ONE SHARE, ONE VOTE AND THE FALSE PROMISE OF SHAREHOLDER HOMOGENEITY

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INTRODUCTION

Corporate law has been forced to confront its political side. Throughout the twentieth century, scholars focused on fiduciary duties, agency costs, and social efficiency in their analysis of the corporation. While the relationships amongst executives, directors, and shareholders were subject to close scrutiny, the most direct relationship—namely, the shareholders' election of directors—was taken for granted, a required but largely uncontroversial (and inconsequential) annual exercise in democracy. The ramifications of this were well understood: the separation between ownership and control is foundational to the field.[1] But this lack of accountability on the part of elected officials to their constituents was to be addressed through shareholder suits, securities regulation, or tender offers. The possibility for electoral oversight was largely assumed to be impossible.

However, a convergence of economic, demographic, and legal forces has created the new world of "shareholder democracy." The growth of institutional shareholders has been accompanied by their interest in exercising collective power to oversee management. As part of their oversight, these shareholders are taking their voting rights seriously. Difficulties in exercising this power still remain, and shareholder democracy advocates have an array of proposals designed to make their voting rights more effective.[2] But, as one set of commentators has noted, "[n]ever has voting been more important in corporate law."[3]

The new importance vested in corporate democratic processes has raised the stakes for the construction of the polity. Lopsided voting arrangements that give a small minority disproportionate power have come under increasing scrutiny.[4] Just as "one person, one vote" resonates with fairness for the average American, the phrase "one share,

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[1] The seminal work is ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). Their work on the separation of ownership and control has arguably led to much of the later work in the field. *Cf.* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1624 (2001) ("It was as if everyone already knew (from Berle and Means) that the master problem of corporate law was agency costs, and along came an economic model and a vocabulary to elaborate that view.").

[2] *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

[3] Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting* 2 (Univ. of Pa. Law Sch. Inst. for Law & Econ. Research Paper No. 07-18, 2007), *available at* http://ssrn.com/abstract=1007065.

[4] *See, e.g.*, *Times Investors Urged to Take Stand*, CNNMONEY.COM, Apr. 5, 2007, http://money.cnn.com/2007/04/05/news/companies/nytimes_board/?postversion=2007040512 (discussing concerns over dual-class ownership structure at the New York Times Co.).

one vote" provides a powerful slogan for shareholder governance in our corporate law.[5] The phrase is appealing because it provides a system of governance based on a reductive but equitable distribution: each unit shall have the same power of control over the organization. "One share, one vote" has been described as "[t]he most basic statutory rule of [corporate] voting"[6] as well as consistent with "[d]emocratic intuition [and] liberal tradition."[7] Although the standard is simply a default rule in most jurisdictions, most publicly traded companies have adopted it, and it remains the presumptive norm.[8]

Corporate law scholars generally accept the "one share, one vote" standard as the basis for efficient distribution of the corporation's voting rights.[9] According to the theory, shareholders have the right to control the corporation because they own the rights to the residual interest in the corporation (i.e., its profits). Because all other stakeholders in the corporation—employees, suppliers, and customers—are entitled to their contractual claims before profits are paid, shareholders are in the best position to maximize the overall wealth generated by the corporation.[10] The notion that shareholder interests should be pursued as the ultimate ends of the corporation is known as shareholder primacy theory, or the shareholder wealth maximization norm.[11] The shareholder franchise is

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[5] The standard of "one share, one vote" was ensconced in American corporate practice by the New York Stock Exchange in 1926. For a discussion of the New York Stock Exchange rule, see Joel Seligman, *Stock Exchange Rules Affecting Takeovers and Control Transactions*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 465, 468-73 (John C. Coffee, Jr., Louis Lowenstein & Susan Rose-Ackerman eds., 1988). More importantly (for our purposes), corporate scholars have argued that the "one share, one vote" corporate voting structure offers the best structure for maximizing social utility. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 73 (1991).

[6] *Id.* at 72.

[7] Colleen A. Dunlavy, *Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights*, 63 WASH. & LEE L. REV. 1347, 1367 (2006) (quoting Caroline Fohlin, *The History of Corporate Ownership and Control in Germany*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 223, 262 (Randall K. Morck ed., 2005) (alteration to the original).

[8] ROBERT CHARLES CLARK, CORPORATE LAW 361 (1986). The standard has been increasingly popular in European states. *See* Guido Ferrarini, *One Share—One Vote: A European Rule?* 22 (European Corporate Governance Inst., Law Working Paper No. 58/2006, 2006), *available at* http://ssrn.com/abstract=878664 ("[T]he law and practice in European countries is slowly converging towards Anglo-American corporate governance standards, including one share—one vote."). And European Union officials have pushed corporations toward "one share, one vote" in order to "eliminate discriminatory treatment of shareholders." Tobias Buck, *EU Seeks to End Bias Among Investors: Commission Wants 'One Share, One Vote' Principle*, FIN. TIMES (London), Oct. 17, 2005, at 1 (quoting the European Union's internal market commissioner Charlie McCreevy).

[9] Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 777 (2005) ("[S]cholars have not seriously challenged the theoretical underpinnings of the dominant one-share/one-vote approach to corporate voting.").

[10] EASTERBROOK & FISCHEL, *supra* note 5, at 67-70.

[11] For a discussion of the history of the shareholder primacy norm, see Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637,

one way of ensuring that the corporation pursues these ends. Moreover, the "one share, one vote" standard is the best way of ensuring that these ends are pursued. Each shareholder should have one vote for each share so that all shareholders have voting power equivalent to their interest in the residual. This provides all shareholders with the proper incentives to oversee management, choose to accept or reject a proposed merger, and otherwise maximize the wealth generated by the corporation. Otherwise, shareholders would have disproportionate interests in the residual, resulting in disproportionate voting interests.

Critical to the success of this theory, however, is the notion that all shareholders have the same interest—namely, maximizing the residual value of the corporation. Shareholder primacy theory maintains that all shareholders have homogeneity of interest. Indeed, it is seen as a necessary aspect of the theory. If the purpose of the corporation is to maximize the residual, then the shareholders must all agree with this purpose. Otherwise, shareholders may elect directors who will pursue interests apart from residual wealth maximization. Thus, corporate law theorists have repeatedly emphasized the homogeneity of shareholder interests as a critical assumption of the model.[12]

Recent developments in the field of finance, however, have called shareholder homogeneity into question. For example, new derivative financial products allow stockholders to hedge their financial interest such that they no longer have the same interests as their shareholding counterparts.[13] As a result, hedged shareholders might vote against the interests of the corporation in order to maximize the value of their derivative stake. Conversely, shareholders may retain "hidden" ownership of their shares, such that immense voting power in the corporation can be pulled out from seemingly thin air when this voting power would be instrumental.[14] Such shareholders have greater voting power than their reported stock ownership would indicate; indeed, their voting power may be much greater than their interest in residual profits. Based on these conflicts between shareholder interests, some scholars have argued that the theory behind "one share, one vote" is no longer valid and have pushed to exclude certain shareholders from the franchise.[15]

646-50 (2006).

12 *See generally* Paul H. Edelman & Randall S. Thomas, *Corporate Voting and the Takeover Debate*, 58 VAND. L. REV. 453, 464 (2005) (discussing the assumption of homogeneity in other corporate law models).

13 *See* Martin & Partnoy, *supra* note 9, at 778 (describing how equity derivatives may allow a shareholder to reallocate their interest in the residual); Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006) (noting that "[i]n an extreme case, an investor can vote despite having negative economic ownership.").

14 *See* Hu & Black, *supra* note 13, at 836-42.

15 Martin & Partnoy, *supra* note 9, at 778, 793.

However, while this particular type of competing interest is new, competing interests among shareholders are not. Shareholders are not the homogenous share-value maximizers that the "one share, one vote" theory envisions. Instead, shareholders are likely to have a variety of interests that can potentially compete with their interests as shareholders. In addition, even shareholders who have no other financial interests may still have different views on how best to maximize shareholder wealth or their individual shareholder utility. Instead of being a limited exception, the recent growth of hedged shareholders is merely another example of how shareholders fail to comport with the homogenized vision of corporate law.

Moreover, even if shareholders were homogenous, their single-minded focus on profits would not justify giving them sole control over the corporation. Easterbrook and Fischel, in their classic article (and later, book) on shareholder voting, justified the shareholder franchise as the best way to aggregate preferences along a certain axis without descending into constant struggles over power.[16] However, their analysis misreads the literature on social choice and preference aggregation. The need for agreement along a single spectrum fails to justify the elevation of shareholder preferences above all others. When we remove the assumption of shareholder homogeneity and consider the actual conflicted nature of their preferences, we can no longer justify shareholder democracy based on the traditional rationales.

This paper argues for a reconsideration of the traditional justifications for the "one share, one vote" standard, as well as the limitations of the corporate polity to shareholders. In Part I, we draw on the voting rights literature more generally in discussing the considerations that go into creating a system of political voting rights. In Part II, we discuss the shareholder franchise within the corporation, its foundational justifications, and some problems with the traditional notion of the homogenous shareholder. In Part III, we first discuss why shareholder heterogeneity causes problems for the traditional efficiency rationale for the shareholder franchise. We then discuss how, regardless of heterogeneity, preference aggregation theory does not require that only shareholders have voting rights within the corporation. Finally, in Part IV, we begin the discussion of how preference theory and utility maximization might be used to reconfigure the organizational structure of the corporation.

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16 Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); EASTERBROOK & FISCHEL, *supra* note 5.

I. VOTING IN THE POLITICAL ARENA

A. *The Basic Structure of Voting Rights Law*

Life is full of decisions. Some are fairly simple, like what one should order for dinner. A preference for one dish over the others would drive an individual decision. Decisions made by groups of people, however, are more complicated. When forced to order a dish for a group, we need some way of moving from individual desires to a group decision.[17] We need, in other words, a social choice function.[18] There are many kinds of social choice functions to choose from—we could just order what one person wants (the dinner dictator), we could flip a coin, or we could use an approach that seems to better capture the preferences of the members of the group, such as voting. Most democratic institutions have taken this third approach when it comes to translating individual preferences into group choices.[19] Indeed, voting is the sine qua non of democratic decision-making.

When political institutions settle on voting as the preferred method of preference aggregation, they still have many decisions to make about how to structure the process. Those decisions often come to be embodied in a set of legal entitlements, or voting rights, which collectively sketch the contours of polity. These voting rights, though, are not uni-dimensional; instead, there are at least three distinct facets to the rights to vote, each of which is necessary to ensuring full democratic participation.[20]

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17 The study of how we make such moves comes under the heading of social choice theory, which has entered the legal literature under the guise of public choice theory. *See, e.g.*, MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW (1997); DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION (1991).

18 The terminology here follows WILLIAM H. RIKER, LIBERALISM AGAINST POPULISM: A CONFRONTATION BETWEEN THE THEORY OF DEMOCRACY AND THE THEORY OF SOCIAL CHOICE (1982). A social choice function is a rule that translates a preference profile (a set of individual preference orders, one for each member of society) into a social preference order (a complete arrangement of alternatives in order of their attractiveness to society as a whole). *Id.* at 18, 296-97.

19 *See* NORMAN FROHLICH & JOE A. OPPENHEIMER, MODERN POLITICAL ECONOMY 16 (1978).

20 This taxonomy is, in part, borrowed from Pamela S. Karlan, *Maps and Misreadings: The Role of Geographic Compactness in Racial Vote Dilution Litigation*, 24 HARV. C.R.-C.L. L. REV. 173, 176 (1989). *See also* Grant M. Hayden, *Resolving the Dilemma of Minority Representation*, 92 CAL. L. REV. 1589, 1594-1602 (2004) [hereinafter Hayden, *Resolving the Dilemma*] (giving a brief account of the history of each aspect of the right). Other ways of parsing out the right to vote, *see, e.g.*, Richard H. Pildes, *What Kind of Right is "The Right to Vote"?*, 93 VA. L. REV. IN BRIEF 45 (2007), http://www.virginialawreview.org/inbrief/2007/04/23/pildes.pdf, and Pamela S. Karlan, *The Rights to Vote: Some Pessimism About Formalism*, 71 TEX. L. REV. 1705, 1709-20 (1993), are not inconsistent with this conception.

The first aspect of the right to vote involves access—the ability to cast a ballot.[21] This constitutes voting rights at their most fundamental, and is what people are usually talking about when discussing the right to vote. But the mere ability to cast a ballot is not sufficient to ensure meaningful participation. One's vote must be accorded sufficient weight and must be combined with those of other like-minded voters to give the voter an opportunity to influence the outcome of an election. Hence the development of the second and third aspects of the right to vote. The second aspect is the right to cast a vote that carries an appropriate numerical weight, one that is quantitatively undiluted.[22] For most elections in the United States, this means that the election districts must be drawn in ways consistent with the principle of one person, one vote. Even with equal access and equal weighting, however, voters may be denied meaningful participation through a variety of other political practices such as gerrymandering and at-large districting.[23] Such practices, which may qualitatively dilute a group's voting power, gave rise to the third aspect of the right to vote, and are at the heart of much of the nation's voting rights litigation today. A robust understanding of the right to vote, then, involves several distinct (yet related) components. Full democratic participation depends upon enforcement of all three aspects of the right.

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21 For a relatively recent history of the right to vote, see ALEXANDER KEYSSAR, THE RIGHT TO VOTE: THE CONTESTED HISTORY OF DEMOCRACY IN THE UNITED STATES (2000). For information about voting in the early years of the republic, see MARCHETTE CHUTE, THE FIRST LIBERTY: A HISTORY OF THE RIGHT TO VOTE IN AMERICA, 1619-1850 (1969); CHILTON WILLIAMSON, AMERICAN SUFFRAGE: FROM PROPERTY TO DEMOCRACY, 1760-1860 (1960). For information about voting rights in more recent years, with an emphasis on the quest for minority representation, see QUIET REVOLUTION IN THE SOUTH: THE IMPACT OF THE VOTING RIGHTS ACT, 1965-1990 (Chandler Davidson & Bernard Grofman eds., 1994); BERNARD GROFMAN, LISA HANDLEY & RICHARD G. NIEMI, MINORITY REPRESENTATION AND THE QUEST FOR VOTING EQUALITY (1992); STEVEN F. LAWSON, BLACK BALLOTS: VOTING RIGHTS IN THE SOUTH, 1944-1969 (1976); J. MORGAN KOUSSER, THE SHAPING OF SOUTHERN POLITICS: SUFFRAGE RESTRICTION AND THE ESTABLISHMENT OF THE ONE-PARTY SOUTH, 1880-1910 (1974).

22 For background on this aspect of the right to vote, see ROBERT G. DIXON, JR., DEMOCRATIC REPRESENTATION: REAPPORTIONMENT IN LAW AND POLITICS (1968); REPRESENTATION AND MISREPRESENTATION: LEGISLATIVE REAPPORTIONMENT IN THEORY AND PRACTICE (Robert A. Goldwin ed., 1966); GORDON E. BAKER, THE REAPPORTIONMENT REVOLUTION: REPRESENTATION, POLITICAL POWER, AND THE SUPREME COURT (1966); ROBERT B. MCKAY, REAPPORTIONMENT: THE LAW AND POLITICS OF EQUAL REPRESENTATION (1965); Hayden, *Resolving the Dilemma*, *supra* note 20; Grant M. Hayden, *The False Promise of One Person, One Vote*, 102 MICH. L. REV. 213 (2003) [hereinafter Hayden, *False Promise*].

23 *See* Hayden, *Resolving the Dilemma*, *supra* note 20, at 1600-02 (detailing minority vote dilution); Samuel Issacharoff, *Gerrymandering and Political Cartels*, 116 HARV. L. REV. 593 (2002) (discussing political gerrymandering).

B. *Theoretical Underpinnings of the Right to Vote*

The political history of the United States is in large part a chronicle of the battles fought over who, exactly, should receive voting rights. Should blacks be allowed to cast ballots? Women? Resident aliens? Should urban and rural votes be assigned the same amount of numerical weight? What about full-time residents and part-time residents? Should Hispanics that make up a sufficient proportion of the population be guaranteed a certain number of representatives of their choice? What about Republicans? The answers to these questions have been highly contested, and many admit of no simple answers.

Even though there has been little agreement over the proper scope of a particular aspect of voting rights, there has been some common ground. There has been a consistent appeal to certain principles by both sides of most of these debates. Sometimes, those principles are too vague to provide much of a ground for debate—references to "fundamental" notions of equality come to mind. But in other cases, these basic principles are a little less slippery, and provide a better platform for discussion. In this subsection, we will examine one of these basic principles: the relationship between voting rights and one's interest, or stake, in the outcome of an election. We will then discuss the basic aspects of the various proxies that political democracies rely upon to assess that interest for the purpose of conferring voting rights.

1. Voting Rights and Interest

a. Interest and Access

Debates regarding the most basic issue in voting rights—who should be allowed to vote—are informed by many things. But chief among these is an assessment about the degree to which a potential voter is affected by the outcome of the election.[24] Those with a strong interest in the outcome, with a sufficient stake, are prime candidates for the franchise. Those with little or nothing riding on the outcome, on the

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[24] *See* Hayden, *False Promise*, *supra* note 22, at 251-61 (discussing the relationship between preference strength and various manifestations of the right to vote); Melvyn R. Durchslag, Salyer, Ball, *and* Holt: *Reappraising the Right to Vote in Terms of Political "Interest" and Vote Dilution*, 33 CASE W. RES. L. REV. 1, 38-39 (1982) (discussing the fact that "'interest,' implicitly or explicitly, must be the touchstone of the [Supreme] Court's analysis" of several types of voting rights cases). We do not claim that this reason motivates all decisions to enfranchise or disenfranchise people. There are obviously people with strong interests in the outcomes of elections (e.g., people with mental disabilities, children) who are nonetheless prohibited from voting for other reasons, mostly having to do with their competency.

other hand, are rarely extended voting rights. Figuring out which people have a sufficient stake in the outcome of an election, and hence a right to vote, is contentious. But there is often an underlying point of agreement—that we can make that decision based, in large part, on the relative strength of one's interest in the election.

This should not come as a great surprise. Voting, after all, is a social choice mechanism, a way of moving from individual preferences over an array of alternatives (candidates, propositions, dinner options) to group choices. And this is done in a way intended to maximize preference satisfaction.[25] People with a strong interest in the outcome of a vote, with correspondingly strong preferences, are obviously the first candidates for the right to vote in such an election. People with weak or nonexistent preferences with respect to the outcome of a vote do not have much to contribute to this end—their lives, their interests, and their happiness are not much affected by the outcome.

There are additional, related reasons for tying the franchise to preference strength. For example, because those with a strong stake in the outcome have to live with the consequences, they may be more likely to make better decisions. They may, for example, think more deeply about their vote, and may be more likely to educate themselves on the specific candidate or issues at stake. And the outcome of the election may be perceived as more legitimate when those who are greatly affected had the opportunity to vote. The rallying cry "No taxation without representation" trades on this sentiment.

There is, unfortunately, no way to directly test the strength of people's preferences in order to see who should vote. We could, for example, just ask people how strong their interests are, but there would be numerous problems with that approach. First, while many individuals may accurately report that they feel more or less strongly about the outcome of any election, there is no way for them (or anyone else) to neutrally compare such reports with those of other individuals.[26] There is no universal scale upon which to measure everyone's preference strength and, even if there were, there is no omniscient social scientist to peer directly into everyone's minds and make a proper assessment.[27] Second, making those kinds of person-by-person assessments by polling or interviewing people would be prohibitively

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25 Hayden, *False Promise*, *supra* note 22, at 248-49.

26 This is generally discussed as the difficulty in making interpersonal comparisons of utility. For a summary of the problem, see *id.* at 236-47. *See also* INTERPERSONAL COMPARISONS OF WELL-BEING (Jon Elster & John E. Roemer eds., 1991); JAMES GRIFFIN, WELL-BEING: ITS MEANING, MEASUREMENT, AND MORAL IMPORTANCE 113-20 (1986); Peter Hammond, *Interpersonal Comparisons of Utility: Why and How They Are and Should Be Made*, *in* INTERPERSONAL COMPARISONS OF WELL-BEING 200, 238-254 (Jon Elster & John E. Roemer eds., 1991).

27 *See* Hayden, *False Promise*, *supra* note 22, at 245.

expensive, especially when you consider the fact that all representative governments would need to assess all potential voters.[28] And, finally, we would be worried about strategic misrepresentation of the strength of one's preferences, especially since something useful—voting rights—would come with the expression of a strong interest in the outcome of an election.[29] Relying on first-person reports, then, would not work, and has not been the way governmental entities have made such assessments.[30] They have instead relied on various proxies for one's level of interest in the outcome of an election.

There are both historical and contemporary examples involving debates over the extent of the franchise that make this point clear. At the turn of the nineteenth century, many states limited voting to white men who owned a certain amount of real property. These freehold requirements were supported by the idea that those who possessed such property "had a unique 'stake in society'—meaning that they were committed members of (or shareholders in) the community and that they had a personal interest in the policies of the state, especially taxation."[31] The taxpaying requirements that replaced freehold requirements in the early nineteenth century were justified on similar grounds—that only those who shoulder the burdens of government should have a voice in it (turning the traditional rallying cry on its head: "No representation without taxation").[32] In both instances, economic participation is seen as a proxy for an interest in the outcome of an election, and thus a proper prerequisite to the right to vote.

Modern restrictions on the franchise are often justified on the same grounds. Take, for example, residency requirements. These requirements are ubiquitous and constitute such an entrenched part of the democratic landscape that they are rarely analyzed as mechanisms that disenfranchise enormous numbers of people. They go largely unquestioned because we think that residency usually serves as an accurate proxy for one's interest in the outcome of an election. The scope of most government entities' powers is geographically circumscribed, and the belief is that only those living within the territory under control of the entity have enough at stake to vote.[33] In those rare situations when academics or courts challenge residency requirements, they challenge this link between residency and interest,

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28 You could not rely on some other proxy for strength of voter interest, such as residency, for that would beg the question.

29 *See* Hayden, *False Promise*, *supra* note 22, at 240.

30 Except to the extent that voting is not compulsory in the United States. Qualified voters could always just signal their lack of interest by staying home on the election day. *See id.* at 258-59.

31 KEYSSAR, *supra* note 21, at 5.

32 *See id.* at 50, 131.

33 *See* Hayden, *False Promise*, *supra* note 22, at 256-57.

arguing that residency, or the lack of it, is not an accurate proxy for the strength of one's interest in the outcome of the elections.[34] Instead, there are certain classes of nonresidents—such as people who work in the jurisdiction, people who own property in the jurisdiction, or people otherwise affected by the entity's actions—that may be sufficiently affected by the decisions of the governmental entity to be entitled to vote.[35] But the underlying assumption—that only people with a certain degree of interest in the outcome of an election should be allowed to vote—is shared by all.

The Supreme Court has repeatedly endorsed the relationship between the right to vote and the degree of interest in an election. They were most explicit about it in *Kramer v. Union Free School District*, a case involving a challenge to a New York statute that limited voting in school board elections to people who either (1) owned or leased taxable real property in the district, or (2) had children enrolled in the district's schools.[36] The statute was challenged by a childless man who lived with his parents in the district.[37] The Court struck down the restrictions on the franchise as both over- and under-inclusive:

> [A]ppellant resides with his parents in the school district, pays state and federal taxes and is interested in and affected by school board decisions; however, he has no vote. On the other hand, an uninterested unemployed young man who pays no state or federal taxes, but who rents an apartment in the district, can participate in the election.[38]

The restrictions were problematic to the extent that they did not correspond well enough to one's interest in the outcome of the election. The underlying assumption was made explicit by the Court when it explained that a state could indeed limit the franchise to a portion of the electorate that was "primarily affected" by the outcome: it just needed to demonstrate that "all those excluded are in fact substantially less interested or affected than those the [franchise] includes."[39] But the

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[34] *See* Holt Civic Club v. City of Tuscaloosa, 439 U.S. 60, 69 (1978) (explaining that "[t]he imaginary line defining a city's corporate limits cannot corral the influence of municipal actions. A city's decisions inescapably affect individuals living immediately outside its borders."); Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. REV. 1115, 1132 (1996) ("Boundaries exclude people who may be interested in or affected by the decisions made within the boundaries.").

[35] *See* Hayden, *False Promise*, *supra* note 22, at 257. For this reason and others, some scholars have suggested decoupling voting from residency. *See* Richard Thompson Ford, *Beyond Borders: A Partial Response to Richard Briffault*, 48 STAN. L. REV. 1173, 1187-89 (1996); Richard Thompson Ford, *The Boundaries of Race: Political Geography in Legal Analysis*, 107 HARV. L. REV. 1841, 1909 (1994); Jerry Frug, *Decentering Decentralization*, 60 U. CHI. L. REV. 253, 324-25 (1993). For a critique, see Briffault, *supra* note 34 at 1158-62.

[36] 395 U.S. 621, 622 (1969).

[37] *Id.* at 624.

[38] *Id.* at 632 n.15.

[39] *Id.* at 632.

state's goal—to connect the right to vote with the strength of one's interest in the election—was proper.

With respect to access, then, it is fairly clear, as a descriptive matter at least, that the right to cast a ballot is closely tied to the strength of one's interest in the outcome of the election. Because there is no way to directly assess the level of one's interest, however, we are forced to rely upon various proxies—property holding, residency, citizenship, etc.—to determine it. Debates over the scope of the franchise are largely debates over how well particular proxies match up with voter interest. The underlying agreement, though, is that the proxies should reflect the degree of such interest.

b. Interest and Weighting Votes

There may be a similar sort of agreement with respect to assigning numerical weights to votes.[40] After all, the strength of people's preferences varies widely. At some point, we may decide that their interests are strong enough that they should have the right to vote. But that simple, binary approach to voting rights (either you have the vote or you don't) doesn't fully capture the range of people's interests. Perhaps the weight of each person's vote should be calibrated to the strength of their interest in the outcome. Everyone's vote could be assigned a relative weight that reflects the strength of their preferences—thus providing some optimal level of participation.[41]

If such a value underlay the law of vote weighting, this would mean that, after a decision is made to grant the right to cast a ballot, there would be an additional decision with respect to how much weight to assign to each vote. We should expect to see a wide range of numerical weights assigned to people's votes, one that reflected the varying degrees to which they cared about the outcome of the election. Is this something we see when we look at the structure of the second aspect of the right to vote?

At first glance, the answer appears to be no. The one person, one vote standard, which assigns everyone's vote about the same weight, dominates the political landscape. This could mean several things (in addition to the fact that we're just wrong and something else drives these decisions). It may reflect a positive judgment that everyone has, more or less, about the same level of interest in the outcome of most

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[40] One would expect these two aspects of voting rights to be closely related since numerically diluting a vote may have the same effect as prohibiting voting. *See* Hayden, *False Promise*, *supra* note 22, at 255.

[41] *See id.* at 248.

political elections.[42] But that just doesn't make sense: we know that people have a wide range of levels of interest, at least wider than is captured by a simple decision whether or not to allow them to place an equally-weighted vote. Another possibility is that there may be something else at work here, something that limits our ability to develop a more nuanced vote-weighting system. And given what was discussed above about the difficulties in making interpersonal utility comparisons, this appears to make more sense.

As opposed to a positive judgment about the equal-strength of voter preferences, the Supreme Court's one person, one vote standard may actually involve a negative judgment that we will rarely have the type of information about preference strength to assign more nuanced weight to votes.[43] It is our inability to objectively compare relative preference strength that drives our reliance on the one person, one vote standard. Of course, a requirement that political institutions assign equal weight to votes, just like a requirement about assigning differing weights to votes, is itself a judgment about the relative strength of preferences that cannot be grounded on neutral principles.[44] But this may just mean that the Supreme Court was fooling itself when it thought it was developing a neutral, judicially manageable standard for quantitative vote dilution (something that the dissenters to the original malapportionment cases rightly argued at the time).[45]

This view is also confirmed, oddly enough, by an exception to the one person, one vote requirement. As outlined above, the equiproportional standard applies to Congressional and state legislative districts. And it applies to local governmental units that exercise general governmental powers—those that might be expected to affect everyone within the jurisdiction in a similar manner, or to a similar degree.[46] But what about local units that disproportionately affect identifiable groups? The Supreme Court first raised that question in *Avery v. Midland County*, where it noted:

> Were the Commissioners Court a special-purpose unit of government assigned the performance of functions affecting definable groups of constituents more than other constituents, we would have to confront the question whether such a body may be apportioned in ways which give greater influence to the citizens most affected by the

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42 *See id.* at 251.

43 *See id.* at 251-52.

44 *See id.* at 249-50.

45 *See id.* at 250-51; Baker v. Carr, 369 U.S. 186, 300 (1962) (Frankfurter, J., dissenting) (arguing that an equiproportional standard is just one among many "competing bases of representation.").

46 *See* Bd. of Estimate v. Morris, 489 U.S. 688, 694-96 (1989); Hadley v. Junior Coll. Dist., 397 U.S. 50, 54 (1970); Avery v. Midland County, 390 U.S. 474, 484-85 (1968); Hayden, *False Promise*, *supra* note 22, at 252-53.

organization's functions.[47]

The Supreme Court was forced to confront this issue of special purpose districts just a few years later in *Salyer Land Co. v. Tulare Lake Basin Water Storage District*.[48]

Salyer involved a sparsely populated water district that covered close to 200,000 acres of farmland.[49] The district, governed by an elected board of directors, was in charge of the acquisition, storage, and distribution of water.[50] Participation in the board elections, however, was limited to landowners, and their votes were apportioned based on the assessed valuation of the land they owned (a one acre, one vote system).[51] This was challenged as a violation of the one person, one vote requirement, but the Supreme Court rejected the challenge and, in so doing, created the special purpose district exception to the requirement.[52] The Court found that, in cases like this, such a system made sense because the board's powers disproportionately affected landowners (as opposed to mere residents), and affected them in proportion to the amount of land they owned.[53]

This exception to the one person, one vote standard may not prove the rule, but it does give us some insight into its foundation. The one person, one vote rule is the default, in large part, because we think that voter interest in entities exercising general governmental powers is more or less equivalent. When we think we have reliable information to the contrary—when, for example, we think we have a good proxy for judging the strength of people's preferences regarding the outcome of the election—we allow movement away from the default to a more finely calibrated system of voting weights. So we do, in fact, see a calibrated response to perceived voter strength in our basic political institutions. We just don't see it that frequently in the political arena because we rarely have proxies that we believe are reliable enough to make more subtle distinctions.

c. Interest and Combining Votes

Once we ensure that those with sufficiently strong preferences with respect to the outcome of an election have the vote, and we have calibrated those votes, if possible, to the degree of preference strength, there remains work to be done. It turns out that there are many ways to

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47 *Avery*, 390 U.S. at 483-84.
48 410 U.S. 719 (1973).
49 *Id.* at 723.
50 *Id.*
51 *See id.* at 724-25.
52 *See id.* at 730.
53 *See id.* at 729, 734.

prevent groups of voters from successfully aggregating their preferences. The third facet of voting rights—the right to a qualitatively undiluted vote—is designed to prevent this from happening. So does the concern with preference strength inform this third facet of voting rights as well?

There are two reasons to think that it does. First, to the extent that the third aspect of voting rights helps prevent the reasons driving the first two aspects from being thwarted, the third aspect, at a minimum, is preservative of the preference aggregating functions of the first two. For example, we are worried about placing a large minority of voters with similar views into an at-large districting structure that would result in the election of none of their preferred candidates. The at-large voting structure tends to increase the likelihood that large numbers of strongly held preferences will be completely neglected in the outcome. And we're worried about it for that reason, so we make sure that qualitatively dilutive devices aren't used to thwart or distort preference aggregation. Thus, this third aspect of voting rights is not inconsistent with, and serves the end of, tailoring voting strength to preference strength.

Second, the benchmark for claims of qualitative vote dilution seems to involve some assessment of proportionality. Every election has its winners and losers—that's how democracy works. The difficulty in assessing claims of qualitative vote dilution is separating out victims from mere losers. How do we tell for the purposes of section 2 of the Voting Rights Act, for example, when a minority group has had less opportunity to participate and elect representatives of its choice? What is the standard for assessing dilution? While there is no simple answer to the question, almost all solutions depend, in part, on an assessment of proportionality.[54] Proportionality is not strictly applied in most instances, and there is even an express prohibition against a guarantee of proportionality in section 2 of the Voting Rights Act.[55] Yet it is difficult to conceive of a qualitative vote dilution standard completely detached from it.

The structure of voting rights in the political arena, then, involves a series of decisions about how to best aggregate individual preferences into group choices. Generally, we allow those with sufficiently strong interests with respect to the outcome to vote. In cases where we have more nuanced information about the strength of that interest, we allow entities to calibrate the numerical weight assigned to those votes. And in aggregating votes, we worry about various devices that may thwart

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[54] *See* Sanford Levinson, *Gerrymandering and the Brooding Omnipresence of Proportional Representation: Why Won't It Go Away?*, 33 UCLA. L. REV. 257 (1985).

[55] *See* 42 U.S.C. § 1973(b) (2006) ("[N]othing in this section establishes a right to have members of a protected class elected in numbers equal to their proportion in the population.").

the collective expression of these preferences. Many of a polity's decisions with respect to voting rights, then, depend upon finding successful proxies for the strength of voter interest in the outcome of an election.

2. Proxies for Voter Interest

The relationship between voting rights and preference strength should, on reflection, be fairly obvious—after all, voting is merely a method used to aggregate individual preferences. Thus, decisions about who has the right to vote and how much weight to assign to that vote are driven in large part by assessments of voter interest in the outcome of the election. Assessing individual voter interest, though, is easier said than done. There is no way to directly observe or compare levels of voter interest, and merely asking people how much they care about an election is unworkable.

For that reason, those who structure and administer democratic institutions rely on various proxies for the strength of voter interest. For political entities with general governmental powers, we have tinkered with various proxies in the past—e.g., owning property, paying taxes—and have now settled on a variety of proxies such as residency and citizenship that better capture the group of voters who are sufficiently interested in the outcome of elections. (For corporations, we have settled on stock ownership, and in many cases have further calibrated the basic voting rules with the one share, one vote system). The success of the voting structures of both types of institutions depends, in large part, on how well these proxies work.

In order to assess how well a proxy works, we generally look to two features: whether it accurately reflects the degree of interest and whether it is manageable. The accuracy of a proxy for voter eligibility depends on how well it describes the group of people who have sufficient interests in the outcome of the election. There are two basic ways that such a proxy may be off the mark—it may be under-inclusive or over-inclusive. A proxy is under-inclusive if it fails to identify people with an interest in the election, and thus disenfranchises them (of course, a democratic entity could stitch together several under-inclusive proxies in order to more fully capture the entire group of interested voters). A proxy is over-inclusive if it includes people without an interest in the election, and thus dilutes the voting strength of those with a real interest. When it comes to assigning weight to votes, the accuracy of the proxy depends upon how well it is calibrated to the strength of voter preferences.

Take, for example, some of the proxies that have been used in the

United States for voter interest. The early property-holding requirements were fine as far as they went, but they were under-inclusive, disenfranchising vast numbers of property-less residents who had vital interests in the exercise of governmental powers. Residency requirements, on the other hand, seem to better capture the group of interested people, since most people within the geographic jurisdiction of a governmental entity—and thus subject to its police powers, taxing powers, etc.—have quite a bit at stake in the outcome of an election. Residency, of course, may be under-inclusive in that it fails to capture nonresidents who work, own property, or have other interests in the jurisdiction (or over-inclusive since it may enfranchise people who are moving out of the jurisdiction the day after the election and thus have little at stake), but not nearly so much as property-holding requirements. And, as discussed above, states are often prohibited from using a proxy that is too under-inclusive, too over-inclusive, or both. New York's attempt to use having children in the school system or owning or renting taxable real estate as a proxy for interest in the outcome of school district elections, for example, was struck down as both under-inclusive and over-inclusive.

Of course, democratic institutions, both governmental and corporate, could develop more carefully tailored proxies. While there isn't (yet) a machine to peer into people's heads to assess and compare their preference strengths, one could imagine that extensive questionnaires could better determine one's interest in the outcome of any possible election. The answers on those questionnaires could then be frequently updated and double-checked for accuracy. In the end, we would probably have a better sense of who should be voting in a particular election than we do now. The problem, of course, is that such a system would be unmanageable. For starters, it would be quite costly as well as fairly easy to manipulate. Which brings us to the second characteristic of a useful proxy—its manageability.

The manageability of a proxy may mean several things,[56] but, for our purposes, we merely mean whether it is realistically workable. There are many reasons why proxies might be unmanageable. They may be physically impossible (using brain scans to compare preference strengths). They may be too costly (using extensive, constantly updated surveys). Or they may be too readily manipulated (relying on a potential voters' professed interest in an election). In other words, something—be it cost, fraud, or some other factor—may prevent the proxy from accurately reflecting the preference strength of people it is designed to test.

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[56] In voting rights, the manageability of a particular voting rights requirement might mean, for example, that courts will be able to administer the standard in a neutral manner, without injecting their own biases into the case.

Democratic institutions, for good reason, value proxies that are easily managed. In the political arena, freehold and taxpaying requirements were easily administered. There were already lists of people who owned property and paid taxes, usually within possession of the governmental entity holding the election. It would have been difficult for any individual to fraudulently add his name to the list; difficult enough, anyway, that it wouldn't be worth the vote that came with it. This does not mean, of course, that such requirements, standing alone, accurately picked out the group of people who were interested in the result of a particular political election. But they were quite easily administered. In the corporate arena, stock ownership is also something that is easily confirmed, which makes it a readily manageable standard for voting rights.

It is more difficult to come by a manageable standard for the more carefully calibrated proxies necessary to assign different weights to votes. Democratic institutions usually look to something that is both readily confirmed and, not to put too fine a point on it, countable. Whether it is the number of acres owned for the purposes of a water district election or the number of shares owned for the purposes of a corporate election, the presence of readily ascertained and countable acres or shares allows the institution to administer the voting system.

The difficulty in finding manageable proxies for more subtle assessments of preference strength may explain why equal weighting is often the default rule in democratic elections.[57] The one person, one vote standard, for example, is nothing if not easily manageable: one just needs to be able to count and divide.[58] Like some of the easily administered proxies for basic interest in an election, however, there may be reasons why the equal weighting of votes does not come close to accurately capturing preference strength. As John Hart Ely noted, the one person, one vote standard "is certainly administratable . . . the more troublesome question is what else it has to recommend it."[59]

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There is a great deal of underlying agreement, then, that the right to vote, and the weight assigned to that vote, should correspond to the level of a voter's interest in the outcome of an election. Perfect correspondence between voting rights and interest, though, is unattainable, because we do not have precise methods for assessing the

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[57] *See* Hayden, *False Promise*, *supra* note 22.

[58] Avery v. Midland County, 390 U.S. 474, 510 (1968) (Stewart, J., dissenting) (maintaining that apportionment is "far too subtle and complicated a business to be resolved as a matter of constitutional law in terms of sixth-grade arithmetic.").

[59] JOHN HART ELY, DEMOCRACY AND DISTRUST 121 (1980).

strength of voter preferences with respect to any particular election. We must therefore rely upon various proxies that imperfectly capture the degree of voter interest, and strike a balance between the accuracy and manageability of a proxy. In this way, a democratic polity is designed to best reflect the interests of those affected by the exercise of its powers.

II. VOTING IN THE CORPORATE ARENA

The elections of democratic polities are designed to aggregate the preferences of those with some interest or stake in the polity. Corporate elections are no different. And just as "one person, one vote" has become the mantra of preference aggregation in our democratic polity, so "one share, one vote" has become the rallying cry in corporate law. Both standards share some of the same strengths, from a preference-aggregation perspective. One share, one vote has a seemingly perfect correspondence between one's interest in the company and the voting power assigned to that interest. In addition, the standard appears to be easily manageable, and it has the ring of fairness—votes to each according to their share.

One share, one vote, however, is not the "timeless and natural" voting structure that it appears.[60] It is neither a requirement here in the United States nor in Europe,[61] and in fact the percentage of companies with alternative voting structures is increasing.[62] Moreover, shareholder voting has gone through a number of historical trends, reflecting the economical and political concerns of different eras. Indeed, other forms of business organizations aggregate the preferences of their members in a quite different fashion.

More to the point, while much has been written on the proper weighting of corporate votes, less attention is paid to the antecedent (and more fundamental) issue of who receives the right to vote to begin with. The literature often assumes that the franchise is to be restricted to shareholders alone and then discusses how to best parse out voting power among them. This initial restriction, though, disenfranchises large numbers of people—such as employees, customers, and suppliers—with significant interests in the corporate polity.

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60 Dunlavy, *supra* note 7, at 1356 (discussing this perception).

61 *Id.* at 1349.

62 Marco Becht & J. Bradford DeLong, *Why Has There Been So Little Block Holding in America?*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 613, 653-57 (Randall K. Morck ed., 2005) (noting that the number of dual or multi-class share corporations listed on the New York Stock Exchange more than doubled from 1994 to 2001).

Given that most voting systems are intended, at a minimum, to aggregate the preferences of those with an interest in the enterprise, it is curious that many groups with significant interests in the corporate polity are completely disenfranchised. Perhaps this is so because it is difficult to design good proxies for their interests—perhaps there is no accurate and manageable way to pick out those (other than shareholders) with significant interests in a corporation. Perhaps the interests of non-shareholders are best represented by legal relationships other than voting, such as by contract (though it seems that, at their best, such contracts would incompletely capture their interest in the future of the corporation). In any case, this curious question—why voting rights are restricted to one group of interested stakeholders and, further, parsed out according to the one share, one vote formula—requires further inquiry. And that inquiry must begin with a review of the basic nature of the corporate polity itself.

A. *Governance in Business Organizations*

When we think of a corporation, we generally think of the collection of people and assets that make up its everyday business. But in a legal sense, a corporation is a fiction—it is a legal entity created by a government document that has no "independent" existence. Thus, it is perhaps more helpful to conceive of the corporation as a legal structure designed to allocate rights and duties among the collection of people and assets that give the corporation life. The corporation is generally formed for a business purpose. In the nineteenth century, corporations had a specific corporate purpose within their corporate charter.[63] Even though no specific purpose is legally required today, most corporations are formed by a certain collection of people with a certain collection of assets who believe that forming the corporation will better help them achieve a set of business-oriented goals. They could do this without forming a corporation, but forming a corporation under state law in some ways helps them to effectuate their goals. The corporation is designed to facilitate collective economic activity.

The corporation is not the only form of business organization operating in the U.S. economy: along with corporations, there are sole proprietorships, partnerships, business trusts, limited partnerships, limited liability partnerships, and limited liability companies.[64] The complexity of these forms is usually seen as existing along a spectrum, with the sole proprietorship being the most basic and the corporation

[63] NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM (2001).

[64] JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 2 (2d ed. 2003) (including the joint stock company and the partnership association in some states).

being the most advanced.[65] What separates the corporation from other forms of business organization? Scholars have isolated five factors which are considered essential to the corporate form: (1) full legal personality, including the ability to bind the firm to contracts; (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management under a board structure; and (5) transferable shares.[66]

In terms of governance, the two essential corporate features are (3) shared ownership by investors and (4) delegated management. This structure is manifest in a tripartite set of players: the shareholders, the board of directors, and the officers. The shareholders are sometimes designated as the "owners" of the firm: they have the right to receive residual profits as well as the right to elect the board of directors.[67] The directors are, in turn, the locus of authority within the corporation; they are the representatives of the firm when human counterparts to the fictional form are required.[68] The board does not generally run the business, however—directors generally delegate this power to the officers of the corporation. These officers in turn select the remaining employees. The structure is hierarchical, in that shareholders can vote out directors, directors can fire the officers, and the officers can fire the remaining employees.[69]

Other business organizations generally have more flexible governance requirements. In partnership law, the default rule is that each partner has an equal share of the voting power, unless decided otherwise by the partners.[70] Certainly, partners are free to set up alternative voting structures, and most sophisticated partnerships have complicated methods of aggregating the preferences of their members. But the default rule has continuing relevance because partnerships may be created without an explicit agreement between the parties.[71] When

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65 Within the corporation category, closely-held corporations are sometimes separated from publicly-held corporations, although they are formed through the same state incorporation statutes. Closely-held corporations are identified as those with: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in management. Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505, 511 (Mass. 1975).

66 Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439-40 (2001); *cf.* CLARK, *supra* note 8, at 2 (listing four characteristics of the corporation: (1) limited liability, (2) free transferability of investor interests, (3) legal personality, and (4) centralized management).

67 This designation is something of a misnomer. *See infra* note 117.

68 CLARK, *supra* note 8, at 21.

69 Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 555-58 [hereinafter Bainbridge, *Means and Ends*] (discussing the hierarchical nature of corporate structure).

70 UNIF. P'SHIP ACT § 18(e), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 401(f) (amended 1997).

71 A partnership has been defined as "an association of two or more persons to carry on as co-

the parties have not explicitly agreed to form a partnership, they will not have established a governance framework and thus will be given the default setting. Even in situations where one partner has provided substantially more money or labor to the partnership than other partners, all will have an equal vote in partnership decisions.[72]

The "one partner, one vote" default rule can be wildly inequitable, at least if voting power is meant to correspond with one's actual contributions to the enterprise. As an alternative, a court could conduct a simple calculation of the dollars invested by each partner, and votes would be allocated according to the funds invested. Why has the law instead assented to such a blunt division of power? Perhaps most importantly, the default division of profits and losses (the interest in the residual) is to provide each partner with an equal share.[73] As in the "one share, one vote" system, the (default) voting power is equal to the (default) share of profits and losses. In addition, a partner-oriented default rule is much easier to manage than an investment-oriented rule. A "one partner, one vote" default allocation may provide the best mix of interest aggregation and manageability in sorting out voting power amongst partners.[74]

Of course, "one partner, one vote" is only the default rule. Partners who contemplate varying levels of input and interest will generally construct a partnership agreement that allocates votes according to mutual agreement.[75] And there is no requirement that each partner must have an equal vote according to that partner's 'share' in the residual profits. Instead, partners are free to divvy up voting power according to contributions, seniority, experience, involvement, and other factors relevant to governance.[76] There is no scholarly literature saying that partnerships are poorly constructed if they fail to match voting rights to the residual.

The business trust has a similar flexibility in governance. The

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owenrs a business for profit." UNIF. P'SHIP ACT § 6(1), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 202(a) (amended 1997). The definition thus includes individuals who may not have intended to form a partnership. *See, e.g.*, Bass v. Bass, 814 S.W.2d 38, 41 (Tenn. 1991) (holding that "it is not essential that the parties actually intend to become partners.").

72 The control rights in a partnership extend even to ordinary, everyday matters of the business. *See* UNIF. P'SHIP ACT § 18(h), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 401(j) (amended 1997).

73 UNIF. P'SHIP ACT § 18(a), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 401(b) (amended 1997).

74 *See* Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819, 841-42 (2001) (noting that "[e]quality rules for management . . . suit very closely held firms in which the partners' combinations of capital, service, and credit contributions can be assumed to equalize."). *But see id.* at 841 (questioning whether partner intent should sometimes overrule the default).

75 *See, e.g.*, Day v. Sidley & Austin, 394 F. Supp. 986, 992 (D.D.C. 1975) (discussing how "statutory rules governing the rights and duties of the partners are 'subject to any agreement between them.'").

76 *See id.* at 988 (discussing the centralized management structure of law firm partnership).

common law trust has had a rocky history, as it has sometimes been lumped in with partnerships,[77] and at other times has been judged to be a corporation in trust's clothing.[78] This confusion over categorization has hampered the use of the trust as a business organization. However, the trust has dominated some types of business enterprises, such as pension and investment funds.[79] Recently, trust law scholars have argued that the business trust is underrated and that new statutory trusts will provide a new venue for commercial enterprises.[80]

The trust is generally recognized by its strict division between principal and agent, as well as the strong fiduciary duties assumed by the principal. The trust divides its relevant participants into trustees and beneficiaries (or "beneficial owners").[81] Trustees manage the assets of the trust, and the beneficiaries receive the profits of this management. Because trusts were traditionally donative transfers, beneficiaries had no rights or expectations of control over the trustees, despite the trustee's obligation to act on their behalf. However, the law did provide for trustee oversight. Under the common law, the general duty of trustees is "to exercise reasonable care in an effort to preserve the trust property."[82] Trustees are thus liable for acting in their own interest or for violating a duty of care, which is far stricter than the duty of care under corporate law. For this reason, the trust was seen as an inappropriate avenue for entrepreneurial enterprises.[83]

The new statutory trusts provide for more flexibility in governance, and allow the parties to structure the relationship between trustee and beneficiary as they please.[84] Thus, theoretically, the commercial trust

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77 Cox & Hazen, *supra* note 64, at 20.

78 *See* Herbert B. Chermside, Jr., Annotation, *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R.3d 704, 729-30 (1978).

79 *See* John H. Langbeinn, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 168-73 (1997).

80 *Id.* at 166-67; Robert H. Sitkoff, *Trust as "Uncorporation": A Research Agenda*, 2005 U. ILL. L. REV. 31, 35. There is an uncertain number of states with statutory trusts. *Id.* at 35 ("The existing literature, such as it is, puts the count of states with general business trust legislation anywhere from seventeen to thirty-four."). In 1988, Delaware established a statutory trust to some fanfare. DEL. CODE ANN. tit. 12, §§ 3801-3824 (2007).

81 *See, e.g.*, *id.* tit. 12, § 3801 (defining "statutory trust" as "an unincorporated association which [i]s created by a governing instrument under which . . . business or professional activities for profit are carried on or will be carried on, by a trustee or trustees or as otherwise provided in the governing instrument for the benefit of such person or persons as are or may become beneficial owners or as otherwise provided in the governing instrument . . . .").

82 RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 232, cmt. c (1992).

83 Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559, 575-80 (2003).

84 *See, e.g.*, DEL. CODE ANN. tit. 12, § 3806(a) (2007) ("Except to the extent otherwise provided in the governing instrument of a statutory trust, the business and affairs of a statutory trust shall be managed by or under the direction of its trustees. To the extent provided in the governing instrument of a statutory trust, any person (including a beneficial owner) shall be entitled to direct the trustees or other persons in the management of the statutory trust.").

became a completely contractual enterprise—governance could be structured in any way that the relevant parties desired.[85] But such flexibility has thus far not led to a rush of new firms organized as trusts.[86] In part, there is difficulty in establishing the background law and default rules for this new form of organization.[87] As to the broader issue, there is no norm of control in commercial trusts, and by extension no norm that beneficiaries have a share of control proportionate to their interests.

The default rules are a bit more structured for the limited partnership, the limited liability partnership, and the limited liability company. These organizations envision participants with stakes in the residual who do not participate in management. For example, limited partnerships must make clear who the managerial partners are, and who the limited partners are.[88] Limited liability companies have what is known as "chameleon" management: "the firm can choose either direct partnership-type control by the members or centralized control by managers that is closer to, but not as rigid as, the limited partnership format."[89] Participants in these enterprises have substantial flexibility in arranging the division of ownership and control rights. Thus, there is likewise no "one share, one vote" norm in these structures. Instead, voting rights are divided amongst the participants according to agreement.

Finally, closely-held corporations have the same basic corporate structure as publicly-held corporations: the shareholders elect the board of directors, and the board appoints the officers who run the corporation. In closely-held companies, however, these roles often overlap, leading to a governance structure more akin to a partnership than a large corporation.[90] Many closely-held companies have different

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85 *See* Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 CARDOZO L. REV. 325, 326 (2001) ("Moreover, the [Delaware] Act explicitly invites commercial and manufacturing enterprises . . . to take advantage of this marvelous contract-like organizational form, emphasizing its liberal contractarian approach and the freedom to write into or omit from the trust documents anything they wish, or almost anything.").

86 *Id.* at 327.

87 *Id.* at 328. Steven Schwarcz has argued that because of the background of trust law, "[t]he degree to which assets need to be placed at risk in order to satisfy the expectations of residual claimants thus provides a key to distinguishing commercial trusts from corporations." Schwarcz, *supra* note 83, at 578.

88 *See* REV. UNIF. LTD. P'SHIP ACT § 303 (amended 1985), 6A U.L.A. 144-45 (1995). However, under the original Uniform Limited Partnership Act, limited partners may be subject to liability as managing partners if they participate in the governance. UNIF. LTD. P'SHIP ACT § 7 (1916), 6A U.L.A. 336 (1995) ("A limited partner shall not become liable as a general partner unless . . . he takes part in the control of the business.").

89 Ribstein, *supra* note 74, at 843.

90 *See* Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505, 511 (Mass. 1975) (defining closely held corporations as having "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation.").

classes of shares as a method of allocating control amongst different groups of shareholders.[91] In addition, shareholders may agree to certain voting arrangements, such as the pooling of votes into a voting trust or agreeing to vote along certain lines.[92] These voting arrangements are often executed to consolidate a group of disparate shareholders into a majority or to provide protection to minority shareholders over certain critical matters.[93] Because of the limited number of shareholders, closely-held corporations often have a shareholder or a small group of shareholders with actual majority control. Because of this, corporate law generally protects minority shareholders against undue oppression. Although such oppression may relate to the stake in the residual, it more often relates to the ability of minority shareholders to partake in other aspects of the corporate pie—namely, employment.[94] Thus, the minority oppression doctrine recognizes that even if shareholders are all sharing equally in the profits, a majority may still be oppressing minority shareholders by failing to approve a dividend[95] or by not providing employment or other opportunities within the company.[96]

Thus, despite the theoretical notion that a corporation is merely a "nexus of contracts" between the various parties in the firm,[97] the corporation has perhaps the most specific and structured system of governance out of all of the forms of business organization. Business organizations such as commercial trusts, partnerships, and LLCs give their members lots of flexibility to construct the organization as they desire.[98] The corporation, however, is run by a board of directors which

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91 Preferred stock is particularly common in start-up corporations. Venture capital investors prefer to invest with preferred stock, which converts into common stock with multiple voting shares if certain triggers are reached. William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 892 (2002) (noting that "[c]onvertible preferred stock is the dominant financial contract in the venture capital market.").

92 *See, e.g.*, COX & HAZEN, *supra* note 64, at 388-93; FRANKLIN A. GEVURTZ, CORPORATION LAW 486-96 (2000).

93 Perhaps the most famous example of such a trust involves the Ringling family of circus fame. *See* Ringling Bros.-Barnum v. Ringling, 53 A.2d 441, 447 (Del. 1947) (upholding such a trust).

94 *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976) (finding "no legitimate business purpose" to the majority's decision to suspend a minority shareholder's salary, fail to reelect him as a director, and fail to appoint him as an officer); Leslie v. Boston Software Collaborative, Inc., 14 Mass. L. Rptr. 379 (Mass. Super. Ct. 2002) (minority shareholder terminated from his position as treasurer by majority shareholders).

95 *See, e.g.*, Naito v. H. Naito Corp., 35 P.3d 1068 (Or. Ct. App. 2001) (ordering the implementation of dividend policy).

96 For a further discussion of the protection of minority shareholders vis-à-vis the protection of political minorities, see Anupam Chander, *Minorities, Shareholder and Otherwise*, 113 YALE L.J. 119 (2003).

97 For a discussion of the "nexus of contracts" theory, see, for example, STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 27 (2002).

98 This may explain, in part, the enthusiasm that "nexus of contracts" supporters have for business forms such as LLCs and partnerships. *See, e.g.*, Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 185 (2004) (challenging "the assumption that the corporate form is

has been elected by shareholders. This conflict between the flexibility of the model and the strictures of reality presents problems for the justifications behind "one share, one vote."

B. *A Brief History of the "One Share, One Vote"*

As discussed above, other forms of business organizations contemplate substantial overlap between those with an interest in the residual and those with managerial control over the corporation. Such overlap is generally not possible in the modern public corporation. Instead, those investors who are given a residual interest must entrust their funds to other individuals who will actually control the enterprise. In order to deal with the greater diffusion of ownership contemplated under corporate law, the system of governance allows the participants to elect a central governing body, which then can make decisions in a more organized and efficient fashion.[99] Shareholders thus retain a modified form of control in the power to elect their representatives; those representatives, in turn, have actual control over the running of the firm.

How, then, was this control to be shared amongst shareholders? The "one share, one vote" standard seems like a fairly straightforward and natural way of structuring the power relations. In the early days of the corporate form, however, shareholder ownership was not uniformly distributed in the early corporate charters. For much of the nineteenth century, the common law of corporations provided for a default rule of one vote per person.[100] This method tracked the default partnership rule, in which each partner has a vote regardless of his or her financial interest in the partnership. One scholar found that more than a third of a sample of corporate charters from 1825 to 1835 had a "one person, one vote" system of governance.[101] Other charters provided a "prudent mean," in the words of Alexander Hamilton, in trying to balance between shareholders and shares.[102] Such charter provisions provided that the votes-per-share would decrease as the individual shareholder got more and more shares; a shareholder with five shares might get five votes, but a shareholder with 100 shares might only get ten votes.[103] In establishing a "prudent mean" system for the first Bank of the United States, Hamilton rejected a one share, one vote system on the grounds

optimal for publicly held firms.").

99 *See* Bainbridge, *Means and Ends*, *supra* note 69, at 548 (discussing the means of corporate governance through the board of directors).

100 Dunlavy, *supra* note 7, at 1354.

101 *Id.* at 1354-55.

102 *Id.* at 1356.

103 *Id.* at 1357.

that it would allow a few large shareholders to "monopolize the power and benefits of the bank."[104]

Over the course of the nineteenth century, however, corporations decisively moved away from quasi-partnership arrangements. By the end of the 1800s, most states had retreated from mandatory or default rules oriented toward limited the power of larger shareholders.[105] There was a brief period around the turn of the century in which cumulative voting for directors became a tool for protecting small shareholders.[106] And in the early twentieth century, states and corporations moved toward a "one share, one vote" structure as a progressive response to the increasing number of no-vote shares being issued.[107] The term "shareholder democracy" stems from these efforts to make sure that shareholders had a viable vote, both through the shares and through the corporation's proxy machinery.[108]

The "one share, one vote" movement reached its apex in 1988 with the Security and Exchange Commission's adoption of Rule 19c-4.[109] The rule required companies listed on the major exchanges to refrain from issuing shares with disproportionate voting rights.[110] Subsequently, however, the rule was struck down by the D.C. Circuit and was never revived.[111] Exchanges now allow companies to issue dual-class shares and still maintain their listings.[112] Despite the failure of Rule 19c-4, however, the one-share, one-vote norm remains a touchstone of corporate governance. Shareholder advocacy groups like Institutional Shareholder Services look unfavorably upon dual class structures. An unbalanced system of voting rights is likely to hurt a company's corporate governance rating, which may in turn affect how institutional shareholders treat the company.[113] The media has also

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104 ALEXANDER HAMILTON, 1ST CONG., REPORT ON A NATIONAL BANK, H.R. (1790), *reprinted in* 2 THE DEBATES AND PROCEEDINGS OF THE CONGRESS OF THE UNITED STATES app. 2032, 2049 (Washington, Gales & Seaton 1834).

105 Dunlavy, *supra* note 7, at 1358-59.

106 *Id.* at 1362.

107 Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 569 (1991) [hereinafter Bainbridge, *Rule 19c-4*].

108 Dunlavy, *supra* note 7, at 1363-66.

109 17 C.F.R. § 240.19c-4 (1988), *invalidated by* Bus. Roundtable v. SEC, 905 F.2d 406 (D.C.C. 1990).

110 At the time, some companies had issued a new class of stock, as a dividend to current shareholders, that provided an abnormally large number of votes per share. However, these new shares were not transferable, and could only be sold if they were converted to regular one-vote shares of common stock. The effect of such an issuance was to provide "lock in" power for long-term shareholders and/or managers. *See* Bainbridge, *Rule 19c-4*, *supra* note 107, at 566.

111 *Bus. Roundtable*, 905 F.2d 406.

112 *See, e.g.*, NYSE, Inc., Listed Company Manual § 313(B) (2005).

113 *See, e.g.*, Kathleen Pender, *Google's Weak Governance Rating*, S.F. CHRON., Aug. 24, 2004, at C1 (noting that "Google's low mark was largely a result of its dual-share-class structure, which gives founders and other insiders 10 times as many votes per share as outside stockholders.").

latched onto the one-share, one-vote refrain as a litmus test for fair treatment of shareholders.[114]

This Article is primary concerned with the role of one-share, one-vote not in practice, but in theory. The norm is more foundational in the economic theory of corporate law than it has been in practice. As discussed below, the norm connects the shareholder franchise to the maximization of social welfare. This connection plays a critical role in justifying shareholder primacy, the theoretical basis for the bulk of corporate law scholarship.

C. *The Theoretical Underpinnings of "One Share, One Vote"*

If we consider the shareholder franchise along traditional voting rights analysis, we must look at the voting system as a preference aggregation system. The purpose of allowing a vote is to determine the preferences of those who are voting. Elections can be adjusted based on the strengths, divergences, and time-sensitive nature of the preferences at issue. But at root, as discussed in Part I, the purpose of a voting system is to provide a way for a group to sort its preferences along the axis of a particular decision.

If we look at shareholder suffrage in this way, we immediately are struck by the fact that it is only shareholders who are having their preferences aggregated. The corporation encompasses the daily activities of a variety of different players: directors, officers, executives, management, and employees. Moreover, there are outside "stakeholders" who have interests in the activities of the corporation akin to shareholders: bondholders, suppliers, customers, even the community at large. However, when it comes to aggregating the preferences of the polity, in order to determine the leadership of the corporation, only shareholders are invited to participate. The shareholder franchise only assesses shareholder preferences.

The primary normative justification for shareholder voting is the theory of shareholder primacy. Shareholder primacy is the primary theoretical driver not only for the vote, but also for such key concepts as the fiduciary duties of care and loyalty. Shareholder primacy essentially means that corporations exist to serve the interests of shareholders.[115] Put more specifically, the theory mandates that the corporation be run with the goal of maximizing shareholder wealth.

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114 *See, e.g.*, Gretchen Morgenson, *One Share, One Vote: One Big Test*, N.Y. TIMES, April 2, 2006, at 31.

115 *See* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277 (1998) ("The structure of corporate law ensures that corporations generally operate in the interests of shareholders.").

Shareholder primacy could simply be viewed as a democratic legitimacy argument: the corporation has to keep shareholder interests at the forefront because shareholders are the voting polity. But this puts the cart before the horse: after all, who made the shareholders the voting polity? The choice of this group as the enfranchised citizenry is what needs justifying. A variant of this justification is that shareholders are the corporation's "owners" and thus are entitled to the ownership rights of profits and control.[116] However, the ownership justification is also doomed by its circularity: who made the shareholders the "owners"?[117] As corporate law commentators have convincingly pointed out, shareholders simply purchase a set of rights from the corporation. The right to vote is made part of the stock ownership "bundle," but a stock could be constructed (and has at times been constructed) without the right to elect directors.[118] Even shareholders with the right to vote do not possess many of the rights that traditionally accrue to property owners—the right to exclude, for example, or the right of possession.[119] Labeling shareholders "owners" is no more of a justification for the vote than is labeling them "voters."

In their foundational work *The Economic Structure of Corporate Law*, Easterbrook and Fischel provided a justification for shareholder primacy theory beyond simple labels.[120] In looking to ground shareholder primacy in economic theory, they looked to the traditional economic utility rationale of creating the highest level of efficiency or overall social utility.[121] Shareholder primacy theory argues that maximizing shareholder wealth will generate the highest amount of surplus and thus will result in the greatest overall social utility.[122] This premise returns us to the "nexus of contracts" model.[123] Instead of being the "owners" of the corporation, shareholders were one group of many whose contracts with one another jointly created the fictional

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116 The classic example of this perspective is Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32-33, 122-26.

117 *See, e.g.*, Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190-92 (2002) ("[T]he claim that shareholders own the public corporation simply is empirically incorrect.").

118 *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 694 (1986) (discussing the practice of selling shares without the right to vote).

119 Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 754 (2007).

120 EASTERBROOK & FISCHEL, *supra* note 5, at 35-39.

121 *Id.* at 35-39.

122 *Id.*

123 *Id.* at 1-39; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310-11 (1976) (suggesting that nature of firm as nexus for contracting relationships moots discussions of precise corporate boundaries).

corporate "entity."[124] However, shareholders were the sole "residual claimants:" that is, their returns were not payable until the other contractual participants—creditors, employees, customers, suppliers—had been fully satisfied.[125] This perspective assumes that all other claimants have rigidly-set contractual entitlements, such that paying them more than their entitlement would be akin to a gift. Because shareholders are not paid until these set contractual payments have been made, all other claimants received their contractual entitlements, and the shareholders benefited from the maximization of the residual. As Easterbrook and Fischel write:

> As residual claimants, shareholders have the appropriate incentives . . . to make discretionary decisions. . . . Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertakings of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.[126]

Although shareholders do not directly exercise this discretion, their appointed agents do. And these agents realize that they will be ousted from the board and from managerial positions if they fail to do their job of maximizing the surplus.

Thus, shareholder voting is not the cause of shareholder primacy—instead, it is simply one of its reinforcing mechanisms. Of course, as has been dogma since the seminal work of Adolf Berle and Gardiner Means, the shareholder vote in publicly-held companies has not been a particularly effective way of maintaining shareholder primacy.[127] Shareholder votes have been generally an empty exercise in rubber-stamping the slate of candidates nominated by the board. But this is an oversimplification. At the level of closely-held corporations, shareholder votes are a much livelier affair. Here, shareholder primacy is generally effectuated directly by the shareholders themselves through the vote. Even in publicly held companies, a majority or even a properly situated minority shareholder has the power to appoint its representatives to the board and thus control the corporation's fate.

It is the power of a "controlling" interest[128] that drives the law and economics of shareholder voting. At a traditional publicly held corporation, the individual shareholder has little or no motivation to monitor the company or even vote in the election. But when those votes

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124 EASTERBROOK & FISCHEL, *supra* note 5, at 36.

125 *Id.* at 36-37.

126 EASTERBROOK & FISCHEL, *supra* note 5, at 68.

127 BERLE & MEANS, *supra* note 1, at 6.

128 A majority will have de jure control, but a minority interest may also have de facto control over the corporation. *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110 (Del. 1994) (finding ownership of 44% of shares to be a controlling interest).

are amassed together into a controlling interest, they can vote out the current board—often immediately.[129] The shareholders' votes can be amassed through the mechanism of a tender offer—an offer by one entity to buy 50% or more of the company's shares. The market for corporate control imposes the market discipline necessary to effectuate the shareholder primacy norm. If the shareholders are ignored or unhappy, they can sell their shares to another entity that can agglomerate the shares into a majority holding. This new majority holder then can take complete control and make the profits that prior management had failed to generate. In this way, the market for corporate control leads to greater efficiency: the shareholders can sell their shares at a premium, and the acquirer can realize the benefits of control. This potential for market discipline keeps the board and management focused on the shareholders' interests.[130]

The economic benefits of the market for corporate control only occur if shareholders (as a whole) maintain control over the board as well as the ability to transfer that control. This is why the shareholders' interest in the residual profits is linked to their control of the corporation. Otherwise, the critical link between having control and maximizing the residual would be broken.

"One share, one vote" is a "logical consequence" of the theory of shareholder primacy.[131] The "one share, one vote" rule requires that each share of stock have equal voting weight with all other shares. In this way, the voting interest is equal to the interest in the residual. Shares with disproportionate voting power create skewed incentives. As Easterbrook and Fischel argue, "[t]hose with disproportionate voting power will not receive shares of the residual gains or losses from new endeavors and arrangements commensurate with their control; as a result, they will not make optimal decisions."[132] As a result, those with control will have the incentive to seek disproportionate gains that do not directly inure to the owners of the residual.[133] The residual will no longer be maximized, discouraging equity investment and leading to a

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129 DEL. CODE ANN. tit. 8, § 228 (allowing a majority of shareholders to execute any action that may be taken at a shareholders' meeting (including removal of directors) through a written concurrence of those shareholders).

130 *See* Edelman & Thomas, *supra* note 12, at 454 (discussing the importance of shareholder votes in the takeover setting).

131 EASTERBROOK & FISCHEL, *supra* note 5, at 73 ("Votes follow the residual interest in the firm, and unless each element of the residual interest carries an equal voting right, there will be a needless agency cost of management.").

132 *Id.* at 73. *See also* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1945-46 (1996) ("The case for the one share, one vote rule turns primarily on its ability to match economic incentives with voting power and to preserve the market for corporate control as a check on bad management.").

133 *See* Hu & Black, *supra* note 13, at 851 (discussing concerns that controlling shareholders without a commensurate economic stake in the corporation are more likely to "tunnel" away a disproportionate share of firm value).

decline in societal efficiency.

A similar concern about incentives lies behind the prohibition on selling a share's voting rights separately from the share itself. State corporate law does not permit a shareholder to disengage the right to vote from the share and sell it permanently.[134] In addition, there are generally restrictions against buying a vote in a particular election or bribing a shareholder to vote a certain way.[135] Such restrictions may seem counter to the general corporate law preference for private ordering through contract. But vote selling is problematic for the same reason as disproportionate voting: it disengages control rights from the rights to the residual.[136] It may make sense for an individual shareholder to sell the vote, given that the value of the vote for any individual share in a public corporation is close to zero.[137] However, the sale gives greater control to a holder that does not have an equivalent interest in the residual. To some extent, these problems are similar to those related to tender offers; individual shares are worth less when sold individually than their per capita value when agglomerated into a control group. But there is also a separate problem, in that those selling their votes get all of the benefits of the sale but only a fraction of the costs.[138] At root, the problem of control without equity interest would remain, and all shares would be less valuable.

Thus, the theory of shareholder primacy rests on the notion that shareholders will improve social welfare by focusing on increasing the corporation's residual profits. Shareholder primacy is enforced through shareholder voting and by the market for corporate control which uses the shareholder vote to effectuate changes in management. Essential to the theory is the notion of shareholder homogeneity: namely, that shareholders all share a common, homogeneous interest in increasing residual profits.

However, this essential aspect of the theory simply is not true. Shareholders are not homogeneous in the interests—in new ways as well as old. The next section discusses the axes along which the commonality of shareholder interests may splinter.

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134 *See, e.g.*, Hall v. Isaacs, 146 A.2d 602 (Del. Ch. 1958).

135 *See* Schreiber v. Carney, 447 A.2d 17, 26 (Del. Ch. 1982) (noting that individual instances of vote-buying are "easily susceptible of abuse" and thus "subject to a test for intrinsic fairness").

136 EASTERBROOK & FISCHEL, *supra* note 5, at 74 ("Separation of shares from votes introduces a disproportion between expenditure and reward.").

137 This is based on the notion that any individual vote has an extremely low probability of affecting the outcome. *See* Yair J. Listokin, *Management Always Wins the Close Ones* 16 (Yale Law & Econ. Research Paper No. 348, 2008), *available at* http://ssrn.com/abstract=980695 (noting that "management sponsored proposals typically pass easily" with a mean approval rate of 85 percent).

138 Larry E. Ribstein & Bruce Kobayashi, 40 U.C. DAVIS L. REV. 21, 39 (2006) ("Vote buying and selling can, however, be inefficient in some situations because it enables the buyer and the seller to realize gains while losses are incurred by other shareholders.").

III. THE PROBLEMATIC ASSUMPTION OF SHAREHOLDER HOMOGENEITY

In their recent article on encumbered shares, Martin and Partnoy state: "It is simply not true that the 'preferences of [shareholders] are likely to be similar if not identical.'"[139] Martin and Partnoy focus on the problems caused by equity derivatives which carve up various shareholder rights into discrete financial securities. However, there are many ways in which shareholders fail to share common interests—many opportunities for conflict along what has been called "horizontal power relations."[140] These conflicts are explored further below.

A. *The Problem of the Control Group: Majority Rule and Minority Oppression*

The notion of shareholder homogeneity assumes that all shareholders are similarly situated and share similar interests. However, shareholders may have very different economic interests depending on a variety of factors. Perhaps the most fundamental difference is the difference between a shareholder in a control group and a shareholder who is not in a control group. A corporation does not necessarily have a control group—for example, if shares are distributed widely amongst public shareholders with no one holding over five percent. But if a corporation—public or closely held—has a control entity or control group, then the interests of the majority are likely to differ from those of the minority.

The primary benefit of control is the right to apportion the benefits of control entirely to oneself while sharing the costs of such control with the minority shareholders. For example, Corporation X has A as a 52 percent shareholder, while the remaining shareholders B, C, & D each own 16 percent. If A appoints herself as the chief executive officer, she will get 100% of the benefits of her salary. However, since the corporation as a whole pays the salary, A will only incur (by extension) 52 percent of the costs. Similarly, if A sells a valuable company asset to another company which she owns by herself, she will have a strong incentive to underprice the asset. In her management of the corporation, A will have a clear incentive to use her control to drain away corporate assets for her own personal benefit.

The structure of the corporation's control mechanisms is ill-

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[139] Martin & Partnoy, *supra* note 9, at 778 (quoting Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983)) (alteration in original).

[140] Dunlavy, *supra* note 7, at 1351-52, 1351 fig.1.

equipped to deal with this basic problem. Most corporations are arranged under a "majority rules" system in which each director is elected by a majority vote of all of the shareholders. In some states, the "straight voting" system is counterbalanced by a system of cumulative voting, in which each shareholder has a set of votes to distribute among the entire slate of directors.[141] Cumulative voting allows for minority shareholders to have representation on the board. But cumulative voting is relatively rare, especially in Delaware corporations,[142] and even under cumulative voting the majority shareholder still controls the corporation. The system of "majority control" sets up the fundamental problem of minority shareholders not having any control or even input.[143]

This structural problem has led to supplemental doctrines intended to ameliorate or eliminate the effects of majority rule. The duty of loyalty, for example, is an implied, mandatory duty for all corporate directors and officers. It requires them to act in the interests of the corporation as a whole, rather than in their own personal interests. Because the duty applies to directors, it applies by extension to majority shareholders, as their board representative will be subject to this duty. However, controlling shareholders also have a duty of loyalty to the corporation's minority shareholders.[144] The duty of loyalty has a structural element, in that conflict transactions can find a safe harbor through approval by a majority of shareholders or independent directors.[145] However, in Delaware such transactions can also survive the conflict through an after-the-fact "entire fairness" test.[146] Thus, there is some flexibility and discretion in the administration of the duty.

The duty of care is also a mechanism for constraining the majority. The duty requires directors and officers to act with the level of ordinary care expected of a reasonably prudent person.[147] This rule is designed more to counteract agency costs, but it does prevent the majority from running the company in a way that may seem irrational to others. However, the strength of the rule is severely limited by the business

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141 *See* COX & HAZEN, *supra* note 64, at 348-51.

142 *See* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994).

143 Note that this is different than the "agency costs" problem which seems to (pre)occupy most corporate law scholars.

144 *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994) ("A controlling or dominating shareholder standing on both sides of a transaction . . . bears the burden of proving its entire fairness.").

145 *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (2007).

146 *Id.* § 144(a)(3) ("The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders."). For a discussion of the entire fairness test, see Cinerama Inc. v. Technicolor Inc., 663 A.2d 1156, 1178-79 (Del. 1995).

147 MODEL BUS. CORP. ACT § 8.30 (2003).

judgment rule, which provides that directors and officers are free to use their own business judgment in making managerial decisions.[148] As a result, the duty of care has largely become simply a mechanism for requiring directors and officers to be appropriately informed about the corporation's operations and financial health.[149] In the past, the doctrine of *ultra vires* was also used to cabin the majority's discretion on business matters. The doctrine held that corporate directors and officers were not permitted to act on behalf of the corporation outside the scope of the corporation's purpose. However, given the expansive and non-specific nature of most corporations' "corporate purposes," as designated in the corporate charter, the *ultra vires* doctrine no longer has much effect.

Finally, the doctrine of minority oppression is designed as a backstop in cases involving matters in which the majority generally has discretion to operate. The doctrine is generally applied to closely-held corporations in which shareholders participate in the company as both shareholders and employees. Because there is no outside market for shares in a closely-held corporation, shareholders cannot sell their shares and exit if they disagree with the majority's direction. The difficulty of exit has led some courts to rule that shareholders in closely-held corporations must treat each other as more akin to partners and with the "utmost good faith and loyalty."[150] This duty is defined ambiguously in order to capture a range of discretionary activities that do not breach other fiduciary duties on their face.[151] They generally entail participation in the corporation that is controlled by the majority shareholder but is in some way expected to be shared by minority shareholders. As one court put it:

> A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment.[152]

In his article on the history of the shareholder primacy norm, Gordon Smith argued that in the nineteenth century the norm served as

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148 For an example of the discretion given to directors under the business judgment rule, see Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968).

149 *See, e.g.*, In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

150 Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 515 (Mass. 1975).

151 *See* Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 711-12 (1993) (noting that minority oppression has been defined as "burdensome, harsh and wrongful conduct," "a visible departure from the standards of fair dealing," and "frustration of the reasonable expectations of the shareholders").

152 *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984).

the foundation for the doctrine of minority oppression.[153] According to Smith, notions of shareholder primacy were actually generated to resolve horizontal conflicts between different groups of shareholders. As he points out, the seminal "shareholder primacy" case—*Dodge v. Ford Motor Co.*[154]—actually involved a dispute between two groups of shareholders about the direction of the company.[155] In *Dodge*, the court required Ford Motor to issue dividends to its stockholders. The court used the language of shareholder primacy to compel the controlling shareholder (Ford) to distribute profits to minority shareholders (the Dodge brothers). Refusal to issue dividends is a classic example of minority oppression. Smith pointed out that this development of the shareholder primacy doctrine has much more to do with horizontal relations between shareholders and much less to do with the vertical relations between directors, shareholders, and other corporate constituents.[156]

Thus, there are a number of "softer" doctrines designed to deal with the structural differences between the interests of majority and minority shareholders. However, as has been noted, finding a balance between these interests can be difficult to achieve, since the majority has legitimate interests in exercising its right of control.[157] These interests will conflict with those of minority shareholders, particularly over issues such as control of the corporation, employment opportunities, dividends, and other means of sharing the surplus.

B. *The Problem of Differential Voting Powers Amongst Shares*

As discussed above,[158] the efficiency of the "one share, one vote" hypothesis assumes that each share has the right to an equal share of the residual interest. Otherwise, voting shareholders will have different incentives depending on the ratio of voting power to residual interests.

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153 Smith, *supra* note 115.

154 170 N.W. 668 (Mich. 1919).

155 Smith, *supra* note 115, at 315-20.

156 *Id.* at 322-23. Smith argued that ultimately the shareholder primacy norm is largely irrelevant to corporate law and corporate business decisions. *Id.*

157 *See, e.g.*, Nixon v. Blackwell, 626 A.2d 1366, 1376, 1380-81 (Del. 1993) (noting that "well established in our jurisprudence that stockholders need not always be treated equally for all purposes" and arguing it is "inappropriate judicial legislation . . . to fashion a special judicially-created rule for minority investors"); Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976) (noting that the minority oppression doctrine should not "unduly hamper [the majority's] effectiveness in managing the corporation in the best interests of all concerned."); Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1688 (1990) ("The application of strict fiduciary standards to close corporations deprives controlling shareholders of the ability to manage the corporation—to use their own property—as they see fit.").

158 *See supra* Part II.A.

A shareholder with strong voting power but little interest in the residual will have different incentives than those with less voting power and greater stake in the profits. Easterbrook and Fischel noted that the "most basic statutory rule" of shareholder voting was the default rule of one share, one vote, and that this was "the same in every state."[159] They also claimed that agreements to alter this default rule were rare.[160] However, there is evidence that they may have been writing at the high water mark of such a norm, and that differential voting powers amongst shares may be more common than in the past.[161]

Easterbrook and Fischel were writing in the wake of the Security and Exchange Commission's adoption of Rule 19c-4.[162] The rule required that self-regulatory organizations, such as the New York Stock Exchange or NASDAQ, prohibit listed companies from issuing securities that reduced the rights of existing shareholders. The purpose of the rule was to reinforce the "one share, one vote" standard by prohibiting the issuance of shares with disproportionate voting rights.[163] However, the rule was struck down by the D.C. Circuit and was never revived.[164] Currently, the exchanges allow companies with multiple-class shares to be listed; however, certain safeguards are required for companies with these shares.[165]

Although scholars still call for the abolition of dual class voting structures,[166] they appear to be here to stay. Several recent shareholder controversies have involved corporations with dual class shares. Both the New York Times and the Wall Street Journal are controlled by families with shares that have voting power disproportionate to their economic stake.[167] Critics have claimed that the controlling families do not have the proper incentives because they do not have the same

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159 EASTERBROOK & FISCHEL, *supra* note 5, at 72.

160 *Id.*

161 Martin & Partnoy, *supra* note 9, at 784-85 (noting that Easterbrook and Fischel derived this conclusion from a "relatively stable period" in which the New York Stock Exchange refused to list companies with nonvoting shares).

162 17 C.F.R. § 240.19c-4 (1988), *invalidated by* Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

163 At the time, some companies had issued a new class of stock, as a dividend to current shareholders, that provided an abnormally large number of votes per share. However, these new shares were not transferable, and could only be sold if they were converted to regular one-vote shares of common stock. The effect of such an issuance was to provide "lock in" power for long-term shareholders and/or managers. *See* Bainbridge, *Rule 19c-4*, *supra* note 107, at 566.

164 *See Roundtable*, 905 F.2d 406.

165 *See, e.g.*, NYSE, Inc., Listed Company Manual § 313(B) (2005).

166 *See, e.g.*, Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1153 (2004) (arguing that dual class voting structures could be prohibited as a way of protecting minority shareholder interests).

167 The Bancroft family is in the midst of selling the Dow Jones Company, the parent company to the Journal. Frank Ahrens, *Murdoch Seizes Wall St. Journal in $5 Billion Coup*, WASH. POST, Aug. 1, 2007, at A1.

economic risk as the other shareholders.[168] However, such criticisms are subject to the rebuttal that shareholders knew what they were getting when they purchased the stock. Indeed, that is the general justification for multiple-vote or no-vote shares: corporate law should facilitate private ordering, which includes the possibility that certain shareholders will accept less control as part of the bargain. Less control probably means a cheaper price, and shareholders should be permitted to make this bargain if they wish to do so. However, from the perspective of shareholder wealth maximization, shareholders with more control and less risk will have skewed incentives in maximizing shareholder wealth.

In addition to dual class shareholders, there are certain groups of shareholders—primarily holders of preferred shares—who have voting rights that change based on the circumstances. The primary purpose of a preferred share is to give the holder the right to a regular dividend of a specific amount. Holders of preferred shares do not generally have straightforward voting rights within the corporation on matters such as the election of directors. However, many preferred shares have clauses that give each preferred share the right to vote under certain circumstances, such as the failure to pay the regular dividend. Often, preferred shares are given some multiple of common share votes for each share—for example, ten votes in the election for each share of preferred stock. Thus, once certain circumstances trigger these rights, preferred shareholders go from non-voters to super-voters. Bondholders may also have similar clauses of protection when, for example, the corporation misses a payment.

Thus, the notion of a uniform shareholder polity is often factually incorrect. Dual class shares, as well as convertible shares, provide control rights to groups that are not aligned with those groups' interests in the residual. In fact, preferred shares often give voting rights in order to give the holders of such shares in certain circumstances the right to trump the concerns of the common shareholders.

C. *The Problem of Shareholder Vote Buying and Voting Trusts*

Corporate law generally prohibits shareholders from selling their right to vote without simultaneous transfer of the underlying interest in the residual.[169] The converse is also true, although courts have allowed for the theoretical possibility that the seller of stock could retain the

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[168] *See, e.g.*, Rob Kellogg, *Dual-Class Equity Structures*, RISK & GOVERNANCE BLOG, Apr. 20, 2006, http://blog.riskmetrics.com/2006/04/dualclass_equity_structuressub.html; Bill Mann, *Dual-Class Shares, Second Class Investors*, MOTLEY FOOL, Apr. 14, 2004, http://www.fool.com/investing/general/2004/04/14/dualclass-shares-secondclass-investors.aspx.

[169] Hall v. Isaacs, 146 A.2d 602 (Del. Ch. 1958).

vote in order to protect a legal interest.[170] However, there has been a shift in the law with regard to bribery—paying a shareholder to vote a particular way. In the past, vote bribery was not permitted—it was seen as a violation of a shareholder's duty to other shareholders.[171] Over time, however, the rule has shifted to a more permissive stance.

In *Schreiber v. Carney*,[172] the company was seeking shareholder approval of a corporate restructuring in the wake of a merger. The company, Texas International Airlines, needed shareholder approval, and it needed majority approval from each class of stock, which included not only common stock but also three series of convertible preferred stock. Jet Capital held a majority of shares in one of the preferred stock series as well as warrants for a large number of common shares. Jet determined that if the restructuring went through, it would incur a large tax liability unless it had already exercised the warrants. However, it did not have enough cash on hand to exercise the warrants. Thus, it decided that it would have to vote against the merger. In order to resolve this difficulty, Texas International decided to lend money to Jet so that it could exercise the warrants.

The Delaware Chancery Court upheld the loan against a challenge of vote buying. The court recognized two principles behind the general prohibition against vote buying: (1) protecting shareholders against fraud and deceit, and (2) requiring shareholders to exercise their own independent judgment.[173] The court found no hint of fraud or deceit in the instant case, as it was in other shareholders' interests to bribe Jet into voting for the restructuring. In fact, Texas International had secured approval for the loan from other shareholders.[174] The court recognized that shareholders had different interests and that it may be in the interests of certain shareholders to work with other shareholders in developing a negotiated solution. As for the independent judgment principle, its traditional justification was that "by requiring each stockholder to exercise his individual judgment as to all matters presented, [t]he security of the small stockholders is found in the natural disposition of each stockholder to promote the best interests of all, in

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170 *See, e.g.*, Commonwealth Assocs. v. Providence Health Care, 641 A.2d 155, 158 (Del. Ch. 1993) (expressing "doubt whether, in a post record-date sale of corporate stock, a negotiated provision in which a beneficial owner/seller specifically retained the 'dangling' right to vote as of the record date, would be a legal, valid and enforceable provision, unless the seller maintained an interest sufficient to support the granting of an irrevocable proxy with respect to the shares").

171 *See, e.g.*, Cone's Ex'rs v. Russell, 21 A. 847, 849 (N.J. Ch. 1891).

172 447 A.2d 17 (Del. Ch. 1982).

173 *Id.* at 24. The court cited to *Cone's* for the proposition that "[t]he security of the small stockholders is found in the natural disposition of each stockholder to promote the best interests of all, in order to promote his individual interests." *Cone's Ex'rs*, 21 A. at 849.

174 *Schreiber*, 447 A.2d at 20 (noting that the other shareholders "voted overwhelmingly in favor of the proposal.").

order to promote his individual interests."[175] However, the court found that this rationale was "obsolete because it is both impracticable and impossible of application to modern corporations with many widely scattered stockholders."[176] Instead, the court held the loan transaction to a standard of entire fairness.[177]

Voting trusts are somewhat analogous to vote buying in that two voters agree to bind their votes to each other, rather than to their independent self-interest. The Delaware corporation statute, for example, allows parties to contract with each other to vote the same way.[178] The statute allows for a great deal of flexibility—one party may agree to vote as directed by another party in exchange for consideration. In addition, parties may put their shares into a voting trust that is subsequently voted by a trustee.[179] What these arrangements demonstrate is that corporations are not simply a mass of like-minded individuals who are all voting based upon the same self-interest. Instead, conflicts between shareholders may arise, and corporate law allows for mechanisms to resolve them contractually. Given the emphasis on private ordering in corporation law generally, it would make sense to allow for these private arrangements. However, these arrangements contradict the notion of shareholders as a mass of undifferentiated seekers with a singular goal.

D. *The Problem of Hedging the Residual Interest*

As discussed above, selling the vote separately from the stock is generally prohibited, and vote "bribes" are subject to the fairly rigorous "entire fairness" scrutiny. However, new financial derivative products are making it easier to vote in shareholder elections while at the same time having interests divergent from traditional shareholder interests. In effect, shareholders are able to engage in "empty voting," in which they vote their shares without having the same financial stake in the game that other shareholders have.

How does this work? The simplest way is to purchase shares in the company while simultaneously "shorting" the stock. The stock can be shorted through equity derivatives that increase in value as the share

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175 *Id.* at 24.

176 *Id.* at 25 (quoting 5 FLETCHER CYCLOPEDIA CORPORATIONS § 2066 (perm. ed.)); *see also id.* ("[A] shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow stockholders.").

177 *Id.*

178 DEL. CODE ANN. tit. 8, § 218(c) (2007).

179 *Id.* at tit. 8, § 218(a).

price falls.[180] Thus, a party will have countervailing interests—the stock will still have its residual attached, but the "short" position will reward a drop in price for the stock. If the short position is strong enough, the shareholder will actually be encouraged to act against the interests of the corporation in order to trigger a decrease in the share price. There are also less extreme possibilities that would nevertheless allow shareholders to vote despite a complex set of interests that do not overlap with other shareholders. For example, in 2004, Perry Corporation bought 9.9% of the shares in Mylan Labs and voted in favor of a merger between Mylan and King Pharmaceuticals.[181] Perry acquired the stake because it owned King, and it wanted Mylan to agree to the merger. However, Perry also hedged its voting stake in Mylan through a series of equity swaps and other undisclosed transactions. Thus, Perry acquired voting power in Mylan while simultaneously hedging the residual interest in Mylan. Perry was sued by another Mylan shareholder for voting without true economic ownership; however, the case was rendered moot when Mylan called off the merger with King.

Another potential for vote buying is through the borrowing of shares specifically around the record date—the date on which shareholders are locked in as the voting polity for purposes of the election at hand.[182] The purpose of this transaction is to borrow the share specifically for the vote, and then return it to the original owner after the vote. Lending shares for a short period of time is a fairly common practice; it is designed to facilitate short-selling by making the shares available for sale when the short comes due. But if the borrowing is done not to facilitate a short sale, but rather to allow a borrower to vote without economic risk, the practice looks fairly close to vote selling.

Why would shareholders lend their votes to someone else—someone whose interests might be counter to theirs? The main reason is money coupled with ignorance. Financial institutions can lend out the shares for a fee and make money while at the same time keeping the share and the residual. Given the lack of importance or drama in most shareholder votes, these institutions have not really focused on the possibility that borrowers could be targeting shares not to facilitate a short, but rather for the vote. In fact, fund managers have been caught unawares by borrowers who use the vote contrary to the managers' interests.[183] As the practice becomes more widespread, shareholders

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180 Martin & Partnoy, *supra* note 9, at 778, n.14.

181 Hu & Black, *supra* note 13, at 828.

182 *Id.* at 832.

183 *Id.* at 834 (discussing share borrowing in the case of British Land, including the role of one fund manager who unknowingly lent stock to an opponent in the contest).

will likely take more steps to prevent "vote borrowing." But the complexity of many of these transactions may make such monitoring more and more difficult.

E. *The Problem of Management, Employee, and Pension Fund Shareholders*

When considering the kaleidoscope of potential financial interests amongst shareholders, there is one financial interest that perhaps is more important than all of the others—employment. For most, the job is the single most important financial interest that they have. In a diversified portfolio, shares in one particular company are close to irrelevant—it is the overall health of the portfolio that matters. However, one cannot diversify one's employment portfolio to any significant degree. Thus, if one holds a job and shares at a particular company, the effect of the vote on one's employment is likely to determine how one would choose to vote the shares.

Certainly, there are similarities between the interests of a shareholder and the interests of an employee. Both wish the company to perform well. But within the organization, shareholders and employees have different interests when it comes to issues like the level of risk the company should bear, how employees are to be compensated, and how the surplus is to be split. Particularly when it comes to mergers and acquisitions, employees might have very different interests from shareholders if the transaction will bring downsizing or worker replacement.[184] Conversely, employees with shares as well as stock options might choose to vote their shares so as to increase the potential for upside risk.[185] Stock options may have led employees to favor a strategy of short-term stock appreciation without due regard for the potential for down-side risk.[186] In the late 1990s, employees may have been more concerned about their stock and stock option holdings than their job; but as shareholders, they had different interests than those shareholders who did not also hold options.[187]

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184 *See* Matthew T. Bodie, *Workers, Information, and Corporate Combinations: The Case for Nonbinding Employee Referenda in Transformative Transactions*, 85 WASH. U. L. REV. 871 (2008) (discussing employee interests in merger and acquisition decisions).

185 Martin & Partnoy, *supra* note 9, at 792.

186 Since stock options offer the chance for the holder to buy the stock at a certain strike price, the options are worth the same (nothing) whether the stock drops to $1 below the strike price or $100 below the strike price. This incentive scheme may have led to management and employees undervaluing excessive downside risk, including the risk that financial misreporting would come to light. *See* Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. CORP. L. 975, 995-97 (2006) [hereinafter Bodie, *AOL Time Warner*].

187 Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539, 546-50 (2003).

Pension fund shareholders have received significant attention lately for their increasingly visible activities in the realm of corporate governance. Teaming with other institutional investors, pension funds have taken the lead in promoting greater shareholder involvement in corporate issues such as shareholder nominations for directors and approval of executive compensation. For example, AFSCME was the lead plaintiff in a recent Second Circuit decision permitting shareholders to propose easier shareholder access for board nominations.[188] Some commentators who are otherwise committed to shareholder primacy draw a distinction between these activist pension fund shareholders and other shareholders.[189] Since pension funds are often run by unions, commentators accuse pension fund leaders of pursuing their own pro-worker agenda when it comes to shareholder proposals, director votes, and other shareholder matters.[190] Manager discretion is limited, as ERISA requires pension fund managers to run the fund in the interests of the fund participants. But there is room within this discretion to pursue various agendas that have ramifications beyond corporate governance and share price.

Specifically singled out are pension funds for government employees. For years the biggest player in the corporate governance arena was CalPERS, the pension fund for approximately 1.5 million California state and local employees. The CalPERS Board is made up of directors elected by the fund participants, directors appointed by the governor along with other state officials, and ex officio directors who are state officials or agency appointees.[191] CalPERS has long been active in corporate governance and has its own "Focus List" of companies that had questionable corporate governance practices.[192] However, CalPERS has been criticized for pursuing its governance agendas overzealously and for caring more about workers' rights than profits. For example, the CalPERS corporate governance campaign against Safeway was characterized as a "jihad"; critics maintained it was a response to Safeway's harsh stance in labor negotiations, rather

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188 Am. Fed'n of State, County & Mun. Employees v. Am. Intern. Group, Inc. 462 F.3d 121, 129-30 (2d Cir. 2006).

189 *See* Ideoblog, http://busmovie.typepad.com/ideoblog/2006/10/the_shareholder.html (Oct. 27, 2006, 07:35) ("It should be obvious to anybody who cares to look past the rhetoric that the unions are seeking bargaining leverage on behalf of their members, and to ensure their own survival. They are *not* seeking to represent the interests of investors generally.") (emphasis in original).

190 Editorial, *Conflicted in California*, WALL ST. J., May 11, 2004, at A18 (complaining about labor's efforts to "hijack" corporate governance for their own ends).

191 *See* CalPERS, Structure and Responsibilities, http://www.calpers.ca.gov/index.jsp?bc=/about/organization/board/structure-responsibilities.xml (last visited Oct. 21, 2008).

192 CalPERS, Reform Focus List Companies, http://www.calpers-governance.org/alert/focus/ (last visited Oct. 21, 2008).

than to real concerns about underperformance.[193] In addition, some critics have accused CalPERS of using its power to advance the political interests of those who serve on its board.[194]

Despite the potential conflicts between employee-affiliated shareholders and the other shareholders, commentators have not called for such shareholders to be deprived of the franchise. And for the most part, the law has encouraged management and employee ownership of equity interests in their corporation. In fact, the notion of "pay for performance" led to the exponential growth of stock options as a compensation device throughout the 1990s.[195] Agency costs would be reduced and investors would feel more secure, it was argued, if investors knew that the managers also had their income riding on the success of the stock. But such shareholders clearly have different interests than their non-employee counterparts.

F. *The Problem of Sovereign Wealth Funds*

Yet another category of shareholder is causing consternation amongst corporate law theorists. Instead of individuals, companies, or private funds, these shareholders are in effect countries—political states. These governmental financial entities, known as sovereign wealth funds, have recently attracted a fair amount of attention from the media and from scholars. And there is no real consensus on how they should be handled.

Sovereign wealth funds (SWFs) are not a new phenomenon. The oldest such funds have been around for more than fifty years and have operated with little attention.[196] Essentially, a sovereign wealth fund is a fund owned and operated by a country. Unlike state-owned banks or

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193 *Conflicted in California*, *supra* note 190 ("Ostensibly Calpers is upset about underperformance, but the real problem seems to be the tough stance the grocery chain took against labor during a recent strike.").

194 Aaron Lucchetti & Joann S. Lublin, *Corporate Governance: CalPERS Targets Directors Who Neglect Holders*, WALL ST. J., Apr. 16, 2004, at C1 ("The campaign is being fueled partly by the political ambitions of Phil Angelides, California's state treasurer and a Calpers board member, who is considering running for governor of California in 2006."); *see also* Sundeep Tucker, *'Ideological Puritan' who Alienated by Belligerence: Few People Are Likely to Mourn Departure of Sean Harrigan, writes Sundeep Tucker*, FIN. TIMES (London), Dec. 2, 2004, at 27 (discussing the firing of former CalPERS president Sean Harrigan for, in part, "going off on political tangents.").

195 Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138.

196 Robert M. Kimmitt, *Public Footprints in Private Markets; Sovereign Wealth Funds and the World Economy*, FOREIGN AFFAIRS, Jan.-Feb. 2008, at 119, *available at* http://www.foreignaffairs.org/20080101faessay87109/robert-m-kimmitt/public-footprints-in-private-markets.html (discussing Kuwait's creation of the Kuwait Investment Board to invest its surplus oil revenue in 1953).

enterprises, however, SWFs are investment funds that have national funding and pay their dividends to a state government. Pension funds can be characterized as SWFs, but they are generally not included unless they are financed through state commodity exports.[197] The recent oil boom has given new financial heft to many of these funds, as has the foreign exchange imbalances caused by the plunging dollar. Oil has fueled funds in Norway and the Middle East, while currency reserves have provided much of the funding for China's SWF.[198] These funds also vary in their investment strategies. Some invest primarily in government bonds (such as U.S. T-bills), while others have begun to invest more aggressively in private companies. A few funds have actually sought to take significant stakes in corporations, while many others have pursued a quieter strategy of private investment.[199] Estimates place the collective wealth of SWFs at around $2.2 trillion–roughly the same as those in hedge funds and private equity funds combined.[200]

The notion of foreign countries investing in private corporations is troubling to many. The most obvious concern would be a foreign government taking over a private corporation, particularly one with links to national security. The United States has erected a system of oversight for all foreign acquisitions of U.S. companies; such transactions are reviewed by the Committee on Foreign Investment in the United States (CFIUS).[201] There is an automatic forty-five day review process whenever a foreign government seeks controlling interest in a U.S. corporation.[202] It was the potential for such a review that ultimately led China's state oil company to withdraw its bid for Unocal.[203]

Control of private corporations by foreign powers, however, is not the only worry surrounding SWF share ownership. Since SWFs are controlled by foreign governments, they may have interests other than those of the traditional private shareholder. In fact, many see a sinister

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197 Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism* 13 (Stanford Univ. Law & Econ. Olin Working Paper No. 355, 2008), *available at* http://ssrn.com/abstract=1095023. Thus, the Norway Government Pension Fund is characterized as a SWF because it is financed through the sale of oil, while CalPERS is not, since it is financed by employee and state contributions.

198 *Id.*

199 *Id.* at 14.

200 Press Release, Standard Chartered, Standard Chartered—The Increasing Influence of Sovereign Wealth Funds on Global Financial Markets (Oct. 17, 2007), http://www.standardchartered.co.th/news/2007/news_20071017_p1.html (last visited Oct. 21, 2008).

201 50 U.S.C. App. § 2170 (2007); Memorandum of the President of the United States, Oct. 26, 1988, 53 Fed. Reg. 43999.

202 50 U.S.C. App. § 2170 (2007).

203 Gilson & Milhaupt, *supra* note 197, at 6 n.24 (citing Edmund L. Andrews, *China's Oil Setback: The Politics; Shouted Down*, N.Y. TIMES, Aug. 3, 2005, at C1).

side to the investments from countries such as Abu Dhabi, Russia, and China. These countries' funds have recently taken significant stakes in Citibank,[204] the Blackstone Group,[205] and Advanced Micro Devices, a chipmaker with Department of Defense contracts.[206] These holdings trigger concerns about security issues, financial issues, and internal governance issues.[207]

There is some discussion of SWF holdings as potential security risks. But it is hard to see why a SWF acting as a public shareholder would have any more access to sensitive documents or information than other shareholders. Instead, the concern is that SWFs will use their voting power as shareholders to effectuate their governmental agenda, rather than the agenda of shareholder wealth maximization.[208] As one set of commentators puts it, the threat is that the SWFs will engage in "strategic behavior—behavior that benefits the SWF or its sovereign owner in ways that do not proportionately benefit other shareholders."[209] To combat this threat, some have suggested that SWFs either voluntarily agree not to vote their shares or to disclose how they voted.[210] Others have suggested that the voting power of a SWF's shares be suspended for as long as the SWF holds the stock.[211]

SWFs are yet another example of shareholders who may have interests that are deviant from the traditional maximization norm. It is hard to see, however, why these potentially ulterior motives should disqualify them from voting. The most distressing potential example is one in which the SWF uses its voting power to secure favor for its own domestic industries or companies.[212] However, without a controlling interest, it seems unlikely that the SWF would succeed in effectuating its policy, especially if it was a blatant rent-seeking endeavor.

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204 Stanley Reed, *Abu Dhabi's Citigroup Bargain*, BUS. WK. ONLINE, Nov. 27, 2007, http://www.businessweek.com/globalbiz/content/nov2007/gb20071127_878991.htm.

205 Keith Bradsher & Joseph Kahn, *In China, a Stake in Blackstone Stirs Uncertainty*, N.Y. TIMES, May 29, 2007, at C2.

206 Laurie J. Flynn, *Abu Dhabi Takes 8% Stake in Advanced Micro*, N.Y. TIMES, Nov. 17, 2007, at C4.

207 As Ronald Gilson and Curtis Milhaupt have put it, "national security concerns anchor one end of a continuum of issues concerning when the interests of a foreign government may differ from those of an ordinary shareholder." Gilson & Milhaupt, *supra* note 197, at 9.

208 Kimmitt, *supra* note 196 ("SWFs are public-sector entities managing public funds, and profit maximization may not be considered the primary objective.").

209 Gilson & Milhaupt, *supra* note 197, at 23.

210 Bob Davis, *U.S. Pushes Sovereign Funds to Open to Outside Scrutiny*, WALL ST. J., Feb. 26, 2008, at A1 (discussing U.S. Treasury Assistant Secretary Clay Lowery's suggestion that "sovereign-wealth funds that choose to vote their shares when they take noncontrolling stakes in U.S. companies should disclose how they voted.").

211 Gilson & Milhaupt, *supra* note 197, at 23-24.

212 *See id.* at 23 (using the theoretical example of an SWF trying to get the company to authorize favorable technology transfers to companies in the SWF's jurisdiction). However, as Gilson and Milhaupt concede, "[t]o be sure, no one can point to a reported incidence of such behavior." *Id.* at 21.

Assuming the SWF has a significant but far from controlling stake, the SWF would need to rally the support of a majority of shareholders in order to effectuate its scheme. The tension would thus resolve itself—either a majority would fail to sign on, rendering the strategic behavior moot, or a majority would agree with the SWF that the plan was in their best interests. Neither event seems to warrant taking away the SWF's ability to vote. A more realistic concern, perhaps, is that SWFs would join with other "nontraditional" shareholders (such as union pension funds and socially responsible investment vehicles) to promote policies based on political concerns, rather than wealth maximization.[213] In the alternative, SWFs may potentially be more acquiescent to management in an effort to appear as "passive investors." In such cases, SWFs may stifle the efforts of more active shareholders to hold management accountable.[214] Ultimately, however, the power of the vote will determine the appropriate course to take. If a majority of shareholders willingly chooses a certain result, democratic principles would seemingly require the effectuation of that choice.[215]

Sovereign wealth funds are yet another example of a shareholder with potential "ulterior" motives.[216] For some, these potential motives are so threatening that they counsel for the suspension of SWF voting rights in the corporation. National security and welfare concerns may justify restrictions on SWF takeovers and tender offers. Further restrictions on the franchise, however, seem based less on actual security concerns and more on the notion of what a true shareholder should believe. The limitation of SWF voting rights would be yet another deviation from the standard of "one share, one vote" that is deigned necessary to protect the underlying principle.[217]

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213 Gilson and Milhaupt acknowledge that, if their plan were put into place, other countries would likely take steps to limit the rights of U.S. government funds, including state pension funds. These restrictions would limit "the positive impact that shareholder activism by [] state pension funds, most vocally by CalPERS, has had on corporate governance standards in other countries." *Id.* at 30.

214 *Id.* at 9 (noting that SWF investments may have been attractive to investment banks because the SWFs "could act quickly and were thought unlikely either to agitate for change or to seek control.").

215 There is, of course, the same limitation on interested transactions that applies to controlling shareholders.

216 *See* Richard A. Epstein & Amanda M. Rose, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, U. CHI. L. REV. (forthcoming) (manuscript at 16, on file with authors) (noting that "SWFs are not the only investors who may invest 'strategically'. . . ").

217 As this article was in the editing process, the United States government was making massive investments in American Insurance Group (AIG) as well as national banks. *See* Mark Landler & Eric Dash, *Drama Behind a Banking Deal*, N.Y. TIMES, Oct. 14, 2008, at A1; Edmund L. Andrews et al., *Fed in an $85 Billion Rescue of an Insurer Near Failure*, N.Y. TIMES, Sept. 16, 2008, at A1, *available at* http://www.nytimes.com/2008/09/17/business/17insure.html?_r=1&partner=rssnyt&oref=slogin. The role that the United States' "emergency SWF" will play in corporate affairs has yet to be

G. *The Problem of Defining "Wealth Maximization"*

The assumption behind the "one share, one vote" norm is that shareholders have a uniform interest in wealth maximization. Since all shareholders are entitled to part of the residual, they all have an interest in maximizing the size of that residual. The notion that shareholder wealth maximization is not only a goal for the corporation, but in fact the only legitimate goal, has become the dominant normative theory of the corporation. Indeed, Hansmann and Kraakman have proclaimed the primacy of this view: "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value."[218]

As shown above, this assumption is not empirically correct. However, even assuming a mass of shareholders with no other complications or interests, there are still difficulties in implementing the notion of shareholder wealth maximization. The main problem is: when? What is the time horizon for wealth maximization? Hansmann and Kraakman specify "long-term shareholder value" but do not define it. And in fact, shareholders have radically different time horizons for the "maximization" of their shareholder wealth.[219] There may be some shareholders who buy the stock at the IPO and hold it until it passes to their heirs and assignees. But there are other shareholders who hold the stock for a day, a week, a month. There are some shareholders who also have options—they want to max out on the stock at the option exercise date.[220] There are some shareholders who must sell the share once it drops out of a particular index.[221] There are some shareholders who have yearly or quarterly profit margins to meet, and they need the stock to rise to meet those horizons. There are some shareholders who buy

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determined. But these investments raise some of the same concerns that apply to SWF investments.

218 Hansmann & Kraakman, *supra* note 66, at 439.

219 *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579-83 (2006) (discussing the different financial interests of short-term and long-term shareholders).

220 And they want to get the option at the stock's lowest point. Many companies have been accused of gaming the system by backdating the option's strike date to a day with a lower price. For a discussion of the backdating scandal, see David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561 (2007).

221 Index funds track a particular index; they must manage the fund to mirror the composition of the index. *See* Shimon B. Edelstein, Note, *Indexing Capital Gains for Inflation: The Impacts of Recent Inflation Trends, Mutual Fund Financial Intermediation, and Information Technology*, 65 BROOK. L. REV. 783, 811-12 (1999) (discussing index funds); Peter N. Hall, Note, *Bucking the Trend: The Unsupportability of Index Providers' Imposition of Licensing Fees for Unlisted Trading of Exchange Traded Funds*, 57 VAND. L. REV. 1125, 1126 (2004) (describing the composition of exchange traded funds, which may track certain indices by having a sampling of stock from a particular index).

the stock looking to take it over, and then either buy all of the stock or walk away; other shareholders buy the stock on a bet that the takeover attempt will succeed.

Ultimately, shareholders may have very different notions of what "wealth maximization" means. Let us take, for example, a corporation whose shares have been trading at $35. A takeover firm offers shareholders $45 for the stock. The board believes that if this tender offer is fought, shareholders will eventually get $50 for their shares within two months. Or, the board believes that technology in development will eventually lead the stock to be worth $100 two years from now, if the current management remains in place. However, if the technology fails, the shares will be worth only $20. What is the best path towards wealth maximization? Believers in a strong efficient capital markets hypothesis will argue that the $45 is the best choice, as will short-term shareholders. But shareholders with a medium-term horizon may want the board to resist and shoot for $50 per share. Those with even longer term horizons may hope the board fights off the offer entirely and remains in place, shooting for the $100 share price down the road.

Because uncertainties multiply as the time horizon lengthens, shareholder primacy becomes more and more meaningless as it stretches from short to long. Paying high wages to employees or corporate management can be justified based on retention of key talent or reduction in turnover. Customer goodwill justifies slashed prices or expensive research and development. As one commentator has argued, "the mantra of [shareholder wealth] maximization has no distinctive meaning and policy implications if it is not interpreted to mean maximization of short-term value."[222] However, maximization of short-term shareholder value leads to short-time horizons that can cripple business planning and stability. Moreover, a short-term focus encourages corporate fraud and misreporting designed to bolster the stock price now (with the possibly bad consequences to come later).[223]

In addition, shareholders with a diversified portfolio have different interests than shareholders with most of their wealth tied up in one company.[224] Fully diversified shareholders, who have been referred to as "universal owners,"[225] have a stake in corporate success as a whole. Their notion of wealth maximization will be quite different from a shareholder who has invested entirely in a particular company. Scholars

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222 Margaret M. Blair, *Directors' Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885, 890 (2003).

223 Bodie, *AOL Time Warner*, *supra* note 186, at 997-98.

224 Anabtawi, *supra* note 219, at 583-85.

225 JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM 3, 21 (2000).

have argued that portfolio shareholders prefer a policy of portfolio value maximization, rather than individual firm value maximization.[226] In contrast, undiversified shareholders have an incentive to oppose transactions that maximize wealth for all shareholders (by increasing the value of one firm by more than the decrease in value at the shareholders' firm).[227] Professors Ribstein and Kobayashi have used this argument in support of a 'hands-off' approach to vote selling and buying.[228] According to this view, vote buying may be necessary to allow diversified shareholders to pull off transactions that actually hurt shareholders at the company. The portfolio shareholders would buy the votes necessary to carry off the transaction as long as the transaction creates overall positive value for the portfolio.[229]

The notion of maximization of portfolio value strikes at the heart of the shareholder primacy norm. Under this theory, social wealth will not be maximized if each firm seeks to maximize returns for its own shareholders. Instead, social wealth depends not on the actions of individual companies, but on the actions of all companies in the economy. What this means is that in some instances, it would be more efficient (on a societal level) for a company to do something that decreased its own shareholders' wealth. Yet directors would be violating their fiduciary duties if they went forward with the transaction, since it would harm the company's shareholders. This example demonstrates yet another axis on which shareholders split into different groups based on different interests.

H. *The Problem of "Corporate Social Responsibility"*

Finally, we must consider the possibility that shareholders will, in fact, choose something other than wealth maximization as their goal for the corporation. The goal of wealth maximization is assumed, on both descriptive and normative grounds, to be the sole corporate purpose that shareholders desire. Descriptively, shareholders are assumed to be rational actors, and thus are assumed to desire the maximization of their utility. Although scholars recognize that utility can come in many forms, the role of "shareholder" is seen as easily translatable into a wealth-based utility model. In other words, since shareholders invest money in stock in order to make more money (through dividends and

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226 Robert G. Hansen & John R. Lott, Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholder/Consumers*, 31 J. FIN. & QUANTITATIVE ANALYSIS 43, 44 (1996).

227 *Id.*

228 Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 44-45 (2006).

229 *Id.* at 44 (noting that such "costly manipulation" may be useful in overcoming "interference from self-interested managers or undiversified shareholders.").

appreciation of stock price), their utility in holding the stock is derived solely from the financial appreciation of the stock. This reality is also normatively the optimal outcome, since (as economic theory provides) self-interested shareholders will push to maximize the corporation's residual profits, which in turn will maximize the social wealth generated by the corporation.

While many have questioned the normative story of shareholder wealth maximization, it has been assumed to correctly portray the reality of shareholder interests. However, there is increasing evidence that not all shareholders maximize their utility through a program of shareholder wealth maximization. Instead, some shareholders may gain utility through lower profits but higher levels of some other good. There are a few anecdotal episodes of this occurring at individual companies. For example, a number of Disney shareholders hold the stock because of their fondness for Disney animation, particularly the historical works such as Bambi and Snow White.[230] These shareholders supported the efforts of Roy Disney, the nephew of Walt Disney, to restore and maintain the company's tradition of animation and family entertainment.[231] Many of these shareholders attend annual meetings in order to celebrate their association with the company.[232] And they may have played an important role in the no confidence vote against Michael Eisner in 2004, in which 43% of shareholders voted to withhold their votes from him.[233] Eisner had angered some traditionalists by diversifying Disney's holdings and failing to continue Disney's animation successes of the 1990s.[234]

Beyond these individual instances there is a larger phenomenon under the rubric of "corporate social responsibility" (CSR). The CSR movement seeks to bring social, ideological, or political principles beyond profit maximization to bear on corporate decision-making. Proponents of the movement believe that corporations bear social responsibility for their actions beyond what the law may require. And

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230 *See, e.g.*, Frank Ahrens, *Roy Disney's Quest*, WASH. POST, Feb. 21, 2004, at A1 (noting that Disney stock "is widely held by individual shareholders"); Peter J. Howe, *Shareholders Hold Key to the Kingdom*, BOSTON GLOBE, Mar. 3, 2004, at D1 (describing "hundreds of thousands of Disney fanatics who also own stock"); Sarah McBride, *Mice That Roar: Obsessive Fans Join Disney Proxy Fight*, WALL ST. J., Mar. 2, 2004, at A1 ("[H]ardcore Disney fans own stock in the object of their devotion. Those stakes may be just a few shares apiece, but multiplied by thousands of fans across the county, they help make Disney one of the most widely held stocks on Main Street.").

231 Howe, *supra* note 230.

232 JAMES B. STEWART, DISNEY WAR 508 (2005) (discussing the thousands of shareholders who attended the 2004 shareholders meeting).

233 Kenneth N. Gilpin, *Disney Dissidents Rebuke Eisner, Denying Him 43% of Vote*, NYTIMES.COM, Mar. 3, 2004, http://www.nytimes.com/2004/03/03/business/media/03CND-DISN.html?ex=1222488000&en=493365dc8d9d34dd&ei=5070.

234 *See id.* ("During the course of his remarks, Roy Disney suggested that under Mr. Eisner's direction the Disney name and its products had lost their luster and unique character.").

they seek to influence corporate behavior so that concerns such as workers' rights, environment, poverty, and illness become factors in management's calculus.

As individuals, most shareholders do not generally have sufficient power to justify the time and energy required to vote their shares according to their overall social utility, as opposed to just their wealth. Increasingly, however, investors are putting their money into "socially responsible" funds—funds that invest in companies that meet certain social responsibilities targets or thresholds.[235] By the end of 2005, approximately $2.3 trillion was invested in funds targeted towards socially responsible companies, up from $635 billion in 1995.[236] Such funds often underperform the market as a whole.[237] However, their popularity attests to the desires of some investors to promote companies that adhere to certain principles beyond wealth maximization. As the number of socially responsible funds increases, investment houses are diversifying the types of such funds to appeal to a broader variety of investors. Along with funds favoring companies based on labor or environmental policies, there are funds that invest based on Catholic social teaching as well as funds that invest in companies based on the money that those companies give to Democratic candidates.[238]

Socially responsible investing is just a small share of the market now, and it may be that the overwhelming desire of most shareholders is simple wealth maximization. But it may also be that the new era of socially responsible consumerism and investing, when coupled with the shareholder democracy movement, will lead shareholders to support policies that do not directly correlate with wealth maximization. In the end, a system based on and legitimated by shareholder control must admit the possibility that shareholders may choose not to maximize profits.[239] If shareholders choose this route more frequently, a normative theory that justifies the shareholder vote based on the efficiency of shareholder wealth maximization may in fact find that the shareholder vote is no longer the best tool for achieving shareholder

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235 *See* Henry Blodget, *The Conscientious Investor*, ATLANTIC MONTHLY, Oct. 2007, at 78.

236 Jeff Brown, *Save the Earth Sacrifice Your Returns?*, WASH. POST, May 13, 2007, at F01. Of course, this may be so because "performance" is measured along one metric—profitability—that fails to capture additional investor or societal utility generated by investment in such funds.

237 *Id.* ("For the 12 months ended April 30, for example, such funds investing in big-company stocks returned 11.63 percent, compared with 12.28 percent for all big-stock funds. For funds investing in mid-size companies, socially minded versions returned 7.65 percent over the period, compared with 10.24 percent for all funds.").

238 *Id.*; *see also* Blodget, *supra* note 235, at 80-82 (discussing the categorization difficulties of socially responsible investing).

239 Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1433 (2006) ("Managers can promote shareholders' interests without maximizing profits to the extent the shareholders have some objective other than profit maximization.").

wealth maximization.

I. *The Problem of Market Hegemony*

The norm of shareholder wealth maximization may actually reveal a shortcoming in the application of economic theory of shareholder voting (and many other aspects of commercial behavior).[240] Most economic models, for example, treat profit maximization as the sole objective of corporations; non-market values are to be (appropriately) ignored.[241] And indeed, there is plenty of evidence that most corporations really do make decisions based on these profit-maximizing considerations.[242] Shareholders tend to vote on those considerations.[243] Consumers, too, tend to focus on bottom-line considerations when making their marketplace decisions. Factors such as price and product quality tend to dominate consumer choice; the "social values" of the corporations figures little, if it all, in those decisions.[244] Everyone, it seems, focuses on the bottom line when acting in market contexts. This is in marked contrast, by the way, to how people behave in political elections—indeed, it has been suggested that people's votes in political elections are driven by generalized "values" while their votes in the marketplace are driven by individual "tastes."[245]

Markets, then, are hegemonic: people act for personal gain, and other values are only reflected in what they do with that gain.[246] Both proponents and critics of markets agree on this point—their disagreement turns on whether this is a good or a bad thing.[247] Either way, however, economic theory should be able to account for the fact of market hegemony. The traditional explanation is that acting on non-market values (social values, prejudices) is costly, and market

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240 Much of the thinking in this subsection draws upon the thinking of Stephen Ellis, *Market Hegemony and Economic Theory*, PHIL. SOC. SCI. (forthcoming 2008).

241 *See, e.g.*, Norman P. Barry, *Do Corporations Have Any Responsibility Beyond Making a Profit?*, 3 J. MARKETS & MORALITY 100 (2000), *available at* http://www.acton.org/publications/mandm/mandm_controversy_21.php; Patrick Primeaux & John Steiber, *Profit Maximization: The Ethical Mandate of Business*, 13 J. BUS. ETHICS 287 (1994).

242 *See, e.g.*, Sandra E. Black & Elizabeth Brainerd, *Importing Inequality? The Impact of Globalization on Gender Discrimination*, 57 INDUS. & LAB. REL. REV. 540 (2004); Ann Schwartz-Miller & Wayne K. Talley, *Motor Bus Deregulation and the Gender Wage Gap: A Test of the Becker Hypothesis*, 26 E. ECON. J. 145 (2000).

243 *See* Ellis, *supra* note 240.

244 Lois A. Mohr, Deborah J. Webb & Katherine E. Harris, *Do Consumers Expect Companies to be Socially Responsible? The Impact of Corporate Social Responsibility on Buying Behavior*, 35 J. CONSUMER AFF. 45, 67 (2001).

245 *See* KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (2d ed. 1970).

246 *See* Ellis, *supra* note 240.

247 *See id.*

competition drives out high-cost competitors.[248] But this is just bad economics. Standard economic theory tells us that markets should reflect consumer values, not shape them. And those preferences, taken as given, show that people care about a large variety of things, many of which are not self-focused.[249] While economic theory does a good job explaining what happens when people act solely on bottom line considerations, this just shows that the theory presupposes market hegemony, not that it explains it.

Standard economic theory may not give a good account of market hegemony because it posits that people are consulting all of their desires and beliefs when making decisions. In other words, their utility functions are univocal and fixed (or, to the extent they change, they change slowly).[250] For that reason, economic theory lacks the resources to explain why, for example, people appear to consult their "other-regarding" values in some (non-market) situations and not in other (market) situations. The "on-again, off again" nature of people's preferences is also unlikely to be adequately captured by some of the basic extensions of economics, like the various versions of the multiple-selves model.[251] A more convincing extension of economics, however, is one that posits that people do not consult their entire set of preferences when making decisions, but instead rely on a proper subset of their interests.[252] This would account for the highly contextual nature of action generally, and further explain why people seem to be attending to only bottom-line considerations when making decisions in market contexts.

Perhaps this just confirms what was discussed above: that restricting voting rights to shareholders drives the wealth maximization norm rather than the other way around. When people are voting as shareholders, they are acting in one of those market contexts that activate all of their bottom-line desires and not their other values. Just as looking at a glass of cold water may focus one's attention on his thirst, staring at a prospectus may make one focus on a corporation's profitability. A shareholder's interaction with a corporation, in other words, is structured in such a way that naturally leads to a focus on profit maximization. It does not, however, tell us that shareholders or others do not have non-pecuniary interests in the corporation—those interests are just not being adequately reflected in the corporate voting scheme.

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248 *See* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 109-10 (2d ed. 1982).

249 *See* Ellis, *supra* note 240.

250 *See* Grant M. Hayden & Stephen E. Ellis, *Law and Economics After Behavioral Economics*, 55 U. KAN. L. REV. 629 (2007).

251 *See id.*

252 *See id.*

IV. THE CONSEQUENCES OF HETEROGENEITY

The notion of shareholder homogeneity is critical to the normative premise behind "one share, one vote." Easterbrook and Fischel emphasized that shareholders are likely to have "similar if not identical" interests because "the shareholders of a given firm at a given time are a reasonably homogenous group."[253] This homogeneity has several beneficial effects. First, it gives all shareholders an equal incentive to monitor agency costs so as to reduce such costs for all shareholders.[254] If shareholders have different interests, they will have different incentives to reduce agency costs incurred by the corporate form. Second, shareholders with the same interests will have the same objectives for the firm. This consistency of purpose will prevent the firm from becoming a war zone of competing preferences. Easterbrook and Fischel, along with others, have argued that this consistency amongst voter preferences is the key to the stability and prosperity of the corporate form.[255]

Moreover, shareholder homogeneity would solve the interpersonal utility problem discussed in Part I. In a democratic state, voting systems based on "one person, one vote" assume that each person has an equal interest and set of preferences to be expressed in the election. This assumption is almost certainly incorrect.[256] With shares, however, we can define each person's interests and preferences in a corporate election as the number of shares that they hold. Like landowners in a "one acre, one vote" water district, shareholders have an interest in the company that is clearly defined: it is the percentage of the residual they are entitled to based on the number of shares they hold. If we define a shareholder's utility as the interest in the residual, a shareholder's voting power is perfectly correlated with her interest in the residual.

We know, however, that shareholders are not, in fact, homogenous. As discussed above,[257] all of the following types of shareholders have interests beyond the residual: majority shareholders, shareholders with disproportionate voting rights, members of voting trusts, bribed

253 EASTERBROOK & FISCHEL, *supra* note 5, at 70.

254 Martin & Partnoy, *supra* note 9, at 776 (noting that the notion of "one share, one vote" is based on "agency costs considerations"); Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103, 1121 (2002) (noting that any rule other than one share, one vote "wastefully increases the agency costs associated with the corporate form.").

255 EASTERBROOK & FISCHEL, *supra* note 5, at 69-70; *see also* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 62 (1996) ("Investor-owned firms have the important advantage that their owners generally share a single well-defined objective: to maximize the net present value of the firm's earnings.").

256 Hayden, *False Promise*, *supra* note 22, at 236-47.

257 *See supra* Part III.

shareholders, hedged shareholders, sovereign wealth funds, and employee and management shareholders. In each case, the shareholder has interests that threaten to override the shareholder's individual interest in the residual.

Moreover, shareholder heterogeneity is not simply a matter of shareholders with discrete competing interests. There is also heterogeneity amongst shareholders with respect to their definition of wealth maximization. As discussed above, the definition of wealth maximization can be quite different for different shareholders. There is the time horizon issue: at what point is wealth to be maximized? A hedge fund looking for a quick return is different than an index fund looking to stay in the stock as long as it is listed. There is also the question of the diversified portfolio: to what extent is the shareholder seeking to maximize this individual stock or, instead, maximize the entire portfolio? This divide has led some commentators to suggest a normative system of portfolio wealth maximization, rather than share wealth maximization.[258] Correspondingly, shareholders have different risk preferences and may have different tastes for the corporation's approach to risk based on the ratio of their holdings in the individual firm compared to their overall holdings.[259] Shareholders might agree on the goal of wealth maximization and might also share risk and time horizon preferences, but they still might very well disagree about choices the corporation makes in these areas.[260]

Furthermore, the notion that shareholders have a shared interest in wealth maximization is a simplifying assumption. Shareholders are heterogeneous with respect to their utility preferences in that these preferences do not match up directly with wealth. Shareholders—when assessed as individual people—all have individual utility preferences

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258 Hansen & Lott, *supra* note 226; *see also* Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1056 (1996) (discussing the differences between the "corporate law" fictional shareholder and the "portfolio investor" shareholder).

259 For example, an investor who owns $50,000 in stock in company A and has $100,000 overall in his portfolio will have different risk preferences for the firm than will a shareholder who has $50,000 in stock in company A and has $10 million overall in her portfolio. The declining marginal utility of wealth also means that the performance of company A has less effect on the utility of the second shareholder utility, even though both shareholders have the same number of shares.

260 For example, Hewlett-Packard shareholders recently battled over the wisdom of the merger between Hewlett-Packard and Compaq. Michael Brick & Steve Lohr, *Fiorina Claims Victory in Hewlett-Compaq Proxy Battle*, NYTIMES.COM, Mar. 19, 2002, *available at* http://www.nytimes.com/2002/03/19/business/19CND-VOTE.html?ex=1224734400&en=dbfff985a48bb0d8&ei=5070. Hewlett-Packard director Walter Hewlett battled the rest of the company's board and management over the merger, ultimately losing in a close election. Both sides agreed that the merger should be judged on its impact of Hewlett-Packard's success, but they disagreed about whether the merger would help accomplish that goal. Hewlett and the company spent an estimated $100 million in their efforts to persuade shareholders. *Id.*

that go beyond maximization of one's wealth. In their role as shareholder, individuals may put these interests aside and focus solely on wealth maximization. But as the growth of socially responsible investing demonstrates, shareholders may find room to seek non-wealth utility in the corporate setting.

If it seems far-fetched that most shareholders have such heterogeneity, it is only because shareholders in publicly-held companies have no avenues for displaying such heterogeneity. The panoply of shareholder concerns and interests are on constant display in closely-held corporations: there are conflicts over dividend schedules, management staffing, executive salaries, corporate culture, and product development. When shareholders have real power to change corporate policy, they exercise this power in a variety of ways. However, non-controlling shareholders in public corporations cannot generally effectuate changes in corporate policy through their power to vote.[261] The miniscule voting power held by most properly diversified shareholders is only part of the problem. In board of directors elections, shareholders only have a choice if an opposition slate is running against the incumbent board. Such a campaign would require the opposition to invest in expensive proxy materials and disclosure.[262] If there is no opposition, then the shareholder's vote has no effect on the corporate leadership structure.

Thus, the notion of a monolithic shareholder primacy norm is effectuated not by shareholder democracy, but instead by shareholder apathy. Shareholders in a public company have long been divorced from real control of the firm.[263] Thus, most shareholders in public companies are rationally uninterested in exercising their voting in an informed manner. The time and costs associated with researching how best to exercise their preferences would greatly outweigh the utility they would gain from voting in a largely meaningless election. As such, most shareholders will not become properly informed and thus will not use the vote to further their disparate interests. Instead, share voters generally tend to follow the directions of the board and management, when they bother to vote at all.[264]

Shareholders' inability to exercise their control rights results in a power vacuum at the center of the firm. The incumbent board and management are well-placed to occupy that vacuum. The shareholder primacy norm acts as a counterweight on behalf of the shareholders—a

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261 Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 682-94 (2007) (describing the lack of effective shareholder voting power).

262 *Id.* at 688-91 (discussing how proxy costs may run to "hundreds of thousands of dollars.").

263 BERLE & MEANS, *supra* note 1.

264 *See, e.g.*, Listokin, *supra* note 137, at 13-14 (noting that "management sponsored proposals typically pass easily," with a mean approval rate of 85 percent).

norm that the board and management are expected to follow for the benefit of the shareholders. But it is important to remember that the norm of shareholder wealth maximization is a fictional placeholder developed to replace the actual interests of the shareholders.[265] If shareholders truly expressed their preferences through their votes, there would be no need for the norm of residual maximization. Instead, the board and management would be expected to follow the actual preferences of shareholders, rather than simply a presumed wealth maximization preference.

Thus, we see the strange cycle that Easterbrook and Fischel, among others, have used to justify shareholders as the sole franchisees. Shareholders, we are told, will single-mindedly focus on increasing the residual as their sole preference for corporate policy. Because it is in the interests of all corporate stakeholders that the residual be maximized, we should give power to those who have a single-minded focus on such an outcome.[266] However, this single-minded focus is simply an assumption. And in reality, the varying interests of shareholders do not comport with the notion of a shareholder electorate with one homogenized goal. Thus, neither the means nor the ends hold up: shareholders will not all have the same preferences, and thus they will not all seek to effectuate those standards in lock-step voting patterns.

It is for this reason that the shareholder primacy norm has been described as a tool for constraining horizontal conflict amongst shareholders, rather than a tool for maintaining shareholder power over other corporate stakeholders. As Gordon Smith has described, the shareholder primacy norm developed as a response to minority oppression.[267] The oppression doctrine prevents the controlling shareholder from pursuing her own individual interests; she instead must seek to maximize the value of the shares of the corporation as a whole. In this way, the controlling shareholder is constrained against following her own (heterogeneous) interests and must look to benefit all shareholders equally.[268] The "shareholder primacy" norm, accompanied by equitable anti-oppression doctrine, is necessary because the power of the franchise will not mitigate this problem; in fact, it is the cause of the problem. The shareholder primacy norm is, in effect, a way of forcing homogeneity onto a very diverse set of shareholder interests.

Viewed this way, the shareholder franchise is not justified on the grounds of its own preference for wealth maximization. Instead, the

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265 Greenwood, *supra* note 258, at 1052 ("For fictional shareholders, whatever else the people behind them may want, all want to maximize the value of their shares.").

266 Easterbrook & Fischel, *supra* note 5, at 403.

267 Smith, *supra* note 115.

268 *Id.*

shareholder franchise is simply one tool in the corporate law arsenal for enforcing the norm of shareholder wealth maximization.[269] Presumably, there are some issues on which most or even all shareholders would agree, and thus the vote allows shareholders to exercise collective power over the composition of the board or the completion of a certain transaction. However, the shareholder primacy norm is about more than just the vote. The norm is indifferent or even hostile to the preferences of actual shareholders. Instead, the norm assumes that shareholders all prefer wealth maximization and then requires the corporation to be run accordingly.[270]

Because shareholder preferences are irrelevant to shareholder primacy, true shareholder democracy is actually a threat to the shareholder wealth maximization norm. If let loose to express their actual preferences, shareholders might express their preferences for a variety of interests beyond shareholder wealth maximization.[271] Perhaps this explains the recent move of scholars such as Stephen Bainbridge, who supports the goal of shareholder wealth maximization but argues against greater shareholder input.[272] Bainbridge bases his argument primarily on the need for centralized and largely unreviewable discretion in order to maximize efficient business operations.[273] According to Bainbridge, shareholders should only have limited voting rights: "shareholder voting is properly understood not as a primary component of the corporate decision-making structure, but rather as an accountability device of last resort, to be used sparingly, at most."[274]

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269 Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1750 (2006) [hereinafter Bainbridge, *Director Primacy*] ("Like many intracorporate contracts, however, the shareholder wealth maximization norm does not easily lend itself to judicial enforcement except in especially provocative situations. Instead, it is enforced indirectly through a complex and varied set of extrajudicial accountability mechanisms, of which shareholder voting is one.").

270 Greenwood, *supra* note 258, at 1052 ("It follows, then, that the separation of ownership and control is not a vaguely illegitimate deprivation of the rightful prerogatives of ownership, but rather a supremely sensible application of the division of labor."); *id.* at 1053 ("We have come then to a solution to the shareholder puzzle. The fictional shareholder reduces politics to administration.").

271 *Id.* at 1052-53 ("If the corporation were run by and for real people, it would be a hotbed of political controversy. . . . If the real people disagree with the fictional representation, the real people may simply be disregarded as not real shareholders.").

272 *See, e.g.*, Bainbridge, *Director Primacy*, *supra* note 269; Stephen M. Bainbridge, *Means and Ends*, *supra* note 69.

273 Bainbridge, *Director Primacy*, *supra* note 269, at 1749 ("Active investor involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the widely held public corporation practicable: namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors. The chief economic virtue of the public corporation is . . . that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other constituencies.").

274 *Id.* at 1750. According to Bainbridge, this limited right is negotiated through contract. *Id.* ("[S]hareholders have certain contractual rights, which include the requirement that directors

Instead, the corporation requires "the centralization of essentially nonreviewable decision-making authority in the board of directors."[275] As long as the directors operate within the shareholder wealth maximization norms, their decisions in leading the company will be left alone.

Shareholders have a diverse set of competing interests. The right to vote provides a mechanism for shareholders to express those interests vis-à-vis the actual control of the company. In reality, however, only shareholders in closely-held companies have the power and incentives to vote their preferences. In the absence of actual expressions of preferences, the shareholder wealth maximization norm serves as a theoretical stand-in for shareholder preferences. But this norm is just that—a stand-in. If corporate law theory justifies the shareholder franchise based on a homogenous, uniform interest in increasing the residual, it is based on a fiction. In reality, shareholders have a heterogeneous set of interests that are muted only because of the weakness of the shareholder franchise. A stronger form of shareholder democracy would, in all likelihood, exacerbate these divisions by providing more expression for actual preferences. A true shareholder democracy, then, would not reflect the vision of a single-minded electorate pursuing the goal of residual maximization to the benefit of it. It would instead reflect what it really is: control of the corporation by one group of stakeholders.

CONCLUSION

Democracies, both political and corporate, have developed voting systems designed to translate individual preferences into institutional choices. Political democracies typically tie the right to vote to the level of a person's interest in the outcome of the election. People with any type of strong interest in a governmental institution are typically granted the right to vote so long as there is some manageable way to identify them. Corporate democracies, on the other hand, tend to define the requisite institutional interest quite narrowly, and thus restrict the right to vote to shareholders alone. This restriction has found its justification in the assumption that shareholders have a homogeneous interest in corporate wealth maximization. Such homogeneity, it is argued, maximizes efficient preference satisfaction.

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maximize shareholder wealth as their principal decisionmaking norm."). However, to the extent that corporations are creatures of state law, Bainbridge's contractual analysis fails to justify shareholders as the sole participants in the corporate franchise as set by state law.

275 Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 626 (2006).

Unfortunately, the assumption of shareholder homogeneity and many of the conclusions drawn from it are false. It is becoming increasingly clear, for example, that shareholders have many different types of interests in a corporation. In addition, stakeholders such as employees, consumers, and creditors also have interests in corporate governance that are not currently captured through existing contractual regimes. Moreover, many of the conclusions drawn from the assumption of shareholder homogeneity are either based on dated understandings of social choice theory or, in some cases, are flat out inconsistent with the standard economic theory that they purport to embody. As a result, corporate voting schemes are sterile counterparts of their more robust political counterparts.

Because of the theoretical weaknesses of the traditional justifications for "one share, one vote" and the shareholder franchise, corporate law scholars need to reconsider our foundational conceptions of the corporation. We must consider both proxy strength and manageability in determining whether the right to vote would be a proper expression of utility interests by a particular class of stakeholders. We should consider both categorical and temporal dimensions of voting rights in making our determinations.[276] To be true to social utility, we must allow for the expression of monetary and non-monetary utility in our preference aggregation. Finally, we must consider how interests and preferences can be expressed and protected through the entire corporate structure. As noted in Part I, whether one votes or not is just the initial question. The meaning of the vote is defined by what is being voted on, what percentage of votes is required to take action, and the preferences and interests of other voters in the election. Although the corporate polity is generally constructed as a majority vote of shareholders as to each position on the board, there are a number of ways in which the polity could be reconstructed to measure preferences.

These are only initial considerations, which we intend to pursue in future works. But we hope they will begin a reconsideration of the theory behind the shareholder franchise commensurate with its current rebirth in practice.

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276 In looking at various interests, there will be a temptation to consider a static model, in which various factions are constantly pitched in the midst of the same battles. However, interests change over time and depending on the situation. Different corporate factions will have different arrays of alliances. Perhaps even more importantly, the identities and preferences of the stakeholders themselves will change over time. Voting in the corporate context must be considered over time, rather than through a one-round model. *Cf.* Adam B. Cox, *The Temporal Dimension of Voting Rights*, 93 VA. L. REV. 361, 364 (2007) (rejecting the position that "a narrow temporal frame is required for evaluating voting rights claims").