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# The Control and Conflict of Interest Voting Systems

Lynne L. Dallas

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# THE CONTROL AND CONFLICT OF INTEREST VOTING SYSTEMS\*

LYNNE L. DALLAS\*\*

*In this Article, Professor Lynne L. Dallas examines the current system of shareholder voting rights and finds it lacking in many respects. Professor Dallas presents a historical overview of the development of shareholder voting rights and concludes that the current system is a vestige of the nineteenth century. Current limitations on shareholder voting rights also rest on a weak historical foundation. Professor Dallas contends that, contrary to common understanding, current laws fall short of providing shareholders the right to vote on fundamental organic changes when the economic, operational, control, and legal structures of a corporation are considered. Professor Dallas proposes two alternative voting systems, the control voting system and the conflict of interest voting system, and offers hypothetical examples of how they would function. Both are based upon her "power model," which posits that institutional behavior results from a contest for control among power coalitions. These innovative systems promise to be more responsive to the needs of the modern corporation than does the present, outdated system.*

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\*\* Professor of Law, University of San Diego School of Law. J.D. Harvard University, 1975. The writer gratefully acknowledges the helpful comments of Professors Marilyn B. Cane, Alfred F. Conard, Thomas Lee Hazen, Marvin H. Pilcher, Margaret V. Sachs, Edward Ursin, and Christopher Wonnell. Also appreciated is the research assistance from time to time of M. Bell, F. Bottini, J. Duvoisin, D. Garvin, P. Junge, M. Lehman, M. Lubitz, H. Pounder, M. Tharp and M. Waltari.

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## I. INTRODUCTION

The current system of shareholder voting rights is inadequate to meet the needs of the modern corporation. It is based on the nineteenth century conception of the corporation as an entity and is founded on a misinterpretation of express statutory voting provisions. Modern attempts to defend the existing system as requiring voting on fundamental changes flounder when shareholders do not have voting rights with respect to the economic, operational, control/power, or legal structure of the corporation.

This Article outlines two voting systems, the control voting system and conflict of interest voting system. These systems are based on the power model, which recognizes the conflicting interests and control struggles within the modern corporation.<sup>1</sup> These conflicts exist between managers and shareholders, between controlling and minority shareholders, and between shareholders and other constituencies, such as debtholders and employees.<sup>2</sup> The tender offers of the 1980s reflected the dramatic conflicts among these groups. Voting rules, however, proved largely insensitive to these conflicts. The rules were manipulated easily, requiring equitable intervention by courts as a last resort.<sup>3</sup>

Voting rules should be revised to address these conflicts, with appropriate regard for other methods of assuring the accountability of managers, namely judicial oversight and the operation of markets. The decision to adopt the control or conflict of interest voting system and the precise content of the system chosen rests with state legislatures, based on their assessment of the importance of certain control changes and conflicts and on the value of voting when compared with other methods of assuring managerial accountability. This article assists such an assessment by

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1. See *infra* text accompanying notes 154-58.

2. For purposes of developing the systems proposed in this Article, this Article assumes, in keeping with the shareholder-centered focus of corporate law, that only shareholders have voting rights, with the possible exceptions noted in § V B(3). See *infra* text accompanying note 297. An examination of how the control and conflict of interest voting systems would work in a legal context where other constituencies have voting rights would be an interesting undertaking, but is beyond the scope of this article.

3. E.g., *infra* notes 263-67.

providing a detailed description of the subjects for voting included in each system and the required method for voting on such subjects.

Part II of this Article delineates the changing conception of the corporation at the end of the nineteenth century and its effect on shareholder voting rights, exploring the origin of express statutory provisions requiring a majority vote of shareholders on fundamental changes and demonstrating the lack of a solid historical foundation for interpreting these provisions as limiting shareholder voting rights. Nevertheless, this Article understands these rights to be in accord with the entity conception of the corporation. Part II also describes the existing state of shareholder voting rights, which is essentially a vestige of the nineteenth century, and presents new voting rights adopted by states and proposed as a result of the tender offer phenomenon.

Part III challenges the traditional textbook rationale that the existing voting system (including recently adopted and proposed modifications) provides shareholders with the right to vote on fundamental or organic changes in the corporation. Moreover, this section examines and finds wanting more recent justifications for the existing system of shareholder voting. Part IV, therefore, explores current conceptions of the corporation and delineates theoretically the appropriate scope of shareholder voting for the modern corporation. Finally, Parts V and VI develop the control and conflict of interest voting systems, respectively.

## II. THE DEVELOPMENT OF SHAREHOLDER VOTING RIGHTS

### A. *The History of Voting Rights*

Present day shareholder voting rights<sup>4</sup> represent the triumph of entity theories over a competing theory, the contract-partnership conception of the corporation.<sup>5</sup> The concerns of the contractualists focused on

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4. During the latter part of the nineteenth century, a number of theories of the corporation vied for recognition. It is unclear whether those theories facilitated doctrinal development, see Morton J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 223 (1985), whether theory and doctrinal development "emerged and developed more or less simultaneously, each feeding on the other in a dynamic, interdependent process," see David Millon, *Frontiers of Legal Thought I: Theories of the Corporation*, 1990 DUKE L.J. 201, 204, 242-43, or whether the theory followed doctrinal developments resulting from economic changes. See William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1511-13 (1989). In any event, these theories provide a useful means for conceptualizing doctrinal development. The development of some areas of corporate law, such as the demise of the *ultra vires* doctrine, can be explained in the context of the natural entity theory supplanting the artificial entity conception of the corporation. See Millon, *supra*, at 212. As shown in this section, however, the triumph of the natural entity theory over the contract-partnership theory best explains the development of shareholder voting rights.

5. Horwitz, *supra* note 4, at 202-07, 214-22; Herbert Hovenkamp, *The Classical Corpora-*

the concentration of power in a few.<sup>6</sup> They viewed the corporation as similar to a partnership, with the requirement of unanimous approval of shareholders on fundamental matters, and believed generally that shareholders were principals and directors were their agents.

By the end of the nineteenth century this view gave way to the conception of the corporation as an independent entity. Consistent with the evolution of the entity view were three voting developments that resulted in more centralized control: the replacement of unanimous shareholder consent for fundamental changes with majority rule,<sup>7</sup> the development of limited shareholder voting rights in favor of exclusive statutory powers in managers,<sup>8</sup> and the disappearance of weighted voting, which limited voting rights by reference to the number of shares held by an individual shareholder, to be replaced by one share-one vote.<sup>9</sup> These developments coincided with the changing character of American shareholders, from individual entrepreneurs to groups of numerous public investors, and the desire of state legislatures to facilitate corporate development and growth.<sup>10</sup>

### 1. Contract-Partnership Theory

The contractual theory analogized corporations to partnerships.<sup>11</sup> Shareholders constituted the corporation; directors of the corporation

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*tion in American Legal Thought*, 76 GEO. L.J. 1593, 1598-99 (1988); Arthur W. Machan, Jr., *Corporate Personality*, 24 HARV. L. REV. 253 (1911) (arguing that a corporation is a natural entity, but not a person). See generally Note, *The Legal Idea of a Corporation*, 19 AM. L. REV. 114, 115 (1885) (discussing the premise that a corporation may be viewed as either a person or as a limited partnership depending on the circumstances). Before the adoption of general enabling corporation statutes, the corporation was viewed as an artificial entity because it was created by special grant of a charter from the crown or state legislature. Horwitz, *supra* note 4, at 181 (citing *Dartmouth College v. Woodward*, 17 U.S. (24 Wheat.) 518 (1819)); Note, *supra*, at 115.

6. Horwitz, *supra* note 4, at 204-06, 220; see Jeffrey Kerbel, *An Examination of Nonvoting and Limited Voting Common Shares—Their History, Legality, and Validity*, 15 SEC. REG. L.J. 37, 48 (1987).

7. William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69, 89; Horwitz, *supra* note 4, at 203-07; Millon, *supra* note 4, at 215; see *infra* text accompanying notes 21-38.

8. Horwitz, *supra* note 4, at 214-22; Millon, *supra* note 4, at 215-16. See *infra* text accompanying notes 21-38.

9. Kerbel, *supra* note 6, at 49 (citing 2 J. DAVIS, *ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS* 323, 324 (1917)). At common law, the rule of per capita voting applied. *Id.* at 47. Early state statutes provided for weighted voting. *Id.* at 48; see *infra* text accompanying notes 21-38.

10. Horwitz, *supra* note 4, at 197-203, 209-10; Millon, *supra* note 4, at 214-15.

11. *E.g.*, *Railway Co. v. Allerton*, 85 U.S. (18 Wall.) 233, 235 (1873); *New Orleans, J., & G. N. R.R. v. Harris*, 27 Miss. 517, 537-38 (1854).

were merely their "agents."<sup>12</sup> Although early charters and state corporation statutes included management clauses providing that the corporation's business affairs be conducted by the board of directors,<sup>13</sup> the power of management was nevertheless perceived to be derived from shareholders. As late as 1886, a leading treatise, in a section titled "Powers of Directors are Derived from the Shareholders," stated:

The function of the legislature in forming a private corporation is solely to legalize the agreement of its shareholders; and those provisions in an act of incorporation which prescribes [sic] . . . the powers of its agents, merely indicate the nature of the association which shareholders are authorized to form. . . . Every agent who has authority to represent the collective body of shareholders must necessarily derive his powers from the consent of the shareholders themselves.<sup>14</sup>

Even broadly worded management clauses were viewed as limiting directorial authority to "ordinary business transactions."<sup>15</sup> In addition, such clauses did not appear to deprive the majority of shareholders of "the power of directing the general policy of the corporation, and of deciding upon the propriety of important changes in the company's business."<sup>16</sup>

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12. Horwitz, *supra* note 4, at 215-16.

13. The charters of many corporations incorporated by special acts of legislatures contained management clauses. E. Merrick Dodd, Jr., *The Modern Corporation, Private Property And Recent Federal Legislation*, 54 HARV. L. REV. 917, 918 (1941). The charters of manufacturing firms, however, tended to preserve more powers for shareholders. *Id.* at 227-28, 236. Most state general enabling statutes that permitted incorporation by private parties contained management clauses. *Id.* at 100. The first general corporation statute in the United States, enacted in New York in 1811, contained such a clause. Robert A. Kessler, *The Statutory Requirement of A Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696, 703 (1960).

14. VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 515, at 482 (1886). To some extent Morawetz's view appears to stem from the idea that shareholders unanimously consent to a given mode of governance when they join the corporation; a change in that mode of governance by a majority of the shareholders would fly in the face of unanimous consent. *Id.* § 511, at 477; see Horwitz, *supra* note 4, at 203-04.

15. *Allerton*, 85 U.S. (18 Wall.) at 233-35; *Cass v. Manchester Iron & Steel Co.*, 9 F. 640, 642-43 (C.C.W.D. Pa. 1881); *Brown v. Fairmont Gold & Silver Mining Co.*, 10 Phila. Rept. 32, 33 (1873); see also MORAWETZ, *supra* note 14, § 512, at 479 (noting that the board has no "implied authority to make a material and permanent alteration of the business or constitution of a corporation, even though the alteration be within the company's chartered powers").

16. MORAWETZ, *supra* note 14, § 511, at 479; see *New Orleans, J., & G. N. R.R. v. Harris*, 27 Miss. 517, 537 (1854); *Stevens v. Rutland & B. R.R.*, 29 Vt. 545 (1851). *But see Conro v. Port Henry Iron Co.*, 12 Barb. 27 (N.Y. App. Div. 1851) (holding that shareholders could not enter into lease because power to manage was conferred on board of directors, where lease was for all of the corporation's property and was granted to the majority shareholder); *McCullough v. Moss*, 5 Denio 567, 575 (N.Y. 1846) (arguing that if shareholders had authorized the president to make a promissory note, which the evidence did not support, the decision



The majority of shareholders, however, could decide matters only within the original objectives and purposes of the corporation. Borrowing from partnership law, corporate law required that "fundamental" or material changes, outside these purposes and objectives, be dependent upon the unanimous consent of shareholders.<sup>17</sup> Such changes included modifications in the nature or extent of the corporation's business from that set forth in its charter, a sale of all its assets, a merger or consolidation of its business, or dissolution.<sup>18</sup> A dissenting shareholder could enjoin such a change, even if the legislature and a majority of the shareholders authorized it.<sup>19</sup> Moreover, courts released a subscriber for shares from her obligations on her subscription if the corporation did not obtain her consent for such a change.<sup>20</sup>

## 2. Entity Theory

Courts moving away from the contractualist's position refused to enjoin changes even if shareholders did not unanimously approve them. They relied on reservation clauses adopted by states and fictionalized the shareholders' consent.<sup>21</sup> For example, courts construed original charters

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would not be binding because the management power granted to the board of directors was exclusive, and incorporators have no right to interfere with it).

17. *New Orleans, J., & G. N. R.R.*, 27 Miss. at 517; see Carney, *supra* note 7, at 85; Horwitz, *supra* note 4, at 200. Professor Dodd argues that the idea that the charter of a corporation was a contract among shareholders *inter sese* was undermined by early cases permitting auxiliary, nonfundamental, or incidental changes to be made in the charter by majority vote of shareholders rather than unanimous consent. According to Professor Dodd, such an "implied agreement" is an agreement in law, not in fact. E. Merrick Dodd, Jr., *Dissenting Shareholders and Amendments to Corporate Charters*, 75 U. PA. L. REV. 585, 589 (1927); see *Dayton & Cincinnati R.R. v. Hatch*, 3 Ohio Dec. Reprint 501, 507 (1855).

18. *E.g.*, *New Orleans, J., & G. N. R.R.*, 27 Miss. at 527 (involving transfer of all the corporation's assets); *Abbot v. American Hard Rubber Co.*, 33 Barb. 578, 583 (N.Y. App. Div. 1861) (involving transfer of portion of corporation's property essential for transaction of its customary business, and effective dissolution of corporation); *Stevens v. Rutland & B. R.R.*, 29 Vt. 545, 562-63 (1851) (involving an extension of a railroad beyond its originally designated terminus). *But see* *Beardstown Pearl Button Co. v. Oswald*, 130 Ill. App. 290, 294 (1906) (holding that board of directors has authority, without shareholders' consent, to sell all the corporation's assets to pay corporate debts).

19. *E.g.*, *Stevens*, 29 Vt. at 562-63.

20. *E.g.*, *McCray v. Junction R.R.*, 9 Ind. 358, 359 (1857); *Middlesex Turnpike Corp. v. Swan*, 10 Mass. 384 (1813); *Middlesex Turnpike Corp. v. Locke*, 8 Mass. 268 (1811); *Union Locks & Canals v. Towne*, 1 N.H. 44 (1817); *Hartford & N. H. R.R. v. Crosswell*, 5 Hill 383 (N.Y. 1843).

21. *Miller v. State*, 82 U.S. (15 Wall.) 478, 498 (1872); *Venner v. Atchison, T. & S.F.R.*, 28 F. 581, 590 (C.C.D. Kan. 1886); *Durfee v. Old Colony & F. R. R.R.*, 87 Mass. (5 Allen) 230 (1862). The principle set out in *Dartmouth College v. Woodward*, 17 U.S. (24 Wheat.) 518 (1819), that a charter is a contract between the state and the corporation that could not be altered except by the consent of the parties, *id.* at 657-62, was quickly replaced by reservation

to authorize "new and additional enterprises of a nature similar"<sup>22</sup> to those included in the charter or not "so foreign to the purposes and scope of the charter."<sup>23</sup> Therefore, unanimous shareholder consent was not required for the corporation to engage in these new activities. Moreover, in unpaid subscription cases, courts stated that a "fundamental change" was not void if only a majority of subscribers had agreed to the change.<sup>24</sup> The courts released nonconsenting subscribers, however, from their subscriptions.

In *Dayton & Cincinnati Railroad v. Hatch*,<sup>25</sup> the court rejected explicitly the contractualist position. The court maintained that if the contractualist position were correct, changes not fundamental in nature would also require unanimous shareholder consent.<sup>26</sup> Rejecting the notion that a corporation is a partnership, the court held that a corporation is *not* based on the agreement of individuals,<sup>27</sup> but rather is an entity, an "artificial being, having such functions and powers as the law gives it."<sup>28</sup>

In holding that directors have the power to accept real estate for stock, the *Dayton* court rejected the idea that directors are "agents" of shareholders.<sup>29</sup> Using entity language, the court stated that for certain purposes directors and shareholders are "members or limbs, each acting within its appropriate sphere, of that artificial being or entity, to which name and powers of the corporation have been assigned by the law of its creation."<sup>30</sup>

The power of shareholders thus shifted to the board of directors. Directors were not agents of the shareholders; their power was considered "original and undelegated" by shareholders.<sup>31</sup> The courts construed

clauses in state statutes that permitted states unilaterally to make contract changes. *Dodd*, *supra* note 17, at 593-600.

22. *Durfee*, 87 Mass. (5 Allen) at 248.

23. *Venner*, 28 F. at 589.

24. *State v. Bailey*, 16 Ind. 46 (1861); *McCray v. Junction R.R.*, 9 Ind. 358 (1857).

25. 3 Ohio Dec. Reprint 501 (1855).

26. *Id.* at 507.

27. *Id.* at 505.

28. *Id.*

29. *Id.* at 505-06.

30. *Id.* at 506. Along similar lines, a New Jersey appellate court held:

[A] corporation is an individual entity or (artificial) person, just as separate and distinct from the individual persons of its officers, directors, and stockholders as the latter individuals are from any natural person who is a stranger to the corporation. The stockholders, single or collectively, are not the corporation; neither are the officers nor the directors.

*Whitfield v. Kern*, 120 N.J. Eq. 115, 129, 184 A. 333, 341, *rev'd*, 122 N.J. Eq. 332, 192 A. 48 (1937).

31. *People ex rel. Manice v. Powell*, 201 N.Y. 194, 200, 94 N.E. 634, 637 (1911); *see also*

directors' powers granted in management clauses as neither conferred nor revocable by shareholders.<sup>32</sup> Moreover, courts interpreted these clauses to confer exclusive authority over more corporate decisions to the board of directors.<sup>33</sup>

By the late nineteenth century, the unanimous consent requirement for fundamental changes hindered the expansion of corporations into other businesses as well as mergers and consolidations.<sup>34</sup> State legislatures enacted statutory provisions permitting these changes to be made with a lesser vote of shares if the board of directors also concurred with the change. New York adopted one of the earliest of such statutes in 1893,<sup>35</sup> by 1926 virtually all states had adopted similar statutory provisions or reached the same result through court decisions.<sup>36</sup> Finally, as the fear of power residing in a few lessened, weighted voting gave way to a one share-one vote system. By 1912 most shares carried one vote.<sup>37</sup>

By the early twentieth century, the entity theory had prevailed, as reflected in the growth of centralized control. Power over the business and affairs of the corporation resided clearly in management under management clauses. Moreover, contrary to their historical roots, explicit statutory provisions that had been designed to change the common-law requirement of unanimity to majority rule disenfranchised the majority of shareholders from deciding all but the changes described by those provisions.<sup>38</sup>

The approach under the federal proxy rules which evolved in the 1940s<sup>39</sup> is consistent with this development. These rules permitted shareholder proposals only on proper subjects for shareholder action under

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Continental Sec. Co. v. Belmont, 206 N.Y. 7, 16, 99 N.E. 138, 141 (1912) (holding that stockholders can bring action against corporation when the corporate body has neglected affairs or refused to act); Hoyt v. Thompson's Ex'rs, 19 N.Y. 207, 216 (1859) (stating that as a private principal, the board of directors can delegate its authority to agents or committees).

32. *Whitfield*, 120 N.J. Eq. at 130, 184 A. at 341; *Hoyt*, 19 N.Y. at 216.

33. *Whitfield*, 120 N.J. Eq. at 130, 184 A. at 343; *Manson v. Curtis*, 223 N.Y. 313, 322, 119 N.E. 559, 562 (1918); *Continental Sec. Co.*, 206 N.Y. at 16, 99 N.E. at 141; *Powell*, 201 N.Y. at 197, 94 N.E. at 16.

34. Horwitz, *supra* note 4, at 200.

35. *Id.* at 201. Shareholders were often granted appraisal rights if they did not consent to fundamental changes. *In re Timmis*, 200 N.Y. 177, 180, 93 N.E. 522, 523 (1910); Carney, *supra* note 7, at 93-96. For a summary of the controversy over why appraisal rights exist, see Carney, *supra* note 7, at 75 n.19.

36. Horwitz, *supra* note 4, at 202.

37. Kerbel, *supra* note 6, at 49-50.

38. See Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 228 (1962).

39. 17 C.F.R. § 240.14a-7 (1986); Letter of the Director of the Corporation Finance Division Relating to Section 20 and to Rule X-14A-7 Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-3638, Fed. Sec. L. Rep. (CCH) [Vol. 3] ¶ 24,102 (Jan. 3, 1945).

state law.<sup>40</sup> The rules defined these subjects by reference to voting rights contained in express statutory provisions, unless the proposals were in the form of recommendations or requests to management.<sup>41</sup> Accordingly, most of the voting facilitated by the federal proxy rules involves precatory or advisory voting.

### 3. Conclusion

From this historical account, it becomes apparent that the limitations on shareholder voting rights generally understood to exist under state law and the federal proxy rules do not rest on a solid historical foundation. The requirement of unanimous consent for "fundamental" changes evolved in the context of a contract-partnership conception of the corporation where partners (or shareholders) voted on all issues by majority rule, while some issues required unanimous consent. In recognition of the economic needs of corporate development and growth, state legislatures intended the adoption of express statutory provisions to permit the majority of partners (or shareholders) to determine these issues in a manner consistent with the jointly held desires of management and the majority of partners (or shareholders). With the change in the nature of the shareholders from few entrepreneurs to numerous public shareholders, these statutes came to limit shareholder voting rights to the subjects they expressly covered. Management, no longer an agent of shareholders, gained an independent institutional role. These changes would not harm the corporation, which was an entity in which the interests of management and shareholders were aligned in common purpose. Of course, if the organism were to die (dissolution), change its form (articles change), or marry (merger), a vote of its owners would be required.

Today, the entity concept has been replaced by conceptions that depict more accurately the complexity and conflicts within the modern corporation. The tender offer phenomenon of the 1980s and the increasing activism of institutional investors amply demonstrate the conflicts between management and shareholders, controlling and minority shareholders, and shareholders and other constituencies such as debtholders

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40. The Securities and Exchange Commission early took the view that a corporation violated its obligation to disclose all material information to its shareholders concerning the shareholders' meeting if it failed to disclose in its proxy statement information concerning proposals that the corporation knew would be made by shareholders at the annual meeting. See *Securities and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce, 78th Cong., 1st Sess., pt. 1, 169-70 (1943)*.

41. Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,812 (Nov. 22, 1976) [hereinafter Exchange Act Release No. 12,999].

and employees. Thus, to retain the existing voting system one must find a reasoned basis for its application to the modern corporation. Before analyzing the existing system of voting rights, however, one must understand the present state of shareholder voting rights.

### B. *Traditional, Newly Adopted, and Proposed Voting Rights*

As any corporations textbook explains, shareholders, under state statutes, have the right to vote on "fundamental" changes.<sup>42</sup> These changes consist of mergers,<sup>43</sup> a sale of substantially all corporate assets,<sup>44</sup> changes in the corporation's articles of incorporation,<sup>45</sup> and dissolution.<sup>46</sup> In most cases management must first initiate and approve these transactions. The shareholders' rights thus are essentially veto rights,

42. *E.g.*, ROBERT W. HAMILTON, *CORPORATE FINANCE: CASES AND MATERIALS* 690-91 (1989) (citing Elliot J. Weiss, *The Law of Takeout Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 627-30, 641, 648 (1981)); LARRY E. RIBSTEIN, *BUSINESS ASSOCIATIONS* 3-11 (1983). Professors Lewis D. Solomon, Donald E. Schwartz, and Jeffrey D. Bauman refer to these changes as "organic." See LEWIS D. SOLOMON ET AL., *CORPORATIONS, LAW AND POLICY, MATERIALS AND PROBLEMS* 942-43 (2d ed. 1988).

43. *E.g.*, CAL. CORP. CODE § 1201 (West 1991); DEL. CODE ANN. tit. 8, § 251(c) (1991); N.Y. BUS. CORP. LAW § 903(a) (McKinney 1986); REV. MODEL BUSINESS CORP. ACT § 11.01(a) (1984).

44. *E.g.*, CAL. CORP. CODE § 1001(a) (West 1990); DEL. CODE ANN. tit. 8, § 271(a) (1991); N.Y. BUS. CORP. LAW § 909 (McKinney 1986); REV. MODEL BUSINESS CORP. ACT § 12.02 (1984).

45. CAL. CORP. CODE § 902 (West 1991); DEL. CODE ANN. tit. 8, § 242 (1983); N.Y. BUS. CORP. LAW § 803 (McKinney's 1986); REV. MODEL BUSINESS CORP. ACT § 10.03 (1984). The Revised Model Business Corporation Act permits directors to make certain "routine and 'housekeeping'" amendments to the articles without a shareholder vote. REV. MODEL BUSINESS CORP. ACT § 10.02 (1984) (Official Comment); see CAL. CORP. CODE § 902(d) (West 1990). Some amendments to the articles of incorporation and bylaws may be prohibited on public policy grounds. *Burns v. Wray Farmer Grain Co.*, 65 Colo. 425, 428-29, 176 P. 487, 488 (1918); *State ex rel. Cochran v. Penn-Beaver Oil Co.*, 143 A. 257, 259 (Del. 1926); *Taylor v. Groswood*, 14 N.J.L. 222, 228 (N.J. Sup. Ct. 1834); *Costello v. Thomas Cusack Co.*, 96 N.J. Eq. 83, 88, 124 A. 615, 617 (Ch. 1922); *Audenreid v. East Coast Milling Co.*, 68 N.J. Eq. 450, 467, 59 A. 577, 584 (Ch. 1904); *Benintendi v. Kenton Hotel*, 294 N.Y. 112, 117, 60 N.E. 2d 829, 830 (1945); *In re Boulevard Theatre & Realty Co.*, 195 App. Div. 518, 186 N.Y.S. 430, 431 (1st Dep't.), *aff'd mem.*, 231 N.Y. 615, 132 N.E. 910 (1921); *Blatchford v. Ross*, 54 Barb. 42, 45, 37 How. Prac. 110, 112, 5 Abb. Prac. (N.S.) 434, 436 (1869); *Hauser v. York Water Co.*, 278 Pa. 387, 392, 123 A. 330, 331 (1924); *Commonwealth ex rel. Wilde v. Pennsylvania Silk Co.*, 267 Pa. 331, 332, 110 A. 157, 157 (1920); HENRY W. BALLANTINE, *ON CORPORATIONS* 63 (1946); WILLIAM M. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 4186, 4191 (1992).

46. See, *e.g.*, ARIZ. REV. STAT. ANN. § 10-084 (1990); IND. CODE ANN. § 23-1-45-2 (Burns 1989); N.H. REV. STAT. ANN. 293-A: 85 (1987); N.M. STAT. ANN. § 53-16-3 (Michie 1983); REV. MODEL BUSINESS CORP. ACT. § 14.02 (1984). Some states permit shareholders to dissolve a corporation without any action by the corporation's board of directors. *E.g.*, DEL. CODE ANN. tit. 8, § 275(c) (1991) (unanimous consent required); CAL. CORP. CODE § 1900 (West 1990) (50% consent required); N.Y. BUS. CORP. LAW § 1002 (McKinney 1986) (two-thirds consent required).

and hereinafter will be referred to as "shareholder veto rights." Shareholders also have the right to elect<sup>47</sup> and remove<sup>48</sup> directors and in most cases change the corporation's bylaws,<sup>49</sup> without initiation or approval by management.

The federal proxy rules are also relevant to shareholder voting. These rules are applicable to public companies<sup>50</sup> and require disclosure to shareholders of material information on subjects to be voted on at annual meetings.<sup>51</sup> Consistent with the disclosure objective of the proxy

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47. CAL. CORP. CODE § 301(a) (West 1991); N.Y. BUS. CORP. LAW § 703(a) (McKinney 1986); REV. MODEL BUSINESS CORP. ACT § 803(d) (1984).

48. CAL. CORP. CODE § 303(a) (West 1991); DEL. CODE ANN. tit. 8, § 141(k) (1983); N.Y. BUS. CORP. LAW § 706 (McKinney 1986); REV. MODEL BUSINESS CORP. ACT § 8.08 (1984). For the inherent right of shareholders to remove directors for cause, see *Campbell v. Loew's, Inc.*, 36 Del. Ch. 563, 572, 134 A.2d 852, 857 (1957) and *Auer v. Dressel*, 306 N.Y. 427, 432, 118 N.E. 2d 590, 593 (1954).

49. *E.g.*, CAL. CORP. CODE § 211 (West 1991); DEL. CODE ANN. tit. 8, § 109 (1983); REV. MODEL BUSINESS CORP. ACT § 10.20 (1984). Bylaws are important to control of the corporation. They can determine the rules for calling and conducting shareholders' and directors' meetings, the number and qualifications of directors, and the establishment of board committees. In addition, they may contain provisions of particular interest to management concerning indemnification or exculpatory clauses with respect to liability. At common law, shareholders had the sole authority to amend the bylaws, unless that power was delegated by them to directors. *FLETCHER, supra* note 45, §§ 4172, 4178. Shareholders could delegate such power to directors in the corporation's articles. State statutes were enacted that permitted directors to amend bylaws, without an articles provision to that effect. *E.g.*, ALA. CODE § 10-2A-45 (1991); CAL. CORP. CODE § 211 (West 1990); ILL. ANN. STAT. ch. 32, para. 2.25 (Smith-Hurd 1991); S.D. CODIFIED LAWS ANN. § 47-2-49 (1991); TEX. BUS. CORP. ACT ANN. art. 2.23 (West 1991); WASH. REV. CODE ANN. § 23 B.02.020(3)(ii) (West 1992). Some of these statutes attempted to reverse the common law rule by placing primary authority in directors to amend the bylaws, unless the authority to amend the bylaws was reserved to shareholders in the articles. *E.g.*, N.H. REV. STAT. ANN. § 293-A:27 (1991); S.D. CODIFIED LAWS ANN. § 47-2-49 (1991); W. VA. CODE § 31-1-17 (1991); *FLETCHER, supra* note 45, § 4172. But some courts have found that shareholders have the inherent power to amend bylaws regardless of statutory authority. *Rogers v. Hill*, 289 U.S. 582, 588 (1933); *Auer*, 306 N.Y. at 433, 118 N.E. 2d at 594 (1954). Bylaw amendments may be prohibited on public policy grounds. *See supra* note 45. Most state statutes provide that directors may amend bylaws, at least if that right is set forth in the corporation's articles or bylaws. *E.g.*, CAL. CORP. CODE § 211 (West 1990); ILL. ANN. STAT. ch. 32, para. 2.25 (Smith-Hurd 1985); MASS. GEN. LAWS ANN. ch. 156B, § 17 (West Supp. 1991); N.C. GEN. STAT. § 55-10-20 (1990); N.Y. BUS. CORP. LAW § 601(a) (McKinney 1986). Certain limitations are contained in corporation statutes concerning amendment of bylaws by directors. For example, under the California statute, directors cannot amend the bylaws to change a fixed number of directors, to change the maximum or minimum number of directors, or to change from a fixed to a variable board or vice versa. CAL. CORP. CODE § 212 (West 1990).

50. 17 C.F.R. § 240.14a-1 (1988). Corporations with securities listed on a national stock exchange or corporations in interstate commerce with both total assets of five million dollars and a class of equity securities held of record by more than five hundred shareholders are required to register any class of equity securities. 15 U.S.C. § 771(a) & (g) (1987); 17 C.F.R. § 240.12g-1 (1992).

51. *See, e.g.*, 17 C.F.R. §§ 240.14a-3, 14a-101 (1989).

rules, shareholders may include their own proposals in the company's proxy statement, provided that they comply with procedural rules<sup>52</sup> and that their proposals do not fall within the exclusions of Rule 14a-8.<sup>53</sup>

As noted above, proposals not resting on explicit statutory provisions authorizing shareholder voting must be in the form of recommendations or requests to the corporation's board of directors. Important among those proposals that may be excluded, even if only advisory, are proposals that deal with the ordinary business of the corporation,<sup>54</sup> which is often interpreted very broadly;<sup>55</sup> that relate to election to of-

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52. *Id.* § 240.14a-8(a).

53. *Id.* § 240.14a-8(c).

54. *Id.* § 240.14a-8(c)(7). The SEC, in response to questions raised by the Senate Committee on Banking and Currency, explained the rationale of the ordinary business exclusion as follows:

The policy motivating the Commission in adopting the rule . . . is basically the same as the underlying policy of most State corporation laws to confine the solution of ordinary business problems to the board of directors and place such problems beyond the competence and direction of the shareholders. The basic reason for this policy is that it is manifestly impracticable in most cases for stockholders to decide management problems at corporate meetings.

*Hearing on SEC Enforcement Problems Before the Subcomm. of the Senate Comm. on Banking and Currency*, 85th Cong., 1st Sess., pt. 1 at 118 (1957).

In response to criticism that the ordinary business exclusion was being relied on to exclude proposals of considerable importance to corporations and its shareholders, Exchange Act Release No. 12,999, *supra* note 41, at ¶ 80,812, a criticism shared by the court in *Medical Committee for Human Rights*, 432 F.2d. 659, 681 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972), the Commission in 1976 proposed to modify this exclusion to exclude "routine day-to-day matters relating to the conduct of the ordinary business operations of the issuer." Proposed Amendments to the 1934 Act Relating to Proposals by Security Holders, Exchange Act Release No. 12,598, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,634 (July 7, 1976). The Commission suggested that a reasonable standard to distinguish between routine and important business matters was "whether it would be necessary for the board of directors to act on the matter involved in the proposal." *Id.* at 86,599. The Commission ultimately did not adopt the proposal, probably due to substantial criticism mostly from corporate commentators. Exchange Act Release No. 12,999, *supra* note 41, at 87,130. The Commission stated that it rejected this standard because the boards of different companies delegate different amounts of authority to officers and because it could find no satisfactory standard for distinguishing between routine and important business matters. *Id.* at 87,131. The Commission resolved, however, to be more "flexible" in its application of the exclusion than in the past. *Id.* It would not permit the exclusion of matters "which have significant policy, economic or other implications inherent in them." *Id.* However, matters that are "mundane in nature and do not involve any substantial policy or other considerations" would be omitted under the exclusion. *Id.*

55. *See infra* notes 60-64. In addition, no-action letters have been issued for advisory proposals raising significant policy issues such as abortion. Hospital Corporation of America, SEC No-Action Letter, Feb. 12, 1986, *available in* WESTLAW, FSEC-NAL database (holding excludable a proposal concerning medical procedures to be performed at hospital). *But see* Bristol-Myers Squibb Co., SEC No-Action Letter, Mar. 7, 1991, *available in* WESTLAW, FSEC-NAL database (holding not excludable a proposal that the company refrain from making charitable contributions to organizations that support, counsel, or perform abortions). No

action letters have also been issued for proposals involving use of watershed land, Pennsylvania Enterprise, Inc., SEC No-Action Letter, Apr. 12, 1985, *available in WESTLAW*, FSEC-NAL database; use of Indian burial sites, Gulf Oil Corp., SEC No-Action Letter, Feb. 4, 1980, *available in WESTLAW*, FSEC-NAL database; offshore drilling, Exxon Corporation, SEC No-Action Letter, Jan. 18, 1990, *available in WESTLAW*, FSEC-NAL database (holding excludable a proposal to suspend all future activities in pursuit of new offshore leases for oil exploration and development in federal and state waters); sale of pornography, USX Corporation, SEC No-Action Letter, Jan. 26, 1990, *available in WESTLAW*, FSEC-NAL database (holding excludable a proposal to cease sale of adult soft-core pornography at its retail outlets); and advertising standards, General Mills, Inc., SEC No-Action Letter, Jan. 20, 1990, *available in WESTLAW*, FSEC-NAL database (finding excludable a proposal prohibiting company from advertising programs that encourage homosexuality or pornography); Bell South Corp., SEC No-Action Letter, Feb. 11, 1991, *available in WESTLAW*, FSEC-NAL database (holding excludable a proposal relating to corporate advertising ethics policy); General Electric Company, SEC No-Action Letter, Jan. 30, 1989, *available in WESTLAW*, FSEC-NAL database (holding excludable a proposal relating to re-establishing a unit to create broadcasting and advertising standards including specific prohibitions on such matters as sex and violence). *But see* American Brands, Inc., SEC No-Action Letter, Feb. 28, 1991, *available in WESTLAW*, FSEC-NAL database (holding not excludable a proposal relating to establishing committee to report on company adherence to voluntary code of cigarette advertising).

The staff of the Securities and Exchange Commission appears to have recently revised its policy. It now permits management to omit shareholder proposals that request information on equal opportunity and affirmative action programs. *Compare* Wal-Mart Stores, Inc., SEC No-Action Letter, Apr. 10, 1991, *available in WESTLAW*, FSEC-NAL database (holding excludable a proposal requesting the company to report information on company equal employment and affirmative action to shareholders and suppliers) *with* Dayton Hudson Corp., SEC No-Action Letter, Mar. 8, 1991, *available in WESTLAW*, FSEC-NAL database (stating that the same proposal is includable). *Also compare* Capital Cities ABC, Inc., SEC No-Action Letter, Apr. 4, 1991, *available in WESTLAW*, FSEC-NAL database (holding excludable under Rule 14a-8(c)(7) a shareholder proposal regarding affirmative action because it dealt with matters relating to company's ordinary business operations) *with* CBS, Inc., SEC No-Action Letter, Mar. 7, 1991, *available in WESTLAW*, FSEC-NAL database (holding that exclusion was not permitted).

In addition, decisions have recently been made to revise several former policies. The staff of the Securities and Exchange Commission now permits shareholder proposals that relate to plant closings, Pacific Telesis Group, SEC No-Action Letter, Feb. 2, 1989, *available in WESTLAW*, FSEC-NAL database; and production of tobacco products. Loews Corporation, SEC No-Action Letter, Feb. 22, 1990, *available in WESTLAW*, FSEC-NAL database (holding includable a proposal to amend the company's articles of incorporation to provide that the company shall not conduct any business in tobacco or tobacco products); Kimberly-Clark Corp., SEC No-Action Letter, Feb. 22, 1990, *available in WESTLAW*, FSEC-NAL database (holding includable a proposal to require board to take actions leading to the eventual cessation of the manufacture of tobacco products); Philip Morris Companies, SEC No-Action Letter, Feb. 13, 1990, *available in WESTLAW*, FSEC-NAL database (holding includable a proposal to amend the company's articles of incorporation to provide that the company shall not conduct any business in tobacco or tobacco products); American Brands, Inc., SEC No-Action Letter, Feb. 28, 1991, *available in WESTLAW*, FSEC-NAL database (holding includable a proposal to establish a committee to report on cigarette advertisements and policies to ensure compliance with the voluntary code of cigarette advertising). *But see* Philip Morris Companies, Inc., SEC No-Action Letter, Feb. 22, 1990, *available in WESTLAW*, FSEC-NAL database (holding excludable a proposal that company provide a report on its lobbying activities and expenditures to influence legislation regarding cigarette advertising, smoking in public places, and exploiting foreign markets). The Commission also recently has announced its in-



fice,<sup>56</sup> that counter proposals submitted by the corporation,<sup>57</sup> and that

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tention to permit shareholders to make proposals on all forms of compensation to senior executives and directors. Press Conference with Securities and Exchange Commission Chairman Richard Breeden, Fed. News Service (Feb. 13, 1992). This announcement was made in response to proposed legislation introduced in the House and Senate to permit shareholders to submit proposals on executive and director compensation policies. H.R. 2522, 102d Cong., 1st Sess. (1992); S. 1198, 102d Cong., 1st Sess. (1991). The Commission had previously permitted proposals only on golden parachute payments. Ryder Systems Inc., SEC No-Action Letter, Mar. 6, 1990, *available in* WESTLAW, FSEC-NAL database (holding includable a proposal requesting the company to refrain from awarding golden parachutes to executives unless shareholders approve); Eastman Kodak, SEC No-Action Letter, Feb. 22, 1990, *available in* WESTLAW, FSEC-NAL database (holding includable a proposal to adopt a policy prohibiting the company from making compensation payments to its directors, officers, or employees contingent on a merger or acquisition).

56. 17 C.F.R. § 240.14a-8(c)(8) (1987). The Commission has consistently maintained that Rule 14a-8 may not be used by shareholders to nominate or recommend board members. It has maintained this position despite its recognition that:

For the vast majority of shareholders, an election contest is not feasible because of the huge expenses involved. Although shareholders may be permitted to make nominations from the floor at annual meetings, it is clear that this right is of little practical value, since at that point proxies have already been received by management for nominees which it has chosen, and the number of shareholders attending an annual meeting typically is insignificant.

Reexamination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 13,482 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,130 (Apr. 28, 1977). See Reexamination of Rules Relating to Shareholders Communications, Shareholders Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 13,901 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,296 (Aug. 29, 1977). In 1978, the Commission began focusing on the importance of nominating committees. Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 14,970 [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,645 (July 18, 1978). After hearings, the Commission staff issued a report recommending that "[i]f there is not a substantial increase in the percentage of companies with independent nominating committees who consider shareholder nominations, the Commission should authorize the staff to develop a rule to require companies to adopt a procedure for considering shareholder nominations." SECURITIES AND EXCHANGE COMMISSION, 96TH CONG., 2D. SESS., STAFF REPORT ON CORPORATE ACCOUNTABILITY 131 (Comm. Print 1980). After monitoring the number of companies with nominating committees in connection with its three-year (1979-81) Proxy Disclosure Monitoring Program, the staff decided not to recommend such a rule. By 1981, however, fewer than a third of the companies in its sample had nominating committees (an increase from 19.4% in 1979), and only 78% of these committees considered shareholder nominees (a decrease from the percentage that did so in 1979). Analysis of Results of 1981 Proxy Statement Disclosure Monitoring Program, Exchange Act Release No. 18,532, [Vol. 3] Fed. Sec. L. Rep. (CCH) ¶ 24,120 (Mar. 3, 1982).

A possible indication that the Commission is shifting toward a more liberal approach may be signaled by its refusal to give a no-action letter for a recent proposal recommending that a corporation's board institute a mechanism for the nomination of opposition directors. Chitenden Corp., SEC No-Action letter, Mar. 10, 1989, *available in* WESTLAW, FSEC-NAL database. *But see* Thermo Electron, SEC No-Action Letter, Mar. 22, 1990, *available in* LEXIS, FEDSEC library, NOACT file (finding excludable under Rule 13a-8(c)(8) a shareholder proposal recommending the board provide equal opportunities for nomination of oppo-

sition directors); American Telephone & Telegraph Company, SEC No-Action Letter, Jan. 11, 1991, *available in* LEXIS, FEDSEC library, NOACT file Securities (finding excludable under Rule 14a-8(c)(8) a shareholder proposal recommending that two nominees for the board of directors be selected by the unions representing the company's employees). The Commission appears also to be adopting a more liberal position on shareholder debate on management proposals. *Compare* Mobil Corp., SEC No-Action Letter, Feb. 19, 1988, *available in* WESTLAW, FSEC-NAL database (finding includable a shareholder proposal recommending that certain shareholders have the right to make opposition statements to management's proposals in the corporation's proxy statement) *with* Detroit Edison Co., SEC No-Action Letter, Feb. 12, 1980, *available in* WESTLAW, FSEC-NAL database (finding excludable a proposal for fair and equal debate on proposals in the corporation's proxy statement). Proposals that are deemed to question the business judgment, competence, or service of directors are considered to relate to the reelection of directors and thus are excludable under Rule 14a-8(c)(8). *E.g.*, Time-Warner, Inc., SEC No-Action Letter, Mar. 23, 1990, *available in* LEXIS, FEDSEC library, NOACT file (holding excludable a shareholder proposal to censure board of directors for not accepting bid of \$200 per share from Paramount); UAL Corporation, SEC No-Action Letter, Jan. 18, 1991, *available in* LEXIS, FEDSEC library, NOACT file (holding excludable a shareholder proposal admonishing the board of directors for its decisions).

The Commission continues to permit the exclusion of recommendations of specific nominees. 17 C.F.R. § 240.14a-8(c)(8) (1988); *see, e.g.*, City Fed Financial Corp., SEC No-Action Letter, May 17, 1991, *available in* LEXIS, FEDSEC library, NOACT file (holding excludable three proposals nominating individuals for office); Unocal Corp., SEC No-Action Letter, Feb. 8, 1991, *available in* LEXIS, FEDSEC library, NOACT file (holding excludable a proposal recommending inclusion of names of nominees for Directors in proxy statements). In addition, it sanctions the omission of proposals that recommend that a certain number or percentage of directors have certain qualifications. *See* American Telephone & Telegraph Company, SEC No-Action Letter Jan. 11, 1991, *supra*; Harper & Row Publishers, Inc., SEC No-Action Letter, May 9, 1985, *available in* WESTLAW, FSEC-NAL database (holding excludable under Rule 14a-8(c) a shareholder recommendation that the board of directors nominate at least one active employee, selected by participants in the company's profit-sharing or employee stock plan); Allied Corp., SEC No-Action Letter, Jan. 5, 1984, *available in* LEXIS, FEDSEC library, NOACT file (holding excludable under Rule 14a-8(c)(8) a proposal that one member of the board be a non-management salaried employee); Braniff International Corp., SEC No-Action Letter, Feb. 5, 1982, *available in* WESTLAW, FSEC-NAL database (holding excludable under Rule 14a-8(c)(8) a proposed amendment of bylaws that board of directors nominate at least four active employee shareholders, selected by designated employee groups), because the proposal would require that "employees from certain specified employee groups be included in management's slate of nominees"). *But see* Waste Management, Inc., SEC No-Action Letter, Mar. 8, 1991, *available in* LEXIS, FEDSEC library, NOACT file (holding not excludable a proposed amendment of bylaws to provide that a majority of the board of directors be independent); Dillard Department Stores, Inc., SEC No-Action Letter, Mar. 7, 1991, *available in* LEXIS, FEDSEC library, NOACT file (holding not excludable a proposed amendment of bylaws to provide that a majority of the board of directors be independent); *see also infra* note 74 (showing that a shareholder can avoid exclusion by wording the proposal properly). Any proposals on the qualifications of directors must apply to all directors. *E.g.*, Dominion Resources, Inc., SEC No-Action Letter, Feb. 15, 1991, *available in* LEXIS, FEDSEC library, NOACT file (holding not excludable under Rule 14a-8(c)(8) a proposal recommending that each director be required to own at least 2,000 shares of Company stock); Unicare Services, Inc., SEC No-Action Letter, May 13, 1980, *available in* WESTLAW, FSEC-NAL database (holding not excludable under Rule 14a-8(c)(8) a proposal that no director be an officer, director, or principal stockholder of any supplier or customer doing more than \$20,000 business with the company). *But see* Quaker State Corp., No-Action Letter, Mar. 17, 1988, *available in* WESTLAW, FSEC-NAL database (holding not excludable a proposal that only outside directors must own a certain amount of common shares). Proposed legislation intro-

involve specific amounts of cash or stock dividends.<sup>58</sup> Management can omit important subjects under these exclusions. For example, under the ordinary business exclusion, management may omit proposals that raise significant policy issues,<sup>59</sup> that require the corporation to provide additional financial information,<sup>60</sup> that prohibit loans by the corporation to officers,<sup>61</sup> or that require the corporation to report to shareholders on ordinary business matters.<sup>62</sup> In addition, while shareholders routinely vote at annual meetings on auditors, they cannot, under the ordinary

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duced in the House and Senate would permit large shareholders to nominate directors. H.R. 2522, 102d Cong., 1st Sess. (1991); S. 1198, 102d Cong., 1st Sess. (1991).

57. 17 C.F.R. § 240.14a-8(c)(9) (1987).

58. *Id.* § 240.14a-8(c)(13). Instrument Systems Corporation, SEC No-Action Letter, Nov. 12, 1991, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting company declare a dividend to all common stockholders of an option to purchase a share of common stock for every four shares); Shop Television Network, Inc., SEC No-Action Letter, May 20, 1991, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting company, in the event of an early termination compensation payment, to distribute 75% of the payment to stockholders); National Affiliated Corporation, SEC No-Action Letter, Mar. 28, 1991, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting that the company pay a cash dividend of 25 to 50 cents per share to all shareholders).

59. See *supra* note 55.

60. *E.g.*, Ashland Oil Co., SEC No-Action Letter, Nov. 2, 1990, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting information on the company's legal and advertising costs); Santa Fe Southern Pacific Corp., SEC No-Action Letter, Jan. 30, 1986, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting current cost financial statements to determine fair market value of shares); Arizona Public Service Co., SEC No-Action Letter, Feb. 22, 1985, available in WESTLAW, FSEC-NAL database (holding excludable under Rule 14a-8(c)(1) a proposal requesting corporate financial disclosure as improper subject for action by security holders, and also excludable under Rule 14a-8(c)(7) as dealing with matters relating to conduct of ordinary business operations); Pittsburgh & West Virginia Railroad, SEC No-Action Letter, Mar. 19, 1984, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting appraisal or re-evaluation of company properties for purposes of establishing current market value of shares); Firestone Tire & Rubber Co., SEC No-Action Letter, Dec. 12, 1979, available in WESTLAW, FSEC-NAL database (holding excludable a proposal that financial statements reflect effects of inflation).

61. *E.g.*, Ferrofluidics Corp., SEC No-Action Letter, Aug. 16, 1991, available in WESTLAW, FSEC-NAL database (holding excludable a proposal to prohibit the company from lending money or guaranteeing loans to any officer, director, employee, or consultant to the company); Major Realty Corp., SEC No-Action letter, Mar. 19, 1987, available in WESTLAW, FSEC-NAL database (holding excludable a proposal not to make loans to officers and directors).

62. *E.g.*, Pepsico Inc., SEC No-Action Letter, Mar. 7, 1991, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting a report evaluating the impact of several health care programs on the company and its competitive position); International Business Machines Corp., SEC No-Action Letter, Jan. 14, 1991, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting an explanation concerning company actions respecting a particular contract); Carolina Power & Light Co., SEC No-Action Letter, Mar. 8, 1990, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting a report on aspects of the company's nuclear operations); see *supra*

business exclusion, suggest other auditors<sup>63</sup> or even recommend that auditors be rotated from time to time.<sup>64</sup>

As a practical matter, moreover, management retains substantial control over the proxy machinery; this dominance can interfere with the meaningful participation of shareholders in the corporate governance of public companies. Although shareholders have the right to elect directors, the federal proxy rules do not permit shareholders to nominate them for inclusion in the corporation's proxy statement.<sup>65</sup> To make a nomination shareholders must engage in an expensive proxy contest.<sup>66</sup> They often must litigate to obtain a shareholder list<sup>67</sup> and employ a proxy soliciting firm. Even if successful in having their nominee elected, they are not entitled to reimbursement of their costs.<sup>68</sup> Management, on the other hand, has the advantages. It can utilize corporate funds, has

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note 55 (no-action letters permitting the omission of proposals requesting a report on the company's equal opportunity and affirmative action proposals).

63. S.S. Kresge Co., SEC No-Action Letter, Mar. 17, 1976, available in WESTLAW, FSEC-NAL database; Kellogg Company, SEC No-Action Letter, Jan. 23, 1976, available in WESTLAW, FSEC-NAL database; Pay Less Drug Store, SEC No-Action Letter, Apr. 11, 1975, available in WESTLAW, FSEC-NAL database.

64. *E.g.*, Southern New England Communications Co., SEC No-Action Letter, Feb. 11, 1991, available in WESTLAW, FSEC-NAL database (holding excludable a proposal to limit service of any independent audit firm to five consecutive years and six years in any ten consecutive years); Pacific Gas & Electric Co., SEC No-Action Letter, Jan. 18, 1991, available in WESTLAW, FSEC-NAL database (holding excludable a proposal for new accounting firm every four years); Bank of America Corp., SEC No-Action Letter, Feb. 27, 1986, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting that no independent public accounting firm be recommended by the auditing and examining committee for more than five consecutive years); Long Island Lighting Co., SEC No-Action Letter, Feb. 20, 1986, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting, among other things, that no independent public accounting firm be recommended by the audit committee for more than seven consecutive years); Firestone Tire & Rubber Co., SEC No-Action letter, Nov. 25, 1980, available in WESTLAW, FSEC-NAL database (holding excludable a proposal requesting company to consider rotating outside auditors).

65. 17 C.F.R. § 240.14a-8(c)(8) (1992).

66. MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 112 (1976).

67. Regulation of Securityholder Communications, Exchange Act Release No. 29,315, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,811 (June 17, 1991 [hereinafter Exchange Act Release No. 29,315]). Although shareholders can obtain a shareholder list or have their materials sent to shareholders by the corporation at their expense, the election among these alternatives is in the hands of management under Rule 14a-7. 17 C.F.R. § 240.14A-7 (1992). Management generally elects to mail the material giving it substantial control over the "timing and effectiveness" of the shareholders' communications. Exchange Act Release No. 29,315, *supra*, ¶ 84,811, at 81,853 n.63; see Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 542 (1990) [hereinafter, Black, *Shareholder Passivity*] (referring to Rule 14a-7 as a "nonaccess" rule). Recently, the Securities and Exchange Commission proposed revisions to Rule 14a-7 permitting shareholders to elect to receive a shareholder list which would also include more information than under the current Rule. Exchange Act Release No. 29,315, *supra*, ¶ 84,811.

68. EISENBERG, *supra* note 66, at 122 n.88.

ready access to shareholder lists, reviews proxies as they come in enabling its resolicitation of adverse votes,<sup>69</sup> and controls the agenda,<sup>70</sup> timing, location, and conduct of annual meetings.<sup>71</sup> Moreover, management often has considerable influence over large shareholders due to its ability to provide these shareholders with corporate business.<sup>72</sup>

The shareholder proposal rules are also very technical,<sup>73</sup> often requiring the shareholder proponent to hire legal counsel. The shareholder must word the proposal properly to avoid exclusion.<sup>74</sup> Numerous exclu-

69. Black, *Shareholder Passivity*, *supra* note 67, at 542.

70. *Id.* at 592-94; see also John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1277-93 (1991) (arguing that managerial manipulation of proxy agenda inhibits shareholder activism).

71. SECURITIES AND EXCHANGE COMMISSION, 96TH CONG., 2D SESS., STAFF REPORT ON CORPORATE ACCOUNTABILITY 138-88 (Comm. Print 1980) [hereinafter SEC ACCOUNTABILITY REPORT].

72. Black, *Shareholder Passivity*, *supra* note 67, at 595-608; Coffee, *supra* note 70, at 1321; Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117, 147 (1988); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 54 (1991).

73. See Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 20,091 [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,417, at 86,206-07 (Aug. 16, 1983) (Commissioner Longstreth's dissent).

74. The complexity of the Rule is illustrated by the following:

Assume that a shareholder submits a proposal that "a nonmanagement shareholder be elected to the board of directors at the upcoming meeting." This proposal would be excludable under 17 C.F.R. § 240.14a-8(c)(8) [hereinafter Rule 14a-8(c)(8)], which permits the omission of proposals "relating to the election to office," since the proposal applies to the upcoming meeting. Allied Corp., SEC No-Action Letter, Jan. 5, 1984, available in WESTLAW, FSEC-NAL database. If revised to apply only to subsequent meetings, it would nevertheless be excludable under Rule 14a-8(c)(6), because the proposal is worded such that it is beyond the power of the corporation to effectuate. Management cannot "elect" a nonmanagement shareholder to the board; it can only "nominate" candidates, who in turn must be elected by shareholders. American Information Technologies Corp., SEC No-Action Letter, Dec. 13, 1985, available in WESTLAW, FSEC-NAL database (proposal that at least one elected member of the board of directors be a worker-shareholder or retired employee omitted); GTE Corp., SEC No-Action Letter, Jan. 10, 1984, WESTLAW, FSEC-NAL database (proposal that a number of women should be elected to the board of directors excluded). Then, if the shareholder amends the proposal to provide that "a nonmanagement shareholder be nominated to the board," the proposal may be excludable under Rule 14a-8(c)(1), as the proposal is not phrased as a recommendation or request. Northwest Airlines, SEC No-Action Letter, Mar. 2, 1978, WESTLAW, FSEC-NAL database. The SEC, however, would probably point out this error to the shareholder and permit her to amend the proposal. Even so reworded, the proposal may be excludable under Rule 14a-8(c)(8), as it is deemed to relate to the nomination of persons from a "specific group." See *supra* note 56. That is, it does not involve establishing a general qualification for all of the directors. The shareholder can escape this result only by proposing that all nominees be non-management shareholders, see *supra* note 56, or possibly by proposing that the board of directors consider

sions exist, precluding shareholders from exercising a voice on a number of important issues.<sup>75</sup> Moreover, management can include an opposing statement of any length in the corporation's proxy statement, whereas shareholders' proposals and supporting statements cannot exceed 500 words.<sup>76</sup>

As a result of the tender offer phenomenon, some states have adopted new provisions relating to shareholder voting rights.<sup>77</sup> Control share acquisition provisions require a vote of minority shareholders before a shareholder either can acquire<sup>78</sup> or vote<sup>79</sup> shares that are considered "control shares."<sup>80</sup> In addition, a number of states have adopted statutory provisions relating to major transactions in which controlling shareholders have an interest. The statutes prohibit such transactions for a number of years ("business combination" statutes)<sup>81</sup> or should a fair price not be provided ("fair price" statutes),<sup>82</sup> unless the corporation obtains a supermajority vote or vote of disinterested shareholders.

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nominees selected by a committee composed of nonmanagement shareholders. See Bank America Corp., SEC No-Action Letter, Feb. 7, 1980, WESTLAW, FSEC-NAL database (proposal that the company facilitate organization of institutional investor committees and consider a list of nominees from such group not excludable under Rule 14a-8(c)(8)).

Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Menas*, 22 U. MICH. J.L. REF. 19, 85-86 n.257 (1988) (citation format updated).

75. See *supra* text accompanying notes 54-64.

76. 17 C.F.R. § 240.14a-8(a) (1992); see Black, *Shareholder Passivity*, *supra* note 67, at 542.

77. Control share acquisition statutes require a majority vote of disinterested shares before a person can acquire or vote control shares as defined in the statutes. *E.g.*, FLA. STAT. ANN. § 607.0902 (West Supp. 1991); IND. CODE ANN. § 23-1-42 (West Supp. 1990); MASS. GEN. LAWS ANN. ch. 110D, §§ 1 to 13 (West Supp. 1991); MINN. STAT. ANN. § 302A.671 (West Supp. 1991); OHIO REV. CODE ANN. § 1701.831 (Baldwin 1990); see also Model State Control Share Act 3d (Public Discussion Draft, dated March 29, 1988) (requiring such a majority vote of disinterested shares). For a detailed discussion of this Act, see Evan M. Kjellenberg, *The Model Control Share Act is the Best State Takeover Law Alternative*, 8 N. ILL. U. L. REV. 329, 342 (1988).

78. OHIO REV. CODE ANN. § 1701.831 (Baldwin Supp. 1992).

79. FLA. STAT. ANN. § 607.0902 (West Supp. 1991); IND. CODE ANN. § 23-1-42-9 (Burns Supp. 1991); MASS. GEN. LAWS ANN. ch. 110D, §§ 2, 5 (West 1990); MINN. STAT. ANN. § 302A.671(4a) (West Supp. 1991).

80. Control shares are generally defined as shares that result in a person having voting power that is equal to or greater than certain thresholds (20%, 33 1/2%, and 50%). See FLA. STAT. ANN. § 607.0902(1) (West Supp. 1991); IND. CODE ANN. § 23-1-42-1 (Burns Supp. 1991); MINN. STAT. ANN. § 302A.671(2)(d) (West Supp. 1991).

81. DEL. CODE ANN. tit. 8, § 203 (Supp. 1990); IND. CODE ANN. § 23-1-43-18 (Burns Supp. 1991); MINN. STAT. ANN. § 302 A.673 (West Supp. 1991); N.J. STAT. ANN. § 14A:10A-4 (West Supp. 1991); N.Y. BUS. CORP. LAW § 912 (McKinney 1986 & Supp. 1991).

82. CONN. GEN. STAT. ANN. § 33-374a to 374d (West 1987 & Supp. 1991); FLA. STAT. ANN. § 607.0901 (West Supp. 1991); ILL. ANN. STAT. ch. 32, para. 7.85 (Smith-Hurd Supp.

Congressional legislators and the SEC Advisory Committee have also proposed shareholder voting rights on a number of subjects concerning managers who may be inclined to act against the interests of shareholders in order to retain control of the corporation or seek control of another corporation. These proposals advocate shareholder veto rights on poison pills,<sup>83</sup> greenmail,<sup>84</sup> the issuance of specified percentages of voting stock,<sup>85</sup> golden parachutes,<sup>86</sup> shark repellents,<sup>87</sup> lock-ups,<sup>88</sup> and the decision of the corporation to commence a tender offer.<sup>89</sup> Advisory shareholder voting rights have also been proposed for golden parachutes,<sup>90</sup> certain kinds of standstill agreements,<sup>91</sup> supermajority voting provisions,<sup>92</sup> and disenfranchisement provisions that provide for a departure from the one share-one vote principle.<sup>93</sup>

### III. THE RATIONALE FOR VETO RIGHTS UNDER STATE LAW

The existing system of shareholder veto rights rests on the assumption that shareholders have control over "fundamental" or "organic" changes. This section will demonstrate that the current system of voting rights under state law does not rest on such a coherent conceptual framework. This is true even if one considers the newly adopted and proposed voting rights inspired by the tender offer phenomenon.

#### A. *The Lack of Veto Rights Over Fundamental or Organic Changes*

The terms "fundamental" and "organic" do not distinguish between

1991); MD. CORPS. & ASS'NS CODE ANN. §§ 3-601 to 603 (Supp. 1991); MICH. COMP. LAWS ANN. §§ 450.1776-1784 (West 1990).

83. S. 1658, 101st Cong., 1st Sess. (1989); S. 1244, 101st Cong., 1st Sess. (1989); S. 678, 100th Cong., 1st Sess. (1987); H.R. 2668, 100th Cong., 1st Sess. (1987); H.R. 2172, 100th Cong., 1st Sess. (1987).

84. SEC ADVISORY COMMITTEE ON TENDER OFFERS REPORT OF RECOMMENDATIONS 46 [hereinafter SEC ADVISORY REPORT]; S. 1658, S. 1244, S. 1323, 100th Cong., 1st Sess. (1987); S. 521, 100th Cong., 1st Sess. (1987); S. 227, 100th Cong., 1st Sess. (1987); S. 78, 100th Cong., 1st Sess. (1987); H.R. 2668, H.R. 2172, H.R. 1601, 100th Cong., 1st Sess. (1987).

85. SEC ADVISORY REPORT, *supra* note 84, at 44; H.R. 2668; H.R. 2172, 100th Cong., 1st Sess. (1987).

86. S. 1658; S. 1244; H.R. 2668, 100th Cong., 1st Sess. (1987).

87. SEC ADVISORY REPORT, *supra* note 84, at 36-37; *id.* at 86 (separate statement of Frank H. Easterbrook & Gregg A. Jerrell); S. 678; H.R. 2668; H.R. 2172, 100th Cong., 1st Sess. (1987).

88. H.R. 2668; H.R. 2172, 100th Cong., 1st Sess. (1987).

89. SEC ADVISORY REPORT, *supra* note 84, at 130 (separate statement of Arthur J. Goldberg).

90. *Id.* at 38-41.

91. *Id.* at 38.

92. *Id.*

93. *Id.*

subjects over which shareholders do and do not have veto rights. The Random House College Dictionary defines "fundamental" as "being an essential part of, a foundation or basis"<sup>94</sup> and "organic" as "of or pertaining to the constitution or structure of a thing."<sup>95</sup> When one applies these definitions to the corporation, it becomes apparent that "fundamental" or "organic" may refer to the economic, operational, control/power, or legal structure of a corporation. This section examines these structures.

### 1. Economic Structure

Because shareholders are investors, their perspective of fundamental change often focuses on changes in the economic structure of the corporation. Commonly understood, the corporation's balance sheet, namely its capitalization, reflects the economic structure of the corporation. Decisions affecting a corporation's capitalization involve the issuance or repurchase of shares, issuance or retirement of debt, and issuance of dividends or retention of earnings.

Of these decisions, shareholders have only limited veto rights with respect to the issuance of shares. In addition, these rights exist only when the corporation's articles<sup>96</sup> have not previously authorized the shares to be issued (it is commonplace to authorize large numbers of shares in advance) or when a corporation listed on the New York Stock Exchange increases its outstanding shares by twenty percent or more.<sup>97</sup> Veto rights have been proposed for a company's issuance of a certain percentage of its voting shares<sup>98</sup> and for the repurchase of shares from a potential bidder (greenmail).<sup>99</sup> However, neither shareholder veto rights nor proposals for such rights exist for the issuance or retirement of debt,<sup>100</sup> the issuance of dividends or retention of earnings, or the repurchase of stock from other than potential bidders. The federal proxy rules prohibit even advisory voting on these subjects due to the ordinary busi-

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94. RANDOM HOUSE COLLEGE DICTIONARY 535 (rev. ed. 1975).

95. *Id.* at 936.

96. *See supra* note 45 and accompanying text.

97. THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION, § 11.1 n.16 (2d ed. Supp. 1992); Interview with Thomas L. Hazen, Professor of Law, University of North Carolina at Chapel Hill, Chapel Hill, N.C. (Aug. 24, 1992).

98. *See supra* note 85 and accompanying text.

99. *See supra* note 84 and accompanying text.

100. Legislation has been proposed, however, for limiting the debt financing of tender offers. S. 1324, 100th Cong., 1st Sess. § 11(a) (1987) (prohibiting takeovers that are more than 25% debt financed); S. 634, 100th Cong., 1st Sess. § 8(a) (1987) (restricting junk bond financing). *Cf.* H.R. 2995, 100th Cong., 1st Sess. § 4 (1987) (denying any deduction for interest incurred in connection with a hostile stock purchase).



ness<sup>101</sup> and dividend exclusions.<sup>102</sup>

Shareholders do not have veto rights over fundamental changes even if one defines economic structure differently. For example, one may describe structure by reference to the nature of the corporation's business. A decision to make a drastic change in the business, however, such as through the acquisition of the assets of another corporation for non-stock consideration (thus avoiding merger veto rights)<sup>103</sup> or the reinvestment of earnings in a new business, does not require a shareholder vote. One may also define economic structure by reference to a corporation's long-term relationships and commitments. Shareholders do not have a veto right, however, over long-term leases or long-term agreements, such as those with labor or principal suppliers.

In essence, shareholders do not have veto rights over changes in economic structure. While they have veto rights over mergers, sales of substantially all corporate assets, and dissolutions that have a substantial impact on economic structure, they have no veto rights over other changes, such as debt levels, asset purchases, and stock repurchases, that may have the same or greater impact on that structure.

## 2. Operational Structure

Shareholders also do not have veto rights over changes in the operational structure of the corporation. Changes in this structure involve changes in production, from the procurement of raw materials to manufacturing to the distribution of final products. Decisions concerning this structure entail the formation of departments, divisions, and subsidiaries, and the allocation of work among them. None of these decisions, which also represent changes in "economic" structure, require a shareholder vote.

## 3. Control/Power Structure

Additionally, shareholders have no veto rights over various changes in the control/power structure. One may define control structure in formal terms by reference to the corporation's organizational chart describing the hierarchy within the firm. As discussed earlier, however, shareholders do not have veto rights over many changes that can affect this organization of authority within the firm. One may also define control structure by reference to rules determining the authority of directors, controlling shareholders, and minority shareholders. Although share-

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101. See *supra* notes 54-55 and accompanying text.

102. See *supra* note 58 and accompanying text.

103. See *infra* text accompanying notes 231-34.

holders have voting rights on articles<sup>104</sup> and bylaw amendments,<sup>105</sup> the directors' independent authority over bylaw changes can result in a change of control without the shareholders' consent.<sup>106</sup> In addition, at least one group of shareholders, minority shareholders, often do not have authority to prevent changes in articles or bylaws that affect them adversely. Subjects on which shareholders have veto rights under the existing system, such as various article amendments and the sale of substantially all corporate assets, do not involve changes in the control structure.

Control structure may also concern the number of shares outstanding and any agreements among owners of such shares. Shareholders have veto rights over the number of shares authorized in the articles and may enter into a number of agreements, such as voting trusts and voting agreements. A corporation, however, may sell substantially all its assets, have a corporation merge into it, dissolve, or amend its articles without affecting the control structure so defined, *i.e.*, the shares authorized or shareholder agreements. Thus, these shareholder veto rights cannot be rationalized by a change in this control structure. Similarly, when the control structure is defined differently by reference to the substantive terms of various long-term agreements,<sup>107</sup> shareholder veto rights are not explained by changes in that control structure.

Note that shareholders have veto rights over nonstructural control changes such as the identity of directors<sup>108</sup> and, in some states, controlling persons.<sup>109</sup> However, as discussed above under "economic structure," they do not have veto rights over other nonstructural control changes through stock issuances and repurchases. They also do not have authority over popular defensive tactics such as the issuance of stock to friendly pension funds or white knights. Moreover, a board of directors can effectuate a *de facto* merger, resulting in a change of control without a shareholder vote in many states, by issuing voting stock for the assets of another corporation.<sup>110</sup> Thus, shareholder veto rights do not grant

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104. See *supra* note 45 and accompanying text.

105. See *supra* note 49 and accompanying text.

106. See *infra* text accompanying note 263.

107. Of course, the actual control or power structure of the corporation may differ from the structures so defined due to traditional rules and the corporation's dependence on various resources at different times. Dallas, *supra* note 74, at 80-84.

108. See *supra* notes 47-48 and accompanying text.

109. See *supra* notes 77-80 and accompanying text.

110. A purchase of assets does not require a shareholder vote and an issuance of shares would not require a shareholder vote if the shares were already authorized in the corporation's articles of incorporation. Some state courts will not utilize the *de facto* merger doctrine. *E.g.*, *Hariton v. Arco Elecs., Inc.*, 41 Del. Ch. 74, 76-77, 188 A.2d 123, 125 (1963).

shareholder voting rights for either structural or nonstructural control changes.

#### 4. Legal Structure

If one defines the legal structure of the corporation narrowly by reference to the contents of the corporation's articles and bylaws, shareholders have effective veto rights over changes in the corporation's legal structure. This definition explains veto rights over mergers, because most mergers on which shareholders have veto rights require amendments to articles.<sup>111</sup> In addition, this category includes dissolution because dissolution results in a termination of the corporation's legal status.

The sale of substantially all the corporation's assets, however, does not necessarily involve a change in the legal structure of the corporation. One should note also that shareholders do not have veto rights over changes in legal structure, if one defines that structure more broadly to include such subjects as forming subsidiaries or entering into long-term agreements.

#### 5. Conclusion

The terms "fundamental" and "organic" are not used properly to distinguish subjects on which shareholders do and do not have veto rights. One cannot fully describe shareholder veto rights by reference to the economic, operational, or control structure of the corporation. Shareholders do have veto rights over changes in legal structure if that structure involves only the corporation's articles and bylaws. Nevertheless, if one accepts this definition of legal structure, it does not explain veto rights with respect to a sale of substantially all corporate assets and express provisions granting shareholders veto rights over mergers, when a provision providing the right to vote on amendments to the articles would be sufficient.

#### *B. Explanations of Shareholder Veto Rights*

This subsection explores recent explanations of shareholder veto rights by important legal scholars. It also discusses explanations of appraisal rights because so-called fundamental changes often trigger these rights.

Dean Manning, in his influential 1961 article on appraisal rights, argued that existing shareholder veto rights on fundamental changes re-

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111. See SOLOMON et al., *supra* note 42, at 942.

late to changes in legal structure.<sup>112</sup> He noted that mergers, dissolutions, or article amendments cause trauma to the corporate "entity,"<sup>113</sup> resulting in its "assassination,"<sup>114</sup> "death,"<sup>115</sup> or the "amputating, or grafting on, [of] a limb,"<sup>116</sup> respectively. Arguing that shareholder rights are not based on changes in economic structure, he demonstrated that a person could not effectively distinguish among events for which shareholders had appraisal rights from a list of other possible transactions of equal or greater economic significance to the corporation for which shareholders had neither voting nor appraisal rights.<sup>117</sup> He opposed the extension of appraisal rights to transactions that were functionally equivalent to mergers,<sup>118</sup> but, expressing his dissatisfaction with the existing system of appraisal rights, advocated that legal scholars undertake a complete re-evaluation and reworking of the system on a functional economic basis.<sup>119</sup>

Professor Eisenberg, in his influential book *The Structure of the Corporation*, rejected Manning's claim that veto rights over "fundamental" changes involved transactions of legal rather than economic "structural" significance.<sup>120</sup> Professor Eisenberg emphasized the word "structure,"<sup>121</sup> which encompassed decisions affecting the "control apparatus" and the "structure of the business."<sup>122</sup> The "control apparatus" consisted of ground rules for control, such as cumulative voting and the election and removal of directors.<sup>123</sup> Although he did not define decisions affecting the "structure of the business," he distinguished these decisions from other business decisions involving matters outside the ordinary course of business by asking whether making these decisions required "invest-

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112. Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962). Dean Manning maintained that functional economic explanations of "fundamental" changes are bound to fail, because they impose a twentieth century conception of the corporation as a commercial enterprise on a scheme for appraisal rights that is the product of the early nineteenth century legal mind. *Id.* at 244-57.

113. According to Dean Manning, the early nineteenth century legal mind viewed the corporation "as something quite separate from the economic enterprise, three dimensional, virtually alive, a little bit sacred." *Id.* at 245.

114. *Id.* at 246.

115. *Id.* at 245, 250.

116. *Id.* at 251.

117. *Id.* at 241-44.

118. *Id.* at 257-60.

119. *Id.* at 260-62.

120. EISENBERG, *supra* note 66, at 75-77.

121. *Id.* at 15-16.

122. *Id.* at 16.

123. *Id.*

ment" skills or "business" skills.<sup>124</sup> Mergers and dissolutions required a shareholder vote because the skills required to make such decisions were similar to the skills needed to determine whether to "invest" in the business.<sup>125</sup> Professor Eisenberg considered these skills different from the "business" skills needed to make other decisions for the corporation that were outside the ordinary course of business.

While Professor Eisenberg did not argue for the limitation of shareholder voting rights to structural decisions in all cases,<sup>126</sup> he distinguished this class of decisions from all others based on "shareholder expectations" when decisions require different skills.<sup>127</sup> To the extent the law did not provide for appraisal rights for all types of economically significant structural changes, Professor Eisenberg suggested that it was not because appraisal rights rested on legal significance, but because legislatures had been remiss in keeping abreast of the different types of modern corporate transactions.<sup>128</sup> Unlike Dean Manning, Professor Eisenberg suggested statutory modifications to provide appraisal rights for transactions functionally equivalent to mergers.<sup>129</sup>

Professor Eisenberg's thoughtful response to Dean Manning is unpersuasive, however, when he distinguishes "structural" decisions from other business decisions that are also outside the ordinary course of business or, stated differently, when he indicates that the word "structural" is more useful than the terms "fundamental," "major," or "extraordinary" to explain shareholder veto rights.<sup>130</sup> First, this Article's analysis of the term "structure" demonstrates that "structure" does not distinguish between or identify those transactions over which shareholders do and do not have veto rights. This is true even if legislatures adopt the statutory modifications proposed by Professor Eisenberg to extend those rights to functionally equivalent transactions. Second, defining structural decisions by reference to investment or business skills also does not distinguish among such transactions. Investment skills are involved when a shareholder decides to invest in a corporation because of its policies with

124. *Id.* at 14-16.

125. *Id.* at 15. Professor Eisenberg explained:

[T]he skills involved in formulating a decision to merge with Corporation *B* or to liquidate Corporation *B* are similar to the skills involved in formulating a decision to invest in Corporation *B*, and are quite different from the skills needed to formulate an advertising campaign, conduct employee relations, or make steel.

*Id.*

126. *Id.* at 16, 68.

127. *Id.* at 12-16.

128. *Id.* at 75-76.

129. *Id.* at 249-50.

130. *Id.* at 16.

regard to such matters as leverage, dividends, and the nature of the corporation's business, matters over which shareholders have no veto rights. In addition, it is incorrect to characterize the decisions Professor Eisenberg attributes to managers as involving only business skills. Investment skills are also necessary to make important decisions concerning such matters as advertising, employee relations, and steel production.

Unlike Professor Eisenberg, Professors Easterbrook and Fischel, in a frequently cited 1983 article on voting rights,<sup>131</sup> did not focus on differing skills or "structure" to explain shareholder veto rights, but assumed that such rights are explained by the possibility of large gain or loss because of the size of a transaction.<sup>132</sup> For large transactions, shareholders have an incentive to overcome collective action problems.<sup>133</sup> Professors Easterbrook and Fischel expressed concern about the lack of expertise of "passive financial investors" to make "major business decisions," but concluded that shareholder veto rights are presumably efficient because of their durability and uniformity across state statutes.<sup>134</sup>

The incentive-residual rights theory<sup>135</sup> served as the foundation for the arguments of Professors Easterbrook and Fischel. This theory reasons that since shareholders have the greatest risk of loss among corporate constituencies, they are entitled to vote. It follows that the greater the risk to shareholders (the size of the transaction is only one indicator of risk), the more important voting becomes to them. Unfortunately, Professors Easterbrook and Fischel did not compare the economic significance of transactions that require a shareholder vote and those that do not.<sup>136</sup> For example, shareholders do not have the right to vote on the acquisition of substantial assets or the issuance of excessive debt. Professors Easterbrook and Fischel also did not explain why shareholders have the right to vote on some amendments to corporate articles and bylaws that do not involve the possibility of large gain or loss to shareholders. In addition, for reasons explored elsewhere,<sup>137</sup> also suspect is their evolutionary argument concerning the presumptive efficiency of existing shareholder veto rights.

In the context of a discussion of the de facto merger doctrine, Pro-

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131. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983) [hereinafter Easterbrook & Fischel, *Voting*].

132. *Id.* at 416.

133. *Id.*

134. *Id.*

135. Dallas, *supra* note 74, at 53-63.

136. This may be the case because Professors Easterbrook and Fischel do not acknowledge the prior debate on this subject. Easterbrook & Fischel, *Voting*, *supra* note 131, at 397-98.

137. Dallas, *supra* note 74, at 46-48.

fessor Gilson asserted in 1986 that the difficulties encountered by Dean Manning and Professor Eisenberg in explaining shareholder veto rights resulted from their narrow view of "corporate structure."<sup>138</sup> Professor Gilson maintained that "corporate structure" consists of the "interplay of statutory, judicial and market elements."<sup>139</sup> According to Professor Gilson, one should reference this structure, particularly market forces, to answer the question whether events that raise similar economic risks should be treated the same legally.<sup>140</sup> For example, shareholders of an acquiring corporation do not need appraisal rights, whereas shareholders of a selling corporation do, because management of the selling corporation will not be subject to the discipline of markets after the transaction (a final period problem).<sup>141</sup>

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138. RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 577-78 (1986).

139. *Id.* at 577. Professor Gilson also makes this point in Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 821-22 (1982) [hereinafter Gilson, *Shark Repellent*]; Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 848 (1981) [hereinafter Gilson, *A Structural Approach*].

140. GILSON, *supra* note 138, at 579.

141. *Id.* at 578-79. Professor Gilson also applies his analysis to explain why changes of control through tender offers should have different legal consequences (such as voting requirements) from changes of control through mergers and sales of substantially all corporate assets. His argument is based on the proposition that product, capital, and managerial markets mostly deal with managerial inefficiency, leaving the market for corporate control to discipline self-dealing. Gilson, *A Structural Approach*, *supra* note 139, at 839-40. If these other markets do not adequately discipline self dealing, the argument goes, the market for corporate control should be left largely unrestricted to do so. *Id.* at 846-48. Thus, changes of control through tender offers should be treated differently from changes of control in other ways. According to Professor Gilson, shareholder "autonomy" or individual decision making with respect to exit decisions should be the structural principle allocating roles in tender offers. *Id.* at 875-76. This argument rests on the premise that markets deal differently with self-dealing and managerial efficiency. According to Professor Gilson, "[i]ncentives to succeed in the product market are less likely to constrain managerial self-dealing, since what is of concern is management's ability to allocate to itself income generated through *successful* operation of the corporation's business." *Id.* at 839. As for capital markets, he claims that, although stock prices will be adversely affected by self-dealing, managers can finance business activities with retained earnings and debt. *Id.* Moreover, the managerial service market will not negatively view self-dealing, because the buyers in that market are also managers. *Id.* He further notes that, unlike managerial inefficiencies, self-dealing cannot be negated by diversification because it always favors managers. *Id.* at 839-40. Finally, the importance of the market for corporate control is stressed due to the inadequacy of judicial remedies for self-dealing transactions. *Id.* at 840.

While some of these arguments have initial appeal, they become less persuasive on closer examination. An increase in the cost of operations will impact on competitive ability in the product and capital markets, regardless of whether the source is inefficiency or self-dealing. An increase in costs will decrease retained earnings that could have been used for reinvestment in the operations of the corporation's business. Less profitability can impact on the corporation's ability to raise capital not only in the equity markets but in debt markets as well. In addition, the outside managerial market is dependent for the assessment of managerial per-

Professor Gilson's use of the overused and not highly explanatory term "structure"<sup>142</sup> as an integral part of his analysis is unfortunate. His attempt to explain shareholder appraisal rights by reference to the adequacy of judicial remedies or market forces is a valid hypothesis, although it does not provide an explanation for existing rules. Gilson explains the difference in appraisal rights between shareholders of the acquiring and selling corporations on the basis of whether management will or will not be subject to market forces after the transaction. In a sale of assets transaction, however, the final period problem arises for shareholders of the acquiring corporation when the consideration for the assets is a controlling block of stock, but appraisal rights are unavailable to them. Such analysis also does not explain the lack of appraisal rights for shareholders of the selling corporation when the consideration for the assets is cash.<sup>143</sup> For many transactions, moreover, appraisal rights are available for shareholders of both constituent corporations irrespective of which one management ultimately controls.<sup>144</sup> Explaining voting rights on the basis of the final period problem (or the absence of market discipline) also would not encompass shareholder veto rights for amendments to articles and bylaws. Professor Gilson's attempt to explain existing appraisal rights by reference to the final period problem does not have explanatory value. Nonetheless, a sensitivity to the interplay of statutory, judicial, and market forces assists conceptually in determining the appro-

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formance on stock prices which Professor Gilson acknowledges will be adversely affected by self-dealing. *Id.* at 838 n.72. Moreover, if self-dealing cannot be negated by diversification neither can managerial efficiency because, from the perspective of shareholders, whether the loss is frittered away, never made, or ends up in managers' pockets is immaterial. In addition, if the risk of mismanagement is systematic as has been suggested, John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 945-46 (1988), the risk cannot be negated by diversification. While the judicial remedy for self-dealing may be unsatisfactory, the judicial remedy for inefficiency (the business judgment rule) is more so. Finally, self-dealing and managerial inefficiency cannot be so readily separated because inefficiency may reflect other values of management. Although Professor Gilson recognizes this last point, he uses it only to demonstrate the inadequacy of the judicial remedy, Gilson, *A Structural Approach*, *supra* note 139, at 840, but it also undermines his market analysis.

If one were to accept Professor Gilson's argument that product, capital, and managerial markets do not deal well with self-dealing as opposed to managerial inefficiency, such an argument could support the conflict of interest voting system here proposed. The voting system proposed in this Article, however, is not based on this market analysis. It is based on the behavioral analysis that managers have additional incentives to misread exit messages and to approve transactions when their personal interests are thereby furthered.

142. See *supra* text accompanying notes 94-111.

143. *E.g.*, ARIZ. REV. STAT. ANN. § 10-080.A.2 (1990); N.Y. BUS. CORP. LAW § 910(a)(1)(B) (McKinney 1986 & Supp. 1992); REV. MODEL BUSINESS CORP. ACT § 13.02(a)(3) (1984). Net proceeds of the sale must be distributed to shareholders within one year from the date of sale.

144. DEL. CODE ANN. tit. 8, § 262 (c) (1991).



priate sphere of voting rights, as will be discussed in Part IV of this Article. The focus on conflicts of interest present in the final period is also important and is developed more extensively in Part VI.

As the preceding discussion demonstrates, shareholder veto rights are not based on a coherent system in which shareholders have the right to vote on fundamental or structural changes, variously defined. The next section of this Article explores modern conceptions of the corporation in connection with their significance for defining the subjects on which shareholders should have voting rights. Part IV develops the scope of shareholder voting rights under the power model by analyzing the value of voting by comparison with other methods for assuring accountability among shareholders, such as judicial action and market discipline. Parts V and VI discuss the proposed control and conflict of interest voting systems in detail.

#### IV. A THEORETICAL UNDERSTANDING OF VOTING IN THE CORPORATE SYSTEM

##### A. *Modern Conceptions of the Corporation*

Although corporate law scholars have long since abandoned the conception of the corporation as an entity, the current state voting scheme can still be traced to this concept.<sup>145</sup> Two modern conceptions of the corporation demand attention: the power coalition theory<sup>146</sup> and the "nexus of contract" or market theory.<sup>147</sup> Each has potentially different implications for shareholder voting. These new conceptions coincide with the changing perceptions of the corporation and the realities of today's corporate world.

The nexus of contract theory (or market theory) views the corporation as a nexus of contracting relations among individuals for whom management acts as agent.<sup>148</sup> Proponents of this theory generally favor

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145. During the 1930s, the corporation was reconceptualized as an "aggregation of its shareholders for whom management acted as trustee." Millon, *supra* note 4, at 203. This theory was the predecessor to the more modern nexus of contract theory. *Id.*

146. Dallas, *supra* note 74, at 25; Thomas L. Hazen, *The Corporate Persona, Contract (And Market) Failure, and Moral Values*, 69 N.C. L. REV. 273, 314-17 (1991).

147. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 778 (1972); Hazen, *supra* note 146, at 284-87; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. & ECON. 305, 310 (1976); Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

148. Alchian & Demsetz, *supra* note 147, at 778; Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1397 n.8 (1989); Jensen & Meckling, *supra* note 147, at 310; Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530, 1534 n.13 (1989).

permitting shareholders wide latitude in determining rules of internal corporate governance on a firm-by-firm basis.<sup>149</sup> These rules evolve as markets influence managers to put in place optimal governance structures. Private, rather than governmental rules, such as the federal proxy rules, govern the corporation.<sup>150</sup> Corporate law under this theory serves as a standard form contract or set of default rules that the parties can modify freely.<sup>151</sup> For example, shareholders may vote even to relieve directors of their fiduciary obligations.

Contrary to this description, some contractualists argue that certain legal rules cannot be modified by the parties, particularly after the corporation has shareholders.<sup>152</sup> Such conclusions follow even if the corporation's charter provides for such amendments. These arguments, however, do not support the conception of the corporation as a "nexus of contract"; rather, they demonstrate that this theory may not provide an accurate description of the corporation. Contracting does not occur effectively if, as these writers contend in justifying some mandatory legal rules, management controls the proxy machinery and parties are uninformed, rationally apathetic, and unable to price provisions accurately.<sup>153</sup>

The power coalition theory depicts the corporation as an institution whose behavior results from a contest for control among power coalitions which are comprised of groups of individuals.<sup>154</sup> This theory is based not on private contracting, but on power relationships resulting from social, cultural, political, legal, and economic developments.<sup>155</sup> The group or groups that emerge as dominant determine the institution's behavior.<sup>156</sup> The dominance of a group depends not on its stake or the nature of the group's interest in the firm, but rather on the firm's per-

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149. Bebchuk, *supra* note 148, at 1396 n.7; Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) [hereinafter Easterbrook & Fischel, *Corporate Contract*]; Easterbrook & Fischel, *Voting*, *supra* note 131, at 398; McChesney, *supra* note 148, at 1536-37.

150. Easterbrook & Fischel, *Voting*, *supra* note 131, at 418-26.

151. Bebchuk, *supra* note 148, at 1397; Easterbrook & Fischel, *Corporate Contract*, *supra* note 149, at 1444-46; McChesney, *supra* note 148, at 1535-37.

152. John C. Coffee, Jr., *The Mandatory/Enabling Balance In Corporate Law: An Essay on The Judicial Role*, 89 COLUM. L. REV. 1618, 1674-76 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1574-85 (1989). For arguments for mandatory rules for the publicly-held corporation, see Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1471-1515 (1989).

153. See *supra* note 152.

154. Dallas, *supra* note 74, at 30-31.

155. *Id.* at 26, 83-84, 97-99.

156. *Id.* at 31, 41-42.

ceived dependence on the group and the resources it provides.<sup>157</sup> The firm tends to act so as to decrease its uncertainty (or dependencies) by increasing its autonomy and discretion over its environment.<sup>158</sup> Corporate strategies for dealing with dependencies are numerous. Contracting is only one such method. Cooptation, which describes the shareholders' relationship with the corporation, is another.

Cooptation is "the process of absorbing new elements into the leadership or policy-determining structure of an organization as a means of averting threats to its stability or existence."<sup>159</sup> Shareholders are coopted or induced to invest in the corporation to assure its creation or continuance, and, in return, they assume a special role in the governance of the corporation. This participatory role can be effective or real (informal cooptation),<sup>160</sup> or largely illusory (formal cooptation),<sup>161</sup> in which case the participatory role may serve merely to legitimize managerial power to some relevant audience.<sup>162</sup>

Shareholder participation in corporate governance began in small corporations as a recognition of the firm's dependence on the resources provided by capital investors. As the public corporation grew less dependent on shareholders for capital, the importance of shareholders to the corporation became largely to establish legitimacy.<sup>163</sup> Basically, to avoid governmental interference with managerial discretion, the corporation needed to be perceived as private property with private owners in control.<sup>164</sup> That managers have considered voting merely a legitimating tool

157. *Id.* at 71-72, 82-84.

158. *Id.* at 30-31, 82-83.

159. PHILIP SELZNICK, *TVA AND THE GRASSROOTS: A STUDY IN THE SOCIOLOGY OF FORMAL ORGANIZATION* 13 (1966); JAMES D. THOMPSON, *ORGANIZATIONS IN ACTION* 35 (1967).

160. Dallas, *supra* note 74, at 92-93 & nn.281-88.

161. *Id.*

162. *Id.* at 92 n.282.

[W]hen the legitimacy payoff is with a broader audience than the coopted group, the audience is "less likely to critically examine the meaningfulness of expanded participation." This is especially true in the case of shareholder participation in which the public at large [rather than the shareholders] is the relevant audience.

*Id.* at 96 (quoting MICHAEL G. LACY, *COOPTATION: ANALYSIS OF A NEGLECTED SOCIAL PROCESS* 73 (1977)).

163. *Id.* at 93-94.

164. I have previously noted that:

This legitimation derives from three sources. The first source resides in the American respect for private property. Shareholders are generally perceived by the public to be "owners" of the corporation and, therefore, ultimately in control of its activities. Managers, thus, can argue persuasively against governmental interference by relying for legitimacy on arguments relating to the private control of property. The second source of legitimacy rests on the efficiency argument—made by the residual

is evidenced by their desire to avoid real shareholder voting control by proposing dual class capitalizations (placing nonvoting common stock in public hands)<sup>165</sup> and even lobbying state legislatures for provisions that shareholders might not approve.<sup>166</sup> These strategies, however, have undermined the legitimacy of the system, resulting in reexamination of corporate governance in the 1990s.<sup>167</sup>

With the increased activities of corporate raiders and institutional investors, managers found that cooptation is a "two-edged sword."<sup>168</sup> A legitimating device such as voting that brings a group into the policy-making structure of an organization has the potential to provide a real or effective means of participation. For example, despite substantial obstacles to shareholder participation,<sup>169</sup> institutional investors have become increasingly active. This development has been documented extensively elsewhere and, therefore, will not be reviewed here<sup>170</sup> other than to note that increased institutional holdings by certain kinds of institutions (such as public pension funds) have resulted in the transformation of a formal cooptative situation into an informal one.

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rights theorists—that owners have the greatest incentive to utilize corporate resources efficiently, which redounds to the benefit of society. A mechanism for owner participation in decision making thus provides a social reason for combating interference by government in managerial decision making. The third source of legitimacy is the comfort obtained from a system of "checks and balances"—fundamental to the American understanding of justice—whereby managers are perceived to be checked by shareholder participation. It is generally considered beneficial for those holding positions of power to be held accountable to some group or groups other than themselves. That management is purportedly held accountable to shareholders serves to legitimate its exercise of power. Shareholder participation has thus provided the ideological justification for managerial power. Such a justification is particularly important for the large corporation because of the scope of its control over decisions affecting the community at large.

*Id.* at 94-95 (footnotes omitted).

165. Gordon, *supra* note 152, at 1563, 1577-79.

166. Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 129-31 (1987) (arguing that managers have lobbied for provisions in state takeover statutes that shareholders would not approve if subject to their vote).

167. This was the focus of the recent meeting of the Business Section at the Annual Meeting of the Association of American Law Schools held in San Antonio, Texas (Jan. 3-7, 1992), and is reflected in a number of recent law review articles. *E.g.*, Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Martin Lipton & Stephen A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

168. Dallas, *supra* note 74, at 96 & n.302.

169. Black, *Shareholder Passivity*, *supra* note 67, at 530-66, 595-607; Conard, *supra* note 72, at 146-63; Roe, *supra* note 72, at 17-31.

170. Black, *Shareholder Passivity*, *supra* note 67, at 570-75; Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 157-63 (1988).

*B. The Appropriate Scope of Shareholder Voting Rights*

Both the power coalition and nexus of contract theories differ from the entity theory in that they highlight conflicting interests within the firm. Although voting on "fundamental" changes by a majority of shareholders is compatible with the entity theory, a more complex voting system that focuses on control and conflict of interest transactions is arguably more consistent with these new conceptions of the corporation.

Conflicts and control struggles within the firm exist on a large scale in the modern corporate world. Examples include conflicts between managers and shareholders, between controlling and minority shareholders, and between shareholders and other constituencies, such as debtholders and employees. While these conflicts have always been latent, tender offers and buy-outs have brought them into stark relief. In addition, the increased activism of institutional investors<sup>171</sup> reveals that these investors perceive important conflicts between managers and shareholders; they are increasingly unwilling to trust that managers will act in their best interests.

Although the nexus of contract theory focuses on conflicting interests, often referred to as "agency costs,"<sup>172</sup> the voting systems proposed in this Article are not fully compatible with that theory. The proposed systems require a set of rules which govern control and conflict of interest situations that cannot be changed by the parties. In contrast, the nexus of contract theory permits the parties to make any change in rules. Markets impacting on managers determine the appropriate legal rules. Some contract theorists may argue that because substantial market pressures are necessary to force managers to develop rules that are contrary to their more direct interests, the control or conflict of interest voting system proposed in this Article should be adopted. The systems address special situations where the market fails, and, thus, legal intervention is indicated. These arguments, however, merely illuminate the limitations of the contractualist's theory.

The focus on control and conflict of interest situations is fully consistent with the power coalition theory. The legal system focuses logically on changes of power within the enterprise and instances where one party seeks to advance his or her own interest at the expense of another. The systems of voting proposed in this Article are designed to prevent

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171. Black, *Shareholder Passivity*, *supra* note 67, at 570-75.

172. Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1427 n.61 (1985); Robert C. Clark, *Agency Cost Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 77 (John W. Pratt & Richard Zeckhauser eds., 1985).

overreaching and to assure a degree of accountability for any group seeking changes that serve its interests.

In addition, consistent with the focus on power relationships, importance is assigned to different methods, referred to as spheres of accountability, for assuring that those in power act responsibly: voting, markets, and judicial action. This article posits that each of these spheres should operate separately without undue encroachment by the others because each has unique advantages and disadvantages. The three spheres operating independently provide a system of checks and balances. As this country's founders correctly observed, accountability can be served by three branches of government operating in the same terrain but differently. "Free contracting," which, for example, would permit opting out of fiduciary duties, pays too little attention to this political system of checks and balances in the corporate governance system.

The next section assesses the value of voting as a decision-making mechanism compared to other spheres' effectiveness in assuring accountability. One should note that the systems of voting proposed in this Article will not necessarily expand shareholder voting rights, but will change the situations which require a shareholder vote and the kind of vote that is appropriate. This discussion will be followed in Parts V and VI with a detailed delineation of the proposed voting systems, the control and conflict of interest voting systems.

### 1. Voice and Exit as Decision-Making Mechanisms

Market theorists have focused their criticisms of voting as a decision-making mechanism on collective action and free rider problems.<sup>173</sup> Many argue that small shareholders are rationally apathetic about voting. Because of their small investments and inability to obtain reimbursement from the corporation or other shareholders for their costs of becoming more active, they lack the incentive to develop the expertise, spend the time, or incur the costs to vote and participate intelligently in corporate governance. Nevertheless, voting would appear to be superior to managerial fiat in control and conflict of interest situations, and also might provide benefits not attainable by relying on markets. Some have criticized markets, for example, as the sole source of optimal governance arrangements.<sup>174</sup>

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173. *E.g.*, Easterbrook & Fischel, *Voting*, *supra* note 131, at 402-03; Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 821 (1992) [hereinafter Black, *Agents Watching Agents*]; *see also* Coffee, *supra* note 70, at 1317-28 (listing extra-legal causes of shareholder passivity).

174. *E.g.*, Dallas, *supra* note 74, at 59-62, 66-68; Eisenberg, *supra* note 152, at 1488-1514.

At the heart of the collective action problem is shareholder apathy. It should be stressed, however, that apathy is an important part of any political system because it contributes to stability.<sup>175</sup> That apathy can quickly change to activism when conditions warrant it demonstrates amply the value of the limited voting rights that shareholders possess. The recent activity of institutional investors and institutional investor associations<sup>176</sup> demonstrates that this change to activism can occur in the corporate governance area. This activism is particularly significant because it has occurred despite limited voting rights,<sup>177</sup> managerial control of the proxy machinery,<sup>178</sup> and the conflict of interest of certain institutional investors.<sup>179</sup> Had the federal proxy mechanism been disbanded, these institutional investors and associations would have lacked an important access route to influence managerial behavior.

Also, focusing on the apathy of shareholders draws attention away from the effect of voting rights on managerial behavior. The value of voting, in part, reflects the effect that access and disclosure, or the threat thereof, have on managerial decisions. Even advisory voting confronts managers with the reality that their decisions may be brought to the attention of shareholders and subjected to their scrutiny. The appearance of rubber stamp voting does not diminish the importance of voting.<sup>180</sup> Managers often consult large shareholders in advance<sup>181</sup> and are unlikely to propose transactions that shareholders will not approve.<sup>182</sup> Moreover, focusing solely on shareholders' proposals that have been submitted to a vote effectively neglects those proposals withdrawn by shareholders because management agrees to their implementation.<sup>183</sup>

With respect to the lack of incentive shareholders have to develop expertise, shareholders with voting rights are able to determine whether to decide an issue themselves or to defer to management. By voting against a shareholder proposal, or not voting at all, they defer to manage-

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175. ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* 14 (1970).

176. See *supra* note 169 and accompanying text.

177. See *supra* text accompanying notes 54-64.

178. See *supra* text accompanying notes 65-72.

179. See Black, *Shareholder Passivity*, *supra* note 67, at 595-608; Coffee, *supra* note 70, at 1321; Conard, *supra* note 72, at 146-48; Roe, *supra* note 72, at 54.

180. Richard A. Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635, 1683 (1988).

181. *Id.*

182. *Id.*; Ryan, *supra* note 170, at 177 & n.32.

183. See Black, *Agents Watching Agents*, *supra* note 173, at 847-48. But see George W. Dent, Jr., *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1, 21-22 (1985) (arguing that shareholder proposals that are not passed rarely prompt change); Susan W. Liebler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425, 450-52 (1984) (same).

ment. Opponents of shareholder proposals are fearful that shareholders will vote in favor of an action that would, if decided by directors, result in directors breaching their fiduciary obligations. This fear is not well founded,<sup>184</sup> however, mainly because of the broad discretion given to directors under the business judgment rule. Nevertheless, courts or legislatures could address such a concern by providing a standard of directorial conduct in situations where corporate action has been directed by shareholders. In this way, the directors also would remain responsible for corporate actions.<sup>185</sup> A proposed standard would require directors to implement a shareholder resolution when, in their business judgment, a reasonably prudent director could adopt it.<sup>186</sup>

In addition, the increasing participation by institutional investors affects informed voting positively. Shareholders have formed associations to provide information to institutional investors on voting matters.<sup>187</sup> A critical mass of institutional investors may now exist who can influence corporate governance.<sup>188</sup> In the past shareholders arguably may have been inclined to become more informed when selling shares than when voting those shares. The force of this argument is diminished by the size

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184. No-action letter files are replete with letters from management arguing under the ordinary business exclusion that a shareholder's proposal might force directors to breach their fiduciary duty because the proposals may not, in the judgment of the directors, be in the best interest of the corporation. *E.g.*, Shareholder Proposal of Dirk W. Van De Graaf, Letter of Gaston & Snow, Mar. 7, 1990, available in WESTLAW, FSEC-NAL database; Baltimore Gas & Electric Co., Letter of David A. Brune, Feb. 6, 1990, available in WESTLAW, FSEC-NAL database; American Brands, Inc., Letter of Chadbourne & Park, Feb. 22, 1990, available in WESTLAW, FSEC-NAL database. Similarly, early cases involving the enforceability of shareholders' agreements were concerned that constraining managerial discretion by enforcing the terms of such agreements would threaten directors' independence, and lead to breaches of their fiduciary duties to act in the best interest of the corporation. *West v. Camden*, 135 U.S. 507, 514, 520, 523 (1890); *Jackson v. Hooper*, 76 N.J. Eq. 592, 602, 75 A. 568, 573 (1910); *Creed v. Copps*, 152 A. 369, 370 (Vt. 1930); 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 5.20, at 91-92 (3d. ed. 1987).

185. The directors should remain responsible for the activities of the corporation, particularly when it is a publicly-held corporation. The shift in control through a shareholders' directive is not so dramatic as a provision in the articles of incorporation of a closely-held corporation providing that the corporation shall be managed by shareholders rather than by a board of directors. In such cases, shareholders are subject to the liability of directors. *E.g.*, DEL. CODE ANN. tit. 8, § 351 (1991). By providing for the exercise of judgment by directors of a shareholders' directive under the standard of review proposed, responsibility remains properly centralized in management.

186. The business judgment rule can be applied in the absence of evidence of self-dealing. The case would explore whether the directors who decided to implement the shareholder's resolution were grossly uninformed and had no rational basis for believing that a reasonably prudent director could have adopted the course of action directed by shareholders. The business judgment rule is discussed in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

187. Black, *Shareholder Passivity*, *supra* note 67, at 573; Conard, *supra* note 72, at 143-44.

188. Black, *Shareholder Passivity*, *supra* note 67, at 524, 567-70.



of institutional holdings<sup>189</sup> and economies of scale<sup>190</sup> in proposing resolutions to a number of companies. As for the capabilities of institutional investors, these institutional investors are the same investors on whom market theorists rely to provide informed markets.

The above discussion does not deny the importance of collective action problems. Indeed, they are important, as are legal impediments to shareholder voting<sup>191</sup> and conflict of interest problems.<sup>192</sup> Nevertheless, voting is at least an equally valuable method of assuring managerial accountability when compared to exit, as the following discussion will further demonstrate.

In the economic arena, a bias exists in favor of exit over voting or voice.<sup>193</sup> Critics view voice in the realm of the political and as disruptive and inefficient.<sup>194</sup> Even those recognizing the value of voice often perceive its value only when the market fails. To the contrary, as the first point below demonstrates, it is valuable to ensure a corporation's responsiveness to shareholders even when the market prices shares accurately. In addition, voice may be under-utilized when it is more efficient than exit in encouraging such responsiveness.

In the economic arena, arguments concerning the superiority of exit to voice have been confined largely to consumer goods; the same arguments, however, do not necessarily apply to stock. For example, some have claimed exit shows preferences more directly than voice. Market choices are perceived to be finer and more articulate.<sup>195</sup> While this argument may be somewhat persuasive with respect to simpler products—although even here exit does not convey whether the dissatisfaction is with price, quality in performance, or aesthetics—the message given to management through selling or not buying more complex products is unclear. The ambiguity of the message is particularly severe with respect to stock, which reflects an investment in a vast enterprise.

An economist might respond that the message simply is that the

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189. *Id.*

190. *Id.* at 524, 580-84.

191. See *supra* note 169 and accompanying text.

192. Black, *Shareholder Passivity*, *supra* note 67, at 595-608; Conard, *supra* note 72, at 139-52.

193. HIRSCHMAN, *supra* note 175, at 16-17; Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671, 1673 (1985).

194. HIRSCHMAN, *supra* note 175, at 17; Dent, *supra* note 183, at 14-16; Liebler, *supra* note 183, at 438-39, 454.

195. HIRSCHMAN, *supra* note 175, at 17; James M. Buchanan, *Individual Choice in Voting and the Market*, 62 J. POL. ECON. 334, 341 (1954). But see ROBERT A. DAHL & CHARLES E. LINDBLOM, *POLITICS, ECONOMICS AND WELFARE* 422-27 (1976) (noting the "shortcomings of market choice" and "the badly calculated choices of individuals in the market").

shareholder is dissatisfied with the expected return on her investment; by the mere act of selling, the shareholder does not convey her assessment of the manner in which the company has erred. Management may misread her assessment in the absence of voice. This misreading may be particularly likely with respect to control matters or to matters involving a managerial conflict of interest, such as a corporation's adoption of a large golden parachute contract for senior executives. Moreover, management may not discern the shareholder's social responsibility messages, such as dissatisfaction with a company's business in South Africa, its treatment of minorities, or the effect of its business practices on the environment.

So, as the product purchased becomes more complex, the message given to management through exit becomes less precise. Voting is an alternative to exit permitting a direct and more articulate expression of preferences. The value of voting in this regard exists regardless of the market's ability to price shares accurately.

Commentators praise exit as being less coercive than voting and more responsive to individual and differentiated concerns.<sup>196</sup> A person can, as an individual, choose whether or not to exit; a majority vote, however, will bind the minority as well. Exit therefore is viewed as consistent with the normative principle of shareholder autonomy.<sup>197</sup> When one takes into account the ambiguity of the message provided by exit, however, voting provides shareholders the opportunity for a wider range of expression. A system that encourages activities desired by some persons inevitably will restrict the choice of others. This result follows whether exit or voice drives the system.

One can argue that while voting provides a wider range of choices with respect to the policies and activities of a particular corporation, exit provides a wider range of choices among corporations. Primary reliance on exit encourages persons to migrate to corporations with policies they prefer; different persons will migrate to different corporations. The majority voting construct does not give persons holding majority views the incentive to exit; rather they will impose their views on corporations through voting. All corporations eventually will reflect the same general views; shareholders with less widely held views will not find compatible corporations in which to invest.

Two problems arise with this argument, aside from its debatable assumption concerning efficient markets. First, exit is an imperfect mechanism for the expression of approval or dissent on a wide range of issues.

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196. Buchanan, *supra* note 195, at 339.

197. Cf. Gilson, *A Structural Approach*, *supra* note 139, at 869 (preferring shareholder autonomy in tender offers).

Shareholders may choose one corporation over another because they prefer on balance the policies of that corporation. This choice means that they may actually prefer some policies of the corporation from which they exit. Exit does not provide a means for shareholders to endorse the positive policies of the corporation they leave or to disapprove those policies of the corporation in which they then invest.

Second, the ambiguity of the messages sent by exit provides management with leeway to avoid responding to shareholders' concerns. This lack of responsiveness will be more likely with respect to certain policies that benefit management, or with which management has a conflict of interest. Voting, therefore, generally provides a wider range of choices for shareholders and fosters greater managerial accountability.

The exit option also has drawbacks from the standpoint of coercion in the tender offer context. Although all shareholders may favor existing management, they may nevertheless sell their shares at a premium to a bidder because they fear that other shareholders will tender their shares to the bidder,<sup>198</sup> leaving remaining shareholders with lower-valued minority shares in a corporation controlled by the bidder. Collective decision-making in this change of control context can free the individual shareholder from the coercive aspects of exit.<sup>199</sup>

Another claimed advantage of exit is that an individual is more likely to consider alternative costs when making a decision to exit than when participating through voting in collective decision-making.<sup>200</sup> The responsibility of making the decision to exit rests solely with the individual. For this reason, Von Mises, in speaking of the advantages of the market over the democratic voting process, claimed that the market is "less corruptible."<sup>201</sup> This argument is less significant, however, in the shareholder voting context because, assuming the shareholder becomes informed,<sup>202</sup> the economic impact of voting decisions on the shareholder should be readily apparent to him. The shareholder owns a proportionate interest in the enterprise, and the Securities and Exchange Commission requires disclosure to him of economic consequences.

The costs considered by the shareholder when voting may be in fact

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198. Lucian A. Bebchuk, *The Pressure to Tender: An Analysis and A Proposed Remedy*, 12 DEL. J. CORP. L. 911, 923, 926 (1987); Booth, *supra* note 180, at 1646-47, 1683; Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 307-09 (1983).

199. Bebchuk, *supra* note 198, at 931-32, 934-35; Booth, *supra* note 180, at 1683.

200. Buchanan, *supra* note 195, at 337, 340.

201. LUDWIG VON MISES, SOCIALISM 21 (1951) (contending that "[t]he average man is both better informed and less corruptible in the decisions he makes as a consumer than as a voter at political elections").

202. See text accompanying notes 188-90.

more extensive than those considered by the shareholder when exiting. Professor Buchanan argues that decision-making through voting may broaden a person's identification, resulting in decision-making based on a more inclusive value scale.<sup>203</sup> If that is the case, voting may be particularly preferable to exit when the issue involves the internalization of external costs. Because the method chosen may affect the quality of decision-making or the costs taken into account, voting may better address corporate social responsibility issues than exit.

In a similar vein, commentators argue that a shareholder's decision to exercise voice through the submission of a proposal under the federal shareholder proposal rule may not take into account the cost to the corporation of including the proposal in its proxy statement.<sup>204</sup> Other shareholders, who subsidize the individual's expression of concern, do not benefit because most shareholder proposals do not obtain sufficient favorable votes.<sup>205</sup> Exit is preferable because, with respect to that decision, the unhappy individual shareholder bears all the costs. The federal shareholder proposal rule, however, addresses the collective action problem that plagues shareholder voting by decreasing the individual shareholder's cost of participation. The costs of the system are not large in absolute terms,<sup>206</sup> and, as a method of demonstrating dissatisfaction, it is much less costly than the market's ultimate weapon: the takeover.<sup>207</sup> Individual exit itself is not inexpensive because commissions and tax consequences must be taken into account.

Further differences between exit and voice are important. First, exit provides choices that are limited to existing alternatives,<sup>208</sup> whereas voice provides a mechanism for choosing among future courses of action.<sup>209</sup> Shareholders may exit when a corporation has entered into an unfortunate transaction, but they suffer losses on the sale of their shares. If shareholders can vote in advance on the transaction, their vote may prevent or alter it. Moreover, the specter of shareholder voting causes man-

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203. Buchanan, *supra* note 195, at 336-37, 342.

204. Dent, *supra* note 183, at 14; Liebler, *supra* note 183, at 438-39.

205. Dent, *supra* note 183, at 12; Easterbrook & Fischel, *Voting*, *supra* note 131, at 423; Liebler, *supra* note 183, at 438-41, 467.

206. Dent, *supra* note 183, at 14, 38; Liebler, *supra* note 183, at 454.

207. Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1425-26 (1985); Louis Lowenstein, *Hostile Takeovers: A Remedy of First Report or Last Resort*, 15th ANN. SEC. REG. INST. 9 (1988). Costs of tender offers include share acquisition costs, legal and other professional costs, and costs of solicitations and advertisements. See Lowenstein, *supra* at 31 ("At an average of roughly four percent of transaction values, the fees [for takeovers] have been aggregating about \$6-7 billion a year.").

208. VON MISES, *supra* note 201, at 271.

209. HIRSCHMAN, *supra* note 175, at 16, 38, 43; Buchanan, *supra* note 195, at 339.

agers to consult shareholders before proposing certain transactions.<sup>210</sup> Consultation is less likely to occur if the shareholders' only recourse is exit.

Second, relying on exit as a decision-making mechanism has the perverse effect of encouraging activities favored by those persons who are no longer affiliated with the corporation.<sup>211</sup> Once enough shareholders have left because of dissatisfaction with the corporation, the market effect of their exit arguably causes their views to be considered by management. In contrast, voting permits the expression of choices by shareholders who have a continuing stake in the enterprise.

Finally, the corporation benefits if shareholders exercise voice rather than merely exiting, which could create financial difficulties for the corporation. Thus, the corporation may be better served by viewing exit, rather than voice, as a last resort.<sup>212</sup>

The more ready acceptance of exit by shareholders confirms Professor Hirschman's observation that individuals may be better served through one mechanism rather than another, but that they nevertheless choose not to use the better one.<sup>213</sup> He gives, as a classic example, shareholders' reaction to a corporation's economic difficulties. In his view such difficulties ordinarily trigger exit, when in fact management is more sensitive at those times to voice.<sup>214</sup> He further notes that the mechanism less used will be routinely undervalued.<sup>215</sup>

The explanation for the use of exit may reside in the observation that the easier it is to exit, the less shareholders will use voice (although, ironically, that is also when voice is most effective).<sup>216</sup> The difficulty of disposing of large blocks of stock and indexing<sup>217</sup> provide possible expla-

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210. Ryan, *supra* note 170, at 177 n.312.

211. HIRSCHMAN, *supra* note 175, at 46-47.

212. *Id.* at 253-54; Buchanan, *supra* note 195, at 338-39.

213. HIRSCHMAN, *supra* note 175, at 122.

214. *Id.*

215. *Id.* at 80-81, 125.

216. *Id.* at 82-83.

217. Institutional shareholders who index funds (such as CalPERS) may be viewed as long-term investors. See Black, *Agents Watching Agents*, *supra* note 173, at 882. As long-term investors, they may have a greater incentive than traders to monitor the performance of corporations in the index. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 863-64 (1991); Bevis Longstreth, *Reflections on the State of Corporate Governance*, 57 BROOK. L. REV. 113, 118-19 (1991) (citing position of CalPERS). *But see* Coffee, *supra* note 70, at 1341 (arguing that index managers have little reason to monitor because of "radical cost economizing" due to fierce competition among index managers); Louis Lowenstein, *Index Investment Strategies and Corporate Governance*, 1991 ANNUAL COLLOQUIUM ON CORPORATE LAW AND SOCIAL POLICY 1, 13-17 (providing reasons why most indexes prefer to sit "on their hands").

nations for the increasing use of voice by institutional investors.<sup>218</sup> As institutional investors gain experience with this mechanism, they may use voice more frequently. Even so, the legal limitations on shareholder voting<sup>219</sup> and conflicts of interest of institutional shareholders<sup>220</sup> limit to some degree its more extensive use.

The comparison of exit and voice demonstrates that voting is particularly useful in certain circumstances. First, voting on specific topics is desirable because of the ambiguity of the message inherent in exit. If the shareholders' dissatisfaction is general and nonspecific, however, exit may be more appropriate, depending on one's assessment of the efficiency of markets in disciplining managers. Second, shareholder voting is preferable to exit on control issues (such as cumulative voting provisions) and conflict of interest issues (such as executive compensation and interested transactions). Because of the ambiguity of the message given by exit, managers are likely to resist interpretations that will result in changes that may adversely affect them. Third, having shareholders vote on changes of control can lessen the coercive aspect of exit in the tender offer context. Control share acquisition statutes recently adopted by a number of states contain such voting rights.<sup>221</sup> Finally, voting is particularly useful when making decisions on a more inclusive value scale is desirable. Thus, voting on social responsibility proposals is better than exiting, even though voting by shareholders on these issues was one of the last areas to receive the Commission's support. One should also note that voting is more important in closely-held corporations because exit is more difficult.

## 2. Comparison of Voting and Judicial Oversight of Corporate Behavior

Voting and judicial action provide needed checks and balances on the corporate governance system that management administers. This section compares these spheres of accountability.

Both voting and judicial oversight have advantages. Voting permits shareholders to review a transaction in advance and requires disclosure before a transaction becomes binding.<sup>222</sup> Judicial oversight occurs after the fact, but it permits consideration of the nature of the power relationship between the parties and the evaluation of unanticipated problems.

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218. Conard, *supra* note 72, at 145 n.92.

219. See *supra* text accompanying notes 52-76.

220. See *supra* note 72 and accompanying text.

221. See *supra* notes 77-80.

222. Lowenstein, *supra* note 198, at 317, 330.

Each method also has disadvantages that are, in part, offset by the availability of the other to assure accountability. For example, voting is permitted only on certain subjects,<sup>223</sup> but any transaction may warrant judicial oversight. Voting suffers from collective action problems and is plagued by managerial domination of the proxy machinery. Judicial oversight, however, protects shareholders from overreaching by management.

Judicial oversight has its own problems, including numerous procedural obstacles such as demand requirements<sup>224</sup> and motions to dismiss by litigation committees.<sup>225</sup> It becomes substantially illusory when courts apply the business judgment rule<sup>226</sup> and is expensive and time consuming. Voting, however, particularly under the control and conflict of interest voting systems proposed in this Article, decreases the necessity of judicial oversight by permitting shareholders to review important transactions before they occur, especially in situations where breaches of duty are most likely to happen or where the potential harm to shareholders may be most severe.

### 3. Separate Operation of Spheres of Accountability

Judicial oversight, markets, and voting rights serve as important checks and balances in the corporate governance system. No method of accountability should readily restrict the others. For example, shareholders should not vote to relieve directors of their fiduciary obligations or vote to restrict unduly the operation of markets.

At first glance, it may seem inconsistent to advocate voting rights for shareholders generally, but to prohibit shareholder voting on most resolutions that would limit the fiduciary duties of managers.<sup>227</sup> Voting rights for shareholders, however, generally increase the accountability of managers. This result is consistent with the purpose of voting rights. But permitting shareholders to relieve directors of fiduciary obligations

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223. See *supra* text accompanying notes 42-49; see also Parts V and VI, *infra* notes 229-320 and accompanying text (concerning the voting rights included in the control and conflict of interest voting systems).

224. See, e.g., *In re Kaufman Mut. Fund Actions*, 479 F.2d 257, 262 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Aronson v. Lewis*, 473 A.2d 805, 809-10 (Del. 1984).

225. See, e.g., *Zapata Corp. v. Maldonado*, 430 A.2d 779, 783-84 (Del. 1981); *Auerbach v. Bennett*, 47 N.Y.2d 619, 623-24, 419 N.Y.S.2d 920, 922, 393 N.E.2d 994, 996 (1979).

226. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1985); *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

227. This discussion is not only relevant to statutes permitting directors to be relieved of their duty of care, but to cases that apply a lesser fiduciary duty standard because a shareholder vote has been taken. See, e.g., *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 177, 178-79, 91 A.2d 57, 58 (1952).

would serve to decrease the accountability of managers. When one accepts the value of having checks and balances in the corporate system, one can be less concerned with the disadvantages of voting when voting operates to increase accountability, but be more concerned with those disadvantages when decreased accountability results. Of course, another reason for not permitting shareholders to vote to relieve directors of their fiduciary obligations is that third parties, such as debtholders and employees, also benefit from directors' meeting certain fiduciary obligations.<sup>228</sup>

Where the adoption or deletion of shareholder voting provisions impacting market operations would increase accountability, the advantages of voting should receive greater weight. When such provisions would decrease accountability, however, the disadvantages of voting assume more importance. Of course, whether accountability is affected substantially depends on one's assessment of the value of markets and judicial action and the provision's effect on the operation of these spheres.

#### V. REWORKING SHAREHOLDER VETO RIGHTS UNDER STATE LAW: THE CONTROL VOTING SYSTEM

A voting system constructed under the umbrella concept of control is consistent with modern conceptions of the corporation and the current corporate environment. This umbrella concept provides a more workable framework than a "risk of loss" umbrella under which voting rights depend on a proposed transaction or provision change's effect on the risk of a shareholder's investment. It is exceedingly difficult to determine the effect on risk of different kinds of transactions and provision changes.<sup>229</sup> In addition, the impact on risk of similar transactions or provision changes can vary for different corporations and for the same corporation

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228. Under the residual rights theory, for example, control by shareholders is justified on the basis that shareholders as residual owners have the greatest incentive to maximize the value of the firm. Dallas, *supra* note 74, at 49-63. Of course, the argument would be that they maximize the value of the firm by relieving directors of some fiduciary obligations.

229. An effort to tie shareholder veto rights to the effect a transaction has on the systematic risk of a shareholder's investment in a company is consistent with the positions of Professors Manning and Eisenberg on appraisal rights. Even so, tying voting rights to alterations of the beta of a corporation's stock (or its sensitivity to systematic risk) by more than, say twenty-five percent, is unworkable. GILSON, *supra* note 138, at 573-77. Numerous factors affect systematic risk, making measurement of changes in beta difficult and unrealistic. Although perfection in a voting scheme cannot be expected, a voting system based on the degree of risk requires too many difficult valuation judgments that would need to be made for each corporation. For example, what impact does a decision to list or de-list the corporation's stock on a national stock exchange or to adopt cumulative voting have on the beta of the corporation's stock? Moreover, these questions are based on the debatable assumption that the beta of the corporation's stock is stable over time. *Id.* at 577.



at different times. This observation does not imply that one can always identify control changes (and conflict of interest transactions) easily. Nevertheless, a comprehensive, consistent, uniform system of shareholder voting rights can best be based on control and conflict of interest concepts. These concepts also focus on matters of special economic significance. As this Article will discuss later, the risk of loss concept, however, has some limited use within the control and conflict of interest voting schemes, to limit further voting rights.<sup>230</sup>

### A. *Evolving Trend to Focus on Control Changes*

Support exists for providing special legal rules for control changes in statutes, legal reform proposals, and judicial opinions. In fact, one can discern an increasing tendency by state legislatures and scholars to focus on protecting shareholders in control change situations. Control changes are central to statutory merger provisions adopted in a number of states in accordance with the Revised Model Business Corporation Act (RMBCA), which deny shareholders of the surviving corporation voting and appraisal rights if their corporation's articles of incorporation remain unchanged and their corporation does not issue more than twenty percent of its outstanding voting stock in the merger.<sup>231</sup>

The official comment to this RMBCA provision,<sup>232</sup> however, does not acknowledge explicitly the provision's main focus on control (here vote dilution). It states that the "theory behind this [modification] is that shareholders' votes should be required only if the transaction fundamentally alters the character of the enterprise or substantially reduces the shareholders' participation in voting or profit distribution."<sup>233</sup> Contrary to this language, the provision does not require a shareholder vote on a transaction that "fundamentally alters the character" of the surviving corporation, such as a merger in which the surviving corporation issues debt securities, property, or cash to acquire another corporation's business, or where the consideration given equals or exceeds the value of twenty percent of the voting stock of the surviving corporation. In addition, this provision does not require a vote for a merger that substantially reduces the earnings of the corporation available for "profit distribution," such as a merger in which a corporation assumes a substantial amount of debt to acquire another corporation. Thus, the underlying rationale of this provision is that voting is required on mergers that sub-

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230. See *infra* Part VI E.

231. REV. MODEL BUSINESS CORP. ACT § 11.03(g) (1984); see DEL. CODE ANN. tit. 8, § 251(f) (1991); CAL. CORP. CODE § 1201 (West 1990) (16 2/3%).

232. REV. MODEL BUSINESS CORP. ACT § 11.03 cmt. 2 (1984).

233. *Id.*

stantially reduce the shareholders' "participation in voting." Not only does the RMBCA fail to acknowledge fully the importance of this dilution principle to its modification, but it does not provide for voting rights in all situations where such a dilution occurs. For example, with a triangular merger<sup>234</sup> it is possible to deny voting rights to shareholders notwithstanding a substantial dilution of their voting rights.

The American Law Institute's tentative draft of the *Principles of Corporate Governance (ALI Draft)*<sup>235</sup> represents a further evolution of the focus on control changes. Section 6.01 of the *ALI Draft* recommends that shareholders vote on "control transactions."<sup>236</sup> This is designed generally to cover transactions in which corporate entities sell, acquire or combine assets or businesses<sup>237</sup> and to address the substance of a transaction (for example, whether dilution has occurred) rather than its form.<sup>238</sup> Unlike the system of voting proposed in this Article, section 6.01 is limited in scope and does not appear to adhere consistently to the change of control concept. This may, in part, be due to the *ALI Draft*'s numerous revisions, resulting in a document consisting of an amalgam of views of various drafters and the ALI membership. Section 6.01 applies only to transactions and does not cover other kinds of changes in control such as amendments to bylaws.<sup>239</sup> It is limited to transactions in which board approval is necessary and thus does not address the new shareholder voting rights under control share acquisition statutes.<sup>240</sup> Moreover, it provides for a majority vote of shareholders<sup>241</sup> in all situations, in contrast to the control voting system which provides for supermajority voting and voting by disinterested shareholders in appropriate situations. In addition, the *ALI Draft* does not adhere consistently to the control concept in its definition of "control transactions." For example, it does not require a shareholder vote for certain kinds of transactions, such as mergers, consolidations, or mandatory share exchanges, in which the surviving corporation issues no more than twenty-five percent of its equity securities, even though control may in fact have changed due to the securities

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234. A triangular merger involves the merger of a subsidiary with a target company in which the stock of the parent company held by the subsidiary is distributed to the target company's shareholders. See GILSON, *supra* note 138, at 528-32.

235. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATION (Tentative Draft No. 11, April 25, 1991) [hereinafter ALI DRAFT].

236. See *id.* § 6.01; see also *id.* § 1.32 (defining control transactions).

237. *Id.* §§ 1.32, 6.01, cmt. d at 509-10.

238. *Id.* § 6.01 cmt. 2(2) at 507; see also *id.* § 1.32, cmt. a at 50-51 (noting that the ability to classify a given transaction in any of several forms can obscure its substance).

239. *Id.* § 6.01, cmt. d at 511.

240. *Id.* at 509-10; *id.* § 1.32, cmt. b at 55.

241. *Id.* §§ 1.01a(a), 6.01, cmt. a(2) at 507.

being issued to a control person or group.<sup>242</sup> It does not require shareholders in an acquired corporation to vote on a merger if the acquiring corporation issues less than twenty-five percent of its equity securities, even though control has changed as far as these shareholders are concerned.<sup>243</sup> In addition, the *ALI Draft* defines a sale of assets as a control transaction when the corporation is left without a "significant continuing business," even though control by shareholders of the selling corporation may not have changed over the transferred assets.<sup>244</sup>

Court decisions have also recognized that different rules may be necessary in conflict of interest or change of control situations. For example, in *Weinberger v. UOP, Inc.*,<sup>245</sup> the Delaware Supreme Court recognized the importance of the minority shareholder vote in merger transactions in which controlling shareholders are parties. Provided there is full disclosure, such a vote results in the burden of proof shifting to the complaining shareholders to prove the transaction was unfair.<sup>246</sup> In addition, the Delaware Supreme Court has created an enhanced business judgment rule to apply when change of control issues are involved.<sup>247</sup> The courts in Delaware also have invalidated board actions that serve the primary purpose of impairing or impeding shareholder democracy or voting rights.<sup>248</sup>

### B. *The Proposed Control Voting System*

This section develops a system of voting rights based on the concept of control. Voting rights are triggered by changes affecting the exercise of voice that alter control or power relationships in three situations: between management<sup>249</sup> and shareholders, between controlling and minority shareholders, and between common shareholders and other non-management coalitions, such as preferred shareholders and debtholders. In addition, voting rights are triggered by transactions that result in the

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242. Section 1.32(a)(1) of the *ALI Draft* specifically excludes mergers, consolidations, and mandatory share exchanges of this type from the definition of transaction in control. *Id.* § 1.32(a)(1) & at 507-08. If the American Law Institute drafters intended some mergers, consolidations, and mandatory share exchanges of this type to be considered transactions in control under the general language of § 1.32(a)(3), the language of and comment on § 1.32 should be modified accordingly.

243. *See id.* § 1.32(a)(1).

244. *Id.* § 1.32(a)(2); *see infra* text accompanying notes 294-96.

245. 457 A.2d 701, 703 (Del. 1983).

246. *Id.*

247. *See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985).

248. *See, e.g., Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659-63 (Del. 1988).

249. In this Article, the term "management" refers to directors of the corporation who are also employees and officers of the corporation.

acquisition, maintenance, or loss of control by a power coalition, or by the substantial dilution or nullification of voting rights. Under this control voting scheme, changes that alter control relationships, whether by the corporation's amending its articles or bylaws, issuing or repurchasing stock, or merging or selling its assets, require a shareholder vote.

The control voting system contains several underlying assumptions. The main assumption is that the shareholders' central right is to elect and remove directors, and that all other voting rights are related to this right. Shareholders have a right to vote on provisions or transactions that affect the shareholders' right to elect and remove directors. The reason for this assumption is that otherwise the system would duplicate largely the existing system, which is not based on any consistent principle. Because change of control is the theme, the right to elect and remove directors is the logical starting point for building the system. Also assumed is majority rule, although the deletion of a provision benefiting minority shareholders requires that the same percentage vote cast in its favor on adoption be cast in favor of its deletion. This latter rule gives appropriate deference to the degree of support that the provision had at its adoption and to the loss of control by minority shareholders. State legislatures could specify other starting points.

The principal rules are as follows. The addition or deletion of a provision that shifts control from shareholders to managers requires a majority vote of disinterested shares,<sup>250</sup> but it does not require a vote of the board. The addition or deletion of a provision that shifts control from managers to shareholders may be approved by the board alone or by a majority vote of shares.<sup>251</sup>

The addition or deletion of a provision that shifts control or power

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250. Disinterested shares in this context would exclude shares over which voting could be exercised or directed by directors who are also employees of the corporation or by officers of the corporation or by a person with whom such director or officer has a "close," "controlling," or "financial" relationship. See *infra* text accompanying notes 308-10. In addition, disinterested shares would exclude shares held by the corporation or any subsidiaries, shares held by any savings, employee stock ownership, or other employee benefit plan of the corporation or any of its subsidiaries to the extent that the voting of those shares is exercised or directed by such corporation or any such subsidiary or by persons selected by such corporation or any such subsidiary. For purposes of this Article, disinterested shares would also exclude shares subject to standstill agreements with the corporation or any such subsidiary.

251. Alternate systems provide for the approval of a shift of control from managers to shareholders either by both shareholders and directors or by disinterested shareholders. The former system gives directors a veto power over such shift. I have rejected this alternative because I believe that, other than for mandatory provisions, the shareholders, not directors, should decide the appropriate allocation of control between managers and shareholders. I have also rejected the system that gives disinterested shareholders control over the shift in power from managers to shareholders in recognition of the fact that managers have the power which is being shifted.

from the majority shareholders to minority shareholders requires the approval of a majority vote of shareholders. If the shift places additional power in the board of directors, a majority vote of disinterested shares is required. The deletion or addition of a provision that results in a shift of control from minority shareholders to majority shareholders requires the same percentage vote that was cast to create the present situation. Shifts of control among majority and minority shareholders neither permit nor require board participation.

In addition, a shift in control with respect to the exercise of voice from common shareholders to other coalitions requires a majority vote of disinterested shares.<sup>252</sup> A shift of this control back to shareholders requires the consent of the other coalitions.

Finally, a transaction that results in the acquisition, maintenance or loss of control by one of the following four methods requires a majority vote of disinterested shares: (1) the acquisition of control by a control person or group, (2) the loss of control by a control person or group, (3) the entrenchment of management by a transaction affecting share ownership, or (4) the substantial dilution or nullification of voting rights.<sup>253</sup>

This Article analyzes below a number of hypothetical transactions and provisions to demonstrate when the control voting system mandates shareholder voting rights. The article also analyzes voting procedures in the event that shareholder voting is required. One should note, however, that states need to enact default provisions for situations where shareholders have not voted. Under the control voting system, the significant question in selecting default provisions is whether power should reside initially in management, majority shareholders, or minority sharehold-

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252. Disinterested shares in this context would exclude shares over which voting could be exercised or directed by shareholders who would benefit as members of the other coalition or persons who have a "close," "controlling," or "financial" relationship with such shareholders. See *infra* text accompanying notes 310-12.

253. With respect to the first method, disinterested shares would exclude shares concerning which voting could be exercised or directed by the emerging control person or group and any person having a "close," "controlling," or "financial" relationship with such person or group. See *infra* text accompanying notes 286-89, 310-12. For the second method, disinterested shares would exclude shares concerning which voting could be exercised or directed by persons who would be in control of the corporation after the transaction and any person having a "close," "controlling," or "financial" relationship with such controlling person. See *infra* text accompanying notes 286-89, 310-12. Disinterested shares for the third method would exclude shares concerning which voting could be exercised or directed by management and persons "friendly" to management. See *infra* note 284. With respect to the fourth method, disinterested shares would exclude shares concerning which voting could be exercised or directed by shareholders who do not experience the same dilution or deprivation of voting rights over transferred assets as other shareholders with the same kind of stock. If more than one method for changing control occurs in the same transaction, all applicable definitions of disinterested shares will be used to determine the shares entitled to vote.

ers. In addition, if a state chooses default provisions that place control in majority shareholders rather than management or minority shareholders, that state may wish to require sunset rules for provisions adopted by shareholders that shift power away from majority shareholders, at least when the adopted provisions shift power from majority shareholders to management.

A state should enact some mandatory provisions involving control that cannot be changed by a vote of shareholders. Under the control voting system, a state would select those provisions on the basis of whether they serve to protect spheres of accountability such as judicial action, markets, and voting and on an assessment of the effectiveness of these spheres in assuring accountability. For example, a state may enact mandatory provisions concerning shareholder notice, the right of a percentage of shareholders to call meetings, and possibly mandatory written consent procedures to preserve the sphere of accountability through voting. For purposes of demonstrating the analysis of changes under the control voting system, however, shareholders are assumed to have the right to change these provisions. The article proposes rules for both the adoption and deletion of such provisions. Be advised that a legislature may obtain different conclusions as to whether shareholder veto rights are called for under the control voting system if it disagrees with the description or effect attributed to a transaction or provision discussed below.

This Article contemplates that a legislature would enact a statute that lists common provisions and transactions and the pertinent voting rights attributed thereto under the control voting system. The statute would also cover less common provisions and transactions with general control shift language, which would require the board of directors of a company in the first instance to determine the effect on control of a provision or transaction. A shareholder could challenge the board's decisions under general fiduciary principles.

### 1. Corporate Articles and Bylaws

Under the laws of most states, board approval and a vote of shareholders is necessary to amend corporate articles.<sup>254</sup> Either shareholders or the board acting alone can amend bylaws.<sup>255</sup> Under the proposed voting system, the method for changing a provision will no longer depend

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254. See cases and statutes cited *supra* note 45.

255. See cases and statutes cited *supra* note 49.

on which corporate document contains the provision.<sup>256</sup> The substance of the provision will determine the amendment method. Moreover, because the direction of the control change differs depending on whether it involves the amendment or deletion of a provision, different methods may apply to the amendment or deletion of the same provision.

a. Name, address or principal office, purpose clause

None of these provisions commonly found in a corporation's articles or bylaws would require a shareholder vote under the control voting system. Changes in these provisions do not affect the shareholders' right to elect or remove directors.<sup>257</sup>

b. Examples of articles or bylaw provisions altering control relationship between management and shareholders

The following sections analyze provisions that shift control between management and shareholders.

*(i) Staggered board provisions*

The articles may contain a provision that divides directors into classes so that only a fraction of the directors come up for re-election each year. Under Delaware law, directors may be divided into one, two, or three classes.<sup>258</sup> A staggered board provision presents an obstacle for a new controlling shareholder who desires majority representation on the board, particularly where directors may be removed only for cause.<sup>259</sup> Under current law, the adoption or deletion of such a provision requires a majority vote of both the board of directors and shareholders.<sup>260</sup>

Under the control voting system the analysis would be as follows. The adoption of a staggered board provision would shift control from shareholders to management for a period of time. Thus, adoption would require a majority vote of disinterested shares. In addition, deletion would require either the board's acting alone or a majority vote of shares.

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256. That some provisions in a corporation's articles should not require shareholder approval has been recognized. See REV. MODEL BUSINESS CORP. ACT § 10.02 (1990).

257. Changes in a purpose clause cannot be analogized either to a sale of assets transaction that leaves the corporation without a significant business or to dissolution. See *infra* text accompanying notes 294-96. Whereas the latter two transactions have the effect of essentially rendering the rights of shareholders to elect or remove directors meaningless, the former change does not. Changes in the purpose clause arguably fall within the conflict of interest voting system. See *infra* text accompanying notes 314-19.

258. DEL. CODE ANN. tit. 8, § 141(d) (1991).

259. See *id.* § 141(k).

260. See, e.g., *id.* § 242.

Staggered board provisions could be viewed as decreasing the accountability of managers through interference with the operation of markets and thus arguably could fall outside the sphere of voting. However, staggered board provisions do not reduce substantially such accountability.<sup>261</sup>

(ii) *Number of directors; straight voting*

The adoption of an amendment increasing the number of directors in a corporation with straight voting can result in the board's becoming ineffective because of its unwieldy size. Increasing the number of directors beyond seven will arguably have this effect if the board's desired function includes effective governance.<sup>262</sup> Because such an amendment tends to shift power from the shareholders to an internal management group, its adoption would require a majority vote of disinterested shares. An amendment that decreases the number of directors can have the opposite effect and, therefore, its adoption would require either a vote of the board or a majority vote of shares.

A state legislature could devise a more sophisticated approach. Either an increase in the number of directors to more than seven or a decrease in the number of directors from a number greater than seven to some lesser number would be subject to these rules. Under this modification, an increase in the number of directors from three to seven would not require a shareholders' vote.

Section V *B(1)(c)(ii)* and section V *B(1)(d)(iii)* discuss the rules applicable to an increase or decrease in the number of directors in a corporation with cumulative voting.

(iii) *Call, notice, date, and location of shareholders' meeting*

Because directors can amend a corporation's bylaws, they can thwart the exercise of shareholder control by amending procedural rules contained in the corporation's bylaws that relate to shareholders' meetings. Courts have found it necessary to place some equitable limitations on the directors' power to amend the bylaws.<sup>263</sup> A case in point is *Schnell v. Chris-Craft Industries*, where the board of directors accelerated the date of the corporation's annual meeting after being notified that a

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261. Gilson, *Shark Repellent*, *supra* note 139, at 793-96.

262. HENRY MINTZBERG, *POWER IN AND AROUND ORGANIZATIONS* 88 (1983). Professor Mintzberg cites a study finding that the "average size of action-taking groups among officers and directors was 6.5 [persons], while that of nonaction groups was 14 [persons]." *Id.*

263. *E.g.*, *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971); *see also infra* note 265.



shareholder intended to wage a proxy fight.<sup>264</sup> The Delaware Supreme Court enjoined the acceleration of the meeting date and reinstated the old date, because the court found that the directors' purpose in amending the bylaws was to perpetuate themselves in office and to thwart the exercise of shareholder democracy. While recognizing the board's statutory right to amend the bylaws, the court stated that "inequitable action does not become permissible simply because it is legally possible."<sup>265</sup> This reasoning could invalidate other amendments by directors, such as the postponement of a meeting date at which insurgents have planned action,<sup>266</sup> deletion of a provision permitting a certain percentage of shares to call a special shareholders' meeting, the change of the record date being used for a consent procedure,<sup>267</sup> or the change of location of a shareholders' meeting to a remote location. The determination of "purpose" is problematic, however, and the court's reasoning may be contrary to authority clearly granted to directors by state statutes.

The control umbrella would eliminate the problem of contrary statutory language. In addition, the focus would be on the effect of the amendment and not, as in *Schnell*, on the purpose of the directors.<sup>268</sup>

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264. *Schnell*, 285 A.2d at 438-39.

265. *Id.* at 439; see *International Banknote Co., Inc. v. Muller*, 713 F. Supp. 612, 627 (S.D.N.Y. 1989) (enjoining enforcement of a bylaw requiring the filing of nominees 45 days prior to annual meeting, in part because the bylaw was adopted within 24 hours of notice of proxy contest and 58 days before scheduled annual meeting); *Lerman v. Diagnostic Data Inc.*, 421 A.2d 906, 914 (Del. Ch. 1980) (holding invalid a board's action setting the annual meeting with 63 days' notice, because one of the corporate bylaws required Board nominees to be submitted at least seventy days in advance of the annual meeting); *Petty v. Penntech Papers, Inc.*, 347 A.2d 140, 143 (Del. Ch. 1975) (holding that where selective redemption by the corporation of its preferred stock might be directed towards maintaining management in control, issuance of a temporary restraining order was proper); *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769, 775-77 (Del. Ch. 1967) (holding invalid an exchange of stock which had the primary purpose of reducing a shareholder's holdings below a majority); *Canada S. Oils, Ltd. v. Manabi Exploration Co.*, 33 Del. Ch. 537, 543-44, 96 A.2d 810, 813-14 (Del. Ch. 1953) (enjoining the issuance of stock which had the primary purpose of depriving shareholder of majority voting control).

266. *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1208-09 (Del. Ch. 1987). *But see Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1121-23 (Del. Ch. 1990) (deferring annual meeting, in response to announcement of proxy contest and tender offer did not impair or impede effective exercise of franchise, when date for annual meeting had not yet been fixed).

267. *Midway Airlines, Inc. v. Carlson*, 628 F. Supp. 244, 246-47 (D. Del. 1985).

268. To some degree Delaware courts have given greater attention to the effect of board actions when interference with the shareholders' franchise is involved. For example, in *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 658-59 (Del. Ch. 1988), the court held that the board of directors did not act self-interestedly when it added two new board members in response to a shareholder's proposal to increase the size of the board and elect new board members through consent solicitation. Nevertheless, the court found that board members had violated their fiduciary obligations because the effect of its action was to interfere with the shareholders' franchise. The court, however, returning to a focus on purpose, said that such

The fact that valid business reasons may support the amendment does not remove the shareholders' right to vote on the control shift. Because changes in call, notice, date, and location of shareholders' meetings often are designed to apply to the next shareholders' meeting, the requirement of a shareholder vote would preclude them, unless these changes are made applicable only to future meetings or if the changes are neutral with respect to control. This result is not troublesome, however, because it discourages management from acting self-interestedly to shift control to itself when confronted with a proxy contest. The present need for court intervention to prevent inequitable conduct expressly permitted by statutes is an indication of the inadequacy of those statutes. A more equitable statute such as that proposed here would make court intervention unnecessary, except in extraordinary situations.

Specifically, the deletion of a provision allowing shareholders to call a special shareholders' meeting results in a power shift from shareholders to managers and thus would require a majority vote of disinterested shares. The adoption of such a provision has the reverse effect and, therefore, would require action by the board of directors or a majority of shareholders. As previously noted, a state legislature may desire to enact mandatory call provisions in order to preserve the accountability of managers through voting.

The adoption of a notice provision that gives shareholders insufficient time to mount an effective proxy contest shifts power from shareholders to managers and would, therefore, require a majority vote of disinterested shares. The deletion of such a provision would have the reverse effect and would require action by the board or a majority of shareholders. A state legislature could provide for minimum and maximum notice periods and deem changes within these limits to have a neutral effect on control.

A control shift is more difficult to identify when the date or location of a shareholders' meeting is to be changed. Directors must determine

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interference would be permissible if the board members could show a compelling business purpose for their actions, which had not been shown in this case. *Id.* at 659-63.

In *Unilever Acquisition Corp. v. Richardson-Vicks Inc.*, 618 F. Supp. 407 (D.C.N.Y. 1985), the court made no reference to purpose. In that case the court invalidated the issuance of "piggyback" preferred stock which provided for twenty-five votes per share unless the shares were transferred, in which case the shares were only entitled to five votes per share for the first thirty-six months. *Id.* at 408, 410. The court's holding rested on a statutory provision, § 202(b) of Delaware General Corporation Law, for the proposition that such a restriction on transfer requires a shareholders' vote. *Id.* at 409-10. Interestingly, though, the court also cited *Schnell* for the proposition that a "change in corporate structure of this magnitude" required shareholder approval, without reference to the board's purpose in making the change. *Id.* at 410.

whether a control shift is involved. Under the principles enunciated in *Smith v. Van Gorkom*,<sup>269</sup> directors would be required to inform themselves as to all information that was reasonably available to them<sup>270</sup> in order to determine whether the change would shift control from shareholders to directors. For example, if the change would substantially disrupt the efforts of shareholders planning a proxy contest and management is aware of these plans, the change is precluded unless the directors obtain the approval of a majority of disinterested shares.

The adoption of a provision that gives directors the discretion to determine from year to year the date and location of the shareholders' annual meeting shifts control from shareholders to managers and would require a majority vote of disinterested shares. One could argue, however, that such a provision falls outside the sphere of voting because it undermines unduly the accountability of managers by interfering substantially with the ability of shareholders to wage a proxy contest. The deletion of this provision would require approval by the board or a majority vote of shares.

*(iv) Provision for shareholders' action without a meeting (not mandated by statute)*<sup>271</sup>

A provision allowing shareholders to act by written consent permits shareholders to act without having a meeting. This right is particularly important in some states where shareholders do not have the right to call special meetings unless a provision to that effect is included in the corporation's articles or bylaws.<sup>272</sup> The adoption of a written consent provision shifts control from management to shareholders by providing shareholders an alternate method for participating in the governance of the corporation. Under the proposed control voting system, the board or a majority vote of shares may adopt such a provision. The deletion of a written consent provision shifts power from shareholders to the management and would require a majority vote of disinterested shares. State

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269. 488 A.2d 858 (Del. 1985).

270. *Id.* at 872.

271. Most states provide for shareholder action without a meeting unless such provision is deleted by an amendment to the articles of incorporation. CAL. CORP. CODE § 603 (West 1990); DEL. CODE ANN. tit. 8, § 228 (1991); N.Y. BUS. CORP. LAW § 615 (McKinney 1986); 15 PA. CONS. STAT. ANN. § 2524 (Supp. 1991). The Revised Model Business Corporation Act, however, provides for action by the written consent of all shareholders entitled to vote but does not specifically allow for deletion of such provision from the articles of incorporation. REV. MODEL BUSINESS CORP. ACT § 7.04 (1984).

272. DEL. CODE ANN. tit. 8, § 211(d) (1991); N.Y. BUS. CORP. LAW § 602(c) [Table T.1] (McKinney 1986). *But see* CAL. CORP. CODE § 600(d) (West 1990) (mandating that 10% of shares can call special meetings of shareholders).

legislatures may desire to enact mandatory written consent provisions in order to preserve the accountability of managers through voting.

*(v) Removal of Directors; Vacancies*

The adoption of a provision permitting the removal of directors only for cause or permitting directors to fill vacancies shifts power from shareholders to managers and, therefore, would require a majority vote of disinterested shares. The deletion of such provisions or the adoption of a provision permitting directors to be removed with or without cause or permitting shareholders to fill vacancies results in control moving from managers to shareholders and thus would require a majority vote of directors or shareholders.

- c. Examples of articles or bylaw provisions altering the control relationship between controlling and minority shareholders

The following examples illustrate the proper analysis when provisions shift control between controlling and minority shareholders.

*(i) Cumulative voting provisions (not mandated by statute)*

Cumulative voting provisions permit individual shareholders to accumulate the votes they can cast for all directorate positions and vote them for fewer positions.<sup>273</sup> Cumulative voting increases the opportunity for minority shareholders to elect a fraction of the board; with straight voting, majority shareholders elect all the directors. The adoption of a cumulative voting provision shifts control from controlling to minority shareholders. Under the proposed control voting system, adoption of this provision would require a majority vote of shares. The deletion of the provision would require the same percentage vote that was cast for its adoption. A disinterested vote of shares is not required, because arguably a cumulative voting provision does not alter effectively the power relationship between management and shareholders.

*(ii) Decreasing number of directors; cumulative voting (not mandated by statute)*

If a corporation utilizes cumulative voting, an amendment decreasing the number of directors on the board alters the control relationship between controlling and minority shareholders, because minority shareholders will have to accumulate more votes to elect a director to the

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273. DEL. CODE ANN. tit. 8, § 214 (1991).

board.<sup>274</sup> Such an amendment shifts control from minority to controlling shareholders.<sup>275</sup> Adoption would require the same percentage vote as was cast in favor of cumulative voting. Section V B(1)(d)(iii) discusses an amendment increasing the number of directors in a corporation with cumulative voting.

- d. Examples of articles or bylaw provisions altering both the control relationship between management and shareholders and between controlling and minority shareholders

(i) *Simple supermajority shareholder voting provisions; high quorum requirements*

Simple supermajority voting and high quorum requirements shift control from controlling to minority shareholders by requiring the consent or attendance at meetings of minority shareholders. Like staggered board provisions, however, they also entrench management. Such provisions discourage potential tender offerors because they either must acquire more than a majority of the shares or persuade minority shareholders to accede to their plans for the corporation.

Accordingly, the rules applicable either to a shift of control from controlling to minority shareholders or a shift of control from shareholders to managers are not clearly applicable. In recognition of the latter shift, however, the adoption of such provision should require a majority vote of disinterested shares.<sup>276</sup> Moreover, in recognition of the former shift, the required vote to delete the provision should be the same percentage vote that was cast for the provision's adoption.

Like the staggered board provision, supermajority voting and high quorum provisions arguably could fall outside the sphere of voting, but these provisions also do not substantially reduce managerial accountability through interference with the market for corporate control.<sup>277</sup>

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274. California law mandates for certain corporations cumulative voting that can be invoked by a proper request from a shareholder. CAL. CORP. CODE §§ 301.5, 708 (West 1990 & Supp. 1992). Consequently, California law gives special attention to requiring a minimum number of directors and to procedures for changing the number of directors. *Id.* § 212.

275. This effect can be seen by reading the facts in *Coalition To Advocate Public Utility Responsibility, Inc. v. Engels*, 364 F. Supp. 1202, 1204 (D. Minn. 1973).

276. Had this rule been in operation when *Treco, Inc. v. Land of Lincoln Savings & Loan*, 572 F. Supp. 1455 (N.D. Ill. 1983), *aff'd*, 749 F.2d 374 (7th Cir. 1984), was decided, management may not have been able to defeat the efforts of plaintiff shareholders by adopting a supermajority bylaw provision.

277. Gilson, *Shark Repellent*, *supra* note 139, at 800. Some supermajority voting provisions require a supermajority vote on a merger or other transaction with a "related person" (a party having a substantial ownership interest in the corporation) only if the transaction is not

(ii) *Control share acquisition provisions (not mandated by statute)*

Briefly, a control share acquisition provision prohibits a person from voting or acquiring control shares unless a majority of "disinterested shares" vote in favor of granting the control shares voting rights.<sup>278</sup> Shares owned by management and the acquirer of control shares are considered "interested shares."<sup>279</sup> This provision is, in essence, a supermajority voting provision because the minority shareholders have power over who will control the corporation. The provision also decreases the coercive aspect of tender offers by permitting collective decision making by shareholders.<sup>280</sup>

Under the control voting system, this provision shifts control from controlling to minority shareholders, which normally would require a majority vote of shares for its adoption. Because the provision may make it more difficult for a potential acquirer to obtain control and thus may serve to entrench management, however, it requires a majority vote of "disinterested" shares. The deletion of this provision shifts power from the minority to controlling shareholders and, accordingly, requires the same vote that was cast in favor of its adoption.

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approved by a majority of "continuing directors," defined as directors who were in office at the time the related person acquired a substantial interest in the corporation. *Id.* at 785. The effect of such a provision is to put in the hands of the continuing directors the decision as to whether a majority or supermajority vote will be required. Because the decision as to whether the corporation should adopt a supermajority voting provision is a matter for a majority vote of disinterested shares, whether this power should be delegated to directors is likewise a decision requiring such vote.

The analysis concerning the deletion of this more complex supermajority voting provision (with the express delegation of authority to directors) is more involved than the analysis of the simple supermajority voting provision discussed in the text. For the simple supermajority voting provision, the same vote that secured the adoption of the provision is required to delete it, because its deletion would shift power from minority to majority shareholders. Whether the deletion of this more complex supermajority voting provision will shift power from minority to majority shareholders depends on the decisions continuing directors make. A supermajority vote would not be required if continuing directors approve transactions. Deletion of the provision therefore would not shift power from minority to majority shareholders over these transactions. The primary shift in control resulting from the deletion of this provision is over whether a majority or supermajority vote is required. Because its deletion mainly results in a shift in power over this decision from continuing board members to majority shareholders, a majority vote of shares or continuing board members should be required for its deletion.

This complex supermajority provision is arguably outside the sphere of shareholder voting. A legislature might prohibit such provisions on the grounds that they substantially reduce the accountability of directors by increasing the directors' discretion over the operation of the market for corporate control.

278. See *supra* notes 77-79 and accompanying text.

279. See, e.g., FLA. STAT. ANN. § 607.0902 (West Supp. 1992); IND. CODE ANN. § 23-1-42-3 (Burns 1989); OHIO REV. CODE ANN. § 1701.01 (1992).

280. Bebchuk, *supra* note 198, at 931-32, 934-35; Booth, *supra* note 180, at 1683.

(iii) *Increasing number of directors; cumulative voting (not mandated by statute)*

Addition of an amendment increasing the number of directors of a corporation with cumulative voting can increase minority representation on the board because fewer votes must be accumulated to elect board members. This amendment thus shifts power from controlling to minority shareholders. In addition, an amendment increasing the number of directors can arguably make the board a less effective governing body,<sup>281</sup> thus shifting power from shareholders to management. Accordingly, increasing the number of directors requires a majority vote of "disinterested" shares.

2. Corporate Transactions: Public and Private Issuances and Repurchases of Stock, Mergers, Consolidations, Mandatory Share Exchanges, Sale of Assets, Dissolution and Other Transactions

These corporate transactions can result in the acquisition and loss of control by various shareholders over the election of directors. Four effects on control can occur: (1) a person or group can emerge with a controlling interest, (2) a person or group can lose a controlling interest, (3) management can become further entrenched by a transaction affecting share ownership, and (4) shareholder voting rights can become diluted or effectively nullified. A board of directors will often need to determine the effect on control of the transaction, which determination could be challenged by shareholders under general fiduciary principles.

First, a corporate transaction in which the issuance, cancellation, redemption, or repurchase of shares results in a new person or group controlling the corporation requires a majority vote of disinterested shares. The transaction may include a merger, sale of assets, or public or private offering. Shares held by the emerging control person or group<sup>282</sup> are interested shares for purposes of the vote.

Second, approval of a transaction that causes a control person or group to lose a controlling interest over the corporation requires a majority vote of disinterested shares. For example, a merger can result in a corporation's control person or group losing control over the corporation's assets once these assets become part of the merged entity. In addition, the issuance of shares can result in a reduction of the percentage ownership of a control person or group, causing a loss of control by the

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281. See MINTZBERG, *supra* note 262.

282. See *infra* text accompanying notes 286-89 for a discussion of the meaning of control and control group.

person or group.<sup>283</sup> Each of these transactions would require a majority vote of disinterested shares. Shares of the control person or group losing control would not be considered interested shares for purposes of the vote.

Third, a transaction affecting share ownership that results in management and persons friendly to management (“friendly persons”)<sup>284</sup> maintaining or acquiring control requires a majority vote of disinterested shares. Such a transaction would include an issuance of control shares to management or friendly persons or the repurchase of control shares from an opposing person or group.<sup>285</sup>

One can define control at the set percentage levels found in control share acquisition statutes<sup>286</sup> or by using the general definition of control suggested by the *ALI Draft*. The *ALI Draft* defines control as the “power, directly or indirectly . . . to exercise a controlling influence over the management or policies of a business organization”<sup>287</sup> and creates a presumption that the ownership of more than twenty-five percent of the equity interest in a business organization constitutes control; the ownership of less than that percentage of stock alone raises the opposite presumption.<sup>288</sup> In addition, the definition of a control group is important. The *ALI Draft* defines it as “a group of persons who act in concert to

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283. Cf. *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 362, 230 A.2d 769, 775 (Del. Ch. 1967) (finding that directors breached fiduciary duty in authorizing exchange of stock with the primary purpose of reducing a shareholder’s holdings below a majority); *Canada S. Oils, Ltd. v. Manabi Exploration Co.*, 33 Del. Ch. 537, 543-44, 96 A.2d 810, 813-14 (1953) (enjoining the issuance of stock for the primary purpose of depriving shareholder of majority voting control).

284. For purposes of this Article the term “management” refers to those directors who are also employees and officers of the corporation. Persons friendly to management are persons with whom such director or officer has a “close,” “controlling,” or “financial” relationship. See *infra* text accompanying notes 308-10. Such persons also include the corporation or any of its subsidiaries and any savings, employee stock ownership, or other employee benefit plans of the corporation or any of its subsidiaries to the extent that voting of the shares held by the plan is exercised or directed by such corporation or any such subsidiary or persons selected by such corporation or any such subsidiary. Such persons also include a person holding shares of the corporation pursuant to a standstill agreement with the corporation or any such subsidiary. This same definition is used in determining “disinterested shares” in the context of a shift of control from shareholders to management. See *supra* note 250.

285. Such a transaction could also include the selective redemption of voting preferred stock, *Petty v. Penntech Papers, Inc.*, 347 A.2d 140, 143 (Del. Ch. 1975), or the issuance of piggyback preferred stock with differing voting rights depending on whether they are transferred. *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407, 410 (S.D.N.Y. 1985) (noting that the issuance of piggyback preferred stock with reduced voting rights for 36 months after they are transferred could have had the effect of increasing a controlling group’s voting power from one-third to a majority for 36 months).

286. See *supra* note 80.

287. ALI DRAFT, *supra* note 235, § 1.05(a).

288. *Id.* § 1.05(b).



exercise a controlling influence over the management or policies of a business organization pursuant to an arrangement or understanding with each other.”<sup>289</sup> The concept of persons friendly to management is broader and includes persons not in the control group but who can be expected to be friendly to management.<sup>290</sup> It would include any person acquiring shares subject to standstill agreements and shares owned by pension funds over which the corporation has authority to appoint trustees or portfolio managers.<sup>291</sup>

Fourth, a transaction that substantially dilutes or deprives shareholders of voting rights over corporate assets requires a majority vote of disinterested shares. The dilution of voting rights increases the collective action problem of shareholders by decreasing the voting significance of each share. For example, shareholders may experience a substantial dilution of their voting rights when their corporation issues a large amount of stock to others in a public or private offering or when their corporation issues a large amount of stock to others in a merger or sale-of-assets transaction.<sup>292</sup> Thus, the corporation’s issuance of a “large amount of stock,” which one may define as twenty percent of the corporation’s outstanding voting stock, requires a majority vote of disinterested shares. A series of unrelated transactions in which shares are issued can also substantially dilute shareholder voting rights. To deal with this dilution caused by a series of small transactions, however, shareholders should vote on the shares authorized in the corporation’s articles rather than on each individual transaction.<sup>293</sup>

In addition, the deprivation of shareholder voting rights requires a majority vote of disinterested shares. For example, such a vote would be required by shareholders who receive no continuing voting interest in the merged entity, such as minority shareholders in a freeze-out merger, or by shareholders who experience a change of control over the assets in that merged entity in one of the ways enumerated in this section. Similarly, a corporation’s sale of its assets, leaving the corporation without a

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289. *Id.* § 1.06.

290. *See supra* note 284.

291. *See supra* note 284.

292. This rule is similar to the New York Stock Exchange requirement discussed *supra* text accompanying note 97. It rejects the distinction made by § 1.32(b) of the *ALI Draft*, *supra* note 235, between widely distributed public offerings and private offerings. The effect of both offerings is the same as far as dilution is concerned. Moreover, the description of a public offering in the *ALI Draft* is not sufficiently precise and may exclude from voting a transaction having one of the control effects mentioned above.

293. Thus, a shareholders’ vote would be required to authorize shares and for certain issuances.

significant business,<sup>294</sup> and an accompanying change of control with respect to the transferred assets, requires a majority vote of disinterested shares. Dissolution of the corporation would also deprive shareholders of voting rights by rendering them meaningless, requiring a majority vote of disinterested shares.

The *ALI Draft* requires a majority vote of shares for a sale-of-assets transaction in which the corporation and its subsidiaries are left without a significant continuing business.<sup>295</sup> This definition appears consistent with control concerns, because control over the election of directors is largely meaningless when a corporation has been left without such a business.<sup>296</sup> Nevertheless, a change of control as defined by the four methods discussed in this section may not have occurred if shareholders receive ownership interests in the acquiring corporation such that they retain control over the transferred assets. Therefore, as previously noted, whether voting is required for a sale-of-assets transaction, defined as one in which the corporation is left without a significant continuing business, depends on whether a change of control in one of the four ways discussed in this section has occurred as a result of the transaction.

### 3. Transactions Altering the Control Relationship Between Voting Shareholders and Non-Management Coalitions, such as Preferred Shareholders and Debtholders

A state legislature may wish to require shareholder voting on shifts of control between voting shareholders and non-management coalitions, such as preferred shareholders and debtholders. A shift in control from voting shareholders to a non-management coalition requires a majority vote of disinterested shares. Voting shareholders who are also members of the non-management coalition own interested shares. In order to reverse this shift in control, the disinterested consent of the non-management coalition should be given by some method.

Because control under the control voting system involves control over the election of directors, preferred shareholders and debtholders are the coalitions most likely to be involved. Control can shift from common shareholders to preferred shareholders when a transaction results in the issuance of preferred shares with voting rights. If these shares (1) create

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294. See *infra* text accompanying notes 295-96.

295. ALI DRAFT, *supra* note 235, §§ 1.32(a)(2), 6.01(b).

296. This justification differs from the explanation in the Comment to § 1.32 of the ALI DRAFT, *supra* note 235, § 1.32, cmt. b(3) at 58-59, which appears to focus on whether senior executive officers remain with the corporation. In addition, under the control voting system, other asset transactions that have one of the four effects mentioned in this section would require a majority vote of disinterested shares.

a new controlling interest in a person or group, (2) cause a person or group to lose a controlling interest, (3) entrench management by issuing such shares to management or persons friendly to management, or (4) dilute substantially existing voting rights, the issuance requires a majority vote of disinterested shares. For example, if the board confers on blank-check preferred shares the right to vote as a class on mergers, the issuance of these shares would require a majority vote of common shares either because of the creation of a control group that can veto this important kind of transaction or because the issuance substantially dilutes the voting rights of common shareholders. Subsequent issuances of preferred shares in this class may or may not have significant additional control consequences. With respect to an additional issuance, common shareholders and/or preferred shareholders are entitled to vote if the issuance affects control in one of the four ways. The existing preferred shareholders, for instance, have a right to vote on an additional issuance if it would dilute substantially their voting rights. Because a series of unrelated transactions in which shares are issued can also substantially dilute voting rights, a majority vote of shares (whose rights would be diluted) is required to authorize preferred shares (with voting rights specified). Finally, if debtholders acquire voting rights (permitted in some states),<sup>297</sup> the same rules would apply.

Particularly onerous and unusual terms in contracts with other coalitions<sup>298</sup> can effectively render the voting rights of shareholders over the election of directors meaningless. These contracts require a majority vote of disinterested shares.

#### 4. Limitations on the Concept of Control/Power Used in the Control Voting Systems

One can utilize the concepts of power and control to delineate a more extensive system of voting rights than that outlined above. The system discussed above focuses on the effectuation of changes in control through the exercise of voice, not exit. Moreover, it concentrates on control over board membership, namely, the rules for electing board members and for issuing voting shares. Of course, the central assumptions of this system are the importance of the board of directors and the right to elect a board member.<sup>299</sup> The following sections discuss extensions of the

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297. DEL. CODE ANN. tit. 8, § 221 (1991).

298. *Hodge v. Cuba Co.*, 142 N.J. Eq. 340, 346-47, 60 A.2d 88, 92-93 (Ch. 1948); EISENBERG, *supra* note 66, at 89-90.

299. See MINTZBERG, *supra* note 262, at 70-95, 547-54 for a discussion of this issue. See also EISENBERG, *supra* note 66, at 139-85 (discussing the various types of boards and the powers they wield).

system of control voting.

a. Changes of Control Through Exit

Unlike staggered board and supermajority voting provisions, a number of defensive tactics affect only the exercise by shareholders of exit, not voice. Defensive tactics decrease the likelihood that a change of control through exit will occur by increasing the bidder's costs of taking over the corporation. In a takeover, shareholders are not concerned with changing the management of the corporation, but with exiting the corporation at a premium.

Whether these kinds of defensive tactics should require a shareholder vote depends on whether matters that influence negatively a bidder's decision to seek control should require a vote. One cannot explain such voting on the basis of there being a shift of control from shareholders to managers, to minority shareholders, or to non-management coalitions. On the contrary, the control relation involved is between managers and potential bidders, who may or may not be existing shareholders. The principle that would support voting by existing shareholders on these tactics is managerial conflict of interest, which provides the basis for voting under the conflict of interest voting system discussed in Part VI.

Nevertheless, if a state legislature is not prepared to embrace the conflict of interest rationale for voting and instead adopts control as the operative concept, one can devise a rationale under a broad control rubric which provides for voting on these defensive tactics. Postulated is a shift in control from existing shareholders to managers over the exit decision. Managers decrease shareholders' power over exit decisions when they affect the conditions under which exit will occur.

Of course, virtually all decisions by management provide conditions for exit. Numerous management decisions, such as whether to open or close a plant, to develop a new product, or to establish a distributorship network in some areas and not others, influence a bidder in deciding whether to seek control of a corporation. Nevertheless, one can distinguish managerial decisions that adopt defensive tactics from other decisions by whether they are specifically designed to influence a change of control through exit. One can identify these decisions in two ways: Either (1) they adopt a provision or transaction that is triggered by a change in control, or (2) they adopt a transaction that is outside the ordinary course of business when a tender offer is imminent or pending. This Article describes below examples of defensive maneuvers that fall within these two categories. Note that with respect to any of these defensive

tactics one can argue that they reduce substantially managerial accountability through interference with an effective market for corporate control and, therefore, their adoption falls outside the sphere of shareholder voting.

(i) *Defensive Tactics Triggered by a Change in Control*

(a) Right of Redemption

Redemption provisions provide shareholders the right to redeem their shares at a specified price when a person acquires control of the corporation.<sup>300</sup> This right does not affect the exercise of voice, but by making an acquisition more costly it affects the likelihood of a change of control through exit. Therefore, expanding the concept of control to include the exit decision would require a majority vote of disinterested shares to adopt redemption provisions.

(b) Poison Pills

A wide variety of poison pills exist.<sup>301</sup> An example of a poison pill is preferred shares issued by a target corporation to its common shareholders as a dividend. When a change of control occurs, the preferred shares become convertible into an amount of securities in the target corporation or the bidding corporation that equals or exceeds in value the tender offer price.<sup>302</sup> Similar to the redemption right, the issuance of poison pill preferred shares increases the cost to a bidder of acquiring the corporation and, accordingly, discourages a change in control through exit.

Of course, a vote of common shareholders is required if the preferred shares contain voting provisions, for the reasons given in section V B(3). The conversion feature of these preferred shares does not contemplate control share acquisitions.<sup>303</sup> Therefore, control share acquisition provisions will not be implicated.

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300. Redemption rights are found in fair price provisions and some control share acquisition statutes. *E.g.*, FLA. STAT. ANN. §§ 607.0902(11), 607.1302(1)(c) (West Supp. 1992); IND. CODE ANN. §§ 23-1-42-11, 23-1-44-8(a)(4) (Burns 1989); MD. CORPS. & ASS'NS CODE ANN. §§ 3-601, 603, 708 (Supp. 1991); MICH. COMP. LAWS ANN. § 450.1799 (West 1990).

301. ROBERT C. CLARK, CORPORATE LAW § 13.6, 574-75 (1986); Susanne S. Dawson et al., *Poison Pill Defensive Measures*, 42 BUS. LAW. 423, 424 (1987).

302. GILSON, *supra* note 138, at 637-39; Virginia G. Goelz, *Internal Transfers of Control Under Poison Pill Preferred Issuances to Shareholder: Toward A Shareholder Approval Rule*, 60 ST. JOHN'S L. REV. 94 (1985).

303. Booth, *supra* note 180, at 1663-66.

(c) Cyanide Capsules

A cyanide capsule is a default provision included in a loan agreement that a transfer of control triggers. At first blush this provision may appear indistinguishable from a provision providing debtholders the right to vote on control changes, which would require a shareholders' vote for the reasons given in section V B(3). The cyanide capsule, however, does not permit the debtholder both to invoke the default provision and to remain a debtholder of the corporation. The provision is essentially an exit option, which increases the cost to the bidder of acquiring the corporation. Accordingly, it is similar in operation to the right of redemption or poison pill and would be treated in the same way.

(d) Golden Parachute

A golden parachute is executive compensation triggered by a change of control. This provision does not affect control through voice mechanisms, but, like redemption rights, poison pills, and cyanide capsules, makes a change of control through exit more costly. Like these provisions, expanding the concept of control to include the exit decision would require a shareholders' vote on this type of compensation.

*(ii) Business Decisions that are Outside the Normal Course of Business and are Made When a Tender Offer is Imminent or Pending and that are Outside the Ordinary Course of Business*

(a) Certain Repurchases of Voting Securities; Greenmail

Like certain stock issuances, certain share repurchases shift control with respect to the exercise of voice from shareholders to managers and, therefore, fall within a control voting system that focuses on voice. These repurchases consist of repurchases of "control shares" from a person or group (greenmail) and repurchases that reduce the amount of outstanding shares so that shares owned by management and "friendly" persons become "control shares."<sup>304</sup>

However, other repurchases, such as a public self-tender by a target corporation to defend itself from a pending tender offer or a repurchase of less than a control block from a potential bidder (greenmail), make a change of control through exit less likely. These repurchases affect the exit decision and, therefore, fall within the more expanded concept of control.

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304. See *supra* text accompanying notes 284-85, 290-91.

(b) Defensive Acquisitions

A target corporation may make a defensive acquisition. This acquisition may cause the corporation to use its excess cash, to increase its liabilities, or to create antitrust problems for the bidder. This defensive tactic decreases the likelihood of a change of control through exit. Like other defensive maneuvers discussed in this section, it does not affect the exercise of voice.

(c) Crown Jewels

In order to induce a white knight to acquire the target corporation, the target corporation may grant to the white knight an option to buy a valuable asset (crown jewel), which will make the corporation less attractive to another bidder. The granting of the crown jewel makes it more likely that the change of control through exit will be in favor of one bidder approved by management over another. Such a provision shifts power from shareholders to managers with respect to changes in control through exit.

(d) High Dividends

To prevent a change of control through exit, the corporation may make a number of decisions, out of the ordinary course of its business, that will make the change of control by exit less likely and possibly more costly. These decisions include declaring substantially higher dividends when a tender offer is pending or imminent.<sup>305</sup>

b. Control over Business Decisions

Shareholders may seek additional voting rights giving them control over additional subjects, such as the purposes of the corporation, executive compensation, whether the company should discontinue business in South Africa, or the amount of debt the corporation should incur. However, the control voting system here envisioned extends only to changes of control through the exercise of voice in selecting directors, and possibly to changes of control at the board level through exit. A precatory voting system such as exists under the federal proxy rules may also permit voting rights in those situations. The conflict of interest voting system discussed in section VI includes additional voting rights.

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305. Professor Thomas L. Hazen has suggested that it may be advisable to condition a shareholders vote on whether dividends substantially deplete corporate assets. Letter from Thomas L. Hazen, Professor of Law, University of North Carolina at Chapel Hill School of Law, to Lynne L. Dallas, Professor of Law, University of San Diego School of Law 2 (April 16, 1990) (on file with the North Carolina Law Review Association).

### 5. Summary of Comparison with Existing Law

This section compares the control voting system with current state law. First, under the control voting system, shareholders have veto rights with respect to certain provisions included in the corporation's articles or bylaws. Conversely, shareholders do not have voting rights with respect to other provisions regardless of their location. The method for voting depends on the nature of the power shift involved and also on the direction of the shift, which direction depends on whether a provision is being adopted or deleted. Second, shareholders do not necessarily have voting rights on mergers and sales of substantially all the assets. The determination of voting rights depends on whether a change of control by one of the four methods occurs: (1) a person or group emerges with a controlling interest, (2) a person or group loses a controlling interest, (3) management becomes further entrenched by a transaction affecting share ownership, or (4) shareholder voting rights over corporate assets are diluted or effectively nullified. Shareholders of a constituent corporation in a merger are entitled to a majority vote of disinterested shares if they experience such a change of control. For a sale of assets transaction, if a corporation has sold its assets leaving it without a significant continuing business, the shareholders are entitled to a vote of disinterested shares if a change of control over the transferred assets results. Third, a shareholders' vote is required to dissolve the corporation under the control voting system because such a transaction would render shareholder voting rights meaningless. Fourth, some defensive tactics require a shareholders' vote because they involve a change of control through the exercise of voice. If the concept of control is expanded to exit decisions, defensive tactics, which are triggered by a change of control or which are outside the ordinary course of business and are adopted when a tender offer is pending or imminent, also require a shareholders' vote.

## VI. THE CONFLICT OF INTEREST VOTING SYSTEM

Whereas the control voting system mandates voting on changes of control, the conflict of interest voting system provides for voting on provisions or transactions involving conflicts of interests for management or controlling shareholders. Self-dealing transactions require voting, because management and controlling shareholders are psychologically more inclined to depart from their fiduciary obligations or to misread exit messages in those situations.

### A. *Summary of Conflict of Interest Voting System*

Some of the rules developed for the control voting system apply also



to the conflict of interest voting system. The rules developed for provisions that shift control from shareholders to managers apply equally to the conflict of interest voting system. Managers have a conflict of interest in voting on such shift. A shift of control from shareholders to managers requires a majority vote of disinterested shares. In addition, the rules developed for provisions that shift control from majority to minority shareholders and that have the additional effect of placing power in the board of directors also apply to the conflict of interest voting system. Because managers have a conflict of interest with respect to these provisions, they require a majority vote of disinterested shares.

Moreover, the rules developed for provisions that shift power from minority to controlling shareholders and from another coalition to shareholders apply also to the conflict of interest voting system, because of the controlling shareholder's conflict of interest. Thus, a shift of control from minority to majority shareholders requires the same percentage vote that was cast to create the current situation, and a shift of power from another coalition to shareholders requires the consent of the other coalition.

The rules under the control voting system that apply to provisions that shift control from controlling to minority shareholders, and that do not place additional power in the board of directors, do not require a shareholders' vote under the conflict of interest voting system. Neither managers nor controlling shareholders have a conflicting interest with respect to the adoption of those provisions. In addition, under the control voting system, the rule that a majority vote of shares may elect or remove directors arguably is inconsistent with the conflict of interest voting system. Because the controlling shareholder may seek a managerial interest, a vote of disinterested shares on the election or removal of directors is initially indicated. Such a vote would require interested shareholders to obtain the support of other shareholders, thus preventing overreaching by interested shareholders and encouraging attention to the interests of all shareholders. A weighted voting system that recognizes the number of shareholders as well as the percentage of shares required to elect or remove directors may be more appropriate, however, because it avoids disenfranchising the controlling shareholder but at the same time recognizes his conflict.

Some transactions that require a shareholder vote under the control voting system do not require a vote under the conflict of interest voting system and vice versa. For example, a transaction that changes control will not require a shareholder vote if managers or controlling shareholders have no conflict of interest in the transaction, such as where the transaction shifts control to some other person or group. In addition, even

though a transaction does not affect control, a shareholder vote may be required under the conflict of interest voting system if managers or controlling shareholders have a conflict of interest with respect to the transaction. Finally, a shift of control from managers to shareholders requires a majority vote of disinterested shares.

The following section develops a definition of "conflict of interest transactions" for voting purposes. Section C then explores arguments for expanding the conflict of interest voting system to require voting on subjects not included in that definition.

### B. *Defining Conflict of Interest Transactions*

One could develop a definition of conflict of interest transactions from existing state statutes and fiduciary duty cases that often apply a higher standard of review if the court finds that the board of directors has a conflict of interest.<sup>306</sup> Nevertheless, greater precision in defining conflicting interests is advisable when such transactions will require a shareholder vote because a transaction may be invalid if it proceeds without a vote.<sup>307</sup> By contrast, some uncertainty in fiduciary duty cases is not a problem since all transactions should be able to meet the higher standard of review used in conflict of interest cases. Moreover, ambiguity in defining conflict of interest transactions in a fiduciary duty context serves as a deterrent to wrongdoing.

This section defines fairly precisely conflict of interest transactions for voting purposes to provide guidance to managers in determining which transactions require a shareholder vote. Briefly, a transaction is a conflict of interest transaction if a director, controlling shareholder, or a person with whom the director or controlling person has a "close," "controlling," or "financial" relationship, is a party to the transaction, has a direct financial interest in the transaction, or has a financial interest in the other party to the transaction.<sup>308</sup>

When such a person is a party to the transaction, the transaction

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306. *E.g.*, *Fliegler v. Lawrence*, 361 A.2d 218, 221-22 (Del. 1976); *Schlensky v. South Parkway Bldg. Corp.*, 19 Ill. 2d 268, 275, 166 N.E.2d 793, 800 (1960).

307. Of course, legislatures may wish to provide penalties for directors who negligently fail to obtain the vote, but permit invalidation of the transaction only after consideration of the equities involved.

308. The definition of conflict of interest transactions proposed in this article can be compared and contrasted with other definitions of such transactions used in fiduciary duty cases and for disclosure purposes. The ALI DRAFT, *supra* note 235, §§ 1.02, 1.18, provides a definition of conflicts for determining the standard of review for fiduciary duty claims. In connection with the solicitation of proxies, the Securities and Exchange Commission has required the disclosure of conflicts of interest of director nominees. Regulation S-K, 17 C.F.R. § 229.404 (1991) [hereinafter Commission Rule].

involves a conflict of interest. A state may wish, however, to limit the scope of voting to transactions where the degree of conflict is high. One may measure the level of conflict by the percentage or dollar amount of the person's gross income or assets involved in or to be derived from the transaction ("the one factor income or asset test"). The percentage or dollar amount fixed may vary depending on whether the person involved as a party is the director or controlling shareholder, or is a person with a close, controlling, or financial relationship with the director or controlling shareholder.<sup>309</sup>

When the person involved has a direct financial interest in the transaction, a conflict of interest exists. The seriousness of the person's conflict of interest may determine the scope of voting. The one factor income or asset test, which the percentage or dollar amount of the person's gross income or assets involved in or to be derived from the transaction, can be used in determining the extent of the conflict. Again, the percentage or dollar amount fixed may depend on whether the person who has the direct financial interest is the director or controlling shareholder or a person with a close, controlling, or financial relationship with the director or controlling shareholder.

A conflict of interest transaction also includes a transaction in which the person has a financial interest in the other party or an affiliate of the other party to the transaction. The financial interest may derive from various relationships, such as employee, partner, shareholder, director, or creditor. The degree of conflict involved may limit the scope of conflicts voting. Determining the degree of conflict depends on three factors: (1) the extent of the person's interest in the other party or its affiliate, (2) the significance of the interest to the person, and (3) the importance of the transaction to the other party or its affiliate. A degree of conflict test would consider the percentage or dollar amount of the interest in the other party (or its affiliate), the percentage or amount of the person's income or assets derived from or invested in the other party (or its affiliate), and the percentage or dollar amount of the other party's (or its affiliate's) income or assets involved in the transaction (the "three-factor income or asset test").

For example, one may define a conflict of interest transaction as a transaction where the person owns or receives at least one percent of the

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309. The ALI DRAFT, *supra* note 235, and the Commission Rule, *supra* note 308, apply also to transactions in which the corporation and a director or controlling shareholder are parties, except that the Commission Rule applies only to shareholders' owning more than five percent of the corporation's voting securities and to transactions involving more than \$60,000. Neither definition places importance on the significance of the transaction to the director or shareholder involved as a party, as does the income or gross assets test outlined above.

income or assets of the other party (or its affiliate), where the person derives at least ten percent of his income or invests at least ten percent of his total assets in the other party (or its affiliate), and where the other party (or its affiliate) obtains at least five percent of its gross income or invests at least five percent of its total assets in the transaction. These numbers may vary depending on whether the person is the director or controlling shareholder, or a person with a close, controlling, or financial relationship with the director or controlling person.<sup>310</sup>

One may define a person with a close relationship with the director or controlling person as follows:

- (i) The spouse (or a parent or sibling thereof) of the director or controlling shareholder, or a child, grandchild, sibling, parent (or spouse of any thereof) of the director or controlling shareholder, or an individual having the same home as the director or controlling shareholder, or an individual for whom the director or controlling shareholder has financial responsibility [measured by a percentage of the director or shareholder's income or assets], or a trust or estate of which an individual specified in this clause (i) is a ten percent or more beneficial owner;
- or (ii) a trust, estate, incompetent, conservatee, or minor of which the director or controlling shareholder is a fiduciary.<sup>311</sup>

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310. The ALI DRAFT, *supra* note 235, is less precise in defining what constitutes a person's interest in the other party and does not take into account all three factors. *See id.* § 1.18. According to the *ALI Draft*, a director with a financial interest or 10% equity interest in the other party to the transaction has a conflict of interest if the interest is sufficiently substantial that it could reasonably be expected to affect the director's judgment. *Id.* The *ALI Draft* considers the first factor and also appears to focus on the second factor, that is, the significance of the interest to the director. The third factor, the importance of the transaction to the other party to the transaction, however, is not taken into account.

In addition, the *ALI Draft* would exclude from its definition of interests in the other party to the transaction the interest of a director or general manager; the Commission's Rule does not apply to a directorate interest in the other party. *Id.* The conflicts formula suggested above would not necessarily exclude such interests, although in many cases the financial interests of directors would not satisfy the formula.

The Commission focuses on all three factors when it generally defines materiality. Commission Rule, *supra* note 308, § 404(a) (Instruction to Paragraph (a) of Item 404). Specifically, it focuses on the first factor in an indirect manner when it excludes from the definition of materiality less than 10% limited partnership or equity interests in the other party to the transaction. *Id.* § 229.404(a) (Instruction 8A(ii) and 8B). Moreover, it focuses on the third factor when it requires the disclosure of a more than 10% equity interest or position as an executive officer of the other party to the transaction if the transaction involves over five percent of the consolidated revenues of the other party. *Id.* § 229.404(b). The Commission also focuses on a fourth factor, the size of the transaction, which is one measure of the risk of loss to the corporation of entering into the transaction, by requiring the disclosure of certain interests if more than five percent of consolidated revenue of the corporation is involved in the transaction. *Id.* § 229.404(b).

311. This definition is similar to Revised Model Business Corporation Act § 8.60(3), except that a close relationship is deemed to exist with an individual for whom the director or control-

A person with a controlling relationship with the director or controlling shareholder is a person who controls or is controlled by, or is under common control with the director or controlling shareholder. More specific definitions of these persons are possible. One can define a person who has a financial relationship with the director or controlling person as a person who is the source of or the investment vehicle for a certain percentage or dollar amount of the director or controlling shareholder's income or assets.<sup>312</sup>

C. *Arguments for Including Additional Transactions in the Conflict of Interest Voting System*

Support for expanding the subjects on which shareholders can vote under the conflict of interest voting system exists in Professor Gilson's article discussed above, in which he argued that managers are more likely to act in their interest and against the interests of shareholders when they will not be subject to the discipline of the market after the transaction (the final period).<sup>313</sup> This argument suggests there should be shareholder voting on transactions that result in management or the controlling shareholder "losing" control as well as on corporate dissolution and some sale of asset transactions that leave the corporation with an insignificant continuing business.

Professor Eisenberg has argued that all "structural" changes, even if they do not result in a loss of control, present conflict of interest problems for managers because they involve nonfinancial incentives and values, such as concern for personal power and prestige, personal identi-

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ling shareholder has financial responsibility. The definition applies to controlling shareholders, and a close relationship is deemed to exist with a trust or estate of one of the individuals specified in clause (i) in which that individual has a beneficial ownership interest of ten percent or more (rather than an ambiguous "substantial interest"). REV. MODEL BUSINESS CORP. ACT § 8.60(3) (1984). In addition, the definition of immediate family members is consistent with the Commission's Rule which, unlike the *ALI Draft*, specifically lists "in-laws." It adopts the *ALI Draft*'s inclusion of a person for whom a director or shareholder has financial responsibility, but does not require the difficult assessment of whether the financial responsibility is sufficiently substantial to be reasonably expected to affect the director or shareholder's judgment adverse to the corporation. In addition, it does not include, as does the *ALI Draft*, more remote familial relationships that have the same degree of intimacy, relationships not based on consanguinity, or a legally established matrimonial relationship. These relationships, however, would most likely be covered by including an individual having the same home as the director or controlling shareholder.

312. The *ALI Draft* covers transactions in which a person has a pecuniary interest (*i.e.*, has a business relationship with a director or owns more than 10% of the equity interest in the corporation) only if such interest is deemed sufficiently substantial that it would reasonably be expected to affect the director's judgment. ALI DRAFT, *supra* note 235, § 1.18. The Commission Rule does not expressly address them.

313. See *supra* note 141 and accompanying text.

fication with the corporation, and a desire for security.<sup>314</sup> For example, managers may have nonfinancial incentives when they approve corporate acquisitions that do not result in a change of control.

Nonfinancial incentives are also involved in certain managerial decisions that Professor Eisenberg does not classify as "structural." For example, a low debt to equity ratio can enhance management's sense of security, as Professor Donaldson has noted.<sup>315</sup> Moreover, the use of earnings for investments rather than for dividends can fuel the growth of the corporation, thus satisfying management's desire for personal power and prestige. Tender offers by bidding firms may be motivated in many cases by hubris.<sup>316</sup> Decisions to expand the purposes of the corporation or extend its duration likewise may involve nonfinancial incentives.

A legislature could require a shareholder vote on transactions that, on average, are shown not to benefit shareholders and that satisfy plausible, personal, nonfinancial values of managers, such as power and security. For example, if the evidence concerning the benefits to shareholders of mergers is somewhat mixed,<sup>317</sup> the legislature could require a shareholder vote on all mergers even though a loss of control or conflict of interest (as defined in the preceding section) is not involved. Moreover, a vote on dividends may be appropriate if the return on retained earnings is found to be significantly lower than the return on funds obtained through debt and equity financing. In addition, a legislature may conclude from evidence of returns from tender offers<sup>318</sup> that shareholders of the bidding corporation should have the right to vote on the bid.<sup>319</sup> Of course, one can argue that such a right for bidding company shareholders falls outside the scope of voting because it reduces substantially managerial accountability by interfering with the market for corporate control.

Defensive tactics that affect the exercise of exit rather than voice fall more easily into the conflict of interest voting system than the control voting system. Managers have a conflict of interest when voting on such tactics. Their conflict of interest is not dependent on their subjective purpose or intent in adopting the tactic,<sup>320</sup> but on the objective fact that they

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314. EISENBERG, *supra* note 66, at 30-36.

315. GORDON DONALDSON, *MANAGING CORPORATE WEALTH* 54-56 (1984).

316. Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986).

317. See Lyman Johnson, *Minnesota's Control Share Acquisition Statute and the Need for New Judicial Analysis of State Takeover Legislation*, 12 WM. MITCHELL L. REV. 183, 204-06 (1986).

318. Coffee, *supra* note 141, at 938.

319. Such a right has been proposed by Arthur J. Goldberg. SEC ADVISORY REPORT, *supra* note 84, at 130 (Separate Statement of Arthur J. Goldberg).

320. Thus, the problem of determining subjective intent or motive discussed by Professor Gilson can be avoided. Gilson, *A Structural Approach*, *supra* note 139, at 827-30.

may be more easily replaced without such tactics. Management's conflict of interest is most evident (1) when the decision or transaction is conditioned on a change of control, or (2) when the decision or transaction is outside the ordinary course of business and is adopted when a tender offer is imminent or pending. Section V B(4)(a) described both tactics.

Finally, a state legislature could conclude that nonfinancial conflicts of interest are present to a heightened degree in certain transactions and, therefore, require a shareholder vote. For example, a transaction where the director or controlling shareholder is a director of the other party to the transaction might present such a case. Such a director rarely would satisfy the financial interest test included in the last section. A legislature, however, could conclude that a director or controlling person's ego plays so large a part in causing such transactions that it requires a shareholder vote.

#### *D. Comparing the Conflict of Interest Voting System*

One may summarize the conflict of interest voting system by comparing it with the control voting system and existing state law. First, as under the control voting system, whether a shareholder vote is required depends on the effects of the addition or deletion of a provision in the corporation's articles or bylaws, as does the identification of the proper voting method. The location of a provision, whether in the corporation's articles or bylaws, is irrelevant to this issue. Unlike the control voting system, however, only shifts of control with respect to which management or controlling shareholders have a conflict of interest require a shareholder vote.

A second dissimilarity between the two systems is that directors are elected or removed under the conflict of interest system in accordance with a weighted voting system that takes into account the number of shareholders as well as percentage of shares voting.

Third, transactions, including mergers and sale-of-asset transactions, that require a majority vote of disinterested shares consist of those in which a director, controlling shareholder, or a person with whom the director or controlling person has a close, controlling, or financial relationship, is a party to the transaction, has a direct financial interest in the transaction, or has an interest in the other party to the transaction. Mergers between parent companies and subsidiaries, for example, require a majority vote of disinterested shares. Golden parachutes or other forms of executive compensation, if they meet the financial-interest test heretofore proposed, also require such a vote.

Fourth, if a state adheres to Professor Gilson's final period analysis,

it would require a majority vote of disinterested shares for dissolutions and certain sale of asset transactions that leave the corporation without a significant continuing business.

Finally, decisions or transactions triggered by a change of control or decided when a tender offer is pending or imminent and that are outside the ordinary course of business require such a vote. Sixth, a legislature could conclude that personal, nonfinancial incentives of managers impact a number of transactions, based on evidence that, on average, these transactions do not necessarily benefit shareholders. Approval here would require a majority vote of disinterested shares.

### *E. Risk of Loss Limitations*

Rules measuring the degree of conflict do not take into account the importance of the transaction to the subject corporation, although they attempt to measure the likelihood that management will make decisions not in the interest of shareholders. State legislatures may wish to add a risk-of-loss threshold test to the conflict of interest voting scheme. Different thresholds might be used for situations where interests are direct and where they are indirect (in the other party to the transaction), possibly using a \$60,000 threshold for transactions in which interests are direct and a percentage or dollar amount of the corporation's income or assets for transactions in which the interests are indirect.

## VII. CONCLUSION

For some time, scholars have recognized the need to rework state law governing shareholder voting rights. Modifications of state statutes to cover transactions functionally equivalent to mergers reflect patchwork efforts in this area.<sup>321</sup> One can see signs of more endemic changes in recent revisions of state statutes<sup>322</sup> and in the *ALI Draft* proposal,<sup>323</sup> both of which focus on control. Moreover, attention given by courts<sup>324</sup> and statutory provisions<sup>325</sup> to disinterested share voting, and congressional and Securities and Exchange Commission proposals for voting rights on defensive tactics,<sup>326</sup> are further indications of changing conceptions of voting and methods for voting.

This Article attempts to develop conceptual frameworks that en-

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321. GILSON, *supra* note 138, at 572-73.

322. *See supra* text accompanying notes 231-34.

323. *See supra* text accompanying notes 235-44.

324. *See supra* text accompanying notes 245-46.

325. *See supra* notes 78-79.

326. *See supra* text accompanying notes 83-93.



compass these developments and suggests bases for reworking shareholder voting rights. Because corporations are powerful political, economic, and social institutions, an effective system of checks and balances is necessary for managerial accountability to shareholders and the public at large. For this reason, the ALI project and the ABA Committee on Corporate Laws should examine the control and conflict of interest voting systems developed in this Article for the purpose of proposing to state legislatures the revision of shareholder voting rights.