consideration to debentureholders to secure waiver of covenant restricting shareholder dividends as against public policy or breach of fiduciary duty). A similar result may be achieved through an exchange offer. *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 878, 882 (Del. Ch. 1986) (denying plaintiffs’ request to enjoin corporation from offering to exchange several series of debentures for new debt on condition that debentureholders vote to eliminate certain financial covenants that impeded proposed financial restructuring).

¹⁴¹ See, e.g., *Schreiber*, 447 A.2d at 25 (noting that “[t]he agreement in question was entered into primarily to further interests of Texas International’s other shareholders”).

¹⁴² See, e.g., *id.* at 26 (describing vote-buying “as a voidable transaction subject to a test for intrinsic fairness”).

¹⁴³ See, e.g., *In re IXC Commc’ns, Inc. S’holders Litig.*, No. C.A. 17324, 1999 WL 1009174, at *9 (Del. Ch. Oct. 27, 1999) (unpublished opinion) (noting that 169 institutional investors, collectively holding more than 60% IXC shares of record, were “still in a position independently to void the allegedly onerous effect of this vote-buying transaction” through their “ability to exercise an informed shareholder franchise”).

¹⁴⁴ See, e.g., *Kass*, 1986 WL 13008, at *4 (noting that offer was one made publicly to all voters on same terms).

¹⁴⁵ See, e.g., *In re FLS Holdings, Inc. S’holders Litig.*, 1993 WL 104562, at *279 (Del. Ch. Apr. 21, 1993) (unpublished opinion) (noting that directors, in allocating merger consideration, owed fiduciary duties to both preferred and common stockholders, which absent procedures “sufficient in themselves to give reasonable assurance of fairness,” may require heightened judicial review); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986) (concluding that plaintiff’s claim to fair allocation of merger proceeds, to right to contest defendants’ exercise of appropriate care in negotiating proposed merger, and to be free of overreaching as to timing of merger fairly implicate fiduciary duties); *Dalton v. Am. Inv. Co.*, 490 A.2d 574, 579-80, 582-83 (Del. Ch. 1985), *aff’d*, 501 A.2d 1230 (1985) (finding that “answer” to plaintiff’s charge of breach of “fiduciary duty of fairness” in connection with defendants’ dealings and allocation of merger consideration “turns on factual determination” of defendants’ conduct in negotiating acquisition).

It is also difficult to conceive of transactions initiated by shareholders that raise such purely distributive concerns (e.g., deciding how much each class of shareholder or stakeholder receives in a transaction that maximizes firm wealth) without an independent intervening board decision.¹⁴⁶ As a result, in most cases, there will be an opportunity for judicial review of transactions that might otherwise affect individual classes of shareholder unfairly. For example, an insurgent group may seek to replace the board of a corporation in the belief that the new board will take actions to increase firm wealth. Any distribution of this wealth among equity stakeholders, whether through merger consideration, dividends, or an amendment to contractual preferences, requires a board decision subject to judicial review. Board decisions to distribute wealth to nonshareholder constituencies — such as employees, creditors, or bondholders — may also be subject to review for conflicts of interest under the duty of loyalty. As such, it might not be advantageous for other shareholders to spend large sums to borrow votes to oppose election of a slate that is expected to improve firm wealth, except as part of a bargaining game to extract a larger portion of the increase in firm wealth within the range of fair outcomes enforced by judicial review.¹⁴⁷

While transactions that increase firm wealth pose some concerns about fair treatment of various shareholder groups, situations in which vote buying is employed to reduce firm wealth, either by vetoing transactions that would have been expected to increase shareholder wealth or approving transactions that are expected to reduce

¹⁴⁶ An example of how such a transaction might occur is *Dalton v. American Investment Co.*, 490 A.2d 574 (Del. Ch. 1985), *aff'd*, 501 A.2d 1238 (1985). In *Dalton*, a class of preferred shareholders sought to challenge an acquisition transaction in which the common shareholders voted in favor of a transaction that would cash their common shares out at \$13 per share, but did not make any provision for cashing out preferred shareholders. *Id.* at 575. The preferred shareholders argued that the board breached its fiduciary duties to the preferred class by failing to negotiate a purchase price for their shares, rather than to allow the acquirer to acquire control without negotiating with the preferred shareholders. *Id.* Had the preferred shareholders negotiated a right to veto such transactions (or to be cashed out in the event such a transaction were to occur), the acquirer would have been compelled to bargain with them as a class for their approval.

¹⁴⁷ How such benefits are allocated among competing constituencies within the scope of outcomes permitted by law is a subject of debate among economists. *Cf.* Ariel Rubinstein, *Perfect Equilibrium in a Bargaining Model*, 50 *ECONOMETRICA* 97, 99 (1982) (developing various models of two-person bargaining over partition of “pie” of fixed size). For example, Rubinstein concludes that in a model with fixed bargaining costs for each interval of play, the party with the higher bargaining cost “gets almost ‘nothing.’” *Id.*

shareholder wealth, are more problematic. I consider in turn transactions that potentially reduce net firm wealth without reducing net social wealth and transactions that potentially reduce both net firm wealth and net social wealth.

2. Transactions that potentially reduce net firm wealth but do not reduce net social wealth.

The analysis of transactions that potentially reduce net firm wealth but do not reduce net social wealth turns in part on whether the gain in net social wealth is shared with the public. Empty-voting transactions, for example, may arise in the context of mergers or other transactions in which one corporation's shareholders derive benefits at the expense of another's. The diversification of individual and institutional shareholder portfolios may reduce the need for greater protection of shareholders in such intercorporate transactions.¹⁴⁸ For example, to the extent that transactions among publicly held companies improve or have a neutral impact on the total value of all publicly held companies in a given industry or the broader market, institutional or individual shareholders holding a sector-specific or broad-based index portfolio do not care how those benefits are specifically allocated among the shareholders of each party to the transaction.

To the extent that such transactions can increase the combined value of the two firms, the use of borrowed votes might increase the likelihood that favorable transactions will occur, notwithstanding the perceived harm to one of the constituent corporations. This does not necessarily mean that empty-voting transactions are necessary to accomplish such transactions. One commentator has specifically suggested, for example, that management can replicate any beneficial effects of vote buying if it undertakes to require the party benefiting from the consummation of a transaction requiring a shareholder vote to share any net social wealth through a side payment.¹⁴⁹ Empty

¹⁴⁸ See Anabtawi, *supra* note 1, at 584 (suggesting that if institution owns shares of both target and acquirer, it should remain indifferent to adequacy or excessiveness of consideration paid in transaction); *cf.* Easterbrook & Fischel, *supra* note 5, at 410-11. *But see* Kahan & Rock, *supra* note 78, at 1073-77 (noting that, while institutions are on both sides of many socially desirable acquisition transactions, and therefore indifferent as to allocation of consideration between targets and acquirers, hedge funds purposefully acquire disproportionate voting power to affect outcomes).

¹⁴⁹ See Gordon, *supra* note 28, at 377-78. Gordon gives the following example: assume that outsider *O* would like corporation *C* to effect a transaction that would result in a benefit of \$5 per outstanding share to *O* but cost shareholders *S*₁ through *S*_{*n*} \$3 per share. *Cf. id.* at 377. In such situations, *O*, rather than contract with other shareholders, can simply enter into a side-deal with *C* in which *O* compensates all

voting may nevertheless remain an important tool in those cases where shareholder action is necessary to accomplish such transactions, either because a vote is necessary to ratify a board-initiated transaction or because the board is opposed to the action (e.g., a hostile tender offer made directly to shareholders).

Thus, for example, in a recent transaction, Perry Corporation, a hedge fund, was alleged to have obtained an empty voting interest in an acquiring company, Mylan Laboratories, that had entered into a transaction to purchase a target company, King Pharmaceuticals, in which the hedge fund held an economic interest.¹⁵⁰ Assuming that Mylan had overbid for King and that Mylan's shareholders might have otherwise rejected the resolution of merger adopted by the board, a reviewing court would have been confronted with the question of whether a hedge fund could use an empty voting interest in an acquiring company to cause it to ratify a transaction that enriched the target company's shareholders at the acquiring company's expense.¹⁵¹

If the benefits of empty voting transactions are not shared with public shareholders (e.g., an acquisition of a public company by a private equity firm), the effect of vote buying largely depends upon the size of the private benefit that the insurgent receives relative to any change in firm value resulting from the transaction. In these transactions, it may be reasonable for both the insurgent group and larger shareholders to commit to borrow votes in support of their respective positions, up to a maximum price beyond which their respective net benefit from the transaction is zero.¹⁵² As long as the

shareholders for their loss at a price of \$3 to \$5 per share (effectively splitting the benefit to O with all shareholders of C). Cf. *id.*

¹⁵⁰ Complaint at 6-7, *High River Ltd. P'ship v. Mylan Labs., Inc.*, 353 F. Supp. 2d 487 (M.D. Pa. 2004) (No. 04-2677). Perry reported in a Schedule 13D filing with the SEC that it obtained this voting interest by purchasing 9.89% of King's outstanding shares (26.6 million shares) and entering into short sales "against the box" (i.e., selling borrowed shares collateralized by its shareholdings) and swap agreements with various financial institutions. *Id.* at 6; see also Oesterle, *supra* note 99, at 24 (noting Perry paid "substantial fees, in the millions," to establish this position).

¹⁵¹ High River discontinued the lawsuit after Perry sold its Mylan shares and Mylan determined not to proceed with the transaction. *Icahn Discontinues Litigation Against Perry Corp. and Mylan Laboratories*, SCIENCE LETTER, June 28, 2005, 2005 WLNR 9958167.

¹⁵² A simplified model of shareholder behavior illustrates the intuition behind this point. Assume, without loss of generality, that a group of insurgents intends to cause a corporation to enter into a transaction that will result in a decrease of shareholder wealth (ΔS , expressed as a positive number) and a private benefit to the group (R). Assume the insurgent group owns no shares and intends to borrow the required percentage of votes to meet the voting threshold for approval of the transaction under state corporation law and any applicable charter and bylaw provisions (m , $0.5 < m \leq$

1). The insurgent group should be willing to borrow the votes necessary to approve the transaction, up to the price at which the borrowing cost equals the private benefit. Thus, the maximum price per share that the insurgent group would be willing to pay to borrow votes ($p_{activist}$) should equal:

$$p_{activist} = \frac{R}{mn}$$

where n represents the total number of shares in the corporation outstanding.

Assume further that a group of long-term institutional shareholders holds a significant percentage of the corporation's shares (k , $k < 1 - m$) and is willing to borrow the minimum number of additional votes necessary to block the proposed transaction as long as it is efficient to do so. Let us assume further that institutional shareholders do not incur any additional costs apart from the fee paid to borrow shares (e.g., cost of researching the proposal and coordinating action); if the field of shareholder action under corporation law is sufficiently narrow to provide legal certainty, and the cost of analyzing proposed actions may be outsourced to advisory firms (who spread such costs out among all institutional customers), proponents need not incur the full cost of such activities. See, e.g., Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 577-78 (1990) (using more detailed model that considers balance of costs among proponents, nonproponents, and corporation). The institutional shareholders should be willing to borrow the additional $1 - m - k$ percentage of shares necessary to block the transaction, but only if the price at which the total borrowing cost equals the shareholders' internalized benefit from preventing the transaction ($k\Delta S$) exceeds the maximum price that the insurgents are willing to pay to borrow shares.

Under these circumstances, the maximum price per share ($p_{institutions}$) that institutional shareholders would be willing to pay to borrow votes would equal:

$$p_{institutions} = \frac{k\Delta S}{n(1 - m - k)}$$

Let us further hypothesize that if $p_{institutions} > p_{activists}$, the institutional shareholders will win the vote with probability of 1; if $p_{institutions} \leq p_{activists}$, the institutional shareholders will win the vote with probability of 0: Because the success of a contest involving share-lending transactions does not rely on the effectiveness of "getting out the vote," but rather focuses solely on the amount of the borrowing fee, the discount relating to the uncertainty of success may be reduced dramatically. See, e.g., Grundfest, *supra* note 1, at 910 (observing that "profit-maximizing shareholder will agree to bear the private costs of participation . . . only when those costs are less than the anticipated benefits to that individual shareholder . . . weighted by the estimated probability . . . that the shareholder's participation in the initiative will contribute to generating those benefits").

Generally speaking, the institutional shareholders are likely to bid against the insurgent group only if:

$$p_{institutions} > p_{activists}$$

Solving for k gives the necessary percentage of shares held by committed long-term

net impact on social welfare is positive, the minimum percentage of shareholders necessary to hold up a transaction should decrease as private benefits increase relative to shareholder losses.¹⁵³ Insurgents should have an incentive, moreover, to reduce opposition by reallocating benefits to mitigate shareholder losses.

Thus, the availability of vote buying may permit socially desirable transactions to take place more frequently.¹⁵⁴ Vote buying does not ensure shareholders a more equitable distribution of the benefits derived from such transactions. Shareholders' recourse for such distributive fairness is to seek appraisal, or to mount a traditional campaign against tender (or against lending of votes by noncommitted shareholders) to hold out for more value.¹⁵⁵ Shareholder losses, moreover, may be mitigated through traditional defensive measures enacted by the board or by state corporation law, to the extent shareholders fear insurgents more than incumbents.

3. Transactions that potentially reduce net social wealth and net firm wealth.

Transactions that provide private benefits to vote-buying insurgents at the expense of both social wealth and shareholder wealth are the most worrisome. These might involve value-destroying acquisitions, replacement of competent officers and directors with cronies, or bylaw amendments that needlessly undermine managerial productivity.

shareholders to hold up approval of the proposed transaction:

$$k > \frac{R(1-m)}{R+m\Delta S}$$

Assuming that $R > \Delta S$ (i.e., society is better off if the transaction is consummated, even if the shareholders suffer loss), the percentage of shareholders (k) necessary to hold up the transaction increases asymptotically to $(1 - m)$ as $R/\Delta S$ approaches infinity: Because the change in net social wealth ($R - \Delta S$) increases as $R/\Delta S$ increases (while $R/\Delta S > 1$), if the percentage ownership of the committed shareholder base is constant (and less than $1 - m$), vote buying by insurgents makes it more difficult for shareholders to oppose more socially desirable transactions.

¹⁵³ See *infra* Part III.C.2 (discussing extent to which this model can achieve long-term equilibrium and consequences for implementation of vote buying market).

¹⁵⁴ Cf. Blair et al., *supra* note 90, at 437-39 (suggesting same in context of change-of-control transaction, using significantly more refined model).

¹⁵⁵ Cf. Guhan Subramanian, *Post-Siliconix Freeze-Outs: Theory and Evidence*, 36 J. LEGAL STUD. 1, 23-24 (2007) (finding "strong evidence that minority shareholders receive lower . . . [cumulative abnormal returns] in tender-offer freeze-outs than in statutory merger freeze-outs").

Consider a transaction in which outsider *O* benefits by slightly less than \$3 per outstanding share in a transaction that would cost shareholders S_1 through S_n \$3 per share.¹⁵⁶ In this hypothetical, *O* may nevertheless seek to cause corporation *C* to effect the change by purchasing a bare majority of votes from other shareholders (at a price presumably up to \$6 per share) to vote for the change.¹⁵⁷ Those shareholders who sell their votes are made whole (or perhaps even profit) for the loss in value sustained by the corporation, while those shareholders who do not will suffer a \$3 loss per share. “Responsible vote buying” by a sufficient number of shareholders with a credible long-term commitment to the corporation may deter such abusive transactions.¹⁵⁸

If outsider *O* is prepared to pay a bare majority of shareholders a price up to \$6 per share to effect a transaction that would reduce the value of corporation *C* by \$3 per share, institutional shareholders collectively owning $33\frac{1}{3}\%$ of *C*'s shares might find it advantageous to bid up the borrowing price to stave off the proposed change (again, in the context of a single-iteration game).¹⁵⁹ While none would pay more than \$3 per share owned, collectively they might bid to borrow $16\frac{2}{3}\%$ of *C*'s shares at up to \$6 a share to prevent the threatened loss. Thus, a short-term out-of-pocket expense by S_2 and S_3 might be justified if preventing the proposed transaction inures to their long-term benefit.¹⁶⁰

Roughly speaking, as the private benefits obtained in such transactions decline relative to the potential loss to shareholders, the opposition threshold should decrease as well. An increase in the voting threshold naturally decreases the threshold for committed shareholders as well, as reflected in the use of supermajority requirements to create greater hold-up power as a defensive tactic in certain fundamental transactions.¹⁶¹ Vote buying may be tolerable if adequate protections are devised to ensure that voting interest may be borrowed in a public market on equal terms, particularly in situations

¹⁵⁶ See Gordon, *supra* note 28, at 376-77.

¹⁵⁷ Assume that the corporation *C* has 1 million shares outstanding, *O* currently owns one share, and *O* must acquire the right to vote 500,000 shares to approve the transaction. If the benefit *O* stands to gain is \$3 per share (\$3,000,000), *O* might logically bid up to \$6 per share to acquire the power to vote 500,000 shares ($500,000 \times \$6 = \$3,000,000$).

¹⁵⁸ Clark, *supra* note 9, at 807.

¹⁵⁹ Applying the equation, *supra* note 152, if $R \leq \Delta S$ and $m = 50\%$, then $k \leq 33\frac{1}{3}\%$.

¹⁶⁰ Of course, in most cases neither party will attempt to acquire an outright majority, and as suggested below, potential bidders in a vote buying market could be required to internalize some of the loss of share value.

¹⁶¹ See *infra* Part III.C.1.

where management is unwilling to cause the corporation to act in a manner that increases shareholder wealth.

If empty voting is inevitable, and yet shareholder voting is too valuable a tool of corporate governance to forgo, the analysis above suggests that the participation of long-term committed shareholders might theoretically neutralize concerns about its potential abuses. At present, institutional investors and other long-term shareholders have little opportunity, incentive or regulatory support for participating in “empty voting” transactions. A market for borrowing public shares, as described in the next Part, might change that equation.

III. CONSTRUCTING A HYPOTHETICAL MARKET FOR BORROWING PUBLIC SHARES

A market for borrowing public shares would institutionalize the voting of shares by persons disproportionate to their economic interest in the corporation. Why is such a hypothetical market worthy of consideration in the face of historical resistance to such transactions? First, as described above, markets already exist for decoupling voting and economic interest, although they are currently not subject to comprehensive regulation and are generally available only to sophisticated investors. Second, the decoupling of voting and economic interest may, in some cases, lead to socially neutral or socially more efficient outcomes. Accordingly, concerns about empty voting might well be neutralized if a market could open the opportunity to participate in empty voting transactions to a broader class of sophisticated shareholders and shine greater light on the purposes for which and the prices at which such votes are acquired.

A market for borrowing public shares would build on the existing legal infrastructure for securities-lending markets to allow socially efficient “empty voting” transactions to take place openly, while allowing courts and regulators to police abuses of other forms of “empty voting” under traditional common law rules. If such transactions take place in a regulated market, institutional investors would have greater freedom and incentive to expend resources to participate in such transactions, consistent with their fiduciary obligations to their beneficiaries. A public market would also force greater transparency on the identity of persons voting shares, their reasons for acquiring voting or investment power, and their valuation of such voting or investment power.

In this section, I sketch the framework of a hypothetical market in which committed long-term shareholders might borrow shares held by other shareholders. In subpart A, I describe what such a market might look like, within the framework of stock exchange or clearing agency rules. In subpart B, I list some of the practical benefits that would follow from the creation of such a market, and in subpart C, I consider some of the obstacles that regulators and policy makers would face in implementing such a market in the context of the existing regulatory framework.

A. *The Hypothetical Market*

Consider a market for borrowing public shares in which existing shareholders may freely lend or borrow title to common stock in public corporations in connection with certain shareholder actions. The hypothetical market would be open for borrowing shares in large-capitalization corporations. The exchange on which the shares would be primarily listed, or the clearing agency responsible for clearing and settling transactions in the shares, would be responsible both for operating the market and promulgating the rules and standards governing its activities.¹⁶² The aggregation and lending of small blocks of shares owned by nonprofessional investors (“retail shares”) through a market for borrowing public shares would be a straightforward extension of current securities-lending practices.¹⁶³ Rules of the proposed market would require issuers to schedule “auction dates” in

¹⁶² Limiting a market for borrowing public shares to top-tier exchange-traded firms is preferable to the extent that their shares are more likely to be held by a significant number of institutions and are not as susceptible to manipulation in the private securities lending market in light of their larger capitalization. The application of exchange listing standards and clearing agency rules to such firms would also resolve many technical issues relating to the timing of announcements, record dates, and meeting dates. *See, e.g.*, NYSE, Inc., Listed Company Manual § 4 (2002) (providing rules and policies governing shareholders’ meetings and proxies). Exchange listing standards and trading rules, as well as the rules of clearing agencies, are subject to public notice and comment and approval or disapproval by the SEC. 15 U.S.C. § 78s(b) (2006) (establishing procedures for rule changes by self-regulatory organizations); *see also id.* § 78c(a)(26) (2006) (defining “self-regulatory organization” to include registered securities exchanges and registered clearing agencies).

¹⁶³ The legal infrastructure of the current share lending market could be appropriated wholesale, but without the customer protection regulation necessary to insulate share lenders against counterparty risk. As it is done today, broker-dealers who seek to borrow shares must typically execute written securities lending agreements with their customers (or with banks acting as a lending agent for private client accounts) and must mark collateral to market daily. 17 C.F.R. § 240.15(c)(3) (2007).

connection with specific shareholder actions — such as a vote or tender offer — in advance of the date on which persons eligible to vote are determined under the relevant state’s corporation law (“record date”) or other determinative date for such action.¹⁶⁴ At present, for example, such an auction might take place shortly after an announcement of the shareholder meeting pursuant to stock exchange rules.¹⁶⁵

A shareholder who is indifferent as to how her shares are voted or as to whether her shares are tendered could make her shares eligible for borrowing for purposes of voting or tendering in two ways. First, she could issue a blanket instruction to her broker to that effect (subject to revocation). Second, she may impliedly accept lending of her shares

¹⁶⁴ Holding title on the record date is typically determinative of voting rights. DEL. CODE ANN. tit. 8, § 219(c) (2008) (providing that only registered owners of corporation’s shares as evidenced by corporation’s stock ledger are entitled to vote at shareholder meeting). The vast majority of corporate shares publicly traded in U.S. securities markets, however, are registered in the name of Cede & Co., an affiliate of the DTCC, which is a registered clearing agency for equity securities under section 17A of the Exchange Act, 15 U.S.C. § 78q-1 (2006). As a result, Cede & Co. may seek to exercise the powers of a record owner on behalf of and subject to the instructions of the ultimate beneficial owners under state law. *In re* Appraisal of Transkaryotic Therapies, Inc., No. Civ.A. 1554-CC, 2007 WL 1378345, at *4 (Del. Ch. May 2, 2007) (unpublished opinion) (holding that Cede & Co. was record holder of shares voted against merger and that subsequent changes in beneficial ownership of such shares was irrelevant if Cede & Co. sought to exercise appraisal rights on behalf of current beneficial owners). See generally Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1236-43 (2008) (describing operation of custodial ownership system).

¹⁶⁵ NYSE rules require a minimum of ten days’ notice to the Exchange prior to the record date. NYSE, Inc., Listed Company Manual § 401.02 (1998). SEC Rule 14c-7 requires registrants (those issuers with a class of equity security registered under section 12 of the Exchange Act) to provide broker-dealers, banks, and other entities that exercise fiduciary powers in nominee name or otherwise with a minimum of twenty days’ notice prior to the record date. 17 C.F.R. § 240.14c-7(a)(1)(ii)(B), (a)(3) (2008). Lending votes over a record date well in advance of a meeting would prevent shareholders from recalling shares during a shareholder meeting; one could envision shareholder meetings that are delayed or prolonged, as management keeps polls open in an effort to win shareholder votes. See, e.g., *In re* MONY Group, Inc. S’holder Litig., 853 A.2d 661, 669-70 (Del. Ch. 2004) (describing allegations that MONY executives were tipping certain persons of decision to set new record date for vote on merger inimical to shareholder value, in light of “anomalous increase in trading in MONY shares” by such persons); *State of Wis. Inv. Bd. v. Peerless Sys. Corp.*, No. Civ.A. 17637, 2000 WL 1805376, at *3-5 (Del. Ch. Dec. 4, 2000) (unpublished opinion) (noting that Peerless’ chairman “adjourned [its] Annual Meeting for 30 days without closing the polls on Proposal 2” in order to “solicit votes on Proposal 2, but only from selected shareholders,” without public disclosure of those activities); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661-62 (Del. Ch. 1988) (citing two cases where delaying shareholder meeting was not per se invalid if board had “compelling justification” in interests of corporation).

by failing to deliver instructions to her broker before the applicable deadline. In effect then, the default rule would be that shares are eligible for borrowing unless the shareholder explicitly makes her shares ineligible. While the second option might be currently infeasible because record dates are at present determined before the deadline for submitting voting instructions,¹⁶⁶ legislators and regulators may consider reducing the interval between the record date and the date of a shareholder meeting,¹⁶⁷ or announcing the agenda for a shareholder meeting in advance of the record date.¹⁶⁸ The exchange or clearing agency responsible for operating the market might also run

¹⁶⁶ See discussion of NYSE Rule 452, *infra* Part III.B.3. The deadline for a shareholder to transmit voting instructions to its broker under Rule 451 (and *a fortiori* for a broker to vote shares without instruction on behalf of a customer under Rule 452) typically will fall well after the record date. Compare NYSE, Inc., Rules 451(b)(1), Rule 452 (2002 & 2003), available at http://rules.nyse.com/NYSE/NYSE_Rules (stating instructions due no later than 10 days prior to shareholder meeting), with NYSE, Inc., Listed Company Manual § 401.03 (1998), available at <http://www.nyse.com/Frameset.html?displayPage=http://www.nyse.com/lcm/1078416930447.html?archive=no> (stating recommended record date at least 30 days before shareholder meeting); see also Kahan & Rock, *supra* note 164, at 1257 (noting that institutional shareholders who participate in securities-lending markets may be disenfranchised on matters of importance to them if agenda for meeting is announced after record date).

¹⁶⁷ Kahan & Rock, *supra* note 164, at 1270 (suggesting requirement that “the board announce the date of the meeting and its agenda at same the time as it announces record date” to facilitate both freeze or recall of shares and to permit market for votes to flourish); Nathan, *supra* note 31, at 7-8 (advocating reduction in interval between record and voting dates in effort to match voting rights in “real time” with economic interests). A reduction in the interval between the record date and the date of the shareholder meeting will become increasingly feasible as technology facilitates the electronic delivery of proxy materials. Shareholder Choice Regarding Proxy Materials, Release No. 34-56135, 72 Fed. Reg. 42,222 (Aug. 1, 2007) (adopting amendments to SEC’s proxy rules, *inter alia*, (i) to require issuers to post proxy materials on publicly accessible Internet website and (ii) to require issuers and intermediaries to provide notice of the availability of such materials and to explain how to access them); Internet Availability of Proxy Materials, Exchange Act Release No. 34-55146, 72 Fed. Reg. 4148 (Jan. 29, 2007) (to be codified at 17 C.F.R. pt. 240) (adopting amendments permitting issuers and other persons to furnish proxy materials via notice and Internet access).

¹⁶⁸ Delaware has recently amended its General Corporation Law to permit corporations to separate the record date for determining the stockholders entitled to vote at a meeting from the record date for determining those stockholders entitled to notice of the meeting. DEL. CODE ANN. tit. 8, § 213(a) (2009) (eff. Aug. 1, 2009). For example, if the board of directors were to choose one date for providing notice to shareholders of a shareholder meeting, and select a later date for determining which shareholders were permitted to vote, shareholders would have an interval of time within which to purchase, sell, borrow or lend shares, or to recall loaned shares, in anticipation of the meeting.

a series of auctions over the period during which a tender offer is open, to the extent that an insurgent group seeks to mount a simultaneous tender offer and proxy contest.¹⁶⁹

Unlike traditional securities loans, in which borrowing fees typically reflect the duration of the loan,¹⁷⁰ a borrowing fee would be set by a single-price auction after the close of business on each auction date.¹⁷¹ The loan would last for the duration of the proposed corporate action,¹⁷² with a limited right of recall before the record date for a vote or expiration of a tender offer.¹⁷³ Eligible borrowers would submit competitive bids (i.e., bids to pay a per-share fee up to a specific price, akin to a “limit order”) or noncompetitive bids (i.e., bids to match the fee set by the market, akin to a “market order”).¹⁷⁴ In allocating borrowed shares, the market operator would accept noncompetitive bids first, followed by competitive bids at the highest price through successively lower prices, up to the amount of shares available. The market operator would prorate bids at the lowest accepted price.¹⁷⁵ All

¹⁶⁹ See 17 C.F.R. § 240.14e-2 (2007).

¹⁷⁰ See, e.g., MSLA, *supra* note 114 (providing for loan fees or rebates that are “computed daily” and accrue during pendency of loan or transfer of associated collateral); see also MSLA GUIDANCE NOTES, *supra* note 123, § 5, at 8 (noting that “Section 5.1 sets forth a framework in which the parties can agree upon fees consistent with common practice in the securities lending market”).

¹⁷¹ Cf. 31 C.F.R. § 356.20(c) (2007) (stating rules for accepting bids in Treasury auctions).

¹⁷² Because the interval of time between notice of a shareholder action and the consummation of such action will vary, the duration of the loan must be sufficiently flexible to permit full use of shareholder powers in connection with the proposed action. State law and listing standards may set minimum intervals between the record date and meeting date. DEL. CODE ANN. tit. 8, § 213 (2007) (setting minimum 10-day interval between record date and meeting date, when board elects to fix record date); *id.* §§ 251, 271(a) (2007) (setting minimum 20-day notice requirement for mergers and sales of substantially all assets, respectively); NYSE, Inc., Listed Company Manual § 401.03 (suggesting minimum of 30 days between record date and meeting date fixed by board of directors), available at <http://www.nyse.com/Frameset.html?displayPage=http://www.nyse.com/lcm/1078416930450.html?archive=no>. Delaware laws may also set maximum intervals, see, e.g., DEL. CODE ANN. tit. 8, § 213 (2007) (stating up to 60 days), which may nevertheless be extended by adjournments. See, e.g., *id.* § 213(a) (providing that board of directors “may fix a [new] record date” for adjourned meeting).

¹⁷³ To preserve each shareholder’s right to recall shares for voting before the record date, or for tender while a tender offer is open pursuant to 17 C.F.R. § 240.14d-7 (2007), withdrawals could be effected by prorating withdrawn shares from each borrower’s borrowed shares. To forestall abuses, withdrawal would bar the shareholder from relending the shares during the pendency of the tender offer or until after the vote has been taken.

¹⁷⁴ See LAWRENCE HARRIS, TRADING & EXCHANGES 71-78, 90-91 (2003).

¹⁷⁵ Cf. 31 C.F.R. § 356.20(a) (2007) (describing process by which U.S. Treasury

successful bidders would pay the lowest accepted price per share; that price would reflect the market's assessment of the value of the right to vote or dispose of shares with respect to the particular corporate action.

The market I have described so far would also incorporate various rules to prevent vote-buying abuses. First, the rules governing the market could limit eligible borrowers to entities with an existing, substantial economic interest in the corporation, as a way to ensure that they internalize part of any adverse impact on shareholder wealth.¹⁷⁶ Second, the disclosures applicable to major shareholders and persons soliciting proxies could be extended to borrowed votes.¹⁷⁷ Third, participation in a market for borrowing public shares could be

accepts competitive and noncompetitive bids in auctions of U.S. government securities).

¹⁷⁶ See Clark, *supra* note 9, at 806-07. A threshold may be established as an absolute percentage, or by reference to the top *n*th percentile of the security's holders by size of holdings. Market rules might also establish a minimum holding period as a further means to measure long-term commitment. See, e.g., 17 C.F.R. § 240.14a-8(b)(1) (2008) (establishing one-year holding period for eligibility to submit shareholder proposal). Conversely, to permit share borrowing in connection with a tender offer, amendments would be necessary to SEC Rule 14e-4, which prevents persons or groups of persons from tendering an amount of shares that exceeds their "net long position" in the security. See *id.* § 240.14e-4(b)(1) (2007). The rule was designed, in the context of "partial tender offers," to prevent persons with access to borrowable shares from diminishing the risk of prorated acceptance of their tendered shares by "secur[ing] acceptance of a disproportionately larger number of the securities owned by them than could be secured by other persons who tendered only securities that they owned." Prohibited Transactions in Connection with Partial Tender Offers, Exchange Act Release No. 28660, 55 Fed. Reg. 50,316, 50,316-17 (Dec. 6, 1990).

¹⁷⁷ For example, section 13(d) of the Exchange Act requires certain persons "acquiring more than five per centum of certain classes of securities" to file certain disclosures with the SEC, 15 U.S.C. § 78m(d) (2006), while Exchange Act Rule 14a-3 requires persons soliciting proxies to furnish and publicly file a proxy statement containing certain disclosures. Cf. 17 C.F.R. § 240.14a-3 (2007). Scholars have commented on the extent to which such disclosure requirements adequately reach acquisition of voting power through borrowed shares or the physical settlement of derivatives transactions, and whether extensions of such rules to include synthetic positions are possible. See Briggs, *supra* note 8, at 706-08 (noting that, despite technical omission of certain disclosures regarding synthetic positions and counterparty ownership, "well-founded fear" of disclosure drafters has to date deterred material omissions in hedge fund proxy contests); Hu & Black, *supra* note 5, at 875-76, 881 (describing technical omissions in definition of "beneficial ownership" under existing disclosure schedules that may not capture "morphable" ownership or share-lending transactions and proposing "integrated ownership disclosure" scheme). One complication is that section 3A of the Exchange Act currently excludes any "security-based swap agreement" from the definition of a "security" and generally prohibits the Commission from "promulgating, interpreting or enforcing rules" with respect thereto (except as provided in § 16(a)). 15 U.S.C. § 78c-1 (2006); see also *supra* note 107. An exchange, of course, would not be bound by such a limitation.

conditioned upon preregistration and a declaration of the participant's present voting or tendering intentions with respect to the impending shareholder action.¹⁷⁸

If the timeframe for bidding is sufficiently open (such as during a tender offer), transparent bidding could provide greater information to individual shareholders about whether to make shares available for lending or to exercise their rights as shareholders directly.¹⁷⁹ For example, exchange or clearing agency rules could require potential vote borrowers in a market for borrowing public shares to discuss in public filings the expected benefits shareholders individually or collectively might receive from specific business decisions they would implement. These public filings would require potential vote borrowers to reveal the amount they would likely bid for shareholder votes, in a manner similar to solicitations in connection with tender offers. Also, similar to Regulation FD's fair disclosure requirement, exchange or clearing agency rules might require private disclosures of bidding thresholds to be disseminated promptly to the public in order to apprise other potential share borrowers of the range of bids they might expect to compete against. Failure to observe such rules might trigger not only sanctions under exchange rules (e.g., a prohibition against participating in share borrowing markets for a specified period of time) but also result in an injunction against the voting of shares or the invalidation of a shareholder vote in the event of fraud.¹⁸⁰

A hypothetical market for borrowing public shares, as described above, would represent a fundamental change in the way we think about shareholder voting. But even on a purely practical level, it might mitigate some of the inefficiencies inherent in conducting a vote among diffuse public shareholders through our current share holding system. While designing such a market would pose substantial

¹⁷⁸ See, e.g., 17 C.F.R. § 240.13d-101 item 4 (2008) (requiring certain persons acquiring securities of registered issuer subject to section 13(d) of Exchange Act to “[s]tate the purpose or purposes of the acquisition” and to “[d]escribe any plans or proposals which the reporting persons may have which relate to” certain transactions involving issuer).

¹⁷⁹ Cf. Bebchuk & Kahan, *supra* note 41, at 1081 (stating takeovers entail less information costs because investors can focus on price, rather than information).

¹⁸⁰ See, e.g., DEL. CODE ANN. tit. 8, § 225 (2007) (providing that Court of Chancery may “hear and determine the validity” of any election or result of any vote of stockholders upon other matters); *Macht v. Merchs. Mortgage & Credit Co.*, 194 A. 19, 23 (Del. Ch. 1937) (issuing injunction against voting shares “where a clearly identifiable thread of inequitable purpose runs through the fabric of [defendant’s] interwoven acts”); *Hall v. Isaacs*, 146 A.2d 602, 614 (Del. Ch. 1958) (declining to accept results of shareholder vote because of impermissible purchases of votes and appointing master to hold new election), *aff’d*, 163 A.2d 288 (Del. 1960).

challenges, I believe that legislatures, regulators and courts could compensate for these through changes in regulatory policy and greater judicial review of suspect transactions. In the remainder of this Part, I consider the practical benefits and design challenges posed by the hypothetical (in subparts B and C, respectively). Part IV then addresses the implications such a market would have for the role of shareholders in corporate governance.

B. A Market for Borrowing Public Shares May Mitigate Inefficiencies in Shareholder Voting

Facilitating empty voting by committed shareholders may quell some of the objections to the use of the shareholder voting as a tool of corporate governance that stem from the inefficiencies of collective shareholder action. One of the reasons why empty voting by activist shareholders is problematic, as discussed above, is because voter participation in public corporate decision making is highly erratic. While it may be rational for individual shareholders to remain apathetic, collective decision making requires leadership and commitment by professional, long-term shareholders. This is especially true for shareholders who wish to exercise greater influence in routine corporate decision making (e.g., outside the context of mergers or other fundamental transactions) without dealing with the hassles of concentrated ownership.

A market for borrowing public shares could improve shareholder decision making, for example, in three ways. First, it can help secure the voting quorums and voting majorities necessary to make shareholder meetings more effective tools of corporate governance, without necessarily dismantling the tripwires and other defensive tactics used to limit aggregation of voting power by one or more shareholders. Second, the ability of professional shareholders to devote relatively more attention to routine matters would make it more feasible to “unbundle” corporate decision making and thereby allow shareholders to ratify a broader range of transactions. Third, a market for borrowing public shares eliminates the need to confer proxy authority and voting discretion on broker-dealers and securities intermediaries who are currently responsible for collecting and transmitting voting instructions under the Exchange Act.

1. Navigating increased voting thresholds and decreased tripwires.

A market for borrowing public shares can help secure the voting quorums and voting majorities necessary to make shareholder meetings

more effective tools of corporate governance, without necessarily dismantling the tripwires and other defensive tactics used to limit aggregation of voting power by one or more shareholders. From the perspective of a corporation law drafter, voting thresholds might ideally be set in a manner that minimizes incentives to vote strategically.¹⁸¹ For example, higher thresholds raise the problem that minority shareholders may hold out to get a better deal than other shareholders,¹⁸² while lower thresholds may facilitate effective challenges to control by incumbents if other shareholders do not actively participate in the voting process. From the perspective of managers, however, setting voting thresholds and tripwires strategically is an effective defensive tactic against hostile acquisitions.¹⁸³ As a result, commentators often debate the appropriate thresholds for certain fundamental transactions with these incentives in mind.¹⁸⁴

Voting toeholds or tripwires — the concentration of ownership that triggers certain statutory or regulatory requirements¹⁸⁵ or corporate

¹⁸¹ See Zohar Goshen, *Voting (Insincerely) in Corporate Law*, 2 THEORETICAL INQUIRIES L. 815, 821 (2001) (discussing how level of consent required in transaction subject to vote affects natural strategic voting).

¹⁸² See *infra* note 189.

¹⁸³ See, e.g., Brett W. King, *The Use of Supermajority Voting Rules in Corporate America: Majority Rule, Corporate Legitimacy, and Minority Shareholder Protection*, 21 DEL. J. CORP. L. 895, 918-23 (1996) (summarizing debate over whether supervoting majority rules as antitakeover mechanisms protect minority shareholders or entrench management).

¹⁸⁴ See, e.g., Black & Kraakman, *supra* note 15, at 1978 (advocating two-thirds majority threshold for fundamental transactions in Russia, given weak market controls and weak public enforcement over insiders); cf. David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 489 (1992) (arguing for simple majority in Chapter 11 context, even though some argue higher two-thirds majority threshold is necessary to avoid quick confirmation of promanagement reorganization plan).

¹⁸⁵ The Williams Act establishes a 5% initial tripwire for disclosure of shareholdings in a class of equity securities registered under section 12 of the Exchange Act. 15 U.S.C. § 78m(d) (2006). The Exchange Act establishes a 10% tripwire for disclosures by principal shareholders regarding their beneficial ownership and related matters with respect to shares in a class of equity securities registered under section 12 of the Exchange Act. *Id.* § 78p(a)(1) (2006); see also 17 C.F.R. § 240.16a-3 (2007) (setting forth reporting requirements for persons required to file statements pursuant to section 16(a)(1) of the Exchange Act). Some states have adopted statutes that may limit a controlling shareholder's ability to vote acquired "control shares" on certain matters beyond certain tripwires as well. See, e.g., DEL. CODE ANN. tit. 8, § 203(a)(2), (c)(5) (2007) (establishing moratorium on business combinations between corporation and any holder of 15% or more of its outstanding voting stock unless certain conditions are met); MINN. STAT. ANN. §§ 302A.011, subdiv. 38, 302A.671, subdivs. 2(d), 4a (West 2007) (requiring shareholder approval

actions¹⁸⁶ — follow a similar dynamic. Tripwires are set low enough to provide notice of concentration of shares before a hostile acquisition attempt takes place. If tripwires are set too low, however, they may reduce liquidity and share prices in securities markets if a significant number of shareholders are unable to increase their holdings when stock prices periodically slide.¹⁸⁷ To the extent that a group of acquiring persons or reporting persons acting in concert can activate a tripwire, tripwires have the further effect of discouraging collective action.¹⁸⁸ Moreover, lower voting tripwires may increase the number of individual shareholders who must vote in favor of a particular corporate matter to garner the minimum number of required votes.

Both increases in voting thresholds and decreases in voting tripwires are likely to operate as a one-way ratchet. Managers or legislators, for example, may raise thresholds or reduce tripwires during periods of high takeover activity, for example, but then do not necessarily readjust them to prior levels once the threat of hostile acquisition abates. While there may be theoretical limits on the degree to which voting thresholds may be raised,¹⁸⁹ or voting tripwires may be

prior to exercise of voting rights in shares acquired in certain “control share acquisition” transactions that confer voting power in three specified ranges); 15 PA. CONS. STAT. §§ 2562, 2564(a) (2007) (providing that “control shares” acquired in “control share acquisitions” that confer voting power in three specified ranges shall not have voting rights unless restored by shareholder vote).

¹⁸⁶ Recent studies have observed that the average acquisition threshold for poison pill plans is approximately 15%, although some firms have thresholds as low as 10%. See, e.g., William J. Carney & Leonard A. Silverstein, *The Illusory Protections of the Poison Pill*, 79 NOTRE DAME L. REV. 179, 184 n.18 (2003) (citing various studies from late 1990s).

¹⁸⁷ See, e.g., *Lotus Development Raises Trigger Point For Poison-Pill Plan*, WALL ST. J., Sept. 18, 1991, at B4 (reporting that corporation, “citing recent interest by institutional investors in expanding their ownership, amended its poison-pill plan by increasing the trigger threshold to 15% ownership of its common stock from 10%”).

¹⁸⁸ See 17 C.F.R. § 240.13d-5(b)(1) (2007) (providing that “[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership for purposes of section 13(d)” of the Exchange Act).

¹⁸⁹ Delaware instructively sets an 85% threshold for purposes of waiving the three-year moratorium on business combinations with affiliates, DEL. CODE ANN. tit. 8, § 203(a)(2) (2007), and a 90% threshold for purposes of effecting a short-form merger transaction. *Id.* § 253(a) (2007). Recent Delaware case law encourages bidders in hostile tender offers to acquire significantly higher percentages of shares to avoid liability for breach of a controlling shareholder’s fiduciary duty to minority shareholders. See, e.g., *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 243 (Del. 2001) (holding that execution of short-form merger under Delaware General Corporation Law section 253 following tender offer is not subject to review for “entire

reduced,¹⁹⁰ the effect of such one-way movements is to exacerbate existing collective action and hold-out problems. For example, the Second Circuit,¹⁹¹ the SEC,¹⁹² and the Delaware legislature¹⁹³ have each

fairness”); *In re Siliconix S’holders Litig.*, No. Civ. A. 18700, 2001 WL 716787, at *6 (Del. Ch. June 21, 2001) (unpublished opinion) (holding that actions of nonaffiliated bidder in tender offer are not subject to “entire fairness” review “unless actual coercion or disclosure violations are shown”).

¹⁹⁰ For practical purposes, the 5% tripwire under the Williams Act is likely to be the baseline for all tripwires that may be triggered by nonpublic activity (e.g., purchases of securities by an acquisition group) to the extent that issuers or other affected parties may not be able to police ownership at lower levels. *Cf.* *GAF Corp. v. Milstein*, 453 F.2d 709, 720-21 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972) (noting that “section 13(d) was intended to alert investors to potential changes in corporate control” and that injunctive relief is available in private actions under Act because “[s]tockholders are generally unaware of the necessary background information to judge the truth or falsity” of inaccurate statements); *see also* *Portsmouth Square, Inc. v. S’holders Protective Comm.*, 770 F.2d 866, 871 n.8 (9th Cir. 1985) (noting that “[e]very court of appeals but one that has been faced with the question has held that an issuer corporation has standing to seek injunctive relief under section 13(d)”). States may nevertheless seek to employ (and enforce) lower thresholds for various purposes. The Ohio General Corporation Law, for example, prohibits “any person” from voting additional shares acquired for value “during the period beginning with the date of the first public disclosure of a proposal for, or expression of interest in, a control share acquisition of the issuing public corporation” — regardless of any affiliation or association with the person proposing a control share acquisition — if “(i) [t]he aggregate consideration paid or given by the person who acquired the shares, and any other persons acting in concert with the person, for all such shares exceeds . . . [\$250,000]; [or] (ii) [t]he number of shares acquired by the person who acquired the shares, and any other persons acting in concert with the person, exceeds . . . [0.5%] of the outstanding shares of the corporation entitled to vote in the election of directors.” OHIO REV. CODE ANN. § 1701.01(CC)(d) (West 2008) (defining “interested shares” to include such persons); *see also id.* § 1701.831(E)(1) (2008) (requiring shareholder vote, excluding “interested shares,” to determine whether person may make proposed control share acquisition).

¹⁹¹ *AFSCME v. Am. Int’l Group, Inc.*, 462 F.3d 121, 123 (2d Cir. 2005) (holding that “a shareholder proposal that seeks to amend the corporate bylaws to establish a procedure by which shareholder-nominated candidates may be included on the corporate ballot does not relate to an election within the meaning of . . . [Rule 14a-8(i)(8)] and therefore cannot be excluded from corporate proxy materials under that regulation”).

¹⁹² *Shareholder Proposals Relating to the Election of Directors*, Exchange Act Release No. 56914, 72 Fed. Reg. 70,450, 70,450 (Dec. 11, 2007) (to be codified at 17 C.F.R. pt. 240) (adopting amendment to Rule 14a-8 codifying SEC interpretation that such proposals are excluded and overruling Second Circuit’s interpretation in *AFSCME v. AIG*).

¹⁹³ Delaware, for example, has entered the fray by taking the unusual step of shielding from directorial amendment a bylaw amendment requiring that directors be elected by majority vote. DEL. CODE ANN. tit. 8, § 216 (2007) (providing that “[a] bylaw amendment adopted by stockholders which specifies the votes that shall be

had to grapple in different ways with the question of whether to establish majority voting as the norm for board elections. To do so would give teeth to “just vote no” campaigns to eliminate underperforming board members.¹⁹⁴ Such efforts run the risk that remaining directors would fill any vacancies if incumbents who are not reelected are forced to resign without the election of a successor by majority vote.¹⁹⁵

A market for borrowing public shares can help mitigate collective action and hold-out problems. Committed shareholders can easily muster quorums and voting majorities if they can borrow and vote shares; as a result, managers will find it easier to effect beneficial transactions that require shareholder participation. Moreover, committed shareholders can meet these thresholds without acquiring, individually or in concert, sufficient shares to trigger tripwires, as long as they are allowed to communicate their voting intentions and the reasons behind them. Similarly, a significant minority shareholder will find it more difficult to exercise hold-out power to extract unreasonable concessions if other shareholders can augment their voting power to meet the applicable threshold. For routine or noncontroversial matters, a market for borrowing public shares can thus reduce some of the uncertainty and cost of soliciting shareholder votes.

2. Reducing transaction costs of unbundled decision making.

The ability of professional shareholders to devote relatively more attention to routine matters would make it more feasible for shareholders to vote for or against particular business objectives individually, rather than elect a slate of directors once a year that most closely reflects its view on a “bundle” of business matters.

necessary for the election of directors shall not be further amended or repealed by the board of directors”). Under the default rules in many states, directors are elected to the board by plurality vote. See, e.g., *id.* § 216(3) (providing that, in absence of any contrary specification in certificate of incorporation or bylaws, directors are elected by plurality vote); N.Y. BUS. CORP. LAW §§ 614(a), 617(b) (McKinney 2007) (same); see also MODEL BUS. CORP. ACT § 7.28(a) (2005) (same).

¹⁹⁴ See Grundfest, *supra* note 1, at 926-36.

¹⁹⁵ See William K. Sjostrom, Jr., *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 487-88 (2007) (concluding that majority voting provisions in practice are “smoke and mirrors” because “directors are ultimately selected by the existing board regardless of how shareholders vote”). In connection with the amendment to section 216 discussed in note 193 above, the Delaware legislature recently amended the Delaware General Corporation Law to make binding a director’s resignation from the board if she is not reelected by a majority vote, regardless of whether a successor is voted in. DEL. CODE ANN. tit. 8, § 141(b) (2007).

Historically, shareholders have exercised their voting power only in limited circumstances. Generally, to the extent that shareholders possessed specific views on transactions being considered by the corporation, the only way to advance their agenda was through the annual election of directors sympathetic to those views. Accordingly, shareholders necessarily “bundled” all such considerations into a single annual vote for a particular slate of directors. In recent years, regulators have expanded the range of matters subject to shareholder ratification,¹⁹⁶ and shareholder activists have sought to broaden the scope of matters put to a shareholder vote.¹⁹⁷ While these proposals allow shareholders to exercise greater control over the corporation’s agenda (and thus reduce the cost of selectively screening, monitoring, and if necessary, challenging, their elected directors),¹⁹⁸ they can decrease the efficacy of shareholder voting in the absence of a mechanism for promoting collective action by informed investors.

In theory, the discounted present value of the right to vote a share on each successive matter before the corporation’s shareholders for the foreseeable future should equal the “voting” premium. Unbundling, therefore, raises the costs of decision making by raising the transaction cost of exercising the right in individual votes.¹⁹⁹ Absent a mechanism

¹⁹⁶ For example, both the New York Stock Exchange and the NASDAQ Stock Market have amended their corporate governance requirements for listed companies to require ratification of board decisions respecting executive and director equity-compensation plans, and material changes thereto. NYSE, Inc., Listed Company Manual § 303A.08 (2004) (requiring shareholder approval of equity compensation plans); NASDAQ, Inc., Stock Market Rule IM-4350-5, at 29 (2004), available at <http://www.nasdaq.com/about/CorporateGovernance.pdf>.

¹⁹⁷ See *supra* note 52.

¹⁹⁸ The alternative — threatening to oust incumbent boards in the long term for deviating from the shareholders’ will — may not be as effective because the shareholder base changes over time and a rational signal cannot be sent that shareholders will muster the requisite “toughness.” Bebchuk, *supra* note 1, at 858. *But see* K.A.D. Camara, *Shareholder Voting and the Bundling Problem in Corporate Law*, 2004 Wis. L. REV. 1425, 1457 (arguing that “bundling” problem is “illusory” and that shareholders “should oust deviant directors . . . so long as the benefit of having a faithful board exceeds the one-time . . . cost of ousting a particular incumbent board”).

¹⁹⁹ Commentators advocating unbundling of shareholder voting also stress the need for partial reimbursement in proxy contests that do not involve a change in the composition of the board because reimbursement is not likely to be available under current law for a successful dissident group that does not take control of the board. See Bebchuk & Kahan, *supra* note 41, at 1108-10 (describing conditions under which challengers in proxy contest are reimbursed); see also *id.* at 1113-15 (discussing “theoretical and empirical arguments” for why providing some compensation to challengers is “more likely to lead to more efficient entry decisions” than providing no compensation at all). Bebchuk has proposed, for example, mandatory reimbursement of dissents in proxy contests if they succeed in garnering 33% of the vote. Bebchuk,

for pricing such voting rights, raising the transaction cost of exercising shareholder voting rights may further encourage managers and insurgents to induce rationally apathetic shareholders to alienate their voting interest in exchange for more tangible consideration.²⁰⁰ The relative certainty created by a vote-buying mechanism also might help mitigate unfavorable distortion of management's incentives if management cannot accurately predict shareholder sentiment.²⁰¹

3. Eliminating the uncertainty of proxy voting and discretionary voting.

A market for borrowing public shares also eliminates the need to confer proxy authority and voting discretion on broker-dealers and securities intermediaries who are currently responsible for collecting and transmitting voting instructions under the Exchange Act. Under the current system of proxy voting, broker-dealers and banks carrying accounts for shareholders are responsible for identifying, transmitting voting materials to, and collecting voting instructions from the beneficial owners of the shares carried in "street" name.²⁰² This system can break down in any of several, well-documented ways.²⁰³ As a result, shares often go unvoted and votes actually cast are lost

supra note 31, at 699. Opposing commentators have argued that mandatory reimbursement would only increase the incentive to bring spurious challenges. See, e.g., Lipton & Savitt, *supra* note 44, at 745 & n.38 (noting that "fractional reduction in the cost of an economy-wide proxy program" under Bebchuk's proposal "might make frequent challenges net beneficial to a special interest").

²⁰⁰ See Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19C-4 and to Professor Gilson*, 89 COLUM. L. REV. 979, 1002 (1989) (noting tendency of shareholders to assent to dual class recapitalizations because "shareholder votes remain utterly irrelevant for an indeterminate period of time" until takeover event and are therefore difficult to price); see also Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1577-78 (1998) (describing use of dividends or cash incentives to effect dual class recapitalizations).

²⁰¹ Ayres & Cramton, *supra* note 1, at 1037 (arguing that too much interference "distort[s]" management's incentives to short-term, while too little interference results in "deficient" managerial shirking); Lipton & Savitt, *supra* note 44, at 743, 746 (noting that proxy contests can result in significant "waste and disruption," even when they ultimately have no support, and can ultimately lead management to take actions that appeal to short-term shareholder interest rather than long-term capital appreciation).

²⁰² See 17 C.F.R. §§ 240.14b-1, .14b-2 (2007) (setting forth obligation of registered brokers and dealers and banks, respectively, in connection with prompt forwarding of proxy communications to beneficial owners).

²⁰³ See Kahan & Rock, *supra* note 164, at 1268 (providing chart summarizing various "pathologies" and their effect on corporate voting).

altogether.²⁰⁴ A share-lending market might well reduce these problems because voting rights will be concentrated in shareholders who actively seek to participate in a shareholder meeting. Such a market, moreover, might reduce the likelihood of mistake in the process of counting and verifying shareholder votes, to the extent that complexity is tied to the number of participating shareholders, rather than the number of shares each shareholder votes.²⁰⁵

A share borrowing market could also provide the impetus to phase out brokers' discretionary voting power. New York Stock Exchange ("NYSE") member organizations currently have the discretion to vote proxies with respect to shares held in customer accounts on matters that are "routine" if instructions have not been received from the beneficial owner within ten days of the shareholder meeting.²⁰⁶ Among other possibilities, brokers may allocate these votes to customers whose shares they have lent out to others, if they have not prorated loaned shares among customer accounts.²⁰⁷

To accommodate the increased use of "withhold" or "just vote no" campaigns, the NYSE has proposed to exclude "uncontested" board elections from the "routine" matters.²⁰⁸ This creates the possibility

²⁰⁴ See generally *id.* at 1249-53 (discussing these pathologies).

²⁰⁵ See generally *id.* at 1251-55 (same).

²⁰⁶ Under NYSE Rule 452, a NYSE member organization may give a proxy to vote stock held for the account of a customer on routine matters, provided that it has transmitted proxy soliciting material to the beneficial owner (or her designated investment adviser) and has not received voting instructions by the date specified under NYSE Rule 451 (the tenth day preceding the meeting date). NYSE, Inc., Rules 451(b), 452.10 (2002 & 1994). Matters not deemed routine include proposals that are the subject of a "counter-solicitation" or proxy-contest, that relate to a merger or consolidation with an unaffiliated company, or that authorize modifications to the rights and powers of shares. NYSE, Inc., Rule 452.11 (2003).

²⁰⁷ See, e.g., Kahan & Rock, *supra* note 164, at 1258-63 (describing how broker-dealers reconcile "overvoting" problems with DTCC caused by receipt of voting instructions from customers whose shares have been lent out). A broker-dealer may generally lend any "margin securities" held for the account of its customers without requiring a specific amount of collateral. See Board Interpretation of July 1940, Fed. Res. Reg. Serv. § 5-471(R) (1940); see also 17 C.F.R. § 240.15c3-1(c)(2)(iv)(B) (2007) (requiring adjustment to net capital to reflect "the market value of stock loaned in excess of the value of any collateral received therefor"); RECHLIN, *supra* note 116, § 7:14, at 7-16 & n.1. "Fully paid" or "excess margin securities" held in a customer account (as defined in 17 C.F.R. § 240.15c3-3(a)(3), (5) (2007)) may only be loaned under the SEC's Customer Protection Rule pursuant to a written agreement with the customer and subject to 100% collateralization marked-to-market daily by cash or cash-equivalent securities. 17 C.F.R. § 240.15c3-3(b)(3).

²⁰⁸ NYSE Group, Inc., Self-Regulatory Organizations: Notice of Filing of Proposed Rule Change by the New York Stock Exchange LLC Relating to NYSE Rule 452 and Listed Company Manual Section 402.08, File No. SR-NYSE-2006-92, at 4 (October 24,

that shareholders will execute insufficient proxies to constitute a quorum or to elect a board with a voting majority.²⁰⁹ Some brokers have implemented “proportional voting” — under which brokers vote discretionary shares in proportion to a representative sampling of a retail shareholder vote — with the expectation that NYSE members might adopt such a system as part of the NYSE’s proposal.²¹⁰

If proportional voting proposals effectively intensify the preferences of engaged shareholders, shareholder votes could become increasingly unpredictable. In particular, if brokers vote discretionary shares in accordance with the voting preferences of their own retail accounts, the outcome of shareholder votes would turn on the composition of each broker’s customer base, rather than the intensity of its voting interest.²¹¹ In such circumstances, allowing engaged shareholders to

2006), available at [http://apps.nyse.com/commdata/pub19b4.nsf/docs/A2CC4C68070815068525721100589E90/\\$FILE/NYSE-2006-92.pdf](http://apps.nyse.com/commdata/pub19b4.nsf/docs/A2CC4C68070815068525721100589E90/$FILE/NYSE-2006-92.pdf); see also Whitehouse, *supra* note 79 (discussing impact of brokers’ discretionary votes in “withhold” campaign directed against 10 of 11 members of Home Depot’s board).

²⁰⁹ Lowering quorum requirements may help individual corporations resolve this problem. See, e.g., DEL. CODE ANN. tit 8, § 216 (2007) (permitting corporation to reduce quorum for shareholder meetings to no less than one third of shares entitled to vote). This comes at the expense of allowing leveraged shareholders to acquire proportionately greater voting power at a shareholder meeting. For example, a group of hedge funds holding 25% of the voting interest of an issuer would have the equivalent of 50% of the shareholders’ collective voting power if only 50% of shareholders participate at a shareholders’ meeting.

²¹⁰ NYSE *Proposes to Eliminate Broker Discretionary Voting for Directors*, Broker-Dealer Compliance Rep. (BNA) Vol. 9, No. 23 (June 6, 2007) (describing discretionary voting practices of Charles Schwab & Co., Merrill Lynch, Goldman Sachs, and Morgan Stanley). The Securities Industry and Financial Markets Association (“SIFMA”) has been working to refine the process by which such a representative sampling is obtained. For example, a broker might vote shares held for customer accounts for or against a particular candidate or proposal (i) in proportion to the percentage of “all votes cast at an annual meeting” in favor or against the item in question, (ii) in proportion to the percentage of all votes “cast by all beneficial owners at all brokers” in favor or against the item in question (but excluding votes cast directly by registered stockholders), or (iii) in proportion to the percentage of votes to be cast on behalf of beneficial owners whose shares are held by such broker pursuant to their voting instructions. *Id.*

²¹¹ Brokers A and B each hold 100,000 shares for the account of retail customers. Assume that 15% of Broker A’s customers vote for an executive compensation plan, 10% vote against, and 75% do not vote. Assume further that 30% of Broker B’s customers vote for the plan, 35% vote against, and 35% do not vote. Brokers A and B, in a system of proportional voting based on the preferences of each broker’s own customers, would cast a total of 113,846 votes for the plan (60,000 shares held by Broker A and 53,846 shares held by Broker B) and 86,154 against (40,000 shares held by Broker A and 46,154 held by Broker B), even though the shares actually voted were evenly split on the proposal.

intensify their preferences through a vote buying scheme would seem to be preferable to scaling recorded preferences of similarly situated shareholders.

Whatever practical benefits a hypothetical market for borrowing public shares may bring to the current shareholder voting process, it also raises several logistical challenges. For example, such a market should ideally function seamlessly with existing proxy voting and share lending mechanisms. Institutions would also have to be confident that their willingness to participate in such markets would not come at undue cost, either for individual votes or for a series of votes necessary to deter determined looters. Finally, to the extent that officers and directors would have an incentive to manipulate such markets to produce favorable outcomes, policymakers would need to consider the extent to which such persons can participate in vote borrowing markets. I consider these specific issues in the next subpart.

C. Designing a Market for Borrowing Public Shares Poses Substantial, but Surmountable, Challenges

A market for borrowing public shares, of course, would raise many pragmatic issues for regulators and other policymakers. Among the most obvious are: (1) whether a share borrowing market would undermine the existing proxy voting scheme; (2) whether retail voting rights are priceable; (3) whether institutional investors would in fact protect efficient incumbents from repeated attack from insurgents; (4) whether a public share borrowing market would impact the private market for share borrowing; and, finally, (5) whether management should be able to borrow shares to cast votes in their own favor. Some of these would require shifts in legislative policy and heightened judicial review. None of these should present so challenging an obstacle as to rule out the creation of such a market, particularly in the context of the existing market for “empty votes.”

1. Would a share borrowing market undermine proxy voting?

The hypothetical market outlined in this Article is based on the model of private securities lending markets, rather than traditional proxy solicitation. In part, this is because vote borrowers may wish to exercise both voting and investment power with respect to borrowed shares, such as during a proxy contest coupled with a tender offer. Reliance on the existing framework for securities lending would also provide significant legal certainty to and industry familiarity with the ground rules for a market for borrowing public shares. Borrowing

shares may be preferable to buying proxies because it avoids obstacles to the use of proxies that may arise under state law, such as the validity of “irrevocable” proxies.²¹² To the extent that share lending has traditionally required borrowers to be able to pass title to innocent third-party purchasers,²¹³ a stronger legal case exists for distinguishing such transactions from the purchase of proxies.

Share borrowing does, however, threaten the existing scheme of proxy regulation. If proxy solicitation is no longer necessary to obtain shareholder approval of board nominees or other critical shareholder action, there is the threat that publicly disclosed proxy solicitations could be supplanted by greater “back-room” negotiation that is not subject to the disclosure requirements and injunctive remedies available under section 14(a) of the Exchange Act.²¹⁴ This concern is addressed to a degree by the disclosure requirements associated with participation in a share borrowing market, but will only be as effective as the enforcing exchange or remedies available under state law to annul shareholder actions taken without adequate public disclosure.

There is one critical difference between vote borrowing and proxy-voting: while items traditionally disclosed in proxy statements must be disclosed in sufficient detail to be ripe for a shareholder vote, share

²¹² See, e.g., RESTATEMENT (THIRD) OF AGENCY § 3.12 cmt. d (2006) (discussing evolution of judicial views on the propriety of enforcing “irrevocable” proxies).

²¹³ See *supra* notes 121-23 and accompanying text (describing operation of securities lending markets). Another, perhaps equally important, consideration is that the centralized federal regulation of short selling, and of the clearance and settlement mechanisms through which securities loans take place more generally, may preempt or preclude state and other federal legislation that would subject the operation of a share borrowing market to duplicative or inconsistent regulation. See, e.g., *Whistler Inv., Inc. v. DTCC*, 539 F.3d 1159, 116-68 (2008) (holding that SEC regulation of clearing agencies and national market system preempted plaintiff’s state law claims regarding DTCC’s stock borrowing program); *Pet Quarters, Inc. v. DTCC*, 545 F. Supp. 2d 845, 853 (E.D. Ark. 2008) (same); *Nanopierce Tech., Inc. v. DTCC*, 168 P.3d 73, 85-86 (Nev. 2007) (same), *cert. denied sub nom. Vyta Corp. v. DTCC*, 128 S. Ct. 2428 (2008); see also *In re Short Sale Antitrust Litig.*, 527 F. Supp. 2d 253, 259-61 (S.D.N.Y. 2007) (holding that plaintiff’s federal antitrust claims against various brokerage firms engaged in alleged price fixing and other wrongful conduct with respect to borrowing and purported borrowing of securities in connection with short sale transactions were precluded by virtue of SEC’s exercise of its legal authority to regulate short selling) (*citing Credit Suisse Secs. (USA) LLC v. Billing*, 127 S. Ct. 2383 (2007)).

²¹⁴ See Regulation of Communications Among Securityholders, Exchange Act Release No. 30849, 57 Fed. Reg. 29564-01, 29565 (July 2, 1992) (comments of Business Roundtable) (noting “disturbing trend toward determination outcome of shareholder voting by secret back-room lobbying of and negotiations with institutional investors”); Anabtawi, *supra* note 1, at 596 (suggesting that direct negotiations may equally result in bargaining for private interests rather than for shareholder wealth maximization).

borrowing would permit borrowing shareholders some flexibility to negotiate the ultimate resolution on which shareholders vote. Such a market would create the opportunity for a critical group of shareholders to negotiate the terms of a proposed bylaw initiative or other shareholder resolution (including resolutions that might require prior board approval) independent of the timetable for distributing proxy materials.

2. Are retail voting rights priceable?

For a share borrowing market to function properly, participants must be able to value retail voting rights. Some studies suggest that markets are able to gauge the value of voting rights as distinct from other rights appurtenant to shares.²¹⁵ More importantly, to the extent that vote borrowing focuses on individual transactions, rather than the present value of all vote borrowing opportunities, the “value” of voting rights should mirror the value of particular transactions or expected business decisions for which the vote borrowing is effected.

From the perspective of retail shareholders, however, a market for borrowing public shares would appear to yield little direct economic benefit. Commentators have suggested that votes in a market for borrowing public shares would “sell” for an infinitesimally small price.²¹⁶ Unless there were a compelling reason to believe that the outcome of a vote would be predictable, all rational short-term shareholders would be likely to lend shares, rather than hold and vote shares, to avoid suffering an uncompensated loss if the transaction were approved over their opposition.²¹⁷ In addition, in most cases, the bidding should be uncontested. Even if both insurgents and incumbents intended to bid, once interested bidders have identified themselves and evaluated each other’s interest in participating, the

²¹⁵ See, e.g., Robert F. Reilly, *Quantifying the Valuation Discount for Lack of Voting Rights and Premium for Voting Rights*, 24 AM. BANKR. INST. J. 54, 55 n.1 (2005) (citing various studies indicating that stock market price for publicly traded voting common shares is generally greater than stock market price for comparable publicly traded nonvoting common shares).

²¹⁶ André, *supra* note 9, at 592 n.246; Blair et al., *supra* note 90, at 427-32, 441 (hypothesizing effects of allowing sale of institutional voting rights in context of contest for control); Christoffersen et al., *supra* note 30, at 2913; Easterbrook & Fischel, *supra* note 5, at 411; Goshen, *supra* note 5, at 741 (coerced sale is unavoidable).

²¹⁷ Goshen, *supra* note 181, at 825.

parties most likely to lose might refrain from bidding in order to avoid paying borrowing fees.²¹⁸

But the failure of the market to generate revenue for retail investors is not the appropriate test of its effectiveness.²¹⁹ Indeed, it may well be necessary, as discussed in the next subpart, to minimize the cost and frequency of participation in a market for borrowing public shares in order to sustain a long-term equilibrium in the balance of voting power among institutional shareholders, outsiders, and insiders.

3. Would institutional shareholders protect good incumbents against repeated attacks by determined looters?

The proposed market would permit vote borrowing on specific record dates, rather than over a period of time. Nevertheless one could imagine a vote-buying market structured in a manner similar to futures contracts or long-term stock loans, in which voting interest is locked up for extended periods of time. Long-term borrowings, however, diminish flexibility in creating coalitions of voting interest; by contrast, short-term borrowing over individual record dates or tender offers would permit different constituencies to finance vote borrowing as necessary to achieve collective objectives.²²⁰ Moreover, tying vote borrowing to specific record dates eliminates the incentive for management to schedule matters for a shareholder vote once particular voting blocs are locked in.

On the other hand, institutions will be deterred from participating in a share borrowing market if an issuer's management is subjected to repeated challenges by outsiders that cannot be resolved without

²¹⁸ Of course no system of disclosure can fully predict the outcome of a bidding process, and parties seeking to vote against nuisance or rent-seeking proposals therefore might not anticipate the willingness of the proponent of such proposals to bid up the price of a vote. Directors and shareholders can allay such concerns, for example, by agreeing that certain items most susceptible to abuse in a shareholder voting process, such as shareholder-sponsored bylaws, would be subject to multiple readings. See Bebchuk, *supra* note 1, at 872-73 (arguing that nuisance proposals or proposals motivated by short-term interests would be deterred in system in which shareholder proposals would be adopted only if approved in two successive annual meetings); see also Gordon, *supra* note 28, at 381-84.

²¹⁹ A minimum increment could be established to ensure that retail investors have some incentive to lend their shares and that insurgents' threats to borrow votes are not entirely "costless."

²²⁰ But see André, *supra* note 9, at 586-88 (arguing that difference between purchase and "rental" of votes may not be significant, despite potential for permanent disenfranchisement, if vote purchaser is likely to use such voting power to cash out public stockholders); see also text accompanying notes 199-201 *supra*.

actually incurring the expense of borrowing votes.²²¹ In general, if we assume that hedge funds or other shareholder activists selectively target firms from which they will encounter the least resistance and extract the greatest value,²²² the need to invoke the mechanisms of this hypothetical market to deter socially undesirable shareholder initiatives should be sufficiently infrequent. In addition, to the extent that even unsuccessful participants in a vote-buying market must pay for borrowed shares in the proposed auction mechanism, the cost of unsuccessful bidding should specifically deter looters from targeting the same firm more than once.

A market for borrowing public shares would only be a reasonable alternative to expanding regulation or curtailing shareholder involvement if a credible commitment by long-term shareholders to fight harmful initiatives generally “costs” nothing (except in end-game transactions) or if long-term shareholders have other means to recoup their “investment” in incumbent management. For example, institutional shareholders could respond to the threat of repeated attacks by adopting shareholders bylaws that protect incumbents against ouster — such as eliminating annual elections or imposing supermajority requirements for a specific period of time to permit management to effect needed reforms.²²³ This would ensure that when shareholders win a contested election to defend a particular slate of directors or business objective, the corporation enjoys a sufficient period of time to allow the board to make needed reforms or to pursue the business objectives and thus recoup the value expended by their shareholder advocates.

4. What would the impact of public share borrowing be on private share lending?

The rules governing a market for borrowing public shares should not discourage hedge funds and other special interest borrowers from continuing to borrow shares from financial institutions and institutional lenders. Current securities lending practices, as

²²¹ Hu & Black, *supra* note 5, at 854 (asserting that, to maintain equilibrium that transcends individual voting decisions, voting rights, once obtained, must be able to “be held indefinitely”).

²²² See *supra* notes 74-82 and accompanying text (discussing hedge fund activism).

²²³ Cf. Lipton & Rosenblum, *supra* note 31, at 225-26 (stating that quinquennial elections protect officers seeking long-term business goals from decisions adversely affecting short-term profits); William K. Sjostrom, Jr., *The Case Against Mandatory Annual Director Elections and Shareholders’ Meetings*, 74 TENN. L. REV. 199, 201 (2007) (noting that Minnesota and North Dakota have made annual meetings optional).

described above,²²⁴ should not make it more difficult to comply with a requirement that publicly held shares for which no voting instructions have been given be lent on a public stock lending market.²²⁵ Such a market would merely substitute the intensity of market interest for brokers' discretionary voting.

Moreover, such a market might make acquiring voting interests through derivatives or securities lending markets less desirable. First, the number of retail shares available for borrowing in a public market is likely to be overshadowed by a significant margin the number of shares loaned in connection with short sales,²²⁶ particularly if efforts are made to ensure that institutional shareholders recall their shares before material votes.²²⁷ Second, the extension of disclosure requirements, such as those described in Part III.A,²²⁸ would eliminate much of the stealth advantage gained out of private share borrowing. To the extent that private share-lending transactions do not satisfy the requirement that borrowing and lending opportunities be open to all shareholders, moreover, courts could continue to apply corporate law jurisprudence respecting vote-buying transactions to private market borrowings effected for the sole purpose of manipulating shareholder voting.²²⁹

²²⁴ See *supra* notes 114-23 and accompanying text.

²²⁵ See *supra* notes 206-07 and accompanying text; *cf. In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345, at *3-4 (Del. Ch. May 2, 2007) (permitting clearing agency, as record holder of corporation's shares, to perfect appraisal rights with respect to aggregate number of shares not voted in favor of merger, notwithstanding intervening change in beneficial ownership of shares).

²²⁶ The Commission's Office of Economic Analysis recently conducted a study of short selling activity involving certain pilot and control securities listed on the NYSE and the AMEX ("Exchange-listed securities"), and the top-tier NASDAQ National Market ("NASDAQ NM securities") to determine the impact of eliminating the tick-test for short sales. OFFICE OF ECONOMIC ANALYSIS, SEC, ECONOMIC ANALYSIS OF THE SHORT SALE PRICE RESTRICTIONS UNDER THE REGULATION SHO PILOT (Sept. 14, 2006 draft). Without delving into the staff's conclusions regarding the impact of the Pilot program, the Study reported that short selling activity accounted for 26.32% of transactions in NYSE- and AMEX-listed Pilot securities and 37.76% of transactions in NASDAQ NM Pilot securities effected during the six-month pilot test period. *Id.* at 62. The average monthly short interest in Exchange-listed and NASDAQ NM Pilot securities was 4.01% and 5.94%, respectively. *Id.*

²²⁷ See, e.g., Hu & Black, *supra* note 5, at 899-901 (suggesting that regulators "strengthe[n]" existing guidance encouraging lenders to recall shares for voting purposes); Raaijmakers, *supra* note 98 (recommending that "institutional investors . . . be encouraged to develop sound policy on securities lending in light of their voting policy" as part of transparency required in respect of their voting conduct and policy under Dutch law).

²²⁸ See *supra* notes 177-79 and accompanying text.

²²⁹ See *supra* notes 125-27 (describing circumstances under which courts have traditionally found vote-buying schemes invalid).

The design of a market for borrowing public shares could also include regulatory incentives that make a public stock borrowing market more palatable for pure “vote borrowers.”²³⁰ For example, because stock borrowing for purposes of voting or tendering shares raises fewer economic risks than stock borrowing for purposes of financing securities positions or facilitating short sales, regulators would not require transfers of collateral that might otherwise be required to secure conventional securities loans.²³¹ As a result, persons interested in influencing the outcome of shareholder votes might prefer to comply with public disclosure rules and borrow shares more cheaply in the hypothetical market, rather than pay an additional premium in an effort to effect a conventional securities borrowing surreptitiously.

5. Should management be able to participate as share borrowers?

There is nothing inherently inconsistent about permitting individual directors and officers to borrow shares in their personal capacity and using their own funds, other than transactions from which they are ineligible to vote under current corporation law due to conflicts of interest.²³² Indeed, management borrowing might send a credible

²³⁰ Stocks loaned for sale to third parties, as described above, are typically collateralized by cash or cash-equivalent securities and marked-to-market daily, because the lender takes the risk of losing any appreciation in the value of the shares if the borrower defaults on the loan. See MSLA GUIDANCE NOTES, *supra* note 123, at 6-7 (describing practice of collateralizing securities loans under the MSLA and daily “mark-to-market” adjustments in amount of collateral). Similarly, a person who purchases shares using borrowed funds and hedges such purchases with a derivative must likely pay fees for both transactions that reflect the credit risk inherent in both transactions. Oesterle, *supra* note 99, at 28-29.

²³¹ To the extent that current Federal Reserve Board and NYSE regulations require broker-dealers to classify securities lending transactions by “purpose” in order to ensure compliance with applicable-margin requirements, the recordkeeping burden should not be onerous. See 63 Fed. Reg. 2806, 2811 (Jan. 16, 1998) (providing that broker-dealer “will not be permitted to borrow securities from a customer or broker-dealer that is not . . . [exempt from Regulation T’s margin requirements under § 220.2 as an “exempted borrower”] in order to relend them unless the relending is for a permitted purpose such as a short sale or fail transaction” without depositing amount of cash collateral that would be required if loan were characterized as loan of cash against securities collateral under Regulation T and SRO margin rules); RECHLIN, *supra* note 116, § 7:17, at 7-22 & n.2.

²³² See, e.g., DEL. CODE ANN. tit. 8, § 144 (2007) (transactions with interested directors); MASS. GEN. LAWS ch. 110D, §§ 1(d)(ii), (iii), 5 (2008) (same); OHIO REV. CODE ANN. §§ 1701.01(CC)(d), 1701.831(E)(1) (requiring shareholder vote, excluding “interested shares” owned by officers and employee-directors, among others, to determine whether a person may make a proposed control share

signal that management is willing to pay out, in advance, some of the expected gains from its continued tenure, or at least to reimburse investors for their inability to improve performance. Coupled with the public support of institutions that either vote their shares or borrow additional shares to support management, challenges to management should remain infrequent.

One of the key differences between purely persuasive proxy contests and proxy contests facilitated by vote borrowing, however, is that management would not be able to use corporate funds to take countermeasures. The corporation could not vote shares that it “borrows” in its name (just as a corporation may not vote treasury shares) unless it borrows them for the benefit of a private account over which it has fiduciary discretion. Declaring “dividends” to shareholders as a way to encourage them to vote with management or tender shares into an exchange offer is unlikely to dissuade shareholders from lending their shares²³³: because dividends and other economic interests must be passed on by share borrowers to share lenders,²³⁴ retail shareholders lose nothing if they lend shares and stand to gain if share borrowers collectively hold out for better terms.

Moreover, unlike corporate funds used by management to finance or reimburse proxy expenditures, funds used by management to borrow shares in their individual capacity are unlikely to qualify for reimbursement. Reimbursement for management’s proxy expenses is generally permitted only when effected for the purpose of informing shareholders and only if the amounts expended are fair and reasonable.²³⁵ While the cost of preparing and distributing proxy materials to shareholders would continue to be borne by the

acquisition) (2008); MODEL BUS. CORP. ACT § 8.63 (2005) (detailing director’s conflicting interest transactions); *see also* André, *supra* note 9, at 597.

²³³ *But see* Black, *supra* note 1, at 825-26 (disparaging this practice in dual class recapitalizations).

²³⁴ Many securities lending agreements will require borrowers to forward “cash or other consideration paid or provided by the issuer of . . . [a loaned security] in exchange for any vote, consent or the taking of any similar action in respect of such [s]ecurity.” MSLA, *supra* note 114, at §§ 8, 25.19(f).

²³⁵ *Levin v. Metro-Goldwyn Mayer, Inc.*, 264 F. Supp. 797, 802 (S.D.N.Y. 1967) (refusing to find that alleged amounts paid by management from corporate funds to solicit proxies were “excessive” or that method of operation disclosed by MGM management in proxy statement was “unfair or illegal”); *Rosenfield v. Fairchild Eng. & Airplane Corp.*, 128 N.E.2d 291, 293 (N.Y. 1955) (observing that courts “will not hesitate to disallow” proxy expenditures if not made in best interests of stockholders and corporation, or if fairness and reasonableness of amounts is duly and successfully challenged); *see also* COX & HAZEN, CORPORATIONS § 13.22, at 360-61 (2d ed. 2003) (citing these cases as establishing general principle).

corporation, specifically financing management's private borrowing of shares would not meet this test. Increasing executive compensation for the purpose of financing the borrowing of shares (which would be subject to public disclosure) could also raise concerns regarding self-dealing. With enhanced judicial scrutiny, management participation in a market for borrowing public shares should not necessarily result in a depletion of corporate funds.

The market described above would significantly change purposes and praxis of the shareholder franchise in response to what might seem an otherwise unmanageable threat of abusive vote buying. However fanciful or strained its premises may be, the market addresses in a novel way two major problems in corporation law. First, it replaces the "one-share/one-vote" paradigm for public corporations with a voting system more reflective of shareholder interest and intensity. Second, as discussed in the next section, it may help reconcile competing theories of shareholder governance by giving shareholders more effective tools to communicate with management and giving managers greater incentive to cooperate with committed long-term shareholders.

IV. HOW THE HYPOTHETICAL MARKET CAPTURES THE TENSION BETWEEN COMPETING THEORIES OF SHAREHOLDER GOVERNANCE

The hypothetical market for borrowing public shares I have described captures the tension between advocates of limited shareholder power and advocates of greater shareholder voice: it allows boards to manage corporate affairs while allowing shareholders to use their limited oversight tools in a more effective manner. Such a market is fully consistent with the premise that excessive use of shareholder voting power, at the expense of managerial discretion, can lead to poor decision making and unduly favor one class of stakeholders at the expense of others. But this market would nevertheless afford institutional investors a means to signal approval or disapproval of managerial performance more intensely, and more frequently, than with sporadic proxy contests or tender offers.

The hypothetical market could achieve this balance in several ways. On the most basic level, it would permit more effective use of existing shareholder rights, such as voting in proxy contests and tendering into hostile acquisitions. Second, it would allow managers and long-term committed shareholders more effectively to signal mutual trust, or as

the case may be, disagreement with corporate objectives. Third, it might induce engaged shareholders to focus their activism on concrete proposals with quantifiable benefits that other shareholders will be willing to support financially. And finally, it would create opportunities for regulators of investment fiduciaries — such as the SEC and the Department of Labor — to require institutional shareholders to take greater care in reserving and exercising voting rights with respect to the shares in which they invest.

A. *More effective use of existing shareholder rights.*

At the most basic level, a market for borrowing public shares allows more effective use of existing voting and tendering powers. If we view corporations as a “nexus of contracts,” pursuant to which shareholders retain certain voting and investment powers, the market permits the assignment of those powers just as other commercial and investment markets permit the assignment of contractual benefits to third parties. Thus, the market allows market participants to borrow shares for the purpose of tendering them (or not tendering them) in a public tender offer, as well as to borrow shares for the purpose of voting them in routine or contested corporate actions. One implication is that proxy contests and tender offers would become more freely interchangeable for accomplishing a change of control.²³⁶ Another implication is that share-borrowing transactions might therefore facilitate better pricing of tender offers and improve the efficiency of change-of-control transactions.²³⁷

B. *Building trust between managers and long-term shareholders.*

A market for borrowing public shares would enhance the trust between shareholders and management by enabling shareholders to signal this trust through the iterative process of voting over a series of corporate actions. Some commentators have suggested that firms enjoy a competitive advantage when their constituent groups successfully cultivate and support mutual trust; stakeholder groups build this trust by making long-term investments in the firm.²³⁸

²³⁶ Indeed, Levmore particularly notes that the same collective action problems which might motivate a ban on vote selling could equally apply to justify the use of defensive tactics in the context of hostile takeovers. Levmore, *supra* note 9, at 123 n.21.

²³⁷ See Blair et al., *supra* note 90, at 421 (positing that, in context of hostile takeovers, vote-selling market would improve efficiency of market for corporate control).

²³⁸ Margaret M. Blair & Lynn A. Stout, *Trust, Truthworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1740 (2001) (suggesting that

Certainly, voting in accordance with management's recommendations is a signal of cooperation. But even more strongly, a willingness to borrow votes to protect management or express support is an even stronger signal. This affirmative cooperation, which evinces, if nothing else, a measure of commitment long enough to recoup the costs of borrowing shares,²³⁹ may make management more responsive to long-term reform.²⁴⁰

For example, shareholders may use borrowed shares to reward managers for good corporate governance with measures to ensure their survival. Just as activist investors may seek to challenge poorly performing boards through bylaw amendments that eliminate poison pills and staggered boards, shareholders that approve of management's performance might adopt charter amendments or bylaws that eliminate annual elections or meetings,²⁴¹ staggered boards or that require multiple readings of shareholder initiatives.²⁴² Lawmakers might also give greater latitude to engaged, long-term shareholders to help corporations produce and periodically update a set of rules that confer the optimal amount of discretion on management.²⁴³

"trust" among corporate participants can reduce agency costs and foster "team production" in situations where markets and law may be unable to do so); John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1496 (1990) (describing corporate governance as series of "coalitions" among managers, shareholders, and other stakeholders, in which institutions may support good managers against unruly stakeholders, and vice versa; in such series, the iterative nature of game leads to cooperation); Gordon, *supra* note 28, at 385 (observing that "[t]he need for institutions to assemble coalitions of other institutions, the fact that institutions hold shares in many other firms and thus are engaged in a repeated play game with significant reputation effects, may limit the potential for rent-seeking behavior").

²³⁹ Ayres & Cramton, *supra* note 1, at 1061.

²⁴⁰ For example, to the extent that management may seek the active assistance of institutional shareholders to deter predatory action by special interests or hostile bidders, participation of institutional shareholders in a public market for borrowing shares may provide some managers with some evidence of such institutional investors' beliefs about the quality of current management and their likely response to threatened changes to the status quo. See Blair & Stout, *supra* note 238, at 1742 (noting that "[i]ndividuals in social dilemmas decide to cooperate or defect not primarily by calculating their individual payoffs but instead by looking at and trying to decipher others' beliefs, likely behaviors, and social relationships with themselves").

²⁴¹ Cf. *supra* note 223.

²⁴² Bebchuk, *supra* note 1, at 839; see also Gordon, *supra* note 28, at 353.

²⁴³ Bebchuk and Hamdani have argued that legislators should err on the side of restrictive default rules of corporation law while permitting shareholders, to the extent that shareholders can overcome collective action problems, to initiate reversals of certain default rules as necessary to enhance firm value. Lucian Arye Bebchuk & Assif Hamdani,

Conversely, long-term shareholders might signal indifference or discord by refusing to participate in the hypothetical market when their interests do not align with those of management.

C. *Encouraging concrete shareholder proposals with quantifiable benefits.*

Because vote buying has quantifiable costs, participants in a market for borrowing public shares would seek quantifiable benefits in exercising voting rights. Binding shareholder actions would likely need to have measurable benefits or costs for activists, institutions, or managers to consider spending material amounts to borrow shares in addition (or as an alternative) to traditional proxy solicitation.²⁴⁴ For example, an insurgent group seeking, through a proxy contest, to induce a newly constituted board to effect an asset sale and distribution of gains might seek to justify to long-term shareholders (who might be inclined to reject the plan) that the transaction presents a positive net present value for the corporation's shareholders. By contrast, while the hypothetical market would not eliminate the right of shareholders to put shareholder proposals on the ballot that reflect employee or public interest concerns, shareholders are likely not to expend resources to borrow shares in favor of or in opposition to such proposals unless they have clear long-term benefits.

Managers, in considering whether to comply with such business objectives or "precatory" proposals, are likely to consider, among other factors, the value that shareholders place on the right to borrow (or to lend) shares in voting on such matters. Activist groups with social or political agendas may need to articulate more clearly the benefits to the firm (and not to particular constituencies of the firm) flowing from such proposals if they wish to generate enough interest among potential share borrowers to justify bidding for the right to vote shares for or against such proposals. The market for borrowing

Optimal Defaults for Corporate Law Evolution, 96 NW. U. L. REV. 489, 505-06 (2002).

²⁴⁴ See, e.g., Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, J. FIN. ECO. 409, 409 (2005) (finding, inter alia, that staggered boards are associated with "economically meaningful reduction in firm value," as measured by Tobin's Q and "suggestive evidence that staggered boards bring about, and not merely reflect, a reduced firm value"); Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 939 (2001) (finding that deterrent effect of "effective" staggered boards reduced returns "on the order of 8-10%" for shareholders in firms that were hostile acquisitions targets). See generally INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 93-99 (Nov. 30, 2006) (citing additional empirical studies relating to other takeover defenses).

public shares can thus play a role as a screening mechanism for proposals that managers and shareholders consider worthy of shareholder attention.

D. Enhancing fiduciary responsibilities of institutional shareholders.

The presence of a market for borrowing public shares will put greater pressure on institutional shareholders to become involved in governance, if only to recall and vote shares consistent with their fiduciary duties. As described above, existing share lending programs (e.g., for the purpose of effecting short sales or covering “fails to deliver”) rely on institutional shareholders as a source for borrowed shares. The profitability of these programs may lead institutional shareholders to avoid recalling shares as record dates approach, on the theory that the immediate profits earned from share lending are sufficient proof that they have acted in the best interests of their clients. Commentators have criticized this policy because it allows institutions to avoid participating in major shareholder votes if their shares happen to be loaned out over the record date.²⁴⁵ The presence of a transparent market for borrowing public shares — in which borrowing fees reflect the importance of the matters under shareholder consideration — may well provide regulators with the information necessary to discourage institutional shareholders from lending out portfolio shares when a material shareholder vote is nigh.

A market for borrowing public shares might also empower regulators to require institutional shareholders to participate more aggressively in corporate governance. For example, ERISA regulations and other investment management guidelines permit institutional shareholders to expend money on shareholder campaigns and proxy contests (short of contests for control).²⁴⁶ One could view vote-

²⁴⁵ See, e.g., Hu & Black, *supra* note 5, at 901 (observing that, for institutional shareholders, “lending will often be privately optimal” because of fees earned, even if “collectively, institutional voting could benefit all shareholders” by increasing shareholder value); see also International Corporate Governance Network, Stock Lending Code of Best Practice 1 (recommending that institutions establish parameters for lending agents to balance “the long-term economic interest in better governance” and “the interest in maximising short-term remuneration”), available at http://www.icgn.org/organisation/documents/slc/code_final.pdf. Disclosure requirements with respect to securities lending programs, while helpful, do not fully address this problem. See, e.g., 15 U.S.C. § 80a-8(b)(1) (2006) (requiring registered investment companies to disclose policies inter alia, with respect to “making loans to other persons”).

²⁴⁶ 29 C.F.R. § 2509.94-2 (2007) suggests that ERISA plans are permitted to take into account the net impact of transactions on their investment, after accounting for costs, when deciding how to vote.

borrowing costs as an inherently more accountable way of protecting investment value: borrowing votes requires an outlay of discrete sums for a specific transaction, rather than expending the funds for “printing, mailing, legal, solicitation, travel, advertising and public relations expenses” associated with proxy contests that may have doubtful merit.²⁴⁷ Regulators might therefore encourage institutions to support incumbents or insurgents in contested votes through the borrowing of retail shares if, after accounting for costs, the net impact of their borrowing activity on investment value is positive.

CONCLUSION

If a stable institutional market for borrowing public shares were to emerge from the gray market for “empty votes,” it would serve as a vindication for shareholder primacy in public share markets. It would dramatically shift the focus of shareholder voting power onto wealth-maximizing initiatives, rather than distracting political or social proposals. It might also improve the efficiency of shareholder decision making, as expensive proxy contests are replaced by public negotiations involving multiple shareholder constituencies. More importantly, it would help check the potentially deleterious consequences of “vote borrowing” transactions.

And yet, institutional shareholders may simply have no interest in covering the short-term costs of share borrowing to ensure long-term gains. If this vision of shareholder participation seems implausible or unworkable, perhaps advocates of less shareholder intervention have the better argument. Avenues exist for communicating shareholders’ views on matters of corporate policy outside of the voting process.²⁴⁸ Broadening the substantive reach and procedural accessibility of shareholder voting in a world of empty voting could result, at best, in more distractions for management and, at worst, an endless parade of deleterious proxy contests. Active participation in share borrowing may thus be the last stand for shareholder primacists.

²⁴⁷ See, e.g., *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 230 (Del. 2008) (describing proposed bylaw that would permit shareholders nominating short-slate of candidates in election of directors to seek reimbursement of various expenses undertaken in soliciting proxies).

²⁴⁸ See, e.g., *Electronic Shareholder Forums*, Exchange Act Release No. 34-57172, 73 Fed. Reg. 4450 (Jan. 25, 2008) (adopting final rules providing exemptive relief for sponsorship of and participation in electronic shareholder forum).

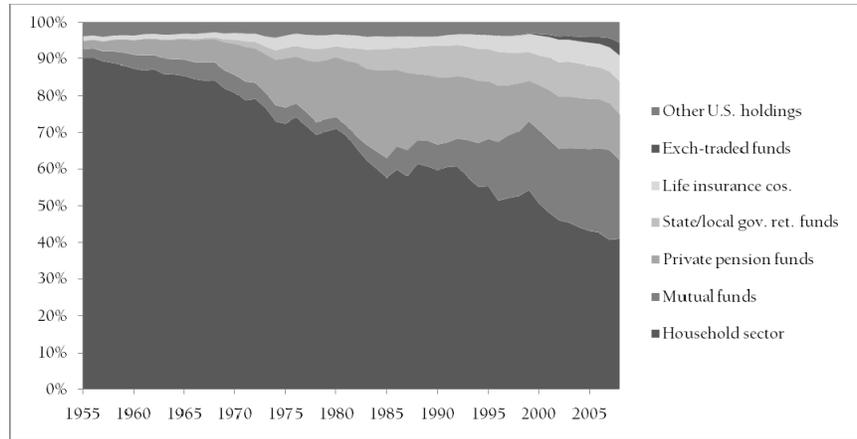
APPENDIX

Table 1. Corporate Equities Outstanding (billions of dollars outstanding at end of period)

| | 1955 | 1960 | 1965 | 1970 | 1975 | 1980 | 1985 | 1990 | 1995 | 2000 | 2005 | 2008 |
|------------------------------|---------|---------|---------|---------|---------|-----------|-----------|-----------|-----------|------------|------------|------------|
| Household sector | \$248.2 | \$359.8 | \$616.1 | \$650.2 | \$584.6 | \$1,010.4 | \$1,229.5 | \$1,961.4 | \$4,434.2 | \$8,147.3 | \$8,004.4 | \$5,502.4 |
| Mutual funds | 6.9 | 14.8 | 30.9 | 39.7 | 33.7 | 42.4 | 113.7 | 233.2 | 1,024.9 | 3,226.9 | 4,175.7 | 2,851.9 |
| Private pension funds | 6.1 | 16.5 | 40.8 | 67.1 | 108.0 | 232.0 | 515.8 | 605.9 | 1,256.8 | 1,970.6 | 2,537.0 | 1,653.9 |
| State/local govt. ret. funds | 0.2 | 0.6 | 2.5 | 10.1 | 24.3 | 44.3 | 120.1 | 284.6 | 703.5 | 1,298.7 | 1,715.8 | 1,237.6 |
| Life insurance companies | 3.6 | 5.0 | 9.0 | 14.6 | 27.5 | 46.3 | 74.0 | 81.9 | 309.6 | 891.9 | 1,161.8 | 929.9 |
| Exchange-traded funds | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 1.1 | 65.6 | 285.8 | 473.9 |
| Property-casualty ins. cos. | 5.4 | 7.5 | 12.0 | 13.2 | 14.2 | 32.3 | 57.0 | 79.9 | 133.5 | 191.4 | 199.5 | 162.1 |
| Brokers and dealers | 0.9 | 0.5 | 1.2 | 2.0 | 3.4 | 3.3 | 14.1 | 9.6 | 34.2 | 77.2 | 158.3 | 109.2 |
| Federal govt. ret. funds | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.3 | 11.5 | 56.6 | 112.6 | 85.6 |
| Closed-end funds | 2.8 | 5.0 | 5.6 | 4.3 | 5.8 | 4.9 | 4.2 | 16.2 | 41.9 | 36.6 | 105.6 | 76.2 |
| State/local govts. | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 4.8 | 26.4 | 93.2 | 96.8 | 83.1 |
| Savings institutions | 1.0 | 1.3 | 2.3 | 2.8 | 4.4 | 4.2 | 5.2 | 8.8 | 14.3 | 24.2 | 26.2 | 22.7 |
| Commercial banking | 0.0 | 0.0 | 0.0 | 0.1 | 0.2 | 0.1 | 0.1 | 2.2 | 5.0 | 11.9 | 24.1 | 0.3 |
| Federal government | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 188.4 |
| Rest of the world | 6.6 | 9.3 | 14.6 | 27.2 | 33.4 | 74.7 | 136.8 | 242.6 | 484.6 | 1,483.0 | 2,039.1 | 1,812.5 |
| Holdings at market value | \$281.8 | \$420.3 | \$734.9 | \$831.2 | \$839.4 | \$1,404.9 | \$2,270.4 | \$3,531.3 | \$8,481.3 | \$17,575.0 | \$20,642.8 | \$15,189.8 |

Source: FEDERAL RESERVE BOARD, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES (1955–2008)

Graph 1. Corporate Equities Outstanding (as percentage of total outstanding held by U.S. persons at end of period)



Source: FEDERAL RESERVE BOARD, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES (1955–2008)