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E-PROXIES FOR SALE? CORPORATE VOTE-BUYING IN THE INTERNET AGE

Douglas R. Cole*

Abstract: Advances in electronic communications technology promise to invigorate shareholder voting as a viable tool for corporate governance, for example by decreasing the cost, and thereby increasing the frequency and effectiveness, of proxy fights. Increased use of shareholder voting, though, forces renewed focus on issues related to the shareholder voting process. One such issue is vote-buying. Traditionally, courts have treated vote-buying in the corporate context as per se illegal. More recently, however, courts have relaxed their attitude toward such transactions, a move generally applauded by commentators. This article argues that the newfound judicial acceptance of vote-buying is problematic, at least for publicly-held corporations. The article examines the reasons offered in support of vote-buying in such corporations, and suggests that the same benefits could be obtained, without the threat of harm presented by vote-buying, through the use of turnout payments to encourage shareholder participation in corporate voting contests. With regard to closely-held corporations, however, the article argues that vote-buying serves a useful preference aggregation function and generally should be permitted

"Vote-buying" evokes images of illicit deals by campaign workers attempting to fix political races on behalf of their candidates.[1] Vote-buying, however, is not limited to the political arena; it has implications for corporate governance as well. Recently, questions regarding the appropriate treatment of vote-buying, particularly vote-buying in the context of political elections, have sparked renewed interest among commentators.[2] While focusing their efforts largely on civic voting, these

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1. For instance, in the late 1800s, William Tweed and his Tammany Hall cronies made extensive use of vote-buying (among other things) to control New York politics. *See* ALEXANDER B. CALLOW, JR., THE TWEED RING 208–09 (1966) ("On the eve of election, the boss and his ward leaders collected an army of the party faithful, the unemployed, the underworld, the flotsam and jetsam of the slums—the bums, frowsy, bleary-eyed, and ragged—and entertained them royally at the saloons, where votes were openly bought and sold."). More recently, vote-buying allegations arose in the 2000 presidential election. *See* Richard S. Dunham, *Sleight of Hand at the Polls: Florida Isn't an Exception*, BUSINESS WEEK, Nov. 27, 2000, at 50, *available at* 2000 WL 24486679 (reporting that in Wisconsin a campaign worker "was caught on tape trying to influence voters by offering homeless people cigarettes if they would cast absentee ballots"); *cf.* Richard L. Hasen, *Vote Buying*, 88 CAL. L. REV. 1323, 1327–28 (2000) (giving brief historical overview of vote-buying in political contests and tracing it as far back as Greece and Rome).

2. *See generally* Hasen, *supra* note 1 (analyzing the potential bases supporting a ban on vote-buying in civic elections); Saul Levmore, *Voting with Intensity*, 53 STAN. L. REV. 111 (2000)

scholars express support for the proposition that vote-buying in the corporate governance realm largely is, and should be, permissible.[3] In doing so, they draw on recent case law and earlier commentary suggesting that a judicial tolerance toward corporate vote-buying is consistent with shareholder wealth-maximization principles.[4]

This Article argues that a permissive attitude toward vote-buying arrangements in the corporate governance realm is inappropriate, and that both courts and commentators have failed to recognize or appreciate the harm to shareholders such arrangements could entail. This failure takes on special significance in light of the potential for an increase in such transactions provided by the reduced communication costs resulting from increased Internet connectivity. This Article focuses on corporate vote-buying in the Internet age, identifying both the possibilities and the risks that such technology provides for enhancing shareholder participation in corporate governance.

Whether vote-buying matters turns, at least in part, on whether shareholder voting matters. The role and importance of shareholder voting in corporate governance has long been the subject of debate among courts and commentators.[5] Theoretically, the power of the vote

(discussing the use of voting as a technique for aggregating preferences and considering the role vote-buying might play in such preference aggregation).

3. The support these commentators offer for vote-buying is by no means unqualified. Saul Levmore, for instance, states that "[a]lthough there is not much law on the subject, I will go along with the current wisdom that vote-buying in corporate law is now more acceptable than it once was and that we are soon likely to see more explicit legislative and judicial approval of trading in shareholder voting rights." Levmore, *supra* note 2, at 138.

4. *See* 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, 565–72 (1990); Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 806–07 (1979). *But see* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 74–75 (1991) [hereinafter ECONOMIC STRUCTURE] (arguing that vote-buying serves no legitimate purpose and should be banned).

5. For an excellent discussion of changes in judicial and academic attitudes toward shareholder voting over time, see Dale A. Oesterle & Alan R. Palmiter, *Judicial Schizophrenia in Shareholder Voting Cases*, 79 IOWA L. REV. 485 (1994). Many commentators have concluded that the shareholder vote, at least in a corporation with widely dispersed share ownership, is virtually worthless due to the collective action problems the shareholders face in coordinating their votes. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 310 (1999) ("In both theory and practice . . . shareholders' voting rights—at least in publicly-traded corporations—are so weak as to be virtually meaningless."); John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 849 (1999) (discussing collective action problems); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402–03 (1983); Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76

offered the ultimate corporate owner (i.e., the shareholder) a means to retain control over corporate management. Recognition of the collective action problems that plague the voting process, however, as well as the availability of much stronger tools to discipline corporate managers, led many commentators to conclude that the power to vote was almost meaningless as a mechanism for corporate governance.[6] Indeed, by the mid-1980s, discussion of shareholder voting as a viable means of removing entrenched corporate management was supplanted almost

CAL. L. REV. 1, 43 (1988) ("The reliability of shareholder voting as a decision mechanism for the public corporation has come under sharp attack on the grounds that widely dispersed shareholders face severe 'collective action' problems in dealing with managers who control the proxy machinery."). Other commentators see more hope for shareholder voting power, at least in a world populated by large institutional investors. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 580–84 (1990) (discussing whether institutional investors may be able to overcome the collective action problems that plague shareholder voting). While at least some commentators have suggested that shareholder voting is essentially meaningless, Delaware courts have long taken a different view, asserting that the power of the shareholder vote is the legitimizing principle underpinning all of corporate law. *See, e.g.*, Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1994) ("Because of the overriding importance of voting rights, this Court and the Court of Chancery have consistently acted to protect stockholders from unwarranted interference with such rights."); State of Wis. Inv. Bd. v. Peerless Sys. Corp., No. Civ.A. 17637, 2000 WL 1805376, *7 (Del. Ch. Dec. 4, 2000) (referring to "the fundamental importance of the voting rights of shareholders"); Hoschett v. TSI Int'l Software, Ltd., 683 A.2d 43, 44 (Del. Ch. 1996) (referring to "[t]he critical importance of shareholder voting both to the theory and to the reality of corporate governance"); Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."). Indeed, Delaware at one point considered shareholder voting rights so important that they were addressed in Delaware's Constitution. *See* DEL. CONST. art. 9, § 6 (amended 1903) (mandating that "[i]n all elections for directors or managers of stock corporations each shareholder shall be entitled to one vote for each share of stock he may hold"). These seemingly disparate views on the importance of shareholder voting are not necessarily contradictory; the vote could be symbolically important while at the same time useless as a practical matter.

6. The recognition of the collective action problems presented by voting among a widely-dispersed share ownership, with the concomitant agency cost problems, is widely attributed to Adolf Berle and Gardiner Means in ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). For a discussion of the impact of these collective action problems on the viability of shareholder voting as a control mechanism, see sources cited *supra* note 5. *See also* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10, 12–13 (1991) (discussing Berle-Means view of importance of shareholder voting); Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule?*, 70 S. CAL. L. REV. 741, 749–63 (1997); Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980) (discussing collective action problems shareholders face in responding to a takeover bid). These collective action problems are discussed in greater detail *infra* Section I.B.

entirely by reliance on the possibilities presented by corporate acquisition through means of a tender offer.[7]

Since the late 1980s, however, corporate managers seeking to insulate themselves,[8] often aided by state legislatures leery of seeing local corporations acquired and the corporation's assets moved beyond the reach of the legislature's taxing power,[9] have erected sophisticated takeover defenses designed to prevent acquisition. Thwarted by these defenses, potential acquirers once again turned to the power of the shareholder vote, attempting to wrest control of the corporation through proxy contests or consent solicitations,[10] but their initial attempts proved both costly and largely unsuccessful.[11]

7. *See, e.g.*, Peter J. Henning, *Corporate Law After the Eighties: Reflections on the Relationship Between Management, Shareholders and Stakeholders*, 36 ST. LOUIS U. L.J. 519, 533 (1992) (stating that tender offers replaced proxy fights as principal means of hostile acquisition); Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1864 (1989) ("Over the past two decades, the hostile takeover has replaced the proxy fight as the more potent vehicle for wresting corporate control from incumbent management."); Guhan Subramanian, *A New Takeover Defense Mechanism: Using an Equal Treatment Agreement as an Alternative to the Poison Pill*, 23 DEL. J. CORP. L. 375, 383–97 (1998) (discussing history of shift from proxy fights to tender offers as means of obtaining change in corporate control). Of course, the new owner (i.e., the successful tender offer bidder) would accomplish the actual change in management through use of his or her shareholder powers. The concentration of all of the shares in a single owner, however, would remove the collective action problems that had protected the entrenched management prior to the transaction.

8. Not surprisingly, corporate managers do not express their goals so directly. Rather, they typically speak of protecting the shareholders' "long-term interests." According to these managers, the market is "undervaluing" the company, and the shareholders need only wait for the market to return to rationality for them to realize share gains far in excess of those offered by the corporate "raiders." *See, e.g.*, *Bank of Scotland Launches Surprise $34 Billion Hostile Bid for NatWest*, DOW JONES BUSINESS NEWS, Sept. 24, 1999 (reporting that the NatWest Board requested shareholders to reject a takeover bid at a 20% premium to market prices because it "undervalues" the company); *Allied Colloids Snubs Hercules' $1.8-Billion Bid*, CHEMICAL WEEK, Dec. 3, 1997, at 11 (stating that in response to bid at 23% premium to market price, Allied Colloids' board "advised shareholders to reject the bid, saying that it undervalues the company").

9. In the words of one commentator:

> What motivates states to enact antitakeover legislation? Wary of raiders' tendencies to liquidate companies, close plants, and lay off workers, state legislators seek to protect home-based businesses. More specifically, the impetus likely derives from two sources: the enacting state's desire to protect nonshareholder constituencies, including managers who are unable or unwilling to persuade shareholders of the value of internal defensive measures, and financial protectionism, where states desire to retain and maximize tax-generating resources.

John H. Matheson, *Corporate Governance at the Millennium: The Decline of the Poison Pill Antitakeover Defense*, 22 HAMLINE L. REV. 703, 714–15 (1999).

10. *See* J. Harold Mulherin & Annette B. Poulsen, *Proxy Reform as a Single Norm? Evidence Related to Cross-Sectional Variation in Corporate Governance*, 17 J. CORP. L. 125, 131–32 (1991) (discussing evidence regarding shift from hostile takeovers back to proxy solicitations as means to acquire corporate control). Proxy solicitations and consent solicitations are two different but related

The advent of new technology, in particular the communications opportunities afforded by personal computers and the Internet, holds renewed promise for the role of shareholder voting in corporate governance. Electronic mail and Internet-based communications provide dissident shareholders (or potential acquirers) a means of instant, widespread, low cost disclosure of the information they wish to share with fellow shareholders. This technology similarly offers the possibility to drastically reduce the price associated with soliciting votes, whether proxies or consents, from these shareholders.[12] While these technological advances may herald the emergence of shareholder voting as a viable means of acquiring and/or exercising corporate control, they also focus renewed attention on the scope of permissible inducements one may

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means of achieving action through shareholder voting. Proxy solicitation refers to the process of obtaining a shareholder's right to vote on issues presented at the annual meeting. *See, e.g.*, DEL. CODE ANN. tit. 8, § 212 (1991 & Supp. 2000) (describing proxies). Consent solicitation, on the other hand, involves obtaining written shareholder consent to some proposed action not in conjunction with the annual meeting. *See, e.g.*, *id.* tit. 8, § 228 (describing consents). For the regulations regarding proxy and consent solicitations in public companies, see SEC Rules 14a-1 to 14a-15; 17 C.F.R. §§ 240.14a-1 to 240.14a-15 (2000). Each solicitation method has distinct advantages and disadvantages. The machinery of the proxy solicitation process, as well as the timing of the annual meeting, are largely in the control of corporate management. This often makes meaningful participation by dissidents difficult. Consent solicitations, because they need not occur in conjunction with an annual meeting, are more easily initiated and controlled by a dissident shareholder. The difficulty here, however, is that action by written consent requires consent by a majority of all outstanding shareholders, while action by proxy requires only a plurality of the votes actually cast at the annual meeting (assuming a quorum is present). For a more complete discussion of the distinction between proxy solicitation and consent solicitations and the advantages and disadvantages of each, see generally Eric S. Robinson, *Defensive Tactics in Consent Solicitations*, 51 BUS. LAW. 677 (1996).

11. Proxy solicitation contests typically cost millions of dollars. *See* Kenneth J. Bialkin et al., *Proxy Contests for Corporate Control*, 474 PLI/Corp. 9, 57 (1985); Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 896 n.71 (1994); MARK A. SARGENT, PROXY CONTESTS HANDBOOK Intro. 2 (1993) (stating that a "dissident shareholder can conduct a proxy contest for $1 to $15 million"); Alison Leigh Cowan, *The Trench Warriors*, N.Y. TIMES, May 29, 1988, § 3 at 1 (describing proxy solicitation as costing $1.7 million exclusive of legal and investment banking fees). The dissidents achieve complete success in only about 30% of the contests. *See* Randall S. Thomas & Kenneth J. Martin, *The Impact of Rights Plans on Proxy Contests: Reevaluating* Moran v. Household International, 14 INT'L REV. L. & ECON. 327, 329–30 (1994) (reviewing 76 proxy contests conducted between 1986 and 1991). Dissident groups, however, are at least partially successful in slightly over 50% of all cases. *Id.*

12. In 1998, for instance, ADP Investor Communications Services, a proxy solicitation firm, charged its corporate clients $0.03 for processing proxies returned by Internet, less than one-tenth the $0.34 it charged for processing proxies returned by mail. HOWARD M. FRIEDMAN, SECURITIES REGULATION IN CYBERSPACE 11-16 (2d. ed. 1998); *see also* Catherine S. Powell, *Electronic Proxy Voting in Wisconsin Would Benefit Corporation, Shareholders*, 72 WIS. LAW. 28 n.6 (Feb. 1999) (reporting similar figures). If investors agree to receive their proxy materials electronically, as well as to vote electronically, the savings are even greater. FRIEDMAN, *supra*, at 11-16.

offer a shareholder in an attempt to secure her vote. In particular, should it be permissible to buy shareholder votes?

This Article examines corporate voting in the Internet age and discusses the appropriateness of vote-buying in light of the expanded possibilities for active shareholder involvement in corporate governance. Section I discusses the role shareholder voting plays within a corporation. After providing a brief historical perspective, Section I discusses the various collective action problems that undermine shareholders' attempts to use voting as a means of corporate management. It then discusses the potential impact communications technology may have on those collective action problems.

Section II describes "vote-buying" and the role it has played in corporate voting. After briefly reviewing the early judicial treatment of vote-buying as per se illegal, it discusses the shift to a rule of reason regime, first announced in the seminal case of *Schreiber v. Carney*.[13] This modern approach requires a case-by-case analysis of vote-buying transactions and attempts to separate "good" vote-buying from "bad."

Section III addresses whether the newfound judicial receptiveness toward vote-buying (since *Schreiber*, courts have not struck down a single instance of alleged vote-buying)[14] actually advances the goal of shareholder wealth maximization. It considers whether vote-buying in a publicly held corporation, in light of the reduced transaction costs promised by electronic communication, might present a viable mechanism for invigorating shareholder participation. It concludes, however, that despite suggestions by commentators to the contrary, a permissive attitude toward traditional vote-buying cannot be justified on this basis. Indeed, closer analysis of previous cases suggests that even apparently beneficial instances of traditional corporate vote-buying could instead be seen as examples of coercive wealth transfers between various classes of corporate stakeholders. This Section then distinguishes a separate, but related, concept—the idea of paying shareholders to participate in voting, independent of the voting option they select. It suggests that this type of vote-buying—a "turnout incentive"—may hold promise for empowering shareholder voting while avoiding the difficulties traditional vote-buying presents.

Finally, Section IV examines whether a different judicial treatment of vote-buying in the close corporation context may be appropriate. In

13. 447 A.2d 17 (Del. Ch. 1982).

14. For discussion of the post-*Schreiber* cases, see *infra* notes 150–87 and accompanying text.

particular, it suggests that with regard to close corporations, the shareholders' principal concerns often arise from difficulties in coordination rather than collective action problems. This Section argues that shareholders in close corporations are less likely to share uni-peaked preferences[15] on corporate voting issues than the shareholders in large public corporations, and suggests that close corporations could use vote-buying as a means of aggregating preferences. Section IV concludes that while other techniques could potentially achieve the same results, vote-buying might represent an efficient mechanism for accomplishing such preference aggregation, justifying a different treatment with regard to close corporations.

This Article concludes that while the Internet and electronic communication may reinvigorate shareholder voting as a useful tool for corporate governance, courts and legislatures should be reluctant to accept vote-buying as part of the new voting regime, at least with respect to publicly-held corporations.

I. THE ROLE OF SHAREHOLDER VOTING IN CORPORATE GOVERNANCE AND THE IMPACT OF THE INTERNET

Perhaps the fundamental problem plaguing the corporate structure is the divergence between ownership and control that occurs as a result of shareholders (i.e., owners) entrusting control over their capital contributions to a separate group, corporate managers, whose interests may diverge from those of shareholders.[16] Shareholders confront the

15. "Uni-peaked preferences" refers to those situations in which the voters (here shareholders) share identical preferences with regard to the voting alternatives presented. DANIEL A. FARBER & PHILLIP P. FRICKEY, LAW AND PUBLIC CHOICE 48–49 (1991); *see also* Maxwell L. Stearns, *Standing Back from the Forest: Justiciability and Social Choice*, 83 CAL. L. REV. 1309, 1378–81 (1995) (providing an example of voting outcomes in the face of uni-peaked preferences). That is, the voters would all rank the various potential outcomes in the same order. By contrast, "multi-peaked preferences" refers to situations in which the members of the group have divergent preferences. Stearns, *supra*, at 1331–33. The magnitude of a given peak is a function both of the number of people that share the preference, and the intensity with which they hold it.

16. Berle & Means are credited with first recognizing the importance of the divergence problem. *See* BERLE & MEANS, *supra* note 6. The notion that the divergence between ownership and control is a central problem of corporate law is a staple of the law and economics literature. *See, e.g.*, Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1913 (1996) (explaining that corporate law "should have the same principal goal in developed and emerging economies—succinctly stated, to provide governance rules that maximize the value of corporate enterprises to investors"); Matheson, *supra* note 9, at 709 (stating that "The great challenge of corporate law in the modern era, then, is to minimize agency costs by constraining abuse of managerial discretion"); Henry N. Butler & Fred S. McChesney, *Why They Give at the*

choice between investing time and effort in monitoring the corporate managers, or suffering the deleterious effects (for example, excessive salaries or shirking) that may result from such divergence. Much of corporate law can be understood as an attempt to adopt rules that minimize these agency costs.[17] In this Section, the Article discusses the agency costs shareholders face and examines the role voting plays in minimizing those costs. In particular, it discusses the collective action problems that affect voters in their attempt to coordinate voting efforts. It then discusses the promise that modern electronic communications, in particular the Internet, hold for enhancing shareholder coordination.

Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation, 84 CORNELL L. REV. 1195, 1197 (1999) (discussing how both the agency cost model of corporate law and the contractual theory of the firm are grounded in concerns about divergence between ownership and control); ECONOMIC STRUCTURE, *supra* note 4, at 9–11; 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, 1169–74 (1981). This view, while widely accepted, is controversial. Some commentators have suggested that the importance of this divergence as an explanatory force of corporate law has been overstated. For example, in Blair & Stout, *supra* note 5, the authors contend that this divergence theory of corporate law reflects a "shareholder primacy" view (i.e., that the directors should focus solely on the wealth effects of their decisions on shareholders) that fails to explain corporate law either normatively or positively. They suggest that corporate management is better understood as a "mediative hierarchy" that balances competing desires advanced by various corporate constituencies. *Id.* at 271–87; *see also, e.g.*, William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180, 208–15 (1992), and sources cited therein, discussing the corporate form in terms of its "mediative effects." Other commentators have suggested that this "shareholder primacy" view should be replaced by a paradigm in which the scope of the directors' focus extends to all corporate "stakeholders" or even to society as a whole. *See generally* Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409 (1993) (suggesting beneficial aspects of "multi-constituency" approach to corporate law, whereby director duties are directed toward those affected by corporate acts); Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991) (arguing that directors should be empowered to pursue dual goal of maximizing stockholder wealth and minimizing stakeholder loss); David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991).

17. *See, e.g.*, Matheson, *supra* note 9, at 709; ECONOMIC STRUCTURE, *supra* note 4, at 34–35. As noted above, some commentators challenge the importance of these agency cost issues. *See supra* note 16. Examples of tools designed to minimize agency costs are the duties of care and loyalty. The prospect of ex post director liability for mismanagement or theft provides appropriate ex ante incentives for directors to avoid shareholder harms. As with voting, however, the effectiveness of judicial enforcement of these duties as a means to discipline corporate managers is open to question. *See* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 465–66 (1998).

A. *The Divergence of Ownership and Control*

In most publicly held corporations, shareholders are not involved in the day-to-day operations of the company; these operations are largely left to management.[18] Management, however, may have interests that are not perfectly aligned with those of the shareholders. The classic example is the issue of management salaries. Managers, as a rule, would prefer high salaries and little work; shareholders, of course, have diametrically opposed preferences.[19]

This divergence in preferences between the corporate principal (i.e., the shareholders) and the agents raises the prospect of monitoring costs. That is, shareholders are faced with the choice of either suffering the costs the divergences impose or undertaking monitoring to ensure that the management is faithfully carrying out its task of maximizing shareholder wealth.[20] Such monitoring is, of course, not free, and shareholders seek to minimize the net costs associated with it.[21] This can involve, for instance, attempts to create self-enforcing mechanisms to align management's financial incentives with those of the shareholders.

18. Members of "management" can include shareholders. Indeed, in many, if not most, corporations, the corporate officers and directors receive at least part of their compensation in stock or stock options. For instance, according to the KORN/FERRY INTERNATIONAL 22ND ANNUAL BOARD OF DIRECTORS STUDY 6 (1995), 62% of outside directors receive stock or stock options as part of their compensation. *See also* Michael S. Knoll, *An Accretion Corporate Income Tax*, 49 STAN. L. REV. 1, 21 (1996) (noting that corporate directors and officers are typically compensated in stock or options); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governanace Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 919 n.113 (1996) (citing Korn/Ferry study). In managing the day-to-day affairs of the corporation, however, the persons are acting as "managers," not in their capacity as "shareholders."

19. *See* George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 889–91. This is not to suggest that shareholders as a group prefer that the corporation pay low salaries. Low salaries might prevent the firm from attracting talented managers. Rather, the shareholders would prefer that for a given level of productivity, the corporation pay as little as is necessary. Managers, on the other hand, would prefer greater corporate largesse.

20. This again assumes a "shareholder primacy" view of corporate law. Commentators arguing against this view have suggested that management's "goal" is actually much broader, and includes balancing the interests of competing corporate "stakeholders" or even society as a whole. *See supra* note 15. The proponents of these broader views of corporate responsibility, however, largely have failed to explain why shareholders would choose to invest their capital in firms that undertake such balancing acts (assuming the existence of other corporations that do not elect to treat shareholder interests as one of many "balancing" factors).

21. More correctly, shareholders attempt to minimize the sum of the monitoring costs plus the costs resulting from the agents' dilatory conduct. That is, the rational shareholder will incur an additional dollar of monitoring cost only if it results in a savings of at least one dollar in losses arising from agent misconduct.

Examples of this include performance-based compensation and stock options.[22]

Shareholder voting is another weapon in the shareholders' arsenal for use in this ongoing quest to minimize the costs resulting from the divergence between management and shareholder interests. Through their collective votes, shareholders can elect the board of directors who, in turn, are responsible for managing the affairs of the corporation.[23] If the board is lax in performing its oversight role or, alternatively, has been "captured" by management, shareholders can theoretically elect a new board that presumably will exercise greater vigilance. That is, through their collective will, shareholders can effect changes in corporate control either by replacing directors and (indirectly) management[24] in the event of poor shareholder returns, or even by dissolving the corporation or merging it with another.[25]

Courts and legislatures have viewed this right to control the corporation through voting as one of the most fundamental aspects of share ownership. Courts, for example, have characterized this right as the shareholder's "supreme right and main protection,"[26] or "a right so essential to the enjoyment of property in stock that, it has been suggested, it is a part of the property itself."[27] State legislatures and the

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22. *See generally* D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1062–1109 (1996) (discussing various tools commonly employed to align managers' and shareholders' incentives).

23. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1991 & Supp. 2000) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

24. Shareholders do not have the right to hire or fire corporate officers and cannot force directors to do so. *See* DEL. CODE ANN. tit. 8, § 141(a) (affairs of corporation managed by the board); Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254, 265 (Del. 1995) ("It is a fundamental principle of Delaware General Corporation Law that directors, rather than shareholders, manage the business and affairs of the corporation."); *see also* Peter V. Letsou, *Shareholder Voice and the Market for Corporate Control*, 70 WASH. U. L.Q. 755, 759–63 (1992) (discussing limitations on ability of shareholder to direct day-to-day activities of corporation). The full extent of shareholder participation in day-to-day corporate management is the right to elect the board. Of course, the right to elect (or remove) directors provides indirect control over director choices. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(k).

25. *See* DEL. CODE ANN. tit. 8, §§ 251 (merger), 271 (dissolution). The shareholders cannot accomplish either a merger or dissolution directly. A merger, for instance, must begin with a resolution by the board, *id.* tit. 8, § 251(b), which in turn is put to the shareholders for vote. The shareholders can, however, elect directors supportive of a merger, and thus accomplish indirectly what they cannot accomplish directly.

26. Stokes v. Cont'l Trust Co., 78 N.E. 1090, 1093 (N.Y. 1906).

27. *In re* Diamond State Brewery, 2 A.2d 254, 256–57 (Del. Ch. 1938); *see also, e.g.*, Hoschett v. TSI Int'l Software, Ltd., 683 A.2d 43, 44 (Del. Ch. 1996) (referring to the "critical importance of

drafters of the Model Business Corporation Act have taken a similar view toward the importance of shareholder voting rights, mandating that for every corporation, one or more classes of shares, taken together, must have unlimited voting power in the company.[28]

Of course, shareholder voting is not the only means, or even necessarily a primary one, of actually performing management oversight. For instance, reputational constraints often bind management's discretion.[29] Even the CEO of a corporation must be concerned about her next job. Laying waste to the corporate assets of the company she is managing is hardly a strong recommendation for her next position.

The market for corporate control provides an even more important monitoring function.[30] The threat of hostile takeover with its resultant

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shareholder voting both to the theory and to the reality of corporate governance"); Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1193 (Del. Ch. 1998) (shareholder vote is "ideological underpinning upon which the legitimacy of directorial power rests") (quoting Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988)).

28. For example, New York's corporate code specifies that:

> the certificate of incorporation may deny, limit or otherwise define the voting rights and may limit or otherwise define the dividend or liquidation rights of shares of any class, *but no such denial, limitation or definition of voting rights shall be effective unless at the time one or more classes of outstanding shares or bonds, singly or in the aggregate, are entitled to full voting rights.*

N.Y. BUS. CORP. LAW § 501 (McKinney 1986) (emphasis added). The Model Business Corporation Act (MBCA) provides that the articles of incorporation must authorize "one or more classes of shares that taken together have unlimited voting rights." MODEL BUS. CORP. ACT ANN. § 6.01(b) (1998). Twenty-four states have adopted this statute. *See id.* at xxvii (listing states that have adopted the act). For examples of state statutes, see FLA. STAT. ANN. § 607.0601 (West 2000); N.C. GEN. STAT. § 55-6-01(c) (1999); WASH. REV. CODE § 23b.06.010(2) (2000). While not adopting the MBCA language, Delaware's corporate statute provides a similar result, at least implicitly. *See* DEL. CODE ANN. tit. 8, § 251(b).

29. *See* Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 583–84 (1997) (discussing reputational constraints on managers with respect to fraudulent disclosures); Smith, *supra* note 22, at 1079 (discussing limitations reputational concerns impose on managerial behavior). For a discussion of some limitations of reputational constraints as a means of minimizing agency costs, see Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 694–702 (1999) (discussing the breakdown of reputational constraints in corporate end-game scenarios).

30. According to Matheson, *supra* note 9, at 710:

> In addition, market forces, like the market for corporate control, may also constrain managerial abuses. At one extreme, this monitoring model views shareholders as owners of the corporation and posits that stock ownership is like ownership of any other property. Unhappy shareholders can simply sell their shares to others. At the least, such conduct should evidence their displeasure with management. If sold to a bidder in a tender offer, such a sale might result in the ouster of management. Throughout the 1970s and much of the 1980s, this market in corporate control acted as an important mechanism for monitoring corporate behavior.

removal of entrenched management can provide strong incentives to fully utilize corporate assets.[31] Notwithstanding these alternative methods for disciplining corporate management, however, an important question to consider in discussing any aspect of corporate voting, including vote-buying, is the extent to which it aids or injures the shareholders' attempt to use their voting power as a means of monitoring management performance.

B. *Collective Action Problems and Their Impact on Shareholder Voting as a Means To Minimize Agency Costs*

While voting in theory empowers shareholders to monitor corporate managers, in practice, collective action problems often prevent shareholders from using the power of the vote to do so. These problems arise from three related sources. First, if there are a significant number of corporate shareholders, each may be rationally apathetic with respect to the outcome of a particular vote. Second, any group activity that results in a uniform benefit to the group independent of individual input of any group member is subject to what is commonly called the free-rider problem. Finally, even absent free-riding, large groups face significant transaction costs in attempting to organize group behavior. Each of these issues contributes to the problems shareholders face in attempting to use their vote to maximize corporate returns.

1. *Rational Apathy*

As a general matter, that people choose to vote at all, whether in corporate or civic elections, is somewhat of a mystery.[32] A rational voter would vote only if the benefits of voting (i.e., the increased likelihood of the voter's preferred outcome winning the election) outweigh the costs associated with casting the vote. The only vote that matters, however, is the "swing vote," and even if there is only a relatively small number of

31. How successful these incentives are at disciplining corporate management is a topic of strong debate. Easterbrook and Fischel, for example, have argued that the market forces are quite strong. *See* ECONOMIC STRUCTURE, *supra* note 4, at 96. Others have argued that the strength of these incentives has been vastly overstated. *See, e.g.*, Dent, *supra* note 19, at nn.33–37 (arguing that the takeover market does not really act to constrain managerial discretion).

32. Commentators often refer to the "voter's paradox" or the "paradox of voting." For a detailed discussion of the paradox of voting, and some potential explanations for why people vote in spite of the seeming irrationality of doing so, see Richard L. Hasen, *Voting Without Law*, 144 U. PA. L. REV. 2135, 2138–47 (1996).

voters, the possibility that a given voter will cast this decisive ballot is small. Although this is especially true with respect to civic elections given the "one-person one-vote" rule, the same theory applies to large publicly-held corporations with widely-dispersed share ownership.[33]

Moreover, even if the shareholder were convinced that his or her vote would be the deciding vote, the shareholder may lack incentives to participate in the voting process. In order to vote correctly on a given proposition, a shareholder must first determine the probable returns associated with each possible voting option. For example, assume the shareholders are voting on a single issue with two outcomes—A or B. Correctly choosing between them requires the shareholder to determine the wealth effects of A versus B. Unfortunately, developing this information is, or at least may be, very expensive for the shareholder.[34]

For instance, assume that the company has put the question of whether it should market an additional $100 million in bonds in order to build a new production facility to shareholder vote.[35] Each shareholder can either vote yes or no. The "proper" vote, of course, will depend on the interest rate of the bonds, the probable rate of return on the production facility, the opportunity cost associated with dedicating management time and energy into the development of new production facilities, and myriad other factors.

An in-depth assessment of these factors would prove very expensive. Any given shareholder choosing whether to make this expenditure must acknowledge that he will get but a very small proportion of the return of any increase in the net worth of the company. That is, assume that the investment would be advisable and would increase the net worth of the company by roughly $10 million. If there are 10 million shares, that results in only a $1 per share increase. Shareholders holding few shares could ill afford to invest significant amounts to determine whether they should vote yes or no. In such situations, it may well be rational for the shareholder to appear apathetic by choosing not to vote.[36]

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33. There is one important difference between civic and corporate voting in this regard. Civic voting typically does not have a "quorum" requirement, while corporate voting does. *See, e.g.*, DEL. CODE ANN. tit. 8, § 216 (1991 & Supp. 2000). Thus, if there are insufficient shareholder votes present either in person or by proxy, shareholder action cannot occur. In general, this should increase shareholder incentives to vote.

34. *See* Clark, *supra* note 4, at 779–82; Easterbrook & Fischel, *supra* note 5, at 402–03.

35. An example similar to the one posited here is offered in ECONOMIC STRUCTURE, *supra* note 4, at 66–67.

36. *See* Clark, *supra* note 4, at 779–82; Peter J. Henning, *Corporate Law After the Eighties: Reflections on the Relationship Between Management, Shareholders and Stakeholders*, 36 ST. LOUIS

2. *The Free-Rider Problem*

Even shareholders owning large blocks of shares who would otherwise have the proper incentives to invest in information may choose not do so because of the free-rider problem.[37] Assume, for instance, that in the example above two shareholders each hold three percent blocks in the company. Either of them could afford to invest roughly $90,000 in researching the issue and still increase their wealth.[38] Each of them, however, would prefer that the other make the research expenditure. That is, each would prefer to free-ride on the information produced by the other. Because the shareholders benefit collectively (on a per share basis) from the "proper" outcome on the vote, each individual shareholder has the incentive to let another shareholder undertake the informational costs associated with voting.

The free-rider problem is further exacerbated in the voting context because information is a public good,[39] and voting is an information-intensive activity. One of the prime motivators of information development in other markets—the ability to profit from private

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U. L.J. 519, 533–34 (1992) (discussing rational apathy among shareholders). More correctly, the shareholder *acts* apathetic. That is, the shareholder is not truly apathetic; she presumably prefers the course that will yield the greater return on her investment. Because of the information costs, however, she is unable (or unwilling) to distinguish which option better promotes her interest. Even in such situations, voting may still benefit the shareholder. Voting may signal to management the shareholder's willingness to become involved in corporate governance, thereby increasing the incentives for the board to manage the company with the shareholder's interests in mind. For a discussion of the strategic use of voting as a signaling mechanism, see ERIC A. POSNER, LAW AND SOCIAL NORMS 122–25 (2000).

37. Clark, *supra* note 4, at 783–84.

38. Of course, this is not entirely correct. The return on this investment to one of the three percent shareholders would indeed be $90,000, so either one could afford to spend $89,999 and still increase their wealth. However, before performing the analysis, the shareholder does not know what the profit will be; that is what he was attempting to determine. Thus, before the analysis, the shareholder would not have a good idea what investment in information would be prudent. For instance, assume that after investigation, the shareholder determines that the result of the vote would have no wealth effects on the corporation. That is, the net value of the corporation would remain exactly the same independent of which option was chosen. In that case, any expenditure by a shareholder would be wealth decreasing for that shareholder.

39. That is, information is non-diminishable and non-rival. It has the potential to be shared with another for no marginal cost other than the cost of distribution. For a thorough discussion of information as a public good in the corporate governance context, see Kimberly D. Kraewic, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 458–60 (2001); Dale Arthur Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: "Are We There Yet?,"* 20 CARDOZO L. REV. 135, 198–201 (1998) (discussing firm-specific information as a public good).

information—is not present in the voting arena.[40] In other areas, people can often offset their information costs by an associated profit from developing information that is not available to others in the market. Patent, copyright, and trade secret law, for example, allow people who develop valuable information to benefit privately from it.[41] With voting, on the other hand, private information does very little good. Imagine, for instance, that a minority shareholder invests the necessary amount to determine the "proper" voting choice. In order for that information to benefit the shareholder at all, the shareholder must convince the remaining shareholders, or at least a majority, to vote in the same manner as he does.[42] That is, the information that he developed does him absolutely no good in the voting contest as private information; it is only by the dissemination of the information that the shareholder can hope to benefit at all.[43] This results in a systematic underinvestment in voting information.[44]

40. Note that this comment is strictly confined to voting. Shareholders may be able to profit from private information about a company through other means, for example by purchasing shares (if the information indicates that the market is undervaluing the company) or selling shares (if the information shows that the market is overvaluing the company). Concerns that corporate insiders might profit privately from information derived as a result of their positions in the corporation led to the inclusion of a ban on insider trading in the Securities and Exchange Act of 1934 (1934 Act). *See* 15 U.S.C. § 78p(b) (1994).

41. *See, e.g.*, Rebecca S. Eisenberg, *Patents and the Progress of Science: Exclusive Rights and Experimental Use*, 56 U. CHI. L. REV. 1017, 1024–27 (1989) (explaining how the patent system serves to overcome free-rider problems associated with information goods such as inventions). Securing private benefits is not the *justification* for the patent or copyright statutes. Courts and commentators generally agree that the principal purpose underlying these laws is securing public benefit through increased investments in invention and the arts. *See, e.g.*, Carol M. Silberberg, *Preserving Educational Fair Use in the Twenty-First Century*, 74 S. CAL. L. REV. 617, 621 (2001) ("The immediate effect of our copyright law is to secure a fair return for an author's creative labor. But the ultimate aim is, by this incentive, to stimulate artistic creativity for the general public good." (citing Twentieth Century Music Corp. v. Aiken, 422 U.S. 151, 156 (1975))). The means of achieving this end, however, is through allocation of exclusive rights, thus resulting in private benefits.

42. This is typically accomplished through a proxy or consent solicitation. *See infra* Section I.C.

43. Of course, this is not entirely true. Rather than try to influence the vote, the shareholder can attempt to profit from the privately-developed information by buying or selling shares of the stock. Assuming the shareholder has information that the other investors do not have indicating that the value of the company will increase, the shareholder could conceivably enter into transactions with the other shareholders to purchase their shares at advantageous prices. This immediately suggests an interesting question. Why would a shareholder convinced that the value of the company would increase with a correct voting outcome ever attempt to buy votes? It seems it would be much more likely that the shareholder would elect to buy shares. By buying votes, the informed shareholder must spread the gains derived from use of the privately-developed information with the other shareholders. By buying their shares, the shareholder could keep the entirety of the gains. *See infra* notes 211–17 and accompanying text. It may be that constraints imposed either by liquidity

3. *Voting and Coordination Problems*

Coordination problems among shareholders further compound this problem. Imagine, for instance, that in the example offered above a "correct" decision on the voting issue would cost $10,000 to develop. Imagine further that there are 1000 shareholders who each invest $1000 in information.[45] If the shareholders each act independently, this would result in a total research expenditure of $1 million, and yet still result in each of the shareholders holding inadequate information to cast his or her ballot appropriately. Clearly, the shareholders would benefit from some type of coordinated research.

C. *Proxy Solicitation and Collective Action Problems*

One way in which shareholders could attempt to coordinate their voting activities would be through use of some form of proxy solicitation process. A simplified description of such a process would be one in which a dissident group puts forward a proposal inconsistent with a proposal offered by the board.[46] This could be, for example, a different slate of proposed directors, a bylaw amendment, or a response to a merger bid from another firm.[47] The board and the dissident group then compete for proxies (or consents) from the remaining shareholders.

Providing for a proxy solicitation process addresses, at least in theory, shareholder collective action problems in three ways. First, to the extent that one or more of the shareholders develops information, it gives those shareholders a method for distributing it to other shareholders. Even though shareholders may be rationally apathetic given the prospect of developing their own voting information, to the extent that they can receive it free of charge from others, they would presumably be willing

limitations or a shareholder rights plan prevent acquisition of additional shares. In such cases, sharing the information with the other shareholder voters is a second-best solution. *See infra* notes 249–62 and accompanying text. At least the shareholder will participate in the resulting gain to the extent of his or her holdings.

44. *See* MANCUR OLSEN, THE LOGIC OF COLLECTIVE ACTION 28 (1971).

45. *See* ECONOMIC STRUCTURE, *supra* note 4, at 66.

46. For a more detailed discussion of the proxy solicitation process and the overlapping web of federal and state regulations that govern its conduct, see Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1142–64 (1993).

47. In general, a proxy solicitation could occur in connection with any issue on which a shareholder vote is required. Common examples of such acts include those listed in the text. *See, e.g.*, DEL. CODE. ANN. tit. 8 §§ 141(d) (shareholder vote elects board); 242 (shareholder vote required to amend charter), 251 (shareholder vote required to approve merger) (1991 & Supp. 2000).

to act on it.[48] Second, an individual shareholder (at least one who owns a significant number of shares) may be more willing to invest in voting information if she knows that there is a method in place for distributing the information, thereby making it more likely that the information would actually influence the outcome of the vote. Finally, a proxy solicitation process ameliorates, at least to some degree, the shareholder coordination problem. It encourages shareholders to share information in a way that helps prevent multiple shareholders from making overlapping investments in voting information.

While the possibilities of such contests are at least conceptually beneficial to shareholders, in practice they are of questionable effectiveness. The Securities and Exchange Commission (SEC) has implemented rules for proxy contests with respect to securities registered under the Securities and Exchange Act of 1934 (1934 Act).[49] Section 14(a) of the 1934 Act requires that any communications made with a shareholder for the purpose of securing the shareholder's proxy must comply with this set of rules.[50] These rules specify, for example, the information that must be sent,[51] how that information must be presented,[52] and the filing requirements the soliciting party must meet before sending the solicitation.[53] While these rules may help in terms of increasing shareholder comprehension of, and willingness to rely on, the information provided, they also impose substantial costs on dissidents' attempts to communicate with their fellow shareholders.[54]

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48. This is not a complete answer to the rational apathy problem. Note that even if the information is provided, the voting decision is not "free." Shareholders must still invest sufficient time and energy to review and analyze the material presented in the proxy solicitation, and may even find it necessary to invest additional time and energy in verifying some or all of the information presented. Moreover, in a proxy solicitation contest, the shareholder would presumably need to read two or more competing proxy solicitations and attempt to determine which of the asserted positions best serves his or her interest. At the very least, however, use of the proxy solicitation process should lower the amount of investment in voting information, thereby presenting at least a partial response to the rational apathy situation.

49. The Securities and Exchange Act is codified at 15 U.S.C. §§ 78a–78ff (1994 & Supp. 1999). The statutory text authorizing the SEC to regulate proxy solicitations appears at 15 U.S.C. § 78n(a). For the SEC rules implemented pursuant to that authority, see SEC Rules 14a-1 to 14a-15; 17 C.F.R. § 240.14a (2000).

50. 15 U.S.C. § 78n(a).

51. 17 C.F.R. §§ 240.14a-3 to 240.14a-4.

52. *Id.* § 240.14a-5.

53. *Id.* § 240.14a-6.

54. *See* Douglas G. Smith, *A Comparative Analysis of the Proxy Mechanism in Germany, Japan and the United States: Implications for the Political Theory of American Corporate Finance*, 58 U. PITT. L. REV. 145, 190 & n.240 (1996) ("Several commentators [have] argued that the [pre-1992]

While the SEC continues to tinker with the proxy solicitation process in an attempt to invigorate it,[55] it is fair to say that, to date, it has not been a panacea for the collective action problems shareholders face. To begin with, the contests tend to be relatively expensive to the challenger, on the order of several million dollars for a typical contest.[56] Thus, in determining whether or not to develop voting information, the shareholder must not only consider the cost of developing the information, but also the cost of distributing it through the proxy process. At the same time, dissidents engaging in proxy solicitation contests have had only very limited success.[57] One empirical study reviewed 76 proxy solicitation contests and determined that the challengers achieved complete success in only approximately 30% of cases,[58] hardly the kind of success rate one would expect to induce major investment in such activities.

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proxy rules inhibited the ability of shareholders to monitor management and check managerial excesses and inefficiency by placing a costly barrier in the way of communications among shareholders.") (citing other sources); *see also supra* note 11 (collecting sources regarding average cost of proxy solicitation contest). It should be noted that the rules do also provide some benefits to dissidents. For instance, SEC regulations provide that if a dissident's solicitation meets SEC requirements, the corporation must either provide a list of the voting shareholders to whom the information should be sent, or, at the soliciting party's expense, mail the information to the shareholders itself. 17 C.F.R. § 240.14a-7.

55. *See, e.g.*, SEC Release Nos. 33-7760, 34-42055, IC-24107, 64 FR 61408, *available at* 1999 WL 1014713 (Nov. 10, 1999) (making revisions to proxy solicitation rules for stated purpose of permitting "increased communications with security holders and the markets"); *see also* Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 26 (1993) (discussing then-pending SEC amendments to the proxy rules that subsequently have been enacted).

56. *See* Palmiter, *supra* note 11, at 896 n.71 (estimating expense of "about $5 million" for a typical proxy contest); SARGENT, *supra* note 11, at Intro. 2 (1993) (stating that a "dissident shareholder can conduct a proxy contest for $1 to $15 million"); Cowan, *supra* note 11, at 1 ($1.7 million exclusive of legal and investment banking fees); *see also* Bialkin et al., *supra* note 11, at 56; Mark A. Stach, *An Overview of Legal and Tactical Considerations in Proxy Contests: The Primary Means of Effecting Fundamental Corporate Change in the 1990s*, 13 GEO. MASON L. REV. 745, 776 (1991) ("Proxy contests can be very expensive. For example, during a proxy fight for control of Lockheed, the incumbents spent approximately $8 million and the insurgents spent approximately $6 million.").

57. *See* André, *supra* note 4, at 578 n.184 (citing studies indicating that insurgents are successful only 20–40% of the time).

58. *See* Thomas & Martin, *supra* note 11, at 329–32 (conducting a review of 76 proxy contests conducted between 1986 and 1991). Thomas and Martin do note, however, that dissident groups are at least partially successful in slightly over 50% of all cases. *Id.* For a complete analysis of dissident success rates in proxy contests reported on an annual basis for the years 1957–77, and 1981–85, see RONALD E. SCHRAGER, CORPORATE CONFLICTS: PROXY FIGHTS IN THE 1980S 8–11 (1986).

D. *The Impact of the Internet on Corporate Proxy Contests*

As the foregoing discussion suggests, both shareholder voting generally and proxy solicitation in particular are relatively expensive. Participants in these activities face three principal types of costs: information costs (the costs of detecting managerial shortcomings and developing a competing position), disclosure costs (the regulatory compliance costs and the communication costs to transmit the information to other shareholders), and collection and tabulation costs (the costs to process the proxies returned as a result of the solicitation efforts). As such costs fall, however, proxy solicitation contests should become a more viable mechanism for encouraging shareholder participation.[59]

The development and implementation of Internet communications and electronic mail offer great promise to reduce all three types of costs.[60] Unfortunately, until recently, attempts to adapt these technologies to the proxy contest realm faced both significant technological and legal hurdles. In 1990, less than 1% of American households had routine access to electronic messaging or the Internet.[61] From a regulatory standpoint, perhaps the most significant impediment to the use of electronic communications in proxy contests was the statutory requirement under the corporate code of most states that a proxy be "signed" by the shareholder granting it, with no explicit authorization of electronic signature or transmission.[62]

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59. *See* Andy Dworkin, *Shareholder Knockout*, THE OREGONIAN, Sept. 24, 2000, at E1:

> Several experts also said the Internet is turning fights in shareholders' favor. People angry about a company's performance can meet like-minded investors through stock chat rooms in Yahoo and other websites. They can post proxy statements and other campaign materials electronically, cutting down printing cost. "I think there's going to be more and more dissident activity around the annual meeting as costs get lower and lower." [John] Wilcox [Vice-Chairman of the proxy solicitation firm Georgeson Shareholder Communications, Inc.] said.

60. Friedman, for example, estimates that electronic distribution of proxy solicitation materials would result in savings of approximately $2.50 to $5.50 per shareholder in printing and mailing costs. FRIEDMAN, *supra* note 12, at 11-16. On the tabulation side, ADP Investor Communication Services, a firm that provides proxy distribution, collection, and tabulation services, charges $0.03 to process an Internet proxy, less than one-tenth the $0.34 it charges to process those proxies returned by mail. *Id.*

61. Thomas P. Vartanian, *The Emerging Law of Cyberbanking: Dealing Effectively with the New World of Electronic Banking and Bank Card Innovations*, *in* DOING BUSINESS ON THE INTERNET: THE LAW OF ELECTRONIC COMMERCE, 452 PLI/Pat 141, 197 (1996) ("In 1990, when Internet access first became more readily available to the public outside of government, research or academic organizations, there were approximately 1 million users.").

62. FRIEDMAN, *supra* note 12, at 11-13.

Today, however, both the legal and the technological barriers have been significantly reduced. Over 40% of the shareholding public now has an e-mail address and daily Internet accessibility, up from approximately 26% only two years ago.[63] Moreover, new subscribers are obtaining Internet access every day, and estimates have predicted that by the middle of 2001, over half of all individuals in the United States will have Internet access.[64] Since 1985, thirty states have adopted statutes permitting electronic proxies.[65] The Delaware code, for example, provides that:

> Without limiting the manner in which a stockholder may authorize another person or persons to act for such stockholder as proxy pursuant to subsection (b) of this section, the following shall constitute a valid means by which a stockholder may grant such authority: ... A stockholder may authorize another person or persons to act for such stockholder as proxy by transmitting or authorizing the transmission of a telegram, cablegram, *or other means of electronic transmission* to the person who will be the holder of the proxy ... provided that any such telegram, cablegram or other means of electronic transmission must either set forth or be submitted with information from which it can be determined that the telegram, cablegram or other electronic transmission was authorized by the stockholder.[66]

With these legal and technological barriers largely removed, the benefits of the Internet and electronic mail for proxy solicitation (and

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63. For a thorough review of current Internet penetration, broken down by various demographics including race and income, see U.S. DEP'T OF COMMERCE, NAT'L TELECOMM. AND INFO. ADMIN., FALLING THROUGH THE NET: TOWARD DIGITAL INCLUSION [hereinafter *Digital Divide*], *available at* http://www.ntia.doc.gov/ntiahome/fttn00/contents00.html (last visited July 31, 2001). *See also* Mark E. Budnitz, *Privacy Protection for Consumer Transactions in Electronic Commerce: Why Self-Regulation Is Inadequate*, 49 S.C. L. REV. 847, 850 (1998) (stating that almost 20% of American households have Internet accounts); Michelle J. Kane, Note, Blumenthal v. Drudge, 14 BERKELEY TECH. L.J. 483, 484 n.8 (1999) (finding that as of 1998 America Online had 12.5 million subscribers). The 20% penetration in 1998 reflects a more than twofold increase over the previous year. Haran Craig Rashes, *The Impact of Telecommunication Competition and the Telecommunications Act of 1996 on Internet Service Providers*, 16 TEMP. ENVTL. L. & TECH. J. 49, 59 (1997) (stating that in 1997 only 7% of households had Internet access).

64. *See Digital Divide*, *supra* note 63, at xv (Executive Summary).

65. *See* Jacqueline Dosick, *State Law Amendments Make It Easier To Implement Electronic Proxy Voting*, 3 No. 7 Wallstreetlawyer.com: Sec. Elec. Age 19 n.1 (Dec. 1999), *available at* WESTLAW, 3 No. 7 GLWSLAW 19 (last visited July 31, 2001) (listing 30 states plus Puerto Rico that, as of the date of publication, had statutes permitting electronic proxies).

66. DEL. CODE ANN. tit. 8, § 212 (1991 & Supp. 2000) (emphasis added).

shareholder voting generally) should be imminently realizable. Information costs should fall as corporate monitoring becomes both more easily, and more timely, accomplished. Corporations will have the opportunity, and potentially the obligation, to make more frequent disclosures of material information. Especially in light of the information technology used by most large corporations to track operational results, corporate web pages could be required to reflect up to date results, forecasts, and other firm-specific information.[67] Such regulations would permit shareholders to detect corporate mismanagement more quickly and easily, and thus sooner realize the need to mobilize the shareholder vote.

Perhaps the greatest promise of the Internet is the potential for reducing disclosure costs. Electronic mail offers world-wide, instantaneous, nearly cost-free communications capabilities. While it would be difficult for a given dissident shareholder to identify the appropriate e-mail addresses of her fellow shareholders, proxy solicitation firms can be expected to fill the void by maintaining extensive databases containing that information.[68] The required information could then easily, quickly, and cheaply be distributed directly to the shareholders for their consideration.[69] Moreover, the use of

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67. *See, e.g.*, Oesterle, *supra* note 39, at 218–25 (discussing possibility of requiring continuous disclosure of corporate operating results). One of the first commentators to consider the disclosure possibilities offered by advances in electronic communications technology was Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985). He more recently updated his proposal in Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 WASH. U. L.Q. 753, 770–76 (1997) (discussing version of continuous disclosure system). Of course, the extent to which corporations will be, as opposed to "could be," required to provide continuous disclosure is largely dependent on SEC and state law disclosure requirements. Technological feasibility, however, is undoubtedly an important first step toward implementation of such requirements.

68. Proxy solicitation firms specialize in the distribution and collection of proxy solicitation forms. They are "middlemen" in the proxy solicitation process. Perhaps the largest such firm is ADP Investor Communication Services. *See* Cary I. Klafter, *Using Web Sites for Investor Relations and Stockholder Meeting Materials*, SEA GLASS-CLE 435, 437 (1998) (same); D. Craig Nordlund, *Electronic Dissemination of Disclosure Documents*, 1093 PLI/Corp. 39, 42 (1999) (describing ADP as the "key" proxy solicitation firm); Oesterle & Palmiter, *supra* note 5, at 510 (stating that over 70% of proxy solicitations are conducted by ADP). Both corporations and dissident shareholder groups typically utilize such firms as part of their proxy solicitation efforts. Because of the solicitation firms' specialization in communications, one would imagine that they would be among the first to take advantage of the possibilities offered by the Internet.

69. Taking complete benefit of the communications possibilities presented by the Internet and electronic mail would require amendments to the SEC regulations. *See* FRIEDMAN, *supra* note 12, at 12-1 to 12-7 (discussing necessary changes). For instance, the regulations currently require that proxy statements be mailed to security holders. 17 C.F.R. § 240.14a-7 (2000). In contrast to e-mail,

web-pages may also allow for more complete disclosures of information relating to the voting options. For example, SEC regulations currently impose a 500-word limitation on descriptions of shareholder proposals included within proxy solicitation statements.[70] Shareholders making proposals could include within this description the address of a website containing more detailed information regarding their proposal.[71]

These possibilities have not gone unnoticed. Indeed, according to one commentator:

> Dissidents and shareholder activists were among the first to recognize the potential of the Internet. Bennett LeBow and the Brooke Group took their proxy fight against RJR Nabisco into cyberspace, posting all their proxy materials and fight letters on the home page of their proxy solicitation firm, Georgeson & Company Inc., and publishing the Web site address in all the printed materials and advertisements.[72]

As technological and legal hurdles continue to disappear, one must assume that such tactics will increasingly become a part of everyday corporate life.

II. THE JUDICIAL TREATMENT OF VOTE-BUYING

The previous Section considered the corporate voting process, the problems endemic to it, and the potential for the Internet to address at least some of those concerns. If technological advances can serve to reinvigorate shareholder voting as a tool for corporate governance, however, it is important to revisit issues that may affect the voting process. One such issue is the appropriate treatment of vote-buying. This Section discusses vote-buying and the role it could play within the voting

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"snail mail" (i.e., standard U.S. mail) is a particularly cumbersome device for communicating proxy information. Typically, the information is first sent to the institution in whose "street name" the stock is held, then forwarded to the brokerage, and finally on to the actual shareholder. FRIEDMAN, *supra* note 12, at 11-14 to 11-16. Electronic distribution could automate this three-stage distribution process leading to nearly instantaneous transmission to the ultimate voter. *Id.*

70. 17 C.F.R. § 240.14a-8(d) (2000) ("The proposal, including any accompanying supporting statement, may not exceed 500 words.").

71. *See* Robert A. Prentice, *The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5*, 47 EMORY L.J. 1, 19 n.92 (1998) (discussing use of websites as means of avoiding 500 word limitation imposed by SEC); John C. Wilcox, *Electronic Communication and Proxy Voting: The Governance Implications of Shareholders in Cyberspace*, 11 NO. 3 INSIGHTS 8, 11 (Mar. 1997).

72. Wilcox, *supra* note 71, at 11.

process. It begins by defining vote-buying and distinguishing it from voting trusts and vote-pooling agreements—related, but distinct, methods of coordinating voting power. It then briefly describes the judicial treatment of vote-buying, including the historical antipathy to such arrangements and the modern shift toward more relaxed judicial scrutiny.

A. Vote-Buying Defined

Delaware courts have used the term "vote-buying" to refer broadly to any "voting agreement supported by consideration personal to the stockholder, whereby the stockholder divorces his discretionary voting power and votes as directed by the offeror."[73] In one case, a corporate agreement to extend a loan to a large shareholder in return for the shareholder's support of a merger constituted vote-buying.[74] Similarly, another court held that a guaranteed job with the corporation in exchange for voting in a particular manner constituted vote-buying.[75] In short, a vote-buying agreement is one in which ownership (i.e., the right to claim a residual interest in the assets of the corporation) is separated from the shareholder's only means of control (i.e., the right to vote on how those assets should be used) in exchange for consideration.

Of course, conceptually, vote-buying could take many forms. For instance, votes could be bought on a one-time basis. The shareholder would deliver a proxy giving the purchaser the right to vote on one issue, such as a given election of the board of directors.[76] Alternatively, vote-buying could entail the permanent transfer of the right to vote the share.[77]

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73. Schreiber v. Carney, 447 A.2d 17, 23 (Del. Ch. 1982); *see also In re* IXC Communications, Inc. S'holders Litig., No. C.A. 17324, C.A. 17334, 1999 WL 1009174, at *8 (Del. Ch. Oct. 27, 1999) (citing *Schreiber*); Weinberger v. Bankston, Fed. Sec. L. Rep. P 93,359 1987 WL 20182, at *4 (Del. Ch. Nov. 19, 1987) (citing *Schreiber*); *In re* Sea-Land Corp. S'holders Litig., Civ. A. No. 8453, 1987 WL 11283, at *3 (Del. Ch. May 22, 1987) (citing *Schreiber*).

74. *Schreiber*, 447 A.2d at 23 ("It is clear that the loan constituted vote-buying as that term has been defined by the courts.").

75. Hall v. Isaacs & Sons Farms, Inc., 146 A.2d 602, 613 (Del. Ch. 1958).

76. Indeed, SEC Rules provide that with regard to securities registered under the 1934 Act, proxies are limited in duration to the next annual meeting following the proxy solicitation. *See* 17 C.F.R. § 240.14a-4(d)(2) (2000).

77. There are limitations on the ability to accomplish long-term vote sales through use of proxies. Delaware law limits proxies to three years duration unless the proxy specifically states a longer duration. DEL. CODE ANN. tit. 8, § 212 (1991 & Supp. 2000). More importantly, if the share is registered under the 1934 Act, SEC rules provide that no proxy solicited "shall confer authority . . . [t]o vote at any annual meeting other than the next annual meeting . . . to be held after the date on which the proxy statement and form of proxy are first sent or given to security holders." 17 C.F.R. § 240.14a-4(d)(2). This limitation on proxies does not prevent the use of other techniques to effect a

This would in effect create a derivative instrument, independent from the underlying share and encompassing only the right to vote the share of stock.[78] Presumably a market could arise in which these voting rights were traded just like any other sort of instrument.[79] In fact, some have suggested that there may be benefits to permitting just such a market.[80] Both forms of vote-buying present interesting, albeit somewhat different, questions. Surprisingly, the law treats them the same.[81]

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long-term sale of voting rights. *See, e.g.*, *infra* note 78 (discussing dual-class recapitalizations); *infra* Section II.B (describing voting trusts and voting agreements, both of which can be characterized in appropriate circumstances as involving the long-term sale of voting rights).

78. Dual-class recapitalizations are a form of a permanent "sale" of votes. *See generally* André, *supra* note 4, at 620–23. In a dual-class recapitalization, a single class of stock is divided into two classes, one with superior dividend rights, and one with superior voting rights. For example, the "super-voting" class may have twenty votes per share, while the "super-dividend" class has only one vote per share, but the right to receive two times the per-share dividend awarded to shares in the super-voting class. In the dual-class recapitalization, each shareholder is given the right to trade each of his existing shares for either a "super-voting" share or a "super-dividend" share. This presents each shareholder with a classic example of the prisoner's dilemma. Each shareholder would prefer to keep the voting power with non-management-aligned shareholders in order to permit effective monitoring. Thus, each shareholder would prefer that a group of outsider shareholders maintain voting control. However, because no single shareholder can be certain that his election of super-voting stock will maintain outside control, the strictly dominant strategy for each shareholder is to elect the "super-dividend" shares. Management shareholders, because they face greatly reduced coordination problems, can elect the "super-voting" shares. Thus, through a dual-class recapitalization, the management shareholders can effectively deprive the outside (i.e., non-management) shareholders of their voting power permanently. *Id.* at 620. Because of the potential for abuse, in 1987, the SEC promulgated Rule 19c-4 preventing dual-class recapitalizations. 17 C.F.R. § 240.19c-4 (1990). In *Business Roundtable v. S.E.C.*, 905 F.2d 406, 417 (D.C. Cir. 1990), the D.C. Circuit struck down the rule as an unconstitutional exercise of the SEC's regulatory authority. As a practical matter, however, Rule 19c-4 is still effective with regard to issues traded on national exchanges. The New York Stock Exchange has made compliance with the text of the SEC rule a listing requirement for all companies traded on that exchange. *See* NYSE Listed Company Manual § 313, *available at* www.nyse.com/listed/listed.html (last visited July 31, 2001). The American Exchange and NASDAQ have similar rules in effect. *See* American Stock Exchange Listing Standard § 122, *available at* www.complianceintl.com/amex (last visited July 31, 2001); Nasdaq Rule 4351, *available at* www.nasdr.com (last visited July 31, 2001).

79. *See* Douglas H. Blair et al., *Unbundling Voting Rights and Profit Claims of Common Shares*, 97 J. POL. ECON. 420, 421–22 (1989) (noting that Wall Street professionals were urging the creation of such a market and theorizing that such a market would make the market for corporate control more efficient).

80. *Id.*

81. *Compare* Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982) (providing for one-time vote-buying), *with* Good v. Texaco, Inc., No. 7501, 1985 WL 11536 (Del. Ch. Feb. 19, 1985) (providing for irrevocable proxy for one year).

B. *Other Voting Arrangements*

Vote-buying agreements are not the only means whereby the shareholder can separate ownership of the underlying share from the power to vote that share. While vote-buying itself has always been subject to governance by the common law,[82] two other methods of divorcing ownership and control—voting trusts and voting agreements—are explicitly permitted by Delaware statute.[83]

In a voting trust, a group of shareholders transfers legal ownership of their stock to a trustee for the purpose of vesting in him the right to vote but retains beneficial ownership of the shares.[84] Throughout the duration of the trust, the trustee has the right to vote the stock, but he maintains a fiduciary duty to the shareholders.[85] Furthermore, the trust agreement may specify the manner in which the trustee must vote the shares.[86]

Voting agreements, by contrast, do not involve the transfer of shares to a trustee. The participants merely sign an agreement specifying that each of them will vote their shares as provided in the agreement.[87] The agreement can either specify the actual vote (i.e., the shareholders can agree to vote for a specific candidate for the board), or it can simply specify a procedure for determining how to vote.[88] Because of concerns about the separation of ownership and control, both voting trusts and

82. *See* discussion *infra* Sections I.C, I.D.

83. *See* DEL. CODE ANN. tit. 8, § 218 (1991 & Supp. 2000) (permitting voting trusts and agreements).

84. *Id.* § 218(a). Until recently, such trusts were limited to a term of ten years, but 1994 amendments to the Delaware corporate code abolished this limitation.

85. *See* 5 FLETCHER CYC. CORP. § 2091.10 at 438 (1996) ("Voting trustees should be held to adhere to the usual fiduciary principles of a trust."); JAMES D. COX ET AL., CORPORATIONS § 13.33, at 13.84 (1995 & Supp. 2001) (noting that trustees' discretion to vote the shares is "subject to their fiduciary duties"). For cases discussing the existence of this duty, see Regnery v. Meyers, 679 N.E.2d 74, 79 (Ill. App. 1997) (holding that trustee has fiduciary duty to members of voting trust); Siegel v. Ribak, 249 N.Y.S.2d 903, 906 (N.Y. 1964) (same). At least one court has held that the parties to the trust can contractually narrow the scope of the fiduciary duty. Warehime v. Warehime, 761 A.2d 1138, 1141 (Pa. 2000).

86. DEL. CODE ANN. tit. 8, § 218(a).

87. *Id.* § 218(c).

88. *Id.* § 218(a).

voting agreements were originally limited to ten-year terms.[89] A 1994 amendment to the Delaware code, however, abolished this limitation.[90]

The main difference between voting trusts or voting agreements on the one hand, and vote-buying on the other, is the nature of the consideration employed. With regard to the former, the traditional form of consideration is the reciprocal pledge of the other parties involved to vote their shares in the prescribed manner.[91] If cash or any other form of consideration personal to the shareholder were offered to induce a party to enter an otherwise legal voting agreement, the transaction would constitute vote-buying and should be analyzed as such.[92]

Delaware courts have long considered voting trusts and voting agreements to be in derogation of the common law prohibition on interfering with voting rights, and thus have construed the statutory provisions permitting them narrowly.[93] Historically, strict compliance with all of the statutory requirements for establishing a voting trust was a necessary prerequisite to judicial enforcement.[94] When the statutory requirements were met, however, Delaware courts have ordered specific

89. *See, e.g.*, Perry v. Mo.-Kan. Pipe Line Co., 191 A. 823 (Del. Ch. 1937) (striking down voting trust for exceeding ten-year limitation). For a discussion of reasons why people should be wary of a long-term separation of ownership and control, see Easterbrook & Fischel, *supra* note 5, at 403–06, 410–11.

90. Brenda J. Houck, *1994 Statutory Amendments to the Delaware General Corporation Law*, 20 DEL. J. CORP. L. 477, 492–93 (1995).

91. *See, e.g.*, Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 53 A.2d 441, 443 (Del. 1947) (describing voting agreement where consideration on the part of each party was promise to vote shares in specified manner); Pitman v. Lightfoot, 937 S.W.2d 496, 501–02 (Tex. App. 1996) (discussing various shareholders who contributed stock to voting trust to create control group). The principal purpose of voting trusts and agreements is to allow shareholders to exercise control over the corporate entity by pooling their voting power and voting it as a block. Ben Fixman v. Diversified Indus., Inc., 1 DEL. J. CORP. L. 171, 178–79 (Del. Ch. 1975).

92. *See* Schreiber v. Carney, 447 A.2d 17, 23 (Del. Ch. 1982) ("Vote-buying, despite its negative connotation, is simply a voting agreement supported by consideration personal to the stockholder . . . ."). Including voting agreements supported by personal consideration within the category of "vote-buying" responds to one of Hasen's criticisms of attempts to restrict vote-buying. In his article, Hasen argues that it makes little sense to regulate vote-buying because parties could easily evade limitations on it through use of voting trusts or voting agreements, and thus "a ban on explicit vote-buying will simply increase the transaction costs of engaging in vote-buying by requiring a more cumbersome method to reach the same result." Hasen, *supra* note 1, at 1352–53. If, however, courts limit per se acceptance of voting trusts and voting agreements to those situations where no personal consideration is present, Hasen's criticism seems misplaced. Parties could not engage in vote-buying simply by structuring the transaction as a voting agreement or voting trust.

93. *See* Abercrombie v. Davies, 130 A.2d 338, 344 (Del. 1957); *see also* Oceanic Exploration Co. v. Grynberg, 428 A.2d 1, 6–7 (Del. 1981) (discussing historical treatment of voting trusts).

94. *See Abercrombie*, 130 A.2d at 344.

performance of the voting agreements.[95] Furthermore, the recent trend has been to relax the requirement of strict compliance.[96] Thus, it seems clear that, at least in some instances, the unbundling of ownership and voting control is allowed. As discussed below, however, the nature of the consideration present in such arrangements—that is, a reciprocal voting pledge—prevents use of these techniques as a means to coercively transfer shareholder wealth.[97] Accordingly, whatever we may think about these arrangements, they offer little guidance to the issue at hand.

C. The Historical Prohibition on Vote-Buying

While courts have grudgingly accepted the legislative mandate to enforce certain types of voting arrangements, the common law approach to vote-buying was a regime of per se illegality.[98] Courts offered two principal reasons for this approach. First, vote-buying was seen as a corrupting influence on the fiduciary duty each shareholder in a corporation was thought to owe his or her fellow shareholders.[99] Second, courts rejected vote-buying in the corporate context as analogous to vote-buying in the democratic process.[100] Just as vote-buying would corrupt the democratic process, robbing the government of its legitimacy, so would it affect corporate activities and decisions. This Section examines these two arguments against vote-buying and concludes that while the articulated reasoning is superficially appealing, upon closer examination, neither basis provides much support for the historical judicial antipathy toward vote-buying in the corporate context.

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95. *See* F. O'NEIL, O'NEIL'S CLOSE CORPORATIONS § 5.37 (1992) (collecting cases).

96. *See Oceanic Exploration Co.*, 428 A.2d at 7; *see also* COX ET AL., *supra* note 85, § 13.33, at 13.85 ("The modern attitude is to uphold arrangements that do not comply with all the requirements of the state voting-trust statute as long as the arrangement does not otherwise violate public policy.").

97. *See infra* note 210.

98. *See, e.g.*, Smith v. S.F. & N.P. Ry, 47 P. 582, 590 (Cal. 1897) ("The stockholder cannot separate the voting power from his stock by selling his right to vote for a consideration personal to himself."); Chew v. Inverness Mgmt. Corp., 352 A.2d 426, 430 (Del. Ch. 1976); Macht v. Merchs. Mortgage & Credit Co., 194 A. 19, 22 (Del. Ch. 1937); Brady v. Bean, 221 Ill. App. 279 (1921); Morgenstern v. Cohon, 141 N.E.2d 314, 317 (N.Y. 1957).

99. *See infra* Section II.C.1; *see also* André, *supra* note 4, at 543 n.27 (collecting cases).

100. *See infra* Section II.C.2; *see also* André, *supra* note 4, at 542 n.26 (collecting cases).

1. *Vote-Buying and Fiduciary Duty*

The fiduciary duty concept arose from the notion that each corporate shareholder owed every other shareholder the duty to vote using her own independent judgment. The stated basis for this obligation was the belief that "[t]he security of the small stockholders is found in the natural disposition of each stockholder to promote the best interests of all, in order to promote his individual interests."[101] Of course, this reasoning is more accurately stated in reverse: the "natural disposition" of each shareholder, assuming the shareholder acts rationally, is to promote his or her own individual interest. In the absence of vote-buying, the shareholder presumably could promote his or her individual interest only by maximizing the value of his or her shares, thus achieving the collective good of shareholder wealth maximization. In other words, an outright prohibition on vote-buying can be understood as an attempt to insure that shareholders' interests remain closely aligned. It would be difficult, if not impossible, for one shareholder to benefit in his role as a shareholder without every other shareholder capturing the same benefit.

This judicial hostility toward vote-buying was merely an early example of the courts' recognition of the problems presented by a divergence between ownership and control. A purchaser of corporate votes, especially if it was a person without an ownership interest in the company, could use his or her control to injure the corporate shareholders.[102] Indeed, the only reason such a person would purchase votes would presumably be if he or she could obtain a return on the investment in vote-buying through exploitation of the corporate control. It was through exposing the other shareholders to this risk that a vote-selling shareholder violated his or her fiduciary duties.

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101. Cone Ex'rs v. Russell, 21 A. 847, 849 (N.J. Ch. 1891), *cited in* Schreiber v. Carney, 447 A.2d 17, 24 (Del. Ch. 1982).

102. *See, e.g.*, Bostwick v. Chapman, 24 A. 32, 41 (Conn. Super. Ct. 1890):

> It is the policy of our law that ownership of stock shall control the property and the management of the corporation, and this cannot be accomplished, and this good policy is defeated, if stockholders are permitted to surrender all their discretion and will in the important matter of voting, and suffer themselves to be mere passive instruments in the hands of some agent, who has no interest in the stock, equitable or legal, and no interest in the general prosperity of the corporation.

See also Cone, 21 A. at 849 (noting that the transfer of voting rights "is the more dangerous because the person intrusted with the power has no such inducement to promote the interests of the corporation as the stock-owner has."); André, *supra* note 4, at 542 n.25.

Modern case law, however, rejects the notion that shareholders, at least minority shareholders, owe their fellow shareholder any fiduciary duty.[103] Minority shareholders now have well-recognized rights to compete with the corporation in other business endeavors,[104] to withhold corporate opportunities,[105] and even to engage in business transactions that will result in financial detriment to the corporation's other shareholders.[106] In light of the courts' rejection of any fiduciary duty in such contexts, it would be difficult to argue that there is some "fiduciary duty" that would prevent a shareholder from selling his vote.[107]

103. *See, e.g.*, Priddy v. Edelman 883 F.2d 438, 445 (6th Cir. 1989) ("Minority shareholders owe no fiduciary duty to fellow shareholders."); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) ("Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest or exercises control over the business affairs of the corporation."); *see also* J. A. C. Hetherington, *Defining The Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L REV. 9, 12 (1987) (citing HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 240, at 653 (3d ed. 1983) ("Shareholders . . . have traditionally been said to owe no fiduciary obligations to each other."); Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the United States and the Repeal of Poison Pills: A Practitioner's Perspective*, 1992 COLUM. BUS. L. REV. 223, 249 (1992) ("Clearly, shareholders owe no fiduciary duty to each other when exercising their voting rights."). For a more thorough discussion of minority shareholder rights in close corporations, see generally Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749 (2000). Majority or controlling shareholders, by contrast, do have a fiduciary duty to the minority shareholders. *See, e.g.*, Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1113–14 (Del. 1994) (discussing nature and extent of the fiduciary duty); G & N Aircraft, Inc. v. Boehm, 743 N.E.2d 227, 240–41 (Ind. 2001) (same).

104. *See* Dowell v. Bitner, 652 N.E.2d 1372, 1378 (Ill. 1995).

105. *See* Advanced Communications Design, Inc. v. Follett, 615 N.W.2d 285, 293–94 (Minn. 2000) (holding that even in close corporation, minority shareholder owed no fiduciary duty that would prevent him from soliciting corporate customers).

106. *See generally* Waters v. Double L, Inc., 769 P.2d 582, 583–84 (Idaho 1999) (stating that shareholder can vote on transaction in manner favorable to him, even if adverse to other shareholders); *see also Kahn*, 638 A.2d at 1113–14 (stating that fiduciary duty limited to controlling shareholder); *Ivanhoe Partners*, 535 A.2d at –1344 (same); *In re* Shoe-Town, Inc. Stockholders Litig., No. C.A. 9483, 1990 WL 13475 (Del.Ch. Feb. 12, 1990) (same).

107. While the rejection of "fiduciary duty" applies only to minority shareholders, it is doubtful that a majority shareholder would sell his votes. The majority shareholder has control, and thus is not subject to the collective action problems minority shareholders face in determining whether or not to sell their vote. See *infra* notes 205–13 and accompanying text. Interestingly, an argument could be made that the person purchasing the votes has become a "controlling shareholder," and thus owes a fiduciary duty to the remaining shareholders. *See* Zirn v. VLI Corp., 621 A.2d 773, 778 (Del. 1993) (fiduciary duty as majority shareholder).

2. *Analogies to Vote-Buying in the Democratic Process*

The idea that vote-buying was illegal per se also had roots in an analogy to vote-buying in the political arena. The general purpose of the vote in both the commercial and the political forums is roughly analogous—to pick representative agents[108] to manage an institution for the benefit of the voters, or in some cases to decide a specific issue.[109] Courts and legislatures had uniformly rejected vote-buying in the political context as a perversion of the democratic process.[110] The argument that, by analogy, vote-buying should be illegal in the corporate context had many supporters, both among courts and commentators.[111]

More recently, commentators have begun to question whether this analogy is accurate.[112] In a recent article, Richard Hasen discussed three potential rationales for the universal ban on vote-buying in political contests: equality, efficiency, and inalienability.[113] The equality rationale recognizes that the poor are more likely to sell votes, and the wealthy are more likely to buy them, leading to a greater concentration of political power in the wealthy merely because of their wealth.[114] The efficiency

108. In the case of corporations, shareholders elect the board of directors; in government, voters elect the officials.

109. Shareholders will sometimes vote on specific issues such as mergers or recapitalizations. In the democratic process the referendum performs a similar role.

110. All fifty states and the federal government have enacted statutes making it a crime to buy votes in government elections. *See* Hasen, *supra* note 1, at 1324 n.1 (collecting statutes). For examples of statutes banning vote-buying in political contests see ARIZ. REV. STAT. § 16-1014 (1998); MASS. GEN. LAWS ANN. ch. 56, § 32 (West 1990); N.M. STAT. ANN. § 1-20-11 (Michie 1995); OHIO REV. CODE ANN. § 3599.01 (Anderson 2000); WASH. REV. CODE ANN. § 29.85.060 (West 2000); WIS. STAT. ANN. § 12.11 (West 1996). More recently, commentators have begun to inquire whether there may be some benefits to permitting at least some forms of vote-buying in political contests. Saul Levmore, for instance, suggests vote-buying in such contests might be useful as a preference aggregation tool. Levmore, *supra* note 2, at 142–58. Richard Hasen, on the other hand, draws a distinction between what he refers to as "core vote-buying" (i.e., direct payment for votes) and "non-core vote-buying" (i.e., incentives such as campaign promises), and, while he generally condemns the use of the first in political contests, he is more ambivalent about the latter. Hasen, *supra* note 1, at 1370–71.

111. *See, e.g.*, André, *supra* note 4, at 542 n.26 (collecting a list of cases); *see also* Peter N. Flocos, *Toward a Liability Rule Approach to the "One Share, One Vote" Controversy: An Epitaph for the SEC's Rule 19c-4?*, 138 U. PA. L. REV. 1761, 1785–87 & nn.109–24 (1990) (discussing early academic support for the analogy).

112. *See* Clark, *supra* note 4, at 804–05; Daniel Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 141 (1987); Flocos, *supra* note 111, at 1784–90; Hasen, *supra* note 1, at 1324–38.

113. Hasen, *supra* note 1, at 1324–26.

114. *Id.* at 1329–31.

rationale suggests that vote-buyers might engage in rent-seeking behavior[115] that diminishes net social wealth.[116] The inalienability rationale turns on "a moral judgment that votes should not be salable," which grows either out of the notion that voting is a group right belonging to the community as a whole and, accordingly, is not alienable by individual voters, or out of a broader anti-commodification norm that suggests that selling votes would do violence to our conception of what voting means.[117] Hasen argues that none of these three rationales requires a ban on vote-buying in corporate contests. Equality is not an issue because of the broad, shared understanding that corporate law is not concerned with equality, but rather wealth maximization.[118] Inalienability fails as a justification because there is simply no anti-commodification principle applicable to corporate law.[119] Inefficiency, he suggests, fails to support a ban because courts can provide sufficient policing to weed out inefficient (i.e., non-wealth-maximizing) transfers.[120]

While the efficiency point is potentially overstated,[121] Hasen certainly seems correct that—as other commentators[122] and modern case law[123] have also recognized—there are significant differences between civic and corporate voting. Voting in political contests is a public, not a private right.[124] It attaches, not as a result of contract law, but rather as a reflection of status. Furthermore, while a corporation's existence, and the

115. "Rent-seeking" has been defined as "the attempt to obtain economic rents (i.e., rates of return on the use of an economic asset in excess of the market rate) through governmental intervention in the market. An example of rent-seeking is a firm's attempt to secure government-granted monopolies." Jonathan R. Macey, *Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 471, 472 n.4 (1988).

116. Hasen, *supra* note 1, at 1331–35. In other words, the purchasers of the votes may use their voting power to secure politicians who would act favorably to the vote-purchasers at the expense of other constituents. For instance, a government contractor could use purchased votes to elect officials who would execute above-market government contracts with the contractor, or a special interest group could purchase votes to elect officials who would promote laws beneficial to that group.

117. *Id.* at 1335–38.

118. Hasen recognizes that his rejection of the equality argument turns on corporate law incorporating a strong shareholder wealth maximization norm. *Id.* at 1353. If that norm is rejected, as some commentators suggest it should be, *see supra* note 16, the equality argument may have greater applicability to vote-buying.

119. *Id.*

120. *Id.* at 1351–52.

121. *See infra* notes 221–74 and accompanying text.

122. *See* Clark, *supra* note 4, at 804–05; Fischel, *supra* note 112, at 141; Flocos, *supra* note 111, at 1784–90.

123. *See, e.g.*, Kass v. Eastern Air Lines, Inc., 1986 WL 13008 at *2 (Del. Ch. Nov. 14, 1986).

124. *See* Clark, *supra* note 4, at 804; Flocos *supra* note 111, at 1785–93 & nn.109–49.

role of the shareholder's vote therein, is predicated in large part on concepts of wealth maximization, government often concerns itself with allocative and redistributive issues.

Perhaps the single most important difference between the corporate and political voting regimes is the availability of a viable "exit" option. That is, share ownership is an entirely voluntary undertaking. If a shareholder disagrees with the course of action a corporation selects, the shareholder can terminate his or her ownership interest by selling the shares.[125] Citizens, by contrast, do not have the same range of options open to them. Renouncing citizenship and acquiring citizenship in another country certainly entails more substantial costs than selling corporate shares on the market. The absence of a viable exit option makes strong protection of the "voice" option[126] far more important in the political arena.[127] Thus, whatever we conclude regarding vote-buying in the political sphere, it does little to inform our choice regarding vote-buying in the corporate world.

D. *The Modern Treatment of Vote-Buying*

The modern treatment of vote-buying in corporate law reflects an outright rejection of the earlier notions of per se illegality. The shift in the judicial attitudes toward vote-buying was announced in 1982 in *Schreiber v. Carney*.[128] In *Schreiber*, a shareholder brought a derivative action on behalf of Texas International Airlines, challenging a loan made by Texas International to Jet Capital, a 35% shareholder in Texas International.[129] The loan grew out of a restructuring involving a merger between Texas International and Texas Air Corporation.[130] Under the corporate charter, the merger required a majority vote from each of a number of different classes of stock.[131] Because Jet Capital owned a majority of the shares in one of the voting classes, it could maintain a

125. Note that the availability of "exit" is not a complete answer to shareholder concerns about manipulation of the voting process. To the extent that damage has been inflicted on a corporation as a result of the manipulation, the price a share will command is likely less than it would have been absent the wrongful conduct.

126. The voice option refers to the right to vote or, in other words, to make one's voice heard.

127. *See* Flocos, *supra* note 111, at 1788–90 & nn.125–37.

128. 447 A.2d 17 (Del. Ch. 1982).

129. *Id.* at 18.

130. *Id.*

131. *Id.* at 19.

blocking position on the merger, even though the other shareholders overwhelmingly supported the merger.[132]

Jet Capital agreed that the merger was in the best interests of Texas International, but refused to support it, allegedly because of adverse income tax effects resulting from its ownership of a number of warrants.[133] Although it could escape these negative tax consequences by exercising the warrants, it stated that it lacked sufficient cash to do so. Thus, it felt constrained to vote against the merger.[134] In order to overcome this impasse, the board of Texas International agreed that Texas International should provide a loan to Jet Capital to fund its early exercise of the warrants.[135] The loan was put to shareholder vote and overwhelmingly approved.[136]

At least one shareholder, Leonard Schreiber, however, did not approve of the transaction. He filed suit asserting that the transaction constituted vote-buying and, under well-established law, was illegal per se.[137] The court agreed with Schreiber that the loan constituted vote-buying.[138] According to the court, however, vote-buying was not per se illegal, but rather must be examined on a case by case basis.[139] Here, the vote-buying passed judicial scrutiny.[140]

In order to reach this result, the court was forced to distinguish precedents that at least superficially appeared to hold vote-buying illegal per se.[141] In doing so, the court reexamined the old cases, and found two propositions. First, vote-buying arrangements were illegal when they

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.* at 20.

136. *Id.*

137. *Id.*

138. *Id.* at 23. It is not entirely clear why this transaction involved vote-buying. After all, the corporation loaned the money to the shareholder, it didn't merely give it away. It appears, however, that the terms of the loan were more favorable than the shareholder could have gotten elsewhere. According to the court, "borrowing money at the prevailing interest rates ... was deemed too expensive by the management of Jet Capital." *Id.* at 19. Presumably the 5% rate offered by Texas Air for the loan, *id.*, was lower than market. A sub-market interest rate loan would constitute consideration.

139. *Id.* at 25.

140. *Id.*

141. *See generally* Chew v. Inverness Mgmt. Corp., 352 A.2d 426 (Del. Ch. 1976); Hall v. Isaacs & Sons Farms, Inc., 146 A.2d 602 (Del. Ch. 1958), *aff'd* 163 A.2d 288 (Del. 1960); Macht v. Merchs. Mortgage & Credit Co., 194 A. 19 (Del. Ch. 1937).

acted "to defraud" or "disenfranchise" stockholders."[142] The *Schreiber* court characterized *Macht v. Merchants Mortgage & Credit Co.*,[143] for instance, one of the principal cases prohibiting vote-buying, as involving "a series of *criminally manipulative* transactions instigated by a designing director in order to wrest control of the corporation from the other stockholders for *fraudulent* motives."[144] According to the *Schreiber* court, this proposition retained its vitality, but simply was not implicated by the facts presented.[145] The second proposition was that vote-buying was illegal per se because it violated public policy. The court, citing evolving ideas of "public policy" and changed attitudes toward the function of shareholders in corporate governance, explicitly rejected this as a basis for invalidating vote-buying agreements.[146]

The court was quick to point out, however, that its rejection of per se invalidity for vote-buying agreements should not be taken as a sign that courts would openly embrace these agreements.[147] The court noted that vote-buying agreements had a potential for abuse. Thus, although vote-buying agreements would no longer be void, they would still be voidable and subject to a test of intrinsic fairness.[148] The agreement in question here clearly passed this test, according to the court, as the disinterested shareholders had overwhelmingly approved it following full disclosure.[149]

To summarize, the state of the law after *Schreiber* required Delaware courts to undertake a three-part test. First, determine if the agreement in question constitutes vote-buying. That is, does it involve the transfer of voting power in exchange for consideration personal to the shareholder? If it does, then determine whether it acts to defraud or disenfranchise the other shareholders. Finally, even if there is no fraud or disenfranchisement, treat the agreement as a voidable transaction subject to the test of intrinsic fairness.[150]

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142. *Schreiber*, 447 A.2d at 23.

143. 194 A. 19 (Del. Ch. 1937). The *Schreiber* court described *Macht* as the leading case for the proposition that vote-buying was illegal per se. *Schreiber*, 747 A.2d at 23.

144. *Schreiber*, 447 A.2d at 23 (emphasis added).

145. *Id.* at 26.

146. *Id.* at 25.

147. *Id.* at 26.

148. *Id.*

149. *Id.*

150. *Id.*

Delaware courts have addressed allegations of vote-buying a number of times since the decision in *Schreiber*. In each of these cases, the court has whole-heartedly embraced the *Schreiber* court's rejection of per se illegality. In fact, as described below, some of these decisions go even farther than *Schreiber*. Yet, in none of these cases was the voting agreement struck down as illegal.

On two of these occasions, the court determined that the agreement in question did not constitute vote-buying. In doing so, the courts narrowed the expansive definition of vote-buying adopted by *Schreiber*. In *Henley Group, Inc. v. Sante Fe Southern Pacific Corp.*,[151] for instance, the court held that *Schreiber* required as an "essential element of a vote buying agreement . . . that '. . . the stockholder divorces his discretionary voting power and votes as directed by the offeror.'"[152] According to the *Henley* court, the fact that the party in the present case was not legally obligated to vote in a certain way precluded any finding that vote-buying had occurred.[153] Thus, under *Henley*, a threshold requirement for vote-buying is a legally binding obligation to vote in a certain manner.

In the other case, *Rainbow Navigation, Inc. v. Yonge*,[154] the court instead focused on the issue of consideration. In that case, Van Reesema, one of three shareholders in a closely held corporation, switched loyalties.[155] As a result, the directors of the company were removed from office and the corporate bylaws were amended.[156] The displaced directors brought suit, alleging that the vote that removed them was illegal because Van Reesema's vote had been bought.[157] According to the directors, Van Reesema switched only after being offered a "consulting agreement" and the release of certain legal claims against him.[158] According to the judge, however, this arrangement did not constitute vote-buying for two reasons. First, Van Reesema's expectation of a consulting agreement was not legally enforceable at the time of the vote.[159] Secondly, the

151. No. CIV. A. No. 9569, 1988 WL 23945 (Del. Ch. Mar. 11, 1988).

152. *Id.* at *7 (quoting *Schreiber*, 447 A.2d at 23).

153. *Id.*

154. No. CIV. A. No. 9432, 1989 WL 40805 (Del. Ch. Apr. 24, 1989).

155. *Id.* at *1.

156. *Id.*

157. *Id.* at *2.

158. *Id.* at *5.

159. *Id.* at *7.

consideration was not "a principal motivating force" in Van Reesema's decision to vote the way that he did.[160]

Taken together, these two cases narrow the broad definition of vote-buying *Schreiber* offered. To constitute vote-buying, three things now must occur. First, the "seller" must have a legally enforceable right to the consideration offered. Second, that consideration must have been a "principal motivating force" in the shareholder's vote. Finally, the seller must have a legal obligation to vote in a certain manner. Absent these three elements, a vote-buying charge will not stand.

Two other cases have addressed the second prong of the *Schreiber* test, whether the alleged vote-buying acted to "defraud or disenfranchise" the other shareholders. First, in *Kass v. Eastern Air Lines, Inc.*,[161] *Schreiber* was extended to a case involving bondholder consents. Eastern was attempting a merger with Texas Air. As part of the deal, Eastern desired to pay a $1.75 dividend to its shareholders.[162] Payment of such a dividend, however, would violate certain covenants contained in various outstanding convertible debentures.[163] These covenants could be altered only with the consent of two-thirds of the holders of these instruments.[164] In an attempt to secure these consents, the board of Eastern offered to pay each debenture holder who consented either $35 in cash or $125 in free Eastern ticket vouchers for each $1000 in face amount of debentures for which consent was given.[165]

Not surprisingly, debenture holders who were opposed to relaxing the covenants challenged this as illegal vote-buying.[166] In analyzing this claim, the court, much like the *Schreiber* court, quickly rejected the argument that analogized corporate vote-buying to vote-buying in political contests.[167] According to the court, the political system involved important non-commercial considerations, and thus a trade of votes for money would be corrupting.[168] Commercial transactions, on the other hand, involved solely commercial values, and thus, "commerce in votes"

160. *Id.* at *10.
161. 1986 WL 13008 (Del. Ch. Nov. 14, 1986).
162. *Id.* at *1.
163. *Id.*
164. *Id.*
165. *Id.*
166. *Id.*
167. *Id.* at *2–*3.
168. *Id.*

was much more acceptable.[169] The court went so far as to say that in the commercial setting, "to conclude that the offering of money in exchange for consent (vote) is necessarily corrupt or a per se violation of public policy strikes [the Court] as quaint."[170]

The court thus rejected per se illegality and chose to adopt the *Schreiber* analysis. Because the consideration was openly offered to each of the bondholders on the same terms, the court concluded that it was not fraudulent and could not act to disenfranchise any of the voters.[171] Interestingly, it never addressed the third prong of the *Schreiber* test. It did not treat the offer as a voidable transaction subject to approval by the disinterested voters.[172]

Most recently, a Delaware court addressed this issue in In re *IXC Communications, Inc. Shareholders Litigation*.[173] There, IXC, a telecommunications company, placed itself "in play" by hiring an investment bank to develop merger options.[174] Ultimately, Cincinnati Bell, Inc. (CBI) forwarded a proposal to merge the two companies by having the IXC shareholders exchange their shares for shares in CBI.[175] During the course of negotiations that led to the merger proposal, CBI met with General Electric Pension Trust (GEPT), IXC's largest shareholder with nearly a 40% stake.[176] CBI and GEPT reached a "side-deal" regarding the proposed merger.[177] Pursuant to that deal, CBI purchased half of GEPT's IXC holdings for $50 per share.[178] In exchange, GEPT agreed to vote its remaining shares in favor of the merger.[179]

After CBI presented its merger proposal to the board and the board approved, dissident shareholders attempted to enjoin the shareholder vote

169. *Id.* at *3.

170. *Id.*

171. *Id.* at *4. This conclusion overlooks the coercive aspects of group action in light of a prisoner's dilemma situation. *See supra* notes 98–107 and accompanying text.

172. Of course, when the offer is open to all, it would be difficult to find disinterested voters. However, *Schreiber* then requires the court to perform a judicial inquiry into the intrinsic fairness of the transaction, an inquiry the court in *Kass* failed to undertake.

173. No. C.A. 17324, C.A. 17334, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999).

174. *Id.* at *1.

175. *Id.* at *2.

176. *Id.*

177. *Id.* at *3.

178. *Id.*

179. *Id.*

necessary to complete the merger.[180] The shareholders argued, inter alia, that the CBI-GEPT deal constituted impermissible vote-buying.[181] In addressing this charge, the court concluded that the arrangement could well be considered vote-buying.[182] Under *Schreiber*, however, the court continued, such arrangements were void only if they acted to defraud or disenfranchise the remaining shareholders.[183] Here, according to the court, the plaintiffs admitted there was no fraud, so the only question was disenfranchisement.[184] With regard to that issue, the court concluded that, because GEPT held only a 40% interest (prior to its sale of 50% of its shares to CBI), the agreement could not act to disenfranchise the remaining independent shareholders.[185] Finally, in response to the plaintiffs' argument that the precommitment of the 40% interest in support of the merger would "almost lock up" the vote, leaving the remaining shareholders with "scant power" to oppose the deal, the court said merely: "'*Almost* locked up' does not mean 'locked up,' and '*scant* power' may mean less power, but it decidedly does not mean 'no power.'"[186]

Under *IXC*, then, it appears that so long as less than 50% of the vote is in the hands of the vote-purchaser prior to the election, the transaction is not subject to challenge on disenfranchisement grounds. Moreover, as in *Kass*, the court in *IXC* failed to address the third prong of *Schreiber*. That is, it did not subject the vote-buying to approval by the disinterested shareholders or a test of "intrinsic fairness." Whether this indicates that intrinsic fairness is no longer part of the vote-buying analysis is unclear.[187] What is clear, however, is that under modern case law, vote-buying agreements receive far more generous treatment from the courts than they have in the past.

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180. *Id.* at *1.

181. *Id.* at *7–*9.

182. *Id.* at *3.

183. *Id.* at *8.

184. *Id.*

185. *Id.* at *9.

186. *Id.*

187. *See generally* Royce de R. Barondes, *An Economic Analysis of the Potential for Coercion in Consent Solicitations for Bonds*, 63 FORDHAM L. REV. 749 (1994) (suggesting based on game theoretic model of bond solicitations that disclosure, rather than regulation, is sufficient to protect bondholders from coercion, thus obviating need for fairness inquiry).

III. VOTE-BUYING AND SHAREHOLDER WEALTH EFFECTS

As discussed above, the historical prohibition on vote-buying was premised on two separate arguments: a moral legitimacy argument that condemned vote-buying as a matter of principle,[188] and a shareholder wealth effects argument that decried vote-buying based on its presumed harm to other shareholders' economic interests.[189] The modern treatment of vote-buying rejects as inappropriate any consideration of the former, and focuses exclusively on the latter. With regard to the wealth-effects argument, it concludes that while shareholder wealth effects are the appropriate standard against which to judge vote-buying, those considerations do not support the earlier per se prohibition on vote-buying.[190] Instead of rejecting vote-buying transactions wholesale, the *Schreiber* court's three-prong approach attempts to segregate vote-buying transactions on a case-by-case basis. The "defraud or disenfranchise" prong, operating in conjunction with the requirement of "intrinsic fairness" (to the extent that prong remains), appears to direct courts to undertake this separation based on a determination of the shareholder wealth effects resulting from the particular vote-buying transaction at issue.[191]

The shift to a paradigm in which the regulation of vote-buying centers exclusively on a shareholder wealth maximization norm is not, in and of itself, troublesome. Shareholder wealth effects are a core concern throughout corporate law,[192] and there is no immediately apparent reason why those effects should not also be a core concern with regard to vote-buying. Nevertheless, accepting shareholder wealth maximization principles as an appropriate basis for regulating vote-buying does not

188. *See supra* Section II.C.2.

189. *See supra* note 102 and accompanying text.

190. *See supra* Section II.D.

191. If this is indeed what the *Schreiber* rule intends courts to capture, certain post-*Schreiber* interpretations of the test are questionable at best. For instance, *IXC*'s focus on a "true majority" standard to determine whether the vote-buying transaction "disenfranchised" the remaining shareholders seems like a purely mechanistic test wholly-divorced from the underlying wealth effects on the company shareholders. *See supra* notes 178–79 and accompanying text.

192. Edward S. Adams & John H. Matheson, *A Statutory Model for Corporate Constituency Concerns*, 49 EMORY L.J. 1085, 1094–95 (2000). While these authors argue that directors should take account of broader constituencies, they acknowledge that "[t]he traditional view of corporate law commands directors to make decisions that will maximize shareholder wealth." *Id.* at 1094. This view of corporate law, referred to as the shareholder primacy view, is a central tenet of traditional corporate law. *See supra* note 16 and sources cited therein.

necessarily imply that the shift away from a per se rule to a case-by-case approach furthers that goal.

To determine whether or not the shift is beneficial requires further consideration of two things; first, the likely uses of vote-buying in a permissive regime, and, second, the ability of courts to separate beneficial and detrimental vote-buying transactions. If vote-buying transactions are never beneficial to shareholders (or, if the potential costs associated with such transactions as a whole far outweigh the benefits), it may be that a per se rejection of such transactions better serves shareholder interests. Even if there are potentially beneficial vote-buying transactions, if courts are poorly equipped to separate them from detrimental transactions, a per se rule may still have advantages, notwithstanding the potential that certain pro-shareholder transactions would be blocked.

This Section discusses various potential uses for vote-buying. It first considers whether permitting vote-buying might allow shareholders to use such transactions to overcome the collective action problems that interfere with the their ability to use voting as an effective means of corporate control, but concludes that this is unlikely. It then discusses the possibility that vote-buying could be employed to facilitate corporate looting or effect coercive wealth transfers between various investor classes. It concludes that both of these represent very real threats, that the potential for such abuses must figure prominently in determining the appropriate regulatory approach, and that, to date, courts have proven incapable of identifying instances in which these harms have occurred.

Finally, this Section discusses what some commentators have advanced as the principal pro-shareholder justification for vote-buying, the possibility that potential acquirers could employ such transactions to overcome certain types of takeover defenses (in particular poison pills) through which management has attempted to insulate itself from the market for corporate control. While in these limited circumstances vote-buying may indeed prove beneficial to shareholders as a group, this Section discusses whether these same benefits could be achieved through the related idea of turnout payments—that is, paying a shareholder to vote, independent of the voting option the shareholder selects. It argues that limiting permissible "vote-buying" to such turnout payments would benefit shareholders by dismantling management's takeover protection, without exposing shareholders to the potential for abuse present in traditional vote-buying.

A. *Vote-Buying as a Response to the Collective Action Problems of Shareholder Voting*

As described above, four principal obstacles confront shareholders in developing and using information in corporation governance. First, any shareholder owning few shares will not capture a sufficient amount of gain on any corporate vote to make any but the smallest investment in information worthwhile.[193] Second, even large shareholders, who might otherwise have sufficient economic incentives to pursue voting information, may fall prey to the free-rider problem.[194] Third, in a voting contest, there are no gains to be made from private information.[195] Fourth, coordination problems may prevent an efficient use of any investments in voting information.[196]

One possible shareholder response to these difficulties would be use of a vote-pooling arrangement. This would be very similar to the voting trust described earlier. Each shareholder would transfer his or her proxies to a common pool. These proxies would then be voted as a block. In this way, the information costs could be allocated to the members of the pooling arrangement based on the amount of their investment. Because all shareholders would be sharing the costs, there would be no free-rider problem. Finally, there would be no duplicative research costs because the individual shareholders would not be developing the information on their own. The manager of the common pool would have a fiduciary duty to vote the shares in such a manner as to maximize shareholder wealth.[197]

Of course, an actual transfer of proxies to the common pool would not be necessary. Each shareholder could simply be a member of an information-pooling cooperative. The members would pay dues based on their share ownership and that money would be used to monitor corporate performance and research voting issues. After all, assuming the pertinent information yields a clear choice on a voting issue, there is no

193. *See supra* Section I.B.1.

194. *See supra* notes 37–38 and accompanying text.

195. *See supra* notes 39–44 and accompanying text.

196. *See supra* Section I.B.3.

197. If the arrangement were a voting trust, the fiduciary duty would arise as a matter of course. *See supra* note 85. If the shareholders used some other contractual arrangement to achieve the pooling, the fiduciary duty of the person voting the shares could be created and specified in the contract creating the arrangement. *See* RESTATEMENT (SECOND) OF AGENCY § 376 (1958) (stating that agent's fiduciary duties specified by contract creating agency).

need for a single trustee to control the actual proxies—the individual shareholders would all presumably vote in the appropriate way.[198]

If vote-buying were necessary, or even helpful, to such shareholder pooling arrangements, the potential shareholder benefits might justify judicial acceptance of it. It is doubtful, however, that a permissive approach to vote-buying would facilitate such arrangements, because it is unlikely that votes would be "bought." Rather, shareholders would "buy" memberships in the voting pools or trusts. By sharing the information costs, the shareholders, as equity participants in the corporate endeavor, would collectively benefit. While this sounds like a rational solution to the collective action problem, there are, as a practical matter, very few voting trusts in existence.[199] Furthermore, those that are in use operate almost exclusively in closely held private corporations.[200] At first glance this is somewhat anomalous because it would seem that the coordination and free-rider problems would be smaller with respect to close corporations for two reasons.[201] First, the smaller number of shareholders makes coordination, in general, much easier. Second, closely held corporations tend to be held within families or small groups of close friends. The extra-corporate ties that bind these groups should help to ameliorate any free-rider concerns through the use of social sanctions against the free-rider.

Whatever the benefit of vote-pooling in the close corporation, the question remains—why aren't there more such arrangements in large public corporations? There are at least three possible answers to that question. First, it may be that voting trusts do not really overcome the

198. The assertion that they would vote in the same manner assumes (1) that the shareholders share the same level of risk aversion (probably a safe bet in a publicly held corporation where a majority of the shareholders are likely diversified), (2) that no subgroup of shareholders stands to benefit separately from the transaction underlying the vote, and (3) that there is clearly a "right" way to vote from a shareholder wealth maximization perspective.

199. One commentator, for example, refers to the "absence of voting trusts" and offers reasons to explain it. Barry E. Adler, *Politics and Virtual Owners of the Corporation*, 82 VA. L. REV. 1347, 1367 (1996). Other commentators have suggested certain disadvantages that have led to "limited use of voting trusts." William S. Hochstetler & Mark D. Svejda, *Statutory Needs of Close Corporations—An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?*, 10 J. CORP. L. 849, 948, 1011 (1985).

200. ECONOMIC STRUCTURE, *supra* note 4, at 65.

201. Of course, coordination and free-rider problems are not the only governance difficulties a corporation might face. Other governance problems may be exacerbated in closely held corporations. *See infra* notes 275–82 and accompanying text; *see also* Clark, *supra* note 4, at 802 ("Voting trusts and vote pooling agreements are basically devices created to solve the peculiar and troublesome collective action problems of closely held corporations, such as the difficulty of achieving cooperation and avoiding voting deadlocks.").

free-rider problem. Shareholders, after all, cannot be forced to join a voting trust, they must do so voluntarily. With respect to the vote-pooling or voting trust arrangements described above, there would be little incentive to join. Any single shareholder would want others to join the pool, but he would prefer to remain outside it himself. The information costs are borne only by those who are members of the pool. The information developed, however, works to the benefit of both those in the pool and those who are not. This creates a clear incentive against membership.

A second possibility is that membership in a voting trust or similar arrangement would hinder (or even prevent) transfer of the shares.[202] All shares in the trust are legally owned by the trustee. Even if the beneficial owner could transfer her beneficial interest, legal ownership would presumably remain with the trustee.[203] That is, even upon transfer, the shares would remain subject to the voting disability imposed by the trust.

A third possibility is that there *are* a number of arrangements that approximate voting trusts, but they are not recognized as such. For example, in a mutual fund, the members' individual funds are pooled and then invested by the fund manager. The fund manager controls the votes of any stocks purchased by the fund. In return for the investment services that the manager provides, he receives a management fee. One of these "services" is usually the voting of the shares. This is, in effect, exactly the pooling arrangement suggested earlier. The "actual shareholders"[204] pool their shares and then pay a third party to vote the shares appropriately. Furthermore, the various funds are rated on their ability to provide shareholders high returns.[205] Thus, to the extent that shareholder

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202. Conceivably, membership could impact the ability to list the shares on a national exchange. All three national exchanges discourage actions that interfere with the voting rights assigned to shares. *See* NYSE Listed Companies Manual at §§ 308, 313, *available at* www.nyse.com/listed/listed.html (last visited July 31, 2001); American Stock Exchange Listing Standard § 122, *available at* www.complianceintl.com/amex (last visited July 31, 2001); Nasdaq Rule 4351, *available at* www.nasdr.com (last visited July 31, 2001).

203. A related reason for the lack of voting trusts may be that the trustee is subject to capture. That is, the concentration of voting rights within the trustee means that, if management can capture the trustee, management is entirely insulated from shareholder discipline. *See* Adler, *supra* note 199, at 1366–67. Concentrating the voting rights in a trust potentially facilitates such capture to the detriment of shareholders. Of course, the trustee's fiduciary duty may impose at least some limitations on the extent to which he or she can cooperate with management to the detriment of shareholders.

204. That is, the mutual fund members who are the "beneficial owners" of any profits received.

205. For an example of such a rating service, see the Morningstar rating system, *available at* www.morningstar.com (last visited July 31, 2001).

voting has an effect on corporate wealth, the fund managers have an incentive to invest the efficient amount in acquiring information and voting the shares.[206]

Whether or not mutual funds act as collective voting pools,[207] it is clear that permitting vote-buying will not, as a general matter, serve as a means of overcoming the collective action problems associated with voting. If shareholders were attempting to use vote-buying for those purposes, the votes should have a negative, not a positive, price. Thus, this understanding of vote-buying simply does not provide an explanation for cases in which charges of vote-buying have arisen (all of which have involved positive prices for votes), nor does it provide guidance as to how courts should handle such cases.

B. *Vote-Buying and Corporate Looting*

That vote-buying does not facilitate shareholder attempts to overcome the information and coordination problems associated with voting does not, by itself, answer the question of whether vote-buying should be permissible. There may be other "pro-shareholder" results associated with judicial leniency toward vote-buying. In order to further explore this question, assume for the moment that vote-buying were legal. Two important issues immediately come to mind: the identity of the purchasers and the pricing mechanism in the market. An analysis of these considerations suggests two things. First, vote-buying would permit purchasers to exploit shareholder coordination problems and, as a result, shareholders would sell their votes both too often and too cheaply. Second, that purchasers are seeking votes rather than shares suggests the purchasers do not plan to use the resulting voting power to enhance share values.

206. This does not imply that fund managers will be active voters, only that they will be efficient. It may be that the efficient voter does not invest in voting, preferring instead to exercise his or her exit option (i.e., sell the shares). *See generally* ECONOMIC STRUCTURE, *supra* note 4, at 88–89.

207. There are limitations on a mutual fund's ability to do so. In particular, various legal restrictions act to keep the percentage of stock a mutual fund owns in a single company relatively low. For an in-depth discussion of these restrictions, see MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 102–23 (1994). For example, under the Investment Company Act of 1940, 15 U.S.C. § 80a (1994 & Supp. 1999), a mutual fund cannot advertise itself as "diversified" if it owns more than 10% of the stock of a single company, and, if it owns more than 5% of the shares of a company, the fund is treated as an affiliate and an underwriter for securities law purposes. *Id.* at §§ 80a-2(a), -5(b)(1). Moreover, if the fund does not meet the requirements for diversification, adverse tax consequences follow. ROE, *supra*, at 106–08.

1. *The Price of Votes and the Prisoner's Dilemma*

It is likely that shareholder votes would command a very small price. According to one commentator, in fact, any non-zero price should be sufficient to purchase a vote.[208] This should not be read as implying that shareholders do not value their vote; studies indicate that non-voting shares generally trade at a 2–4% discount from otherwise identical shares that include voting rights.[209] Rather, the willingness of voters to accept low prices for their votes can best be explained by reference to collective action problems. Assume that the issue on which the purchaser would like to buy the vote requires a 51% majority of the shares to pass. Any small shareholder knows that his or her vote is unlikely to matter in the election. Thus, the shareholder has little reason not to sell his or her vote. Further, the shareholder realizes that if he or she fails to sell the vote, and the purchaser acquires them elsewhere, the shareholder's vote will be meaningless but at the same time he or she will have foregone the offered consideration.[210] Thus, the shareholder is caught in the classic prisoner's dilemma.[211]

208. Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175, 177 (1988); *see also* Easterbrook & Fischel, *supra* note 5, at 411.

209. ECONOMIC STRUCTURE, *supra* note 4, at 71. Other researchers suggest the "voting premium" is substantially higher. *See* Haim Levy, *Economic Evaluation of Voting Power of Common Stock*, 38 J. FIN. 79, 88 (1983) (citing a voting premium of 45.5%); *see generally* Oesterle & Palmiter, *supra* note 5, at 520–21 & n.165.

210. Note that this is not the case where the only consideration is a reciprocal pledge to vote in the same manner. There, the "consideration" has no value independent of the voting contest, and thus the offeree does not forego anything of value by declining the offer. Thus, traditional voting trusts or vote pooling agreements do not have the coercive effect of vote-buying arrangements.

211. Interestingly, the most recent article in favor of vote-buying assumed that the tender offer provisions of the Williams Act would apply to vote-buying. André, *supra* note 4, at 589 & nn.224–28. The Williams Act, which regulates tender offers, is contained in §§ 13(d)–(e) and 14(d)–(f) of the 1934 Act, 15 U.S.C. §§ 78m(d)–(e) and 78n(d)–(f) (1994), and the regulations thereunder, 17 C.F.R. §§ 240.13d-1 to 13e-4, 240.14a-1 to .14f-1 (2000). It requires that a person making a tender offer for all or some percentage of a company's shares make it on equal terms to all shareholders. 15 U.S.C. § 78n(d)(7). If the shareholders tender "too many" shares (i.e., more than the stated goal of the tender offer), each of the tendering shareholders has the right to participate in the tender offer in proportion to the shares he tendered. *Id.* § 78n(d)(6). The Williams Act was designed to ameliorate the coercive nature of a tender offer. (A tender offer involves a prisoner's dilemma because non-tendering shareholders may receive less for their shares than the tender price.) If the Williams Act does indeed apply to an offer to buy votes rather than shares, it may help to nullify the coercive nature of a vote-buying transaction. It is not at all clear, however, that the Williams Act would apply to transactions involving the purchase of votes. Furthermore, in the context of votes, the protection against the prisoner's dilemma is not as effective. Unlike shares, votes not tendered are completely worthless if a sufficient number are tendered. That is, non-tendering voters have no right of

Of course, while this is true for situations in which share ownership is widely dispersed among numerous small shareholders, it does not hold true when there are concentrated blocks. Imagine for instance that a shareholder has 50% plus one of the shares of voting stock. That shareholder would presumably not be willing to sell even a single vote for a small price.

This suggests the following about vote-buying: to the extent that shareholders participate both as buyers and sellers, permitting vote-buying would tend to concentrate voting power in the hands of the largest shareholders. Small shareholders will in general agree to accept small prices for their votes. Similarly, small shareholders would not be willing to pay much for the votes of others. After all, if a shareholder owns 1% of the outstanding stock, purchasing an additional 1% of the votes would not be likely to make that shareholder's vote dispositive.

Large shareholders, on the other hand, would have a greater incentive to purchase votes. Assume there are one hundred shares of voting stock in a corporation, and the largest shareholder has forty-nine of them. The shareholder would presumably be willing to pay some amount to purchase the additional two votes necessary to gain control of the corporation, and, because of the prisoner's dilemma problem noted earlier, the shareholder should have no difficulty doing just that.[212] In general, the larger the size of a shareholder's current holdings, the more the shareholder would be willing to pay for votes (up to the point where he or she obtains a sufficient number of votes to ensure the desired level of control).[213]

In sum, large shareholders may be able to avoid the coercive aspects of a vote purchase offer. In publicly-held corporations with widely-dispersed share ownership, however, coordination difficulties among the shareholders will permit vote purchases on the cheap.

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appraisal. *Cf., e.g.*, DEL. CODE ANN. tit. 8, § 262(a) (1996) (providing that after merger dissenting voters have right of appraisal for their shares).

212. Each of the remaining shareholders must, in effect, compete with the others to sell two votes. Since the value of the remaining votes after the sale is zero, the competitive price should approach zero.

213. Assume a corporation that has 100 issued and outstanding shares. If a shareholder has one share, purchasing an additional vote provides her with 1/50th of the remaining votes needed. If, on the other hand, the shareholder has thirty-five shares, an additional vote represents 1/15th of the remaining voting power required. Thus, the latter shareholder should be willing to pay more. Of course, if the shareholder already holds an outcome-determinative number of votes, he or she would presumably be unwilling to pay anything for the remaining votes.

2. *Who Buys Votes?*

If a potential vote purchaser believes that a certain outcome on a shareholder voting issue will result in increased corporate wealth, the purchaser's best option is to purchase the shares, not the votes. By purchasing the shares, the shareholder will acquire the entire increase in wealth associated with the purchased shares. If the shareholder purchases only the vote, he or she will merely capture the gain in wealth associated with those shares previously owned. Thus, if a potential purchaser has the option to purchase either the shares or the votes and chooses the latter, it suggests that the purchaser is not intending to use the vote for reasons that would increase corporate wealth, but rather to "loot"[214] the corporation.

Who are likely candidates for looting through vote acquisition? As described previously, one class of vote purchasers could be the large shareholder. It is not clear, however, that this group is likely to use vote buying to engage in looting. Large shareholders extracting wealth from a corporation also hurt themselves in their capacity as shareholders. For example, assume a 40% shareholder extracts $1 from the corporation through his or her purchase of voting control. Even if the extraction is costless,[215] the shareholder's net benefit is only sixty cents. Forty cents of the dollar already "belonged" to the shareholder. From this sixty cents, the costs of purchasing the votes[216] must also be subtracted. Thus, in general, the greater the percentage stake a shareholder owns, the less the shareholder's incentive to engage in vote-buying to loot the company.[217]

214. "Looting" refers to the improper extraction of wealth from the corporate form, for instance through excessive salaries, sale of corporate outputs or assets at an artificially low price, or purchase of corporate inputs at an artificially high price. *See* ECONOMIC STRUCTURE, *supra* note 4, at 129–31; Clark, *supra* note 4, at 795.

215. There may be some costs, such as "cover up" costs, associated with the transfer. The magnitude of those costs will depend both on the difficulty of concealing the transfer, as well as the legal rules surrounding such transfers.

216. The costs referred to here include both the purchase price for the votes as well as the costs, such as communication costs, associated with making the offer and undertaking the purchase.

217. Indeed, in a permissive vote-buying regime, the large shareholder may often be forced into the role of "reluctant purchaser." That is, if a potential looter makes an offer for shareholder votes, the large shareholder may find it necessary to bid against the looter in order to protect the value of the shareholder's stake in the company. While at least one commentator has suggested that the potential for competing bids serves to protect shareholder vote sellers from the coercive nature of the prisoner's dilemma, *see* Levmore, *supra* note 2, at 139, as this example indicates, the possibility of such a bidding war may result in a coercive wealth transfer away from large shareholders.

Even so, a permissive attitude toward vote-buying would provide at least some additional possibilities for looting by large shareholders. While the large shareholder has, in some sense, a pre-existing "claim" to some portion of the corporate dollar, the shareholder would no doubt prefer the entirety to that portion, thereby providing the shareholder an incentive for vote-purchases to solidify control. In a regime that banned vote-buying, by contrast, the large shareholder seeking to obtain greater control to facilitate looting would need to acquire additional shares in order to do so. Requiring the "looting shareholder" to purchase shares rather than votes would likely diminish such looting for two reasons. First, purchasing shares would be more expensive than purchasing votes alone, thus increasing the price of obtaining the desired level of control. Second, the harm imposed on others by the shareholder's looting would be diminished.[218] In essence, a ban on vote-buying would force the shareholder to internalize a greater portion of the costs imposed by the looting.

Other corporate constituency groups are in even better position to use vote-buying to engage in looting because they can do so while suffering none of the detrimental effects associated with share ownership in the looted firm. Three prime examples of this are management, vendors, and customers. Management could derive benefits from controlling the vote even absent any ownership in the underlying shares. Because of the role it plays in the corporation, management can often extract benefits to the disadvantage of the shareholders.[219] By taking the shareholder's vote and placing it with management, these problems are exacerbated; management simply has greater control and hence a greater ability to loot. Furthermore, by allowing management to control the vote (one of the other monitoring mechanisms), the threat of a hostile takeover is impaired: management can use its purchased shareholder voting power to prevent the takeover transaction. The ability of management to inflict harm on the shareholders is especially pronounced in situations where management purchases the right to vote for an extended period of time.[220]

218. That is, if the shareholder's stake increases from 40% to 60%, S0.60, rather than S0.40, of every dollar "looted" already "belonged" to the shareholder. As a result, harms to the remaining shareholders are proportionately reduced.

219. For example, management can raise salaries, create generous retirement plans, or provide extravagant corporate perquisites. *See* André, *supra* note 4, at 598–99.

220. For instance, in a successful dual-class recapitalization, management shareholders can acquire effectively complete control for a period of unlimited duration. *See id.* at 620–21.

However, it still presents a problem even if the management purchases the vote on an issue by issue basis.

Similarly, allowing corporate vendors or customers to control the vote could be detrimental to a corporation. Either of these groups could use the vote to install board members "friendly" to their causes, or use this possibility to gain "converts" among the current board. This possibility could result in the corporation continuing contracts on terms less favorable than could be obtained elsewhere, thus redirecting corporate profits from shareholders to these outside groups.

This analysis suggests the following general rules. Those desiring to profit from control by an increase in share values are unlikely to buy votes; they would prefer to obtain control by purchasing the additional shares rather than merely the votes. The groups that prefer to purchase votes without the underlying shares are likely to do so because they intend to loot the company. Thus, a legal rule legitimizing vote-buying increases the risk of looting, particularly when the vote purchaser is a non-shareholder, and courts should be particularly leery of such transactions.

C. *Vote-Buying and Coercive Transfers Between Different Classes of Corporate Participants*

Even where the purchasers are shareholders rather than corporate insiders, vote-buying still presents another potential problem. It may be employed to create coercive wealth transfers between different "classes" of corporate participants. This Section examines two important vote-buying cases and concludes that they may well be examples of just such coercive transfers. The possibility that it could be used to effect such transfers argues strongly against permitting unrestricted vote-buying.

There are many different "classes" of corporate participants. Bondholders, shareholders, preferred shareholders, creditors, to name just a few, all derive substantial economic benefit from the existence of the corporation. The nature of the economic benefit varies greatly between these groups, however, with regard to the nature of the financial risk, the payment mechanisms employed, the term of the investment, the available exit options, and many other characteristics. Even among a single group such as shareholders, there may be separate classes,[221] each

221. *See, e.g.*, DEL. CODE ANN. tit. 8, § 151(a) (1991 & Supp. 2000):

representing a different claim on the residual assets or earnings of the corporation.

The previous Section addressed the manner in which management and suppliers could use vote-buying to the detriment of the shareholder. However, a closer examination of two cases indicates that the various classes of corporate investors can also use vote-buying to better their position relative to investors in other classes.

1. *Extorting Wealth from Bondholders: Lessons from* Kass

Kass v. Eastern Air Lines, Inc.[222] presents an example of just this type of inter-class conflict. As described previously,[223] *Kass* involved a conflict between corporate shareholders and bondholders. The shareholders desired to undertake a merger in a manner that required the relaxation of certain covenants in some of the outstanding bonds.[224] The company sought to purchase with cash and flight coupons the bondholders' consent to amend the covenants.[225] Some of the bondholders attempted to enjoin the offer as impermissible vote-buying, but, using a *Schreiber* analysis, the court upheld the transaction.[226]

The problem with the court's holding is that it did not reflect an important difference between the economic reality of *Schreiber* and that of *Kass*. In *Schreiber*, although the shares were different classes, the residual interest in the corporation was fairly similar. In *Kass*, by contrast, the nature of the economic interest between the disputing parties was quite different. Bondholders do not share in increased corporate growth. They have a fixed upside potential, the stated interest rate, but they do share in corporate losses, at least if those losses cause the corporation to default on its indebtedness. Thus, bondholders as a group tend to be risk averse.[227] They would prefer a corporation make

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> Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, any or all of which classes . . . or series may have such voting powers . . . and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation . . . .

222. 1986 WL 13008 (Del. Ch. Nov. 14, 1986).

223. *See supra* notes 161–72 and accompanying text.

224. *Kass*, 1986 WL 13008 at *1.

225. *Id.* at *2.

226. *Id.* at *5.

227. *See, e.g.*, Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 181 (1989):

"safe" choices because they are not rewarded when risky ventures pay off.[228] Shareholders, on the other hand, have unlimited upside participation. Increases in profits increase shareholder wealth. Thus, they are, in general, more willing to see the corporation adopt a greater risk level.[229]

Bondholders, recognizing this divergence in risk tolerance, generally require covenants in bonds giving them the right to veto certain corporate acts, such as mergers or acquisitions, which can significantly affect the risk of the investment.[230] *Kass* can be seen as a case where the shareholders, acting through the board, deprived the bondholders of the protections offered by these covenants.

In *Kass*, each bondholder found itself in a prisoner's dilemma. Their consent was not likely to influence the outcome of the election. However, if an individual bondholder failed to consent, but the required number of bondholders did, the individual bondholder would be forced to accept the amended covenants without receiving the benefit of the cash offered by the company. The rational choice for each bondholder in this situation was to accept the compensation and give its consent. This was true even if the compensation was not sufficient to offset the additional risk incurred by the bondholders. By allowing the transaction, the court arguably allowed the shareholders to increase their wealth at the expense of the bondholders.

> The most important manifestation of the conflict of interest between fixed claimants and shareholders lies in their attitudes toward the optimal level of risk that a firm should take. Shareholders have a powerful incentive to induce their firms to engage in activities that fixed claimants would consider excessively risky. This is because shareholders stand to reap all of the benefits from the spectacular success of a particularly risky activity, but stand to lose only the amount of their initial capital investment. Fixed claimants, in contrast, do no better when their firm performs very well than when their firm garners only a moderate return. For this reason, shareholders generally retain the right to control most details of a firm's business, subject to the broad contractual protections that fixed claimants extract to protect themselves against default.

See also Thomas E. Stagg & Scott Ferretti, *Contractual Protection: An Existing Remedy for Bondholder Distress*, 4 ST. JOHN'S J. OF LEGAL COMMENT. 245, 253 (1989) ("The bondholder is generally viewed as more risk averse than the stockholder and has a direct interest in preserving corporate capital and earnings in order to maximize firm value.").

228. *See* ECONOMIC STRUCTURE, *supra* note 4, at 68; Macey, *supra* note 227, at 181.

229. *See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 19 (1986) (describing shareholders with a diversified portfolio as risk neutral, or even risk preferring); Macey, *supra* note 227, at 181; Stagg & Ferretti, *supra* note 227, at 252–55 (explaining why shareholders have a higher risk tolerance than bondholders).

230. ECONOMIC STRUCTURE, *supra* note 4, at 68.

It is important to realize that it is not the transfer of wealth per se that was objectionable, but rather the means by which it was achieved. The shareholders, acting collectively through the board, were able to exploit a collective action problem among the bondholders to change the terms of the contract between these two groups. Allowing this type of exploitation results in higher bond rates in general and inefficient pricing of bonds.[231]

Under the holding in *Kass*, bonds can be converted to covenant-free bonds at a relatively low price.[232] However, that in turn implies that lenders will provide little discount for accepting covenants in the first place. Because covenants exist in most debt instruments, they must, as a general rule, improve the wealth of both parties to the transaction. By reducing bondholder reliance on such covenants, consent-buying reduces the magnitude of this wealth.

One potential response by lenders could be to insist upon covenants that cannot be altered even by consent. This approach, however, would also result in deleterious wealth effects. Such immutable covenants would in effect result in precommitment strategies without exit options. Thus, even if both lender and borrower truly wanted to change the terms of the agreement, it would be difficult to achieve.[233]

Another alternative would be for bondholders to form representative committees similar to the board of directors. By forming such committees, the individual bondholder would escape the prisoner's dilemma because each could be guaranteed concerted action among all of the bondholders. Of course, by adopting a board, the bondholders would incur some of the same agency costs currently experienced by corporate shareholders. And, in any event, creating such a board would increase transaction costs associated with the issuance of corporate debt, once again raising the rates from those in a world where the bondholders could not be coercively deprived of the benefit of their covenants through vote-buying. All in all, it seems likely that ex ante, both shareholders and

231. For an argument that bondholders are not necessarily subject to coercion in *Kass*-type consent solicitation, see Royce De R. Barondes, *supra* note 187, at 754. Barondes suggests that bondholders avoid coercion because the consent solicitation process is more accurately modeled as a repeat game rather than a single-shot game. *Id.*

232. The court in *Kass* did not undertake an intrinsic fairness analysis to see if the price paid accurately reflected the value of the covenants given up. *See* Kass v. Eastern Air Lines, Inc., 1986 WL 13008 (Del. Ch. Nov. 14, 1986). Note that in general this could prove to be a very difficult determination for a court to make.

233. Conceivably, if both agreed, the borrower could issue the lender a new bond with different covenants and use the proceeds to retire the old debenture. The transaction costs on such a swap (e.g., the costs of complying with securities law requirements) could, however, prove prohibitive.

bondholders would be better off in a world that did not permit shareholders to purchase consents. By failing to recognize the coercive nature of the transaction at issue, the *Kass* court erred in its decision.

2. Schreiber *as a Rubinstein Game.*

Even *Schreiber* can be viewed as an example of the use of vote-buying to effect a coercive wealth transfer between corporate participants. In *Schreiber*, the corporate bylaws required approval by a majority of each of three voting classes to approve a merger.[234] A single shareholder owned a majority of the shares in one of the classes, and thus could maintain a blocking position on the corporate reorganization.[235]

Everyone, including the blocking shareholder, agreed that the merger would increase corporate wealth, but the blocking shareholder would not agree to it until he extracted a presumably below market rate loan.[236] Although the court did not endeavor to name the price, the favorable terms could, of course, be translated into a cash equivalent. Thus, in reality, *Schreiber* involved an attempt by one shareholder to extract wealth from other shareholders through use of his blocking position.

Of course, this case is different from *Kass* in that the economic interests of the shareholders in *Schreiber* were all the same. That is, all of the shareholders would presumably benefit from an action expected to increase share value. Because the interests among both vote-sellers and vote-buyers were aligned, the coercive transfer must have been accomplished somewhat differently than in *Kass*.[237] After all, as the interests were the same, at first glance it seems that the other classes of stock could just as easily have demanded that their votes be purchased. In other words, it appears that the other shareholders could have rejected the blocking shareholder's demand for a loan. If they had, it would presumably have been in his interest to acquire a loan from secondary

234. Schreiber v. Carney, 447 A.2d 17, 19 (Del. Ch. 1982). For general discussion of the facts of this case, see *supra* notes 128–50 and accompanying text.

235. *Schreiber*, 447 A.2d at 19.

236. *Id.* at 19–20. Jet Capital's management stated that a market rate loan was too expensive, so the 5% rate offered by Texas Air was presumably below market rate. The court does not indicate the magnitude of the difference between the terms offered and the market rate. *Id.* at 19.

237. The key in *Kass* was that the shareholders (vote-buyers) and the bondholders (vote-sellers) had a divergence in interest. *See supra* notes 220–26 and accompanying text.

sources and then still vote for the merger.[238] How then was the blocking shareholder able to complete his extraction?

In essence, the negotiations between the shareholders could be modeled as a Rubinstein game.[239] In the basic Rubinstein game, two parties must agree on how to split some sum of money.[240] Here, the increase in corporate wealth resulting from the merger is the sum that must be split between the players. Furthermore, there is pressure on the players to complete the negotiations as quickly as possible.[241] For simplicity purposes, then, *Schreiber* can be modeled as a game involving two players, A representing the blocking shareholder and B representing the remaining shareholders.[242] Both A and B will gain from permitting the merger, the only issue is the extent to which each gains.[243] The fact that in *Schreiber* the blocking shareholder (A) was able to extract the loan suggests a few possible alternatives.

The course of Rubinstein bargaining is strongly affected by the exit options open to the players.[244] Here, however, there is no exit option for splitting the gains. The only exit option open to the players other than a successful negotiation is to forego the gains entirely. The Rubinstein model predicts that in such a splitting game, if there is perfect information, the players will split the gains evenly.[245] This should imply

238. Presumably, with a loan, the merger would have a positive value for the shareholder. Thus, unless the "cost" of the loan exceeded the benefit of the merger (*see infra* notes 242–47 and accompanying text), the shareholder would obtain the loan and vote for the merger.

239. *See* Ariel Rubinstein, *Perfect Equilibrium in a Bargaining Model*, *in* 50 ECONOMETRICA 97–110 (1982); *see also* BAIRD ET AL., GAME THEORY AND THE LAW 219–41 (1992) (discussing the Rubinstein game).

240. BAIRD ET AL., *supra* note 239, at 224–32.

241. Due to the speed with which business conditions change, merger negotiations are often very time-sensitive. *See* Ashutosh Bhagwat, *Modes of Regulatory Enforcement and the Problem of Administrative Discretion*, 50 HASTINGS L.J. 1275, 1296 (1999) ("Many mergers, especially ones involving publicly traded companies, are often extremely time-sensitive since changes in reported profits or stock prices are likely to unravel any deal over time.").

242. The remaining shareholders could, of course, also be blocking shareholders. The reason one shareholder was able to assume that position while others were not is examined *infra* notes 250–51 and accompanying text.

243. There can be no doubt that the blocking shareholder will benefit from the merger after the loan, otherwise he would continue to oppose it.

244. BAIRD ET AL., *supra* note 239, at 224-32.

245. *Id.* at 224. More formally, Rubinstein predicts that the two players will split the one dollar so that player 1 receives $1/(1+\delta)$, and player 2 receives $\delta/(1+\delta)$, where $\delta = 1/(1+r)$ and r is the per period interest rate of the players. *Id.* at 223–24. *See also* ROBERT GIBBONS, GAME THEORY FOR APPLIED ECONOMISTS 68–71 (1992) (providing inductive mathematical proof of this result). When the time period between offers becomes arbitrarily short, however, $r \rightarrow 0$, and thus $\delta \rightarrow 0$, meaning both player 1 and player 2 receive $1/(1+1)$ or ½ of the dollar. BAIRD ET AL., *supra* note 239, at 224.

that in *Schreiber*, the gains would be split on a per share basis, and A would not be able to extract any wealth from the other shareholders.

In reality, however, such a division of the gains may not actually have been "even." In order to benefit from the transaction, A was required to exercise his warrants, which required obtaining a loan. Thus, A was required to incur a cost[246] that B was not.[247] Obtaining the loan from B[248] might then be seen as a means of splitting this cost in order to arrive at an even split of the net profit from the transaction.[249]

If this is indeed the case, the result of the vote-buying transaction may not be coercive. In fact, vote-buying may allow beneficial transactions to go forward that otherwise would not. To see this, assume that if A doesn't exercise his warrants, the merger will indeed result in negative profits to him personally. However, if A does exercise the warrants, both A and B will benefit by $5. Further assume that it would cost A $6 to obtain the loan. A will not be willing to spend the $6 to benefit by $5, even though in the aggregate the benefits ($10) exceed the costs ($6). By allowing the remaining shareholders to "buy" A's vote, they can share the $6 cost. Indeed, if such cost sharing is allowed, presumably all transactions that are beneficial in the aggregate would occur. Thus, if this were an accurate assessment of what is taking place, vote-buying may be beneficial.

Yet, it is difficult to ascertain whether this is truly taking place. For instance, the "sharing" could easily be skewed by the presence of asymmetric information. Presumably, both A (the blocking shareholder) and B (the remaining shareholders) knew the projected increase in share value resulting from the merger. Thus, A knew B's true valuation of the merger. As discussed previously, however, A had costs associated with the transaction that B did not. Furthermore, B was not necessarily in a good position to know or even accurately estimate those costs;[250] B may

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Note this result remains unchanged even if the two players have different discount rates (i.e., player 1 has a different r and δ than player 2). *Id.*

246. For example, the origination cost of the loan.

247. The other shareholders were engaging in tax-free swaps. Schreiber v. Carney, 447 A.2d 17, 19 (Del. Ch. 1982).

248. The loan was obtained from the corporation, which can be viewed for these purposes as the representative of B (the other shareholders).

249. The net profit would be the increase in shareholder wealth minus the costs associated with the loan.

250. Remember, B is in reality a group of shareholders. As discussed previously, there are collective action problems associated with the group acquisition of information. *See supra* Section I.B.

simply have accepted A's estimate of the costs. If the "net" profits are skewed by A's overblown estimate of its costs, then B may end up "over-reimbursing" A.

This is a slightly less palatable explanation. If B is in the position of being "forced" to rely on A's estimate of his costs because of the collective action problems associated with information gathering, then A can extract a certain amount of additional wealth from B by misrepresenting those costs.

Finally, the negotiations in *Schreiber* could be viewed as a breakdown in the Rubinstein model. The blocking shareholder in Schreiber was a single entity. The other party, by contrast, was a group. The group may have faced collective action problems in the bargaining process that the blocking shareholder did not. For instance, counter-offers may have been very difficult for the group to propose. If counter-offers are relatively more expensive, they are relatively less likely to be made.

In order to avoid this problem, the shareholder group in *Schreiber* used the board as its negotiating representative. However, this in turn may have created an agency problem. The blocking shareholder, for instance, may have been able to "capture" the board, resulting in less forceful negotiations on behalf of the remaining shareholders.[251] Either way, this could be seen as an example of the blocking shareholder exploiting the collective nature of his "opponent."

Independent of which of these explanations best describes what took place in *Schreiber*, it is not clear that vote-buying is desirable in cases like this. By permitting it, the courts allow the opportunity for additional negotiations regarding the distribution of the surplus from a corporate reorganization. These negotiations involve transaction costs including delays in the completion of deals. Against these costs, the only benefit to allowing vote-buying in cases such as *Schreiber* is to permit transactions to go forward that are beneficial in the aggregate, but detrimental to certain shareholders. It does this by permitting the benefiting parties to share their gains with the injured shareholders.

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251. Of course, if this were the case, the shareholders could conceivably have a cause of action against the board for breach of fiduciary duty. *See* Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173, 182 (Del. 1986) (noting that in merger context, board has duty to maximize shareholder values); Christian C. Day, *Corporate Governance, Conrail, and the Market: Getting on the Right Track!*, 26 J. CORP. L. 1, 16 (2000) (explaining that in merger context board has duty, typically referred to as "Revlon duty," to maximize shareholder value). It is likely, however, that even to the extent such a fiduciary duty were to exist, absent gross misconduct, the Business Judgment Rule would make it difficult to proceed on such a claim. *See* Day, *supra*, at 15-24 (discussing Business Judgment Rule in context of merger negotiations).

In general, however, this would involve a very small percentage of cases. Shareholders' interests are usually very closely aligned. That which benefits one (in his or her capacity as a shareholder) generally benefits all. Even in those cases where vote-buying is arguably beneficial, collective action problems and asymmetric information could permit small groups of shareholders in control positions to use it to extract wealth from the remaining shareholders. Thus, even those vote-buying cases involving solely purchases among shareholders, vote-buying is still potentially harmful, and there is reason to suspect that courts are incapable of recognizing and policing the harm when it occurs.

D. Vote-Buying as a Means of Facilitating Control Transactions

As the previous sections demonstrate, vote-buying presents the possibility of corporate looting and/or coercive wealth transfers between corporate participants.[252] Commentators have suggested, however, that the potential benefit of vote-buying as a means to overcome the shareholder costs imposed by "shareholder rights plans" justifies permissive treatment of vote-buying, notwithstanding these identified costs.[253] This Section addresses their arguments, concluding that while its use as a means of overcoming shareholder rights plans may provide some benefits, the same benefits could be obtained through use of turnout incentives, without incurring the potential harms vote-buying presents.

It is widely recognized that the possibility of corporate acquisition is generally beneficial to shareholders.[254] As described above, collective

252. *See supra* notes 214–39 and accompanying text.

253. *See generally* André, *supra* note 4, at 585–606 (suggesting that courts should permit vote-buying as a means around anti-takeover statutes); *see also* Hasen, *supra* note 1, at 1349–52 (suggesting that vote-buying permits potential acquirers to overcome shareholder rights plans, thereby enhancing corporate efficiency); Levmore, *supra* note 2, at 138 (suggesting that vote-buying is pro-shareholder). For discussion of a related idea, see Clark, *supra* note 4, at 806–07 (suggesting that vote-buying should be allowed by shareholders who are planning to recoup their investment by an increase in the share price of the company's stock).

254. *See, e.g.*, Frank H. Easterbrook & Gregg A. Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 291–92 (1984) (arguing that management adoption of defensive tactics is contrary to shareholder interests); Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 9 (1978) ("The market for corporate control and the threat of cash tender offers in particular are of great importance in creating incentives for management to maximize the welfare of shareholders."); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983) (finding that corporate takeovers benefit the shareholders, the bidding firm, and create positive gains).

action problems among shareholders can prevent effective monitoring of corporate managers, leading to entrenched (mis)management and resulting loss in shareholder value.[255] Acquirers seek to purchase control positions in companies suffering from such mismanagement and replace the existing management with better managers, thereby capturing the gains associated with the increased productivity. The monitoring effect created by the potential for such transactions provides a useful tool for keeping the current management focused on creating shareholder value.[256]

During the late 1980s, however, managers (often with the help of state legislatures) had largely succeeded in protecting themselves from the threat of hostile takeovers through the use of sophisticated takeover defenses.[257] These defenses generally fell into two categories: anti-takeover statutes and "shareholder rights plans," the latter of which were often euphemistically referred to by more colorful names such as "poison pills" and "shark repellents."[258] The defenses were designed to allow incumbent managers to thwart the ability of corporate outsiders to effect changes in corporate control through share acquisition.[259] Basically, the defenses adopt provisions whereby, in the event an "unfriendly" suitor purchases a threshold number of shares in the company, some adverse consequence follows.[260] For example, the newly-acquired shares might

255. *See supra* notes 17–47 and accompanying text.

256. *See, e.g.*, Fischel, *supra* note 254, at 9.

257. John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1337–53 (1992) (discussing tools management uses to insulate itself from threat of ouster).

258. For an in-depth description of the poison pill defense, see Matheson, *supra* note 9, at 726–33.

259. *See* Lucian A. Bebchuck & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 119 (2001); William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 752 (1998) (discussing purpose of antitakeover statutes); Alan E. Garfield, *Evaluating State Anti-Takeover Legislation: A Broadminded New Approach to Corporation Law or "A Race to the Bottom?,"* 1990 COLUM. BUS. L. REV. 119, 126 (1990) ("By attempting to stop takeovers, the [antitakeover] statutes serve only one purpose: to entrench current management in power.").

> The most powerful tool to incumbents in impeding bids was the poison pill. The pill provided managers with a highly effective, easy, and costless way to impede an unwelcome bid. Unlike other defensive tactics (such as a target company's defensive acquisition of other companies) that have some effect in the world other than stopping a bid, the pill is an artifice whose only upshot is impeding a bidder.

260. For instance, *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 73–74 (1987), involved an Indiana statute providing that whenever a purchaser gained more than 20% control of a corporation, the shareholder would be precluded from voting unless a majority of the disinterested shareholders

not be permitted to vote, or the corporation might issue a share dividend to all but the newly acquired shares, thereby diluting the acquirer's interest.[261]

Of course, these shareholder rights plans and antitakeover statutes drastically reduced the incentive to attempt a hostile takeover by share acquisition.[262] As a result, incumbent managers may remain in place, resulting in continued inefficient use of corporate assets, or, alternatively, the acquirers may be forced to negotiate a side deal with the board prior to acquisition, thereby turning the hostile takeover into a "friendly" acquisition.[263] In essence, the board holds the corporate assets captive, releasing them only if the acquirer pays ransom, thereby reducing the gain available to be shared between the existing shareholders and the acquirer.

Commentators have suggested that vote-buying presents a possible solution to the problem of management that has entrenched itself through use of shareholder rights plans or anti-takeover statutes.[264] The basic theory is that acquirers could purchase the vote, and then use it to dismantle the protections by replacing the board with one friendly to the acquisition.[265]

It certainly seems correct as an initial matter that vote-buying in such situations is not suggestive of corporate looting. The presumption of looting arises due to the purchaser's choice to purchase votes rather than shares.[266] In the face of the adverse consequences under an anti-takeover statute or shareholder rights plan, however, the purchase of the vote does not indicate a preference for the vote over the share. Rather, the vote purchase is but the first step in the share purchase.

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approved the voting rights. *Moran v. Household Int'l Inc.*, 500 A.2d 1346, 1348–49 (Del. 1985), involved a shareholder rights plan that allowed purchase of the corporate shares at depressed prices in the event of an attempted takeover.

261. *CTS Corp.*, 481 U.S. at 73–74; *see also* Matheson, *supra* note 9, at 726–29 (discussing the various types of poison pills companies have adopted).

262. *See* Matheson, *supra* note 9, at 726–29.

263. *See* Bebchuck & Ferrell, *supra* note 259, at 121, stating that:

> The poison pill, backed by an entrenched management, is extremely formidable. Incumbent management can use this power to prevent an acquisition that they do not want for self-serving purposes (such as saving their jobs). They can also use this power to extract private benefits for themselves, perhaps diverted from what would have otherwise gone to the shareholders, in return for redeeming the pill and allowing the tender offer to proceed.

264. *See supra* note 253.

265. *See generally* André, *supra* note 4, at 585–606.

266. *See supra* notes 214–20 and accompanying text.

Although facilitating control transactions may be a laudable goal, the efficacy of vote-buying as a means of achieving that goal is questionable for at least three reasons. First, if vote-buying is generally recognized as legal, shareholder rights plans and anti-takeover statutes will undoubtedly adjust to prevent "end runs" accomplished through its use. Indeed, shareholder rights plans typically are triggered by the acquisition of "beneficial" as well as actual ownership of shares, and "beneficial ownership" is typically defined to include the acquisition of a share's voting right.[267] Thus, vote-buying would be no more effective than share acquisition in dismantling such plans.

Second, while the possibility of takeovers is undoubtedly beneficial to shareholders, not all takeover bids are necessarily in the shareholders' best interest.[268] For example, given additional time, a competing bid for a company at a higher price might appear. The choice of whether or not to proceed with a given takeover transaction, then, should be left to the shareholders. If vote-buying is permissible, however, shareholders would be generally incapable of resisting the vote purchase due to the collective action problems they face.[269] In light of those problems, the act of tendering the proxy would not necessarily be indicative of the shareholder's preferred outcome on the takeover transaction, but rather merely a reflection of the coercive nature of the vote purchase offer.

Third, vote-buying might present a new opportunity for corporate outsiders to obtain wealth-diverting transfer payments from corporate management. That is, a purchaser might employ a vote-buying transaction for the stated purpose of acquiring sufficient votes to move forward with an acquisition. As described above, at least in a corporation with dispersed ownership, it should be possible to purchase the votes

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267. For example, *Stahl v. Apple Bancorp*, 16 Del. J. Corp. L. 1573 (Del. Ch. 1990), involved just such a plan. The shareholder rights plan was triggered by a shareholder attaining beneficial ownership of a 15% or greater stake in the company. *Id.* at 1577. The plan specifically defined beneficial ownership to include acquisition of the voting right of a share. *Id.* at 1580. The court concluded that under the language of the plan even acquisition of a revocable proxy would constitute beneficial ownership. *Id.* at 1585–86.

268. *See* Lucian A. Bebchuck, *The Case For Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1052–55 (1982) (suggesting that shareholders in the target company achieve benefits when management resists a takeover long enough to permit competing bids to develop); Jim Chen & Edward S. Adams, *Feudalism Unmodified: Discourses on Farms and Firms*, 45 DRAKE L. REV. 361, 425 (1997) (discussing argument that "shareholders often benefit from the increased ability of management to resist a takeover"); Alessandro Portolano, *The Decision to Adopt Defensive Tactics in Italy*, 20 INT'L. REV. L. & ECON., 425, 429–30 (2000) (noting that resistance to takeover bids can generate benefits for target company shareholders).

269. *See supra* notes 234–58 and accompanying text.

quite cheaply.[270] Rather than complete the control acquisition through share purchase, however, the purchaser might instead use the votes (and the threat of a control transaction) to negotiate a transfer payment from the board in exchange for not going forward—that is, extract "greenmail."[271] In short, while it is indisputable that shareholder rights plans and anti-takeover statutes impose costs on shareholders, vote-buying does not necessarily eradicate those costs, and it may in fact impose additional ones.

A better response to the problem of shareholder rights plans, one that captures the benefits of vote-buying without presenting the harms, would be the use of a variant of vote-buying turnout incentives.[272] Under the turnout incentive approach, the shareholder would be paid for voting, independent of the voting option the shareholder selects.[273] Such payments would increase participation in corporate governance because, as noted above, voting is not costless. Even if the voting information is collected and provided to the shareholders, the cost of reviewing and analyzing that information may cause rational apathy among shareholders. A system that paid the shareholder an incentive fee for returning his or her proxy, independent of the shareholder's choice of

270. *See id.*

271. "Greenmail" refers to corporate payments made to potential acquirers in exchange for the acquirer dropping the acquisition plan. For a general discussion of greenmail, see Jonathan R. Macey & Edward S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985). While these authors suggest the possibility that greenmail may have some beneficial effects for shareholders, *id.* at 24–25, it is well accepted that such payments hold at least the potential for harm to shareholder interests. *See* Jeffrey N. Gordon & Lewis A. Kornhauser, *Takeover Defense Tactics: A Comment on Two Models*, 96 YALE L.J. 295, 320 (1986) (arguing that the abusive potential of greenmail justifies an outright ban on the practice); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 934 (1996). The directors' fiduciary duties may provide some limits on their ability to protect their positions through use of greenmail. As a general matter, however, courts have upheld such payments in the past as appropriate exercises of directorial discretion. *See, e.g.*, Polk v. Good, 507 A.2d 531, 537 (Del. 1986) (holding that purchase of raider's block of shares at premium not an abuse of directors' discretion); Grobow v. Perot, 526 A.2d 914, 927 (Del. Ch. 1987) (dismissing shareholder derivative claims predicated on alleged greenmail payment by General Motor's board to Ross Perot).

272. For a discussion of the use of turnout incentives in political contests, see Hasen, *supra* note 1, at 1355–59.

273. Responsibility for the costs of the turnout incentives could be similar to proxy solicitations. The challenging party would bear the cost of paying the incentives, but could recoup those payments out of corporate assets in the event that it was successful, or at the discretion of the directors if it was unsuccessful. *See, e.g.*, Steinberg v. Adams, 90 F. Supp. 604, 607–08 (S.D.N.Y. 1950) (holding that successful proxy opponents can claim reimbursement); Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, 293 (N.Y. 1955) (holding that a corporation, at its option, could reimburse a successful rival faction for expenses incurred in a policy fight).

who received the proxy, would increase shareholder participation without coercively depriving the shareholder of her voice. In other words, the shareholder is no longer compelled to tender his or her vote or face the prospect that it will be worthless. Instead, the shareholder's vote has the same value (the turnout incentive amount) independent of the group for whom it is cast.

In this way, the shareholders have an incentive to review the materials and participate in the voting contest.[274] If the proposed takeover is truly in the shareholder's interest, the shareholder would presumably still tender his or her vote to the acquirer. Because that tender resulted from a turnout incentive, rather than a vote purchase, however, it would be a reliable indicator of the shareholder's true preference rather than a reflection of the coercive nature of the transaction.

IV. VOTE-BUYING AS A TOOL FOR PREFERENCE AGGREGATION IN CLOSELY HELD CORPORATIONS

Up until this point, the primary focus of the discussion has been vote-buying in large publicly held corporations. Closely held corporations, by contrast, provide significantly different regulatory concerns.[275] Although the case law draws no distinction between vote-buying in publicly held and closely held corporations,[276] the different nature of the regulatory concerns between the two suggests a more permissive approach to vote-buying with regard to the latter.

In closely held corporations, information and coordination problems tend to be minimized. The blocks of stock are usually much larger on a percentage basis,[277] so the various shareholders have greater incentives to invest in information. Furthermore, most of the shareholders are also

274. This is not to suggest that turnout incentives would provide a panacea. For instance, a rational shareholder may consider it profit maximizing to decide how to vote based on a coin flip. In that way, the shareholder would receive the turnout incentive without incurring the analysis costs associated with reviewing the information.

275. *See* ECONOMIC STRUCTURE, *supra* note 4, at 228–52; Moll, *supra* note 103, at 756–58 (describing differences between close corporations and traditional public corporations and suggesting that "[c]onventional corporate law norms of majority rule and centralized control can lead to serious problems for the close corporation minority shareholder").

276. *Compare* Henley Group, Inc. v. Sante Fe S. Pac. Corp., No. CIV. A. No. 9569, 1988 WL 23945, at *2 (Del. Ch. Mar. 11, 1988) (discussing a widely held corporation), *with* Rainbow Navigation, Inc. v. Yonge, CIV. A. No. 9432, 1989 WL 40805, at *1 (Del. Ch. Apr. 24, 1989) (discussing a closely held corporation).

277. *See* F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.02 (3d ed. 1998 & Supp. 2000) (defining close corporation as one with relatively few shareholders).

active within the corporation, providing them with better access to information than an outside shareholder might have.[278] In addition, because the shareholders work together and often have familial or social bonds, the free-rider problem is less prevalent.[279] Thus, many of the problems facing shareholders in large corporations with widely-dispersed ownership simply do not exist, or are, at any rate, much less acute, in small, closely held corporations.[280]

At the same time, other problems may replace these concerns. For instance, in closely held corporations, it may be less likely that there are uni-peaked preferences.[281] This, in turn, can generate instabilities in the shareholder voting process such as path-dependent outcomes or cycling.[282]

There are a number of reasons to suspect that multi-peaked preferences may exist in closely held corporations. For the typical shareholder in a publicly held corporation, the shareholder's stake is merely part of the shareholder's diversified portfolio. Because of the protection offered through diversification, the average shareholder is thus likely to be risk neutral.[283] In closely held corporations, on the other hand, one might expect a broader spectrum of risk aversion. Many of the shareholders (e.g., the entrepreneur in a start-up, or the manager/owners following a management-leveraged buyout) may have their entire savings, or at least a very significant portion of it, invested in the company. In addition, they may have a significant portion of their human

278. *Id.* at § 1.08.

279. *Id.* at § 1.02; *see also* Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377, 392 (1990) ("A close corporation provides more direct opportunity for specific private ordering because there exists no large-numbers problem that can lead to free rider questions or rational apathy.").

280. O'NEAL & THOMPSON, *supra* note 277, at § 1.08:

> Because of this combination of [the decision-making function and the risk-bearing function] in close corporations, such corporations can avoid the sometimes costly agency problem of protecting passive shareholders who need some method of monitoring the performance of the corporation's managers and insuring that management's decisions are aligned with shareholder interests.

281. For an explanation of "uni-peaked" preferences, see *supra* note 15.

282. *See generally* FARBER & FRICKEY, *supra* note 15 at 38–62 (discussing Arrow's Theorem). Indeed, Arrow's Theorem holds that in the presence of varying preferences among individual voters (i.e., non-peaked or multi-peaked preferences), no method of combining preferences (e.g., voting) can satisfy minimum standards of rationality. *Id.* at 38–39.

283. George W. Dent, Jr., *The Role of Convertible Securities in Corporate Finance*, 21 J. CORP. L. 241, 245 (1996) ("Most shareholders are risk-neutral toward each public company because they diversify away risk by holding a broad portfolio of investments.").

capital invested in firm-specific capital. Thus, these shareholders would tend toward a higher degree of risk aversion.[284] Other shareholders, such as venture capitalists investing in the corporation, may have a more diversified portfolio, and thus a better risk tolerance. These risk aversion differences could easily lead to multi-peaked preferences.

Moreover, in a closely held corporation, many of the shareholders may also hold positions within the company. This sets up a potential conflict in preferences between the employee-shareholders, and the non-employee-shareholders with respect to issues such as appropriate compensation and dividend policy.[285] To further exacerbate the problem, the exit option may be less easily realized because there is rarely a large, liquid market for shares in closely held corporations.[286] Finally, the same familial and social bonds that serve to minimize the free-rider problem could result in conflicts that disrupt the continuity of corporate control.

Faced with multi-peaked preferences, vote-buying may be a desirable means of preference aggregation.[287] For example, assume that there are three equal shareholders (A, B, and C) in a closely held corporation. Further, assume that an issue comes to vote before the shareholders, for instance, authorization to pursue acquisition of a competitor. A believes

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284. Paul Fellows & S.Y. Wu, *The Scope of Legal Interventions in Corporate Affairs*, 15 J. CORP. L. 465, 472–75 (1990) (discussing entrepreneurial risk aversion and its impacts on financing choices). In fact, "[i]t is generally understood that the transition from an owner-operated sole proprietorship to a public corporation is predicated on either a wealth constraint or the risk aversion of the entrepreneur." Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 14 (1989).

285. That is not to suggest that publicly held companies do not also have employee-shareholders. As a percentage of total ownership, however, the employee-shareholders typically consist of a relatively small group. That is, while there may be multi-peaked preferences with regard to such issues in the publicly held corporation, the relative magnitudes of the preferences in terms of share ownership are quite different.

286. *See* Moll, *supra* note 103, at 789–90 (suggesting that absence of market for shares is primary cause of potential shareholder oppression in close corporations). In addition, the shares may be subject to restrictions on transfer, such as vesting or a corporate right of first refusal at a predetermined price. *See* DEL. CODE ANN. tit. 8, §§ 202(c) (permitting designated categories of transfer restrictions), 342(a)(2) (making the existence of a stock transfer restriction a prerequisite to the election of statutory close corporation status) (1991 & Supp. 2000).

287. This Article is not the first to suggest the general possibilities of vote-buying as a preference aggregation tool. In his recent article, for example, Saul Levmore discusses the use of vote-buying for preference aggregation in civic elections. *See generally* Levmore, *supra* note 2, at 142–58. While he also considers the possibility that similar arguments could support the application of vote-buying to the corporate governance realm, he dismisses the need for preference aggregation there because shareholders share "a single metric, value maximization." *Id.* at 158. As discussed in the text, while this analysis is correct in the context of publicly held corporations, it fails to recognize the possibility of divergent shareholder interests in closely held corporations.

that such an action would result in an expected net return to the company of $10,000, B believes it will result in a $5,000 loss, and C believes that the competitor is priced such that the acquisition would neither result in benefit nor harm (i.e. $0 value).

A would clearly vote for the acquisition, and B against it. The swing vote (C) would have no real basis for deciding one way or the other. However, if vote-buying were permitted, A and B could bid for C's vote. Because A values the vote more highly, A would presumably buy C's vote, and the acquisition would move forward.[288] This results in the option with the highest aggregate shareholder value being chosen.

One possible objection is that this results in C getting more than "his share" of the value. Of course, from a pure efficiency standpoint, such distributional concerns are moot.[289] In any event, it is unlikely that C would receive a large premium. Assuming A, B, and C all have equal information about the others' preferences and the associated prices,[290] B would have very little incentive to engage in an auction for C's vote because he knows that A would outbid him. Without a competing bidder, C would not really have a credible threat to vote with B. Thus, A should be able to "buy" the vote at a relatively low price. In fact, if C holds out for too high a price, A could simply buy B's vote. Once B realizes that he would lose a bidding contest (i.e., A's preference outweighs his), B could easily switch from competing with A for purchase, to competing with C as a seller. This incentive mechanism also serves to keep the price relatively low.

Of course, as a practical matter, many closely held corporations use voting trusts or voting agreements to avoid the control difficulties envisioned here.[291] Or, they may use multiple classes of stock guaranteeing the competing shareholders control over set percentages of the board, a favorite technique in venture capital deals. Vote-buying, however, with its ability to provide relatively efficient preference aggregation, might prove a useful technique in small corporations.

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288. Note that A will be willing to pay up to $3,333 (one third of $10,000) for the vote, while B would only be willing to pay half of that (to avoid his perceived loss of one third of $5,000).

289. So long as all efficient transactions go forward (i.e., shareholder preferences are maximized), the allocative aspects of the vote-buying transaction do not impact the efficiency of the corporation.

290. Given that the example posits a closely held corporation with only three shareholders, this assumption is plausible.

291. *See* O'NEAL & THOMPSON, *supra* note 277, at § 5.02.

CONCLUSION

The Internet promises to make shareholder voting a more frequently used and more powerful tool for corporate management. A renewed interest in corporate voting, however, also requires a closer look at the voting process, and the appropriate limitations on methods used to compete for votes in the corporate world. One such method is vote-buying.

The current legal rule is that vote-buying is, as a general matter, permissible. Although this change from the earlier common law treatment of such transactions as per se illegal has been welcomed by some, it is by no means clear that such transactions are beneficial. In a public corporation, vote-buying presents possibilities for both looting and coercive wealth transfers. While it also has potential as a means to overcome anti-shareholder "shareholder rights plans," that potential could be better achieved through use of turnout incentives. Thus, in public corporations, there are reasons to believe that a return to per se invalidity would be beneficial for shareholders.

In close corporations, vote-buying offers greater promise. Here the principal difficulties are not the collective action problems faced by atomized shareholders in publicly-held corporations. Rather, in a close corporation, the shareholders are more likely to face preference aggregation problems. Vote-buying is potentially a useful tool for overcoming those aggregation problems by allowing the competing shareholders to express the relative strengths of their preferences through bidding for the votes of the more neutral shareholders. While this aggregation can be accomplished through other means as well, vote-buying may represent the most convenient, inexpensive, and efficient tool for achieving it.