EXAMINATION OF JUDICIAL POLICY ON CORPORATE VOTE BUYING IN THE CONTEXT OF MODERN FINANCIAL INSTRUMENTS

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I. INTRODUCTION AND OVERVIEW

Observing that the "shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests,"[1] the Delaware Court of Chancery underscored the fundamental importance of the vote in corporate governance. Courts, commentators, and regulators all have long recognized the importance of corporate voting for functional as well as ideological reasons. Corporate voting theory holds that the franchise is central to the functioning of the market for corporate control and thus, indirectly, for monitoring management.[2] This theory, however, rests on certain assumptions—principally, that "[i]t is not possible to separate the voting right from the equity interest,"[3] and, therefore, shareholders' preferences are "likely to be similar if not identical."[4]

Modern financial instruments are challenging these theoretical assumptions to a radical extent. The massive growth in the use of derivatives and associated reduction in transaction costs have made it possible to separate the economic ownership of a share from its voting rights with relatively little difficulty or expense. This separation is decidedly not just a theoretical possibility: hedge funds and other investors are using these techniques to their advantage in market transactions. The results can be disquieting. This Note will discuss in detail one situation in which a corporation's

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1. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

2. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 406 (1983) (noting that corporate voting facilitates takeovers).

3. *Id.* at 410.

4. *Id.* at 405.

largest voting shareholder effectively had a negative economic interest in the value of the corporation's shares.[5]

Only recently has this phenomenon received any attention in the academic literature. Only a handful of articles deal with the subject, many of them quite brief.[6] More importantly, courts have not yet grappled with the complex issues presented by the use of derivatives to decouple voting rights from the economic ownership of shares, a phenomenon recently termed "the new vote buying."[7] Current definitions in judicial vote-buying doctrine, which polices the separation of ownership and voting rights, simply do not capture this phenomenon.[8] Given the possibly deleterious effects of widespread new vote buying, judicial doctrine will have to adapt to address this important emerging issue.

This Note examines how judicial vote-buying doctrine may be adjusted to remedy this shortcoming. The first two Parts of the Note provide the reader with context in which to consider judicial vote-buying doctrine. Part II takes the reader through an illustrative example of the new vote buying and attempted "empty voting," that is, the voting of shares in which the voter has no, or even negative, economic interest.[9] Illustrations of various alternative new-vote-buying techniques and an examination of the scope of empty-voting practice follow. Part III provides a synopsis of the classic theory underlying corporate voting rights and describes how the new vote buying represents a radical challenge to certain long-held as-

5. *See infra* Part II.A.

6. Professors Henry Hu and Bernard Black claim to have produced the first systematic treatment of the "new vote buying," that is, decoupling voting rights from economic interest using derivative instruments. Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 823 (2006). Other academic journal articles include Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775 (2005), and Jonathan J. Katz, Note, *Barbarians at the Ballot Box: The Use of Hedging to Acquire Low Cost Corporate Influence and Its Effect on Shareholder Apathy*, 28 CARDOZO L. REV. 1483 (2006). Practitioners as well have written short but helpful articles: David Marcus, *Hedge Fund Voting: The Devil We Don't Know*, CORP. CONTROL ALERT, Mar.–Apr. 2006, at 10; Marc Weingarten & Morgan O. Mirvis, *Vote-Buying Raises Questions Under Anti-Fraud Rules*, *in* MERGERS AND ACQUISITIONS 2006, at 407 (PLI Mergers & Acquisitions, Course Handbook Series No. 10160, 2006). No other articles found through Westlaw and LexisNexis searches thoroughly addressed potential judicial responses to challenges presented to vote-buying doctrine by the new vote buying.

7. This phrase was coined by Hu and Black in their comprehensive article, and this Note adopts the term. *See* Hu & Black, *supra* note 6, at 811–12. R

8. *See infra* Part IV.B–C.

9. Hu and Black also claim the phrase "empty voting." *See* Hu & Black, *supra* note 6, at 812. R

sumptions. This challenge calls into question the entire justificatory framework of corporate voting theory.

Parts IV and V offer a critical analysis of the current law on corporate vote buying and substantive suggestions for how courts ought to adapt doctrine to meet the challenges presented by the new vote buying. Specifically, Part IV traces the evolution of judicial vote-buying doctrine through the leading case of *Schreiber v. Carney*.[10] The cases, both historical and contemporary, are analyzed with an eye toward how the arguments therein can be adapted to address empty voting. Additionally, Part IV contains suggestions for how the judicial definition of "vote buying" and aspects of the vote-buying inquiry may be refitted to address empty voting. Part V offers an analysis of the application of an intrinsic-fairness test to empty voting abuses. Finally, the courts' institutional competency in this area is taken into account in the formulation of an adapted intrinsic-fairness approach.

II.
NEW-VOTE-BUYING TECHNIQUES AND SCOPE OF THE PRACTICE

This Part attempts to demonstrate to the reader what the new vote buying and empty voting actually consist of in practice. To that end, Subpart A illustrates in some detail a well-publicized instance of attempted empty voting. The aim is to show that while the combination of transactions is novel, when broken down the practice involves perfectly legitimate transactions. What *is* novel is the net effect of the transactions: a vote-buying arrangement without any obvious counterparty selling a vote, and one in which the buyer has no—or even negative—economic interest in the corporation, the votes of which are purchased and voted. Subpart B then elaborates on this basic example to provide a truncated taxonomy of potential alternative ways to achieve the same effect. Lastly, Subpart C examines evidence that the practice of empty voting has emerged as a global phenomenon and may become more common yet.

A. *The Perry-Mylan Episode*

In July 2004, Mylan Laboratories Inc. and King Pharmaceuticals Inc. announced that Mylan Labs had proposed to buy King Pharmaceuticals in a 4.1 billion dollar stock-for-stock acquisition.[11]

10. 447 A.2d 17 (Del. Ch. 1982).
11. *See* Perry Corp., Beneficial Ownership Report (Schedule 13D) (Nov. 19, 2004).

Though the acquisition presented certain synergies,[12] analysts were skeptical of the deal,[13] and Mylan Labs' share price dropped sharply when it was announced. Prominent investor Carl Icahn, at that time the largest shareholder in Mylan, vociferously objected to the transaction from the outset.[14] He claimed that the companies had overstated the potential synergies, among other problems, and eventually Icahn offered to buy the shares of Mylan Labs he did not own at a significant premium.[15]

During this time, Perry Corporation, a hedge fund,[16] held just under seven million shares of King Pharmaceuticals and stood to gain at least twenty-eight million dollars in profit if the deal was consummated.[17] Consummation, however, required shareholder approval, which seemed unlikely given the share price drop and Icahn's opposition to the deal.[18] In order to push the merger through, Perry increased its position to a 9.89 percent stake in Mylan Labs, in addition to its stake in King Pharmaceuticals.[19] With respect to its position in acquirer Mylan Labs, however, Perry entered into hedging transactions with brokerage firms.[20]

Perry's purpose in the hedging transactions was to nullify any economic risk in its shares of Mylan Labs through an equity swap and related hedges by the counterparty brokerage firm.[21] The

12. Specifically, King Pharmaceuticals had some valuable patents and a sales force experienced in the marketing of cardiovascular products, while Mylan Labs had plans to introduce a new drug for the treatment of hypertension. *See* Christopher Faille, *Perry Plans to Sell Stake in Mylan*, DAILY NEWS, Mar. 23, 2005, at 1; *Icahn & Co.: Icahn Discontinues Litigation Against Perry Corp. and Mylan Laboratories*, PHYSICIAN L. WKLY., June 29, 2005, at 9.

13. Tara Croft, *Mylan: King Deal Doomed*, DAILY DEAL, Jan. 13, 2005, at 1.

14. *See* Faille, *supra* note 12. R

15. *See id.*; Croft, *supra* note 13. R

16. There is no universally accepted definition of "hedge fund," nor is the term defined under the federal securities laws. *See* Joseph C. Long, *A Hedge Fund Primer*, *in* SECURITIES ARBITRATION 2005, at 235, 235–36 (PLI Corp. Law and Practice, Course Handbook Series No. 6855, 2005). The term has developed into "a catch-all classification for many unregistered privately managed [and lightly regulated] pools of capital." *Id.*

17. Andrew Ross Sorkin, *Nothing Ventured, Everything Gained*, N.Y. TIMES, Dec. 2, 2004, at C1.

18. *See id.*

19. Perry Corp., Beneficial Ownership Report (Schedule 13D) (Nov. 19, 2004).

20. *Id.* Specifically, the firms were Bear Stearns Securities and Goldman Sachs & Co. *Id.*

21. *See* Sorkin, *supra* note 17; High River Ltd. P'ship v. Mylan Labs., Inc., 383 F. Supp. 2d 660 (M.D. Pa. 2005). R

transactions worked as follows:[22] Perry bought the needed Mylan shares from a brokerage firm, along with the right to sell those shares back to the firm at the purchase price. The brokerage firm acquired a purchase right from Perry to buy back the shares at the price at which they sold to Perry. At the same time, the brokerage firm entered into separate short-selling transactions[23] with third-party shareholders in order to hedge against the possibility of the share price dropping. Thus, the transaction resulted in a wash for the two parties; neither had an effective interest in Mylan Labs' stock price movements. Perry could sell its shares back at the purchase price, so it was protected from any drop, and, if there was any substantial gain, the brokerage firm would buy back at the price at which they sold. Thus, the brokerage firm could profit from any share price increase on this side of the transaction, but that profit would be offset by the need to repay an equal number of shares which had been borrowed from third parties. These two reciprocating transactions conversely protected the brokerage from any drop in the share price as well. Though the parties effectively eliminated market risk, the brokerage firm received substantial fees while Perry acquired the largest voting bloc in Mylan Labs without any market risk.[24]

Effectively, however, Perry did not have a true absence of economic interest in Mylan shares; it had a *negative* interest in the company. The higher the premium Mylan Labs paid for King Pharmaceuticals, the more Perry would profit thereby.[25] The danger of the largest shareholder having a negative economic interest in the company in which it holds shares should be readily apparent.

22. The mechanics of the transactions involved are reported on in Jesse Eisinger, *Icahn Cries Foul at Perry's No-Risk Play in Takeover Fight*, WALL ST. J., Dec. 15, 2004, at C1. However, the explanation that follows is my own.

23. To establish a short position, an investor typically borrows a share and sells it. *See, e.g.*, DAVID L. SCOTT, WALL STREET WORDS 349 (2003). For instance, the short-selling transaction here would involve the brokerage borrowing Mylan shares from third-party shareholders and then selling those shares on the market. This is essentially a bet that the price will drop and the brokerage firm will be able to repay the borrowed shares with cheaper shares, thus profiting from the share price drop.

24. Carl Icahn, through High River Limited Partnership, had control of slightly fewer shares than Perry Corporation. *See* Complaint at 10–11, High River Ltd. P'ship v. Mylan Labs., Inc., No. 04-2677 (S.D.N.Y dismissed May 31, 2005) [hereinafter Icahn Complaint].

25. Perry profited by whatever premium Mylan offered for King shares. Presumably, the market would devalue Mylan shares the more it overpaid for King—thus the negative economic interest of Perry in Mylan shares.

With no shortage of righteous indignation, Carl Icahn filed suit through his company, High River Limited Partnership.[26] The complaint alleged, among other claims, common law fraud and violation of Rules 10b-5 and 13d-1 of the 1934 Exchange Act[27] for failing to disclose the vote-buying scheme.[28] Icahn also requested that the court disallow all votes tainted by vote buying on grounds of fraud and/or dilution of the voting power of votes not tainted.[29] In addition, the complaint alleged that other unknown entities were acting in concert with Perry Corporation, and that together they controlled nineteen percent of the Mylan votes.[30]

Perhaps unfortunately for the development of judicial policy on vote-buying hedge transactions, the lawsuit and the proposed acquisition ended not with a bang but with a whimper. Accounting problems at King Pharmaceuticals resulted in earnings restatements.[31] As a result, on February 28, 2005, the potential acquirer and target announced they would terminate the proposed acquisition.[32] On Wall Street, Mylan shareholders greeted the news with some relief as their stock went up slightly.[33] Icahn subsequently dropped his suit.[34] The Securities and Exchange Commission ("SEC") commenced an investigation, but no public information has been released as a result.[35]

Perry Corporation's attempt to influence Mylan Laboratories' proposed acquisition of King Pharmaceuticals is most appropriate as an illustrative example for several reasons. To begin with, it was fairly well publicized compared to many of the other instances of

26. *See* Icahn Complaint, *supra* note 24, at 6 (claiming that Perry's hedging transactions "are classic examples of the kinds of manipulative arrangements that arbitrageurs and hedge funds are increasingly employing, outside of the public's awareness and without effective regulation or oversight, to generate profits at the expense of ordinary shareholders"). R

27. *Id.* at 15.

28. *Id.* at 20, 29.

29. *Id.* at 37.

30. *Id.* at 14.

31. Croft, *supra* note 13. R

32. *Icahn & Co.: Icahn Discontinues Litigation Against Perry Corp. and Mylan Laboratories*, *supra* note 12, at 9. R

33. When the news broke, Mylan Labs stock rose from $17.17 per share to a high of $17.65 before settling at $17.50 at close. Croft, *supra* note 13. R

34. *Icahn & Co.: Icahn Discontinues Litigation Against Perry Corp. and Mylan Laboratories*, *supra* note 12, at 9. R

35. Ianthe Jeanne Dugan, *Hedge Funds Draw Scrutiny over Merger Play*, WALL ST. J., Jan. 11, 2006, at C1. No publicly disclosed result after the SEC's Wells Notice could be found.

this type of activity.[36] Additionally, the case was partially litigated; both sides submitted briefs.[37] And lastly, the illustration is a relatively straightforward scheme that resulted in dramatic misalignment of interests in that the vote purchaser had a negative economic interest in the corporation the shares of which it had purchased and intended to vote.[38]

B. Numerous Methods Are Available to Achieve Empty Voting

In comparison with the myriad techniques available to decouple voting power from economic ownership, the mechanics of Perry Corporation's hedging transactions are relatively basic.[39] The complexity of the technology and the attendant financial calculations, combined with the range of techniques available, present a daunting challenge. The challenge is not just one for academic observers to account for, but for any regulatory body to grapple with in attempting to promulgate efficient safeguards for this practice. Likewise, courts adjudicating cases that challenge empty voting should not only deal with the complexities of the instant facts, but additionally should keep an eye toward developing a judicial policy that can work with a range of possible new vote-buying methods.

Other parties have likely used equity derivatives in manners similar to that employed by Perry Corporation in its attempt to influence Mylan Labs. For instance, anecdotal evidence suggests that such techniques were used in connection with French insurer AXA's acquisition of Mutual of New York ("MONY").[40] AXA issued convertible debt securities which were convertible only if the acqui-

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36. *See, e.g.*, Andrew Ross Sorkin, *Icahn Accuses a Hedge Fund of Stock Manipulation*, N.Y. TIMES, Dec. 13, 2004, at C5; Andrew Ross Sorkin, *For a Takeover Artist, One Bluff Too Many?*, N.Y. TIMES, Nov. 28, 2004, at C6.

37. Motion to Dismiss, High River Ltd. P'ship v. Mylan Labs., Inc., 353 F. Supp. 2d 487 (M.D. Pa. 2004) (No. 1:04-cv-02677); Icahn Complaint, *supra* note 24. **R**

38. *See supra* this Part.

39. A detailed taxonomy is beyond the scope of this Note. Professors Hu and Black have drafted two companion pieces which contain detailed analyses of the mechanics of the new vote buying. *See* Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343, 345–53 (2007) (addressing finance audience); Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011, 1020–37 (2006) (addressing legal practitioners and regulators).

40. *See* Sorkin, *supra* note 17. **R**

sition was completed.[41] Investors on both sides of the transaction—holders and short sellers of the convertible bonds—acquired voting shares of MONY, while hedging their positions in a manner similar to Perry Corporation.[42] Additional anecdotal evidence indicates that similar techniques were also employed by voters in the Hewlett-Packard acquisition of Compaq in 2002.[43]

A range of other options are available to decouple the economic risk from the voting rights of a share.[44] This decoupling can be effected through the use of forward contracts: the future price of the share is negotiated beforehand, thus the seller-holder of the share has no economic interest in the movement once it has contracted for the sale.[45] Zero-cost collars[46] can be utilized to eliminate market risk in a position. The investor purchases a put option[47] while simultaneously selling ("writing") a call option.[48] The premium received for the call option will roughly compensate the investor for the price of buying the put option.[49] The effect is a safety collar around the price range between the low put option price and the higher call option price. Lastly, a technique known as record date capture utilizes the share lending market to allow potential empty voters to borrow shares for a short period before the record date, effectively acquiring the voting rights but constraining risk in the share price to a brief period of ownership.[50]

41. *In re* MONY Group, Inc. S'holder Litig., 853 A.2d 661, 667–68 (Del. Ch. 2004).

42. *Id.* at 669–70 (discussing plaintiffs' allegations to that effect).

43. *See, e.g.*, Sorkin, *supra* note 17. **R**

44. This paragraph offers a small sample of options available to the empty voter. A full discussion of the myriad techniques is outside the scope of this Note. For guidance on this issue see both articles by Hu & Black, *supra* note 39. **R**

45. There is substantial evidence that Liberty Media used this technique to purchase a substantial stake in News Corporation. *See* Hu & Black, *supra* note 6, at 830–31. **R**

46. "Zero-cost collars" arise from the investment position of being short a call option and long a put option for stock already owned. The premium received from selling the call option is used to pay for purchase of the put. The collar is designed to protect an investor against a decline in the price of the stock without requiring the investor to sell the stock and pay a tax on capital gains. SCOTT, *supra* note 23, at 344. **R**

47. A put option contract involves the right but not the obligation to sell an asset at a certain price. *Id.* at 295.

48. A call option contract involves the right but not the obligation to buy an asset at a certain price. *Id.* at 46.

49. *Id.* at 415.

50. The risk may be completely eliminated by combining record date capture with a hedging transaction of the type described above.

This is by no stretch an exhaustive list. The aim is rather to provide a sense of the myriad techniques that modern financial instruments make available to decouple share ownership and economic risk. All the instruments and methods mentioned above have perfectly legitimate and important uses, especially in risk management. However, the variety and complexity is at once a boon to investors and a challenge to boards of directors, regulators, and judges among others.

C. Evidence That Empty Voting Is Widespread

Despite its recent emergence, there is substantial evidence that vote buying through hedging transactions has been utilized on many occasions in several countries.[51] The 2002 Hewlett-Packard takeover of Compaq[52] and the acquisition of MONY by AXA France in 2004[53] are but two recent examples.

It is difficult to substantiate any exact figures for the incidence of empty voting because, under most securities regulations regimes, the hedging transactions are not generally subject to disclosure requirements in the contexts in which empty voting occurs.[54] Under United States law, the federal disclosure regimes can be "bewilderingly complex,"[55] but, in sum, large empty voting positions obtained by new-vote-buying strategies employed for a short period around the record date are not captured by the disclosure requirements.[56]

In their comprehensive and thorough article on the new vote buying, Henry Hu and Bernard Black document evidence they compiled of eleven occurrences of empty voting dating back to 2002.[57] Perhaps unsurprisingly given the global reach of capital, the phenomenon has emerged contemporaneously worldwide: empty voting has affected the corporate control market in Australia, Canada, Germany, Hong Kong, Italy, Japan, New Zealand, the United Kingdom, and the United States—at least.[58]

51. Hu & Black, *supra* note 6, at 848–50. **R**
52. Eisinger, *supra* note 22. **R**
53. Sorkin, *supra* note 17. **R**
54. Hu & Black, *supra* note 6, at 864. **R**
55. *Id.*
56. *Id.* at 888. Hu and Black exhaustively detailed both the disclosure regime and potential new-vote-buying positions before reaching their conclusion. *See generally id.*
57. *Id.* at 848–49 tbl.2 (listing empty voting and other hedging transactions in chart form).
58. *Id.* at 816.

Hu and Black elaborate on several factors that have contributed to the emergence of new vote buying; additionally, all of these factors point toward it occurring with increasing frequency.[59] To begin with, financial technology has undergone near-exponential growth in volume and innovation: at the end of 2004, the over-the-counter equity derivative global market was over four trillion dollars, a fifty percent increase over the prior year.[60] This tremendous growth both reflects, and may spur, further reductions in transaction costs, thus making vote-buying hedge transactions even cheaper to effect. Similarly, there has been brisk growth in share lending as well.[61] As in the Perry-Mylan example discussed above,[62] the share lending market enables a number of techniques to decouple voting power from economic ownership in company shares.

Lastly, the emergence of hedge funds has given rise to a class of agents nimble, rich, and expert enough to utilize the techniques of the new vote buying to their advantage.[63] Hedge funds have grown rapidly and are now estimated to have over one trillion dollars in investor assets at their disposal and are capable of leveraging many times this amount.[64]

There is at least some evidence that empty voting is already a relatively widespread practice and will continue to grow. The potential for abuse is obvious. If that abuse remains unchecked it represents a substantial threat—not just to individual companies, but to the market for corporate control as a whole. Part of the seriousness stems from the radical degree to which empty voting, and the new vote buying generally, eviscerate long-held assumptions under-

59. *Id.* at 844–45.

60. *Id.* at 844–45 (citing International Swaps and Derivatives Association, Summary of Recent Survey Results, http://www.isda.org/statistics/recent.html (last visited May 8, 2006)).

61. *Id.* In the United States, the securities lending market rose from $940 billion in 2003 to $1.3 billion a year later. *Id.* (citing Phyllis Plitch, *Funds' Lending Sparks "Short" Debate*, WALL ST. J., May 25, 2005, at B2).

62. *See supra* Part II.A.

63. *See* David Katz & Laura A. McIntosh, *Advice on Coping with Hedge Fund Activism*, 235 N.Y. L.J. 5 (2006).

64. Hu & Black, *supra* note 6, at 845–46. Hu and Black note that there is no reliable data on the exact number of hedge funds or amount under control, but cite as evidence an SEC report entitled "Implications of the Growth of Hedge Funds—Staff Report to the United States Securities and Exchange Commission" as well as other fund estimates. *Id.* at 845 (citing SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS—STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 1 n.2 (2003)).

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lying corporate voting theory. This next Part of the Note briefly discusses this concern.

III.
THE NEW VOTE BUYING UNDERMINES FUNDAMENTAL ASSUMPTIONS IN CORPORATE VOTING THEORY

In order to gain a better understanding of how judicial policy ought to account for the emergence of vote buying through hedging transactions, it is important to understand how this practice alters the long-held assumptions underlying corporate voting rights. It is not that the separation of economic ownership from voting rights is something new, as it is not.[65] What is new is the vast scale with which this can now be done, coupled with the speed permitted by the absence of a counterparty and other dramatic reductions in transaction costs.

Subpart A includes a brief synopsis of the canonical theory justifying the coupling of economic ownership with proportional corporate voting rights. Subpart B concludes this Part with an explanation of how the new vote buying presents a deep challenge to this theory and with a summary of some of the implications for corporate voting-rights theory.

A. *Classic Theory of Corporate Voting Rights*

Under classic contractarian theory, the shareholder's residual claim on the enterprise's value justifies shareholder voting rights and provides the proper incentives to monitor management.[66] Viewing the corporation as a nexus of contracts, it becomes clear that some decision maker must have the power to direct the corporation in situations where those contracts are silent.[67] Several potential candidates emerge: shareholders, managers, bondholders, employees, or any combination of these could potentially make decisions for the corporation in the absence of contractual guidance.

Yet as claimants on the firm's residual value, only shareholders have the proper incentives to make investments until the marginal costs and gains are identical.[68] Because they are last in line in terms

65. See *infra* Part IV.A for analysis of older common law judicial policy toward the separation of votes from share ownership.

66. *See, e.g.*, ROBERT CHARLES CLARK, CORPORATE LAW 389–90 (1986); Easterbrook & Fischel, *supra* note 2, at 403. **R**

67. Easterbrook & Fischel, *supra* note 2, at 403. **R**

68. This paragraph is drawn from the explanation in Easterbrook & Fischel, *supra* note 2, at 403. **R**

of claims on the firm's value, the shareholders realize most of the marginal gains and incur most of the marginal costs for these discretionary decisions. Contrast this with, for instance, a bondholder who would only receive a small benefit—in decreased credit risk—from any marginal gains and therefore be unduly risk averse.

Crucially, shareholders' preferences (for an increase in the residual value of the firm) are "likely to be similar if not identical" given that they have identical claims on the firm's value in proportion to their share ownership.[69] It is only when shareholder preferences are homogenous that it is possible to aggregate preferences into a consistent system of choices.[70]

Substantial collective action problems prevent the above-represented picture from smoothly functioning to reach efficient results in corporate decision-making and monitoring of management. These well-known collective action problems include rational apathy, free rider problems, and unfairness to certain large shareholders even where collective action is successful.[71]

The market for corporate control offers an effective answer to these collective action problems.[72] Although shareholders may devote little effort to the exercise of informed judgment in voting on routine issues, they may be persuaded to sell their shares at a premium to an outsider who will seek to gain value for himself by improving on present management's inefficient operation.[73] Thus, shareholder voting indirectly provides a monitoring mechanism over corporate management.

The proportional right to vote attached to share ownership (the one-share-one-vote rule) is a logical extension of the function of the shareholder vote discussed above.[74] Voting power flows from the residual claim on the firm's value.

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69. *Id.* at 405.

70. *Id.* (citing KENNETH J. ARROW, SOCIAL CHOICE AND COLLECTIVE VALUES (2d ed. 1963)); *see also* Matthew D. Adler & Eric A. Posner, *Implementing Cost-Benefit Analysis When Preferences Are Distorted*, 29 J. LEGAL STUD. 1105, 1141–45 (2000).

71. CLARK, *supra* note 66, at 390–94. For an alternate discussion of the collective action problems, see Easterbrook & Fischel, *supra* note 2, at 403–06, 408–10. **R** **R**

72. Each of these problems is explained in detail in Robert Clark's casebook on corporate law. CLARK, *supra* note 66, at 95; *see also* Easterbrook & Fischel, *supra* note 2, at 408–10. **R** **R**

73. *See, e.g.*, CLARK, *supra* note 66, at 95. **R**

74. *See* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1945–46 (1996) ("The case for the one share, one vote rule turns primarily on its ability to match economic incentives with voting power and to preserve the market for corporate control as a check on bad management.").

> [I]n a system [where] voting rights . . . are not proportional to the voter's stake in the enterprise, there will be a reduced incentive for voters to make optimal decisions, because the gains or losses stemming from these decisions will not be internalized at a level corresponding to the influence of one's vote.[75]

Thus, unless each element of that claim carries equal voting power, there will be needless agency costs; the greater the departure from equal weighting, the greater the agency costs.[76]

There has been an extensive debate both on the efficiency of default rules resulting from state competition[77] and on corporate voting in particular: the scholarship on corporate voting has focused on particular contexts, most notably hostile takeovers[78] and shareholder activism.[79] But crucially, there has been no serious dispute about the now canonical contractarian justification from shareholders' residual claims on the firm's value as described above.[80] Thus, much of the literature assumes, as do Easterbrook and Fischel, that the reduction in agency costs posited by the theory is what shareholders and corporations would bargain for in the ab-

75. Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103, 1121 (2002).

76. Easterbrook & Fischel, *supra* note 2, at 409. There are, apart from reducing agency costs and thus facilitating the market for corporate control, additional justifications for the one-share-one-vote rule. *See* Hu & Black, *supra* note 6, at 851–52. But these appear either peripheral to the U.S. rules on corporate voting or dependent upon the classic theory of corporate voting rights, which in any event is undermined by the new vote buying. *See id.* R R

77. *Compare* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14–17 (1993), *and* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254–58 (1977), *with* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1444 (1992), *and* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 663–84 (1974).

78. *See* Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987); Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988); Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979 (1989).

79. *See, e.g.*, John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1278–93 (1991); Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 187–219 (2001).

80. *See* Martin & Partnoy, *supra* note 6, at 777 & n.11 (surveying then new, unpublished literature on corporate voting and noting that it "ignored the normative basis for the underlying investiture of voting rights"). R

sence of transaction costs. Indeed, the one-share-one-vote rule is the dominant norm among corporations in all states.[81]

B. The Theoretical Challenge Presented by the New Vote Buying

There are two crucial, related assumptions made in the classic theory that no longer hold as consistently after the emergence of the new vote buying. The first is the following assertion: "It is not possible to separate the voting right from the equity interest. Someone who wants to buy a vote must buy the stock too."[82] As demonstrated above,[83] modern financial instruments make this decoupling not only possible, but relatively cheap and non-public. Even if a parallel market in votes were possible,[84] Easterbrook and Fischel reject its viability because of difficult problems of valuation and other costs that are incurred without giving rise to any apparent benefit over the familiar transactions in votes tied to shares.[85]

There is an additional serious concern with a market for decoupled votes, similar to problems which arise in unregulated tender offer situations. For outside investors, votes have quite limited value individually but may have substantial value in the collective, as the collective value of the votes increases with the power to influence the outcome of a given contest. In most circumstances, the value of the vote is small compared with the value of the separated share.[86] But one can imagine a market for votes decoupled from shares in which a buyer can conduct a tender offer, offering one price until it gets a majority of votes and then offering a price of zero thereafter.[87] The situation is even worse than one analogous to an unregulated market in tender offers for full shares be-

81. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 64 (1991).

82. Easterbrook & Fischel, *supra* note 2, at 410. **R**

83. *See supra* Part II.

84. It is relevant to keep in mind that a key advantage seen by those using empty voting (e.g., Perry Corporation) is the non-disclosure of the voter's true economic stake. *See supra* Part II.C. This practice is very far from a transparent and liquid market in votes.

85. Easterbrook & Fischel, *supra* note 2, at 411 (citing Lester G. Telser, *Voting and Paying for Public Goods: An Application of the Theory of the Core*, 27 J. ECON. THEORY 376 (1982), which discusses vote-selling games in which there is no core solution when gains are not equally apportioned or, possibly, even when they are). **R**

86. *See* Hu & Black, *supra* note 6, at 852. **R**

87. *Id.* at 853. Hu and Black draw this analogy and formalize the values of individual votes, thereby measuring the likelihood that a vote will be pivotal. *Id.* The analysis shows that the value of the vote drops sharply as the significant shareholder approaches absolute control, and drops to zero once control is obtained. *Id.*

cause, in the market for full shares, the pool of bidders is at least constrained in its initial offer by the shares' market price, assuming no one will sell below market price.[88] The tender offeror for votes does not face similar constraints and thus, as the price of votes approaches zero, even small private benefits will justify the purchase of control.[89]

The second assumption undermined by the new vote buying is perhaps even more fundamental. Classic corporate voting theory holds that shareholders' preferences are "likely to be similar if not identical."[90] This assertion is critical to the theory of shareholder monitoring because when shareholders' preferences are diverse, it is not possible to aggregate their preferences into a consistent system of choices.[91] This problem is aptly illustrated by the Perry-Mylan episode described above.[92] In that situation, hedge fund Perry Corp. had an interest clearly divergent from the rest of the shareholder class; it was interested in having Mylan Labs overpay as much as possible for the target shares.[93] So the choices in any vote on the acquisition were bound to be inconsistent: Perry Corp. would benefit from choosing to overpay, whereas Mylan shareholders would opt for the exact opposite.

It should be stressed that while new vote buying undermines these long-held assumptions about corporate voting theory, it is not the only financial innovation to do so. Dual-class stock structures and dual-class recapitalizations offer reasonable analogies to the kind of decoupling which is brought about through empty voting. Dual-class (re)structuring and empty voting both decouple, partially or completely, economic ownership from voting control. Part II above discussed how empty voting achieves this decoupling. In a typical dual-class common stock structure, two classes of stock are created: one with substantially greater voting power[94] and another with greater economic benefits. The structure became popular during the 1980s, when the competition for corporate control increased dramatically, because dual-class stock permits insiders, owning the class of higher voting stock, to control a majority of the

88. *Id.*

89. *Id.*

90. Easterbrook & Fischel, *supra* note 2, at 405. **R**

91. *Id.* (citing ARROW, *supra* note 70; Matthew D. Adler & Eric A. Posner, *supra* note 70, at 1141–45). **R**

92. *See supra* Part II.A.

93. *See supra* Part II.A.

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

votes while owning a small minority of common stock.[95] Dual-class recapitalizations, where company managers create a dual-class structure mid-stream, that is, after the company has already sold voting shares to investors, offer an even better analogy to the new vote buying.

However, there are salient differences between dual-class stock structures and empty voting. The most important difference is the element of notice: whether the dual-class structure originates with an initial public offering by a company with a capital structure containing dual-class common stock or a mid-stream recapitalization that is approved by shareholders, there is public disclosure of the departure from the one-share-one-vote norm. With notice, investors have the opportunity to value the shares according to the reduced voting rights and other relevant factors. There is at least some evidence that dual-class recapitalizations substantially lowered share price; the discount is consistent with the ability of insiders to acquire control for less than the market price of one-to-one share.[96] New vote buying, in contrast, requires no such public disclosure or shareholder approval and thus may present hidden costs to uninformed investors. Additionally, there are theoretical arguments that the nondisclosure of decoupling results in an unstable, hidden wedge between economic ownership and voting rights.[97] This undisclosed wedge may culminate in an adverse selection situation in which rational investors discount the prices they pay for shares of all companies because they are unable to distinguish which ones should, in fact, be discounted.[98]

The more narrow aim of this Note is to address what courts ought to do when confronted, as they will be, with legal challenges to empty voting practices. The important point is that the separation of voting power from equity interest introduces dramatic heterogeneity into shareholders' interests, and that heterogeneity

95. *Id.*; *see also* Martin & Partnoy, *supra* note 6, at 785. R

96. *See* Gilson, *supra* note 78, at 808–09; Gordon, *supra* note 78, at 23–30. R

97. Hu & Black, *supra* note 6, at 858–59 (summarizing Stewart C. Myers and Nicholas S. Majluf's arguments, Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984), and applying them to insider new vote buying). Hu and Black also note that "[h]idden, low-cost decoupling could . . . contribute to a 'lemons' equilibrium in which dispersed ownership is unstable even if it maximizes firm value, so that most firms retain concentrated ownership." *Id.* at 859 (citing Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (Nat'l Bureau of Econ. Research, Working Paper No. W7203, 1999), *available at* http://ssrn.com/abstract=203110). R

98. *Id.* at 859.

undermines the justification for and usefulness of proportional voting power in common shares of stock.

Courts have largely agreed with the classic scholarship on the functioning and importance of shareholder voting, calling it, for example, the "ideological underpinning upon which the legitimacy of directorial power rests."[99] Accordingly, courts have been very protective of shareholder rights. For instance, the permissive business judgment rule does not apply to board actions that effectively undermine shareholder voting rights.[100] Part IV critically examines the case law on vote buying to determine the extent to which it rests on the assumptions that have been undermined by the new vote buying and what adjustments may be necessary to effectively address empty voting and related phenomena.

IV. ADAPTING TRADITIONAL JUDICIAL TREATMENT OF VOTE-BUYING ARRANGEMENTS TO FIT MODERN FINANCIAL INSTRUMENTS

As a broad overview, one can divide judicial attitudes toward vote-buying arrangements into two temporal periods.[101] In an earlier period, courts around the United States viewed vote buying in the corporate context as *per se* unlawful.[102] This period began with the first adjudications of vote buying in the United States and lasted until relatively recently.[103] The watershed case of *Schreiber v. Car-*

99. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

100. *See id.* at 661; MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1121, 1131 (Del. 2003).

101. Many sources were helpful in compiling a summary of historical and contemporary vote-buying doctrine. A few particularly helpful sources follow. 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, 540–51 (1990); Douglas R. Cole, *E-Proxies for Sale? Corporate Vote-Buying in the Internet Age*, 76 WASH. L. REV. 793, 819–30 (2001); Joe Pavelich, Note, *The Shareholder Judgment Rule: Delaware's Permissive Response to Corporate Vote-Buying*, 31 J. CORP. L. 247, 248–54 (2005).

102. *See infra* Part IV.A; *see also* Chew v. Inverness Mgmt. Corp., 352 A.2d 426, 430 (Del. Ch. 1976) (holding a vote-buying arrangement void as against public policy).

103. This Note uses Delaware law here, and through much of the discussion of recent development in vote-buying case law, because it is the most thoroughly examined and discussed by courts and in the literature. Courts in Delaware have long had much greater opportunity to monitor public corporations as the state has the most publicly traded corporations. *See, e.g.*, Demetrios G. Kaouris, *Is Delaware Still a Haven For Incorporation?*, 20 DEL. J. CORP. L. 965, 1010 (1995) (observing that "Delaware remains the preeminent state for incorporation").

ney[104] sparked a more exacting examination of vote-buying arrangements and established the contemporary judicial policy.[105] Since then, the judicial treatment of vote buying, in Delaware and elsewhere, has been increasingly propitious.[106]

Part IV has three aims. First, a brief summary of bases for the older judicial rule of *per se* invalidity provides a look at courts' initial justifications for disallowing vote buying of any kind. Next, Subpart B analyzes the case of *Schreiber v. Carney* in depth. The goal of this analysis is not just to parse the case, but to analyze how the court's reasoning in that case may apply to empty voting. The last Subpart examines subsequent case law and makes suggestions for how both the definition and the test in *Schreiber* may be adapted to address empty voting.

A. *Historical Per Se Illegality of Vote Buying*

At common law, vote buying in the corporate context, as well as voting trusts and agreements, were *per se* illegal;[107] case law across the states was unanimous on this point.[108] The Court of Chancery

104. 447 A.2d 17 (Del. Ch. 1982).

105. *See infra* Part IV.B.

106. *See infra* Parts IV.B–C.

107. It is important to distinguish between vote buying on one hand, and voting trusts and voting agreements on the other. *See* Cole, *supra* note 101, at 817–18. The salient difference between these two types of arrangements is the consideration exchanged between parties to the agreements. *Id.* In the case of voting trusts and agreements, the consideration exchanged is a reciprocal promise to vote in an agreed-upon manner. Both are allowed by Delaware law. DEL. CODE. ANN. tit. 8 § 218 (2006). In the voting trust the power to vote is vested in a trustee; in the voting agreement the power to vote remains with the parties but is subject to agree-upon restrictions stipulated in the parties' contract, which may be of varying degrees of specificity. Cole, *supra* note 101, at 817. While vote buying similarly separates ownership of the shares from full discretionary control, the nature of the consideration is different. Vote-buying schemes include consideration personal to the shareholder (e.g., cash payments). *Schreiber*, 447 A.2d at 23. This difference is a critical one. So long as the consideration is a reciprocal pledge to vote in a certain way, each party will still take into account its residual claim on the firm's value and so internalize any costs of its vote in proportion to its share ownership. In the case of vote buying, however, the consideration is personal to the shareholder. Thus the shareholder is compensated for the votes it sold and will not have to internalize its proportion of any marginal costs (in that it may be compensated beyond those costs).

108. *See, e.g.*, Smith v. San Francisco & N. Pac. Ry., 47 P. 582, 590 (Cal. 1897); Stott v. Stott, 242 N.W. 747, 748 (Mich. 1932) (holding vote-buying arrangement "against public policy and void"); Dieckmann v. Robyn, 141 S.W. 717, 718 (Mo. Ct. App. 1911) (holding a vote-buying arrangement void on the basis of public policy because it "operates as a constructive fraud upon the corporation" by inducing the shareholder to "violate whatever trust relation he occupies"); Bache v. Cent.

of New Jersey voiced a typical view when it held in 1911 that arrangements that separate voting power from share ownership constitute a "gross violation" of public policy.[109] Early academic commentators largely agreed with the New Jersey court's assessment.[110]

Surveying the early cases and literature, three justifications for the rigid prohibition become apparent: 1) an analogy to political vote buying; 2) concern that vote selling violates a reciprocal duty owed among all shareholders; and 3) the more fundamental necessity of tying together voting control and share ownership. Judicial opinions often meld these overlapping justifications to find that certain vote-buying arrangements contravene public policy; indeed, a close examination finds the three rationales do share much in common, most fundamentally in that the first two are subsidiary to the third in aligning shareholder interest in the residual value of the firm. Still, it is possible to, and courts did, distinguish between these justifications. Indeed, they offer separate insights into an effective modern approach to corporate vote buying.

1. The Analogy to Political Vote Buying

The analogy between vote buying in the political and corporate contexts is fairly straightforward. All states recognized that corruption and vote buying are intertwined and banned political vote buying;[111] therefore, corporate vote buying must be against public policy. To tie the analogy together, courts focused on the moral

Leather Co., 81 A. 571, 572 (N.J. Ch. 1911) (finding arrangements that separate voting power from ownership in "gross violation" of public policy); *In re* Glen Salt Co., 45 N.Y.S. 568, 574 (N.Y. App. Div. 1897) (holding that the issuance of a proxy to vote for consideration is illegal).

109. *Bache*, 81 A. at 572.

110. *See* Simeon E. Baldwin, *Voting Trusts*, 1 YALE L.J. 1, 7 (1891) ("A sale by a stockholder of the power to vote upon his shares, is illegal, for very much the same reason that a sale of his vote by a citizen at the polls . . . is illegal. Each is a violation of duty; in effect, if not in purpose, a betrayal of trust."); Milton M. Bergerman, *Voting Trusts and Non-Voting Stock*, 37 YALE L.J. 445, 466 (1928) ("The common law, as well as modern statute law, forbids the purchase and sale of the right to vote stock. We are generally committed to the proposition that this would be a harmful practice because of the high probability that such transactions will result in fraudulent and ineffectual corporate management."); Walter K. Tuller, *The Rules Which Determine the Validity or Invalidity of Voting Agreements of Corporate Stock*, 44 AM. L. REV. 663, 690 (1910) ("Agreements . . . where one stockholder agrees to vote in a certain way . . . for a consideration not common to all his co-stockholders, are, of course, clearly fraudulent . . . .").

111. *See* Richard L. Hasen, *Vote Buying*, 88 Cal. L. Rev. 1323 (2000) (citing statutes in multiple jurisdictions).

duties owed by citizens to the state, and legitimacy conditions common to civic and corporate voting.[112] Courts in some cases found the analogy to political vote buying strong enough to be a standalone justification for disallowing the arrangement.[113]

Though some commentators continued to draw the analogy,[114] it has undergone substantial and more or less fatal criticism. In a thorough analysis, Richard Hasen identifies three possible rationales that undergird the prohibition on "core vote buying" in political elections: efficiency, equality, and inalienability.[115] None of the three rationales, Hasen argues, are sufficient justification to ban vote buying in the corporate domain, nor do the three together provide the necessary force.[116] Thus, Hasen concludes that civic and corporate vote buying are "not similar under any important rubric."[117]

2. Reciprocal Duties Among Shareholders

Courts often relied upon the duty to exercise independent judgment as a justification for rejecting vote-buying arrangements.[118] As a corollary to the duty of independent judgment, courts occasionally viewed arrangements for the sale of votes as per-

112. *See, e.g.*, Hafer v. N.Y., Lake Erie & W.R.R. Co., 9 Ohio Dec. Reprint 470, 474 (Super. Ct. 1885). It is apparent that the underlying rationale for objecting to vote buying here overlaps with the objection from reciprocal shareholder duties. However, the two are separate and relied on independently by courts. *See, e.g.*, Warren v. Pim, 59 A. 773, 791 (N.J. 1904); *see also* David Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote,"* 56 CORNELL L. REV. 1 (1970) (arguing that equal weighting of shares gives excessive power to holders of blocs and violates the Constitution).

113. *See, e.g.*, *Warren*, 59 A. at 791.

114. 6A ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1454 (1962).

115. Hasen, *supra* note 111, at 1325. Upon identifying these three rationales, **R** Hasen uses them to evaluate the justifiability of other "non-core" (i.e., non-civic) vote buying practices. *See generally id.* To elaborate, the equality argument is that the poor are more likely to sell their votes than are the wealthy because of the declining marginal utility of money. *Id.* at 1325. This will lead to outcomes favoring the wealthy. *Id.* The efficiency argument is that vote buying allows buyers to engage in rent-seeking that diminishes overall social wealth. *Id.* The inalienability argument against vote buying is that the votes belong to the community as a whole and, therefore, should not be alienable by any individual voter. *Id.*

116. *Id.* at 1353.

117. *Id.*

118. *See, e.g.*, Bostwick v. Chapman, 24 A. 32, 41 (Conn. Super. Ct. 1890); Guernsey v. Cook, 120 Mass. 501, 502 (1876); Harvey v. Linville Improvement Co., 24 S.E. 489, 490 (N.C. 1896); Cone's Ex's v. Russell, 21 A. 847, 849 (N.J. Ch. 1891).

petrating a fraud on other shareholders.[119] The duty was sometimes articulated as one running among shareholders to promote the general interests of the corporation: "[T]he duty which each stockholder owes his fellow stockholder [is to ensure] . . . that the general interest of stockholders shall be protected, and the general welfare of the corporation sustained."[120] But alternatively, certain courts would articulate the duty as of one of "disinterested action"[121] or "individual judgment."[122] However phrased, courts recognized the necessity of interest alignment, that "the security of 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."[123] In the absence of vote buying, self-interest is just an increase in the residual value of the firm, which benefits all shareholders proportionally and all other corporate constituents to some extent.

3. The Inseparability of Ownership and Voting of Common Shares

A closely related, but more fundamental, justification for the *per se* ban on vote buying is the necessity of tying ownership to control. As courts implicitly recognized in finding shareholder duties of independent judgment or of support for the corporate interest, alignment of shareholder interests is a necessity for avoiding hopeless collective action problems.[124] Thus, interest alignment was perhaps the most fundamental of the several articulated reasons for a shareholder duty to support the corporate interest. Well before

119. Palmbaum v. Magulsky, 104 N.E. 746, 746 (Mass. 1914) ("It is the duty of a stockholder of a corporation . . . to act fairly and in good faith. He is not justified in entering into any agreement to vote so as to perpetrate a fraud upon another stockholder."); *Guernsey*, 120 Mass. at 502; 3 WILLIAM L. CLARK & WILLIAM L. MARSHALL, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 657, at 2017–18 (1901) ("It may be laid down as a . . . general principle that any contract on the part of a stockholder or stockholders . . . to vote their shares in a particular way, or not to vote in a particular way, is illegal and void if the agreement contemplates a fraud upon other stockholders, or upon the creditors of the corporation."). The court in Schreiber v. Carney, 447 A.2d 17, 24 (Del. Ch. 1982), explicitly identified violation of the duty of independent judgment as a prior grounds for fraud.

120. *Bostwick*, 24 A. at 41.

121. *Guernsey*, 120 Mass. at 502.

122. *Harvey*, 24 S.E. at 490.

123. *Cone's Ex's*, 21 A. at 849.

124. Though obviously interest alignment alone does not *solve* collective action problems, it at least gives shareholders a chance at acting efficiently in their collective best interests. *See supra* Part III.A.

Berle and Means' classic book[125] on the problems arising from the separation of ownership and control in the corporate context, many commentators discussed the problems arising from the separation of share ownership from voting control.[126]

Quite apart from any duty of independent judgment, courts recognized the danger of separating voting power from share ownership.[127] For instance, the Supreme Court of California, in *Smith v. San Francisco & Northern Pacific Railway*, held that a shareholder who held stock for another party in interest held it "in name only" and was therefore not a "bona fide stockholder" and should not be allowed to vote the shares.[128]

Thus, for many of the same reasons that justify a shareholder duty of independent judgment, courts have traditionally found the separation of share ownership from voting power impermissible: the alignment of shareholder interest in the residual value of the corporation ensures that all shareholders are voting in a good-faith belief about whether marginal gains in the decision exceed the marginal costs. This rationale mirrors the justification for shareholder voting as propounded by Easterbrook and Fischel in the canonical theory underlying corporate voting.[129] Courts have long recognized this reasoning and, as a result, hewed closely to a rule of *per se* illegality for vote-buying schemes.

125. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

126. *See, e.g.*, HARRY A. CUSHING, VOTING TRUSTS 144–47 (1915); Baldwin, *supra* note 110, at 2, 6–7; Bergerman, *supra* note 110, at 466; Jesse W. Lilienthal, *Corporate Voting and Public Policy*, 10 HARV. L. REV. 428, 429 (1897); Marion Smith, *Limitations on the Validity of Voting Trusts*, 22 COLUM. L. REV. 627, 628 (1922). Berle and Means' book was focused on the separation of ownership and control at the corporate level, arguing that managers used the machinery of public corporations to appropriate control from the common shareholder and expropriate personal gain. *See* BERLE & MEANS, *supra* note 125, at 139. R

127. *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."); *Cone's Ex's*, 21 A. at 849; Hafer v. N.Y., Lake Erie & W.R.R. Co., 9 Ohio Dec. Reprint 470, 474 (Super. Ct. 1885) ("The law presumes that the pecuniary interest of a stockholder will be a motion to impel him to vote in such a manner as will promote the interests of the company. Such a motive is entirely lacking in one who is not a stockholder . . . he may be subject to interests and motives other than such as would conduce to the welfare of the company.").

128. Smith v. San Francisco & N. Pac. Ry., 47 P. 582, 586 (Cal. 1897).

129. Easterbrook & Fischel, *supra* note 2, at 403; *see also supra* Part III.A. R

B. The Decision in Schreiber v. Carney

Schreiber v. Carney[130] initiated a true watershed in judicial treatment of corporate vote-buying arrangements. Only a few years earlier, in *Chew v. Inverness Management Corp.*, Delaware's Court of Chancery unambiguously held that a vote-buying arrangement was void for violating public policy.[131] The unique facts in *Schreiber*, however, gave the court a chance to reexamine the prior case law on corporate vote buying from a critical perspective.

Schreiber arose from a derivative action on behalf of Texas International Airlines ("TIA") challenging a loan made to Jet Capital, a thirty-five percent shareholder in TIA.[132] The challenged loan was made because Jet Capital had effective veto power over a proposed restructuring in which TIA would merge into a holding company.[133]

Jet Capital itself conceded the merger was in the best interests of TIA but nevertheless threatened to block the restructuring because of "intolerable" tax consequences.[134] Jet Capital could avoid tax liability by exercising the warrants, but it lacked cash to do so.[135] The Board of Directors at TIA set up an independent committee to study the matter. The committee determined a loan was the best solution, and the parties negotiated a loan "at arm's length," but on terms very favorable to Jet Capital.[136] The proposed loan was put to a shareholder vote and overwhelmingly approved.[137] Plaintiff objected and filed suit, alleging the transaction constituted vote buying and as such was void under well-established law.[138] The "critical inquiry" thus presented to the court was "whether the loan in question was in fact vote-buying, and, if so, whether vote-buying is illegal, *per se*."[139]

The *Schreiber* court began its analysis by enunciating a definition of vote buying that has since become the standard: "Vote-buying, despite its negative connotation, is simply a voting agreement

130. 447 A.2d 17 (Del. Ch. 1982).

131. 352 A.2d 426, 430 (Del. Ch. 1976).

132. *Schreiber,* 447 A.2d at 18.

133. *Id.* TIA's corporate charter required a majority vote from each of several different classes of stock; Jet Capital owned a majority share of one class and therefore could effectively block the merger even though a vast majority of shareholders overall supported it. *Id.*

134. *Id.*

135. *Id.*

136. *Id.* at 20.

137. *Id.*

138. *Id.*

139. *Id.* at 23.

supported by consideration personal to the stockholder, whereby the stockholder divorces his discretionary power and votes as directed by the offeror."[140] The court had no trouble determining that the arrangement between TIA and Jet Capital constituted vote buying.[141]

In contrast to previous decisions, the court considered it an open question whether vote buying was *per se* illegal.[142] The court looked at earlier Delaware case law on the question of corporate vote buying[143] and explained that these cases "emphatically state that vote-buying was against public policy but failed to discuss the reason why," other than condemning the presence of fraud.[144] However, the loan arrangement between TIA and Jet Capital, vetted by an independent committee and a shareholder vote, was almost certainly devoid of any fraud. Therefore, the court would engage the economic and practical realities of the transaction, because "[t]o do otherwise would be tantamount to 'deciding the case on an abstraction divorced from the facts of the case and the intent of the law.'"[145]

The court discussed two central rationales present in the older cases. The first principle is that if the object and purpose of the vote-buying arrangement is to "defraud or disenfranchise the other stockholders," then the arrangement is *per se* illegal.[146] The court held that this principle remains a sound one for evaluating the validity of vote-buying arrangements, and under this rubric the arrangement between TIA and Jet Capital was not illegal.[147]

In its discussion of the "second principle which appears in these old cases," the court enmeshed the two latter grounds discussed in the prior Part of this Note: the duty of independent judg-

140. *Id.* at 23. For a small sample of recent cases citing to this definition see for example Hewlett v. Hewlett-Packard Co., No. CIV.A. 19513-NC, 2002 WL 549137, at *4 (Del. Ch. Apr. 8, 2002); Haft v. Haft, 671 A.2d 413, 421 n.9 (Del. Ch. 1995).

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

142. *Id.*

143. The court cited Chew v. Inverness Mgmt. Corp., 352 A.2d 426 (Del. Ch. 1976); Hall v. Isaacs, 146 A.2d 602 (Del. Ch. 1958); and Macht v. Merchs. Mortgage & Credit Co., 194 A. 19 (Del. Ch. 1937). *Macht*, which the court calls a "seminal case," appears to be the oldest authority in Delaware on corporate vote buying as it cites to older cases in other states that are discussed above in Part III.A. *Macht*, 194 A. at 22.

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

145. *Id.* at 24 (quoting Oceanic Exploration Co. v. Grynberg, 428 A.2d 1, 5 (Del. 1981)).

146. *Id.*

147. *Id.* at 25–26.

ment and the importance of shareholder interest alignment through a tying-together of share ownership and voting control.[148] The court took notice of the duty of independent shareholder judgment and stated that the "apparent rationale is that by requiring each stockholder to exercise his individual judgment . . . '[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.'"[149] Thus, the court recognized that aligning the interests of shareholders in the residual value of the enterprise was the foundation of the duty of independent judgment. The court found that the duty itself was "outmoded" in contemporary law as a result of a changing corporate environment.[150] Therefore, any violation of the heretofore-recognized duty would not serve by itself to invalidate the arrangement between TIA and Jet Capital, and certainly not on a *per se* basis.[151]

However a close reading of the court's reasoning in *Schreiber* shows that the fundamental concern, "the potential injury or prejudicial impact which might flow to other stockholders as a result" of a vote-buying arrangement, remained a pressing concern regardless of any duty, "outmoded" or otherwise.[152] Indeed, before dismissing the duty of independent judgment as outmoded, the court actually examined the TIA agreement in light of any "potential injury or prejudicial impact which might flow to other stockholders."[153] What the court found was that the loan agreement was entered into to further the interests of all TIA shareholders and was overwhelmingly approved by them. Thus, this core policy concern of harm to shareholders not party to the vote-buying agreement "cease[d] to exist."[154] Indeed, as all shareholders vetted the vote-buying transaction, there was objective assurance that the transaction was in the interest of the shareholders—or at least that a vast majority of them believed it so.

As a basis for this examination, the court drew from the "oft-cited" and "particularly enlightening" case of *Brady v. Bean*.[155] In *Brady*, the plaintiff, an influential stockholder, voiced opposition to

148. *See id.* at 24–25. For the discussion of these grounds in separate contexts, see *supra* Part IV.A.2–3.

149. *Id.* at 24 (citing Cone's Ex's v. Russell, 21 A. 847, 849 (N.J. Ch. 1891)).

150. *Id.*

151. *Id.* at 25.

152. *Id.* at 24–25.

153. *See id.* at 25.

154. *Id.*

155. *Id.* at 24 (citing Brady v. Bean, 221 Ill. App. 279 (Ill. App. Ct. 1921)). The *Schreiber* court refers to the case as *Brady v. Bean* after the plaintiff and execu-

the corporation's proposed sale of assets because the consideration for the sale was only sufficient to satisfy the corporation's creditors.[156] Without the knowledge of the other stockholders, the defendant, a substantial creditor of the company, offered the plaintiff a share in the defendant's prior claims in exchange for the withdrawal of his opposition to the sale.[157]

Note that the underlying economic result in *Brady* is close to that which results from the empty voting arrangement in Perry-Mylan: the controller/purchaser of the vote in both cases has in fact no economic interest in the shares being voted. The benefit accruing to the vote buyer results from the transaction being voted on, but is separate from the claim that the share represents.[158] Likewise, the seller's votes are now motivated by interests external to the residual value of the firm. Presumably, this is what the court referred to when it emphasized that the core difficulty with the vote-buying scheme in *Brady* was the "*consideration which was foreign to those rights and interests* [of the shares] *and would likely to induce* [plaintiff] *to disregard*" what a normal shareholder would consider most important, that is, the marginal utility of the proposed transaction.[159]

So a close reading of the *Schreiber* case shows that even though the court recognized the prior abandonment of a duty of independent judgment, it did not also disregard the underlying rationale for that duty. To the contrary, the court recognized the grave potential for abuse inherent in vote-buying arrangements that draw upon "foreign" consideration.[160] The court acknowledged the necessity of aligning the "community of interests"[161] among shareholders in the residual value of the enterprise; otherwise, as discussed above, the justification for shareholder voting disintegrates as shareholder preferences diversify.[162]

Extrapolating a bit, one can see that the *Schreiber* court would have objected to the alleged facts in Perry-Mylan for much the same reasons as it did in discussing *Brady*. The purchased votes in both

tor-defendant, though the case is entitled *In re Grave's Estate* in the reporter. *Id.* This note follows the *Schreiber* court's usage.

156. *Brady*, 221 Ill. App. at 280.

157. *Id.* at 280–81.

158. In Perry-Mylan the disconnect was even more dramatic because the purchaser actually had, albeit indirectly, a negative economic interest in the share price. *See supra* Part II.A.

159. *Schreiber*, 447 A.2d at 24.

160. *Id.*

161. *Id.*

162. *See supra* Part III.B, especially note 66 and accompanying text.

cases were voted not with the residual value of the firm in mind but because of the "foreign consideration": the share of the creditor's prior claims in the case of *Brady* and the premium on King Pharmaceuticals' shares in Perry's case.[163]

This recognition of the inequitable results of introducing foreign consideration is made explicit through the warning of susceptibility to abuse and the imposition of an intrinsic-fairness test enunciated in the court's holding:

> [A]n agreement involving the transfer of stock voting rights without the transfer of ownership is not necessarily illegal and each arrangement must be examined in light of its object or purpose. To hold otherwise would be to exalt form over substance. . . . [A vote buying arrangement] should not be considered to be illegal *per se* unless the object or purpose is to defraud or in some way disenfranchise the other stockholders. This is not to say, however, that vote-buying accomplished for some laudable purpose is automatically free from challenge. Because vote-buying is so easily susceptible of abuse it must be viewed as a voidable transaction subject to a test for intrinsic fairness.[164]

Thus, the court in *Schreiber* did away with the rule of *per se* illegality for vote-buying arrangements and replaced it with an evaluatory rubric that gives the court quite a bit of discretion. One commentator has distilled the holding into a three-step test:[165] (1) Is the arrangement vote buying as defined in *Schreiber*? That is, does it involve the transfer of voting power in exchange for consideration personal to the shareholder? (2) If yes, then is its effect or purpose to defraud or disenfranchise the other shareholders? (3) If not, then does the arrangement pass a test for intrinsic fairness? Though this approach at first appears to have at least the potential to be a fairly vigorous examination, courts since *Schreiber* have largely blunted its application. The next Subpart examines how this has been done, and what adjustments to the definition and tests are necessary in order for courts to effectively respond to new vote buying and empty voting in particular.

163. The fact that there is no consideration in an empty voting transaction, at least in the usual sense, should not be an impediment to analyzing the transaction under the vote-buying rubric. *See infra* Part IV.C.1.

164. *Schreiber*, 447 A.2d at 25–26.

165. Cole, *supra* note 101, at 826. R

*C. Post-*Schreiber *Development of the Law*

The departure from *per se* illegality has been much more dramatic than one would have predicted reading the *Schreiber* court's cautious, conditional acceptance of one particular vote-buying arrangement. The *Schreiber* court certainly did not view its decision as any radical departure or significant overruling of prior law; it plausibly distinguished the heavily vetted loan agreement from the facts of the earlier cases which adhered to the *per se* rule of illegality.[166] But after *Schreiber*, Delaware courts effectively have moved all the way to the other side of a spectrum, to a rule of near *per se* legality: until only a few months ago,[167] not one decision since *Schreiber* had disallowed a vote-buying arrangement—a span of over a quarter-century. Such a result undermines any view that Delaware courts have in fact been applying the type of case-by-case, fastidious investigation prescribed by the *Schreiber* decision. Each of three steps in the *Schreiber* analysis described above[168] have been narrowed or modified in subsequent cases, and the aggregate effect is a test that has very little bite. In order for courts to address new vote buying, and especially empty voting, some adaptation of each of these three steps is necessary.

1. The Definition of Vote Buying

The *Schreiber* court offered a definition of vote buying—"simply a voting agreement supported by consideration personal to the stockholder, whereby the stockholder divorces his discretionary power and votes as directed by the offeror"—that was appealing in the basic sense that it captured well an understanding of what is involved in classic vote buying.[169] Additionally, the definition was flexible enough to accommodate a range of practices designed to effectuate the same arrangement. Indeed, the definition arguably is, with limited adaptation, flexible enough to capture the new vote buying.

But subsequent judicial glosses on this basic definition have resulted in subtle accretion of conditions which, though not a dramatic departure, in sum represents a slight narrowing of the application of the *Schreiber* prohibitions on fraud and disenfranchisement, and its requirement of intrinsic fairness. The following cases suggest a raising of the definitional hurdle, and at least

166. *Schreiber*, 447 A.2d at 23–25.
167. Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 47 (Del. Ch. 2008).
168. *See supra* Part IV.B.
169. *Schreiber*, 447 A.2d at 23.

demonstrate the reluctance of some courts to take up *Schreiber* on its call for substantial skepticism in any evaluation of vote buying. The Subpart on the definition of vote buying concludes by examining prior cases with an eye toward the necessary definitional modifications that would allow a court to apply vote-buying doctrine to instances of empty voting.

a. Cases Narrowing the Definition of Vote Buying

Delaware cases decided after *Schreiber* have narrowed the definition of vote buying. In *Henley Group, Inc.* v. *Santa Fe Southern Pacific Corp.*, the Court of Chancery found that a vote seller had not divorced its discretionary power as required by the *Schreiber* definition because the seller was "not legally obligated" by the agreement to vote in a certain manner.[170] Later, in *Rainbow Navigation, Inc. v. Yonge*, the Delaware Court of Chancery again rejected the contention that vote buying had occurred because the expectation was not "legally enforceable."[171] However, the court added that "more importantly," the purported vote-buying agreement was not "the principal motivating force" behind the vote.[172] Though the requirements that the vote-buying arrangement be "legally enforceable" and the "principal motivating factor" have not been definitively adopted by any court, neither have *Henley Group* and *Rainbow Navigation* been specifically overruled. Thus, any potential plaintiff challenging an instance of empty voting must grapple with these potential additional requirements.

b. How Empty Voting Fits with the Current Definition of Vote Buying

Neither of these two potential additions to the *Schreiber* definition—legal obligation and principal motivation—is likely to present significant problems in a legal challenge of empty voting. A legal enforceability requirement seems to beg the question and thus appears, prima facie, somewhat beside the point. In any event, the over-the-counter swaps that form the basis of a Perry-Mylan–like attempt would presumably be enforceable.

Likewise, while "principal motivating factor" is necessarily a fact-dependent inquiry, any requirement to this effect does not appear to present a substantial hurdle to challenging an instance of empty voting. Again, using Perry-Mylan as the pertinent example, it would be very difficult for Perry, or any similar empty-voter, to ar-

170. CIV. A. No. 9569, 1988 WL 23945, at *7 (Del. Ch. Mar. 11, 1988).
171. CIV. A. No. 9432, 1989 WL 40805, at *10 (Del. Ch. Apr. 24, 1989).
172. *Id.*

gue that it bought the shares and hedged out the economic risk for any other reason *but* to acquire the votes.[173] The fees brokerages charge for their substantial transaction costs are not cheap, and the empty voter is left with nothing but the shares.[174]

Other aspects of the *Schreiber* definition need adjustment to square with the transactions involved in empty voting achieved through the new vote buying. It is apparent that the definition of vote buying offered in *Schreiber*, strictly construed, does not capture vote buying achieved through hedging transactions as there are no counterparties whereby a buyer pays a shareholder to vote a certain way, and there is no "consideration personal to the shareholder" in the usual sense. Instead, traditionally owned shares are eviscerated through a hedging-out of the economic risk associated with their ownership.

Those differences should not be, however, a substantial impediment to judicial monitoring of empty voting. To begin with, the definition in *Schreiber* is a very basic one, arguably intended to reach a broad range of cases.[175] The court in *Schreiber* specifically stressed that engaging the economic realities of the transaction was of paramount importance in an analysis of vote buying.[176] Vote-buying doctrine has been the vehicle by which courts have policed the decoupling of share ownership from voting control since early common law.[177] *Schreiber* is a recent revision in which the court specifically recognized that adaptations were necessary in light of developments in corporate law.[178] The definitional niceties adopted therein should be no bar to continuing to police this decoupling by responding to technological developments in the marketplace.

Such adaptation would not require much. The true inquiry is whether there has been a separation of ownership from voting rights that resulted in the voter having interests substantially diver-

173. This is a claim of degree. If shares were only slightly hedged, arguably it is not vote buying, or empty voting, at all. This aspect of degree is discussed more in detail below in Part V.

174. It may be the facts in *Rainbow Navigation* were unique. There was substantial factual dispute over the existence of any agreement, in addition to whether the purported vote seller would have voted as he did in the absence of any agreement. *See Rainbow Navigation*, 1989 WL 40805, at *7, 10.

175. For instance, in *Schreiber* itself the consideration was not simply a cash payment between shareholders, but a loan made by the corporation to a shareholder. Schreiber v. Carney, 447 A.2d 17, 20 (Del. Ch. 1982).

176. *Id.* at 24.

177. *See supra* Part IV.A.

178. *Schreiber*, 447 A.2d at 24.

gent from the other shareholders. This does not necessitate a counterparty agreeing to vote in a certain way in exchange for consideration foreign to the corporate interest.

Reflecting on the role that consideration plays in finding vote buying, it appears that this element is not foundational, but rather consideration evidences that the seller is requiring compensation for parting with the voting discretion and with it the ability to exercise judgment as to the marginal utility of the proposal being voted on. But because the value of the vote is often small in comparison to the value of the share,[179] substantial consideration in return for the vote indicates that the seller probably is receiving compensation not just for the vote, but for any detriment to the seller's interests that may be occasioned by the purchaser winning the vote. On this view, the absence of a counterparty should make the court even more vigilant, not less: in classic vote buying the counterparty would still retain economic ownership, and so would provide some check on the vote buyer's proposed vote through the consideration demanded. In the extreme case, the seller would refuse to sell the vote if it would eviscerate the share price and the buyer did not provide adequate consideration, which would approach the share purchase price as the value of future revenue streams from those shares declined. In the new vote buying, this check is entirely absent: brokerage fees are the only cost of the vote-buying transaction.

Thus, the absence of these two elements, counterparties and consideration, need not prevent a court from finding vote buying where the economic realities indicate it is not only present, but being used in detriment to other shareholders' interests. As the court in *Schreiber* cautioned: "To do otherwise would be tantamount to 'deciding the case on an abstraction divorced from the facts of the case and the intent of the law.'"[180]

2. Proof Required to Show That the Object or Purpose Is to Defraud or Disenfranchise

Notwithstanding a narrower definition, several cases concluded that vote buying occurred and analyzed the arrangement for evidence of fraud or disenfranchisement. During the subsequent interpretation of these separate prohibitions, Delaware courts have set relatively onerous burdens on plaintiffs who attempt to show that a particular vote-buying arrangement is fraudulent or results in

179. *See* Hu & Black, *supra* note 6, at 852–53. R

180. *Schreiber*, 447 A.2d at 24 (quoting Oceanic Exploration Co. v. Grynberg, 428 A.2d 1, 5 (Del. 1981)).

disenfranchisement. Only very recently, in a particularly egregious set of circumstances, has a Delaware court found evidence of fraud and disenfranchisement sufficient to disallow an instance of vote buying.[181]

a. Fraud

Schreiber's fraud prong is a tricky one. Because no court has invalidated a vote-buying agreement between shareholders on the grounds of a fraudulent purpose or effect, it is difficult to find judicial authority to construe what the *Schreiber* court meant when it ruled that voting agreements "should not be considered to be illegal *per se* unless the object or purpose is to defraud . . . the other stockholders."[182] Common law fraud in contract or tort requires at least a material misrepresentation.[183] But in the case of most shareholder vote-buying arrangements, and especially in the case of empty voting, nondisclosure is a key advantage. Absent a duty to disclose, it is difficult to see how a voting agreement between a shareholder and an outsider or other shareholder could be strictly construed as fraud given that there is usually no representation to other shareholders, material or otherwise.[184] And material misrepresentation is not the only problematic element.[185]

In addition to these conceptual difficulties, the case of *Wincorp Realty Investments, Inc.* v. *Goodtab, Inc.* establishes that challenging a vote-buying arrangement, even one that is very probably "fraudulent" in the sense of misleading other principal shareholders, requires a substantial damage element as well.[186] In *Wincorp*, one shareholder "for a flat cash payment, acquire[d] the voting rights of another shareholder for the purpose of voting himself into the office of corporate director, regardless of the other economic bona fides" and did not disclose the arrangement to other principal

181. Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 47 (Del. Ch. 2008). *Portnoy* was the first case since *Schreiber* in 1982 to disallow a vote-buying arrangement in the corporate context.

182. *Schreiber*, 447 A.2d at 25–26.

183. 26 Samuel Williston, Williston on Contracts § 69:3 (Supp. 2006); Restatement (Second) of Torts § 525 (1981).

184. The *Schreiber* court discarded any duty of independent judgment among shareholders as "outmoded." *Schreiber*, 447 A.2d at 25. Notwithstanding the federal securities laws, there does not appear to be any duty of disclosure of the sort that would be required for a finding of fraud. Disclosures required by the securities laws, such as Schedule 13D, are a closer question. *See supra* Part II.C, especially note 54 and accompanying text.

185. Reliance and, in the case of contract, the absence of a counterparty in new vote buying would prove troublesome in numerous hypothetical situations.

186. No. 7314, 1983 WL 8948 (Del. Ch. Oct. 13, 1983).

shareholders.[187] Even conceding that the plaintiff's fraud argument was "strong stuff," the court did not find sufficient injury to enjoin the election.[188] Additionally, it refused to disallow the agreement on public policy grounds, distinguishing the agreement in *Schreiber* as not "between two shareholders as such" and because it did not involve a transfer of voting rights but a withdrawal of opposition.[189] Finding insufficient harm seems even more inexplicable than these two dubious grounds used to distinguish *Schreiber*: what more harm is necessary in a motion to enjoin a rigged election than an adverse outcome?

In a very recent case, Vice Chancellor Strine breathed new life into judicial monitoring of corporate vote buying by using the fraud prong of the *Schreiber* test to invalidate the results of a corporate election.[190] In *Portnoy v. Cryo-Cell*, the management of Cryo-Cell International, Inc. used nearly every underhanded trick in the book, including secret vote-buying arrangements, stalling the election and even asking the FBI to intervene, in order to secure its position against insurgent shareholders clamoring for new management.[191] Noting that the review called for by *Schreiber* is "an extremely important safeguard of the stockholder voting rights,"[192] the court invalidated the election results because management made a clandestine arrangement to create a new board seat for the vote seller's designee in exchange for his vote.[193] This invalidation was the very first instance of disallowing of a vote-buying scheme since *Schreiber*, over a quarter-century before.

However while *Portnoy* is undoubtedly a significant event in the context of judicial oversight of corporate vote buying, there are substantial reasons to believe that it may not be readily extendible to empty voting. First and most importantly, the court took great pains to emphasize that management's violation of its duty of disclosure was the "narrow[ ] reason why this [vote-buying scheme]

187. *Id.* at *4.

188. *Id.*

189. *Id.* at *5. Both grounds distinguishing *Schreiber* appear to make false, or at least very tenuous, distinctions. When a corporation transfers consideration, it is transferring at least some shareholder assets (as well as other claimants' assets). Secondly, a withdrawal of opposition *just is* an agreement to vote a certain way. The point here though is not the correctness of the decision, but that the *Wincorp* court appears to require a very high showing of harm to disallow an arrangement for fraud.

190. Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 47 (Del. Ch. 2008).

191. *Id.* at 46–47.

192. *Id.* at 69.

193. *Id.* at 72.

was improper and inequitably tainted the election process."[194] It explicitly distinguished the case in which the vote buying is solely among shareholders, who have no such duty.[195] Secondly, the facts of *Portnoy* are so extreme that one wonders whether even the court in *Wincorp* would have allowed the election results to stand.

In conclusion, one sees that the *Wincorp* court stretched to impressive lengths to distinguish *Schreiber* and required a very onerous showing of harm for the plaintiff. *Portnoy*, though a substantial step in a potential reawakening of judicial oversight in corporate vote buying, explicitly distinguished between vote buying where management is involved and vote buying between mere shareholders.[196] Given these considerations, and the general difficulties of applying a fraud prong to an empty voting arrangement, such a test would be of little help to a court adjudicating the validity of an empty voting scheme.

b. Disenfranchisement

The case law that has developed around the disenfranchisement prong is similarly foreboding to a potential plaintiff wishing to challenge a vote-buying arrangement. Though there has not been a definitive holding on point, recent cases suggest that to disenfranchise other shareholders, a vote-buying agreement must either capture a majority of the number of votes[197] or at least be outcome-determinative.[198]

In examining whether a vote-buying scheme that "*almost* completely lock[ed] up the vote" disenfranchised other shareholders, the court in *In re IXC* was dismissive: "'*Almost* locked up' does not mean 'locked up,' and '*scant* power' may mean less power [to win the election], but it decidedly does not mean 'no power.'"[199] The court then concluded that when "a numerical majority of shareholders" are able to vote as they please, they are still "in a position independently to void the allegedly onerous effect of this vote-buying transaction," and thus the transaction has not disenfranchised the non-party shareholders.[200]

194. *Id.*

195. *Id.* at 74.

196. *Id.*

197. *See In re* IXC Commc'ns, Inc. S'holders Litig., No. C.A. 17324, 1999 WL 1009174, at *8–9 (Del. Ch. Oct. 27, 1999).

198. *See* Hewlett v. Hewlett-Packard Co., No. CIV.A. 19513-NC, 2002 WL 818091, at *12 n.92 (Del. Ch. Apr. 30, 2002).

199. 1999 WL 1009174, at *8.

200. *Id.* at *9.

In a more recent case, *Hewlett v. Hewlett-Packard Co.*, the court appeared to disagree with *In re IXC* as to whether a majority of votes is necessary.[201] However, the court did hold to the slightly lower threshold of outcome-determinacy.[202] Although the court found no vote-buying agreement on the instant facts of the case, it noted that the examination would ultimately be of "greater academic than practical interest" because the number of votes involved was, arguably, not enough to be outcome determinative.[203] Thus, it appears that while Delaware courts will accept something less than a majority of votes,[204] the number of votes purchased must at least be enough to decide the outcome of the election. This seems to square with a literal reading of "disenfranchise," taken to mean not allowing a party to vote or, more liberally, rendering its vote meaningless. Given the complexities involved with corporate voting and vote counting, and the fact that less than a majority of votes is often more than sufficient to win an election,[205] requiring a majority of votes actually to be purchased seems an excessively onerous burden.

The court in *Portnoy* appears to have agreed with this sentiment. Although the opinion took into account the fact that the election in question was decided by a "razor-thin" margin,[206] the court did not seem to require an outcome-determinative number of tainted votes to disallow the election.[207] The court noted that

201. Hewlett v. Hewlett-Packard Co., No. CIV.A 19513-NC, 2002 WL 549137, at *5 (Del. Ch. Apr. 8, 2002).

202. *Hewlett*, 2002 WL 818091, at *12 n.92.

203. *Id.* In ruling on a motion to dismiss, the same Chancellor Chandler wrote:

> I also disagree with HP's assertion that to establish the invalidity of a vote-buying agreement, a plaintiff must show that a majority of all outstanding shares was obligated to vote in favor of the transaction as a result of the vote-buying. . . . Less than a majority of votes can be decisive in tipping the results of an election one way or another. If voiding the votes cast in accordance with a fraudulent vote-buying agreement with corporate management is sufficient to change the result of a vote, I am again of the opinion that the defrauded or disenfranchised shareholders should not be prevented from bringing a vote-buying claim.

Hewlett, 2002 WL 549137, at *5.

204. At least one court outside Delaware seems to have relied on *In re IXC*, 1999 WL 1009174, to find that a majority of votes is required. *See* Hudson v. Prime Retail, Inc., No. 24-C-03-5806, 2004 WL 1982383, at *14 (Md. Cir. Ct. Apr. 1, 2004) (discussing *In re IXC* and noting that the acquirer in the proposed merger did not "lock up" the vote, and thus the transaction did not disenfranchise plaintiffs).

205. *See Hewlett*, 2002 WL 549137, at *5.

206. Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 73 (Del. Ch. 2008).

207. *Id.* at 76.

"[a]lthough a change in the voting of the [management-purchased] bloc alone would not have turned the election,"[208] the improper and clandestine vote-buying tactics used by management were sufficient to disallow the election results.[209]

Thus, while *Portnoy* provides some substantial indication that a court may be willing to disallow a vote-buying scheme that influenced less than a majority of the votes, it is difficult to decipher exactly what the sufficient percentage is under these mixed precedents.

3. What Happened to Intrinsic Fairness?

The court in *Schreiber* perceptively noted that "[b]ecause vote-buying is so easily susceptible of abuse, it must be viewed as a voidable transaction subject to a test for intrinsic fairness."[210] While this test has never been robust, intrinsic fairness as an inquiry in many recent cases has faded to the point that it is not even mentioned.[211]

The omission is puzzling because in cases where vote buying is prevalent (but perhaps not necessarily solely sufficient to be outcome-determinative), one can easily see how such arrangements are far from intrinsically fair to shareholders not party to the vote-buying agreement. The number of votes bought, in addition to the number of votes otherwise controlled by the purchaser, may be voted on considerations wholly personal to the purchaser and irrelevant to, or even detrimental to, the other shareholders whose interests are affected by the outcome. Therefore, even a non-outcome-determinative (in the sense of being insufficient to, by itself, alter the outcome of the vote) number of purchased votes may substantially affect the chances of the outcome being optimal in terms of marginal costs being less than marginal gains. Additionally, the vote-purchaser will not have internalized the cost of its vote in proportion to its residual claim, as it may have hedged or otherwise limited its exposure to any drop in the share price. Thus, in several aspects a vote tainted by empty voting simply will not be intrinsically fair to the non-party shareholders.

In re IXC presents an example of this situation in the context of classic vote buying: the defendant-purchaser bought five million shares at a substantial premium in consideration for the agreement

208. *Id.*

209. *Id.* at 47.

210. Schreiber v. Carney, 447 A.2d 17, 26 (Del. Ch. 1982).

211. *See, e.g.*, *In re* IXC Commc'ns, Inc. S'holders Litig., No. C.A. 17324, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999); Hewlett v. Hewlett-Packard Co., No. CIV.A. 19513-NC, 2002 WL 818091 (Del. Ch. Apr. 30, 2002).

of the seller to vote all the remaining shares in accordance with the purchaser.[212] Even if the number of votes purchased was not close to a majority, shareholders on the other side of the vote now had to obtain a supermajority to win "on the merits," or according to a calculation of marginal costs and benefits. When one factors in the shares already owned by the purchaser plus the five million shares purchased at a premium plus the votes purchased—all of which may be voted according to interests personal to the purchaser—the disparity and thus the unfairness of the situation is stark. Nonetheless, the court declined even to mention evaluating the deal along an intrinsic-fairness rubric. Omissions of this type have led one commentator to question whether the intrinsic-fairness test is still viable in Delaware courts.[213]

One other case along these lines bears mentioning. In *Kass v. Eastern Air Lines, Inc.*, consent was needed to relax certain bond covenants in the context of a proposed merger.[214] Cash or airline vouchers were offered to buy the approval, but only those bondholders who consented would receive the consideration.[215] Thus, the bondholders were placed in a classic prisoner's dilemma situation, with a rational incentive to defect quickly to avoid receiving nothing.[216] The situation is nearly exactly analogous to the problematic context of the unregulated tender offer market for votes discussed in Part III.B.[217] Still, the *Kass* court omitted any intrinsic-fairness evaluation.

The situation is even more troublesome in the case of the new vote buying. New vote buying is not limited by a counterparty; votes may be bought more cheaply and certainly less publicly.[218] Given the relatively widespread use of empty voting and its likely increase in frequency,[219] courts will undoubtedly be confronted by challenges to empty voting in the near future. Thus, they must prepare

212. *In re IXC*, 1999 WL 1009174, at *8.

213. Cole, *supra* note 101, at 830. **R**

214. No. CIV.A. 8700, 8701, 8711, 1986 WL 13008, at *1 (Del. Ch. Nov. 14, 1986).

215. *Id.* at *1–2.

216. *See* Cole, *supra* note 101, at 843. **R**

217. The Part discusses the analogy to an unregulated tender offer market for shares, where the same problems exist. *See* Hu & Black, *supra* note 6, at 852–53 (formalizing the values behind this theory). **R**

218. The disclosure problem is beyond the focus of this Note. Still, encompassing the new vote buying in a disclosure regime is a critical first step both in providing information and possibly curbing abuse. Reformation of the disclosure rules is the subject of Hu & Black. *See supra* note 6. **R**

219. *See supra* Part II.C.

to address such abuses. The next Part discusses how courts ought to utilize a more robust intrinsic-fairness inquiry to, at the least, clamp down on blatant abuses.

V.
ISSUES OF INSTITUTIONAL COMPETENCY AND THE APPLICATION OF INTRINSIC FAIRNESS TO EMPTY VOTING

Part IV has attempted to suggest ways in which current judicial doctrine on corporate vote buying can square with empty voting. This part now addresses more specifically how courts may apply the test in *Schreiber* to empty voting, and whether courts are even the institution best suited to police this decoupling. Subpart A discusses alternative institutions that may be more effective at this task. Subpart B then turns to an analysis of the application of an intrinsic-fairness test by courts to police empty voting abuses.

A. Institutional Alternatives for Policing Empty Voting

This Note has argued that policing the decoupling of share ownership from voting rights is becoming increasingly necessary in the context of modern financial instruments.[220] While judicial vote-buying doctrine has been the traditional means of policing this decoupling,[221] courts certainly are not the only institution capable of monitoring ownership and voting rights. There is, then, a threshold question of whether courts need play an active role in monitoring the new vote buying.

This Part examines institutions capable of policing the practice of new vote buying and empty voting in particular. Specifically, in addition to courts, the SEC, individual states and corporations all are to varying degrees capable of developing responses to the practice of empty voting. However, the current reality is that each of these players faces obstacles which make judicial oversight necessary, at least in the near term. It is possible that with more information, as well as time for analysis and formulation, these other institutions may develop an efficient and fair solution apart from any judicial policy. However, while such informed, broad rulemaking does not appear imminent, challenges to empty voting through litigation do. Thus, courts will likely play a role in addressing empty voting. This role is not without its difficulties, and so this Part con-

220. *See supra* Parts II–III.
221. For a more detailed discussion of common law vote-buying doctrine, see *supra* Part IV.A.

cludes by discussing certain problems with courts monitoring empty voting from a comparative institutional-competency perspective.

1. Securities and Exchange Commission

Because of its centrality to securities regulation, the SEC is perhaps an obvious alternative monitor. Yet the SEC is unlikely to offer substantive remedial measures for several reasons. Most prominently, previous efforts by the SEC to directly regulate corporate voting rights have been struck down as "invad[ing] the 'firmly established' state jurisdiction over corporate governance."[222] An attempt to regulate the percentage of economic ownership that a record owner must have in order to vote its underlying shares, for instance, would have many similarities with a rule imposing a one-share-one-vote standard.[223]

There is scant evidence that the SEC, or federal government in general, views empty voting as a serious threat, much less that immediate steps to address the problem are forthcoming.[224] Only very recently did SEC Chairman Christopher Cox acknowledge the phenomenon and suggest preliminary steps to study it: "We're focused on both more precisely defining the problem set and on using all of our authorities to tailor appropriate solutions."[225] Corporations have in the past been successful in stunting other SEC regulatory initiatives, such as mutual fund board independence requirements and direct shareholder nomination of directors.[226]

Expanding the disclosure regime would be an important first step toward gathering more information along the lines Chairman

222. Bus. Roundtable v. SEC, 905 F.2d 406, 413 (D.C. Cir. 1990). In *Business Roundtable*, the D.C. Circuit held that the SEC had exceeded its statutory authority in promulgating a rule barring national security exchanges from listing stock of corporations which nullify, restrict or disparately reduce per share voting rights of common shareholders. *Id.* at 412–14.

223. *See id.* at 410–17.

224. Hu and Black can only cite to one instance of public sector recognition of empty voting in the United States. Other countries were not far ahead. Hu & Black, *supra* note 6, at 819 n.18. **R**

225. Kara Scannell, *Hedge Funds Vote (Often); In Proxies, Borrowed Shares Fill Ballot Box; SEC May Act*, WALL ST. J., Mar. 22, 2007, at C1. The article notes that empty voting was "thrust in the spotlight" by Henry T.C. Hu and Bernard Black. *Id.*

226. *See* Jill E. Fisch, *Institutional Competition to Regulate Corporations: A Comment on Macey*, 55 CASE. W. RES. L. REV. 617, 623 (2005). While it is not as immediately obvious that individual corporations would object as strongly to SEC intervention on empty voting, directors may have compelling reasons (both legitimate and possibly rent-seeking) in wanting to tailor their own rules.

Cox suggests.[227] Still, even assuming that the SEC has the power to promulgate and enforce more substantive regulations, they are unlikely to appear soon. Given the complexity of the calculations involved for market-wide rules, the dearth of clear information on empty voting market practices[228] and the enormous variety of techniques available to potential empty voters,[229] developing effective and efficient regulations is a daunting and doubtless lengthy project.

2. State Legislatures

Though they surely would not have the *Business Roundtable* jurisdictional impediment,[230] it is not clear that states would be better equipped to address empty voting in the short term. State legislature drafting committees would run into the same problems that confront the SEC: there is a dearth of information on empty voting practices, but an overabundance of complexity in the multitude of techniques available and the intricacy of the financial calculations involved in issuing broad rules.

Additionally, it is not apparent that there is sufficient political will to push through necessary rule changes. Though there has been some curt acknowledgment of the empty voting phenomenon on federal and international levels, there is no evidence that state legislatures are even aware of the issue. In the context of substantial reforms of corporate regulations, a publicly acknowledged crisis-level problem is often necessary to tip the balance in favor of far-reaching reform because, from a public choice theory[231] perspective, large businesses are often in a good position to resist new regulation, especially on the state level.[232] Given the absence of public

227. *See generally* Hu & Black, *supra* note 6, for a thorough discussion on a plausible approach to modifying the federal securities disclosure regime. **R**

228. Empty voting, arguably, is not captured by the current securities disclosure regime. *See supra* Part II.C.

229. For a brief taxonomy of techniques and citation to sources with more thorough discussion, see *supra* Part II.B.

230. *See supra* note 222. **R**

231. Public choice theory uses economic tools to study problems that are traditionally in the province of political science. Specifically, public choice theory is used to study the behavior of voters, politicians and government officials as primarily self-interested agents. *See, e.g.*, KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (1951); DUNCAN BLACK, THE THEORY OF COMMITTEES AND ELECTIONS (1958); JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT (1962). Legal scholars have used public choice theory to analyze the impact of interest groups on American politics. *See, e.g.*, PHILIP P. FRICKEY & DANIEL A. FARBER, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION (1991).

232. *See* Fisch, *supra* note 226, at 618–19. **R**

outcry and the current secrecy with which much empty voting occurs, it is unlikely that sufficient impetus for corporate voting reform will occur anytime soon.

Lastly, reform on a state level may be more vulnerable to capture than nationally implemented rulemaking; corporations are able to exert a powerful influence on the political process.[233] While corporations may have good reason to limit empty voting, the new vote buying generally can easily be used to entrench management.[234] Even if management were to intervene, there is at least some evidence that management-initiated legislative changes to corporate law may be less efficient than other sources of change.[235]

3. Individual Corporations

Corporations may be the most plausible market actors to develop effective responses to empty voting problems. Large corporations—those more likely to be subject to empty voting schemes, such as the one attempted by Perry Corp.[236]—would presumably have sufficient sophistication (or be able to buy such advice) to address empty voting efficiently. The threat of becoming victimized, as Mylan Laboratories nearly was, should spur many boards to address the issue. Even if Perry-Mylan and the similar, less highly publicized instances of empty voting were insufficient spur for reform, just over the last year empty voting has increasingly become a focus of corporate concern.[237]

233. *See, e.g.*, Jill E. Fisch, *How do Corporations Play Politics?: The Fedex Story*, 58 VAND. L. REV. 1495, 1497 n.7 (2005) (citing Fed. Election Comm'n v. Beaumont, 539 U.S. 146, 152 (2003) for the proposition that corporations are able to exert a potentially "deleterious" influence on political elections).

234. *See infra* note 238 and accompanying text. R

235. *See* William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 717, 728 (1998) (compiling empirical data on the rate of change and the sources of change of corporate law and concluding that management-sponsored changes in corporate law present a greater threat to efficient laws than do other sources of change).

236. Public corporations with larger market capitalizations would likely be more prone to a Perry-Mylan-type scheme because the potential payoff would be larger. The profit for an empty voter (presumably a hedge fund such as Perry Corp.) would be a function of the number of shares it owned in the target corporation multiplied by the premium paid on those shares. The hedge fund would want to stay below a ten percent stake to avoid recapture of short-swing profits. *See* Exchange Act Rules, 17 C.F.R. §§ 240.16a-1(a), .16a-2 (2007).

237. *See, e.g.*, Scannell, *supra* note 225. Additionally, practitioners in the last year have begun to issue ominous prognostications. *See, e.g.*, David Marcus, *Hedge Fund Voting: The Devil We Don't Know*, CORP. CONTROL ALERT, Mar.–Apr. 2006, at 10. R

Nonetheless, there are substantial hurdles for a corporation wishing to address empty voting. Whatever the substantive content of the corporate rule, it will obviously limit the franchise in some instances. For this reason, a charter amendment is likely the necessary route. A board-passed bylaw addressing empty voting would almost assuredly fail to pass judicial scrutiny.[238]

Addressing empty voting via charter amendment seems the more feasible alternative. Even though such a charter amendment would in some instances limit the shareholder franchise, the more rigorous vetting process of a charter amendment is likely to insulate the reform somewhat from judicial scrutiny.[239] Thus, a corporation might by charter amendment address empty voting in any number of ways, as the one-share-one-vote rule is only a default under Delaware law.[240]

Assuming a charter amendment could be used to address adequately potential empty voting in the host corporation, the multitude of potential ways to address potentially problematic empty voting could give rise to serious collective action problems. The gamut of uses for which derivatives can be employed, in risk management and otherwise, gives rise to numerous competing interests. For instance, management will likely aim to protect at least some amount of hedging of their shares, and that may be both legitimate and in the shareholders' interest.[241] Likewise, large institutional investors may want to protect share lending, as it is a large source of profit for these parties.[242] Problematically, however, these tech-

238. *See* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003). Stressing the democratic importance of the shareholder vote, the Delaware Supreme Court recently emphasized, "This Court and the Court of Chancery have remained assiduous in carefully reviewing any board actions designed to interfere with or impede the effective exercise of corporate democracy by shareholders." *Id.* Courts' scrutiny here is both appropriate and desirable. A board-adopted bylaw would be susceptible to management manipulation. *See supra* notes 45–46 and accompanying text. For a more extended discussion of the use of derivatives to entrench management, *see* Hu & Black, *supra* note 6, at 831–32. Hu and Black point out that, like many other aspects of their use, employing derivatives for insider hedging is not an unqualified bad; insider decoupling can help align management's interest (which is often more risk averse) with that of shareholders. *Id.* Still, the potential for abuse is serious, so judicial oversight is appropriate. **R**

239. *See* Williams v. Geier, 671 A.2d 1368, 1377 (Del. 1996) (upholding a charter amendment, stressing the importance of the "traditional review of disinterested and independent director action in recommending, and the vote of the stockholders in approving the Amendment").

240. DEL. CODE ANN. tit. 8 § 212(a) (Supp. 2006).

241. *See supra* note 238 and accompanying text. **R**

242. The revenue from share lending has been estimated at $8 billion dollars a year. *See* Scannell, *supra* note 225. **R**

niques and many others with legitimate uses can be employed successfully to effectuate exactly the type of empty voting attempted by Perry Corporation.[243] Thus, collective action problems would arise, making consensus between the competing interests exceedingly difficult to coordinate, especially given the substantial hurdles required to amend a corporate charter.[244] And yet many of the hedging and lending techniques legitimately employed by the voting constituents may have to be constrained if empty voting is to be effectively curtailed. Lastly, as noted above in the context of state legislatures and the SEC, the lack of full information may make consensus for reform, and certainly effective reform, less likely. Therefore, although corporations may be a possible locus for addressing empty voting, at least in the near term adequate and widespread responses in a sufficient number of corporations seem unlikely to appear.

4. State Courts

As this Note has discussed above, many of the other market participants will encounter obstacles that make reforms sufficient to address empty voting abuse unlikely in the immediate future. Thus, courts will almost certainly be the venue that initially adjudicates debate over empty voting, whether this is optimal from an institutional competency perspective or not. And, to be sure, there are substantial difficulties with judicial supervision in this area.

Perhaps the most problematic aspect of potential empty voting litigation is the sheer complexity involved in valuing financial derivative positions. As Professors Hu and Black note, the intricacies involved in these calculations can be "fearsome," even to those trained in economics and finance.[245] The fundamental problem is that it may be exceptionally difficult to pin down, for a particular window of time, the true economic ownership in the shares owned (and being voted) based upon the value of the derivative instruments used to hedge the ownership position.

243. *See supra* Part II.B for a brief taxonomy.

244. *See, e.g.*, DEL. CODE ANN. tit. 8 § 242(b) (2001) (requiring, *inter alia*, multiple class vote vetting of proposed amendments).

245. Hu & Black, *supra* note 6, at 889 ("[W]e attempted to invent a workable scheme for numerical disclosure of effective economic ownership. The effort became absurdly complex [sic] and we gave it up as misguided."). Such complexity illustrates only one type of problem which broader rules would have to grapple with: whether those rules required disclosure or substantively limited voting below a threshold economic ownership position. R

Still, this complexity need not present an *intractable* obstacle to the adjudication of empty voting controversies. The parties must reach final resolution of their dispute, after all. But, more helpfully, both parties are likely to be sophisticated, as they were in the litigation initiated by Carl Icahn against Perry Corporation.[246] Thus, a full trial will include extended explication of the underlying facts and expert testimony as to their relevance. Of course, this is no guarantee that judges, let alone juries, will acquire the level of comprehension needed to justly decide empty voting trials. But this difficulty is hardly exclusive to empty voting disputes. Determining causation and valuing damages in securities fraud cases,[247] determining causation in medical malpractice suits[248] and apportioning liability according to market share[249] all involve sometimes daunting complexity, arguably outside many courts' expertise. In short, the inherent complexity in empty voting cases cannot bar parties from receiving a legal remedy.[250]

And despite the hurdles, there are several beneficial aspects to potential judicial intervention in empty voting abuses. To begin with, the nature of the litigation process, in that the decisions are limited to the disputants before the court, is likely to be a boon. Much of the "fearsome" difficulty with promulgating broader rules is the inherent flexibility in the use of derivative instruments that makes it nearly impossible to account for the multitudinous permutations in use and valuation.[251] Empty voting cases would involve

246. Perry Corp. is an investment firm (hedge fund) with almost nine billion dollars under management. *See* Perry Corp., Institutional Investment Managers Report (Form 13F) (Sept. 30, 2006). Carl Icahn, acting through his company High River Limited Partnership, has been a high-profile and active investor for decades. *See, e.g.*, CHARLES D. ELLIS, WALL STREET PEOPLE 137 (2001). Both parties in a future empty voting litigation are very likely to be just as sophisticated because the scheme itself involves complex valuations and very large amounts of capital. *See supra* Part II.A.

247. *See, e.g.*, Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 346 (2005).

248. *See* Gen. Elec. Co. v. Joiner, 522 U.S. 136, 146–47 (1997).

249. *See* Sindell v. Abbott Labs., 607 P.2d 924, 937 (Cal. 1980).

250. There is at least some plausible basis for hope that helpful precedent will emerge from Delaware courts before these issues have to be litigated in less sophisticated venues. The majority of large U.S. companies incorporate in Delaware. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1061 (2000). Delaware courts have particular expertise in complex corporate litigation and are more active in "making law." *See id.* at 1071. Other states' courts often follow Delaware's lead. *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 903 n.92 (1990) (describing frequency with which prominent Delaware decisions have been cited by other courts).

251. *See* Hu & Black, *supra* note 6, at 889. R

an isolated instance and result in a rule that could be distinguished if it appears inappropriate in a subsequent case. Secondly, a public trial of empty voting is likely to provide publicity within the financial community that may provide a deterrent against abuses, as well as some educational value in a full discovery of the facts. Lastly, at least in the case of Delaware courts, there is some evidence that rapid judicial responses to novel issues in corporate law add value to firms.[252]

In conclusion, many of the institutional alternatives share similar problems of inadequate information and need time to reach informed consensus on effective reform. It is of course possible that, from a comparative institutional competence perspective, other institutions or a combination thereof will be better suited to develop long-term rules governing empty voting and the new vote buying generally. However, empty voting is already a fairly common, global practice,[253] which has the potential to give rise to litigation similar to that initiated by Carl Icahn against Perry Corp.[254] Thus, courts will likely be the institution of first instance when faced with an empty voting controversy.

B. *Intrinsic Fairness Applied to Empty Voting*

A fundamental question becomes evident: given that courts are likely to be the arbiters of first instance in empty voting controversies, how should they address the new vote buying and empty voting in particular? Much of the bite of a *Schreiber*-like test applied to empty voting will come through a court's inquiry into the intrinsic fairness of the transaction.[255] While evidence of fraud or disenfranchisement may, in rare cases, be sufficient to disallow an instance of empty voting, especially where management is involved in the scheme, even transactions like the one set up by Perry Corp. are likely to survive a fraud/disenfranchisement inquiry.[256] Thus, for

252. *See* Fisch, *supra* note 250, at 1085–89 (citing Comments at the AALS Section on Business Associations, Washington D.C. (Jan. 6, 2000)) (providing support for the "value of responsiveness" and Ron Gilson's observation that "corporate law matters when the real world changes"). **R**

253. Hu and Black compile a list of eleven occurrences of empty voting in numerous countries from 2002 to 2005 and note that their list is assuredly incomplete. Hu & Black, *supra* note 6, at 848–49 tbl.2. **R**

254. Icahn Complaint, *supra* note 24. **R**

255. *See* Schreiber v. Carney, 447 A.2d 17, 26 (Del. Ch. 1982).

256. To recapitulate, the arguable absence of a duty to disclose will usually prevent a finding of something like common law fraud. *See supra* Part IV.C.2.a. Given the complexities involved with corporate voting, and vote counting combined with the outcome-determinative requirement, a finding of disenfranchise-

courts to provide an effective monitor of empty voting abuse, a robust intrinsic-fairness test must be developed.

A fairness test appears prima facie appropriate to evaluate empty voting. The empty voting scheme attempted by Perry Corp., for instance, offends a sense of fair play: had the empty voting succeeded, a merger would have been approved notwithstanding a near-consensus opinion that it was ill advised.[257] But fairness in empty voting transactions can be further fleshed out. To begin with, one can safely assume that investors have an expectation of one-share-one-vote when they buy stock unless there is notice otherwise: with some disclosed exceptions, "one-share/one-vote remains the dominant practice and rule."[258] When acquiring a voting share there is, therefore, a reasonable expectation to have a proportional claim on the firm's value and to be able to dictate, in proportion to the ownership claim, the choice of the "community of interests."[259] Empty voting strikes at the heart of this "fair" system—fair in the sense of power proportional to ownership, and fair in the sense of meeting investor expectations as to their rights.[260] Departures from the one-share-one-vote rule have certainly been possible, but public disclosure of those departures is required, allowing for appropriate discounting of the affected shares' price.[261] Empty voting abuses, if not addressed, would effectively enable certain large investors with the capital and expertise to externalize the costs of certain corporate decisions onto other shareholders. Thus, policing empty voting by an evaluation of intrinsic fairness is appropriate.

There is the possibility that beneficial aspects of empty voting may emerge: empty voting may provide a cheaper way to aggregate votes into better-informed hands, thus circumventing some serious collective action problems that hinder effective shareholder oversight.[262] Lowering these impediments may enliven investor activism and the market for corporate control, thus leading to more effec-

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ment will probably capture only a small number of cases. *See supra* Part IV.C.2.b and cases discussed therein.

257. It is a reasonably safe assumption that Perry Corp. also would have agreed that the merger was ill advised, as they profited in proportion to the amount Mylan Labs overpaid for King Pharmaceuticals. *See supra* Part II.A.

258. Martin & Partnoy, *supra* note 6, at 786. The authors present a detailed history and development of the one-share-one-vote rule up to the present. *See id.* at 781–87. R

259. *See Schreiber*, 447 A.2d at 26.

260. *See supra* Part III.A–B.

261. *See supra* note 87. R

262. *See* CLARK, *supra* note 66, at 390–93 (describing the rational apathy and free rider problems in the context of corporate voting). R

tive oversight of management. There are, however, problems with this sanguine picture of empty voting's potential usefulness. To begin with, there is substantial disagreement about the desirability of increasing shareholder power vis-à-vis management.[263] Even if these arguments are put to the side, there still seems to be little way to separate the "good" empty voting from the "bad" without a fact-intensive inquiry into the individual instance of empty voting.[264] In any event, the intrinsic-fairness test described in this Part is not a *per se* ban on voting with less-than-full economic interest, so there is still some room for "good" empty voting. However, given the risks of a proliferation of Perry-type empty voting, close monitoring is warranted.

It is apparent that an intrinsic-fairness inquiry amounts to an exercise in line drawing, and a complex one at that. The core problem of empty voting is the undisclosed divergent, or even directly opposed, economic interest of the empty voters. Thus, the fundamental issue a court must grapple with is measuring how far a divergence from the shareholders' community of interests is acceptable as intrinsically fair. Guiding this inquiry is the recognition that perfect proportional alignment of shareholders' interests in the residual value of the firm is next to impossible.[265] For example, manager-shareholders will likely be more risk averse because of, among other factors, the human capital invested in the corporations.[266] Nevertheless, a minimum baseline may be put forward: shareholders should not be allowed to vote stock in which they have zero economic interest. Without economic interest, the justifica-

263. *Compare* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 205–14 (1991) (arguing that the threat of hostile takeovers compels management to satisfy short-term expectations and thereby discourages investments that would bear fruit only over a longer period, such as research and development and other capital expenditures), *with* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 865–70 (2005) (arguing for a dramatic reduction of management insulation from shareholder intervention). *See also* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006).

264. Such a factual inquiry would resemble the intrinsic fairness test described in this Part. For one, the inquiry would focus on the empty voter's economic interest in the shares being voted. Presumably, a "good" empty voter—i.e., one seeking to remove ineffective managers or those extracting large private benefits of control—would not want to minimize its economic interest in the shares being voted; what economic incentive would the empty voter then have to replace existing management with better people?

265. *See* Easterbrook & Fischel, *supra* note 2, at 403–04; Anabtawi, *supra* note 263, at 593. **R**

266. *See, e.g.*, Martin & Partnoy, *supra* note 6, at 792. **R**

tion for allowing a vote—the interest in the firm's residual value, which properly aligns incentives—falls away.

It should be noted that this test as applied to empty voting is entirely consistent with the inquiry proposed by the court in *Schreiber*.[267] As argued above,[268] though the court recognized that a duty of independent judgment was "outmoded" in contemporary law,[269] it did not entirely abandon the justification for that duty, namely, the danger of "*consideration which* [is] *foreign to those rights and interests* [of the voted shares] *and would likely to induce* [the voter] *to disregard*" maximizing the firm's residual value.[270] The court in *Schreiber* explicitly recognized the necessity of continued vigilance in its role policing the decoupling of ownership from voting rights and thus emphatically gave notice that it would void any transaction which failed an intrinsic-fairness test.[271] Thus, while the *Schreiber* court did not elaborate further on the intrinsic-fairness test, it seems that a radical, undisclosed departure from the community of interests is exactly the danger that the court would disallow as intrinsically unfair.

Additionally, a court's decision need not be governed by a calculation of economic interest in shares alone: an intrinsic-fairness test invites a factual inquiry into the surrounding circumstances of the vote-buying transactions. Indeed, the court in *Schreiber* not only closely examined the facts surrounding Texas International Airlines' purchase of Jet Capital's votes, but contrasted that context with the more dubious situation in *Brady v. Bean*.[272] In *Schreiber*, the court found ample vetting of the vote purchase by shareholders, a substantial factor contributing to the conclusion that the scheme was not abusive.[273] In *Brady*, the situation was very close to the economic reality underlying the Perry-Mylan situation: in both situations the incentive to vote shares flowed from interests that were wholly apart from the residual value of the corporation the shares of which were being voted.[274] Thus, it was not only the economic interest in the underlying shares, but the legitimacy, in terms of disclosure and vetting, of that departure from the community of

267. Schreiber v. Carney, 447 A.2d 17, 26 (Del. Ch. 1982).

268. *See supra* Part IV.B, especially notes 158–62 and accompanying text.

269. *Schreiber*, 447 A.2d at 24.

270. *Id.*

271. *Id.* at 25–26.

272. *Id.* at 20, 24 (examining the TIA transaction and the facts in Brady v. Bean, 221 Ill. App. 279 (Ill. App. Ct. 1921)). For a more detailed discussion of the facts in *Schreiber* and in *Brady*, see *supra* Part IV.B.

273. *Id.* at 20.

274. *See supra* notes 158–59 and accompanying text.

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interests which played a role in evaluating the intrinsic fairness of the vote-buying transaction. The recent case of *Portnoy* supports this view that an inquiry under *Schreiber* may take into account the whole picture: in *Portnoy* the court explicitly noted that "the first order review required by *Schreiber* . . . looks to the subjective motivations of the defendants [and] is an extremely important safeguard of the stockholder voting rights."[275]

While the intrinsic-fairness inquiry may present investors with an indeterminate or "muddy" rule, there may be significant value to indeterminacy.[276] Jill Fisch has argued that the value of bright-line rules is overstated.[277] Standards, according to Fisch, "permit the lawmaker to tailor the result in a case and to thereby avoid the hardship or unfairness associated with application of a crystalline rule without destroying the applicable doctrinal structure."[278] As we have seen, the uncertainty associated with empty voting, coupled with the complexity and range of techniques possible and their legitimate applications, may make broad crystalline rules impractical in the near term anyway.[279]

Thus, to sum up, while courts may not be the most effective institution at promulgating broad, bright-line rules in the long term, a judicial response to empty voting is likely to be a necessity given the obstacles other institutions face in addressing the issue. An inquiry into the intrinsic fairness of the vote-buying transaction is an adequate response and is consistent with the current doctrine in Delaware courts. While the test will necessarily be a line-drawing exercise in each case, the standard need not be a bright line; it may be fact dependent. Indeed, there may be significant value in not promulgating hard-and-fast rules before more information about empty voting becomes available.

275. Portnoy v. Cryo-Cell Int'l Inc., 940 A.2d 43, 69 (Del. Ch. 2008).

276. *See* Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 578 (1988) (describing "muddy" as "fuzzy ambiguous rules of decision" similar to standards).

277. Fisch, *supra* note 250, at 1082 ("In cases in which factual distinctions are important, a rule based approach is likely to be unworkable."). This observation applies well to empty voting, where the complexity and legitimate applications of derivatives make factual inquiry a necessity. **R**

278. *Id.*

279. *See supra* Part V.A.

VI. CONCLUSION

Empty voting has only recently emerged on a substantial scale, but numerous market conditions suggest that it is likely to grow as a practice and, therefore, as a potential source of serious abuse. If unchecked, the possible repercussions of widespread empty voting are grave. Shareholder voting is crucial to our current system of corporate governance, and corporate voting depends upon a link between voting rights and economic ownership. Empty voting threatens to undermine this link, and with it the market for corporate control.

Courts have traditionally policed the coupling of economic ownership and voting rights through vote-buying doctrine, and courts are likely to be the guardians of first instance against empty voting abuse. However, as leading commentators on empty voting have noted: "Corporate case law governing 'classic' vote buying does not touch [empty voting]."[280] Therefore, courts must adapt judicial doctrine to account for the economic realities of the changing marketplace. This Note has provided a suggestion for how best to do so.

280. Hu & Black, *supra* note 6, at 818. R